

Inflation Report

August 1999

The *Inflation Report* is produced quarterly by Bank staff under the guidance of the members of the Monetary Policy Committee. It serves two purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among MPC members as an aid to our decision making. Second, its publication allows us to share our thinking and explain the reasons for our decisions to those whom they affect.

Although not every member will agree with every assumption on which our projections are based, the fan charts represent the MPC's best collective judgment about the most likely path for inflation and output, and the uncertainties surrounding those central projections.

This *Report* has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

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The Overview of this *Inflation Report* is available on the Bank's web site: www.bankofengland.co.uk/infrep.htm. The entire *Report* is available in PDF format on www.bankofengland.co.uk/ir.htm.

Overview

Growth in the UK economy has resumed in recent months, while inflation has fallen below the 2½% target. Over the past year, robust domestic demand—especially household consumption and business investment—has sustained annual GDP growth above 1%, despite the sharp deterioration in the trade position caused by the strength of sterling and global economic weakness. Those external factors have helped to subdue inflation, and domestic cost and price pressures have eased too. In particular, rising employment has been accompanied by declining nominal pay growth.

Prospects for the world economy have continued to improve since the *May Report*. Activity in the United States remains buoyant, but growth may be starting to ease and interest rates have risen. There are signs of a pick-up in the euro area, including some recovery in business confidence. In Japan, strong growth was recorded in the first quarter, but sustained recovery of private domestic demand is not yet evident. Prospects for many, but not all, emerging market economies in Asia and Latin America have also brightened. The period of falling world prices may be coming to an end as activity recovers, and the oil price has risen sharply in recent months. But risks to the global economic outlook remain. Trade imbalances have widened further, and demand might be vulnerable to a fall in asset prices.

Apart from two virtually flat quarters around the turn of the year, UK output is now estimated to have increased by 0.5% per quarter—close to the trend growth rate—from late 1997 to the second quarter of this year. Over that period manufacturing output has declined while service sector growth has been strong. In recent months, however, there are signs of some recovery in manufacturing activity.

The domestic and external components of demand remain in sharp contrast. Final domestic demand—ie excluding inventory investment—was 3.7% higher in 1999 Q1 than a year earlier. Household consumption

and business investment, both of which are now estimated to have been stronger than previously thought, grew by 3.3% and 11% respectively. Inventory investment contributed negatively to overall demand growth as stock build-ups were corrected, especially in the winter quarters of flat output. And net trade—exports less imports—made a negative contribution to growth of 2.3 percentage points.

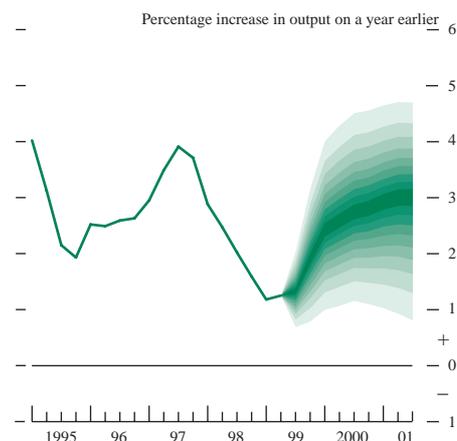
Survey indicators point to strengthening activity. Consistent with the recent profile of output growth, business expectations and consumer confidence measures, which fell steeply in the autumn, have now recovered uniformly to their levels before the international economic turbulence of last year. The Bank's regional Agents also report that sentiment is improving, though perhaps less robustly than survey measures might suggest, and with significant sectoral and regional variation.

Narrow money holdings have accelerated in recent months, but broad money growth has eased, largely on account of movements in financial company deposits. Credit growth—especially secured lending to households—has been buoyant, and the housing market has picked up, sharply in some areas. The official interest rate was reduced by 0.25% to 5% in June, but money-market interest rates over the short to medium term have risen steeply since the *May Report*.

Despite the slowdown in activity, employment has continued to rise, though modestly in recent months. The latest revisions to the National Accounts have increased measured productivity growth over the past year. However—in contrast to the United States—UK productivity growth has been below trend since the mid 1990s, but is expected to pick up. Unemployment has declined further—to 6.2% on the Labour Force Survey measure, and to 4.4% on the claimant count, the lowest level since 1980. The available evidence on vacancies, employment intentions, and skill shortages suggests that the labour market overall is tight but steady.

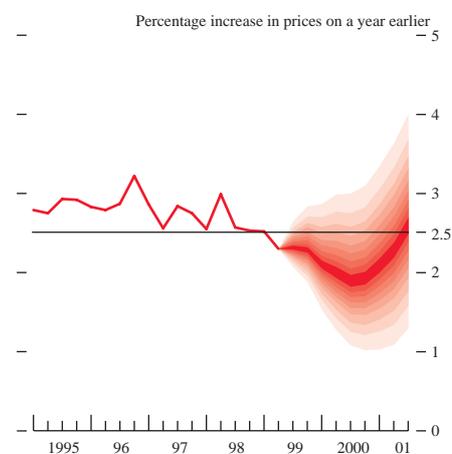
Nominal pay growth—an important indicator of domestic inflationary pressure—has eased further. The annual growth rate of earnings per worker as measured by the Average Earnings Index declined to 4.3% in the three months to May, during which time the National Minimum Wage came into effect. Public sector pay growth has risen, but private sector earnings growth has

Chart 1
Current GDP projection based on constant nominal interest rates at 5.0%



The fan chart depicting the probability distribution for output growth is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for output. 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 the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

Chart 2
Current RPIX inflation projection based on constant nominal interest rates at 5.0%



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. 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 the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

declined markedly. Overall, recent wage settlements are on average about half a percentage point lower than a year ago. Inflation expectations and average hours worked have fallen substantially over the same period, so the underlying trend in real earnings growth is less clear. Nevertheless, pay pressures have been weaker than expected in relation to employment and output.

The exchange rate is a key determinant of import price inflation. Sterling strengthened further in May. This, together with evidence of softening pay and price pressures, led the Monetary Policy Committee to reduce the official interest rate at its June meeting. Sterling eased somewhat in July, and the starting-point for the exchange rate in the MPC's current projections is slightly below the central path assumed in the *May Report*.

The MPC's current projection for the annual growth rate of GDP—based on the assumption that the official interest rate remains constant at 5%—is shown in Chart 1. The profile is stronger than the May projection. First, data revisions have increased estimated growth over the past year, so that the current growth rate is above 1% rather than below. Second, growth prospects are judged to have strengthened in view of the improved outlook for consumer expenditure, the housing market, inventory investment and the international environment. In the central projection, annual growth rises to around 3% in 2001.

The Committee's best collective judgment of the prospects for RPIX inflation is shown in Chart 2. The most likely outcome is for inflation to decline from its present level of 2.2% to below 2% over the next year or so, before rising slightly above target by the end of the two-year forecast period. The balance of risks around this central projection is slightly on the upside.

There is considerable uncertainty about the inflation outlook, and not all Committee members share the judgment about inflation prospects shown in Chart 2. In particular, some Committee members prefer to base their central projection on an assumption that the nominal exchange rate stays constant, rather than declining on account of interest rate differentials. This lowers the inflation profile—by around 0.4 percentage points at the two-year horizon—and slightly weakens the growth profile. Some of these Committee members judge, moreover, that there are further downside risks to inflation from the possibility of lower profit margins or

weaker pay pressure than in the projection in Chart 2. However, these might be offset, at least in part, by greater upside risks from oil prices.

Some other Committee members take the view that pay pressures are likely to be somewhat stronger than reflected in the projection in Chart 2. This raises the inflation profile—by about 0.2 percentage points at the two-year horizon—but has little effect on the profile for GDP growth.

Weak world prices and the strong pound have helped to subdue inflation over the past two years. Domestic inflationary pressure has eased as well, to an unexpected degree in relation to activity and employment, and inflation expectations have fallen substantially—to around the 2½% target level. The immediate outlook is for growth with low inflation. The future relationship between output growth and inflation is less clear. Given these uncertainties, the Monetary Policy Committee will pay close attention to emerging evidence on the links between activity, costs and prices, and the implications for the future path of inflation in relation to the target.

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Section 2

The international environment
Quarterly Bulletin, August 1999, pages 253–61.

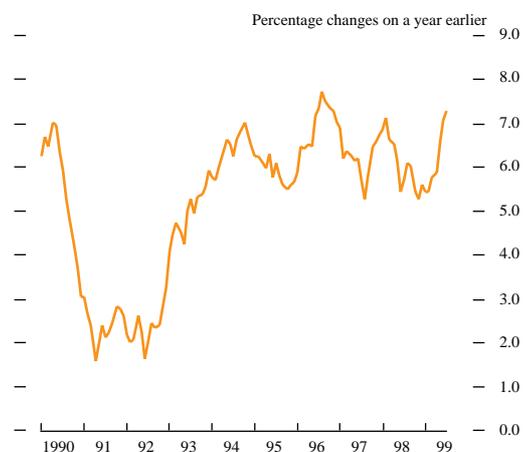
Table 1.A
Growth rates of notes and coin, M4 and M4 lending^(a)

Per cent		3 months (b)	6 months (b)	12 months
Notes and coin	May 1999	7.5	7.3	6.6
	June	7.8	6.9	7.1
	July	8.8	7.5	7.3
M4	Q3 1998	8.8	8.8	9.2
	Q4	6.2	7.5	8.1
	Q1 1999	3.7	4.9	6.9
	Q2	3.8	3.7	5.6
M4 lending	Q3 1998	9.7	8.1	8.6
	Q4	5.5	7.6	7.7
	Q1 1999	6.9	6.2	7.2
	Q2	8.2	7.6	7.6

Source: Bank of England.

(a) Seasonally adjusted.
(b) Annualised.

Chart 1.1
Growth in notes and coin



Source: Bank of England.

The MPC voted to cut the Bank's repo rate by 0.25 percentage points to 5% on 10 June. At its meetings in July and August, the MPC voted to maintain the rate at that level. On 30 June, the US Federal Open Market Committee voted to raise the federal funds target rate by 0.25 percentage points to 5%, the first increase for two years. Since the *May Report*, financial markets' short-term interest rate expectations have risen in the United Kingdom, the United States and the euro area.

The sterling exchange rate depreciated by 1.3% on a trade-weighted basis between 5 May and 4 August. Equity prices have fallen slightly in the United Kingdom, the United States and the euro area since the *May Report*, but have risen strongly in Japan. UK house price inflation has picked up, and there is some indication of higher growth in commercial property prices.

Growth in notes and coin rose strongly in the second quarter of 1999, and reached its highest annual rate in July since November 1996. Although broad money growth has continued to slow, this is primarily owing to a contraction in the deposits of non-bank financial corporations. The broad money holdings of households and non-financial corporations have been a little more robust, which seems consistent with the recent stronger evidence on domestic demand. Growth in secured lending to individuals in the second quarter was high by recent historical standards, in line with greater housing market activity.

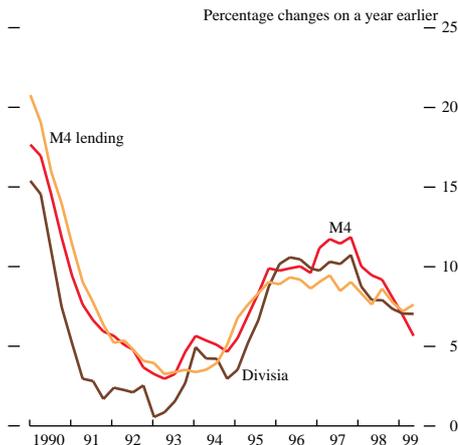
1.1 Money and credit

Narrow money

The value of notes and coin in circulation grew at an annualised rate of 8.8% in the three months to July (see Table 1.A), and the twelve-month growth rate rose to 7.3% (see Chart 1.1).⁽¹⁾ Some of this increase in growth is likely to reflect reductions in interest rates, which have lowered the opportunity cost of holding cash. But stronger growth in notes and coin is also consistent with

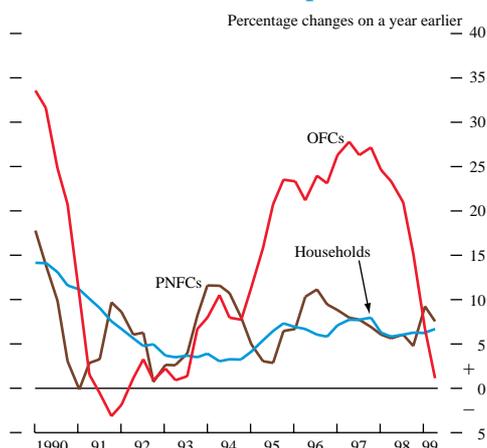
(1) After adjustment for the combined effect of the new £2 and 50 pence coins, the annual growth rate of notes and coin is estimated to have risen from 5.8% in April to 7.4% in July.

Chart 1.2
Growth in M4, M4 lending and
Divisia money



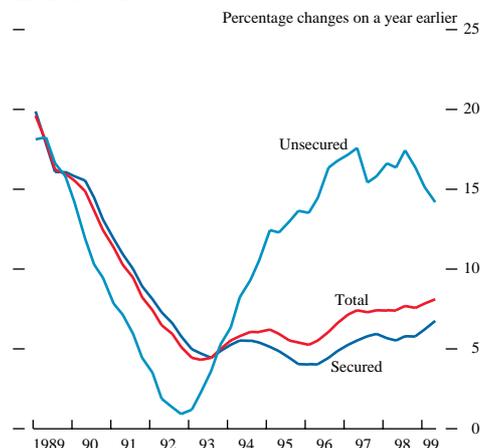
Source: Bank of England.

Chart 1.3
Growth in sectoral M4 deposits



Source: Bank of England.

Chart 1.4
Net secured and unsecured lending to
individuals



Source: Bank of England.

a pick-up in nominal spending, so narrow money growth may be accompanied by faster growth in spending in the near future.

Broad money

The annual rate of growth of M4 fell by 1.3 percentage points in the second quarter of 1999 to 5.6%, its sixth consecutive quarterly fall (see Chart 1.2). M4 lending, which measures bank and building society lending to the rest of the private sector, grew by 7.6% in the year to Q2, 0.4 percentage points higher than in the first quarter.

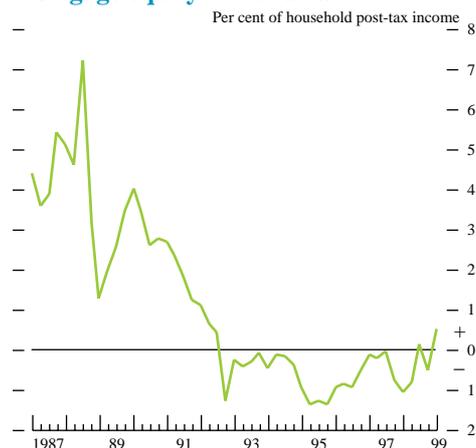
The relationship between M4 and aggregate spending is complicated by the fact that some M4 deposits are held as savings rather than for conducting transactions. An alternative indicator is broad Divisia money, which is a weighted sum of M4 components designed to reflect better the transactions motive for holding deposits. The amount of transactions services that a deposit provides is assumed to be inversely related to the associated interest rate. So the higher the deposit rate, the more illiquid that deposit is assumed to be; and the weight given to the deposit in the Divisia index is correspondingly lower. Divisia money growth was little changed in the second quarter at 7.0%, but was higher than M4 growth.

The profile of aggregate M4 since 1995 has been driven primarily by other financial corporations (OFCs) (see Chart 1.3), which are non-bank financial intermediaries such as insurance companies, pension funds, unit trusts and securities and derivatives dealers. Their money holdings are motivated more by portfolio considerations than by spending on goods and services. This makes it particularly hard to draw implications about nominal demand from aggregate broad money growth. But annual growth in households' and private non-financial corporations' (PNFCs') deposits rose in the first half of 1999, and this seems more consistent with other evidence of a pick-up in domestic spending.

Household sector

Annual growth in households' M4 deposits was 6.8% in the second quarter, 0.5 percentage points higher than in 1999 Q1. Total net lending to individuals (ie households excluding non profit making institutions and unincorporated businesses), which includes lending by institutions other than banks and building societies, grew by 8.1% in the year to 1999 Q2, its highest rate of growth since the fourth quarter of 1991 (see Chart 1.4).

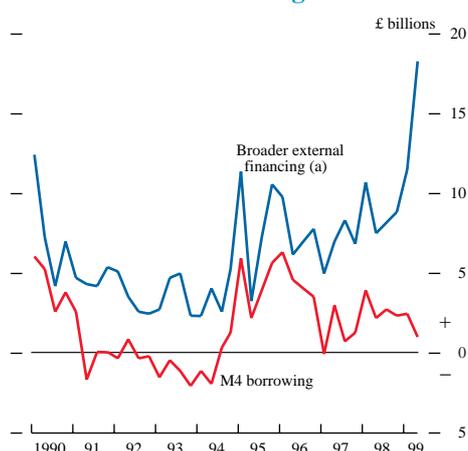
Chart 1.5
Mortgage equity withdrawal^(a)



Sources: Bank of England and ONS.

(a) The Bank estimates aggregate MEW as net lending secured on dwellings plus local authority capital grants for housing minus housing investment and council house sales.

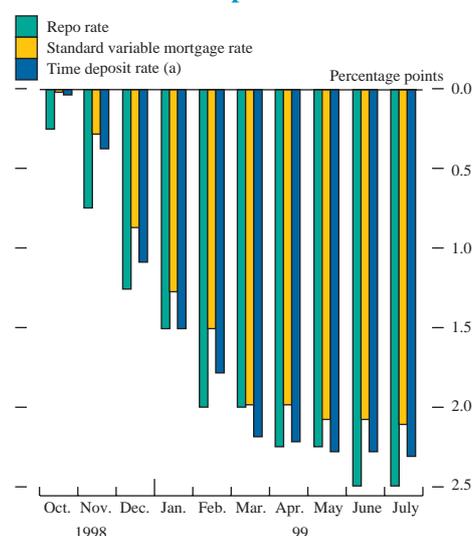
Chart 1.6
PNFCs' external financing



Source: Bank of England.

(a) M4 borrowing plus capital issues and foreign currency borrowing from banks and building societies.

Chart 1.7
Cumulative changes in repo rate and selected retail rates since September 1998



Source: Bank of England.

(a) 90-day notice period.

Lending secured on dwellings accounts for around 80% of the stock of total lending to individuals. Secured lending has picked up strongly, growing by 6.8% on a year earlier in 1999 Q2, its highest rate of growth since the second quarter of 1992. And the value of loan approvals for house purchase rose sharply in March and has remained high. To the extent that these housing transactions are completed, the outlook for future secured lending remains robust.

As well as borrowing for house purchase, secured borrowing includes mortgage equity withdrawal (MEW), eg where a household releases a portion of its housing equity by increasing its existing mortgage. Mortgage equity withdrawal may be picking up: as a proportion of households' post-tax income, the Bank's estimate of MEW in the first quarter of 1999 was positive, having been negative for most of the 1990s, although the level remains low relative to the late 1980s (see Chart 1.5). Some of the mortgage equity withdrawal in the first quarter may feed through into future consumption, and continuing strength in property values could encourage further mortgage equity withdrawal.

Growth in net unsecured lending remains strong in relation to nominal spending, but has been slowing in recent quarters (see Chart 1.4). The twelve-month growth rate of unsecured lending to individuals was 14.2% in 1999 Q2, compared with the recent peak of 17.4% in the third quarter of 1998. The fall in the growth rate may in part be the result of some households substituting unsecured borrowing with mortgage equity withdrawal.

Private non-financial corporations

PNFCs' M4 deposits grew by 0.5% during the second quarter of 1999, following a very strong one-quarter growth rate of 4.5% in 1999 Q1. So although the twelve-month growth rate fell to 7.6% in the second quarter from 9.2% in Q1, the rate is still somewhat higher than in 1998. PNFCs' M4 borrowing weakened slightly in the first half of the year. But this measure captures only sterling borrowing from UK banks and building societies. A broader measure of PNFCs' financing, which includes foreign currency borrowing from banks and building societies and sterling and foreign currency capital market issues, grew strongly in the second quarter (see Chart 1.6). Rising corporate borrowing may be related to stronger business investment, and possibly to greater merger and acquisitions activity.

Other financial corporations (OFCs)

OFCs' deposits have contracted so far in 1999, following four years of strong growth. The annual growth rate now stands at 1.1%, compared with 15.2% in the final quarter of 1998. In contrast to the weakness in deposits growth, OFCs' M4 lending picked up in the second quarter, growing by 10.3% on a year earlier, compared with 8.5% in 1999 Q1.

1.2 Interest rates and asset prices

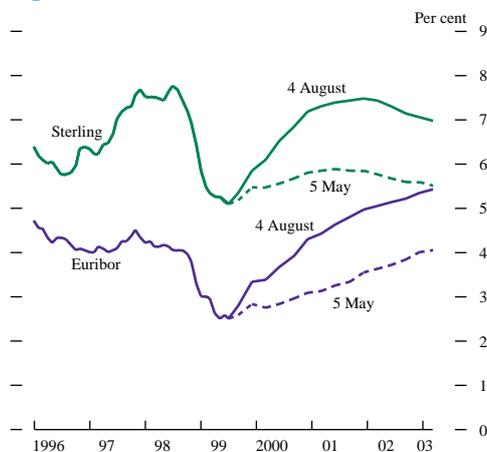
Short-term interest rates

The MPC has successively reduced the Bank's repo rate from 7.5% in October 1998 to its current level of 5%. Changes in official rates are quickly reflected in short-term wholesale market rates, and therefore have an immediate impact on the interest income and payments of holders and issuers of short-term wholesale money-market instruments. Official rate changes also feed through into retail interest rates, but usually with a lag. These lags may have lengthened recently. Chart 1.7 shows that although the 200 basis point reduction in the Bank's repo rate between October 1998 and March 1999 was quickly matched by reductions in retail deposit and lending rates, there has been little subsequent change in retail rates, although the repo rate was cut in April and June. By dampening the impact of rate changes on variable retail rates, delayed pass-through may increase the lags inherent in monetary policy, or even diminish its effect.

Expectations of future short-term nominal interest rates as measured by futures prices have risen since the *May Report* by around 150 basis points at a two-year horizon, both in the United Kingdom and in the euro area (see Chart 1.8). Expectations of short-term US interest rates have also risen, but by less. Chart 1.9 shows the risk-neutral probability distribution of three-month sterling interest rates derived from options prices on 4 August 1999. The upward skew indicates that, in the market's view, the balance of risks to short-term UK interest rates over the next two years is on the upside.

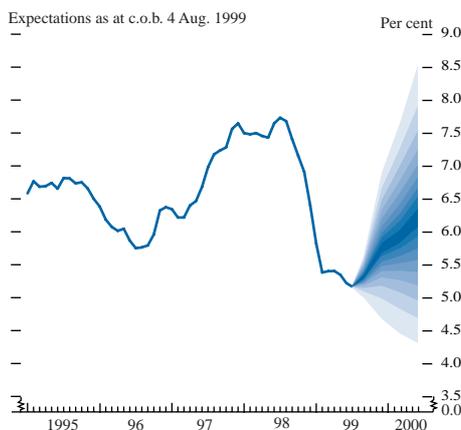
An important issue for monetary policy is whether higher nominal interest rates indicate a rise in the real cost of borrowing, because of higher risk-free real interest rates and/or higher inflation risk premia, or result from higher expected inflation. But these components are not easy to measure. The most direct measure of the

Chart 1.8
Sterling and Euribor interest rate expectations



Sources: Bank of England, Bank for International Settlements and LIFFE.

Chart 1.9
Implied distribution for sterling three-month interest rates



Sources: LIFFE and Bank of England.

The fan chart depicting the probability distribution for short-term interest rates is rather like a contour map. At any given point, the depth of shading represents the height of the probability density function implied by the markets over a range of outcomes for short-term interest rates. The markets judge that there is a 10% chance of interest rates being within the darkest, central band at any date. Each successive pair of bands covers a further 10% of the probability distribution until 90% of the distribution is covered. The bands widen as the time horizon is extended, indicating increased uncertainty about interest rate outcomes.

Table 1.B
The recent evolution of inflation expectations^(a)

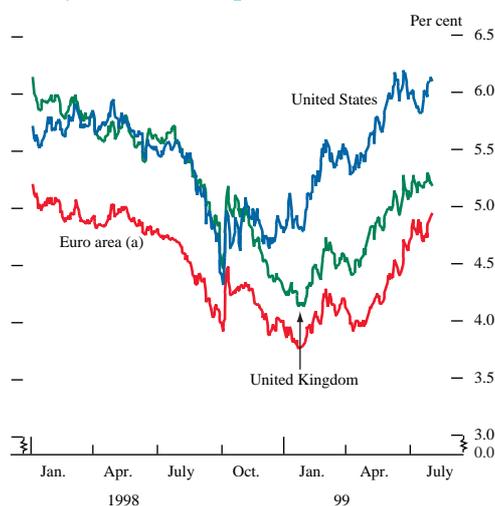
Percentage increases in prices

	1998			1999	
	Q2	Q3	Q4	Q1	Q2
RPI inflation rate 12 months ahead					
Academic economists	3.2	2.9	2.5	2.3	2.3
Business economists	3.1	2.6	2.1	2.1	2.2
Finance directors	3.4	3.1	2.6	2.3	2.3
Investment analysts	3.3	3.3	2.4	2.4	2.3
Trade unions	3.3	3.2	3.0	2.7	2.5
General public	4.4	4.5	4.2	4.1	4.0
RPI inflation rate 12 to 24 months ahead					
Academic economists	3.1	3.0	2.7	2.6	2.6
Business economists	2.9	2.4	2.3	2.5	2.7
Finance directors	3.2	2.9	2.9	2.5	2.4
Investment analysts	3.3	3.1	3.0	2.7	2.8
Trade unions	3.8	3.6	3.2	2.8	3.2
General public	5.1	5.1	4.7	4.6	4.6

Source: Barclays Basix survey.

(a) Figures refer to RPI inflation except for General public, for which the measure of inflation is not specified.

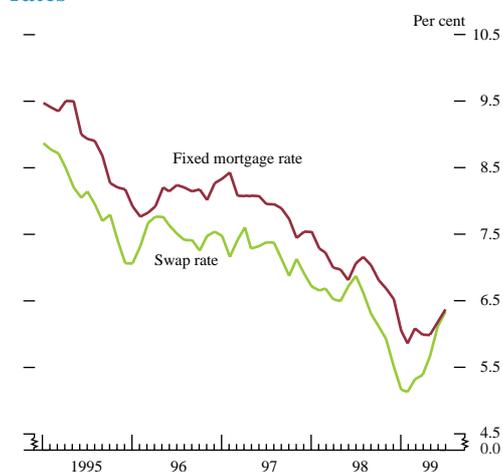
Chart 1.10
Ten-year nominal spot interest rates



Source: Bank of England.

(a) Calculated from the prices of French and German government bonds.

Chart 1.11
Five-year fixed mortgage and swap interest rates



Sources: Bank of England and Bloomberg.

risk-free real cost of borrowing is that derived from the prices of index-linked gilts. The implied forward risk-free real yield at a two-year horizon rose slightly to 1.8% on 4 August from 1.7% on 5 May. But without a measure of the inflation risk premium the magnitude of the rise in the overall real cost of borrowing is hard to gauge.

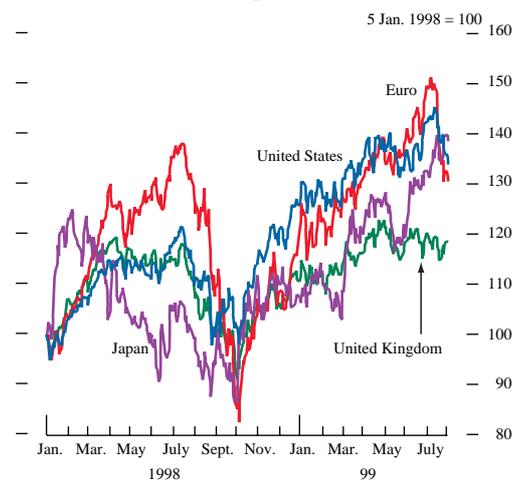
An alternative approach is to compare nominal interest rates with inflation expectations from surveys. Table 1.B shows results from the Barclays Basix survey, which reports inflation expectations for both 12 months ahead and 12 to 24 months ahead, for five groups of professions and the general public. Only business economists raised their 12 month ahead inflation expectations between the first and second quarters of 1999, by 10 basis points. For 12 to 24 months ahead, higher inflation expectations in Q2 are a little more widespread, but the implication remains that much of the recent increase in short-term nominal interest rate expectations reflects higher expected real borrowing costs.

Long-term interest rates

Ten-year nominal spot interest rates on gilts rose by around 50 basis points to 5.2% between 5 May and 4 August. Some of this increase reflects the higher short-term rates discussed above, but more than half of the rise is due to higher rates at the two to five-year horizon. The rise in long-term UK interest rates may be part of a broader phenomenon: long-term rates have been rising in the United Kingdom, United States and euro area for much of 1999 (see Chart 1.10). Part of the reason for this may be higher global inflation expectations, as the outlook for world activity has improved and the oil price has strengthened.

One channel through which higher long-term interest rates may influence domestic spending is via fixed-rate mortgages. Banks and building societies commonly set fixed mortgage rates on the basis of the interest rate in the swap market, at which they can exchange the fixed income received on fixed-rate mortgages for floating-rate income, in order to hedge their interest rate exposure. Chart 1.11 shows that there is a fairly close relationship between fixed mortgage rates and swap rates. Swap rates have risen so far in 1999 and, although fixed mortgage rates have also risen, the spread between swap rates and fixed mortgage rates is at a very low level. It is possible therefore that fixed mortgage rates might increase further.

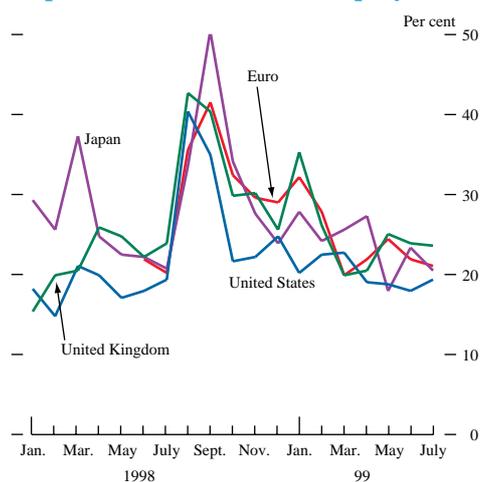
Chart 1.12
Selected world share prices^{(a)(b)}



Source: Bloomberg.

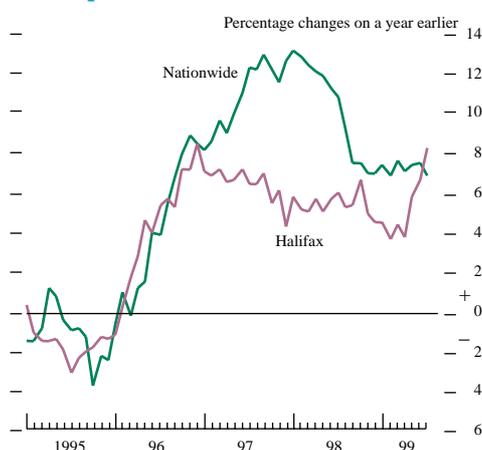
(a) In US dollars.
(b) FT-SE All-Share, Nikkei 225, Standard & Poor's 500 and Dow Jones Euro Stoxx.

Chart 1.13
Implied volatilities in world equity markets



Source: Bloomberg.

Chart 1.14
House price inflation



Sources: Halifax plc and Nationwide Building Society.

Equity prices

The FT-SE All-Share index fell by 1.4% between 5 May and 4 August, and US and European equity prices are also lower (see Chart 1.12). But Japanese stock prices have risen strongly, reflecting an apparent improvement in the economic outlook following higher growth in Japanese output in the first quarter of this year. The turbulence in world equity markets that followed the Russian debt crisis in August 1998 seems to have dissipated. Uncertainty about future stock returns, as measured by implied volatilities from options prices, has fallen in all the major stock markets over the first half of 1999 (see Chart 1.13).

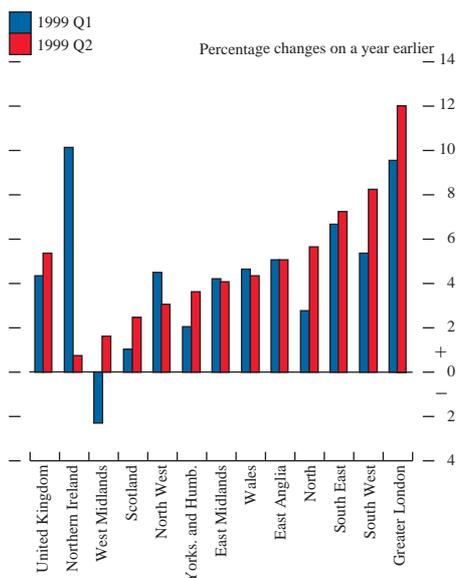
Within the UK market, the FT-SE 100 index fell by 3% between 5 May and 4 August, compared with a 3% rise in the Mid 250 index and a 6% rise in the SmallCap index. Insofar as larger UK stocks are more sensitive than smaller company stocks to international factors, the outperformance of smaller stocks may indicate an improvement in the outlook for the United Kingdom relative to the world economy over the past three months. The MPC has assumed in its central projection that nominal UK equity wealth grows in line with nominal income.

Property prices

There are signs that house price inflation is increasing. The Halifax house price index rose by 6% in the three months to July on a seasonally adjusted basis, the highest rate since January 1989. The annual rate of growth of the Halifax index was 8.2% in the year to July 1999, while the Nationwide index grew by 6.9% (see Chart 1.14). Also, the Royal Institute of Chartered Surveyors' (RICS) June 1999 survey shows that 66% of chartered surveyors were reporting rising house prices over the previous three months, compared with 34% in June 1998. House price rises in the first half of 1999 have been strongest in London and the South East (see Chart 1.15). Although house price inflation in London and the South East led that in other UK regions in the late 1980s, evidence of a leading relationship in the 1990s is less clear.

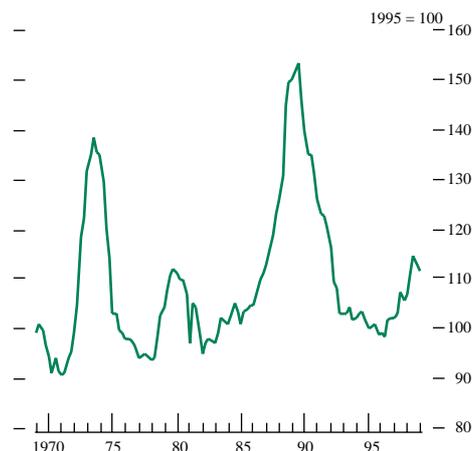
The MPC has reviewed its assumption about house price inflation. In the past, the central assumption has been that house prices will grow in line with average earnings, so that the ratio of house prices to average earnings is constant over the MPC's two-year forecast period. But there have been periods in recent decades in which this ratio has risen quickly and substantially (see

Chart 1.15
Halifax regional house price inflation



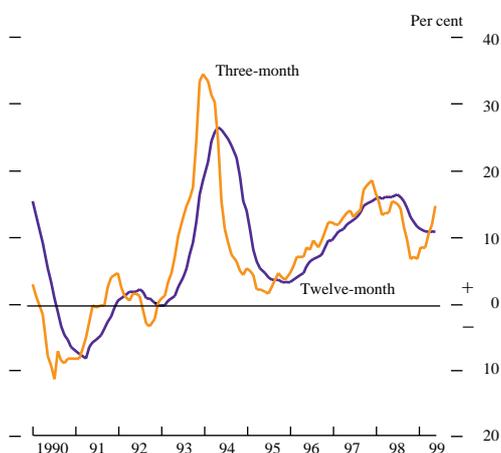
Source: Halifax plc.

Chart 1.16
House price to earnings ratio



Sources: Department of the Environment, Transport and the Regions and ONS.

Chart 1.17
Returns on commercial property



Source: Investment Property Databank Ltd.

Chart 1.16). The MPC has assumed in its central projection that house prices will grow at around twice the pace of average earnings over the next two years.

Evidence from a number of sources points to greater activity in the commercial property market. First, the FTA Real Estate index has risen by 25% in 1999 compared with a 10% rise in the FT-SE All-Share index. Second, the Merrill Lynch-Gallup survey of UK fund managers has shown a positive balance in relation to UK property over the five months to July, compared with ten consecutive negative balances between May 1998 and February 1999. Third, commercial property returns appear to be picking up. The Investment Property Databank Ltd (IPD) calculates returns on UK commercial property on the basis of rents and changes in capital values. Chart 1.17 shows that although twelve-month property returns in June 1999 were 6 percentage points lower than in July 1998, three-month returns have been rising since the turn of the year, largely as a result of higher capital gains.

Exchange rates

The sterling effective exchange rate index (ERI) appreciated for much of the first half of 1999, peaking at 106.1 on 4 June (see Chart 1.18). The MPC’s decision to cut the repo rate on 10 June was followed by a gradual fall in the index, and overall the ERI depreciated by 1.3% between 5 May and 4 August. Underlying this was a 1.1% depreciation against the euro (which has a weight of 65% in the ERI). The MPC’s assumptions regarding the path of sterling over the forecast period are discussed in Section 6.

1.3

Summary

Growth in narrow money has risen strongly, and although aggregate broad money growth continues to slow, growth in the deposits of the non-financial private sector has been somewhat higher in 1999 so far. The link from money growth to inflation is complicated in the short and medium term, but higher growth in money supports the projection of rising nominal demand growth. Lending to individuals secured on dwellings has been growing more strongly, consistent with greater activity in the housing market and a pick-up in house price inflation, and the MPC is now assuming that the ratio of house prices to average earnings will increase.

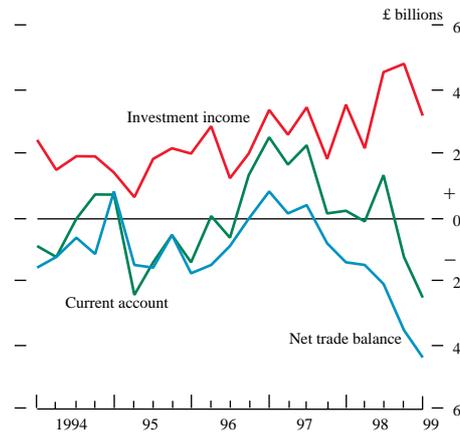
Chart 1.18
Sterling ERI



Source: Bank of England.

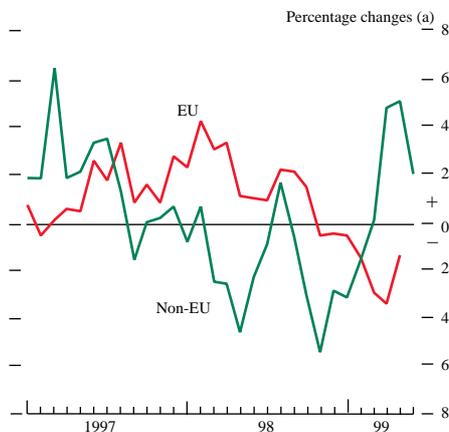
Nominal interest rate expectations have risen in the United Kingdom, especially around the two-year horizon. It seems likely that part of this rise reflects a higher real cost of borrowing, as recent surveys have shown little movement in short-term inflation expectations. But the continued rise in world long-term government bond yields suggests that investors may have revised upwards their expectations of global inflation over longer horizons. UK equity prices have fallen slightly since the *May Report*, and the sterling exchange rate has depreciated.

Chart 2.1
The UK current account, net investment income and trade^(a)



(a) At current market prices.

Chart 2.2
UK export volumes growth



(a) Three months on previous three months.

GDP rose by 0.5% in 1999 Q2 following two quarters of little growth. The cumulative effect of the National Accounts revisions published on 29 July raised the level of GDP at constant market prices by 0.4% up to 1999 Q1, with upward revisions to private consumption and fixed investment. Consumption growth has picked up in recent quarters, and the recovery in measures of consumer and business confidence seen at the time of the *May Report* has continued. Domestic demand growth has been partly offset by continued negative contributions to growth from net trade, as import growth has remained strong and exports have been flat. But the prospects for exports have improved since May, as the outlook for world growth and trade has strengthened.

2.1 External demand⁽¹⁾

Net trade has detracted from GDP growth each quarter since 1997 Q3, and over the year to 1999 Q1 made a negative contribution to growth of 2.3 percentage points—together with the previous two quarters, the largest for ten years. The nominal deficit on trade in goods and services reached £4.4 billion in 1999 Q1 and the current account recorded a deficit of £2.5 billion. But the decline in the current account since the beginning of 1998 has been less marked than the widening of the trade deficit. Higher investment income, resulting from returns on foreign direct investment, has partly offset the deficit on trade (see Chart 2.1). A large proportion of UK foreign assets are held in the United States, so the strong performance of the US economy, and the US stock market, could help to account for this.

UK export volumes of goods and services fell by 1.1% over the year to 1999 Q1. The slower growth of export volumes in 1997 and 1998 reflected the lagged effects of sterling's appreciation and developments in non-EU economies, in particular the contraction of demand in emerging markets and oil-exporting economies (see Chart 2.2). In recent quarters, however, export volumes of goods to EU economies have fallen whereas exports to economies outside the European Union have

(1) For a detailed discussion of international economic developments, see 'The international environment' article in the *Quarterly Bulletin*, August 1999, pages 253–61.

Table 2.A
UK export volumes^(a)

Percentage changes three months on previous three months

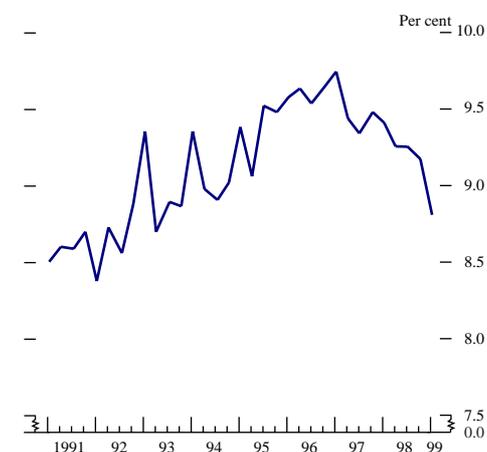
	Dec. 1998	May/June 1999 (b)
European Union	-1.3	-1.3
Other Europe	1.2	1.8
North America	-2.0	6.6
Asia (c)	3.1	4.4
Oil exporters	5.5	4.9
Other OECD	-5.4	7.6
Rest of the world	-8.7	4.1

(a) Figures for exports to Asian countries are on an overseas trade statistics basis; all other exports are on a balance of payments basis. All non-EU export volumes are calculated by deflating export values using the aggregate price index for exports to non-EU countries.

(b) Data for the European Union available up to May.

(c) Asia comprises Japan, South Korea, Hong Kong SAR, Malaysia, Singapore, Taiwan, Thailand, China and the Philippines.

Chart 2.3
UK goods export volume share of EU markets



Sources: ONS and OECD.

(a) UK exports relative to EU imports; volume data scaled to actual market share in 1991.

Chart 2.4
Import penetration: ratio of imports to final expenditure



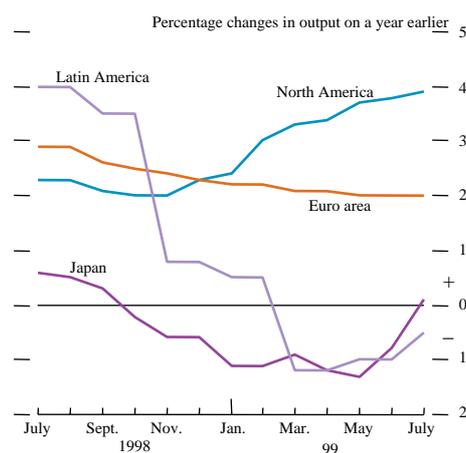
recovered. UK exports of goods to North America have grown at a fast rate, exports to Asia have risen and exports to the other non-EU economies have also picked up (see Table 2.A).

The strength of sterling against the euro and the slowdown in domestic demand in the larger European Union economies explain the widening of the UK trade deficit with the European Union. The weakening of exports to the European Union is largely a result of falling export volumes to Germany, which accounts for some 13% of UK exports of goods. Chart 2.3 shows that the United Kingdom's export volume share of EU markets has declined since the beginning of 1997.

UK import demand depends on the strength of domestic demand, UK exports (which influence imports through re-export activity and demand for imported material inputs), the price of imports relative to domestically produced goods, and other factors such as changes in trade specialisation. Chart 2.4 shows the extent of import penetration in the UK economy, measured by the ratio of import volumes to final expenditure (domestic demand and exports). The upward trend is common for most countries. It has been aided by progressive opening up of world markets, the reduction of trade protection and falling real transport costs. UK import prices have fallen sharply compared with those for domestically produced goods since mid 1996. This, combined with the recent outturns for domestic demand, would be expected to boost the volume of imports relative to domestic production and so accelerate import penetration. However, import penetration has increased at a steady pace since 1995, with little noticeable acceleration following sterling's appreciation. Over the forecast period the MPC expects growth in domestic demand to be stronger than projected at the time of the *May Report*, but for import penetration to continue to rise at its recent steady pace.

Looking ahead, the prospects for world growth and trade have improved further since the *May Report*. The Asian Development Bank has projected stronger growth in 1999 for the emerging markets in Asia, with positive prospective growth overall for the newly industrialised economies (NIEs) and South East Asia. Consensus Economics forecasts for Asia have been revised up. Forecasts for Latin America have improved marginally in July (see Chart 2.5), though perceptions of financial fragility in some parts of the region have increased since May.

Chart 2.5
Consensus forecasts for 1999 growth



Source: Consensus Economics; mean projections.

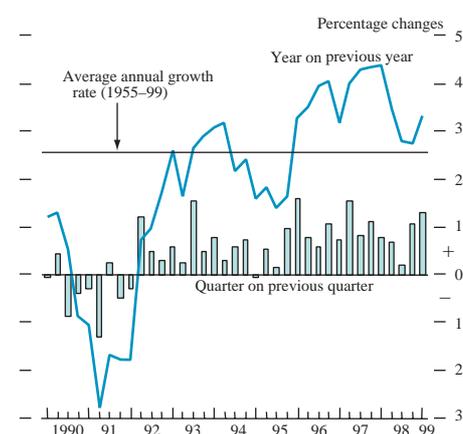
Table 2.B
GDP and expenditure components^(a)

Percentage change on a quarter earlier

	1998		1999
	Q3	Q4	Q1
Consumption:			
Households	0.2	1.1	1.3
Non profit making institutions serving households	0.8	1.0	1.2
Government	0.4	0.8	1.7
Investment	4.0	1.9	0.2
of which, business investment	5.5	4.6	0.5
Final domestic demand	1.0	1.2	1.1
Change in inventories (b)	-0.1	-0.4	-0.4
Domestic demand	0.9	0.8	0.7
Net trade (b)	-0.5	-0.8	-0.6
GDP at market prices	0.5	0.0	0.1

(a) At constant 1995 market prices.
(b) Contribution to quarterly growth.

Chart 2.6
Household consumption growth



Overall prospects in the major industrialised economies have also improved since May. In the United States GDP grew by 4.1% in the year to 1999 Q2. Annual GDP growth has been running at more than 3% for the past three years. The timing or extent of any prospective slowdown in the US economy remains difficult to gauge. The outlook for Japan is a little brighter than three months ago: industrial production was higher than expected in June and perhaps pointed to little change in GDP in Q2, rather than a fall. Consensus Economics project slightly stronger activity in 1999 for Japan. Recent surveys of business confidence for France and Germany have pointed to a strengthening of growth in the second half of 1999 and in 2000.

Taking all these developments together, the MPC expects world activity to be stronger than judged in May, as a result of higher US growth, and slightly brighter prospects for the euro area, Japan and developing economies. That should increase world trade growth, and so the MPC's central expectation for UK export market growth has been revised up to about 6% in 2000. A much lower negative contribution to GDP growth from net trade is expected in 2000 than in 1999. But the MPC has assumed that there is a possible downside risk to world activity from a more pronounced slowdown in the US economy, for example linked to a steep decline in equity prices.

2.2 Domestic demand

UK domestic demand rose by 0.7% in 1999 Q1, following an increase of 0.8% in 1998 Q4. The National Accounts release on 29 July included revisions to domestic demand back to 1997. The cumulative effect up to 1999 Q1 was to raise domestic demand by 0.7%, with upward revisions to consumption and investment. Consumption growth has strengthened since 1998 Q3 and business investment has also made a significant contribution to domestic demand growth (see Table 2.B). Quarterly growth of final domestic demand, which excludes the contribution from inventory investment, has been 1% or more for three consecutive quarters.

Consumption

The level of household consumption in the National Accounts was revised up and the cumulative effect of these revisions up to 1999 Q1 was 0.9%. The slowdown in consumption growth in 1998 is now less marked than previously thought. Consumption grew by 1.3% in 1999 Q1, up from 1.1% in 1998 Q4 (see Chart 2.6). Part

Table 2.C
Consumers' expenditure on goods and services^{(a)(b)}

Percentage changes on a quarter earlier

	1998		1999
	Q3	Q4	Q1
Durable goods:			
Total	0.6	1.5	3.6
<i>of which:</i>			
Vehicles	-0.8	2.3	3.6
Other durables	1.9	0.8	3.6
Non-durable goods:			
Total	-1.0	0.1	0.6
<i>of which:</i>			
Foods	-1.0	-1.1	-0.3
Other goods	-0.8	0.8	1.5
Clothing and footwear	1.4	0.0	2.9
Services	1.2	1.9	1.5
Total household expenditure	0.2	1.1	1.3

(a) At 1995 constant prices.

(b) Seasonally adjusted.

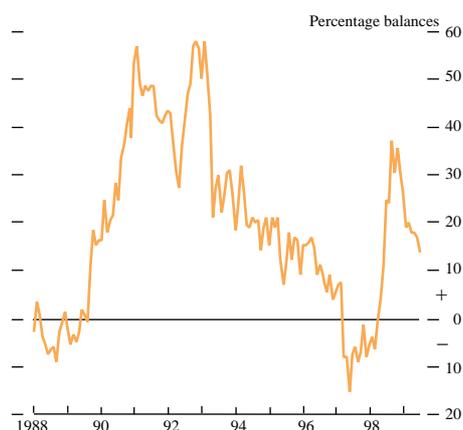
of the increase in consumption in Q1 is likely to be erratic and is a result of the change of the registration date for new car sales from August to twice a year, in March and September. That will have changed the seasonal pattern of vehicle spending and possibly boosted spending in the first quarter by around $\frac{1}{4}$ – $\frac{1}{2}$ percentage point. But Table 2.C shows that the strength of consumption was broadly based.

More timely monthly indicators suggest that consumption growth may have remained robust in recent months. Retail sales volumes rose by 0.9% in the three months to June. The CBI Distributive Trades survey also pointed to a strengthening of retail demand; the balance of retailers reporting a rise in sales compared with a year earlier rose to +20 in the three months to July from +10 in the previous three months. However, retail contacts of the Bank's regional Agents reported slow growth in retail sales in the latest three months, somewhat weaker than the evidence from the official data and other surveys.

The previous two *Reports* discussed possible reasons why the slowdown in consumers' expenditure in 1998 appeared sharper than the MPC had expected, given the buoyancy of its main determinants (labour income and wealth). The February and May *Reports* assumed that the relative weakness of consumers' expenditure would persist, and would result in a slower pick-up in consumers' expenditure over the forecast period than suggested by past behaviour. But the latest data point to less of a slowdown in consumers' expenditure in the first three quarters of 1998 and a strong recovery in 1998 Q4 and 1999 Q1 (even after adjusting for vehicle spending). That is more in line with past strong growth of labour income and wealth. Therefore the MPC has revised its projection for consumers' expenditure over the forecast period so that it is in line with past behaviour. The MPC has also assumed that the risks to the forecast from consumption are on the upside over the next twelve to eighteen months. The pattern of consumers' expenditure growth over the past twelve months may have been linked to the turnaround in confidence, changes in official interest rates, and possibly to changes in equity and housing wealth.

Households aim to smooth expenditure by borrowing in response to short-term changes in income, and so will take into account expected future earnings and wealth when making spending decisions. So changes in expectations about future earnings and wealth, and about

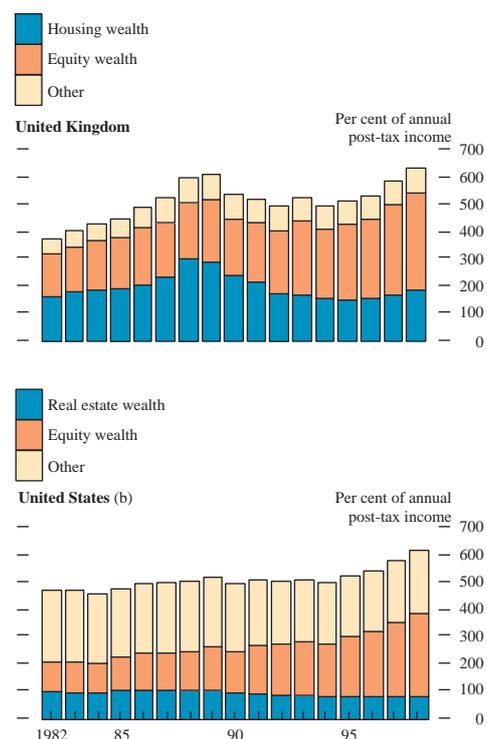
Chart 2.7
Expectations of a rise in unemployment over the next twelve months^(a)



Source: GfK.

(a) Balance of responses to the question: 'How do you think the level of unemployment in the country will change over the next twelve months?'

Chart 2.8
UK and US household wealth^(a)



Sources: Bank of England, IMF *World Economic Outlook* May 1999, and Federal Reserve Board, *Flow of Funds Accounts*, Table B100.

- (a) Housing wealth is calculated net of mortgage liabilities for both the United Kingdom and the United States.
 (b) Households and non profit making institutions, except real estate which covers households only.

the uncertainty surrounding them, can also affect spending. Consumer confidence fell back sharply in the summer and autumn of 1998 in a number of countries, including the United Kingdom, perhaps as a result of turbulence in global financial markets. But since the beginning of 1999 confidence has improved and expectations of rising unemployment in the United Kingdom have fallen back (see Chart 2.7). Household uncertainty about future employment and income appears to have diminished and that is likely to have contributed to the pick-up in expenditure. Cuts in official interest rates since October 1998 are also likely to have led to a degree of substitution towards current, from future, consumption. But the rise in medium-term yields since May, discussed in Section 1, might dampen the impact.

Changes in wealth (financial and housing) may reflect changes in expectations about future income. But changes in the composition of wealth may also indicate different paths for prospective aggregate consumption growth. In the 1990s financial wealth has made a larger contribution than housing wealth to the increase in overall UK personal sector wealth, and the same is true for the United States (see Chart 2.8). That contrasts with the 1980s when housing wealth was more important for the United Kingdom.

An increase in equity wealth may influence aggregate consumption less than an increase in housing wealth if the holders of equities tend to spend a lower proportion of any increase in income than homeowners (ie equity holders have a lower marginal propensity to consume). High-income households tend to have a lower propensity to consume than low-income households. In the United Kingdom, as in the United States, equity wealth is skewed towards higher-income households, whereas housing wealth is more evenly distributed by income and net wealth (see Table 2.D). This may mean that expenditure is less sensitive to an increase in equity wealth than housing wealth. Furthermore, since around two thirds of household equity wealth in the United Kingdom is held indirectly by pension funds and insurance companies, it may be more difficult to use this form of wealth as collateral for borrowing.

UK housing wealth began to rise as a proportion of total household wealth in 1998 and house prices appear to have accelerated in the first half of 1999, perhaps linked to the recovery in confidence. An increase in house prices, relative to other goods and services, would

Table 2.D
United Kingdom: shares of equity and housing assets in net wealth (in 1995^(a))

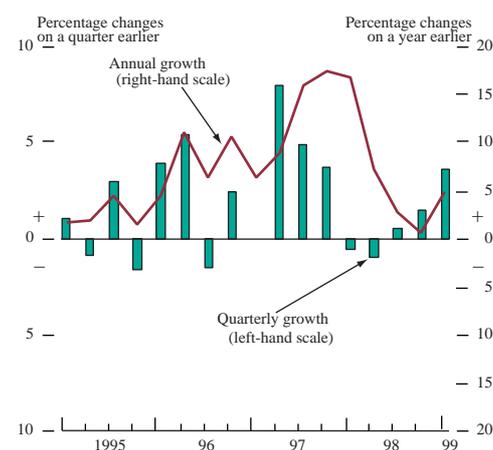
Percentage shares of net wealth

Income Lower limit of net wealth (£'s)	Equity wealth	Housing wealth (b)
25,000	3.9	51.7
40,000	4.0	55.9
50,000	4.8	45.3
60,000	5.2	49.1
80,000	6.4	48.2
100,000	9.4	40.2
200,000	15.2	39.6
300,000	23.8	32.9
500,000	29.4	32.2
1,000,000	39.1	29.8

Source: Inland Revenue Statistics 1998.

- (a) These estimates are based on inheritance tax, capital transfer tax and other data. Top and bottom net wealth brackets are excluded because the estimates are unreliable. The data exclude the value of pension assets. Their inclusion would reduce but would not eliminate the skew of equity wealth towards high-income households.
 (b) Net of mortgage liabilities.

Chart 2.9
Consumers' expenditure on durable goods^(a)



(a) At constant 1995 market prices.

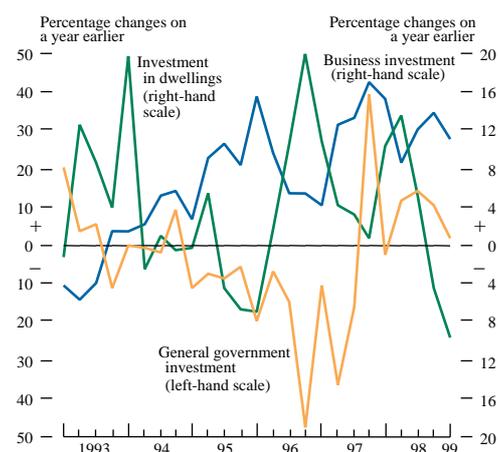
increase homeowners' wealth. But an increase in house prices also raises the costs facing first-time buyers or those trading up to larger properties—and they may cut back on other forms of spending to invest in housing. This would tend to dampen the overall effect on expenditure on non-housing goods and services. But a rise in housing wealth can boost the expenditure of homeowners who are able to use their house as collateral against borrowing. Latest data show that this may be beginning to happen. Estimates of mortgage equity withdrawal were positive in 1999 Q1, having been negative most of the time since 1992. Mortgage equity withdrawal may have partly substituted for unsecured borrowing (see Section 1). Over the forecast period house prices and therefore housing wealth and mortgage equity withdrawal are expected to strengthen.

An increase in housing transactions could also influence consumers' expenditure by bringing forward or raising spending on durables. The number of loans approved and particulars delivered have risen by 17% and 8% respectively since mid 1998. The pattern of durables spending since 1997 is also likely to have been influenced by the 'windfall payouts' from building society conversions.⁽¹⁾ Spending on durables is likely to have been moved forward into 1997 and, as Chart 2.9 shows, spending slowed markedly from the end of 1997. The rise in 1999 Q1 might reflect some recovery to a more usual pattern of spending, given housing market transactions. Further 'windfall payouts' are expected next year from, for example, the transfer of Scottish Widows' business to the Lloyds TSB Group, and other demutualisations. The estimated value of these is around a quarter of the size of the 1997 windfalls.

The turn of the Millennium may have some impact on the profile of consumers' expenditure. The Bank's regional Agents have reported that firms in the food and drink sector are anticipating a greater than usual seasonal strengthening of demand in the second half of the year and are likely to build up stocks in advance. Households are likely to stock up on these goods more than usual at the end of this year, for both celebratory and precautionary reasons. To the extent that such spending is precautionary, it may bring forward expenditure that would otherwise have occurred in 2000 Q1. This could affect the pattern of retail spending and inventory holding by firms around the end of the year.

(1) For further details see the November 1997 *Inflation Report*, page 20.

Chart 2.10
Investment by sector

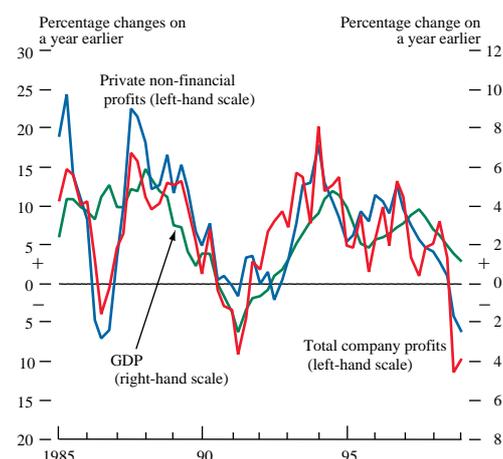


Investment demand

Whole-economy investment rose by 0.2% in 1999 Q1 and was 5.9% higher than a year earlier, following annual increases in investment of more than 7% every quarter since 1997 Q2. Upward revisions to investment in 1997 and 1998 reflected new estimates for investment expenditure on computer equipment. Business investment grew by 0.5% in the first quarter and was 11% higher than a year earlier (see Chart 2.10).

The difference between current and desired capital stock levels is the major influence on investment, though costs may mean that adjustment to the desired capital stock is slow. The desired capital stock cannot be measured but it, and therefore investment, will be affected by firms' current profitability, their expectations of future demand and profits, the cost of capital, capacity utilisation and changes in technology.

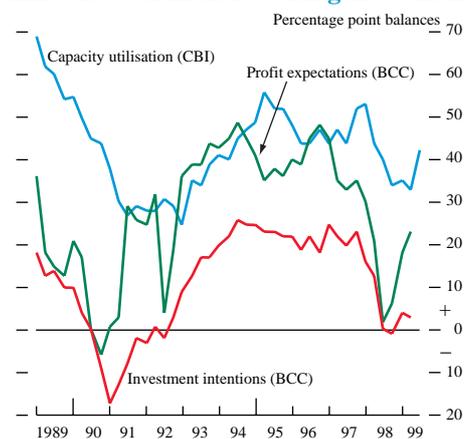
Chart 2.11
Company profits and GDP growth



(a) Excluding the effects of a statistical alignment adjustment.

Latest estimates suggest that total company profits have fallen substantially since early 1998, but these data are often subject to revision. In 1999 Q1 total company profits were around 9% lower than a year earlier, excluding a statistical alignment adjustment used by the ONS to help balance the National Accounts. Profits of private non-financial corporations (PNFCs) have fallen back from a peak in 1998 Q3 and were around 6% lower than a year earlier in 1999 Q1, also excluding the alignment adjustment. The extent of the decline in profits therefore seems large, given that output in the whole economy grew by more than 1% over this period (see Chart 2.11). Other evidence on the current state of company profits does not point to such a sharp decline: CBI business confidence has improved since mid 1998. The number of profit warnings was 6% higher in the first seven months of 1999 than in the same period in 1998.

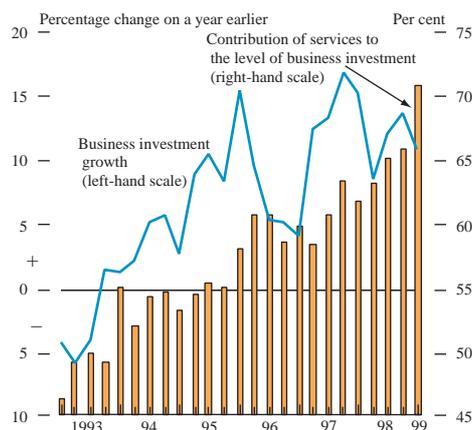
Chart 2.12
Influences on manufacturing investment



Sources: CBI and BCC.

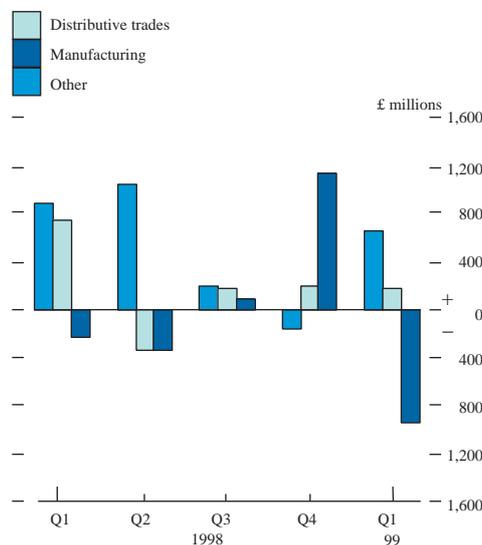
Investment in manufacturing and services has reflected the divergence between these sectors over the past two years. In 1999 Q1 manufacturing investment was at its lowest level for more than two years. But BCC and CBI measures of business confidence in the manufacturing sector have improved since the *May Report*. The July CBI quarterly Industrial Trends survey reported that business optimism had recovered to a balance of 5%, the highest since the beginning of 1997. And spare capacity was broadly in line with its historical average. However, investment intentions, as measured by the BCC survey, suggested only weak increases in manufacturing investment in 1999 Q2—well below the average since the series began in 1989 (see Chart 2.12).

Chart 2.13
Business investment and the service sector



Service sector investment has made an increasing contribution to overall business investment since 1993, as Chart 2.13 shows. It accounted for 70% of total business investment in 1999 Q1, up from less than 50% in 1993; annual growth in services' investment has been close to 20% since 1998 Q2. Increasing investment in computer technology has probably boosted service sector investment, as discussed in the *May Report*. Profit expectations, as measured by the BCC, have also recovered since the autumn of 1998. The BCC survey measure of capacity utilisation has increased a little and investment intentions are broadly in line with the long-run average. These suggest that further growth in service sector investment is likely.

Chart 2.14
Change in inventories^(a)

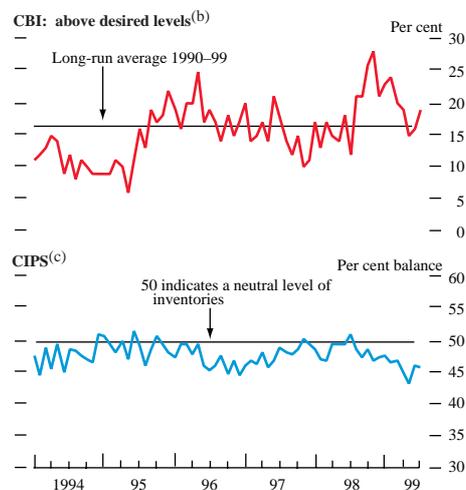


(a) At constant 1995 prices, excluding the alignment adjustment.

Real general government investment fell by 6.2% in 1999 Q1 and was 2% higher than a year earlier. But the fall in Q1 is likely to be erratic. The March Budget maintained the Government's commitment to increase the ratio of net public investment to GDP to 1% by financial year 2001–02. The growth rate of gross government investment is therefore likely to increase.

The prospects for business investment are little changed from the *May Report*. The profile continues to be influenced by the bringing forward of some investment spending on construction projects and IT in advance of the Millennium. This is offset in 2000 by a slowdown in investment growth.

Chart 2.15
Inventories of finished goods^(a)



Sources: CBI, CIPS Manufacturing Survey.

- (a) Seasonally adjusted.
- (b) Balance of responses to the question: 'Do you consider your stocks of finished goods to be more than adequate?'
- (c) Responses to the question: 'Please compare your stocks of finished goods (in units) with the situation one month ago.'

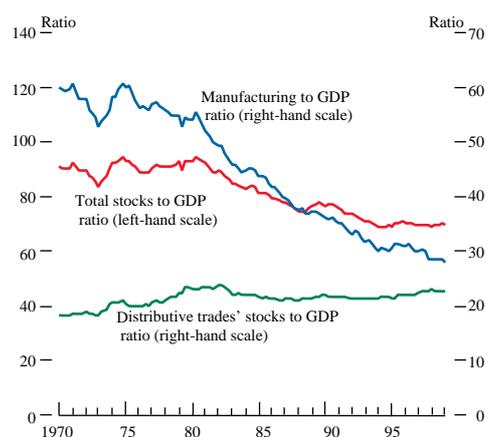
Inventory investment

Whole-economy inventories (excluding a statistical alignment adjustment) fell in 1999 Q1, following a build-up in inventories in 1998 (see Chart 2.14).

Firms have over time economised on inventory investment relative to output, as is evident from the long-run downward trend in the ratio of inventories to GDP. Inventories will vary relative to output during a business cycle. For example, a sharp drop in demand is likely to result in a build-up in inventories above desired levels. There is some evidence that this happened in mid 1998 when the CBI and CIPS manufacturing surveys both pointed to higher than desired stocks of finished goods. The survey measures and official data have fallen back since then, suggesting that some adjustment has taken place (see Chart 2.15).

Since 1994 the inventories-to-GDP ratio has been broadly stable, compared with a long-run decline in the

Chart 2.16
Inventories to GDP ratios^(a)



(a) Constant market prices.

Chart 2.17
Ratio of UK manufacturing inventories to output

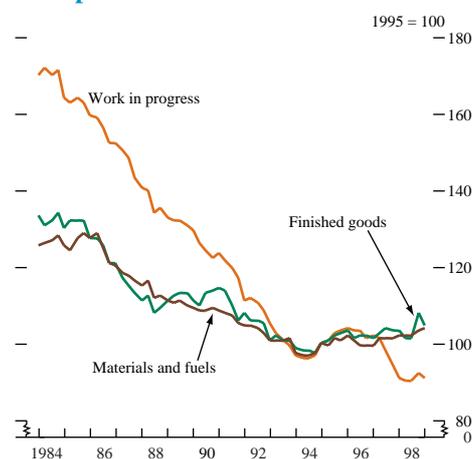
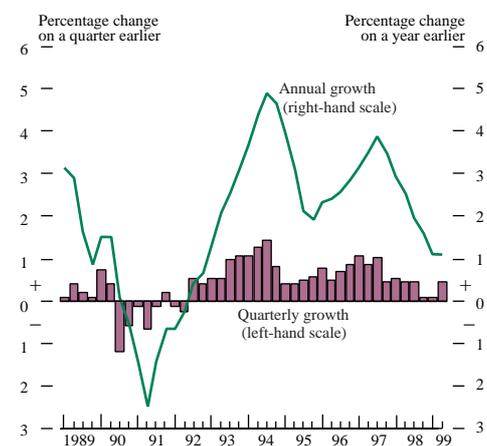


Chart 2.18
GDP growth



ratio since the mid 1970s. Changes in manufacturing largely accounted for the downward trend in inventories as a proportion of GDP, as Chart 2.16 shows, whereas distributive trades' inventories have remained broadly constant. Over time, it is likely that increased integration of production processes, through new technologies, has improved the efficiency of production. That may have reduced the need for 'work in progress' inventories as a proportion of manufacturing output (see Chart 2.17). The change in pattern within the UK manufacturing sector away from traditional heavy engineering and towards new-technology industries has probably reduced the scale of work in progress inventories. Changes in technology (for example business-to-business use of the Internet) are likely to continue to reduce inventories as a proportion of GDP. The MPC has assumed that the downward trend will continue, but at a slower pace than in the 1970s and 1980s.

Public sector demand

Nominal general government consumption rose by 3.8% in the year to 1999 Q1. In assessing the outlook for the public finances, the MPC has maintained as its central case the nominal government expenditure plans and effective tax rates from the 9 March Budget statement. The Government's current nominal expenditure plans are for an increase in spending on goods and services of 5.3% in financial year 1999–2000. The overall stance of fiscal policy is the same as in the *May Report*. HM Treasury projects a structural tightening in terms of the cyclically adjusted net borrowing position of some 0.3% of GDP between 1998–99 and 2000–01.

2.3

Output

According to preliminary estimates, GDP (at constant market prices) grew by 0.5% in 1999 Q2. The annual growth rate remained at 1.2% (see Chart 2.18). The changes to the National Accounts for the 1999 *Blue Book* resulted in revisions to the output side of the accounts which raised the level of output by 0.4% and increased the annual growth rate in 1999 Q1 to 1.2% from 0.7%.

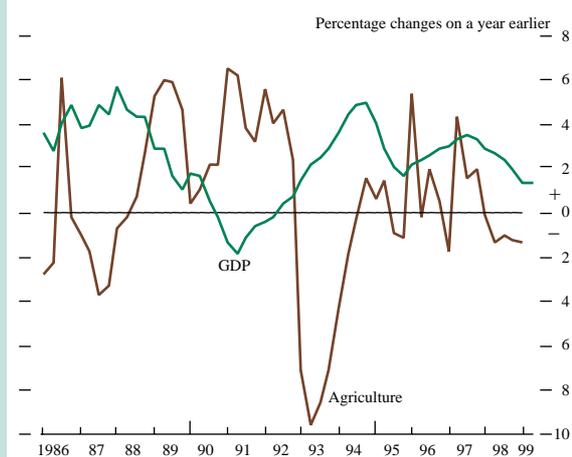
Growth in the service sector was 0.5% in 1999 Q2 and annual growth was 2.4%. Latest data for 1999 Q1 showed that output in the production and agricultural sectors had continued to contract (see Chart 2.19). Agricultural output has been falling since 1997. But agriculture has been affected by sector-specific shocks, which are discussed in the box on pages 20–21.

Agriculture

The share of the agricultural sector in GDP has contracted in recent years, and income from agriculture has fallen sharply. In 1998 it was around 40% lower than its average for the 1990s. Falling world commodity prices and the appreciation of sterling's effective exchange rate have had a marked effect on the sector. Product-specific shocks and longer-term factors have also affected the balance of supply and demand for commodities. As with the other primary sectors, agricultural output is more volatile than whole-economy GDP.

The three main sectors of UK agriculture are: arable crops and horticulture, which accounted for around 38% of the value of agricultural output in 1998; livestock which accounted for 33%; and dairy farming which accounted for 19%. The sector accounted for around 1.3% of GDP at basic prices in 1998, down from 2% in 1989. Agriculture's share of the United Kingdom's workforce in employment was around 2% in 1998, down from just under 2½% in 1989. Many more people are indirectly dependent on the agricultural sector within rural communities and supporting industries. Chart A shows how agricultural sector output has evolved very differently from the economy as a whole. This is partly because agriculture often faces specific supply and demand shocks that are different from those faced by other sectors. For example the sharp drop in agricultural production recorded by the National Accounts at the beginning of 1993 was the result of a change in the Common Agricultural Policy: land set aside from arable farming was increased and that was excluded from production. But it is also the case that some whole-economy shocks, such as exchange rate changes, have a bigger impact on agriculture than on some other sectors.

Chart A
Agricultural output and GDP growth

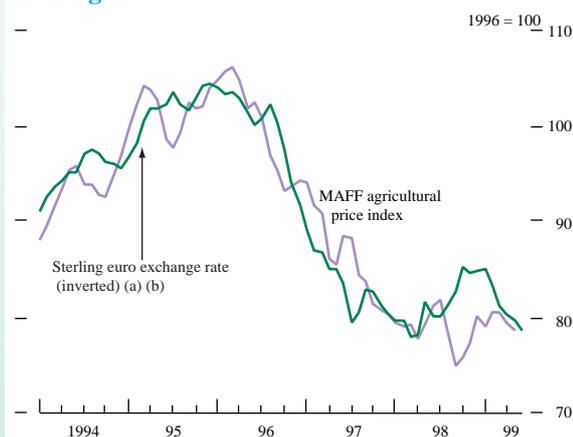


Over the past three years there have been a number of developments that have had severe adverse effects on the United Kingdom's agricultural sector. World dollar agricultural prices fell sharply in 1998, following the financial crises and compression of demand from Asia and Latin America.

Within the European Union, and in the United Kingdom, the prices of cereals, meat and dairy products are set by the system of support prices with reference to Common Agricultural Policy (CAP). These products account for more than two thirds of total agricultural output in the United Kingdom. Support prices are set in euros (Ecu prior to January 1999) and although they were reduced between 1992 and 1995 they have been broadly unchanged since then. Sharp falls in world agricultural prices have resulted in an increased divergence between world prices and high EU euro support prices for cereals, meat and dairy products.

But sterling prices of these products have fallen sharply since 1996, as sterling has appreciated against other European currencies and the euro. Chart B shows how changes in the Ministry of Agriculture Forestry and Fishing (MAFF) agricultural price index are broadly influenced by exchange rate changes. But prices of some products such as root crops have moved very differently from cereals, dairy and livestock prices (see Chart C).

Chart B
Agricultural prices and the sterling euro exchange rate

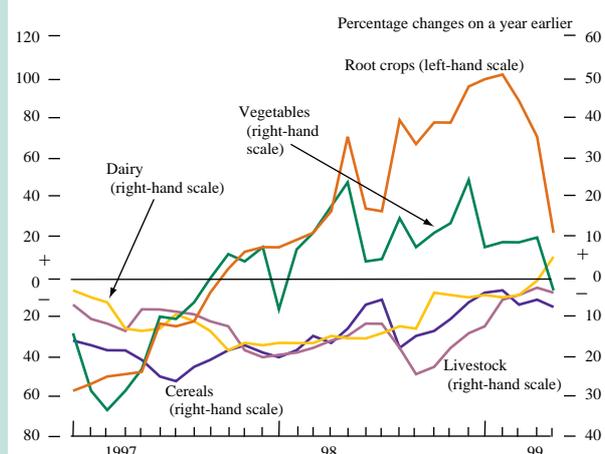


Sources: MAFF and Bank of England.

- (a) Prior to 1999, the sterling euro rate is a synthetic exchange rate based on the trade-weighted legacy currencies against sterling.
- (b) A decrease indicates an appreciation of sterling.

Farmers have been partly compensated for lower support prices by subsidies to income. Following the reforms to the CAP which came into effect in the mid 1990s, total direct subsidies (net of levies) received by UK farmers reached a peak of £4.1 billion in 1996–97. In 1998–99 these fell back to £3.3 billion, reflecting reduced payments relating to lower payouts from the Bovine

Chart C
UK produce: agricultural prices



Spongiform Encephalopathy (BSE) schemes and lower payments for the wheat and barley Arable Area scheme.

In addition to these developments, there have been a number of specific shocks to demand for UK produce. The main shock was the reduction in demand for beef following the BSE crisis in March 1996. That has reduced the livestock output of cattle and calves by 23%. The BSE crisis has also had knock-on effects on other livestock prices. It prompted a further switch from world beef production towards other meat such as lamb, pork and poultry. Production has increased rapidly in some of these sectors in recent years, resulting in a sharp decline in wholesale prices for these products.

All of these developments contributed to the sharp fall in farming incomes; in 1998 they were around 30% lower than in 1997 and around 40% lower than the average for the 1990s. Information from the Farm Business Surveys suggests that reductions in income were seen across most types of farming between financial year 1997–98 and 1998–99. Despite the cheaper cost of feedstuffs, incomes in the dairy sector fell because of lower milk prices. Overseas competition led to lower incomes in cattle and sheep farming.

The latest summary of business conditions by the Bank's regional Agents suggests that the strength of sterling

continued to bear down on incomes in the first half of 1999, and UK farmers may have lost market share to the overseas sector. Confidence has been very weak and declined a little through the second quarter, perhaps reflecting the strength of sterling against the euro over that period. However, this was partly offset by the recent stabilisation of some commodity prices (see Section 4).

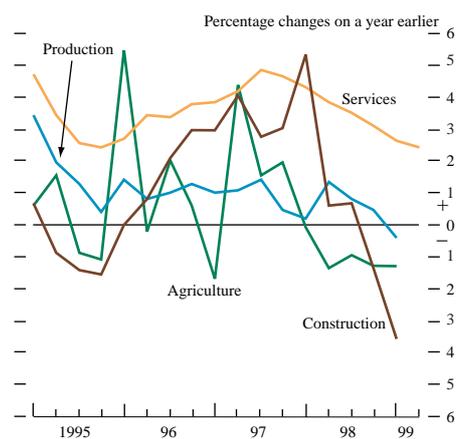
Looking ahead, the outlook for world prices of commodities has firmed since the *May Report*, as a result of improved prospects for world growth and trade. This may be reflected in higher agricultural demand within the European Union over coming quarters. The reforms to the CAP agreed under Agenda 2000 will reduce the prices of cereals, livestock, and dairy products, and move them closer to world prices. That may also raise EU demand. Overall this is likely to have a further impact on farm incomes from 2000, though increases in direct payments to farmers will partly offset the effect of lower support prices. The Agenda 2000 agreement includes cuts in support prices of 15% for cereals and 20% for beef, phased in over two and three years, respectively, from 2000. Cuts in support prices for dairy products have been delayed until 2005–06.

The reforms are likely to have different effects on the arable, dairy and livestock sectors. MAFF estimates that, in the absence of structural adjustment, specialist arable farmers would lose revenues as a result of the reforms, but beef and sheep farmers would gain overall. Greater pressure on the European Union to open up further its agricultural markets is likely to arise from World Trade Organisation negotiations which begin in 2000. In addition, the EU countries may reconsider the CAP in the context of discussions over EU enlargement.

As far as the United Kingdom is concerned, the lifting of the worldwide ban on exports of beef on 1 August should gradually improve the prospects for the sector. The outlook for agriculture as a whole could improve as world commodity prices become firmer. But developments will continue to depend on sterling's exchange rate against the euro. The agricultural sector also remains vulnerable to supply shocks that make production more volatile than in other sectors of the economy.

The pick-up in service sector growth in Q2 and survey evidence point to a renewed strengthening of growth. The BCC services survey reported higher home deliveries in Q2, together with an improvement in orders. The CIPS services survey has also shown a turnaround in overall and new business activity, which rose to their highest levels since March 1998.

Chart 2.19
Output by sector



Manufacturing output growth was revised up by 0.3–0.4 percentage points in 1997 and 1998. But the pattern of growth was little changed. In recent months the contraction in the production industries has diminished. In 1999 Q2 manufacturing output rose by 0.4%, following three quarters of falling output, and was 1.2% lower than a year earlier. Survey data suggest that manufacturing may have reached a turning-point. The July CIPS purchasing managers' index rose to 52.7 and was above the neutral level of 50, indicating an expansion rather than contraction in activity. The CIPS total new orders and export orders indicators rose significantly in July. And the CBI and BCC survey responses on domestic and export orders have also improved since the end of 1998.

Construction output rose by 0.2% in 1999 Q1 and activity appears to have continued to rise in Q2. New construction orders rose in the three months to May. And the CIPS survey measure of total construction activity rose to 64.5 in June, well above the average of 48.5 in the second half of 1998. But housing starts were a little lower in the latest three months.

2.4

Summary

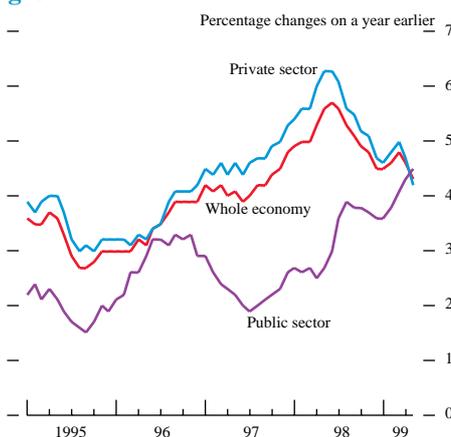
The cumulative effect of the revisions to the National Accounts was to raise the level of GDP by 0.4% up to 1999 Q1, with upward revisions to consumption and fixed investment. Consumers' expenditure has strengthened since 1998 Q3 and the recovery in measures of consumer and business confidence seen at the time of the *May Report* has been maintained. The MPC has raised the profile of consumers' expenditure over the forecast period. The overall prospects for activity have improved since the *May Report*. Developments in the world economy have been moderately favourable over the past three months and the MPC has revised up its projection for world activity and trade. Compared with the *May Report*, the MPC's central projection is for a sharper increase in GDP growth in the near term, before levelling off at around 3% a year.

The demand for labour has not eased as rapidly as had been expected at the turn of the year. The LFS unemployment rate has remained stable at around 6.2%, lower than its previous trough in 1990, and the claimant count has fallen close to 20-year lows. Growth in employment and hours has slowed, but forward-looking indicators no longer suggest that whole-economy employment will fall substantially, and some point to a pick-up in growth. Despite the persistent strength of labour demand relative to expectations, nominal earnings growth has continued to decline. The headline Average Earnings Index measure of annual earnings growth fell to 4.3% in May, reflecting the significant reduction in private sector settlements relative to a year ago—partly because of lower inflation expectations—and a moderation of other pay elements sensitive to movements in economic activity, including overtime and bonuses.

3.1

Earnings

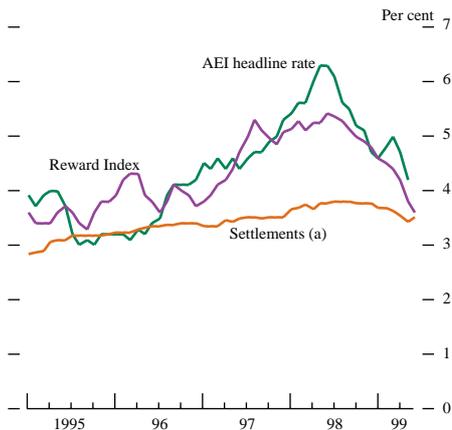
Chart 3.1
Headline average nominal earnings growth



Whole-economy annual earnings growth fell from a peak of 5.7% last June to 4.3% in May, according to the headline measure of the official Average Earnings Index (AEI), a backward-looking three-month average (see Chart 3.1). Recent monthly AEI outturns have been volatile: the measured twelve-month growth rate of average earnings rose from a low point of 4.2% in December to 5.0% in February, before falling back to 4.0% in April and May. Following the recent independent review of the AEI,⁽¹⁾ the ONS is carrying out further work to improve the quality of the index, focusing in particular on updating and expanding the sample of reporting firms. While this work is taking place, the MPC has agreed that the path of earnings growth should be treated as more than usually uncertain. In forming its central projection, the MPC continues to take account of a range of other indicators of pay pressures.

(1) *Review of the revisions to the Average Earnings Index*: Report submitted by Sir Andrew Turnbull and Mervyn King to the Chancellor of the Exchequer, prepared by Peter Sedgwick and Martin Weale, The Stationery Office Limited, March 1999. The main findings and recommendations of the Report are summarised in the box on page 24 of the May 1999 *Inflation Report*.

Chart 3.2
Private sector earnings growth and settlements



Sources: Bank of England, ONS and The Reward Group.

(a) Twelve-month private sector mean, weighted by sectoral employment shares from the 1996 Annual Employment Survey.

The decline in the official measure of earnings growth since last June is more than accounted for by a slowdown in the growth of private sector pay (see Chart 3.1). Other indicators also point to an easing in private sector wage pressures. The Reward Index of earnings growth—based on an independent survey covering almost 900,000 employees, predominantly in the private sector—fell to 3.6% in June, and the Bank’s twelve-month employment-weighted measure of private sector settlements declined to 3.5% (see Chart 3.2).

Shorter-term measures have been even weaker: the average private sector settlement in the three months to May was 3.0%, 0.8 percentage points lower than a year earlier, and the lowest since 1994. The three-month average picked up in June, as the final stage of a three-year pay deal for construction workers came into effect. But average settlements in other parts of the private sector were stable.

Table 3.A
Change in factors affecting private sector settlements between 1997/98 and 1998/99(a)

Change in balance

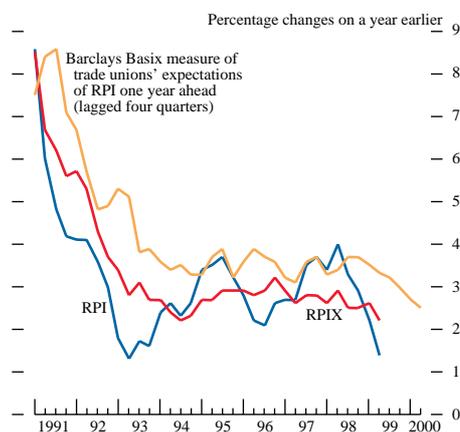
	Services	Manufacturing
Cost of living	-17	-17
Profits	-14	-13
Recruitment/retention	-5	-13
Orders	-3	-12
Ability to adjust prices	1	-4
Productivity	5	-1

Source: CBI Pay Databank Report.

(a) The table shows the change in the balance of firms identifying the factors shown as ‘very important’ upward pressures on settlements between 1997/98 (1.8.97–31.7.98) and 1998/99 (1.8.98–30.6.99).

The factors accounting for the decline in private sector settlements appear broadly based. Table 3.A, drawn from the CBI’s settlements survey, shows how firms’ views of the key influences on pay settlements have changed since last year. A reading of -17 against ‘cost of living’, for example, shows that the balance of firms identifying increases in the cost of living as a very important upward pressure on pay settlements has fallen by 17 percentage points between last year’s settlements round and this. In all but two of the categories in the table, pay pressures are perceived to have weakened compared with a year ago. Lower growth in orders and profits, and reduced concerns about recruitment and retention, have been key factors, but the most important single influence has been the fall in the growth of the cost of living, or inflation.

Chart 3.3
Actual and expected inflation



Sources: Barclays Basix survey and ONS.

Inflation affects nominal earnings growth in several ways. During pay negotiations, wage-bargainers need to form expectations of future inflation in order to assess the real value of pay offers. For a given rate of expected real wage growth, lower inflation expectations imply lower nominal wage growth. Inflation expectations will be influenced by various factors, in particular the credibility of the monetary policy framework, but also the cyclical position of the economy, and recent inflation outturns. As Chart 3.3 shows, current inflation and a representative survey measure of expected inflation have both fallen over the past year or so. Inflation outturns also affect the real value of the wage received over the past year relative to that anticipated a year ago. When inflation is higher than expected, real wage growth will

be correspondingly lower, which may put some upward pressure on settlements as wage-earners seek to recoup lost real income. In fact, as Chart 3.3 shows, inflation on the RPI measure has been rather lower than bargainers expected over the past year. So higher-than-expected real wage growth over the past year may also have been a factor reducing upward pressures on this year's settlements.

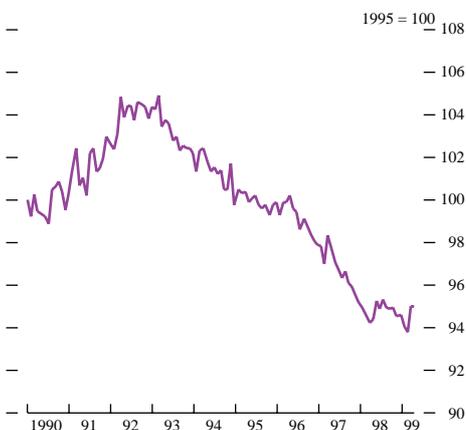
In addition to the basic wage settlement, recent growth in earnings per worker will have reflected many other influences, including changes in overtime and bonuses, and individual payments to meet the requirements of the National Minimum Wage (NMW). Annual growth in overtime has continued to fall, consistent with the slowdown in annual output growth. According to the Labour Force Survey (LFS), the average number of paid overtime hours per worker fell by 10% in the three months to May, compared with the same period a year earlier.

The recent behaviour of bonuses is less clear. A large part of the slowdown in the headline AEI measure between last summer and January this year reflected lower measured growth in bonuses, consistent with the weaker growth in profits in the preceding period. In February, however, the ONS changed the way in which bonus data are collected,⁽¹⁾ which—although beneficial in the longer term—means that neither the official data on annual bonus growth, nor those on annual growth in regular pay (calculated by subtracting measured bonuses from total pay), can be used as reliable indicators of the true bonus contribution to annual earnings growth until February 2000. The Bank's regional Agents report that, in some sectors and regions, where profits and orders growth have remained strong or where there have been persistent skill shortages, pressures to maintain bonuses remain. But overall, bonuses and other special payments appear to have been somewhat weaker in the first half of 1999 than they were in 1998, when bonuses were unusually strong. So lower bonuses have probably contributed to the further slowdown in annual earnings growth.

The slowdown in private sector earnings growth may also indicate a weaker-than-expected initial impact from the National Minimum Wage, which came into force on 1 April. The NMW affects about 1.9 million workers directly, and—assuming full implementation and no

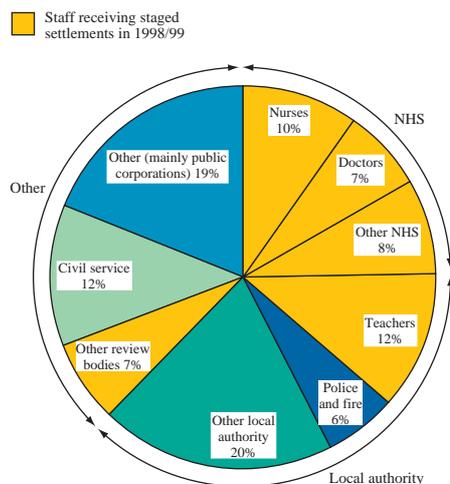
(1) Previously, firms were asked to report bonuses only when there had been a 'significant' change. Since February, they have been asked to report all bonuses paid.

Chart 3.4
Ratio of public sector to private sector earnings^(a)



(a) Based on official Average Earnings Index.

Chart 3.5
Public sector wage bill^(a)



Source: HM Treasury. Pay bill shares shown relate to 1996, the latest year for which complete data are currently available.

(a) Shares do not sum to 100% because of rounding.

other behavioural responses—would imply a rise of some 0.6% in the whole-economy pay bill. In previous *Reports*, the MPC assumed that the actual impact on the level of earnings in 1999 Q2 would be a little lower than this, as the effects of anticipation, substitution, mitigation and any non-compliance more than outweighed upward pressure from differentials restoration.⁽¹⁾ It is too soon to assess these assumptions against the outturns. The Average Earnings Index is unlikely to capture the full effect of the NMW, because a disproportionate number of those entitled to a pay rise from the NMW work in firms that are too small to be selected for the AEI sample. Nor do the latest hourly wage distribution data from the LFS—which cover the period March-May—provide a clear guide: it is unclear how much of the distribution reflects pay received after 1 April, and some LFS survey respondents are known to have a tendency to under-report average hourly pay levels. The ONS has a method of adjusting for this bias, but it requires data from the 1999 New Earnings Survey, and these will not become available until October. Given these uncertainties, the MPC has decided not to adjust its assumptions about the impact of the NMW on earnings growth in the central projection until a clearer picture emerges later in the year. But the risk of a more substantial upward effect has been removed.

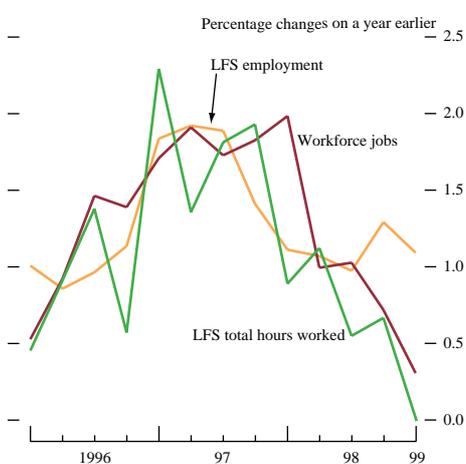
In contrast to the slowdown in private sector earnings growth, public sector pay growth has risen (see Chart 3.1). The pick-up in growth since mid 1997 may reflect something of a stabilisation in average relative pay rates, after a period in which average earnings in the public sector fell quite sharply compared with those in the private sector (see Chart 3.4). But the direct implications for RPIX inflation of these latest movements are likely to be relatively modest. First, although public pay was boosted in April by the implementation of the pay review body awards, some of the rise in the annual growth rate will be temporary, reflecting the fact that, whereas this year's awards were applied in full from April, many of last year's settlements were staged, with part of the settlement delayed until December 1998 (see Chart 3.5). This effect will unwind at the end of this year. Second, rises in public sector pay have little direct impact on measured inflation, because few public sector services are included in the RPIX basket. Third, the impact on domestic demand is unlikely to differ much from that already implied by the Government's published fiscal plans, as long as this year's pay awards do not

(1) Details of the MPC's assumptions regarding the NMW are given in the box on page 30 of the August 1998 *Inflation Report*.

cause the Government to overshoot its expenditure targets. Given the path of government spending, the effects on aggregate demand of a change in the share of this spending allocated to pay are likely to be limited. Finally, it is possible that the rise in public sector pay growth may put some upward pressure on private sector wages. Such effects may be stronger when the overall labour market is relatively tight, as it has been recently. But econometric evidence suggests that, over the past 20 years, changes in public sector pay have typically followed, rather than led, changes in private sector pay.

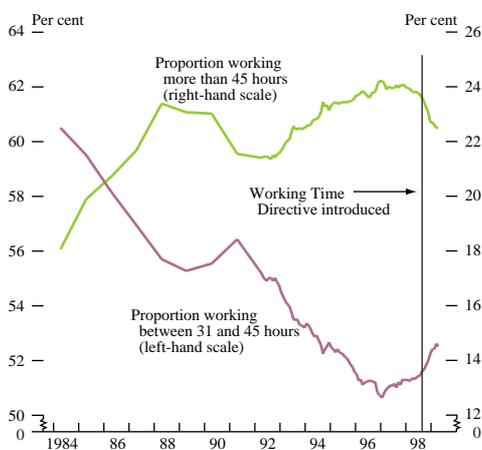
3.2 Employment and unemployment

Chart 3.6
Growth in employment and hours^(a)



(a) Workforce jobs data adjusted for a discontinuity in 1995. LFS growth rates are based on three-month averages centred around March, June, September and December, for comparability with Workforce jobs.

Chart 3.7
Distribution of employees' usual working hours^(a)

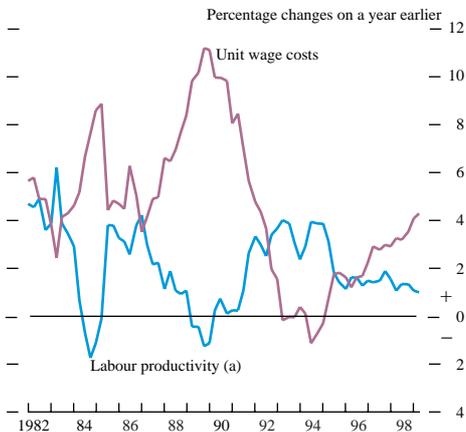


(a) Based on LFS data. Pre-1992 figures based on yearly observations.

The number of hours worked is in principle a better measure of labour usage. Growth in total hours worked has fallen more sharply than employment growth since the middle of last year (see Chart 3.6), reflecting a decline in average hours worked per person. The combination of flat or rising employment and falling average hours is likely to reflect a number of factors. First, the Bank's regional Agents report that, in some sectors and regions facing lower demand growth, firms have sought to avoid the costs of hiring and firing more highly skilled staff by cutting overtime and other hours rather than employment, in the expectation that demand would pick up again relatively soon. Second, since last summer there has been a slight rise in the share of employment accounted for by part-timers, who typically work about 40% of the hours of full-timers. And third, some of the decline since October in the share of employees working longer hours (see Chart 3.7) may

(1) A detailed account of these differences is given in 'Comparison of sources of employment data', *Labour Market Trends* (December 1997).

Chart 3.8
Growth in labour productivity and unit wage costs



(a) Official measure, defined as GDP at basic prices divided by the number of Workforce jobs.

reflect the effects of the introduction of the Working Time Directive, which places restrictions on working more than 48 hours a week.

The continued strength of employment in the face of the slowdown in annual demand growth implied a further decline in labour productivity growth in 1999 Q1, although the upward revisions to GDP, discussed in Section 2, have raised the level relative to previous estimates. Annual growth in the official measure of productivity per worker fell from 1.1% in 1998 Q4 to 1.0% in Q1. Hourly productivity growth has been rather higher in recent quarters, reflecting the more rapid slowdown in hours worked, but it also fell in Q1. The decline in productivity growth raised unit wage cost growth further, to 4.4% in Q1 (see Chart 3.8).

Since 1995, productivity growth has been below its long-run trend. There is no strong evidence that the trend growth rate has shifted. But the cyclical movements in productivity growth around this trend have been rather less pronounced during the 1990s, consistent with the possibility that changes in the structure of the labour market over the past two decades have given firms greater scope to vary both employment and hours worked in response to changes in current and expected demand. It is also possible that some of the slower growth in the second half of the 1990s reflects a one-off shift in the average level of productivity, consistent with labour market reforms encouraging new workers into the labour market. In its central projection, the MPC has attached some weight to both of these possibilities. Growth in productivity per worker is projected to rise back above its trend rate over the forecast period, but the level of productivity is expected to remain somewhat lower than that implied by previous trends.

Table 3.B
Surveys of sectoral employment intentions^(a)

Percentage balance of employers planning to recruit staff

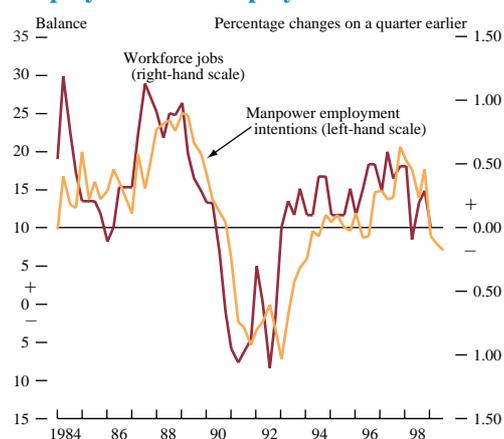
	Series average (b)	1998			1999	
		Q2	Q3	Q4	Q1	Q2
Manufacturing						
BCC (c)	2	10	0	-6	-6	2
CBI (d)	-17	-17	-31	-31	-26	-22
Services						
BCC (c)	12	20	15	15	12	16

Sources: BCC and CBI.

- (a) Seasonally adjusted by the Bank.
- (b) CBI averages from 1979; BCC from 1989.
- (c) Next three months.
- (d) Next four months.

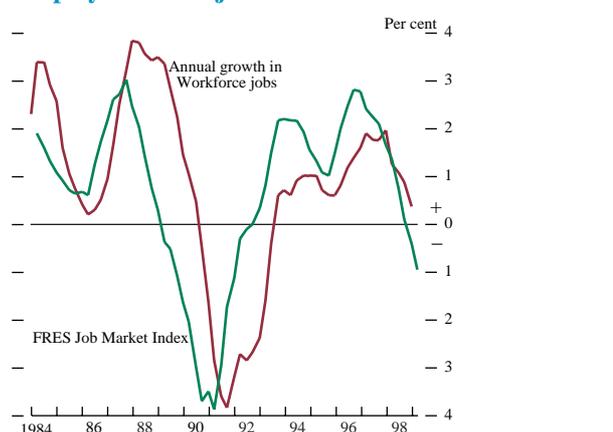
The short-run outlook for productivity growth partly depends on the path of employment growth. Surveys paint a mixed picture, but none suggests that a sharp fall in employment is likely over the next three to six months, and some indicate a modest recovery in expectations. Measures of firms' employment intentions from the British Chambers of Commerce and the Confederation of British Industry have picked up since the previous *Report* (see Table 3.B), and growth in demand for permanent and temporary staff across a range of sectors has recovered a little since the turn of the year, according to the Federation of Recruitment and Employment Services (FRES). But both the Manpower survey of employment intentions and the FRES Job Market Index, which combines data on national

Chart 3.9
Employment and employment intentions



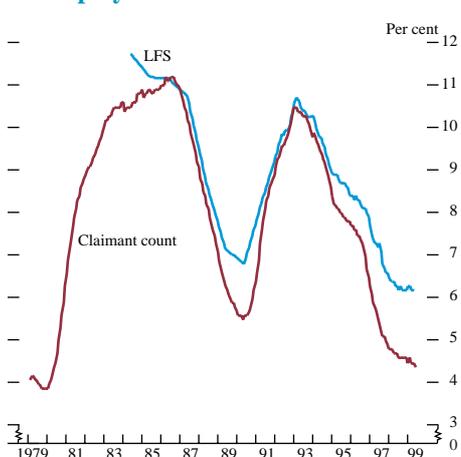
Sources: Manpower and ONS. Manpower series seasonally adjusted by the Bank.

Chart 3.10
Employment and job vacancies



Sources: FRES and ONS.

Chart 3.11
Unemployment rates



Note: Pre-1992 LFS figures based on yearly observations.

newspaper recruitment advertising with figures on the number of vacancies at Jobcentres,⁽¹⁾ remain consistent with a small decline in whole-economy employment in the coming months (see Charts 3.9 and 3.10).

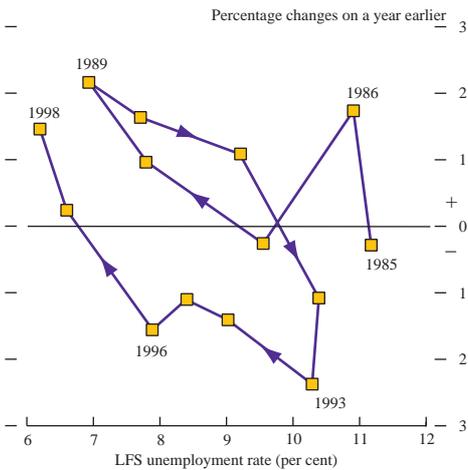
Pay pressures are influenced by, among other things, the gap between the demand for, and the effective supply of, labour. Although increments to the labour supply are typically drawn from those without work, not all of these people exert the same degree of influence on wages. In its central projection, the MPC pays particular attention to those searching for, and available for, work. The LFS unemployment rate—a measure of the size of this group—has remained broadly stable since last summer at around 6.2%, lower than the previous cyclical trough in 1990. The claimant count rate, another measure of unemployment based on the number of people receiving benefit and available for work, was 4.4% in June, close to 20-year lows (see Chart 3.11). Recent unemployment outturns have been lower than expected at the start of the year, and most external forecasters have lowered their projections for the path of unemployment over the next two years.

Earnings growth has been unexpectedly weak, given the persistently low level of unemployment. As discussed above, much of the decline in nominal earnings growth since last summer reflects lower inflation expectations and the cyclical decline in profits, productivity and output growth, rather than the direct impact of labour market conditions. Growth in real unit labour costs—nominal earnings and other labour costs adjusted for inflation and productivity—has continued to pick up, consistent with some upward pressure from labour market tightness. But, for given rates of unemployment, real unit labour cost growth has been considerably weaker in the 1990s recovery than it was at a similar point in the previous cycle (see Chart 3.12). It is possible that this reflects a decline in the equilibrium rate of unemployment, consistent with labour market reforms and structural changes in the economy over the past two decades. But it is impossible to say with any certainty where this rate currently lies.

Another potential reason for the weakness of real earnings growth relative to unemployment is that unemployment may be an inappropriate summary measure of wage pressure, because it takes inadequate account of the heterogeneity of the labour market. For

(1) FRES have adjusted the Jobcentre data used in their measure for a number of known reporting difficulties.

Chart 3.12
Unemployment and growth in real unit labour costs^(a)



(a) Real product wage divided by official measure of labour productivity.

Table 3.C
Probabilities of becoming employed in next three months^(a)

Per cent

Unemployed

Unemployed less than six months	35.1
Unemployed six to twelve months	23.6
Unemployed more than twelve months	11.0

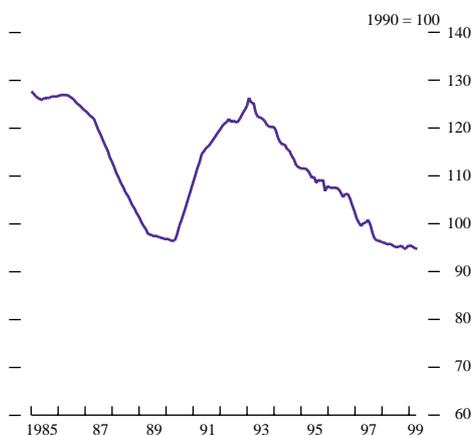
Inactive

Searching for, but unavailable to start, work	23.3
Discouraged (wants a job but not searching because believes none available)	7.1
Wants a job but not searching for some other reason	5.4
Doesn't want a job	3.5

Source: *Employment Policy Institute Employment Audit*, Issue 7, Spring 1998. Based on LFS panel for 1995/96.

(a) Figures in the table show the proportion of each group of non-employed in spring 1995 who were in employment three months later.

Chart 3.13
A weighted measure of non-employment^(a)



Sources: LFS and Bank calculations.

(a) Weighted sum of the number of people in seven categories of non-employment, where the weights are the transition rates of each category into employment relative to the transition rate of those unemployed for six months or less. The series shown is expressed as a 'weighted non-employment rate'.

example, the short-term unemployed may place more downward pressure on wages than the longer-term unemployed, to the extent that they have more of the up-to-date skills and experience currently valued by employers. While aggregate unemployment has been flat or falling compared with a year ago, the number of those in short-term unemployment (of a year or less) has risen a little, according to the LFS. Pay pressures may also be influenced by those who say they want a job but are not currently available for work, and other groups classed as 'economically inactive' rather than unemployed, who collectively account for more than three quarters of non-employment among people of working age.

Table 3.C illustrates how the likelihood of becoming employed varied for different groups of the unemployed and inactive in spring 1995. For example, the first row shows that 35% of those who had been unemployed for less than six months at the start of the period were in employment three months later. Overall, the unemployed were much more likely to become employed than the inactive. But the shorter-term unemployed were much more likely to find a job than the long-term unemployed. And all of those classed as inactive had some positive chance of entering work, with one group in particular—those actively searching but not currently available for work, including students—being more likely to find a job than those who had been unemployed for more than twelve months. These probability rates vary over the cycle, and could also be affected by policy changes such as the Working Families Tax Credit, which comes into effect in October and is designed to increase the number of people willing to move into work from inactivity by increasing the incentive to work. But the relative transition rates between the groups may be somewhat more stable over time. An alternative measure of unemployment, which weights together the number of people in each group using the probabilities shown in the table relative to the probability that someone unemployed for six months or less will find a job, is shown in Chart 3.13. The measure has not fallen quite as far relative to the previous trough as unemployment. But the difference is small. On this measure too, labour market conditions appear to be tight by recent historical standards.

3.3

Summary

Nominal earnings growth has eased. Private settlements have fallen significantly, reflecting the influence of lower

inflation expectations and slower growth in profits and output. Overtime payments are lower than a year ago, and bonuses appear to have fallen. In the light of this, the MPC has lowered the short-term profile for nominal earnings growth in the central projection.

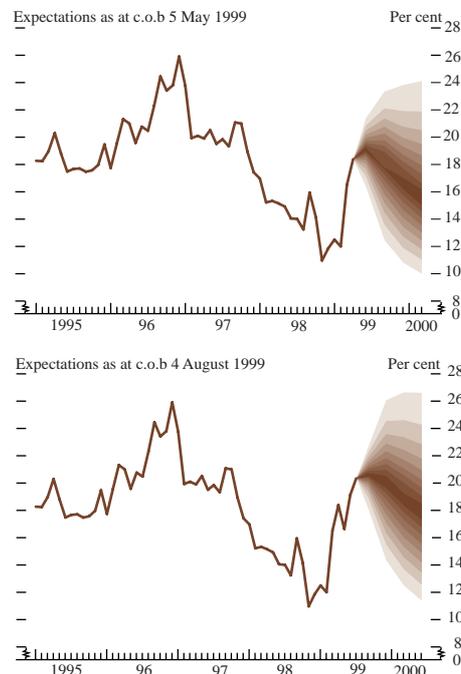
While nominal earnings growth has eased, unemployment has remained close to 20-year lows, and the outlook for employment has improved somewhat since May. As demand growth picks up, a central question for the inflation outlook is the extent to which the available capacity in the labour market will allow growth in employment and hours worked to rise, before triggering renewed inflationary pressures on pay. It is possible that the relative weakness of real earnings growth, given the low levels of unemployment, indicates somewhat greater labour market capacity than previously thought, perhaps reflecting the impact of government reforms and structural changes over the past 20 years. But there is very considerable uncertainty about the potential size of any such effect. The Committee's judgments on the medium-term outlook for earnings are discussed in more detail in Section 6 of this *Report*.

Chart 4.1
Brent crude oil prices



Source: International Petroleum Exchange.

Chart 4.2
Implied distribution for oil prices^{(a)(b)}



Sources: NYMEX and Bank of England.

- (a) Derived from options prices for West Texas Intermediate oil (WTI). Prices for WTI tend to be around \$1 per barrel higher than those for Brent crude oil.
- (b) The charts depict the probability distributions for oil prices at two particular dates, and are rather like contour maps. At any given point, the depth of shading represents the height of the probability density function implied by the markets over a range of outcomes for oil prices. The markets judge that there is a 10% chance of oil prices being within the darkest, central band at any date. Each successive pair of bands covers a further 10% of the distribution until 90% of the distribution is covered. The bands widen as the time horizon is extended, indicating increased uncertainty about oil price outcomes.

RPIX inflation fell below target in Q2, primarily reflecting movements in import prices and earnings growth. The prices of oil and a number of other commodities have risen since the *May Report*, although many remain below their levels a year ago. Import prices remain subdued, though their annual rate of decline has slowed. Similarly, UK manufacturing producer prices have fallen less sharply since the end of 1998. But survey indicators suggest that the rise in costs and prices in the service sector has moderated.

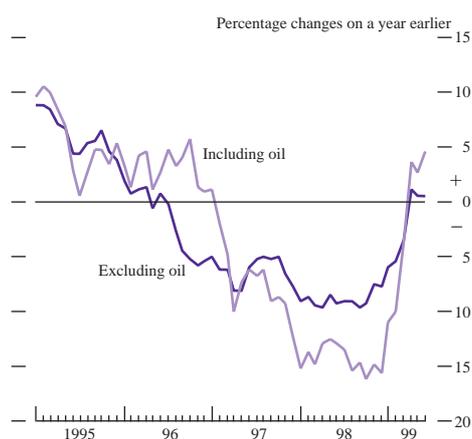
4.1 Raw materials and commodity prices

Oil prices rose further in the past three months, and are well above the low recorded in December 1998. Prices for Brent crude oil rose to more than \$19 in July, from around \$16 at the time of the *May Report* (see Chart 4.1). This increase reflected higher prospective world demand growth, recent estimated declines in oil stocks, and changing market perceptions of likely future oil supply. The latter have been affected by reports of greater compliance by OPEC members with the organisation's production quotas.

Probability distributions of expected oil prices derived from options prices are shown in Chart 4.2. They show that, despite recent sharp oil price movements, the degree of uncertainty about the level of future oil prices has remained broadly unchanged since the *May Report*. In line with market views, the MPC has assumed that some of the rise in oil prices which occurred in July will persist. But part of the recent increase is attributed to short-term factors that are expected to reverse quickly.

World prices for non-oil commodities in 1999 Q1 were well below their levels a year earlier. Prices of many of these commodities had begun to rise by the spring, though the increase in prices was generally smaller than for crude oil. Price rises were also more marked for hard commodities, such as metals, than for soft commodities, such as agricultural products. But the rise in prices was sufficient for the Bank's non-oil commodity price index to have recorded positive annual inflation rates in 1999 Q2 for the first time since mid 1996 (see Chart 4.3).

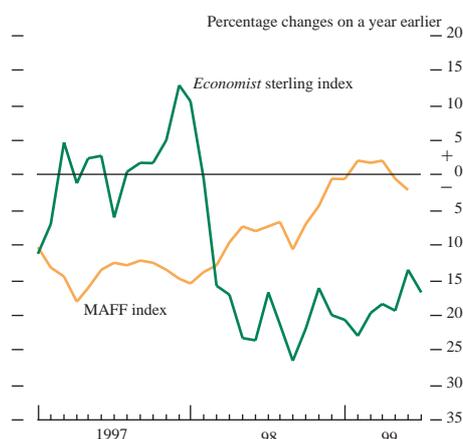
Chart 4.3
Bank sterling commodity price indices^(a)



Source: Bank of England.

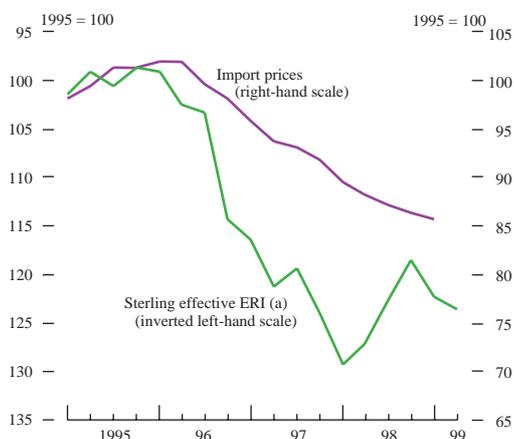
(a) Monthly average of prices of primary commodities, weighted by their importance in UK demand.

Chart 4.4
Food price indices



Sources: The *Economist* and MAFF.

Chart 4.5
Sterling import prices and the exchange rate



Note: The exchange rate index (ERI) is measured against 20 other industrialised countries.

Sources: ONS and Bank of England.

(a) A fall indicates an appreciation.

The *Economist* index of sterling non-oil commodity prices was rather weaker than the Bank's index in the second quarter. The *Economist* index was 1.1% higher in the three months to June than in the previous three months, but 10.3% below its level in the same period a year earlier. The difference between the two indices partly reflects differences in coverage. The two indices also have different weights, with those in the Bank's index reflecting UK demand patterns while the *Economist* index is weighted by OECD imports. This particularly affects the treatment of food in the two indices. Wholesale food prices have a higher weight in the Bank's index than in the *Economist* index, and the Bank's measure of food prices has experienced less marked deflation than the *Economist* measure of world food prices (see Chart 4.4). Furthermore, the Bank's measure is derived from Ministry of Agriculture, Fisheries and Food (MAFF) agricultural prices, which reflect the effects of the Common Agricultural Policy (CAP) in moderating the extent to which changes in world food prices affect UK wholesale prices.

The World Bank and the Economist Intelligence Unit project lower average non-oil dollar commodity prices in 1999 than in 1998. But the rise in prices in recent months, particularly for hard commodities, is consistent with their projections of an increase in prices in the second half of 1999 and through 2000, as global demand strengthens and stock overhangs are eroded. The MPC's central projection is broadly in line with these views.

4.2 Import prices and the exchange rate

Sterling import prices were 0.7% lower in 1999 Q1 than in 1998 Q4, and 4.1% lower than in the first quarter of 1998. This continued fall reflected a further marked decline in imported goods prices in Q1, which were 5.6% below their levels a year earlier. Imported services prices were 1.5% higher on the same comparison. But the annual rate of decline in overall import prices has moderated since 1998 Q3, and monthly data on international trade suggest that goods import prices may have stabilised in 1999 Q2.

Sterling import prices for goods and services fell by 14% between 1996 Q3 and 1999 Q1. The extent of the fall in sterling import prices was less than might have been expected given the marked sterling exchange rate appreciation over this period (see Chart 4.5), particularly since world export prices fell in local currency terms in 1997 and 1998. Previous *Reports* have noted the

possibility that full transmission of the exchange rate appreciation may have been delayed by some overseas producers choosing initially to hold the price of their exports to the United Kingdom unchanged in sterling terms, as their currencies depreciated against sterling. That might have reflected overseas producers' uncertainty about the persistence of the higher sterling exchange rate.

Some further pass-through of the effects of past exchange rate appreciation may therefore act to dampen sterling prices for UK imports. But the MPC's central projection assumes that any such lagged exchange rate effects are more than offset by factors such as projected rises in commodity prices and world export prices, as global demand recovers. Hence sterling import prices are projected to begin rising in the coming quarters.

4.3 Costs and prices in manufacturing

Chart 4.6
Producer price inflation

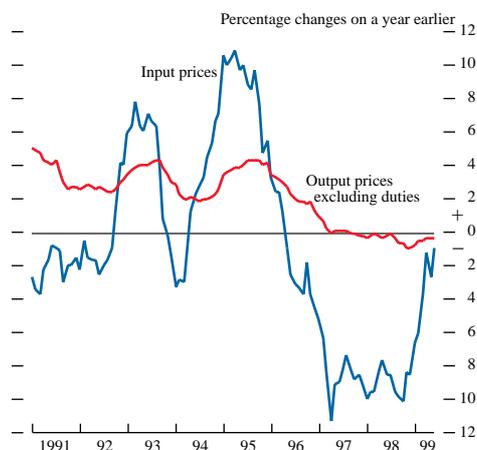


Table 4.A
Manufacturers' costs and prices

Percentage changes on a year earlier

	1998			1999				
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May
Weighted costs (a)	-0.5	-0.8	-0.5	0.0	-0.3	0.1	0.6	-0.4
Unit labour costs (46.8%)	3.8	2.1	2.6	2.4	1.6	1.1	0.9	-0.1
Materials and fuels (30.1%) (b)	-10.1	-8.3	-8.5	-6.7	-6.0	-3.7	-1.2	-2.8
Imports of finished goods (6.9%)	-5.4	-4.4	-4.3	-3.2	-3.3	-2.1	-2.2	-3.3
Bought-in services (16.2%)	2.5	2.7	3.0	3.0	3.0	3.0	3.0	2.9
Output prices	-0.7	-0.9	-0.9	-0.8	-0.5	-0.5	-0.3	-0.3

Sources: ONS and Bank of England.

(a) Percentages shown in brackets reflect weights of components, derived from 1990 input-output tables for the United Kingdom.

(b) Includes imports of semi-finished goods.

Prices of inputs to manufacturing industry remain below their levels a year earlier (see Chart 4.6). However, the annual rate of decline in input prices slowed to 1.7% in 1999 Q2, from 5.5% in 1999 Q1 and an average decline of 9.1% in 1998. That partly reflects the recent rise in oil prices, which directly account for around one tenth of the index. These data were consistent with survey measures such as the Chartered Institute of Purchasing and Supply (CIPS) index of prices paid by manufacturers. This index rose in Q2, though it remained at a level which suggested that input prices continued to decline. Reports from the Bank's regional Agents also suggest that the downward pressure on manufacturers' input prices may be moderating.

Manufacturing output prices rose markedly in March and April, mainly reflecting the effect of higher duties introduced in the 1999 Budget. Excluding these duties, output prices rose slightly in the three months to June, and were a little below their level a year earlier (see Chart 4.6). Excluding volatile components such as food, drink, tobacco and petrol, output prices were broadly unchanged in the first half of 1999. By contrast, the CBI quarterly Industrial Trends survey suggested steeper declines in output prices in July compared with April.

Manufacturers' weighted costs in recent months have risen above their levels a year earlier, though they fell back somewhat in May (see Table 4.A). The implications of this rise for future output prices will depend on the behaviour of manufacturers' price

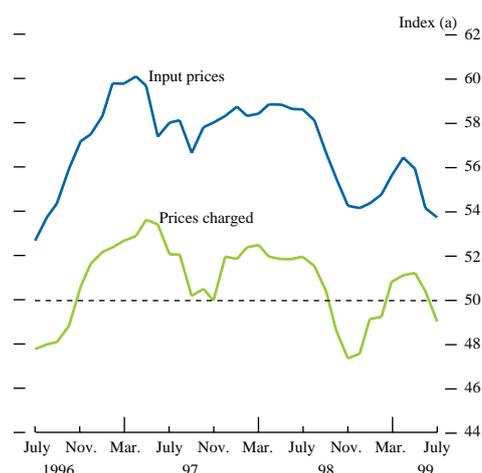
mark-ups over these weighted costs. Research at the Bank has shown that mark-ups tend to move procyclically with economic activity in the United Kingdom, but the full effects of any change in activity are only felt with a lag.⁽¹⁾ Hence the effect of the past slowdown in economic growth may limit the degree to which cost increases are reflected in higher manufacturing prices in the coming months. Reports from the Bank's regional Agents suggest that international competition is also limiting manufacturers' ability to increase their price mark-ups over costs.

4.4 Costs and prices in the service sector

The CIPS indices of input prices and prices charged in the service sector both remained above the neutral level of 50 in the three months to July, signifying a net balance of respondents reporting price increases. But the levels of the CIPS indices suggested that the strength of inflation in service sector costs and prices eased in recent months (see Chart 4.7). The British Chambers of Commerce (BCC) quarterly economic survey also reported muted inflationary pressure. The balance of service sector firms reporting likely price increases in the coming three months fell markedly in Q2. The lower balance reflected declines in the number of firms expecting upward pressure on prices from pay settlements, raw materials costs or financial costs.

The ONS corporate services price indices, which remain under development, pointed to lower inflation in 1999 Q1 in some services. The indices are similar in concept to the components of the ONS manufacturing output prices index. Of the twelve sub-series that are currently published, seven categories of business services recorded lower inflation in 1999 Q1 than in 1998 Q4, one showed no change and four suggested higher inflation.

Chart 4.7
CIPS services survey



Source: Chartered Institute of Purchasing and Supply.

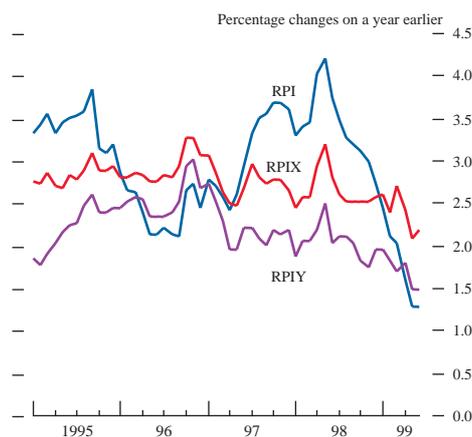
(a) An index level above/below 50 indicates a rise/fall.

4.5 Retail prices

Inflation in retail prices excluding mortgage interest payments (RPIX) fell to 2.1% in May, though it rose to 2.2% in June. RPIX inflation in 1999 Q2 as a whole was 0.2 percentage points below the government's target of 2½%, and below expectations at the time of the May *Report*. Services price inflation remained at 3.3% throughout Q2, just below the average for Q1. Hence most of the decline in RPIX inflation has been

(1) Small, I (1998), 'The cyclical nature of mark-ups and profit margins', *Quarterly Bulletin*, August, pages 267–73.

Chart 4.8
Retail price inflation^(a)



RPIX = Retail price index excluding mortgage interest payments.
RPIY = RPIX excluding VAT, local authorities' taxes and excise duties.

(a) Adjusted by the Bank of England for ONS error in under-recording aggregate price indices between February and May 1995. Other charts and tables in this Report that include measures of retail price inflation are similarly adjusted.

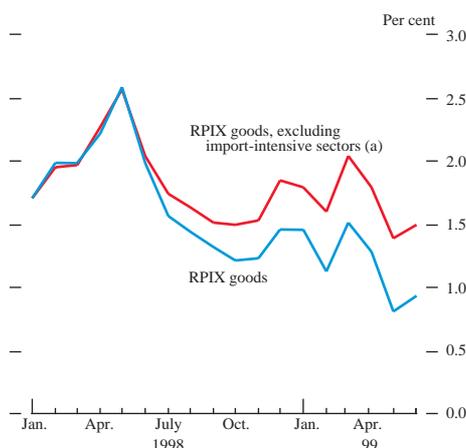
Table 4.B
Effect on RPIX inflation rate of recent fiscal measures^(a)

Date of effect	Changes in tax and duty (b)	Percentage points	
		Effect of each measure	Cumulative effect
1999 Mar.	Road fuel	0.26	0.26
Mar.	Tobacco	0.16	0.42
Mar.	Vehicle excise duty	0.02	0.44
Apr.	Road fuel (1998 Budget)	-0.28	0.16
June	Removal of vehicle excise duty on small cars	-0.02	0.14
July	Insurance premium tax	0.02	0.16
Dec.	Tobacco (1998 Budget)	-0.19	-0.03
2000 Jan.	Alcohol (1998 Budget)	-0.04	-0.07

Sources: ONS and Bank of England.

(a) Table shows direct effect of tax changes, assuming complete pass-through into retail prices.
(b) Changes relate to measures outlined in 1999 Budget, unless otherwise stated.

Chart 4.9
Retail goods price inflation



(a) 'Import-intensive' sectors are defined as those non-food sectors producing consumer goods and services where more than two thirds of the sector's inputs originate as imports. They correspond to the following components of the RPI: electrical appliances, other household equipment, clothing and footwear, chemists' goods, motor vehicle purchase, audio-visual equipment, CDs and tapes, toys, photographic equipment and sports goods.

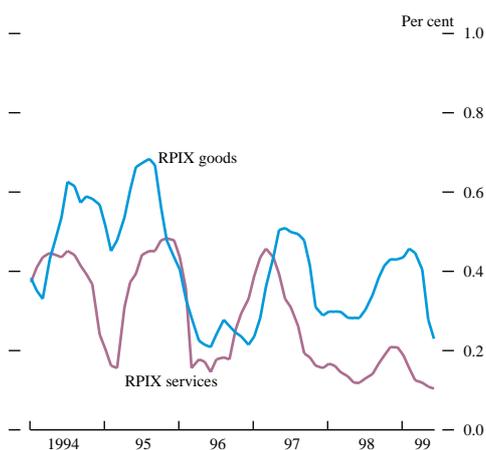
attributable to a fall in goods price inflation, to 1.0% in Q2 from 1.3% in Q1. Annual growth in other key retail price indices also slowed in Q2 (see Chart 4.8). Inflation in RPIY, which also excludes indirect and local authorities' taxes, fell to 1.6% in Q2. The headline RPI inflation rate fell to 1.4% in Q2, reflecting lower interest rates and hence lower mortgage interest payments.

The decline in the rate of goods price inflation partly reflected temporary factors. One was the direct effect of changes in duties on RPIX (see Table 4.B). The May Report noted that higher indirect tax rates following the 1999 Budget had increased RPIX inflation to 2.7% in March. As expected, most of the rise was reversed in Q2, owing largely to the 1998 increase in road fuel taxes dropping out of the calculation of the annual inflation rate. Other fiscal measures from 1998 will drop out later this year, and these are expected to make a further negative contribution to RPIX inflation in December 1999 and January 2000.

Recent declines in import prices were also important in dampening inflation in 1999 Q2. Certain non-food components of the RPIX correspond closely to the most import-intensive sectors of the UK economy. Changes in these RPIX components can account for much of the fall in RPIX inflation between March and May that was not explained by changes in duties. Chart 4.9 shows the influence of price declines in these sectors on RPIX goods price inflation since mid 1998. But prices in import-intensive sectors, as in other sectors, will have been affected in Q2 by the cost of domestic inputs as well as imported inputs. In particular, cost pressures may have been reduced by slower growth in earnings. Import prices are expected to contribute positively to RPIX inflation by the end of the forecast period, consistent with the MPC's assumption that sterling import prices will begin to rise in the coming quarters. The associated exchange rate assumption, as well as the prospects for earnings growth, is discussed in Section 6 of this Report.

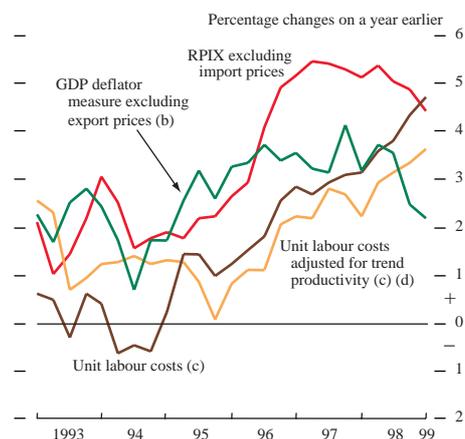
The volatility of retail services price inflation has tended to be lower than that of goods price inflation, and has fallen since 1997 to its lowest level on record (see Chart 4.10). One explanation for this is that the service sector is less import-intensive than the goods sector. It is therefore less affected by international shocks such as fluctuations in the exchange rate and movements in overseas producer prices, so that services prices may

Chart 4.10
Standard deviation of inflation^(a)



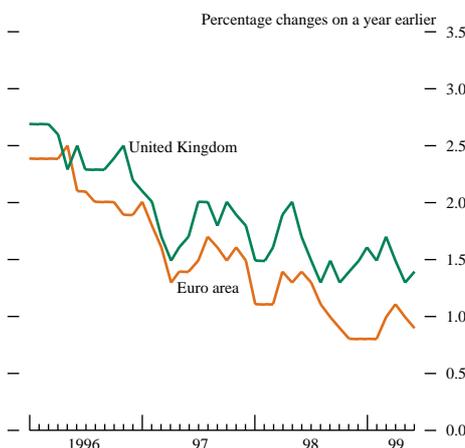
(a) Rolling twelve-month backward-looking standard deviations of annual inflation rates, for RPIX goods and RPIX services.

Chart 4.11
Measures of domestically generated inflation^(a)



(a) All four measures were affected by the revisions to the UK National Accounts that were published on 29 July 1999.
(b) Using GDP measured at market prices.
(c) Using National Accounts measures of employee compensation and productivity growth. The construction of the two unit labour costs series shown in the chart has changed since the *May Report*. They are now based on a measure of employees in the workforce, which has been adjusted by the Bank of England for a break in the series in mid 1995.
(d) Adjusted using long-run trend productivity growth of 2%.

Chart 4.12
HICP inflation



provide a better reflection of trends in domestic inflationary pressure than goods prices. However, services prices do have some import content and goods prices are also influenced by domestic pressures. So other measures of domestically generated inflation (DGI) are constructed in an attempt to strip out international influences on UK goods and services prices. These measures continue to give mixed signals about the direction of domestic inflationary pressure (see Chart 4.11).

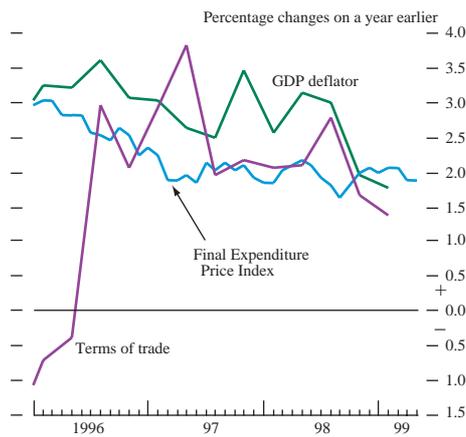
4.6 Other price indices

The Harmonised Index of Consumer Prices (HICP), which is directly comparable with the harmonised inflation measures of other EU Member States, differs from RPIX in its coverage and method of construction.⁽¹⁾ HICP inflation stood at 1.4% in June, compared with 0.9% in the euro area. The gap between UK and euro-area inflation has widened in recent months, but it remains narrower than in the second half of 1998 (see Chart 4.12).

Annual growth in the GDP deflator at market prices, a quarterly measure of whole-economy inflation, fell to 1.8% in 1999 Q1, from 1.9% in 1998 Q4. An alternative, monthly measure of whole-economy inflation has been developed on an experimental basis by the ONS, called the 'Final Expenditure Price Index' (FEPI). Whole-economy inflation as measured by the FEPI was close to 2.0% in the past three quarters. One way in which the FEPI differs from the GDP deflator is in its coverage of the external sector, since it is a deflator for final domestic expenditure rather than gross domestic product. The FEPI thus excludes export prices but implicitly includes import prices, whereas the GDP deflator includes export prices and excludes import prices. Correspondingly, any difference in inflation as measured by the two indices may be affected by movements in the terms of trade, ie the ratio of export prices to import prices. Annual growth in the terms of trade has been positive since 1996 Q3, when sterling began to appreciate. Hence annual growth in the FEPI in each quarter has tended to be lower than inflation as measured by the GDP deflator, though other compositional differences between the two indices meant that in 1999 Q1 the reverse was true (see Chart 4.13).

(1) Further details on the construction of the HICP were set out in the February 1999 *Inflation Report* (page 38) and in *Economic Trends*, December 1998.

Chart 4.13
Whole-economy measures of inflation



4.7

Summary

RPIX inflation fell below target in 1999 Q2, and was lower than projected in the *May Report*. Import prices and earnings growth were both lower than expected. Retail services price inflation was stable in Q2, and survey measures suggest that producer price inflation in the service sector eased. But there were signs that the rate of decline in manufacturing producer prices moderated in Q2, and that import prices may have stopped falling in recent months. After declining further than expected in the early part of the year, prices for non-oil commodities have stabilised in recent months, according to the Bank's commodity price index. Non-oil commodity prices are expected to rise in the second half of 1999 and beyond, as global demand strengthens. Some of the recent sharp increases in oil prices may not be sustained, but the MPC now assumes that a higher oil price will prevail over the next two years than was assumed in the *May Report*. Hence although RPIX inflation is projected to remain below target in the short term, some external factors that have been exerting downward pressure on inflation may soon cease to do so.

This section summarises the economic developments and the monetary policy decisions taken by the MPC since the *May Report*. The minutes of the May, June and July meetings are attached as an Annex to this *Report*. The Bank of England's official dealing rate was reduced from 5.25% to 5% in June, and was maintained at that level in July and August.

The MPC's central projection in the *May Report* was for GDP growth to pick up to around trend by mid 2000, with the risks broadly balanced around this central case. The central projection was for RPIX inflation to fall slightly below target over the next year or so, before rising to around 2.5% at the two-year forecast horizon. On the assumption that the exchange rate was likely to fall by more than implied by interest rate differentials, the balance of risks to inflation was judged to be on the upside. But some Committee members saw greater downside risks to inflation from a stronger exchange rate profile, weaker world activity and prices, and greater pressure on margins, than in the central projection. The *Report* noted that, if sterling did not fall as assumed in the central projection, then, depending on other developments in the economy, further easing of monetary policy might be required to prevent undershooting of the inflation target.

At its meeting on 9–10 June, the Committee noted that sterling had been volatile over the month, but had on average remained at broadly the same value as at the time of the May Committee meeting, and somewhat above the level implied in the central assumption of the *May Report*. The Committee discussed the possible reasons for sterling's movements against the major currencies.

The Committee agreed that the latest data on demand and output had been broadly consistent with the May central projection, but household consumption in Q1 had been a little stronger, and net trade a little weaker, than anticipated. House price inflation had picked up and surveys of consumer and business confidence had continued to improve, although contacts of the Bank's regional Agents reported a more fragile recovery in sentiment. The National Accounts measure of

companies' operating profits had fallen sharply in Q1, but much of this appeared to reflect a statistical adjustment and was therefore more than usually uncertain.

The Committee discussed developments in costs and prices. RPIX inflation appeared to be running below expectations. World commodity prices had picked up somewhat, but indicators of wage pressures remained mixed. Earnings growth in the year to March, as measured by the Average Earnings Index, had been in line with the *May Report*. Private sector settlements had fallen in April, but public sector settlements had risen, reflecting the implementation of the pay review body awards.

The Committee considered the arguments for a reduction in the repo rate. Sterling had been stronger than the path incorporated in the *May Report*. If this persisted, inflation would be more likely to fall below target than had been projected in May. Private sector wage settlements had continued to fall, and RPIX inflation had been slightly weaker than projected. Surveys of households and businesses, and evidence from the Bank's regional Agents, suggested that the recovery in confidence was not yet robust. On another view, however, there was no convincing case for a cut in the repo rate. The value of sterling on the day of the meeting was not very different from that assumed in the May central projection. News on developments in the domestic and world economies was broadly neutral or slightly positive. And the fall in RPIX inflation had little implication for the projection two years out. After weighing these arguments, the Committee voted to reduce the repo rate by 25 basis points to 5%.

At its meeting on 7–8 July, the Committee noted that sterling had fallen a little over the month, and the effective exchange rate index was now close to the central assumption in the *May Report*. Prospects for growth in the world economy had strengthened a little. Forward-looking activity indicators in some euro-area countries had picked up, and US growth had remained robust, although arguably the uncertainties over the future path of the US economy had increased. World commodity prices had continued to rise.

The Committee agreed that the news on domestic activity over the previous month suggested that the projected recovery seemed to be under way, and was, if anything, a little faster than expected. Final domestic

demand in Q1 had been revised up; consumption growth in particular now looked rather higher than had been expected, even after adjusting for special factors. Employment had continued to grow, and the possibility of a substantial rise in unemployment appeared to have diminished. Estimates based on surveys and other published data suggested that GDP growth in Q2 could be marginally higher than envisaged in the May central projection.

The Committee noted that, though activity appeared to have strengthened a little, recent data on prices and wages had been somewhat weaker than anticipated in the *May Report*. RPIX inflation had fallen, and nominal private sector pay growth appeared to be slowing. Possible reasons for this weakness were discussed.

The Committee considered its immediate policy decision. The exchange rate had eased slightly, and the outlook for domestic and international activity had improved somewhat since the previous meeting. But price indicators had been weaker than expected. A key question for policy was whether these movements would prove to be temporary or persistent. This would need to be considered more thoroughly as part of the August *Inflation Report* round, when more data would also be available to help assess the likely direction of future price pressures. In the light of these considerations, the Committee voted to maintain the repo rate at 5%.

At its meeting on 4–5 August, the Committee voted to leave the repo rate unchanged at 5%.

6.1 The inflation projection assumptions

The Committee approved this *Report* on 6 August. It contains the Committee's assessment of developments in the economy since May, and prospects for the medium term. Charts 6.1 and 6.2 below show projections for GDP growth and RPIX inflation up to two years ahead, and the uncertainties surrounding them.⁽¹⁾ The projections assume that the Bank's repo interest rate will remain unchanged at 5% during the next two years, and are conditioned on the assumptions described below.

There has been a further moderate improvement in the prospects for world activity since the *May Report*. Growth in the United States has remained robust and the outlook for activity appears stronger than three months ago. Output growth is expected to ease gradually, although the timing and extent of the slowdown remains difficult to gauge. Business sentiment in the euro area has improved over the past three months, and there are more signs of a prospective recovery in growth. And, while much of the unexpected growth in GDP in Japan in 1999 Q1 probably reflected temporary factors, the outlook nonetheless appears a little brighter. Outside the major industrial countries, prospects for many emerging Asian and Latin American economies have improved over the past three months. Taking these developments together, the MPC has made a further small upward revision to the central projection for global activity. Growth in UK-weighted export markets is now assumed to rise from almost 5% in 1999 to near 6% in 2000. But, as in recent projections, UK exports are likely to grow less quickly than export markets in the short term, as the effects of the past appreciation of sterling continue to filter through.

There are a number of risks to the world outlook. For example, the US economy could slow more rapidly than projected, should asset prices fall and domestic demand growth falter. Trade imbalances among the major economies have widened further. Fragilities remain in some emerging markets. Interest rate spreads on emerging market debt over US Treasuries have edged up

(1) A box assessing the MPC's inflation forecasting record is appended on page 55.

since the *May Report*. So, although the Committee has raised the central projection for world activity, risks around this projection are judged to be weighted to the downside.

Although world activity in the early months of the year was stronger than expected in the *May Report*, inflationary pressures were somewhat weaker. Non-oil commodity prices were lower in the first quarter than assumed three months ago. Moreover, the price of manufactured export goods continued to fall, against earlier expectations of a slight rise. Lower-than-expected world inflation was reflected in UK import prices falling by more than projected in May.

The period of falling world prices may, however, be coming to an end. The prices of some important non-oil commodities have risen in recent months—and commodity-related equities and currencies are signalling upward pressure on prices. Drawing on information from external forecasts, the central projection is based on an assumption that non-oil commodity prices gradually recover from their low point in the first half of 1999. Oil prices have been stronger than expected in the *May Report*, as market conditions have tightened. The central assumption for the oil price has consequently been increased by \$2 per barrel to around \$17 per barrel for Brent crude, although the Committee also noted that the Brent price has risen above \$19 per barrel in recent weeks and that there was a risk that this higher level could be sustained. As world activity strengthens and higher commodity prices gradually feed through, prices of traded goods and services may start to edge up. The rise in world prices from now on may be a little stronger than assumed in the May projection, given the improved outlook for activity. But any pick-up is likely to remain modest, given excess capacity in the production of some key manufactured goods and commodities at the global level. The rise will, moreover, be from a lower starting-level. The outlook for UK import prices will be affected by the changing profile for world prices as well as by the prospects for the sterling exchange rate.

The sterling exchange rate, as measured by the effective exchange rate index (ERI), averaged 103.1 in the 15 working days up to and including 4 August. This forms the starting-point for the exchange rate profile assumed in the projection. It compares with a starting-point of 104.0 at the time of the *May Report* and is slightly below the implied level of 103.4 for August.

As in previous *Reports*, assumptions about the path of sterling in the central projection are linked to the pattern of market interest rate differentials—in turn adjusted for the conventional forecast assumption that UK interest rates are held constant. On this basis, the sterling ERI declines to 96.6 by the end of the two-year forecast period, consistent with bilateral sterling exchange rates of about \$1.56 and 0.71 against the euro (equivalent to DM 2.75). That is a steeper decline than in May. Risks around this central projection are assumed to be symmetric.

There are, however, differences of view within the Committee on the appropriate conditioning assumption for the exchange rate path. Some Committee members preferred an alternative approach, consistent with the random walk hypothesis, of assuming a constant nominal exchange rate at the current level as the basis for the central projection. On this alternative assumption for the exchange rate, RPIX inflation would be 0.4 percentage points lower than in the central case at the two-year horizon and four-quarter GDP growth would be some 0.2 percentage points lower.

The fiscal plans announced by the Chancellor in the March Budget were incorporated into the May projections. These figures remain the basis for the August projections.

Previous projections have already incorporated assumptions about the effects of the National Minimum Wage, the New Deal and the Working Time Directive. Recent outturns for earnings growth have been lower than projected, which may indicate a smaller-than-expected impact from the National Minimum Wage. More evidence is needed. The Committee has, however, removed the upside risk of a larger effect than in the central projection. There is no change to the other assumptions about the effects of labour market reforms.

6.2 The medium-term inflation projection

Output growth has resumed in recent months. According to the preliminary GDP release in late July, output rose by 0.5% in the second quarter, after two quarters in which the level of economic activity was broadly flat. The recent pick-up was a little faster than projected in May, suggesting that the recovery in activity may be gaining momentum more quickly than judged three months ago. The level of activity has also been revised up since the spring of last year. However, the

implications for the medium-term inflation outlook are uncertain. For, although growth may be strengthening a little more rapidly than earlier projected, and from a higher base, short-run inflationary pressures have been weaker than expected three months ago. The Committee has revised its projections for activity and inflation against this background.

Detailed information on the composition of expenditure and output is only available up to the first quarter of this year. Preliminary estimates were published by the ONS in May and June, but full data only became available in late July with the National Accounts *Blue Book* release. As well as completing the picture for the first quarter, this release incorporated revisions to the level and composition of activity for the past two years. The cumulative effect of revisions up to 1999 Q1 raised the level of GDP at constant market prices by 0.4%, with most of the revisions to the level of GDP and its components occurring in 1998. Domestic demand proved stronger than previously estimated, with upward revisions to consumer spending and fixed investment, partly counterbalanced by a downward revision to the volume of government consumption. The upward revisions to GDP are of the same order of magnitude as the cumulative downward adjustments made in February and March. The Committee revisited its earlier discussion on the possible implications for future inflation of the revisions to output. Echoing that discussion, the Committee concluded that the data revisions were not sufficiently large to warrant a material change to the inflation outlook.

The National Accounts release confirmed that overall GDP was essentially flat around the turn of the year, in line with the May projection. The composition of demand was rather different, however. Final domestic demand rose by 1.1% in the first quarter, much more strongly than projected, as consumer spending increased sharply. Stronger-than-expected final domestic demand was not reflected in higher overall activity, however, as firms took the opportunity to correct stock levels more rapidly than earlier judged, and as net trade weakened by more than projected. But the combination of stronger final domestic demand and a reduction of the inventory overhang is consistent with a faster pick-up in activity in the second quarter and thereafter.

The interest rate cuts since October have affected consumer sentiment and behaviour in recent months. Even so, consumer spending has strengthened more

rapidly than expected three months ago. Spending rose sharply in the first quarter from a higher-than-expected level at the end of 1998. Although the rapid growth in the first quarter partly reflected a change in the seasonal pattern of purchases of new cars, the underlying picture was of much higher expenditure than projected in the *May Report*. More timely indicators are consistent with a stronger outturn for consumer spending in recent months as well. Retail sales volumes rose by almost 1% in the second quarter. Consumer confidence indicators have improved further, although the GfK indicator dropped back to April levels in July. Narrow money is rising quickly. Personal lending growth has picked up further and mortgage approvals continue to rise sharply. The housing market is clearly strengthening, providing a further signal of improving consumer sentiment.

The MPC re-examined the prospects for consumer spending given these developments. Previous *Reports* had noted that the initial estimates of consumer spending last year had turned out weaker than expected, given the pattern of other variables such as labour income, wealth, interest rates and unemployment. In previous projections, part of the unexplained weakness had been assumed to persist into the future. But the recent evidence suggested that this adjustment was not warranted: the upward revision to consumer spending in 1998, together with the strength of expenditure in early 1999, had brought consumption growth into line with the rates expected on the basis of average historical experience. The Committee consequently removed the earlier adjustment, raising the projected profile for consumer spending. The Committee also decided to revise upwards the central projection for house price inflation: house prices are now assumed to rise at around double the pace of earnings over the next two years. Faster growth in housing wealth is likely to provide a further moderate boost to the consumer spending outlook. The Committee judged that the risks to the consumption profile were on the upside over the next twelve to eighteen months.

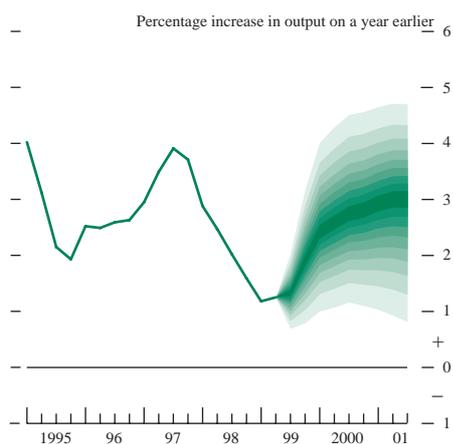
Inventory investment in both the final quarter of 1998 and the first quarter of 1999 was weaker than projected in May, as firms took advantage of robust final demand to correct excess stock levels. Recent surveys have suggested that there may have been further adjustment in the second quarter, but that stock levels are now more closely aligned with desired levels than they were a year ago. Against the background of improved cyclical balance, the Committee reviewed its assumption on the

secular trend in the stock-output ratio. As in previous projections, the Committee judged that further reductions in the ratio were likely, as firms continue to invest in improved stock management techniques, but, drawing on disaggregated analysis and international evidence, the MPC decided to assume a slower pace of decline than before.

Business investment continued to rise quickly, underpinned by very strong growth in service sector investment. Whole-economy investment growth in the first quarter was weaker than projected, however, as public investment fell sharply. The timing of public investment is rather erratic, and the underspend at the end of the previous financial year is assumed to be spent in the current financial year. Overall, there has been little change to the outlook for investment.

Net trade continued to depress overall GDP growth in Q1, as import growth remained strong, while export volumes fell. Rapid growth in domestic demand and the strength of sterling have continued to boost imports. But export growth stalled as global demand growth slowed last year and as UK firms lost share in foreign markets. Although net exports were a little weaker than expected in the first quarter, prospects for the next two years have improved a little. Stronger world trade growth and a slightly softer exchange rate profile are the main reasons. The changes overall are relatively small, however, and the central projection remains that net exports will on average detract from GDP growth in both 1999 and 2000, but at a declining rate.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 5.0%



The fan chart depicting the probability distribution for output growth is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for output. 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 the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

Overall, the Committee considers that the outlook for economic activity has strengthened since May. Faster growth in consumer spending and a slower pace of inventory adjustment should boost domestic demand. And the improvement in the outlook for the international economy has raised prospective export growth.

Data revisions have raised recent estimates of the four-quarter growth rate of GDP. The central projection is for the four-quarter growth rate of GDP at constant market prices to continue to rise as domestic demand growth strengthens, and it may return to assumed trend rates by the end of this year, rather earlier than in the May projection (see Chart 6.1).⁽¹⁾ The four-quarter growth rate continues to rise thereafter before levelling off at around 3%, as world trade growth is assumed to flatten.

(1) Also shown as Chart 1 in the Overview.

Survey evidence from business and households is consistent with the picture of rising growth in the central projection. Agents' contacts also report gradually improving sentiment, although to a lesser extent than some of the surveys. The Agents also report that clear differences remain between sectors and regions, with stronger performance in the service sector and in the south of England.

Recent data for the labour market are also consistent with an improvement in business confidence. Labour demand has been rather stronger than earlier projected. Employment on the LFS measure has continued to rise, and unemployment on both the LFS and claimant count estimates has edged down further. There now seems little likelihood of a substantial fall in overall employment in the coming months.

Although the recovery in activity appears more firmly entrenched than three months ago, news on nominal outturns since May suggests that recent inflationary pressures were again weaker than earlier judged. Import prices were lower than projected. Nominal earnings growth also slowed against expectations. Moreover, RPIX inflation in the second quarter was 0.2 percentage points below the central projection in the *May Report*.

Forward-looking nominal indicators provide mixed signals. Official interest rates are lower than in May, although money-market rates over the short-to-medium term have risen substantially. Narrow money has accelerated. Moreover, while broad money growth has slowed, the recent trend has been largely accounted for by movements in financial company deposits, which may have little immediate implication for nominal demand. Divisia money growth is flat. And credit growth has picked up further, particularly to households. After declining sharply over the past twelve months, surveys of inflation expectations over the next two years are little changed since the *May Report*.

Pay pressures have weakened in recent months in nominal terms. Earnings growth in the private sector has slowed sharply according to the Average Earnings Index and the Reward Index. Private sector settlements are typically running well below levels of a year earlier. Although public sector settlements and earnings growth have increased following the implementation of the pay review body recommendations, private sector influences dominate at the whole-economy level. Headline average earnings growth slowed to 4.3% in May, some 0.5 percentage points lower than in March.

Lower price inflation provides part of the explanation for slower growth in nominal earnings. Inflation expectations have fallen sharply over the past year. For example, the Barclays Basix survey of inflation expectations for the next twelve months held by trade unions has fallen by 0.8 percentage points over the past year. RPIX inflation has slipped below the target. And inflation on the headline RPI measure has dropped to 1.3% in June, a fall of more than 2 percentage points over the past twelve months, as lower interest rates have reduced mortgage interest payments. The gap between RPI and RPIX inflation will begin to close unless there are further reductions in interest rates, but the sharp fall in RPI inflation may have had a temporary effect on wage settlements, over and above the effects of lower inflation expectations and RPIX inflation outturns on settlements.

Real earnings growth has continued to rise on a number of measures. Nonetheless, real earnings growth has been rather weaker than expected three months ago, at a time when the labour market has been rather stronger than projected.

The Committee reviewed the evidence for a change in the relationship between real earnings growth and the degree of tightness in the labour market. Reforms to the labour market over a number of years, such as the tightening of eligibility to claim benefits and the reduction in the power and membership of trade unions, may have lowered the rate of unemployment at which inflationary pressures start to increase. Although the evidence was hard to read and subject to significant uncertainty, the Committee decided that the recent earnings data were consistent with some improvement in the structure of the labour market. An adjustment to the central projection was made to reflect this, lowering the outlook for real earnings growth for a given level of unemployment. The revision of this assumption has contributed to lower nominal earnings growth in the near term than in the May projection, but the stronger outlook for activity and for import prices push in the opposite direction, and are more dominant by the end of the two-year period. Risks around the new central projection for earnings were judged by the Committee to be on the upside.

All members agreed that there was considerable uncertainty surrounding the prospects for earnings, and that it was particularly difficult to form quantified judgments on the potential implications of the improved

functioning of the labour market for the inflationary outlook. Some Committee members preferred a smaller adjustment than in the central projection and thought that real earnings growth could be stronger; other Committee members preferred a larger adjustment and a weaker earnings profile. Depending on the alternative view taken, RPIX inflation could be around 0.2 percentage points higher or lower at the two-year horizon.

Productivity growth tempers the impact of earnings on firms' unit costs. The preliminary estimate for GDP growth and partial LFS data suggest that whole-economy productivity may have risen in the second quarter, the first sign of a reversal of the pattern of weakening productivity growth over recent quarters as activity growth slowed. A turnaround in productivity was expected as the cyclical recovery in activity gathered pace. The Committee has maintained the assumptions from the May forecast that productivity growth per hour will return to its long-run historical average over the next two years, and that structural changes in labour market performance have reduced the variability of productivity over the cycle. Productivity per person will pick up more rapidly than productivity per hour, as average working time lengthens in the cyclical recovery.

RPIX inflation fell to 2.3% in the second quarter, around 0.2 percentage points lower than projected in the *May Report*. Goods prices have been particularly weak. The overprediction can be largely accounted for by weaker import prices and lower-than-expected earnings growth and labour costs. Preliminary estimates of price-cost margins appear to be broadly in line with expectations, and so no fundamental change was made to the assumptions incorporated in the previous projections. A small downward adjustment was, however, made to the level of margins from 2000 Q2 onwards, to take account of the possibility of a more concentrated compression of margins in the water industry following the recent recommendations from OFWAT. This adjustment has no effect on measured RPIX inflation by the end of the two-year period. Risks to the central projection for price-cost margins were viewed as symmetric. Some Committee members considered that an intensification of competitive pressure, driven partly by regulatory developments and linked also to factors such as the impact of information technology on distribution channels, could lead to a structural reduction in the level of margins in some sectors. In their opinion, this

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 5.0%

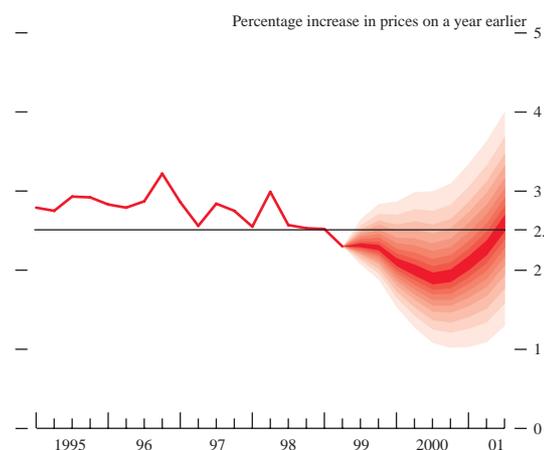
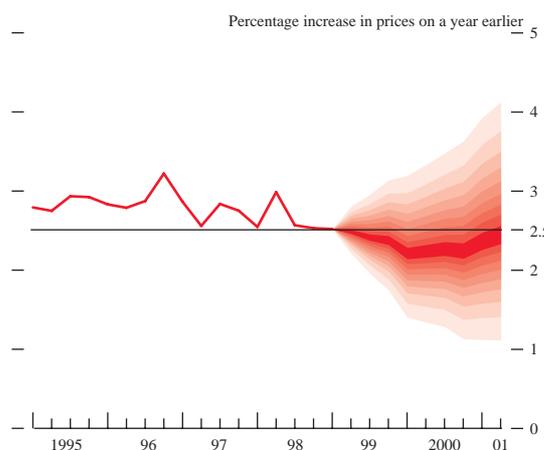


Chart 6.3
RPIX inflation projection in May based on constant nominal interest rates at 5.25%



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. 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 the 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 'How fan charts are drawn' on page 52 of the February 1999 *Inflation Report*.

reduction could lower measured inflation as the adjustment took place by perhaps some 0.2 percentage points at the two-year horizon.

The Committee's best collective projection for the twelve-month RPIX inflation rate—based on the assumption that nominal interest rates are held constant at 5%—is shown in Chart 6.2.⁽¹⁾ Alongside is the projection from the *May Report*, which was based on constant interest rates at 5.25%.

The broad shape of the current profile is similar to May. But there are a number of important differences. The starting-point is lower than in May, as inflation has fallen more rapidly than expected. Inflation is likely to remain below target for much of the forecast period. The trough in inflation may also be deeper as lower earnings growth reduces unit costs in the near term. But over the medium term this is offset by a combination of upward pressures from stronger domestic and world activity, higher oil prices, rising world inflation, lower official interest rates and a weaker exchange rate. In the central projection, inflation picks up to just above the target level by 2001 Q3.

Risks around the central projection for activity growth are slightly on the upside in the first year, reflecting the possibility of faster consumer spending growth, but are weighted to the downside in the second year, reflecting the possibility of a weaker outlook for the world

(1) Also shown as Chart 2 in the Overview.

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2001 Q3

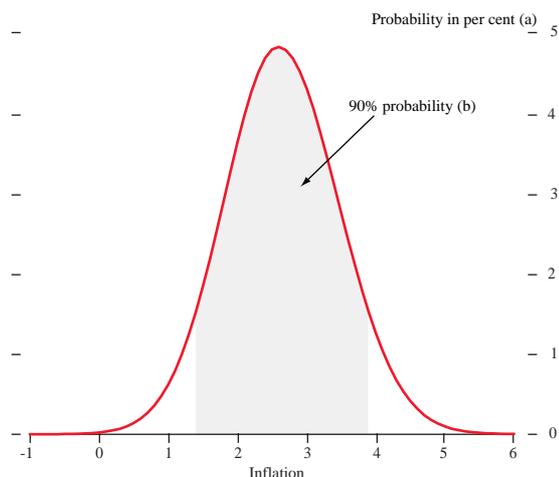
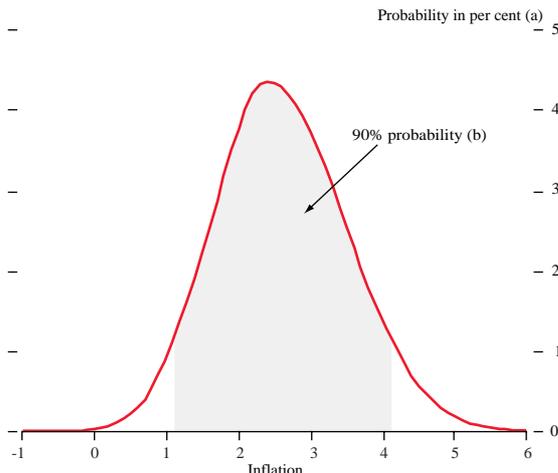


Chart 6.5
May projection for the percentage increase in RPIX in the year to 2001 Q2



Source: Bank of England.

- (a) Probability of inflation being within ± 0.05 percentage point of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (between 2.45% and 2.55%) in the current projection is around 5%.
- (b) The areas shaded light grey contain 90% of the probability, and are consistent with the widest bands shown in Charts 6.2 and 6.3. For further details see 'The *Inflation Report* projections: understanding the fan chart', February 1998 *Quarterly Bulletin*, pages 30–37, and the box on page 52 of the February 1999 *Report*.

Table 6.A
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates^(a)

RPIX inflation						
Probability, per cent	Range:					
	less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
1999 Q4	<1	11	60	28	1	<1
2000 Q4	19	29	28	16	6	2
2001 Q3	7	14	22	24	18	15

GDP growth						
Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
1999 Q4	<1	8	44	40	8	<1
2000 Q4	<1	4	17	36	30	13
2001 Q3	1	6	18	31	29	15

(a) These figures are from the same distributions as the GDP and inflation fan charts, Charts 6.1 and 6.2.

economy and the possibility of an underspend on government expenditure plans. The risks to inflation are weighted to the upside, particularly in the first year, reflecting the possibility of stronger consumer spending and of a smaller improvement in structural labour market performance and hence of higher earnings growth. The downside risks to world activity in the second year provide a partial mitigation. Charts 6.4 and 6.5 show the overall balance of risks to inflation at the two-year horizon. Table 6.A presents the MPC's best collective judgment of the probabilities of various outcomes for inflation and GDP growth.

There are a number of major uncertainties in the outlook, where difficult judgments have been made by the Committee to produce the projections. On some issues, certain Committee members preferred to take a different view. These are not incorporated explicitly in the fan charts or in Table 6.A, but are shown in a new Table 6.B. This table illustrates the possible effects on RPIX inflation and GDP growth of the alternative assumptions. These estimates themselves are highly uncertain and they should be viewed as broad calibrations rather than as definitive point estimates.

There are four areas where different judgments were preferred by some members. Some Committee members preferred to base the projection on the conditioning assumption of a constant nominal exchange rate. That would weaken the outlook for activity and inflation

Table 6.B
Possible effects on RPIX inflation and GDP growth of the alternative assumptions

Difference from central projection in percentage points

RPIX inflation

	Constant exchange rate	Higher earnings	Lower earnings	Lower margins	Higher oil price
1999 Q4	0.0	0.0	0.0	0.0	0.0
2000 Q4	-0.1	+0.1	-0.1	-0.2	+0.1
2001 Q3	-0.4	+0.2	-0.2	-0.2	+0.2

GDP growth

	Constant exchange rate	Higher earnings	Lower earnings	Lower margins	Higher oil price
1999 Q4	0.0	0.0	0.0	0.0	0.0
2000 Q4	-0.1	0.0	0.0	+0.1	0.0
2001 Q3	-0.2	0.0	0.0	+0.1	0.0

relative to the central case: RPIX inflation would be some 0.4 percentage points lower than otherwise at the two-year horizon and GDP growth would be around 0.2 percentage points lower. Views also differed on wage pressures. Some Committee members considered that pay pressures could be rather stronger than reflected in the projection in Chart 6.2: others took the opposite view and judged that earnings could be weaker than in the collective projection. Depending on the view taken, the inflation profile would either be raised or lowered—by about 0.2 percentage points at the two-year horizon—but with little effect on the activity outlook. Some Committee members judged that there were downside risks to inflation from an intensification of competitive pressures which would reduce the level of profit margins. Taking this alternative view, inflation could be around 0.2 percentage points lower than in the central projection at the two-year horizon. Activity would be slightly higher. Finally, some Committee members noted that the oil price had risen to over \$19 per barrel in recent weeks and preferred to base the projections on a higher oil price. Basing the projection on a \$19 per barrel oil price would increase RPIX inflation by around 0.2 percentage points at the two-year horizon.

These assumptions are viewed by the Committee members as a series of separate judgments. The net effect of the alternative assumptions preferred by different Committee members gave rise to a range of views about inflation prospects, illustrating the particular difficulties in judging the outlook for inflation in present circumstances. Some Committee members preferred assumptions that would raise the inflation profile shown in Chart 6.2 by about 0.2 percentage points at the two-year horizon. Other Committee members preferred assumptions that would lower the profile shown in Chart 6.2 by 0.2 to 0.6 percentage points after two years.

The market expectation of the likely path of interest rates has changed markedly since the *May Report*. At close of business on 4 August, implied interest rates on short-sterling futures contracts suggested that the market expectation was, on balance, for official interest rates to rise steadily over the next two years, reaching around 7% by 2001 Q3. So the MPC's projections under the assumption that official rates move in line with market expectations are for significantly weaker output growth and a much lower profile for inflation than in the constant interest rate case (see Charts 6.6 and 6.7).

Chart 6.6
Current RPIX inflation projection based on market interest rate expectations

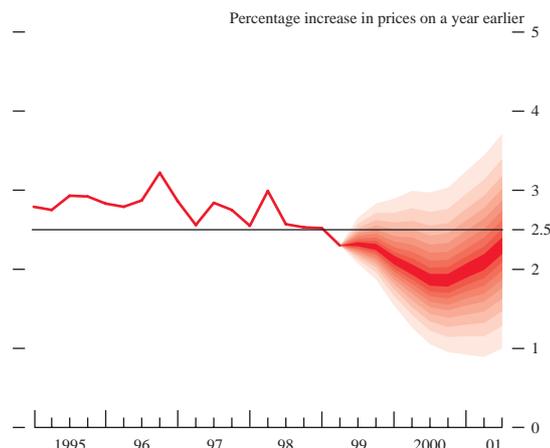


Chart 6.7
Current GDP projection based on market interest rate expectations

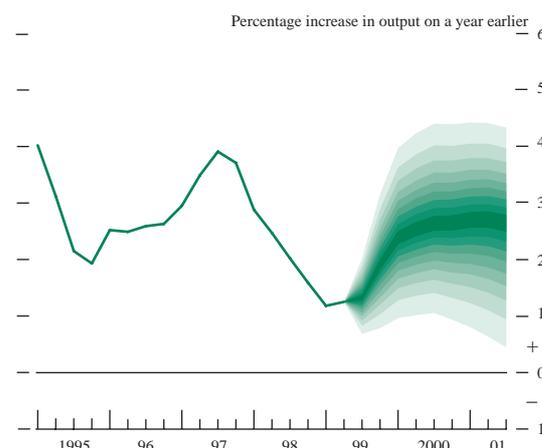
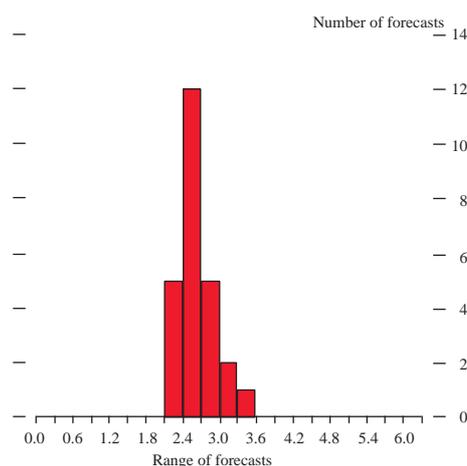


Chart 6.8
Distribution of RPIX inflation forecasts for 2001 Q3



Source: Forecasts of 25 outside forecasters as of 28 July 1999.

Table 6.C
Other forecasters' expectations of RPIX inflation and GDP growth^(a)

RPIX inflation (b)

Probability, per cent	Range:					
	less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
1999 Q4	11	25	41	16	5	1
2000 Q4	8	15	34	28	9	6
2001 Q3	7	12	30	30	13	8

GDP growth

Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
1999 Q4	4	20	49	22	5	1
2000 Q4	2	7	23	40	21	8
2001 Q3 (b)	2	7	17	39	25	10

(a) 26 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table represents the means of the responses for each range. For example, on average, forecasters assign a probability of 7% to inflation turning out to be less than 1.5% in 2001 Q3. Rows may not sum to 100 because of rounding.

(b) 25 forecasters.

6.3 Other forecasts

Chart 6.8 shows the distribution of central forecasts for the twelve-month rate of RPIX inflation in 2001 Q3, based on information from 25 forecasters surveyed by the Bank in late July. The mean forecast for the year to 1999 Q4 was 2.1%, rising to 2.4% in 2000 Q4, and reaching 2.6% in 2001 Q3. The estimate for 1999 is a little lower than the projection made at the time of the April survey, while the estimates for 2000 and 2001 are slightly higher. The forecasters assign just over 50% probability to inflation being above the target in the third quarter of 2001, and just under 50% probability to it being below (see Table 6.C). These estimates have changed slightly since the *May Report*, with further weight being placed on higher outturns for inflation.

The forecasters' average projection for GDP growth in the year to 1999 Q4 is 1½% (with a range of projections from 1% to 2½%), rising to 2¾% in the year to 2001 Q3 (with a range of 2% to 3½%). The estimate for 1999 Q4 is slightly higher than at the time of the *May Report*.

The implications of the latest projections for the stance of monetary policy are discussed in the Overview at the beginning of this Report.

The MPC's inflation forecasting record

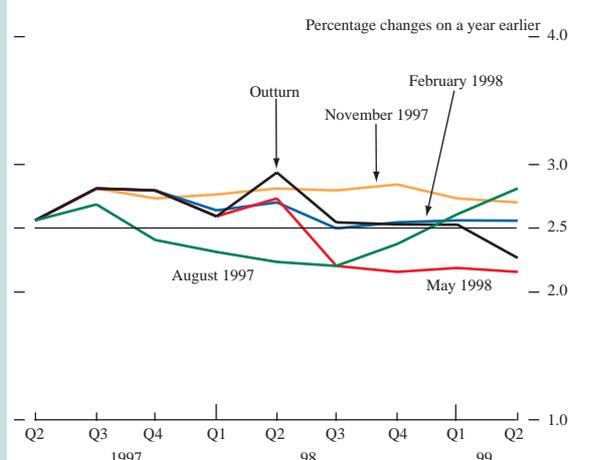
Inflation projections are central to the conduct of monetary policy, because it takes time for interest rate changes to affect inflation; empirical evidence suggests that their full impact may take up to two years.⁽¹⁾ So how have the MPC's projections compared with inflation outturns?

Two factors must be borne in mind when assessing the MPC's forecasting record. First, the MPC's inflation projection takes the form of a probability distribution, not a point estimate, because of considerable statistical and economic uncertainty.⁽²⁾ The question, then, is where in the probability distributions were the eventual outcomes? A way of answering this is to compare the outcomes with the means (ie average outcomes) or modes (ie most likely outcomes) projected by the MPC. Second, the MPC's projections are conditioned on assumptions about economic variables such as interest rates and the exchange rate. The accuracy of these assumptions will affect how the inflation projections compare with the outturns.

The August 1997 *Inflation Report* contained the MPC's first inflation projection.⁽³⁾ Data are now available to compare that projection with outturns seven quarters ahead (ie for 1997 Q4 to 1999 Q2). And the projections made in November 1997, February 1998 and May 1998 can be compared with outturns six, five and four quarters ahead, respectively.⁽⁴⁾

The chart shows the paths of the mean RPIX inflation projections from those *Reports*, together with the actual outcomes. Inflation has sometimes been higher, and sometimes lower, than the projected mean path. On average, the outcome four quarters ahead was broadly in line with the projected mean. However, the outturns were on average 0.2% higher than the projected modes, since the risks around the most likely outcome, or central projection, were generally on the upside.

Inflation Report mean RPIX inflation projections and outturns



These one year ahead forecast errors are small relative to the errors made in *Inflation Report* forecasts from 1993 to May 1997, ie prior to the MPC, with actual inflation turning out close to the centre of the fan charts. But as yet there are a limited number of observations on which to assess the MPC's inflation forecasting record, and over the past two years inflation outturns have on average been less variable than in previous years. Nevertheless, it is important to understand why actual and projected inflation have differed.

To what extent are the inflation forecast errors the result of the conditioning assumption of constant interest rates? This assumption is not very important in explaining forecast errors over the one-year horizon for the four projections at hand, because the profile of actual interest rates has turned out relatively close to the constant interest rate assumption (except during 1999). Only a small proportion of the overall RPIX inflation forecast errors can be explained by the difference between the constant interest rate assumption and the eventual outturn.

What other factors might explain the inflation forecast errors? The effective exchange rate has consistently turned out higher than the MPC had assumed based on interest rate differentials. These errors in exchange rate assumptions, together with unexpected weakness in world traded goods prices, led to a systematic overprediction of import prices: the mean forecast error for four-quarter growth in import prices averaged more than 3 percentage points for the forecasts between August 1997 and February 1998. Accurate import prices on their own would not have helped the inflation projection; indeed, predicted inflation would have been consistently lower than the outturns if future import prices had been predicted more accurately, other things remaining the same.

In contrast to import prices, average earnings growth up to the one-year horizon was on average higher than expected over the four projections. Although the errors are small relative to those on import prices, earnings growth has a larger direct effect on RPIX inflation. But these two influences have not offset each other in a systematic way, resulting in some positive and some negative forecast errors.

The MPC makes projections for GDP growth as well as for RPIX inflation. There are no systematic errors in the one year ahead mean (and mode) GDP growth projections made by the MPC between August 1997 and May 1998. However, domestic demand has consistently turned out higher than predicted. This has been offset by weaker-than-expected net trade, reflecting the unanticipated strength of sterling and adverse external shocks, notably the crisis in Asia.

It is too early to draw strong conclusions about the MPC's inflation forecasting record, given the lags in the transmission of monetary policy, the prevalence of shocks, and the limited number of observations. But there is no obvious evidence so far of large systematic errors.

(1) See *The transmission mechanism of monetary policy*, Bank of England, April 1999.

(2) See 'The *Inflation Report* projections: understanding the fan chart', by Erik Britton, Paul Fisher and John Whitley in the February 1998 *Quarterly Bulletin*, pages 30–37, and 'How the fan charts are drawn', in the February 1999 *Inflation Report*, page 52.

(3) The MPC first met in June 1997.

(4) The numerical parameters (mean, mode and median) from the probability distributions for the RPIX inflation and GDP growth fan charts since August 1997 are available on the Bank's web site: www.bankofengland.co.uk/irprobab.htm.

**Annex:
Minutes and Press Notices
of the monthly
Monetary Policy Committee
meetings**



Minutes of the Monetary Policy Committee meeting on 5–6 May 1999

1 Before turning to its immediate policy decision, the Committee reviewed developments in the world economy, monetary and financial market conditions, demand and output, the labour market, and prices in the context of finalising its latest projections for inflation and output growth; and discussed the appropriate policy response to the further rise in sterling's exchange rate.

The world economy

2 The Committee discussed whether there had been a material change in the world economic outlook, or in the balance of risks, since its February *Inflation Report*. Overall, prospects had slightly improved. In particular, US economic growth had again been strong, and was unaccompanied by manifest signs of rising inflation. It now seemed likely that growth in 1999 would be higher than previously expected. The longer the strength of demand persisted, the greater would be the risk of the economy hitting capacity constraints and inflationary pressures emerging. Unemployment was already significantly below the level previously generally thought to be consistent with stable inflation. Productivity growth had also risen above most previous estimates of its trend, despite the length of the current expansion. The resulting uncertainty about the path of capacity output complicated US monetary policy. If any eventual tightening therefore came as a surprise, there might be a larger reaction in financial markets, particularly given the continuing strength of the equity market. The US outlook was a major area of uncertainty in the world economy.

3 Economic prospects in the euro area remained subdued, and were judged to be slightly weaker than in February. While the 50 basis point reduction in official interest rates should help, business confidence indicators were still weak. Despite some improvement in sentiment, the economic outlook in Japan continued to be uncertain.

4 Conditions in emerging market economies, taken as a whole, had improved somewhat in recent months. This was evident in the yields on US\$-denominated bonds issued by emerging market economy governments, which were on average down about three percentage points relative to US Treasury bond yields since February. The balance of forecasts for growth in Asia was up slightly, and conditions in Brazil seemed more stable than a month ago.

5 The Balkan conflict had already had economic repercussions in some neighbouring countries. It added to uncertainties more widely, and on one view created a downside risk to world activity and prices, through negative effects on confidence if the situation remained unresolved or the conflict spread. This was the kind of risk to which the Committee could if necessary react as developments occurred.

Monetary and financial conditions

6 The Committee noted that its April reduction in interest rates had not yet been reflected fully in bank and building society rates. However, pass through of official rate changes had not always been immediate in the past, and it seemed unlikely that a greater than usual spread between private sector and official rates could be sustained for long.

7 Annual broad money growth had fallen to around 7%, almost entirely on account of reduced money holdings by the non-bank financial sector. Assuming a trend fall in velocity of around 2%

per year, aggregate monetary growth was broadly consistent with the inflation target and trend output growth.

8 Developments in bank lending to different sectors were quite varied. In particular, the annual rate of growth in household credit had risen to about 8%, with secured lending up sharply. Mortgage loan approvals were also strong. Taken together with other signs of housing market momentum, this would need to be watched.

9 Equity prices had continued to rise, with the FT-SE All-Share Index up by over 10% since February. The consequent boost to household wealth would tend to support consumption growth in the period ahead. Private sector investment might also be more buoyant as a result.

10 A significant development in monetary and financial conditions was the further rise in sterling's effective exchange rate. The ERI was up around 3% since the April meeting, and was around 5% higher than the level implied by February's central projection. It seemed that a material part, but not all, of this appreciation could be explained by relative yield curve movements, the sterling yield curve having risen and the euro area yield curve having fallen, reflecting changing market assessments of the outlook for growth and, thus, monetary policy settings. Other market explanations included a change in the sterling/euro risk premium in sterling's favour, possibly related in part to the Kosovo conflict, which appeared to be consistent with the slight appreciation in the euro when there had been news of intensified diplomatic efforts; a possible longer-term rerating of relative UK economic prospects; and increased merger and acquisition-related demand for sterling, although given the liquidity and depth of the foreign exchange market, it seemed unlikely that such transaction-related factors could have had anything more than a brief effect, whereas sterling's rise had been sustained over three months.

Demand and output

11 GDP growth in Q1 was now estimated to have been 0.1%; it was probably slightly higher excluding energy industries. Since the beginning of 1998 there had now been five consecutive quarters of below-trend growth. That should have done a lot to relieve capacity pressures, although judgments could easily differ about the precise balance of aggregate demand and supply. The economy was probably at or slightly past the trough in growth, which was set to recover towards trend.

12 On the demand side, consumption growth now seemed to have been stronger in 1998 Q4 than had been thought in February. The evidence available so far suggested this had been maintained into 1999 Q1. Consumer confidence had risen since February, and housing market indicators were showing signs of renewed strength.

13 The outlook for investment was stronger than a quarter ago, partly reflecting the marked recovery in measures of business confidence and partly the stronger than expected outturns in the second half of 1998. At this early stage of the new monetary framework, it was difficult to know whether the recovery in confidence was the result of the apparently sharper than expected easing of monetary policy, or whether the available measures of business confidence were simply volatile, and perhaps at times misleading, indicators.

14 There were suggestions from the Bank's regional Agents that the recovery in confidence was fragile. It was not possible to substantiate this, but it seemed likely that any recovery in

manufacturing sector sentiment would remain weak while sterling's strength persisted. And it was possible that household sector confidence would be vulnerable to any significant increase in unemployment.

15 As discussed at the Committee's previous meeting, the counterpart to the upward revision to domestic demand growth in 1998 Q4 had been a larger trade deficit. Although this was likely to increase, the current account deficit was likely to be smaller in relation to GDP, partly on account of strong net income on overseas investments.

Labour market conditions

16 As had been the case for some time, labour market indicators painted a mixed picture. On the one hand, nominal settlements were lower, and the Reward index of nominal earnings growth was still slowing. On the other hand, the Federation of Recruitment and Employment Services had reported a slight increase in pay rates in April; and according to the revised January Average Earnings Index and the first February estimate, nominal earnings growth had stopped falling. Nominal earnings growth had in fact fallen by less than most measures of expected inflation, suggesting that expected real earnings growth might have risen. There were two reasons why wage drift—the gap between nominal earnings growth and settlements—might have increased. First, firms might be awarding any pay increases needed to comply with the National Minimum Wage rules outside the normal pay round. Second, there might have been an increase in bonuses, but this was difficult to judge as the ONS's question about bonuses had recently changed, so that there was a break in the series.

17 The labour market remained tight. Employment had been increasing even though output growth had been below trend for the past 15 months or so. Measured by headcount, employment had continued to rise recently, although by less in 1999 Q1 than in 1998 Q4. Taken at face value, this might suggest that the labour market was still tightening. However, part of the increase was accounted for by a rise in the number of part-time workers. Overtime hours had fallen. Overall, hours worked per head had also fallen. Unemployment had risen slightly, but was still close to a 20 year low. According to the latest British Chambers of Commerce survey, employment intentions were less positive in services and flat in manufacturing. Evidence on skill shortages and recruitment difficulties had also suggested some easing, but the picture was not clear.

18 Taking all the evidence together, the Committee judged that nominal earnings growth would be lower in the remainder of 1999 and in 2000 than had been expected in February, partly due to the sustained fall in inflation expectations.

Prices

19 Although the Bank's index of non-oil commodity prices had fallen 3% in the year to March, the twelve-month rate of decline was now much lower than throughout 1998 and into 1999, and the index had risen by 2% during March itself. Oil prices continued to rise, reflecting supply policy changes. It had been suggested that some commodity prices had fallen close to marginal production costs, making it unlikely that prices would continue to fall.

20 Manufacturing input prices (excluding food, beverages, tobacco and petrol) had been flat in March, but were still down 4½% on a year ago. Manufacturing output prices (excluding food, beverages, tobacco and petrol) were also flat.

21 Overall, it seemed likely that the downward pressure on RPIX inflation of falling world commodity prices would come to an end during the two-year forecast period. The RPIX inflation rate had spiked up in March due to the timing of the introduction of various Budget measures. It was expected to fall back in April.

The May inflation and growth projections

22 The Committee agreed the projections to be published in the *Inflation Report* on 12 May.

23 On the assumption of constant official interest rates of 5.25%, the central projection for output growth rose to around the economy's trend rate of growth by the middle of 2000. The risks were broadly balanced.

24 The central projection for inflation was broadly in line with the target over the forecast period. It fell slightly below target for the next year or so, principally on account of sterling's recent appreciation and the lower assumed path for earnings growth; and then rose to about 2½% at the two year horizon, as demand strengthened and the effects of sterling's appreciation wore off.

25 The central projection assumed that sterling's effective exchange rate would depreciate in line with uncovered interest rate parity (ie interest rate differentials). If sterling was likely to fall by more than this, as indicated by most outside forecasts, the balance of risks to inflation was on the upside. That was the view of a majority of the Committee. Some members judged, however, that the balance of risks to inflation was on the downside because they thought sterling was likely to be in line with or stronger than the path assumed in the central projection, and also saw downside risks from weaker than assumed world activity and prices, and from greater pressure on margins.

Other considerations relevant to the policy decision

26 The Committee discussed a range of other issues relevant to its policy decision.

27 How much weight should the Committee place on the central projection for inflation being slightly below target for the next year or so but roughly at target, and rising, at the two year horizon? A number of possible arguments were identified. First, the central projection's saucer shape was largely attributable to sterling's recent appreciation, the effects of which would be temporary. Second, the Committee could consider whether there was a path for policy that could underpin activity growth in the relatively short run while not endangering achievement of the inflation target at and beyond the forecast horizon; this might be achieved by a temporary reduction in interest rates. Third, it was possible that the new monetary framework had altered expectations and thus the speed of the transmission mechanism, with shorter lags from changes in policy to the effects on output and inflation. Views varied on these issues.

28 What did the recent strength of sterling imply for policy? Sterling's renewed appreciation presented a dilemma for policy. It had exacerbated the imbalances in the economy, given the already considerable pressures on exporters and producers competing domestically with imports. The implications for inflation, and thus for monetary policy, depended on the reasons for the appreciation. To the extent that it reflected changed perceptions of the outlook for UK monetary policy, policy should respond only if market expectations were materially wrong. Otherwise, depending on the effect on interest rate expectations, reducing official interest rates now might increase expected inflation. The Committee had agreed, however, that relative yield curve movements did not explain the whole of sterling's recent rise, which would therefore tend to put downward pressure on inflation in the near term. In principle, the forecast process should identify and quantify the various influences on sterling, but this assessment was inevitably imprecise.

29 Given the dilemma for policy created by sterling's rise, the Committee noted that it could, in principle, use two other instruments. The first was a statement explaining the part played by sterling in its eventual policy decision. This option was available whatever the decision on interest rates.

30 The second was foreign exchange intervention. A range of views was expressed. It was possible that combining a reduction in interest rates and a statement with publicly-announced intervention might help to underline the Committee's concerns about the exchange rate. The Committee did not believe that intervention could materially affect the balance between demand and supply in the foreign exchange market; rather it would help to underline the Committee's view about the implications of sterling's strength. However, given that sterling currently seemed well supported in the market, it was not possible to be confident that intervention would have the desired effect, and it could possibly have a perverse effect. It was also important not to confuse the market about the role of the exchange rate in the Committee's analysis and reaction function, which were geared to the inflation target.

The immediate policy decision

31 On one view, there was not yet a convincing case for a further reduction in interest rates. First, the balance of news over the month had been broadly neutral. While sterling had risen in the past month, part of that reflected the stronger outlook for UK output growth. Moreover, mortgage credit growth and approvals and other housing market indicators were stronger; there was more evidence that the trough in output growth had been passed, so that the outlook was now more for a 'gentle take off' than 'a soft landing'; the labour market was apparently still tight, although the evidence was mixed and hard to assess; and the falls in commodity and import prices seemed to be coming to an end. Second, the inflation forecast, which incorporated all the news over the quarter including sterling's sharp rise, did not decisively point to an interest rate reduction. Two years out, the central projection (the mode) was near the target but rising, and with the balance of risks on the upside. If rates were to be reduced by a further 25 basis points, both the mode and the mean would be above the target at two years. Thus, any immediate reduction in rates would probably be short-lived, especially if sterling fell back, as assumed in the projections. Third, it was important not to create confusion about how the Committee analysed and responded to exchange rate changes. There were dangers in appearing to change interest rates in response to high frequency movements in the exchange rate. In particular, it would be highly undesirable if the market reached the mistaken conclusion that the Committee had a simple rule of thumb for trading off interest rate changes against exchange rate changes. A further reduction in interest rates could not be ruled out if the risks of undershooting the inflation target increased. But it would be better to see more evidence on the position of the labour market and on domestic inflationary pressures generally, and whether sterling's strength persisted. A statement explaining that policy might need to be eased further if sterling remained so high would therefore be useful.

32 On a second view there was a clearer case for an immediate further reduction of 25 basis points. The central projection was below target throughout the forecast period. Moreover, contrary to the majority view as reflected in the *Inflation Report* fan chart, the balance of risks to inflation was on the downside. There were not good grounds for expecting sterling to fall by more than implied by interest rate differentials—on the contrary it was plausible that it would remain strong given the range of factors supporting it; the risks to world activity and prices were on the downside; and there could be greater pressure on margins than assumed in the central projection. The current stance of policy was still restrictive. A statement connecting a cut to sterling's strength would also be desirable, possibly combined with intervention.

33 In the view of most members of the Committee, the arguments were finely balanced between no change and a small

reduction. The projection did not require a further cut in interest rates but would not be inconsistent with one. The judgment was therefore partly a matter of tactics, and centred on the best approach to addressing the problems with the balance of the economy created by sterling's strength, consistent with achieving the inflation target. Arguments identified for an immediate cut were as follows. Inflation was projected to be below target throughout the forecast period. The risks of undershooting in the relatively near term were greater than of overshooting further out, especially if the new monetary framework had increased the speed of the transmission mechanism. Given the saucer shape of the projection, with inflation rising through and beyond the second year, delay could mean losing the opportunity for a future reduction, and could therefore risk denting confidence, which in some sectors remained fragile. It would also be easier this month to explain the role played by the exchange rate in a decision to reduce rates, given that the *Inflation Report* was being published the following week; the *Report* could explain the Committee's analysis of the recent appreciation and make clear that there was no simple rule of thumb relating changes in the exchange rate and interest rates. That might be less easy in a non-*Inflation Report* month. Arguments identified against reducing rates, in addition to those summarised in paragraph 31, were as follows. There was not a pressing need to take further action at present to underpin output given that it was projected to recover towards trend, and it was in any case possible that some easing of conditions would come from sterling declining, as projected, at least in line with interest rate differentials. A cut now might therefore mean that rates had to be increased quite soon. In principle there should be no problems with that. But given the still incomplete understanding of the Committee's monetary policy reaction function, such a reversal might adversely affect sentiment. The uncertainties about the effects of a further reduction might also warrant caution. Whether or not rates were reduced, a statement drawing out the implications of the exchange rate for policy would be useful. If rates were left unchanged, the statement could explain that if sterling were to remain so strong then, depending on other developments in the economy, interest rates might have to be reduced in order to reduce the risks of undershooting the target. It was also argued by some that the case for a reduction would be stronger if it could sensibly be accompanied by foreign exchange intervention as well as a statement. If, however, the case for intervention could not effectively be made in current market circumstances, which was the view of some members, then the argument for an immediate reduction was weaker.

34 The Governor invited the Committee to vote on the proposition that the Bank's repo rate be maintained at 5.25%. Five members of the Committee (the Governor, Mervyn King, Alan Budd, Charles Goodhart and John Vickers) voted for the proposition. Four members of the Committee (David Clementi, Willem Buiter, DeAnne Julius and Ian Plenderleith) voted against, preferring a reduction of 25 basis points.

35 The following members were present:

Eddie George, Governor
 Mervyn King, Deputy Governor responsible for monetary policy
 David Clementi, Deputy Governor responsible for financial stability
 Alan Budd
 Willem Buiter
 Charles Goodhart
 DeAnne Julius
 Ian Plenderleith
 John Vickers

36 Gus O'Donnell was present as the Treasury representative.

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 30 April, in advance of its meeting on 5–6 May 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I The international economy

2 Consensus Economics' forecasts for GDP growth in 1999 had continued to be revised up for the United States, and down for Germany and Japan. G3 nominal effective exchange rates had moved little since the MPC's previous meeting, though the euro had weakened further, and the volatility of the yen had decreased.

3 According to the advance estimate of US GDP in 1999 Q1, quarterly GDP growth had slowed to 1.1% from 1.5% in 1998 Q4. Domestic demand had risen by 1.8%, largely due to strong consumption. Consumer confidence had increased further in April, suggesting that strong consumption growth would continue. Net exports had fallen in Q1, partly reflecting the unwinding of special factors that had boosted net exports in Q4. Industrial production had risen by only 0.1% in March, though the NAPM index of industrial confidence had remained strong, and durable goods orders had increased by 2.0% in March. Housing market activity had continued to be robust, though house price inflation remained moderate. Employment cost growth had decreased in 1999 Q1, and consumer price inflation had remained subdued, despite a further fall in the unemployment rate to 4.2% in March. Since the previous MPC meeting there had been a rise in market expectations of US interest rates and in government bond yields. And though equity prices had initially fallen, they had since recovered strongly. US broad money growth had continued to slow.

4 In the euro area, recent data releases had confirmed that GDP had risen by 0.2% in 1998 Q4. The twelve-month growth rate of industrial production had continued to slow in February, and business confidence had fallen again. Consumer confidence had also fallen in the euro area, particularly in Germany. Germany's six Institutes had revised down their forecasts for German growth. Euro-area broad money growth had remained steady, but narrow money growth had risen strongly. This could only partly be explained by the effect of lower interest rates on money holdings in some smaller countries. Euro-area price inflation had continued to be subdued, albeit with substantial differentials between member countries. The ECB had reduced interest rates by 50 basis points on April 8, though short-term euro-area interest rates had fallen by less, as the markets had already priced in much of the ECB's rate cut. Long rates had also fallen.

5 The Bank of Japan had maintained the overnight call rate at 3 basis points, and rates on longer-term instruments had continued to decline. Low overnight rates had resulted in funds being withdrawn from the call market, which might have explained the rise in deposit money (up 9.4% in the year to March). After rising in 1998, the growth of cash in circulation appeared to have stabilised, and the risk premium on Japanese interbank borrowing had fallen to near zero, possibly because of perceptions of increased financial market stability. The annual rate of decline of bank lending and bankruptcies had continued to diminish, perhaps reflecting government policy measures aimed at small firms. However, the value of bankruptcies had reached a new monthly record in March, and unemployment had risen to 4.8%. Inventory levels had continued to fall, and though industrial production had increased by 2.2% in March, most of this rise was offset by downward revisions to earlier months. New construction orders had risen by 5% in the year to March, suggesting that the fiscal

stimulus measures were taking effect. But private demand had remained weak. This, together with reduced imports of erratics, had resulted in continued falls in imports. Consumer prices had fallen by 0.4% in the year to March.

6 Spreads on government bonds in emerging markets over US Treasuries had continued to narrow over the month, and a number of major emerging market currencies had appreciated. Emerging market foreign currency financing had risen in 1999 Q1 owing to increased bond financing in Latin America and Asia. However, the Institute of International Finance had projected that total net external financing of emerging markets would fall in 1999 overall. On balance though, Consensus Economics' forecasts for emerging market growth had been revised up since February.

II Monetary and financial conditions

7 Notes and coin had grown by 0.7% in April (after adjusting for the introduction of the new £2 and 50 pence coins). The strong flow pushed the twelve-month growth rate to 5.7%: a seven-month high. The three and six-month annualised growth rates were both higher than the twelve-month growth rate.

8 M4 had grown by £2.9 billion in March. The twelve-month growth rate was 6.9%, the lowest since June 1995.

9 M4 lending had increased by £6.7 billion in March, though this strong growth had been in part affected by temporary lending (£1 billion) to the company handling the securitisation of part of the Student Loans book. Excluding this effect, the twelve-month growth rate (excluding securitisations) had been 7.3% compared with 7.0% in February. Despite the strong growth in March, the trend decline in M4 lending seen over the past six months seemed likely to continue: the annualised three and six-month growth rates (6.6% and 6.0% respectively) remained below the twelve-month rate.

10 Households' M4 had increased by £0.9 billion in March. The twelve-month growth rate had been 6.5%. The annualised three-month growth rate for 1999 Q1 had been 3.8%: the lowest since 1994 Q2. The weakness in the first quarter may in part have reflected the increased concentration of income tax payments in that quarter following the introduction of self-assessment. Additionally, the March figure had been depressed by an outflow of funds into PEPs: retail unit trust sales had totalled a record £1.8 billion (seasonally adjusted). Households' M4 lending had grown by £3.9 billion in March. Total lending to individuals (excluding lending to unincorporated businesses, but including lending by a number of non-M4 institutions) had increased by £4.4 billion (0.8%) in March, reflecting a strong increase in secured lending.

11 Private Non-Financial Corporations' (PNFCs') M4 had grown by £2.4 billion in March. The strong growth in March was reflected in the figures for 1999 Q1. The twelve-month growth rate in 1999 Q1 had been 9.2%, the highest since 1996 Q4. PNFCs' M4 lending had grown by £1.4 billion in March. This flow had been somewhat stronger than the monthly average for 1999 Q1 (£0.9 billion). PNFCs' sterling capital market issues had risen from £2.4 billion in 1998 Q4 to £6.1 billion in 1999 Q1.

12 Other Financial Corporations' (OFCs') M4 had fallen by £0.5 billion in March. The total flow in 1999 Q1 was -£3.1 billion, the first negative flow since 1993 Q2. The twelve-month growth rate had fallen sharply in 1999 Q1 to 6.6%, compared with 15.6% in 1998 Q4. OFCs' M4 lending had increased by £1.3 billion in March, though this had been inflated by the temporary lending to

the company handling the securitisation of part of the Student Loans book. Even without adjusting for this lending, the twelve-month growth rate in 1999 Q1 had been 8.4%, less than half the 17.5% annual growth rate in 1998 Q1.

13 Turning to price indicators of monetary conditions, there had been little reaction of short-term interest rate expectations (as measured by the near-term short sterling futures contracts) to the 25 basis point reduction in the official repo rate on April 8. Nominal forward rates had increased over the period since the April MPC meeting, with the rise concentrated at the short end of the zero-coupon gilts yield curve. Analysis of bank and building society variable interest rates indicated that the 25 basis point reduction in the official repo rate on 8 April had been only partially passed through to standard variable rate (SVR) mortgages and savings rates.

14 Implied real forward interest rates, derived from index-linked gilts, had risen on the month, particularly following the announcement of the results of the index-linked gilt auction on 28 April.

15 Turning to measures of inflation expectations, the rise in real forward rates had been reflected in a tick down in longer-term inflation forward rates, as derived by a comparison of yields on nominal and index-linked gilts. Survey-based measures of RPIX inflation expectations were broadly unchanged at 2.2%–2.3% for 1999 and 2000. Data from a Consensus Economics survey in April, measuring longer-term inflation expectations, showed that inflation expectations over the period 2001–04 had risen slightly since the previous survey in October 1998.

16 Equity indices had risen sharply in April with the FT-SE 100 and All-Share indices reaching new record highs, but they had fallen below their peak by the time of the May MPC meeting. The FT-SE All-Share index had risen by 0.3% since the April MPC meeting and by 11.5% since the February *Inflation Report*.

17 Turning to the exchange rate, sterling's effective exchange rate had appreciated by 2.8% since the April MPC meeting. This reflected an appreciation of 3.1% against the euro and 2% against the US dollar. A decomposition based on the UIP identity implied that around half of this appreciation was accounted for by 'monetary news'.

III Demand and output

18 The preliminary ONS estimate of GDP growth in 1999 Q1 had been 0.1%, the same as in 1998 Q4. The annual rate of growth had fallen to 0.7%, the lowest rate since 1992. Service sector output had grown by 0.4% in Q1, compared with 0.5% in 1998 Q4. Within services, distribution output growth had picked up to 0.6% in Q1 from 0.1% in Q4 and had been implicitly offset by slower growth in other services. The ONS press release had suggested that there had been a small decline in manufacturing output in Q1 and a sharp decline in utilities output, but that construction and agricultural output had increased in Q1. Volatile energy output was likely to have reduced GDP in Q1.

19 Manufacturing output had fallen by 0.8% in the three months to February but growth had been strong in, for example, electrical industries. Engineering new orders had been positive in February; home new orders had risen by 9.9% in the three months to February and export orders had risen by 5.2%.

20 On the expenditure side of the National Accounts, retail sales had grown by 0.4% in March compared with a fall of 0.3% in February, and by 1.1% in Q1 following a fall of -0.2% in Q4. Annual growth had risen to 1.9% in March and had been 1.5% in Q1. Annual growth in car registrations had been 3% in Q1 and 95% in the year to March, following the move to bi-annual registrations. Although the new seasonal pattern had been

unknown, it was possible that underlying spending on vehicles had fallen between Q4 and Q1.

21 The March CBI Distributive Trades survey had shown a pick-up in expected sales in April, and was subsequently confirmed by the April survey. The GfK consumer confidence balance had been +1.7 in April compared to +1.6 in March, and the MORI indicator had risen sharply towards 0 in March, in line with the GfK measure of general confidence.

22 Both the Halifax and Nationwide house price indices had shown small rises in April (0.2% and 0.1% respectively). Regional data from the Halifax Building Society showed house price inflation had continued to slow in London and the South East in 1999 Q1. But recent survey evidence from the Royal Institute of Chartered Surveyors (RICS) had indicated a strong turnaround in March in house price inflation in London and the South East.

23 Housing activity indicators had picked up. In March loan approvals had risen by 13% and net lending by 36%. The HBF site visits and net reservations had been positive for three months and particulars delivered had risen by 6% in March. RICS sales growth had risen in Q1. The number of properties on estate agents' books had been at an historic low.

24 The PSNCR had been £7.4 billion in March. The PSNB had been £4.1 billion. For the financial year 1998/99 the PSNCR had been -£7.4 billion, the first surplus since 1990/91. The surplus had been £2.2 billion higher than in the Budget, with £1.3 billion lower spending and £0.8 billion higher receipts.

25 Surveys had provided evidence on investment in Q1. The BCC Survey of manufacturers had shown a slight improvement, with a balance of +4% increasing investment in plant and machinery. But the CBI investment intentions balance had fallen slightly to -29%. The BCC services investment intentions balance had remained above its average at +18% in Q1. Data on imports of capital goods and the production of investment goods had suggested increases in equipment investment in Q1. The new orders data had contrasted with the CIPS Construction survey index which had risen to 57.4 in April, the third consecutive rise in activity. The CIPS survey had shown increases in all sectors, other than civil engineering. Housing had been particularly strong, with 2.9% growth in private housing starts in the three months to February and 3.3% growth in completions.

26 The Bank's regional Agents had conducted a survey of their contacts on the effect of the Millennium on investment spending and stocks. Millennium investment spending had already been carried out by 92% of contacts and, of these, 40% intended to spend more before the Millennium. This had mainly been related to IT systems and the Year-2000 problem and, generally, those who had not increased spending had modern systems already. 65% of investment had been additional, 38% had been brought forward (including replacing systems early rather than tampering with existing systems) and 13% had displaced other investment. Of investment yet to be undertaken, 44% would be additional and 23% would be brought forward. Many contacts had not yet made a decision on Millennium stocks, but 24% planned to increase stocks and 4% already had. Retailers had expected strong demand for food and alcohol but there had been no expectation of food shortages. Some manufacturers would be increasing stocks of finished goods to meet demand or disruption to supply.

27 The CBI Industrial Trends reported stock balance had risen to -2, compared with -14, in Q4 but stocks had still been reported to be more than adequate in Q1. The rise in retail sales in Q1 may have further reduced retail stocks with a relatively low +15 balance of CBI retailers reporting more than adequate stocks in March.

28 The goods and services trade deficit had narrowed slightly to £2.6 billion in February because of a narrowing of the goods

deficit; the services balance had been unchanged. Exports and imports of goods had risen in February. The EU goods deficit had widened in February to £1 billion from £0.7 billion in January, but the non-EU goods deficit had narrowed sharply in both February and March. Excluding oil and erratics, export volumes to the non-EU had risen by 8.7% in February and 5.4% in March, but exports to the EU had fallen by 3.3% in February. The rise in exports to the non-EU had been fairly widespread including rises to the US, Asia and oil-exporting countries.

29 Some surveys had provided evidence for the outlook in Q2. The BCC home sales, CBI reported output, and CIPS output survey balances appeared to have bottomed out but had still been negative. CBI and BCC domestic and export orders had picked up but remained low. The CBI April survey had shown a loss of momentum in the recovery of export orders, which may have been related to sterling's resilience and the European slowdown. The BCC home sales and CIPS business activity surveys had also suggested that the service sector slowdown may have been close to its trough. CBI business optimism had risen sharply to -6 in April compared with -40 in March; this may have suggested a trough in GDP, but the relationship between the two had not been particularly close in recent quarters.

IV The labour market

30 LFS employment had grown by 80,000 (0.3%) in the three months to February, compared with the previous three months. Workforce jobs data for the final quarter of 1998 had been revised downwards, further widening the gap with the LFS measure in growth rate terms. The absolute rise in LFS employment had been evenly split between full-time and part-time: full-time employment had increased by 44,000 (0.2%) in the three months to February and part-time employment by 38,000 (0.6%). Total hours worked had been flat in the three months to February, and average hours worked per person had fallen by 0.2%. The recent expansion in employment had been offset by a decline in average hours worked per full-time worker, consistent with a fall in overtime working.

31 The CIPS April surveys reported that manufacturing employment had continued to decline, albeit at a slower rate, but employment in the construction and service sectors had increased. Forward-looking surveys had been mixed. The BCC services survey for Q1 had shown that employment intentions were close to their historic average, while the manufacturing balance had been lower than the average. The CBI manufacturing survey balance had become less negative. The Federation of Recruitment and Employment Services survey had suggested that the demand for employees had risen in April.

32 The number of new notifications at job centres had fallen by 500 in March, but the stock of unfilled vacancies had risen by 400. However, the vacancy figures for Northern Ireland had been affected by a discontinuity in March caused by the introduction of a new computer system, and problems had been discovered with past West Midlands data. Excluding these regions, the underlying trend for vacancies had been broadly flat since early 1998. The National Press Recruitment Advertising index had fallen in March, to its lowest level since December 1996. The BCC survey for Q1 had suggested that recruitment difficulties had persisted, but according to the CBI Industrial Trends survey for Q1 skill shortages had shown a sharp decline, to their lowest level since 1993.

33 LFS unemployment had increased by 32,000 in the three months to February, compared with the previous three months; the rate had edged up to 6.3%. Claimant-count unemployment had risen by 2,000 in March, following a revised increase of 5,700 in February, although the rate had remained unchanged at 4.6%. Inflow rates to the count had risen but remained low by historic standards, while LFS data suggested that redundancies had

increased. LFS figures showed that there had been a fall of 73,000 in the number of economically inactive people in the three months to February, which had been concentrated among the long-term sick, people looking after family/home, and students.

34 Whole-economy annual average earnings growth, as measured by the AEI, had increased to 5.0% in February, reflecting faster growth in service sector earnings inflation. Both public and private sector earnings growth had risen in February. The headline annual rate of whole-economy earnings growth (now referred to by the final month of the three-month period under consideration, rather than the centred three-month average) had increased to 4.6% in the three months to February, from a revised 4.5% in January. The revision in January, due to late returns, had reflected a stronger contribution from bonus growth. There had also been a change in the survey questionnaire between January and February. Prior to February, the questionnaire had asked respondents to identify bonuses paid to employees when the bonus had changed significantly. With effect from February 1999, information on all bonuses had been required, irrespective of the magnitude. Because of this discontinuity, it had not been possible to assess the contribution of bonuses to the rise in average earnings growth in February. In contrast to the AEI, the Reward Index of annual earnings growth had continued to decline into 1999, from 4.6% in January to 4.5% in February and 4.2% in March.

35 The Bank's measure of the whole-economy employment-weighted mean wage settlement (twelve-month moving average) had fallen to 3.6% in March, having remained at 3.7% since June. Using a matched sample (ie only including firms where data were available for both years), the twelve-month mean settlement had decreased to an annual rate of 3.2% for the three months to March 1999, from 3.9% a year earlier. Provisional information for April had suggested that public sector settlements for 1999 had been higher than in 1998. There had also been reports that some settlements had been delayed to April to coincide with the implementation of the National Minimum Wage.

36 Revisions to Workforce jobs data had resulted in some minor revisions to productivity and unit wage cost growth, but the picture had been broadly unchanged. Annual productivity growth had been 0.7% in Q4 and unit wage costs had been accelerating.

V Prices

37 The Bank's index of commodity prices excluding oil had risen by 1.9% in March. The total index had risen 5.5%, reflecting the very sharp increase in oil prices in March. The monthly rises had led to the annual rates of inflation in both indices to rise, though both had remained negative. The Bank's measure of commodity prices had increased in the first quarter, whereas both the *Economist* and the Economist Intelligence Unit measures had fallen. The difference had been explained by the use of different weights and baskets of commodities.

38 The oil price had risen sharply again in April: the one-month future price of Brent crude rose by 20.3%. Evidence from options prices had suggested that the oil price expected in August had increased since the previous MPC meeting, and that there was slightly greater uncertainty around the estimate, but that the risks around the expectation were more balanced (though still slightly on the upside). Producer price inflation had increased in March: input prices largely due to oil and food prices, and output prices because of oil prices and duties.

39 Import and export price had fallen again in February, by 0.1% and 0.6% respectively. But annual inflation had increased to -4.1% and -3.6%, the highest rates since November and December 1996 respectively. The annual rate of retail sales deflator inflation had fallen by 0.4 percentage points to 0.8% in March. The Harmonised Index of Consumer Prices (HICP) rose by 1.7% in the year to March, 0.2 percentage points more than in February,

owing to the effects of the measures introduced in the March Budget.

40 The annual rate of RPIX inflation had risen by 0.3 percentage points to 2.7% in March, for the same reasons as the HICP. The rate excluding taxes and excise duties (RPIY) had fallen by 0.1 percentage point to 1.7%, and the all-items rate of inflation (RPI) had remained at 2.1%, as lower mortgage-interest payments had offset the Budget effects.

VI Reports by the Bank's Agents

41 The Bank's regional Agents reported on their assessment of the economy, drawn from their discussions with contacts over the past month. There had been continued indications that the decline in manufacturing output growth had come to an end. Expectations for output growth in the second half of 1999 had improved. Investment plans had remained focused on cost reduction and product development. Some manufacturers had continued to invest overseas, while others had postponed investment as demand remained subdued. Service sector growth had increased once again, especially advisory services such as accountancy and IT. But the transport industry had continued to report declining demand and increasing fuel costs. Consumer services activity had grown only modestly. Some leisure industry contacts had reported that expansion of capacity was no longer planned. Import penetration had increased, especially for commodities. And overall export growth had been reduced by sterling's appreciation, although certain sectors such as aerospace and telecommunications had reported export growth. German demand had declined but demand from elsewhere in Europe and from North America had remained strong, and there had been modest signs of a recovery in orders from East Asia.

42 Retail sales growth had been subdued; exceptions had included DIY, mobile phones and personal computers. Annual sales growth had improved in March and over Easter, but discounting to clear unwanted stocks had persisted. Discount store sales had continued to grow while department store sales had fallen. Demand for new and used cars had been flat in the first quarter of 1999. There had been a modest increase in demand for housing, part of which had been due to strong demand for properties to rent.

43 Annual pay settlements had generally remained subdued, typically ranging from 0% to 3% in manufacturing and from 2% to 5% in the service sector. But some individual pay settlements had been higher as companies had sought to retain key staff. Manufacturers had reported ongoing job losses. But manufacturers

had been reluctant to shed staff, preferring to rely on natural wastage or to defer decisions in the hope of an upturn in orders. In contrast, service sector recruitment had continued.

VII Market intelligence

44 Expectations of UK interest rates implied by prices from financial markets had risen significantly over the past month. The market's view of the level of interest rates in 2000 and 2001 in particular had increased. Three groups of views had emerged in the market on the likely direction of future interest rate decisions. The first was that interest rates had reached a 'trough' at 5.25%; this view emphasised rising prices in asset markets and growing evidence from surveys of increasing business and consumer confidence. The second group had noted that, while rates might be near to their lows, the risks were still on the downside, and a further reduction in rates was therefore to be expected in the next month or so. The third group believed that the prospect remained for further interest rate reductions: the improvement in surveys had been from a low base, there was a danger of undershooting the inflation target of 2½%, and the exchange rate had remained strong. Despite these differing market views, the range of interest rate expectations for the next two years had narrowed since the start of January, when some in the market had not expected rates to fall as quickly as they had now done, and others had envisaged deeper cuts in interest rates than they now thought in prospect. This suggested that the market now had a clearer view of the UK's position in the interest rate cycle.

45 Sterling had remained strong over the month, particularly against the euro. Expectations of the level of the exchange rate over the next twelve months, based on forward exchange rates and surveys, suggested that sterling would remain close to its current level against the US dollar. However, market data still suggested that the pound would weaken against the euro over the same period. The appreciation of sterling since the start of the year had surprised some forecasters. A number of possible explanations had been advanced, including changes in the expected relative cyclical positions of the United Kingdom and Continental Europe. Market commentators had also suggested that the risk premium on the euro had risen, with the factor most recently cited being the conflict in Kosovo. Over the past month, there had been a number of short-term influences on the exchange rate. There had been demand for sterling related to merger and acquisition activity. Some market participants suggested that there had been portfolio shifts in favour of sterling. And one bank with a large share of the customer market in foreign exchange had reported that its clients had bought back large amounts of sterling over a comparatively short period of time, reversing previously underweight positions.

Minutes of the Monetary Policy Committee meeting on 9–10 June 1999

1 At the start of the meeting on 9 June, the Committee formally acknowledged the receipt of a letter from the Chancellor (attached as an annex) setting out the inflation target at which the Committee should aim in accordance with section 12 of the Bank of England Act 1998.

2 Before turning to its immediate policy decision, the Committee reviewed developments in sterling, the world economy, monetary and financial conditions, demand and output, the labour market, prices and other considerations bearing on its decision.

Sterling's exchange rate

3 Sterling had been volatile over the month, but had on average remained at broadly the same level as at the time of the May Committee meeting and somewhat above the level implied in the central assumption of the May *Inflation Report*. Sterling had risen against the euro since the May MPC, but had fallen against the dollar. Much of the depreciation of sterling against the dollar seemed explicable in terms of changes in market interest rate expectations—as implied by yield curves—since the previous meeting. The publication of the much stronger than expected Japanese GDP data on 10 June was associated with a marked strengthening of the yen, and partly as a consequence an easing of sterling.

4 The depreciation of the euro against sterling and the dollar could not be accounted for purely by movements in interest rate differentials, and was more difficult to explain. Among short run factors, developments in Kosovo might explain some of the weakness in the euro, perhaps through increasing uncertainty and via its potential effects on business and consumer confidence in continental Europe. The markets might also be re-assessing the policy stance in the euro area in the light of the recent discussions of the Italian fiscal deficit in the context of the growth and stability pact. A more fundamental factor was probably continued uncertainty about the prospective strength of the euro area economy when contrasted with continuing strong growth and the pick-up in consumer prices in the United States.

5 The strength in German orders data, and a stronger first quarter GDP figure than expected by the markets, had probably contributed to the slight strengthening of the euro immediately prior to the Committee's meeting. But if it simply reflected an expectation of stronger German demand, this was not apparently embodied in interest rate expectations.

6 Summing up, the Committee noted that the depreciation in the euro since the turn of the year was not especially large in an historical context. Nevertheless, looking at a rate for the synthetic euro against the dollar over a longer period, the euro was stronger than in the early and mid-eighties, but as low as at any time over the past ten years.

7 Turning to sterling, it was difficult to link recent changes in its rate against the euro to past and prospective movements in interest rate differentials. Whether or not the Committee cut at this meeting, the market might take the view that a trough in interest rates had been reached for this cycle. If that caused expectations of the future path of interest rates to be revised up then sterling might strengthen. However, it was possible that a reduction in rates at the current meeting might be accompanied by a fall in sterling. So, as always, the effect on the exchange rate of a possible reduction in interest rates was uncertain. And, in any case, the Committee agreed that whatever the expectation in the market, the future path of interest rates would depend on what developments in the economy as a whole implied for the prospects for inflation.

8 It was also noted that an increase in US rates and further reduction in UK interest rates could eliminate the present short-term interest rate differential. This could be important to those with 'carry trades'—a strategy of borrowing in low yielding currencies to buy higher yielding currencies. There was evidence that some market participants used this strategy. Views differed on how much weight to put on this explanation of sterling strength.

9 Overall, the Committee thought that the situation had not changed much since the previous month's meeting. Sterling had remained, on average, somewhat above the central assumption in the May *Inflation Report* over the past month, and if it were not to weaken as assumed, it raised the likelihood that inflation would undershoot the target.

The world economy

10 There was not much sign of a slowdown in the US economy over the month. The Federal Open Market Committee had recently moved to a bias to tighten. Equity markets had been relatively stable over the month. Taken together the news suggested that the probability of a soft landing for the US economy had improved.

11 Some of the backward looking data in the euro area continued to look quite weak. But the recent orders and unemployment data had been better than expected. German GDP had increased by 0.4% in the first quarter, and was slightly stronger than expected by the markets, but it contained little news relative to the Committee's central assumption in its May projections. The more forward-looking indicators—such as consumer and business confidence—had perhaps shown signs of stabilising.

12 Many of the recent Japanese monthly indicators had been distorted by the Golden Week holidays, which made seasonal adjustment more difficult. But, on balance, they probably suggested that activity was broadly flat. Growth in the monetary base had, however, increased. The GDP figure for the first quarter—released on 10 June—had been surprisingly strong and the stock market had initially rallied. But no analysis of the GDP data was yet available. The Committee noted that there had been quite large quarterly volatility in Japanese GDP over recent years, so were cautious in reading much into one strong quarterly number.

13 The yields on dollar-denominated bonds issued by emerging market economy governments had risen relative to US Treasury bond yields as expectations of a tightening of US monetary policy had increased, though they had shown signs of easing back down more recently. But prospects in Asia seemed a little brighter than a month ago, as did the situation in Brazil and Latin America more generally. Some official Chinese interest rates had recently been reduced by 1%.

14 Overall, the news on prospects for the world economy had been mildly positive over the month, with the euro area and Japan looking a little stronger. The prospects of a soft landing in the United States seemed to have improved, and the downside risks to emerging markets might have eased.

Monetary and financial conditions

15 The strength of the housing market was evident in both price and activity data. The Halifax and Nationwide house price indexes had both risen strongly in May, and the annual rates of increase were now rising. The aggregate rise in house prices over recent months was probably within the bounds of what might be expected given changes in interest rates since last autumn. There were signs of the strengthening housing market in the household sector lending

figures, which had continued to rise over recent months. The Committee recalled that looking forward, its assumption in the central projection of the May forecast was that house prices would rise in line with nominal earnings, which would need to be reviewed in the context of the next forecasting round.

16 Forward short maturity interest rates had risen substantially over the past month, in part reflecting changing expectations about the timing of possible UK entry into EMU and in part accompanying the rise in short maturity rates in the US. Longer maturity nominal bond yields had risen—reflecting those factors and continued fading of the after-effects of the LTCM crisis, which had depressed yields—whereas there had been little change in the yields on UK index-linked government bonds. The Committee discussed the implications of these developments for real rates and inflation expectations.

17 As discussed by the Committee at its January meeting, there was some uncertainty about the level of real yields signalled by index-linked bonds. In particular, past changes to rules relating to pension fund holdings of bonds had led to an increased holding of index-linked bonds by that sector. It seemed that the changes had prolonged effects on yields, as stock holdings were adjusted following actuarial guidance. But it was not clear that this would have significantly distorted the change in implied UK inflation expectations over the past month. However, there had only been a slight rise in inflation expectations in the surveys of other forecasters' projections, which on average had now risen back towards the inflation target of 2.5%. Therefore, since it was not plausible that inflation expectations had risen by as much as short maturity forward rates, it was likely that short-term real yields had risen.

18 At the short end of the curve, there were signs that building society and other lenders had raised interest rates on fixed rate mortgages, so some tightening had occurred. For loans advanced on variable, rather than fixed, interest rates, there had been only a small pass-through of the reduction of official rates in April.

Demand and output

19 The latest data provided no firm reasons to move away from the central projections for demand and output made at the time of the May *Inflation Report*. GDP growth had been revised down 0.1% in the first quarter, and was now flat on the headline market price measure and had fallen slightly measured at basic prices. After adjusting for volatile components such as energy—which had been weak in the first quarter—growth of GDP at basic prices was still in line with the May central projection, at 0.1%. The staff's latest estimates, based on survey evidence on new orders, suggested a pick-up in GDP growth in Q2. This pick-up was still broadly consistent with the May central projection. The National Institute of Economic and Social Research had released its monthly GDP estimate following publication of the industrial production figures. It showed growth of 0.2% in the three months to May, which also suggested an increase in growth from the trough at the turn of the year.

20 Within the expenditure breakdown of GDP, there were some signs that the usually less-volatile components—such as consumption—were stronger on the quarter, while those that were typically more volatile—such as investment—were weaker. However, even in the case of consumption there were special factors. In particular, the change in the registration date for new car sales meant that seasonal adjustment of the Q1 data was difficult and that underlying consumption was probably a little weaker than the headline numbers suggested. That said, the figure was still likely to have been stronger than the Committee had assumed in its May projections. There had been a continuing rise in consumer confidence over recent months. One puzzle was the recent weakness of retail sales in both the official data and in surveys, given the strength of Q1 consumption and consumer confidence.

21 Business surveys had also shown signs of further improvement over the past month, although the tone being reported to the Bank's regional Agents was, on balance, a little softer than this. The latest monthly trade data had pointed to a greater weakening of exports—particularly to the EU—compared to the assumption in the May *Inflation Report*. The CBI survey, while showing an improvement in domestic orders, still recorded considerable pessimism about export orders. The corresponding question in the CIPS survey had, however, shown a recovery in export orders. Although the latest batch of surveys had been conducted after the recent appreciation in sterling, there was some concern about the fragility of the overall rise in survey balances, especially if sterling were to remain strong. The Bank's regional Agents' survey suggested that many companies were expecting sterling to depreciate.

22 The income and expenditure release of the National Accounts also included a sharp fall in the figure for companies' operating profits in the first quarter, which followed a fall in the fourth quarter. The latest evidence on the number of profit warnings, and analysts' profit expectations for 1999, did not yet provide any corroborative evidence of such a sharp fall in the first quarter. It was difficult to know how much weight to place on the fall, until firmer data on profits had been fed into the accounts by the ONS. The operating profit figure included an adjustment, to ensure that the income, expenditure and output measures were aligned from quarter to quarter, but the details of any adjustment in Q1 would not be published by the ONS until the full National Accounts release. The ONS had suggested that the construction output figures were less firmly grounded than usual. As usual, in the run up to the annual re-balancing of the National Accounts there were a number of puzzles in the data, and there were likely to be revisions in due course. It was not possible at this stage to draw any firm conclusions about the likely direction and scale of any revisions.

Labour market

23 There had not been much news on labour market quantities over the past month, relative to what had been expected in the May projections. But looking back over the past three or four months it was, perhaps, still surprising that the labour market had not weakened by as much as expected at the start of the year.

24 On the prices side, earnings growth in the year to March, as measured by the Average Earnings Index, had been in line with the assumption in the May *Inflation Report*. The Reward index had continued to fall. The disparate movements in the public and private sectors complicated the picture for settlements. Recent public sector awards had pushed up the aggregate whole economy twelve-month employment-weighted mean to 3.9%, despite a continuing fall in private sector settlements. A matched sample of private sector settlements also showed that they were lower in April than in the corresponding period last year. More work would be needed on the impact on RPIX inflation of the public sector settlements, both directly and indirectly via their effects on private sector behaviour. As the April figures were not yet available, it was still too early to judge whether the effect of the National Minimum Wage on earnings was in line with the assumption made in the Committee's projections.

25 The continued strength in the latest employment data implied another weak productivity growth figure in the first quarter, and a corresponding rise in unit labour costs. This would continue the pattern of weak productivity growth figures seen over the past four years. The fact that employment continued to grow, and that there had been no significant rise in unemployment, might be consistent with the finding of the Agents' survey. The survey results suggested that, while many companies assumed no change in sterling, more companies were expecting sterling's exchange rate to fall than to rise, and companies might consequently be delaying adjustments to their workforce for as long as possible. However,

this could not explain much of the apparent weakness of productivity growth in recent years. Another possible explanation, among several discussed in recent *Inflation Reports*, continued to be that output was underrecorded, and that the true rate of productivity growth was stronger than recorded, although there was no firm evidence for this. The limited data available for the service sector, relative to manufacturing, made it difficult to reach conclusions in this area.

26 Looking at productivity growth over a longer period, it was probably best to assume that the trend rate of productivity growth—which was what was important for assessing inflationary pressure—had not changed significantly over recent years. Indeed, average productivity growth since 1990 was not out of line with its long-run historical trend.

Prices

27 The Committee noted that both including and excluding oil, sterling commodity prices on the Bank's UK demand-weighted index were now rising in annual terms. The oil price had stabilised in recent weeks. Brent was currently trading at around \$15–\$16 per barrel, and was a little below the peak reached in early May. The oil price was now broadly in line with the assumption made in the May *Inflation Report* for the middle of this year.

28 RPIX inflation had fallen by slightly more than expected in April, largely on account of seasonal foods, which were usually quite volatile. The latest ONS advance estimate of RPIX, which was not usually available at the time of the Committee meeting, suggested that the May figure would also turn out weaker than had previously been expected. Although this seemed likely to have implications for the short-term inflation projection, it was not clear to what extent there was any news for the inflation projections looking two years or so ahead. The recent and prospective fall in RPI inflation to levels well below RPIX, on account of previous reductions in mortgage interest rates, might further reduce pay settlements.

Other considerations bearing on the policy decision this month

29 The Committee's statement the previous month explaining its decision had said that if sterling were not to decline as assumed in the central projection of the May *Inflation Report*, it was likely that inflation would undershoot the inflation target over the coming two years. And, in those circumstances, depending on other developments in the economy, there might, therefore, need to be further easing of interest rates in order to keep inflation on track to meet the 2½% target. At this meeting the Committee reviewed the time frame over which it might need to take action if sterling remained strong and there were no other offsetting developments affecting the inflation outlook. One issue was how big the deviation in exchange rates from the May assumption needed to be in order to be quantitatively significant in terms of the forecast of inflation. Another issue was the appropriate filter to use to smooth high frequency movements in the exchange rate.

The immediate policy decision

30 On one view a further reduction in the official interest rate of 25 basis points was needed to meet the inflation target. There were various strands to this argument, to which members attached different weights.

31 The exchange rate had on average been stronger over the past month than incorporated in the May *Report*. If that strength were to persist, then the likelihood of inflation falling below target would have increased. Although the statement issued last month did not mean that action had to be taken immediately if sterling did not weaken as assumed in the central projection, there seemed to be no advantage in waiting.

32 Some members of the Committee were uneasy, on empirical grounds, about the use of the Uncovered Interest Parity assumption in the central projection, and for them sterling's persistent strength was not a surprise. They placed weight on the observation that a further reduction in UK rates, and the future increase in US rates expected by the market, might mean that the UK would no longer have the highest short-term interest rates of the G7 countries.

33 Some members were also impressed by the fact that since the turn of the year, sterling had consistently turned out stronger than assumed each month. And although the May *Inflation Report* fully reflected the appreciation of the exchange rate in the first part of the year, its persistent rise created a greater sense of underlying strength and weakened perceptions of the likelihood of the sustained fall in sterling that was assumed in the central projection.

34 Private sector wage settlements had continued to fall, although there had been a rise in public sector settlements. The fall in RPI inflation relative to RPIX might further depress settlements. In addition to the news on the exchange rate, the recent outturns and short-term outlook for RPIX suggested that the saucer shape evident in the May central projection for inflation would, if anything, be a little deeper and more protracted than thought then. It might be possible to mitigate this slightly by prompt action, without risking too sharp an upturn in prospective inflation further ahead.

35 Although house prices were rising, so far this seemed consistent with the reduction in interest rates since October. The yield curve had steepened over the past month, and interest rates at maturities of 1–4 years had risen substantially so that, to the extent that this represented a rise in real rates, some tightening had effectively taken place.

36 Some members thought that, although the forward-looking survey indicators were stronger over the past month, consumer and business confidence indicators were still fragile. There was still relatively little firm evidence from official data that activity had picked up in the second quarter. The latest trade data had suggested that the immediate outlook for exports was still deteriorating. The recent weakness of retail sales in both the official data and in surveys, while supported by the Agents' reports, was puzzling. It suggested that expenditure was not yet accelerating. A further reduction in interest rates might help to support business and consumer confidence, which would make the projected upturn in activity more likely, especially in the light of the Agents' survey of companies' exchange rate expectations.

37 Overall, as sterling had not fallen back and given developments in private sector wage settlements and the short-term outlook for retail prices, as well as the tightening of monetary conditions during the month through the rise in short-term market interest rates, those members who had voted for a reduction in the official interest rate the previous month remained of that view; and some others agreed that the balance of risks to inflation now warranted a modest reduction in the official interest rate this month.

38 On another view, there was not a convincing case for a further reduction in the official interest rate. There were three main considerations. First, sterling had been volatile over the month, and the level of the exchange rate index on the morning of the Committee meeting was not significantly different from that assumed in the central projection of the May *Inflation Report*. It was better not to place too much weight on high frequency movements in sterling between quarterly *Inflation Report* projection rounds. Second, there had not been much news to change the picture for activity over the past month. The world economy looked a little brighter. On the domestic economy,

backward-looking indicators were mixed. Output growth had been revised down a little but non-oil output was still rising. Most forward-looking indicators—such as household and business surveys—continued to improve. Consumption growth was strong and house prices had risen sharply over the past month. The full effects of the earlier reduction in interest rates from 7.5% to 5.25% had yet to be seen. There were no strong grounds for diverging from the central projection in the *May Report*. Third, even though there had been little news on activity, RPIX inflation had turned out a little weaker than expected. In consequence, the short-term outlook for inflation was if anything a little lower than a month ago, but there was only a limited amount that the Committee could do at this very short horizon. The implications of the latest ONS advance estimate of RPIX were not clear. In setting monetary policy it was necessary to look further ahead. Looking further out, there was little to change the view, embodied in the May projection, that the benign effects on inflation of the rise in sterling and falls in import prices would be wearing off as domestic activity recovered. There had also been a slight rise in inflation expectations as measured by surveys, which was an indicator that the Committee had placed weight on in the past.

39 The Governor invited the Committee to vote on the proposition that the Bank's repo rate be reduced by 25 basis points to 5.0%. Eight members of the Committee (the Governor, David Clementi, Willem Buiter, Charles Goodhart, DeAnne Julius, Ian Plenderleith, John Vickers and Sushil Wadhvani) voted for the proposition. Mervyn King voted against, preferring to maintain the Bank's repo rate at 5.25%.

40 The following members were present:

Eddie George, Governor
Mervyn King, Deputy Governor responsible for monetary policy
David Clementi, Deputy Governor responsible for financial stability
Willem Buiter
Charles Goodhart
DeAnne Julius
Ian Plenderleith
John Vickers
Sushil Wadhvani

41 Gus O'Donnell was present as the Treasury representative.

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 3 June, in advance of its meeting on 9–10 June 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I The international economy

2 Strong economic growth had continued in the United States. After a downward revision of 0.1 percentage point, owing to weaker net trade, GDP was estimated to have increased by 1.0% in 1999 Q1. The annual growth rate of industrial production had increased to 2.0% in April and the level of output in March had been revised up, bringing the official data more into line with the National Association of Purchasing Managers' (NAPM) index. The growth rate of export volumes had also picked up, with a noticeable rise in sales to Asian countries. But, despite this improvement in exports, the March trade deficit had reached a record level (\$19.7 billion) owing to continued strong import growth. More recently, however, retail sales and employment growth had slowed. The slowdown in the rate of job creation in May was sharper than most commentators had expected, but revisions to March and April data raised the level of non-farm payrolls by 185,000.

3 A few signs of price pressures had begun to emerge. The NAPM prices-paid index rose above 50 in May, the first time it had exceeded the neutral level since December 1997. And consumer price inflation had increased by 0.5 percentage points in April, to 2.3%. Both of these developments were heavily influenced by higher oil prices. More surprisingly, 'core' inflation had also risen and the annual growth rate of average earnings had increased to 3.6% in May. Reflecting these developments, the Federal Open Markets Committee (FOMC) had adopted a bias towards tightening monetary policy. In response, financial market expectations for an increase in official interest rates had been brought forward. On 9 June, the markets were expecting the FOMC to raise interest rates by at least 25 basis points by September and to implement a further tightening over the next two years. The rise in interest rate expectations had led to a slight flattening in the nominal US Treasury yield curve.

4 Within the euro area, the gap between business and consumer confidence had continued to narrow in May, reflecting weaker consumer confidence and an improvement in business confidence. Consumer confidence had been particularly weak in Italy. Euro-area industrial production had been flat in March, though stronger in France and Spain than in Germany and Italy. Broad money growth had remained moderate but narrow money was growing rapidly. In Q1, German GDP had increased by 0.4% and French GDP had grown by 0.3%.

5 Japanese data had been distorted by the Golden Week holiday in April, but the underlying trend appeared to be flat. The Bank of Japan had kept overnight interest rates at 0.03%, and term rates were beginning to decline suggesting that the monetary easing was being passed through. However, total bank lending had continued to fall, as banks had continued to write-off non-performing loans. Industrial production had fallen by 2.7% in April, reversing the rise in March. Housing starts had increased by 1.1% in the year to April, the first rise since December 1996. However, private construction orders had fallen sharply in April, more than offsetting the rise in public construction orders related to the November fiscal package. The unemployment rate had remained at a record 4.8%; employment had decreased and inactivity had increased. The trade surplus had narrowed in April as import growth had exceeded export growth. The deflationary

trend had persisted; in April, 'core' consumer price inflation was -0.1% and domestic wholesale price inflation was -1.9%.

6 In the financial markets, the euro had continued to depreciate, while the yen and dollar effective exchange rates had appreciated over the month. The Nikkei-225 index had fallen by 4% since the May MPC meeting while the S&P 500 had fallen by 2%. Spreads on emerging market bonds had widened slightly, but the nominal exchange rates of these countries were little changed.

II Monetary and financial conditions

7 The growth rate of narrow money had been rising. In May, the three and six-month annualised growth rates for notes and coin, after adjusting for the introduction of the new 50 pence and £2 coins, had increased to 7.7% and 7.4% respectively, up from around 5.0% last autumn. Econometric work by Bank staff suggested that recent interest rate cuts were likely to have started to boost narrow money growth from around the end of last year.

8 M4 had risen by 1.1% (or £8.8 billion) in April, compared with an average monthly flow of just £2.7 billion in the first quarter of this year. M4 lending had also been strong, rising by 0.9% (or £7.8 billion) on the month.

9 The M4 deposits of the household sector had increased by 1.1% (or £5.1 billion) in April. This figure would have been influenced by: the introduction of cash ISAs (which attracted deposits of £1.8 billion over the month); windfall payments of £0.6 billion to account-holders at Birmingham Midshires following the Halifax takeover; and the purchase by the Prudential Corporation from a charitable trust (which is included as part of the household sector) of £0.6 billion of M&G shares. Together these special factors had probably accounted for only around £1.5 billion of the monthly flow (some of the money going into ISAs probably came from the windfall, and some would have reflected a portfolio reallocation away from taxable savings instruments within M4). Adjusting for these considerations, the flow had been around £3.6 billion, significantly stronger than the average monthly increase over the past year (£2.4 billion).

10 M4 lending to the household sector had increased by 0.8% (or £4.0 billion) in April. Total lending to individuals, by both M4 and non-M4 financial institutions, had also been strong, rising by £4.4 billion on the month. Within the total, lending secured on dwellings had been a little weaker than in March, though the monthly flow (£3.0 billion) had remained well above the average for the past year. Consumer credit growth had increased slightly to 1.4% in April.

11 Private non-financial corporations' (PNFCs) M4 deposits had been weak in April, falling by 0.1%. At the same time these companies had borrowed heavily: strong sterling borrowing from UK banks and building societies was matched by strong capital issues. Total borrowing by PNFCs had been £6.5 billion in April. The available evidence suggested that these funds were largely being used for investment, and were not an indication of distress borrowing. Over the year to 1999 Q1, net recourse to banks (net new borrowing minus net new deposits) was much stronger in the service sector, where investment had been strong, than in the manufacturing sector, where any borrowing to cover unexpected shortfalls in cashflow might have been expected to have been concentrated.

12 OFCs' M4 deposits had increased by 2.1% (or £3.8 billion) in April. This strong flow followed three consecutive months in

which OFCs' M4 deposits had fallen. OFCs' M4 borrowing had risen by 0.6% in April.

13 Turning to price indicators of monetary conditions, there had been a marked rise in interest rate expectations implied by longer-dated short-sterling futures contracts: the rate implied by the September 2001 contract had increased by almost 60 basis points since the previous meeting, to 6.4%. A variety of explanations were considered. First, stronger-than-expected US CPI data, coupled with the FOMC's adoption of a bias to tighten monetary policy, had increased expectations that US interest rates might soon be raised. This could have had implications for UK interest rate expectations if, for example, market participants believed that US inflation data were a leading indicator of world-wide inflationary pressure. Second, some domestic data releases over the month suggested a more buoyant outlook for the UK economy.

14 It appeared that mortgage lenders had still not fully passed on the 8 April reduction in the official repo rate. Conversely, there had been large falls in credit card rates reflecting increased competition in that sector.

15 Nominal forward interest rates had increased by some 40 to 45 basis points at the three to five year horizon since the previous meeting. Over the same period, real forward rates had increased by around 5 basis points, so it appeared that medium-term inflation expectations (ie three to five years ahead) had also increased by 35 to 40 basis points. It was possible that the 'true' rise exceeded this: demand for certain gilts to repo for cash over the Millennium period was thought to have increased and this had led to artificially low nominal gilt yields. A measure of inflation expectations three years ahead derived from the swap curve had risen by around 65 basis points. Conversely, survey measures of inflation expectations for the years 1999 and 2000 had either not increased or risen only moderately (by 10 or 20 basis points) and had remained below the 2½% target.

16 The sterling effective exchange rate index had fallen by 0.1% since the May meeting, to 104.6. This was somewhat higher than the level embodied in the central projection of the May *Inflation Report*. Sterling had appreciated by 0.7% against the euro, and fallen by 1.6% against the US dollar. Most of the fall against the dollar was probably related to monetary policy news, in particular a growing expectation that US interest rates would soon be raised. Sterling's rise against the euro was harder to explain in terms of monetary policy news. Compared with the previous meeting, UK equity prices were broadly unchanged.

III Demand and output

17 Quarterly GDP growth in 1999 Q1, at constant market prices, had been revised down from 0.1% to 0%, reducing the annual growth rate to 0.6%. The weakness of GDP in Q1 had been influenced by a sharp decline in energy related output due to the mild winter—excluding the energy, utility, and agriculture sectors, GDP had grown by 0.1%. However, measured at basic prices, output had fallen by 0.1% in Q1, the first decline in seven years. In the first quarter, the level of the expenditure measure of GDP had been 0.7% below the average measure.

18 The downward revision to GDP growth in Q1 had reflected a lower service sector growth estimate of 0.2% (down from 0.4%). Within the service sector, distribution output had increased by 0.6%, transport and communications had grown by 0.2% and business and financial services had fallen by 0.3%.

19 Largely reflecting the weakness of energy output, total industrial production had fallen by 0.9% in Q1. Although manufacturing output had continued to decline, the pace of contraction had slowed to 0.3% in Q1, from 1.3% in 1998 Q4. Construction output had increased by 0.2% in the first quarter but

had been 3% lower than a year ago. The ONS had noted that these figures were less firmly based than normal. Agriculture and fisheries output had fallen by 0.5% on the previous quarter and by 0.6% on a year ago.

20 The expenditure breakdown of GDP had shown domestic demand growing by 0.4% in Q1, with inventories making a contribution of -0.2 percentage points. However, this growth in domestic demand had been offset by a -0.5 percentage point contribution to growth from net trade. The main differences between the expenditure outturns and the projections embodied in the May *Inflation Report* had been stronger consumer spending and weaker investment.

21 Consumer expenditure had grown by 1.1% in 1999 Q1, the highest quarterly growth rate for over a year. Spending on vehicles, durable goods, clothing, communications, and financial services had all been strong. However, it was likely that the vehicle expenditure figures had been influenced by the introduction of the changes to the vehicle registration scheme in March. Pre-tax compensation of employees had grown by 1.9% in the same period. Government expenditure had risen by 1.4%.

22 Total investment had declined by 1.7% in Q1, but had grown by 3.1% on a year ago. Business investment had fallen by 2%, largely owing to steep declines in construction and 'other production' investment. In Q1, manufacturing investment had fallen by 2.5% while service sector investment had increased by 1.1%. Corporate profits had deteriorated further—the gross operating surplus of corporations had fallen by 3.2% in Q1 and by 9.4% in the year to Q1. However, the actual size of the decline in corporate profitability in the first quarter was uncertain, since these data incorporated the quarterly statistical alignment adjustment.

23 In the first quarter, the trade deficit at constant market prices had increased to 4.3% of GDP. Export volumes of goods and services had fallen by 1.4% while import volumes had risen by 0.3%. The goods and services deficit at current prices had widened to £4.6 billion in Q1—the highest figure since 1990. Geographically, demand from EU countries had been particularly weak in Q1—goods exports to the EU had fallen by 4.1%, while sales to non-EU countries had been little changed. Imports of goods had increased by 1.7% in Q1 and by 2.4% in March. The latest monthly trade data pointed to a larger negative contribution to GDP growth in Q1 than had been assumed in the May *Inflation Report*.

24 Turning to developments in Q2, retail sales volumes had fallen by 0.5% in April. However, in the three months to April, sales volumes had increased by 1.8% on a year earlier and by 0.6% on the previous three months. Total car registrations had fallen by 3.9% in May, lowering the annual growth rate to 1.8%, from 6.6%. The CBI Distributive Trades survey had reported lower annual sales growth in May, although orders placed with suppliers had increased sharply. According to the CBI, expected sales growth for June had been the strongest since July 1998. The GfK consumer confidence index had also increased in May, leaving it at its highest level in twelve months.

25 The rise in consumer confidence had been accompanied by a pick-up in housing activity. The number of particulars delivered had increased by 5% in April, and by 9% on a year earlier. Similarly, the number of loan approvals had gone up by 15% in the three months to April. Reflecting these developments, the Halifax and Nationwide house price indices recorded monthly rises of 2.1% and 1.2% in May, with annual inflation at 5.7% and 7.4% respectively. House price inflation in London and south-east England had exceeded the national average since the mid 1990s, and survey evidence from the Royal Institute of Chartered Surveyors had suggested a continuation of this trend.

26 The Chartered Institute of Purchasing and Supply (CIPS) manufacturing output index had been 53.1 in May, the second month in a row in which it had been above the neutral level of 50. The recovery had been led by consumer goods producers; the index for investment goods had remained negative. New orders, both domestic and export, had improved significantly since October 1998. Similarly, the CBI's survey measures of total orders and output expectations had also increased in recent months. However, according to the CBI, export order books had shown no improvement in May.

27 The CIPS services output index had been 56.4 in May, well above the neutral level for the third month running. The CIPS construction survey had reported a rise in construction activity for the fourth consecutive month in May, with the total activity index at its highest level for 14 months, and housing activity had grown at its fastest rate in the last two years.

28 A survey by the Bank's regional Agents covering 140 firms had revealed that the strength of the exchange rate had affected manufacturing firms more adversely than service sector companies. The majority of firms surveyed expected that the pound would remain broadly unchanged or depreciate against the euro over the next twelve months. But, there was little expectation that the sterling-dollar exchange rate would move much in the next year. Most of the manufacturing firms surveyed had indicated that sterling's strength was impacting negatively on both their domestic and external market share. In contrast, the majority of service sector firms surveyed had indicated little impact of the level of sterling on their domestic or export market performance.

IV The labour market

29 Employment had continued to grow, but at a slower pace than in the second half of 1998. According to the Labour Force Survey (LFS), employment had risen by 63,000 (0.2%) in Q1, down from 0.4% in 1998 Q4. Most of the slow-down had reflected slower growth in part-time employment. Provisional data had suggested that manufacturing employment had continued to fall in Q1. The CIPS surveys for May had also pointed to a further fall in manufacturing employment and a slowdown in the pace of service sector job creation. By contrast, the surveys suggested that construction sector employment growth had increased. The May Federation of Recruitment and Employment Services (FRES) survey had pointed to rising demand for permanent placements and temporary staff for the third month running.

30 Total hours worked had risen by 0.3% in the three months to March, but had been only 0.1% higher than a year earlier. The rise in Q1 had reflected the fact that average hours worked by full-time employees had been flat, having previously been falling. The proportion of employees who usually worked more than 45 hours per week had continued to fall in Q1, perhaps reflecting the impact of the Working Time Directive.

31 Discrepancies identified by the ONS in the official series for the number of outstanding Job Centre vacancies meant that the data had become an unreliable indicator of recent trends in vacancies. Notifications of new Job Centre vacancies—which the ONS considered a more reliable measure—had been broadly flat since late 1994. However, the national Press Recruitment Advertising Index (which has a high proportion of professional jobs) had continued to fall quite sharply.

32 The claimant count had declined by 17,400 in April, but had been distorted by difficulties with seasonal adjustment around the Easter period related to changes in the entitlement of students to unemployment benefit. LFS unemployment had risen by 24,000 in Q1. Aggregate unemployment rates on both measures had remained broadly stable in recent months. Short-term LFS unemployment (duration less than a year) had risen, as it had for the previous six months, and long-term unemployment had fallen less rapidly than in previous quarters. The relative dispersion of

regional unemployment rates had increased further, and had now returned to typical levels seen over the past 25 years, having been extremely low for much of the early 1990s.

33 The combination of higher employment and higher unemployment had been associated with a further fall in inactivity of 47,000 in Q1, according to the LFS; rather less than in the previous quarter.

34 The official headline measure of annual earnings growth had increased to 4.8% in March. Both public and private sector earnings had risen; on a sectoral basis, the main contribution had come from the service sector. By contrast, the Reward Index had suggested that earnings growth had fallen, to 4.2% in March and 3.9% in April. But temporary divergences of this size between the Average Earnings Index (AEI) and the Reward Index have not been unusual. According to the FRES survey, the balance of those reporting a monthly rise in pay rates for agency placements had risen slightly in both April and May. And rough calculations suggested that growth in earnings per hour had remained stronger than that in earnings per head.

35 It was not possible to say how much of the rise in the AEI headline rate in March had reflected higher growth in bonuses. Although the official data had appeared to show a sharp rise in the contribution of bonuses to annual earnings growth and a fall in the annual growth of regular pay, both series had been distorted by a change in the method used to collect bonus data. Investigations by the ONS had shown no evidence that the change in bonus reporting had had any distorting effect on the reporting of total gross pay, so the headline AEI rate should have been unaffected. The decline in profits growth in recent quarters suggested that profit-related bonuses could be growing more slowly than previously. But bonuses were also influenced by other factors, including labour market tightness and structural changes in the use of bonus and performance-related pay.

36 The Bank's average twelve-month whole-economy wage settlement measure had increased from 3.6% in March to 3.9% in April. But no settlement information had yet been received from about a quarter of the firms usually in the sample, and the Bank's database over-represented the public sector. Applying the AEI weights to the sectoral indices suggested that weighted settlements had risen only 0.1 percentage point, to 3.7%, in the twelve months to April. A matched sample had suggested that private sector settlements had continued to fall in April, compared with a year earlier. Other reports had also suggested a further slight easing in wage settlements. The Bank's Agents had reported that upward pressures on wages were limited, although some employees were being awarded above-inflation increases because of skills shortages.

V Prices

37 Oil prices had stabilised in May, averaging \$15.83 per barrel. The Bank's non-oil commodity index had increased by 1.7% in the year to April, the first positive annual inflation rate since 1996. This had been mainly the result of higher domestic food and fuel prices (83% of the non-oil index).

38 Largely reflecting the effects of higher oil prices, input price deflation had moderated; in the year to April the index had fallen by 1.3%, following an annual decline of 3.8% in March. Similarly, output prices had increased because of higher petroleum prices and duties, but annual producer price inflation excluding duties (PPIY) had stayed subdued, at -0.3%. Both the CIPS and the CBI surveys had suggested continued producer price deflation. Import and export prices had risen slightly in March, mainly because of higher oil prices.

39 Annual retail sales deflator inflation had remained at 0.7% in April while annual GDP deflator inflation had fallen to 2.0% in 1999 Q1, from 2.6% in 1998 Q4. The fall had been largely

accounted for by lower contributions from the household expenditure and net export categories. Indicators of domestically generated inflation had also fallen in Q1—the GDP-based measure declined to 2.5% and the RPIX-based measure to 4.2%.

40 RPI and RPIX inflation had declined to 1.6% and 2.4% respectively, reflecting the dropping out from the twelve-month comparison of the 1998 Budget road-fuel price effects and weaker food price inflation. In April, annual HICP inflation had fallen by 0.2 percentage points to 1.5%.

VI Reports by the Bank's Agents

41 The Bank's regional Agents reported on their discussions with contacts over the past month. Confidence levels in the manufacturing sector had risen, following subdued activity in Q1, but there had been little evidence of increasing orders. Manufacturers had expected limited growth in the second quarter. Demand from export markets had improved; US demand had remained strong and demand from East Asian and Middle East countries had increased. But sterling's appreciation had forced exporters to cut prices to retain market share and had caused greater import penetration. Manufacturing investment intentions had remained concentrated on productivity gains rather than capacity increases. An increasing number of manufacturers had begun to consider investing abroad.

42 Annual retail sales growth had been sluggish. Retail contacts had expectations of limited sales growth in the second quarter and retail property investment intentions had declined. Sales volumes growth had been largely dependent on price discounting. Sales of fashion and homeware goods had been below normal for the time of year, but strong mobile phone and personal computer sales growth had persisted. Car dealers had reported weak annual sales growth, heavy discounting and a reluctance to build stocks for the new registration in September. In contrast, annual leisure sector growth had continued; restaurants, entertainment venues and tour operators had all reported increased consumer spending. Investment intentions had remained strong. Housing market activity had risen overall; new building had increased, with many first-time buyers evident. That said, growth had been strongest in London and south-east England; elsewhere, significant pockets of negative mortgage equity had persisted.

43 Manufacturing employment had continued to fall and skill shortages to ease. Any labour hoarding had tended to reflect short-term factors, such as waiting for enquiries to become orders, rather than longer-term concerns about replacement of skills. Manufacturing wage growth had fallen, despite the continued need, in many cases, to buy out profit-related pay schemes. Service sector wage growth had remained stronger, though with wide variations depending on individual performance and sector. Skill shortages had continued to ease, even in competitive sectors such as IT, suggesting less upward pressure on future service sector wage settlements.

VII Market intelligence

44 The expected UK interest rate curve implied by prices from financial markets had steepened significantly. In particular, the market's view of the level of interest rates in 2000 and 2001 had increased. This reflected three main factors. First, market expectations of an increase in US interest rates had increased during the course of the month, with US markets pricing in a rise of at least a $\frac{1}{4}$ percentage point in the Federal Funds target rate by September 1999. Second, the market had interpreted recent UK data, such as the CIPS survey and Halifax price index, as strong. Third, some market players' perceptions of the likelihood and timing of UK entry into EMU had changed. This had changed their expected path of UK interest rates over the next five years.

45 The increase in market expectations of UK interest rates had been one factor behind sterling's continued strength in effective terms over the month. Several other factors had influenced market sentiment, including market concern over fiscal discipline in the euro area. Developments in Kosovo had had an impact at particular moments, but were probably less influential than in the previous month. Information from the foreign exchange options market suggested that the downside risk to sterling had increased slightly following the statement accompanying the May MPC meeting, although the effect had not been great and had subsequently been offset by other factors. Some market participants reported that portfolio shifts into sterling and out of the euro had continued, and that this formed part of a readjustment which brought the composition of these portfolios back closer to their historic averages.

Treasury Chambers, Parliament Street, London, SW1P 3AG
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18 May 1999

**Mr Eddie George
Governor
Bank of England
Threadneedle Street
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Dear Eddie

REMIT FOR THE MONETARY POLICY COMMITTEE

The Bank of England Act requires that I specify what price stability is taken to consist of and the Government's economic policy objectives at least once in every period of 12 months.

The framework has performed well in its first two years. Both you, as Chairman, and the members of your committee should be congratulated. Inflation has remained at or around the Government's target, within 0.2 percentage points over the last ten months. Inflation is expected to remain close to target: long-term interest rates are close to their lowest level for over 40 years.

I believe the framework's success reflects a number of factors. First, the objective of monetary policy is clear and unambiguous, a symmetric inflation target. Second, the monetary policy framework is open and transparent allowing the public to scrutinise the decisions that are made. Third an equally clear framework for fiscal policy, together with the presence of the Treasury representative at MPC meetings, has ensured the effective coordination of monetary and fiscal policy. Finally, the high quality of the decisions made reflects the benefits of selecting members on the basis of relevant skills and expertise.

Considering the above, I confirm that the MPC's remit will remain unchanged. I attach a copy of last year's remit for ease of reference.

Yours sincerely

GORDON BROWN

REMIT FOR THE MONETARY POLICY COMMITTEE

The Bank of England Act came into effect on 1 June 1998. The Act states that in relation to monetary policy, the objectives of the Bank of England shall be:

- (a) to maintain price stability, and
- (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

In order to comply with the Act, this remit sets out what price stability should be taken to consist of and what the economic policy of the Government should be taken to be.

Price stability

I confirm that the operational target for monetary policy remains an underlying inflation rate (measured by the 12-month increase in the RPI excluding mortgage interest payments) of 2½ per cent. The inflation target is 2½ per cent at all times: that is the rate which the MPC is required to achieve and for which it is accountable.

My intention is to lock into our policy making system a commitment to consistently low inflation in the long term. The real stability that we need will be achieved not when we meet the inflation target one or two months in succession but when we can confidently expect inflation to remain low and stable for a long period of time.

The framework takes into account that any economy at some point can suffer from external events or temporary difficulties, often beyond its control. The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output.

But if inflation moves away from the target by more than 1 percentage point in either direction I shall expect you to send an open letter to me, following the meeting of the Monetary Policy Committee and referring as necessary to the Bank's Inflation Report, setting out:

- the reasons why inflation has moved away from the target by more than 1 percentage point;
- the policy action which you are taking to deal with it;
- the period within which you expect inflation to return to the target;
- how this approach meets the Government's monetary policy objectives.

You would send a further letter after three months if inflation remained more than 1 percentage point above or below the target. In responding to your letter, I shall, of course, have regard to the circumstances prevailing at the time.

The thresholds do not define a target range. Their function is to define the points at which I shall expect an explanatory letter from you because the actual inflation rate is appreciably away from its target.

Government's economic policy objectives

The Government's central economic objective is to achieve high and stable levels of growth and employment. Price stability is a precondition for these high and stable levels of growth and employment, which in turn will help to create the conditions for price stability on a sustainable basis. In the recent past, instability has contributed to the UK's poor growth performance, not least by holding back the long-term investment that is the foundation for a successful economy.

The monetary policy objectives of the Bank of England are to maintain price stability and subject to that, to support the Government's economic policy, including its objectives for growth and employment.

Accountability

The Monetary Policy Committee is accountable to the Government for the remit set out in this letter. The Committee's performance and procedures will be reviewed by the Court on an ongoing basis (with particular regard to ensuring the Bank is collecting proper regional and sectoral information). The Bank will be accountable to Parliament through regular reports and evidence given to the Treasury Select Committee. Finally, through the publication of the minutes of the Monetary Policy Committee meetings and the Inflation Report, the Bank will be accountable to the public at large.

Restatement of the Remit

The inflation target will be confirmed in each Budget. There is a value in continuity and I will have proper regard to that. But I will also need to consider the case for a revised target at these times on its merits. Any changes to this remit will be set out in the Budget. The Budget will also contain a statement of the Government's economic policy objectives.

GORDON BROWN

Text of Bank of England press notice of 10 June 1999

Bank of England reduces interest rates by 0.25% to 5.0%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 5.0%.

The Committee considered recent economic developments against the background of the May *Inflation Report*. Taking into account all the evidence on the inflation outlook, the Committee judged that it is now more likely that inflation will undershoot the 2½% target, and therefore voted to reduce the Bank's repo rate by 0.25%.

The minutes of the meeting will be published at 9.30 am on Wednesday 23 June.

Minutes of the Monetary Policy Committee meeting on 7–8 July 1999

1 Before turning to its immediate policy decision, the Committee discussed the world economy; monetary and financial conditions; demand and output; the labour market; prices and costs; and other issues relevant to its decision.

The world economy

2 The Committee considered whether the gradual improvement in the outlook for the world economy had continued over the past month.

3 In the United States activity had remained robust, although consumption growth had slowed a little. The Federal Open Markets Committee had raised rates by 25 basis points, accompanying this with a statement that it no longer had a bias to tighten policy. This had been interpreted by the markets as a sign that the prospect of further increases in official rates was now less immediate than they had believed before, and equity prices had reached new highs. The timing and extent of any slowdown in activity in the United States remained unclear, and it was possible that growth might stay above trend for longer than previously thought.

4 Business confidence had picked up a little in Germany and France, with orders in Germany and Italy also showing some signs of recovery. While the steepening of the euro yield curve might reflect some upwards revision in views on activity, this explanation was not consistent with the recent depreciation of the euro. There was market comment that these recent movements might be explained by an increase in concerns related to the fiscal position in the euro area.

5 In Japan the recorded path of output was likely to be volatile. GDP figures indicated growth of 1.9% in the first quarter of 1999. Adjustments to reflect a variety of factors, such as seasonal adjustment techniques, might lead to the initial estimate of growth in Q1 being revised down, though it might still be above most earlier forecasts. Even if such a revision were made, GDP might contract in the second quarter. Nevertheless base money growth continued to pick up, equity prices had risen again and business confidence was a little less weak.

6 GDP forecasts compiled by Consensus Economics for the emerging market economies had generally been revised up over the last month. However, this was not so for some countries, such as Argentina, where yield spreads for government debt over US Treasuries had also increased.

7 The Committee agreed that the prospects for growth in the world economy were now a little stronger than a month ago, although arguably the uncertainties in the United States had if anything increased. If growth in the United States remained strong, and if the Asian recovery gathered pace, this might begin to put pressure on non-oil commodity prices, some of which had already begun to rise, as had commodity-related currencies and equities. It was also argued that the level of world output remained below capacity and no major area except the United States was expected to grow significantly faster than its long-term trend during the coming year or two; such a persistence of spare capacity in both OECD and emerging market economies would continue to restrain global prices for the time being.

Monetary and financial conditions in the United Kingdom

8 Growth in narrow money had risen, with notes and coin growing at their highest rate since end-1996. This appeared to be

consistent with a pick-up in retail sales in Q2. While broad money growth had eased overall, this had not been reflected in the household component. It might be that the reductions in official rates were feeding through into broad money growth for households rather faster than expected, but this was by no means certain. Total household borrowing remained robust, despite some slowing in consumer credit growth.

9 Market expectations for interest rates at the shortest maturities were if anything a little lower than a month ago. However, at the two to three year horizon, interest rates implied by short-sterling futures contracts had increased by around 40 basis points. This might reflect a market view about the cyclical path of interest rates, particularly if market participants believed that the United Kingdom was now less likely to be part of Economic and Monetary Union in the near future. Alternatively, the rise in expected UK interest rates might simply reflect the fact that euro rates had risen at the same maturity; it was not clear whether such a high correlation was warranted. Standard variable mortgage rates had moved little over the month; there was not yet much pass-through into retail rates from last month's reduction in official rates. With the steepening in the yield curve, further increases in fixed rates on new mortgages were possible.

10 The effective exchange rate index had fallen a little over the month, and was now close to the central assumption in the May *Inflation Report*. It was difficult to tell how much significance should be ascribed to this decline. Sterling had moved little against the euro, which accounted for two thirds of the exchange rate index, and was of considerable importance for many UK exporters. Sterling had fallen more against the dollar and was outside the range within which it had traded for some time. The question was raised of whether the significance of such a decline was fully captured by the dollar's weight in the effective index. To the extent that the linkage between sterling and the dollar had weakened, sterling's effective exchange rate might be less susceptible to future movements in the dollar against third currencies.

Demand and output

11 While the estimate of GDP growth was unchanged for the first quarter, revisions had been made to the expenditure components. Growth in consumption was higher than had been thought earlier, and remained strong even when adjusted for a number of special factors, such as a shift in the registration date for new vehicles. The decline previously indicated for business investment had been reversed, although in overall terms investment was flat because of a steep fall in the general government component, which might reflect erratic timing factors. Final domestic demand had been revised up, and was now estimated to have grown by over 1% in the quarter. Much slower stockbuilding and a more negative contribution from net trade (reflecting higher imports) had offset these revisions, leaving the level of GDP unchanged. It was likely that the lower starting point for stock levels would represent a more secure base for output growth in the coming quarters.

12 Retail sales volumes in the three months to May were over 1% higher than in the previous three months, and survey data also indicated a strengthening in activity, not only in services but also in manufacturing and construction. However, reports from the Bank's regional Agents did not suggest much of an improvement in retail conditions, with demand sluggish in many areas.

13 Data from surveys and other published sources had been used to produce estimates for GDP in the second quarter, both by

the National Institute for Economic Research and by Bank staff. These suggested that growth in Q2 could be marginally higher than in the central projection in the *May Inflation Report*. Such estimates were subject to error, but appeared to indicate that the recovery in output growth was on track, and that the prospects for activity were slightly better than had appeared a month ago. One complication, however, was that the annual Blue Book dataset would be published later in July, together with the full Quarterly National Accounts for Q1, and might alter the measured profile of activity for recent years. But the size and direction of any revisions were not yet known.

14 Indications from the housing market, reflecting data on prices, lending and transactions, all suggested a continuing recovery from the previous autumn. Developments in this area would require continued monitoring, although they were not yet a cause for concern.

15 On balance, the Committee agreed that the news over the past month suggested that the projected recovery in activity seemed to be underway and was if anything a little faster than expected.

The labour market

16 Data on labour market quantities were also consistent with a somewhat stronger path than had been expected for activity in Q2. Employment had continued to grow, if at a slower pace, with the increase more than accounted for by full-time workers. Unemployment had again declined slightly, reflecting a fall in the numbers of the short-term unemployed. Despite the slowdown in GDP growth over the past year, the unemployment rate was little changed from its mid-1998 level. Overall, labour market conditions remained somewhat tighter than had been expected, and the possibility of a substantial rise in unemployment had diminished.

17 By contrast, growth in nominal earnings appeared to be slowing more than expected, with the Average Earnings Index (AEI) showing a decline in earnings growth in the private sector and in services. The fall in the twelve-month growth rate to April was particularly marked, in part reflecting a fall in bonus payments by comparison with a year ago. It would be unwise to place too much emphasis on a single month's figure for the AEI, but there were other signs of a deceleration in private sector nominal earnings, for instance in the Reward index. The Bank's matched sample of private sector settlements also showed a decline, from 3.7% a year ago to 3.1% in April, in contrast to the rise in public sector settlements.

18 Reports from the Bank's regional Agents and the Federation of Recruitment and Employment Services provided less evidence of downwards pressure on pay. Nor was there any clear downward trend in the growth of earnings on a per hour basis. In addition, one-year-ahead inflation expectations of trade unionists—as given by the Barclays Basix survey—had fallen by 0.8 percentage points over the past year, rather more than the fall in settlements, indicating that real wages were growing a little faster than a year ago. Developments in the growth of nominal and real wages therefore seemed to be rather different. An explanation might be that the effect of a change in inflation expectations on wage settlements was typically less than one-for-one in the short-term.

19 The Committee noted that the National Minimum Wage had come into effect in April and had been expected to raise measures of average earnings. However, around half of those affected were thought to work in firms which were too small to be covered in the AEI sample. This increased the difficulties of assessing the impact of the minimum wage on earnings more generally. It was possible that more of the effect from the National Minimum Wage had been reflected in earnings before April than had previously been assumed.

20 It was possible, however, that any deceleration in nominal earnings might prove temporary. First, during the past year, RPI inflation had fallen from over 4% to 1.3%. If this was the measure on which wage bargainers focussed, rather than RPIX, it might help explain the slowdown in earnings growth. But as the impact of the reduction in interest rates began to fade, growth in RPI would become closer to that of RPIX. Second, the fall in settlements might reflect the plunge in business confidence in the autumn, when expectations of future profits had been revised down, or the sharp fall in consumer confidence, perhaps due to increasing fears of unemployment. Since then, survey data pointed to a recovery in business and consumer confidence. Third, lower bonus payments might reflect lower profits; if so this might reverse as the economy recovered.

21 However, a temporary downward shock to inflation might persist for some time in so far as the settlements sought by wage bargainers were determined by recent inflation outturns. It was also possible that supply-side factors, such as the increasing importance of the services sector, falling union membership, and labour market reforms, might have reduced the rate of unemployment at which wage inflation would tend to increase.

Prices and costs

22 RPIX inflation had fallen by more than expected in May, foreshadowed by the ONS advance estimate available to the Committee at its June meeting. This was largely accounted for by food prices, and to that extent the impact on prices two years ahead was unclear. That depended, in part, on whether the weakness in non-seasonal food prices was transient or reflected a trend towards a compression of retail margins. Even if the food price weakness were transient, its impact on RPIX two years out would depend on the degree of persistence of the effect of a temporary shock to inflation. In May, other goods inflation had been marginally weaker than expected and services inflation marginally stronger. The annual retail sales deflator had fallen in the year to May—the first fall since the series began in 1986.

23 Both oil and non-oil commodity prices were higher than a year ago and continuing to rise, and evidence from the Bank's regional Agents suggested that downwards pressure on import prices might be moderating. But imported materials prices continued to fall in May, and it was likely that some of the lagged effects of earlier declines in import prices were still to come through to retail prices.

24 Figures for unit labour costs (derived from the wages, employment and output figures), when taken together with price data, suggested that margins might be coming under pressure. But margins might rise again if demand picked up. An alternative possibility was that output (and hence productivity) was higher than suggested by present estimates. In that case potential output could also be higher; if so, there would be no implications for inflation.

25 The Committee noted that, in the short term, RPIX was likely to remain below 2.5%, but that the extent and duration of any undershoot was uncertain. It would depend on the extent to which this fed through into inflation expectations, on future movements in margins and the terms of trade, on changes in the output gap, and on how changes in productivity fed through into real wages. More generally, the outlook for prices given the prospective profile of activity was less clear than the prospects for activity itself, which seemed to be somewhat stronger than earlier expected.

Other issues

26 The Committee noted that the analysis and projections to be carried out for the *August Inflation Report* would allow it to reassess some of the puzzles in the data over the next month: in particular the contrast between activity, which was somewhat stronger than expected, and prices, which were somewhat weaker.

In addition, later in July new national accounts data would be published, more information on earnings would become available, and it would be easier to assess the significance of sterling's recent movements, particularly against the dollar. While not of themselves conclusive, these were reasons for waiting another month to get a clearer picture of the way in which the economy was developing.

The immediate policy decision

27 The Committee identified a variety of arguments for leaving the repo rate unchanged at 5%. Indicators of activity had strengthened over the past month, both in the United Kingdom and overseas. The pattern of revisions to GDP in the first quarter, with stronger final domestic demand and imports, and weaker stockbuilding, suggested stronger growth in subsequent quarters. Indications from surveys and retail sales, as well as the money and employment data, also suggested that growth in Q2 would be a little stronger than expected last month. However, price indicators were weaker than expected. The sharp fall in the twelve-month growth rate of the Average Earnings Index needed more corroboration, but private sector settlements also appeared to be slowing in nominal terms. Finally, the exchange rate had eased slightly over the month, particularly against the dollar. The implication of these factors for inflation over the next two years or so would be examined through the work to be carried out for the August *Inflation Report*.

28 Further arguments for leaving the repo rate at 5% were advanced. One was that given the impact of earlier interest rate reductions had yet to be fully seen, official rates should be kept at 5% until evidence emerged of price pressures in either direction. A second was that rates were now close to their neutral level, and that this was appropriate given the state of the economic cycle and the evidence on employment. A third argument was that against a background with a significant probability for inflation to undershoot the target in the short term, the Committee might be able to wait and see whether some of the developments, for

instance in the labour market, as was looking increasingly likely, reflected structural changes in the economy.

29 On another view, it might have been preferable last month to have left the repo rate unchanged for the reasons set out at the time. Developments over the month had probably strengthened that argument. Although cost increases were lower than expected, other indicators, such as domestic demand, money data and housing market activity, were pointing to a less benign inflation outlook further ahead, and the exchange rate was back in line with the central assumption in the May *Inflation Report*. But there were two reasons for not reversing last month's reduction. First, to do so might affect business and consumer confidence disproportionately. A reduction followed by an immediate rise in interest rates, in the absence of significant news about the economy, did not necessarily have the same impact on confidence as a constant level of rates. Second, a reversal might wrongly be interpreted as a stronger signal of the future path of interest rates than was warranted. It was desirable, therefore, to leave the repo rate unchanged this month.

30 The Governor invited the Committee to vote on the proposition that the Bank's repo rate be maintained at 5.0%. The Committee voted unanimously in favour of the proposition.

31 The following members of the Committee were present:

Eddie George, Governor
 Mervyn King, Deputy Governor responsible for monetary policy
 David Clementi, Deputy Governor responsible for financial stability
 Willem Buiter
 Charles Goodhart
 DeAnne Julius
 Ian Plenderleith
 John Vickers
 Sushil Wadhvani

32 Gus O'Donnell was present as the Treasury representative.

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 2 July, in advance of its meeting on 7–8 July 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I The international economy

2 The international environment had improved a little over the month. Activity in the United States had remained strong, and survey data for the euro area had been largely positive. Growth forecasts for Asia had been revised up.

3 The final estimate of Q1 GDP growth in the United States had been revised up to 1.1% quarter on quarter, reflecting a slightly less negative contribution from trade. In Japan, the estimate for Q1 GDP growth had been surprisingly strong, at 1.9% quarter on quarter. But this most probably overestimated underlying activity. Monthly activity data had suggested weaker growth, and it is possible that some of the public investment reflected orders booked in Q1 that would materialise in Q2. In the euro area, the preliminary estimate of Q1 GDP growth was 0.4% quarter on quarter, in line with the *May Inflation Report* projection. Consumption and investment had grown strongly, while net trade and destocking each subtracted from growth. In Italy, GDP had increased by 0.2% in Q1.

4 The pattern of growth in the major industrialised economies reflected ongoing adjustment to the emerging market crises of the past two years: net trade had made a negative contribution to growth in the major industrialised economies over the past two quarters. Industrial production in the United States had remained steady at around 2% at an annual rate. Data for the euro area as a whole were available only to February. More timely data were available for some individual economies; German industrial production had risen by 1.0% in April, but that was still 1.3% lower than a year ago, while French industrial production had fallen by 0.3% in April, and had been flat on the year-on-year comparison. Retail sales data had showed no sign of a slowdown in consumer spending in the United States. In Japan, retail sales had been stronger than last month, but still lower than a year ago. In the euro area, lack of timely data and distortions caused by the timing of Easter made retail sales data hard to read; German retail sales had risen by 4% in March and fallen by 4% in April.

5 In the United States, the Federal Open Markets Committee (FOMC) had increased the Federal Funds target rate by 25 basis points to 5.0% on 30 June and reverted to a neutral stance towards monetary policy. Interest rates implied by futures contracts had fallen after the FOMC announcement. Short-term inflation expectations had picked up recently, possibly reflecting the rise in energy prices, but long-run inflation expectations had remained flat. Overall the data suggested that consumption had perhaps slowed a little in Q2, but nevertheless remained robust. Consumption had risen in May, but sales data suggested a slowdown in June. Consumer confidence and employment, however, had risen further in June. Some signs of slowing had been apparent in housing sales, but mortgage growth, which appeared to have fuelled consumption, had remained high.

6 The forward-looking information available from surveys indicated a further narrowing of the gap between business and consumer confidence in the euro area in May and June. Business confidence had risen a little (from a low level) and consumer confidence had fallen slightly (from a higher level). The IFO

survey of business confidence in western Germany and the French INSEE business survey had both risen in May, partly reflecting improvements in foreign orders. Italian orders had also picked up. In the United States, the National Association of Purchasing Managers Index had risen above market expectations in June, reflecting rises in the sub-indices for production and new orders. The export orders index had also risen. In Japan, the Tankan survey had shown a small improvement in business sentiment, reflecting better financial conditions.

7 International data on consumer price inflation in May suggested that the pick-up in April had been temporary. In the United States, consumer price inflation fell to 2.0%, from 2.3% in April; for Japan, May's figure was -0.4%; and in the euro area inflation on the harmonised measure had fallen back to 1.0%.

8 Turning to global financial markets, the yen had reached a high of 118 against the dollar around the time of the release of Q1 GDP. Since then, several rounds of intervention had brought it back into the 120–122 range. Implied volatility had subsequently fallen sharply. Japanese bond yields had risen slightly, and equities more markedly, over the month, following the strong GDP data. In the euro area, expectations of short-term interest rates had risen over the past month.

II Monetary and financial conditions

9 Narrow money growth had remained robust. The twelve-month growth rate of notes and coin, after adjusting for the introduction of the new 50 pence and £2 coins, had risen to 7.0% in June, the highest rate since December 1996.

10 M4 had risen by £3.4 billion (0.4%) in May. The annual rate of growth had slowed to 7.0%. The slowdown in aggregate M4 and aggregate M4 lending had been largely driven by Other Financial Corporations' (OFCs') M4 and M4 lending. OFCs' M4 deposits had fallen by £2.0 billion in May, and lending to OFCs had fallen by £1.8 billion in May.

11 The M4 deposits of the household sector had risen by 0.6% (or £2.9 billion) in May. The growth rate of households' M4 deposits had increased generally since 1998 Q2. M4 lending to the household sector had remained strong; it had risen by 0.6% (or £3.1 billion) in May, leaving the twelve-month growth rate unchanged at 7.9%. Total lending secured on dwellings had fallen from £3.1 billion in April to £2.7 billion in May, although gross lending had remained strong. Approvals in May had been strong and, reflecting the current 'tight' state of the housing market, many banks and building societies were now allowing consumers to carry approvals forward if their offers were rejected. This had caused the stock of loan approvals outstanding to rise sharply, and could have altered the relationship between the stock of approvals and secured lending. Monthly consumer credit growth had fallen from 1.3% in April to 0.6% in May, though this in part could have reflected a switch to mortgage equity withdrawal leaving total borrowing for consumption still strong in 1999 Q2. Compared with a year earlier, consumer credit growth remained robust at over 17%.

12 Private Non-Financial Corporations' (PNFCs') M4 deposits had been strong in May, rising by 2.1% on the month (or £2.6 billion). However, this figure had been inflated by a large temporary item; adjusting for this, the flow in May was negative. Lending to PNFCs had fallen by 0.4% on the month (or £0.8 billion). The sharp rise in capital issues since the beginning of the year had continued.

13 Turning to price indicators of monetary conditions, interest rate expectations implied by longer-dated short-sterling futures contracts had risen since the previous MPC meeting: the rate implied by the September 2001 contract had risen by close to 40 basis points to around 6.80%. Expectations of interest rates in the euro area and Japan had risen over the month, which might have contributed to the increase in interest rates implied for the United Kingdom.

14 Nominal forward rates at maturities of 3 to 5 years had risen by between 35 and 45 basis points since the previous meeting; this rise had been in line with the rise in longer-dated short-sterling futures contracts. Longer rates (beyond about 9 years) had fallen by up to 55 basis points. This pattern had also been reflected in swap rates and corporate bond yields which rose by similar amounts at 3 to 7-year maturities.

15 Real interest rates derived from the index-linked gilt market had been broadly unchanged since the previous meeting, suggesting that the rise in nominal rates largely reflected increased inflation expectations. Survey-based measures of inflation expectations available each month had also risen, but by less than those implied by yield curves. According to the survey measures, the rise in nominal interest rates could be split approximately half and half between a rise in real rates and a rise in inflation expectations.

16 The Consensus Economics Forecasts measure of the expected average inflation rate over the next two years had risen since 1999 Q1 by 20 basis points, to 2.3% in 1999 Q2. But over the same time period, the Barclays Basix survey suggested that inflation expectations for the next two years had ticked down. In particular, trade union expectations for the year ahead had fallen from 2.7% in Q1 to 2.5%.

17 The Bank's survey of advertised interest rates suggested that the 25 basis point cut in the repo rate in June had not been passed through to standard variable mortgage rates. Moreover, fixed-rate mortgages had risen over the month: for example, average 5-year fixed mortgage rates with no lock-in had risen by around 20 basis points to 6.20% in June. Furthermore, spreads between fixed-rate mortgages and swap rates had narrowed in recent months, suggesting that further increases in mortgage rates were possible. Unsecured loan rates and savings rates had been broadly unchanged on the month.

18 The FT-SE All-Share index had risen by around 3% to 3069 since the previous meeting, with small and mid-capitalisation stocks continuing to outperform the FT-SE 100. Information technology, resources and cyclical consumer goods stocks had performed relatively well over the month.

19 The sterling effective index had fallen by 1.0% since the June meeting to 103.5, approximately 0.1% below the level implied by the central projection of the *May Inflation Report*. Sterling had fallen by 0.6% against the euro and 2.6% against the dollar. Movements in sterling over the month appeared largely unrelated to changes in UK yields relative to overseas.

III Demand and output

20 According to the latest ONS release, quarterly growth of GDP at constant market prices had been unrevised at 0.0% in 1999 Q1. But the annual rate had been revised up by 0.1 percentage points to 0.7%, and there had been revisions to the expenditure composition of growth in Q1. No revisions had been made to previous quarters, pending the release of the full 1999 Q1 National Accounts. Stronger household consumption and investment in Q1 had been offset by weaker contributions from net trade and stockbuilding. The difference between final domestic demand and GDP growth had widened in Q1.

21 Quarterly growth of gross value added at constant basic prices had been revised up from -0.1% to 0.0%, with service sector growth revised from 0.2% to 0.4%, largely the result of an upward revision to the transport and communications sector (up from 0.2% to 1.3%). Excluding the erratic energy and agriculture sectors, the quarterly growth rate of GDP had been 0.2%.

22 Household consumption growth in Q1 had been revised up from 1.1% to 1.4%, the highest quarterly growth rate since 1997 Q2. Within this, spending on vehicles, household goods, clothing and footwear, and financial services had been particularly strong. The strength of spending on vehicles had probably been affected by the timing change to new vehicle registrations. But this had not accounted for all the strength in spending in Q1.

23 Government consumption growth had been unrevised at 1.4% on the previous quarter. Investment growth in Q1 had been revised up from an unexpectedly low -1.7% to 0.0%. Higher business investment, revised up from -2.0% to 1.7%, had offset a sharp fall in general government investment (-19.2%). The increase in investment had been concentrated in the service sector.

24 On the income side of the accounts, the gross operating surplus of corporations had been revised up from -3.2% to -3.0%. The sharp fall in Q1 had been the largest since 1974 Q1, and was the result of a 4.2% fall in private non-financial corporations, only partially offset by a 4.8% rise in financial corporations. The fall in gross operating surplus had looked sharp, relative to survey evidence and profits warnings, but the inclusion of the alignment adjustment had had a downward effect on the growth of the gross operating surplus. Excluding the alignment adjustment, the gross operating surplus of private non-financial corporations was flat, although the annual rate was little different (at around 5%).

25 The contribution from stockbuilding to GDP growth had been revised down from -0.2 percentage points to -0.4 percentage points. But excluding erratic items, the contribution to GDP growth from stockbuilding was estimated to have been around -0.2 percentage points.

26 The Bank's regional Agents had conducted a survey of their contacts about trends in stock-to-output ratios, both in the recent past and looking to the future. The contacts had been from the manufacturing, retailing and wholesale sectors. The Agents had asked how firms' stock-to-output ratios had changed over the last five years. The majority of respondents (56%) had reported falling ratios. When the responses had been weighted according to firms' turnover, the balance of those reporting rising and falling ratios had been more even. A majority of retailers had reported a rise in stock-to-output ratios on this basis, while manufacturers had continued on balance to show a fall.

27 The Agents had also asked about the future trend of stock-output ratios over the next few years—excluding cyclical influences. A clear majority of respondents had expected their stock-output ratios to fall. This result had been seen across all three sectors. In the retailing sector, increased competition, pressure on profit margins and improvements in information technology had been seen as the drivers of the expected reduction in stock levels as a proportion of sales. A majority of respondents had expected future falls in stock-output ratios to be similar to those in the past, with the exception of retailers.

28 The contribution of net trade to GDP growth had been revised down to -0.7 percentage points from -0.5 percentage points. This had reflected an upward revision to import growth, from 0.3% to 1.1%, which had more than offset the upward revision to export growth (from -1.4% to -1.0%). The Q1 net trade deficit, at 4.5% of GDP, had been the second highest on record.

29 Retail sales volumes had risen by 1.0% in May, following a revised fall of -0.3% in April. The three month growth rate (on the previous three months) had risen from 0.6% to 1.1%. The CBI Distributive Trades survey had suggested continued strength in June with the balance on reported sales at +22, up from +11 in May. The GfK measure of consumer confidence had suggested robust spending growth in Q2; the index had been broadly unchanged in June at 5.8.

30 Most indicators had suggested continuing strength in the housing market. The Nationwide house price index had risen by 0.8% in June; the Halifax index had risen by 1.8%. The annual rates of the two indices had moved closer, at 7.5% and 6.6% respectively. Housing starts had continued to rise from their trough in the autumn of 1998, and the House Builders' Federation survey balance on net reservations had remained at a strong level despite a slight fall in May. The improvement in starts was expected to feed through to higher completions and investment in dwellings over time. Particulars delivered in the three months to May had risen by 3.5% compared with the previous three months, but were 5.4% up on a year earlier. The Royal Institute of Chartered Surveyors' survey had shown a rise in the number of sales per agent in May for the second consecutive month.

31 Construction output had risen by 0.2% in 1999 Q1 and had been broadly flat over the last three quarters. The volume of orders for new work had been slightly weaker over the last two quarters, but was expected to underpin construction output in the short term. The Chartered Institute of Purchasing and Supply (CIPS) construction survey had indicated rising optimism and orders: the construction activity index had risen to 64.5 in June from 62.4. Within this, housing activity had risen faster than total construction, consistent with the pick-up in housing market indicators.

32 The outlook for manufacturing output had improved in June. The CIPS activity index had been above 50 for the third consecutive month. The expected output balance from the CBI survey had been positive in June, for the second month running. The CBI new orders balance had fallen slightly in June, with manufacturers citing the strong pound and weak European demand. Industrial production had risen by 0.1% in May. The CIPS services activity index had been broadly unchanged in June at 56.6. The new business index, at 58.5, had been at its highest level since March 1998.

IV The labour market

33 Employment growth, as measured by the Labour Force Survey (LFS), had slowed further in the three months to April compared with the previous three months, rising by 46,000 (0.2%). Workforce jobs had fallen by around 4,000 in Q1. There had been an increasing divergence between the two employment measures over the past year. During this period, LFS employment had risen by around 300,000 whereas Workforce jobs were only 85,000 higher. The increase in LFS employment during February-April had been more than accounted for by a rise of 57,000 in full-time employment and, consequently, the slowdown in employment growth was less evident in full-time equivalent terms. Higher employment had been offset by average hours per worker falling by 0.3% from the previous three months. Total hours had therefore fallen slightly over the quarter (by 0.2%), but overall, had been broadly flat for a year.

34 Turning to survey information, the CIPS manufacturing survey for June showed that employment had fallen further during the month, though the rate of decline had slowed. In the construction and service sectors employment had expanded further, and at slightly faster rates than they had in May. The Manpower survey of employment prospects for Q3 had shown little change, with the service and public sectors weaker and the manufacturing sector stronger. Information from the Bank's regional Agents suggested that further manufacturing redundancies would be offset

by job creation in services, especially in the hotel and transport sectors, where the Working Time Directive was having a significant impact.

35 Data problems persisted with the stock of unfilled vacancies in Northern Ireland and the West Midlands. Notifications of vacancies had fallen by 15,700 in May, although the trend had been flat. Overall, there had been no clear news in the vacancies data.

36 Both measures of unemployment had fallen. LFS unemployment had fallen by 23,000 to 6.2% in February-April, while the claimant count had fallen by 6,500 in May with the rate unchanged at 4.5%. On both measures, unemployment rates had changed little since mid-1998. The latest fall in LFS unemployment had been mainly among the short-term unemployed. Long-term unemployment had been flat. Changes in the regional pattern of unemployment had been consistent with the strong growth in service sector activity and the decline in manufacturing activity.

37 Inactivity had risen by 25,000 in the three months to April compared with the previous three months, which represented the first increase since mid-1998. This increase had been driven by a rise of 50,000 in the number of people who did not want a job.

38 Annual headline earnings growth for the whole economy had fallen from 4.8% to 4.6% in April. The fall in the headline rate was accounted for by private sector earnings growth, which had fallen by 0.4 percentage points. Public sector earnings growth had risen by 0.1 percentage points. The fall in private sector earnings growth had been particularly surprising given the introduction of the National Minimum Wage (NMW) in April, which had been expected to push up earnings growth. However, it was possible that some firms may have anticipated its introduction and had raised wages before the introduction date. The largest fall in earnings growth was in the services sector, where earnings had fallen 1.1 percentage points in the twelve months to April. In manufacturing, on the other hand, annual earnings growth had increased by 0.2 percentage points. The ONS had said that the fall in earnings growth was partly the result of a broadly based fall in bonuses in the business services sector, and partly the result of some firms paying their bonuses in Q1 rather than in April, as they had done last year.

39 Information from private surveys had suggested that earnings growth was either flat or had fallen slightly. The Reward index had fallen from 3.9% in April to 3.6% in May. The Federation of Recruitment and Employment Services survey on salaries and wage rates in June indicated that earnings growth was unchanged, although the survey was based on a small sample.

40 Wage settlements in May had changed little from the previous month. The twelve-month mean for the whole economy had been unchanged at 3.8%. The private sector mean had fallen by 0.1 percentage points to 3.7%, while the public sector mean had been unchanged at 4.1%. In a matched sample, the mean private sector wage settlement in April had fallen by 0.6 percentage points from the same time last year, somewhat less than the fall in inflation expectations over the same period.

41 The annual growth rate in the ONS measure of labour productivity in Q1 had been the weakest since 1991, rising by only 0.5%. A new productivity survey produced by NTC Research and the Institute of Management Services had suggested a sharp pick-up in productivity growth in Q2. Growth in unit wage costs had risen again in Q1, as wages and salaries had grown faster than productivity.

V Prices

42 The Bank's index of commodity prices including oil had risen by 0.6% in May, following strong rises in March and April.

The index excluding oil had also risen, by 0.2%. But annual inflation in both indices had fallen: to 3.4% (from 4.0%) for the oil-inclusive index and 1.4% (1.7%) excluding oil. The oil price had risen slightly over the month and exceeded \$18 per barrel on 6 July.

43 Producer input prices had fallen by 0.5% in May and the year-on-year inflation rate had fallen back to -2.6% from -1.1% in April. Imported materials prices had continued to fall. Evidence from the CIPS survey had suggested continued but slowing deflation in the near future. The output price level, whether including or excluding excise duties, had been unchanged in May. Total import prices had risen by 0.2% in April, but prices for imports from the non-EU countries had fallen by 0.1% in May. Export prices had risen more sharply—by 0.7% to all countries in April and by 0.5% to non-EU countries in May.

44 The rate of GDP deflator inflation in the first quarter had been revised up by 0.1 percentage points on both a quarterly and annual basis (to 0.4% and 2.2% respectively) in the third release of the GDP data. The retail sales deflator fell for the third consecutive month in May, leading to negative annual inflation for the first time in the series' history. The annual rate of inflation on the harmonised index had fallen by 0.2 percentage points to 1.3% in May, equalling its lowest rate since the series started in 1988.

45 The annual rate of RPIX inflation had fallen sharply, to 2.1%, in May. The rates of RPIY and RPI inflation had also fallen to 1.5% and 1.3% respectively. The fall was largely due to lower food and other goods prices, and had continued the recent pattern where goods price inflation had fallen but services inflation had remained fairly constant. Inflation in April and May had been markedly weaker than the central projection in the *May Inflation Report* forecast. This was entirely because of goods price inflation.

VI Reports by the Bank's Agents

46 The Bank's regional Agents had reported on their general discussions with contacts. The manufacturing recovery had been fragile, but business expectations had improved. And whereas business and financial services had shown ongoing growth, the outlook for consumer services had remained weak.

47 Retail sales had stayed weak. Only discount stores had recorded significant strengthening in activity. Generally, discounting had continued to be widespread. The evidence for other non-retail consumer expenditure had been mixed.

48 Exports to the United States had continued to be strong. The East Asian market on the other hand remained depressed, though the outlook had improved. Demand from Europe had remained weak, particularly from Germany and Italy. Sterling's persistent strength was seen as the main obstacle to rising European orders.

49 Manufacturing employment had fallen further, in contrast to the service sector where employment intentions had firmed. Skill shortages and pay pressures had persisted.

50 Overall, the view had been that activity in Q2 had turned out stronger than in Q1, though the latter had been perceived as very weak.

VII Market intelligence

51 Short-term expectations for UK interest rates had fallen since the previous MPC meeting. For longer maturities, however, rates had risen by around 40 basis points, having been up by 70 basis points or so at one stage. Changes in the shape of the yield curve could be partially attributed to international influences, such as the decision by the FOMC to raise rates, and to shifts in the market's view on UK entry to EMU and hence the future path of UK rates. In the more immediate future most market participants did not expect a further cut in the repo rate this month, given the retail sales data, evidence from surveys and house price data, although some believed that it was possible in the next few months if inflation continued to be below expectations.

52 Sterling had, over the last month, continued to depreciate against the dollar, reaching its lowest level since September 1996, with talk that it had moved into a new trading range. The changing pattern of differentials in official interest rates internationally was thought by many to be an important factor, as were signs of growth in other economies. For these reasons corporate demand for sterling had been less apparent at these levels than before. Data from options markets had suggested that the market saw risks as being on the downside for sterling against both the euro and the dollar.

Text of Bank of England press notice of 8 July 1999

Bank of England maintains interest rates at 5.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.0%.

The minutes of the meeting will be published at 9.30 am on Wednesday 21 July.

Text of Bank of England press notice of 5 August 1999

Bank of England maintains interest rates at 5.0%

The Bank of England's Monetary Policy Committee voted to maintain the Bank's repo rate at 5.0%.

The Committee's latest projections and analysis will appear in the *Inflation Report* to be published on Wednesday 11 August.

The minutes of the meeting will be published at 9.30 am on Wednesday 18 August.

Glossary and other information

Glossary of selected data

AEI: Average Earnings Index.

DGI: domestically generated inflation.

Divisia money: a measure of the money stock in which each component is weighted according to an estimate of its likely use for transactions.

ERI: exchange rate index.

HICP: Harmonised Index of Consumer Prices.

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 at UK banks and building societies by the non-bank, non building society private sector.

PPI: Producer Prices Index.

PPIY: Producer Prices Index excluding excise duties.

Reward Index: a three-month moving average measure of growth in total pay in the United Kingdom, produced by The Reward Group.

RPI inflation: inflation measured by the retail price 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.

Three-month annualised: the percentage change in a series over three months, expressed as an annual rate.

Abbreviations

BCC: British Chambers of Commerce.

BIS: Bank for International Settlements.

CAP: Common Agricultural Policy.

CBI: Confederation of British Industry.

CIPS: Chartered Institute of Purchasing and Supply.

EIU: Economist Intelligence Unit.

FEPI: Final Expenditure Price Index.

FRES: Federation of Recruitment and Employment Services.

FTA: Financial Times Actuaries.

FT-SE: Financial Times Stock Exchange.

GfK: Gesellschaft für Konsum, Great Britain Ltd.

IPD: Investment Property Databank Ltd.

LFS: Labour Force Survey.

MAFF: Ministry of Agriculture, Fisheries and Food.

MEW: Mortgage equity withdrawal.

MFR: Minimum funding requirement.

MPC: Monetary Policy Committee.

NMW: National Minimum Wage.

NYMEX: New York Mercantile Exchange.

OECD: Organisation for Economic Co-operation and Development.

OFCs: Other financial corporations.

OFWAT: Office of Water Services.

ONS: Office for National Statistics.

PNFCs: Private non-financial corporations.

WTI: West Texas Intermediate oil.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Office for National Statistics (ONS).
n.a. = not available.

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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This *Report* is available at: <http://www.bankofengland.co.uk/ir.htm>