

Inflation Report

August 2000

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 paths 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.

The Monetary Policy Committee:

Eddie George, Governor

Mervyn King, Deputy Governor responsible for monetary policy

David Clementi, Deputy Governor responsible for financial stability

Christopher Allsopp

DeAnne Julius

Stephen Nickell

Ian Plenderleith

John Vickers

Sushil Wadhvani

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

Overview

Growth with low inflation has continued in the UK economy. Output in the second quarter of 2000 was 3.1% higher than a year before, and inflation on the RPIX measure was 2.2% in June, just below target. Final domestic demand growth, having been strong throughout 1999, eased in the first quarter of this year—consumers' expenditure continued to increase, but investment and government expenditure fell back. Robust growth in world trade has boosted demand for UK exports despite the strength of sterling, and imports have also grown at a brisk pace. Service sector activity has continued to expand strongly, while industrial production has recovered from weakness at the start of the year. Employment has risen further, and the unemployment rate has declined to its lowest level for a generation. But earnings growth has fallen back from the millennium-related boost to pay around the turn of the year. Commodity price increases—especially for oil—have put some upward pressure on costs. Sterling fell sharply in May, but the exchange rate remains strong.

Activity and trade in the world economy have picked up strongly over the past year or so, and further expansion is in prospect. The momentum of demand and output growth in the United States continued into the first half of this year, but there are tentative signs of some deceleration. Recovery in the euro area, however, has gathered pace. The outlook in Japan remains uncertain—business profitability has improved but consumer demand remains subdued. Emerging market economies, especially those in East Asia, have consolidated upon their strong recoveries from economic setback two years ago. The oil price, though volatile, has generally been stronger than anticipated. In contrast to several years of weak commodity prices, this has given an upward impulse to inflation in a number of countries. The Federal Reserve and the ECB have increased interest rates further since May. There remain clear risks of abrupt and disorderly adjustment in the world economy—for example involving sharp falls in financial asset prices—but there is a good prospect of steady and broadly-based growth.

Output in the United Kingdom is estimated to have increased by 0.9% in the second quarter. That is more than expected, and significantly above the 0.5% growth

recorded in the first quarter. The pick-up in output growth in recent months partly reflects a recovery in industrial production, especially in energy-related sectors, from a decline earlier in the year. But it also reflects strong expansion in service sector activity. While there is no uniform picture within manufacturing or within services, the sharp contrast between these broad sectors remains a feature of business surveys and reports from the Bank's network of regional Agents.

The pattern of demand growth in the first quarter—almost flat final domestic demand but positive contributions from net trade and stockbuilding—contrasts with that recorded in 1999. Consumer expenditure increased in Q1, though at a lower rate than in previous quarters, but investment and government expenditure declined. The slowing of domestic demand early in the year may have resulted in part from temporary factors—for example, unwinding of unusual strength in the run-up to the millennium. Domestic demand growth appears likely to have picked up in the second quarter, but there are indications—including the apparent cooling of the housing market—that the underlying momentum of consumption growth may be easing.

In July, the Chancellor made his statement on the Spending Review, the broad lines of which had been drawn in the March Budget. Relative to the Budget, the profile for total government expenditure going forward is marginally higher—reflecting past underspending—and there is some increase in government consumption financed by lower social security and debt interest payments. Depending on the extent of possible future underspending, these measures may make a small addition to overall demand growth.

Both exports and imports have risen surprisingly rapidly over the past year. Export volumes have been boosted, notwithstanding the high exchange rate, by the robust recovery in the world economy. But the growth rate of imports—supported by the combined strength of domestic demand and rising import penetration—has generally outstripped that of exports, and over the past three years the current balance has moved from surplus to a deficit approaching 2% of GDP. Despite the fall in sterling since May, some further deterioration of the net trade position is in prospect.

Narrow money growth has moderated and broad money growth has risen—both to annual rates around 7%, somewhat above the growth rate of nominal GDP.

Strong credit expansion has continued. Corporate borrowing—from banks as well as capital markets—has risen sharply since last autumn, and annual growth in lending to households remains robust at around 10%. Most indicators suggest that the housing market is softening, although secured lending and mortgage approvals have so far stayed firm.

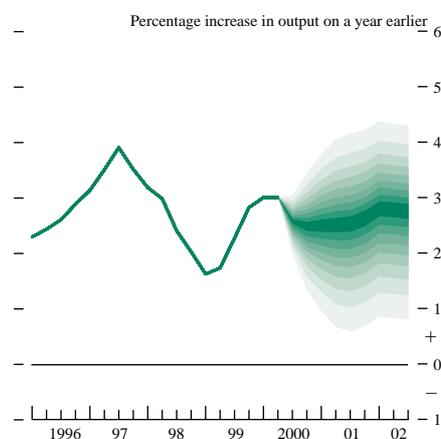
The MPC has maintained the official interest rate at 6% since February. Near-term money market rates—a guide to expected future official interest rates—have eased further since the *May Report*. Longer-term bond yields and equity prices have been fairly stable over that period. The exchange rate, however, fell substantially following its rapid rise earlier in the year. The average value of sterling's effective exchange rate index in the 15 working days to 2 August was 106.1, about 4% lower than three months ago. (This is the starting point for the exchange rate profile in the Committee's projections described below.)

Labour market behaviour is a key determinant of domestic inflationary pressure. Official data since the last *Report* have shown a benign combination of rising employment growth and a sharp fall in pay growth. Employment on the LFS measure has increased steadily since 1993, and grew by 0.5% in the three months to May. Average hours worked decreased, however, so total hours have not risen correspondingly. Unemployment has fallen further—to 5.6% on the LFS measure and to 3.8% on the claimant count, the lowest rate since 1975. Employment intentions are positive, particularly in the service sector, but widespread skill shortages persist.

The headline measure of average earnings growth per head fell from 6.0% in February to 4.6% in May. The boost to pay growth around the turn of the year appears to have been in large part a temporary phenomenon driven by millennium-related payments and bonuses. Wage settlements have been near 3% on average, though there are some reports of prospective upward pressures. Measures of labour productivity growth have picked up over the past year, and growth of unit labour costs has moderated to around 3%. These recent indications of rather weaker-than-expected earnings growth combined with falling unemployment provide some evidence that underlying labour market performance is better than previously judged.

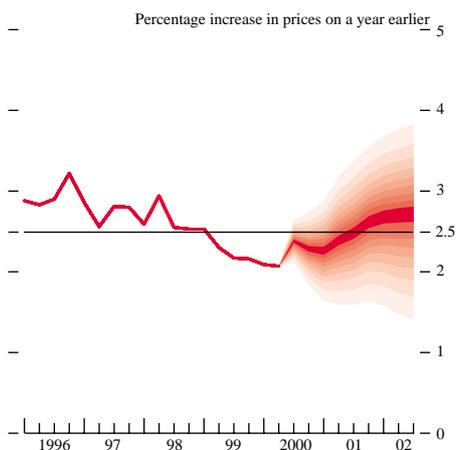
Chart 1 shows the Committee's assessment of the outlook for GDP growth, on the assumption that the

Chart 1
Current GDP projection based on
constant nominal interest rates at 6%



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 6%



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.

official interest rate remains at 6%. In the central projection, annual growth eases from its present rate to around 2½%—near trend—before rising slightly in the second year of the forecast. The profile is similar to that in the *May Report*, with softer consumer demand growth balanced by somewhat firmer external and public sector demand.

Chart 2 shows the corresponding projection for RPIX inflation. As in May, the broad picture is of a gradual increase in inflation over the next two years. The most likely outcome is for inflation to rise, from just below the target at present, to just above the target at the end of the forecast. The profile is slightly higher than in May, as the lower exchange rate offsets weaker pay pressure and consumption growth.

As ever, large uncertainties surround the projections for inflation and growth shown in the charts, and not every Committee member shares all the assumptions that underlie them. Some members prefer alternative assumptions about factors such as competitive pressures and productivity growth, which in combination could raise or lower the inflation profile by up to ½% at the two-year forecast horizon.

The immediate outlook remains one of steady growth with low inflation at around the 2½% target rate. But overall demand and supply must remain in balance if that prospect is to be maintained. This suggests that private sector domestic demand growth will need to slow in the period ahead, and pay pressures must not intensify. The Committee's assessment of the evolving balance of risks to inflation will determine whether further policy changes are required to keep inflation on track to meet the target.

Contents

1	Money and financial markets	3
1.1	Money and credit	3
	Narrow money	3
	Broad money and credit	3
	Household sector	4
	Private non-financial corporations	5
	Other financial corporations	6
1.2	Interest rates and asset prices	6
	Short-term interest rates	6
	Long-term interest rates	7
	Household borrowing rates	7
	Corporate borrowing rates	8
	Real interest rates	9
	Equity prices	9
	Property prices	10
	Exchange rates	10
1.3	Summary	11
2	Demand and output	13
2.1	External demand	13
2.2	Domestic demand	15
	Household sector consumption	15
	Investment demand	17
	Public sector consumption	20
	Inventories	21
2.3	Output	21
2.4	Summary	23
	<i>Box: The housing market</i>	18
3	The labour market	24
3.1	Employment and unemployment	24
3.2	Earnings and settlements	27
3.3	Labour productivity and unit wage costs	30
3.4	Summary	31
4	Costs and prices	32
4.1	Raw materials and commodity prices	32
4.2	Import prices and the exchange rate	33
4.3	Costs and prices in manufacturing	33
4.4	Costs and prices in the service sector	34

4.5	Retail prices	35
4.6	Other price indices	37
4.7	Summary	38
<i>Box:</i>	<i>The distribution of price changes</i>	36
5	Monetary policy since the May Report	40
6	Prospects for inflation	45
6.1	The inflation projection assumptions	45
6.2	The output and inflation projections	51
6.3	Other forecasts	61
<i>Boxes:</i>	<i>The forecast process</i>	49
	<i>The MPC's forecasting record</i>	63
	Agents' summary of business conditions	67
	Annex: Minutes of the Monetary Policy Committee	71
	May meeting	73
	June meeting	81
	June Press Notice	91
	July meeting	92
	July Press Notice	100
	August Press Notice	101
	Glossary and other information	102

Link to Quarterly Bulletin

Section 1

A comparison of long bond yields in the United Kingdom, the United States, and Germany
Quarterly Bulletin, May 2000, pages 150–58.

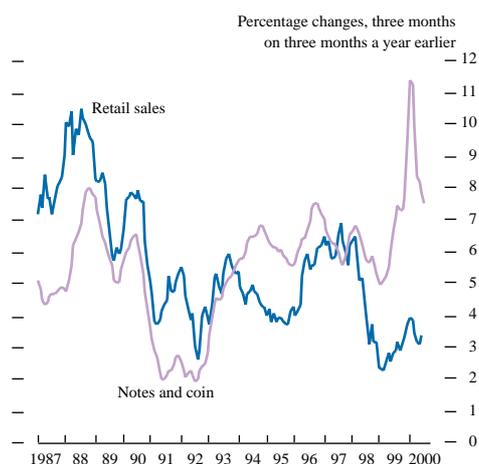
Section 2

The international environment
Quarterly Bulletin, August 2000, pages 233–46.

Narrow money growth has slowed, but remains well above growth in nominal retail spending. Broad money growth has picked up, on account of a more rapid increase in deposits held by private non-financial corporations and non-bank financial corporations. By contrast, the rate of increase in household deposits has eased. Aggregate sterling lending growth has risen further and continues to be much more buoyant than sterling deposit growth. Household credit growth remains strong and corporate borrowing has increased more rapidly.

The Bank of England official interest rate remains at 6% and was last changed in February. The market now anticipates a lower peak in UK official rates than at the time of the *May Report*; the peak is now expected to be around 25 basis points above the current level. UK long-term interest rates have changed little. Official interest rates have risen in recent months in both the United States and the euro area. The sterling effective exchange rate has depreciated significantly since the *May Report*. Aggregate UK equity prices are a little higher than expected at the time of the *May Report*, whereas house price inflation has declined more quickly than expected.

Chart 1.1
Growth of notes and coin and retail sales values



Sources: ONS and Bank of England.

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 (c)	2000 April	-10.3	8.0	8.2
	May	6.9	6.3	7.8
	June	6.9	-0.1	7.5
	July	6.5	-2.3	7.1
M4	1999 Q3	0.5	2.0	3.0
	Q4	8.7	4.6	4.0
	2000 Q1	8.8	8.8	5.3
	Q2	9.3	9.1	6.8
M4 lending (d)	1999 Q3	7.8	8.4	7.2
	Q4	13.0	10.4	9.2
	2000 Q1	13.3	13.1	10.8
	Q2	12.1	12.7	11.5

Source: Bank of England.

(a) Seasonally adjusted.

(b) Annualised.

(c) Growth rates based on an average of weekly observations in the month. July is provisional.

(d) Excluding securitisations.

1.1

Money and credit

Narrow money

Narrow money (M0) consists mainly of notes and coin in circulation held by the household sector. As notes and coin earn no interest they are held primarily for transaction purposes and so may provide information on retail sales trends. Growth in notes and coin has eased in recent months, consistent with the slowdown in retail sales values since the end of 1999 (see Chart 1.1), but continues to exceed growth in nominal retail spending. One potential explanation is that low and stable inflation has increased the relative attraction of notes and coin as an asset.

Broad money and credit

Annual broad money (M4) growth rose to 6.8% in 2000 Q2, from 5.3% in the previous quarter (see Table 1.A).

Chart 1.2
Growth in M4, M4 excluding OFCs, and nominal GDP

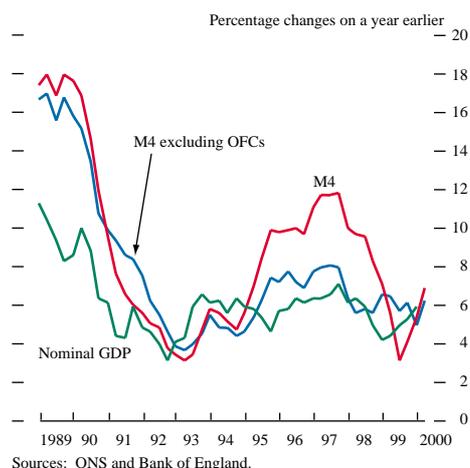
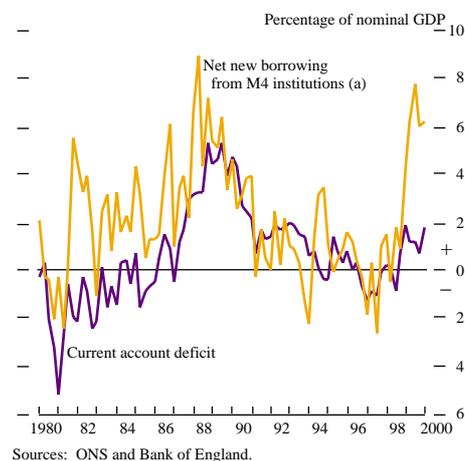
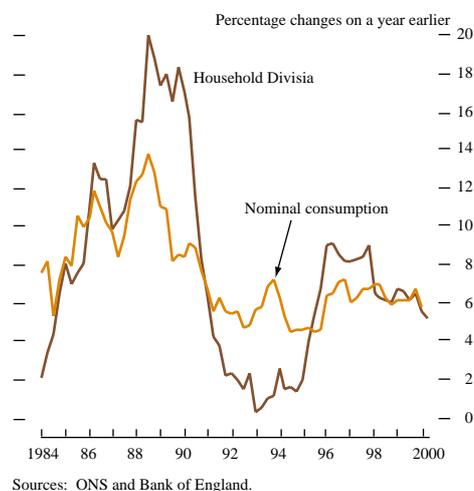


Chart 1.3
Net new M4 borrowing by the M4 private sector and the current account deficit



(a) M4 lending flows minus M4 deposit flows.

Chart 1.4
Household Divisia and consumption



In the recent past, movements in aggregate M4 have been strongly influenced by the money holdings of other financial corporations (OFCs), such as securities dealers, which are less likely to be related directly to aggregate nominal spending on goods and services than money holdings by other sectors. Chart 1.2 shows that, in recent years, M4 excluding OFCs has been more closely related to nominal GDP than M4. Growth in M4 excluding OFCs was higher in Q2 than in the previous quarter.

UK bank and building society sterling (M4) lending to the private sector⁽¹⁾ rose by 11.5% in the year to 2000 Q2 (see Table 1.A), the highest growth rate since 1990. The gap between M4 and M4 lending flows remains high and is close to its late 1980s peak as a percentage of nominal GDP (see Chart 1.3). As discussed in the *May Report*, this gap may partly be related to the current account position. The UK private and public sector collectively can spend in excess of their income by raising funds from overseas. The counterpart to this is a current account deficit. Many firms and households are likely to borrow via the UK banking system, causing domestic borrowing from UK banks (M4 lending) to exceed domestic deposits placed with UK banks (M4 deposits). But cross-border capital flows also include portfolio and direct investment, which can offset UK banking lending flows. That appears to have been happening recently, as sterling funds from overseas flowing through the UK banking sector have been considerably larger than the current account deficit.

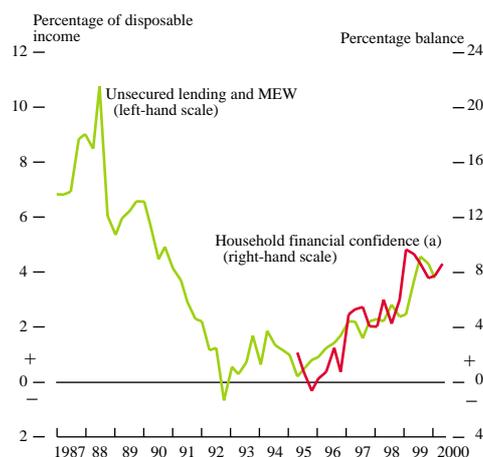
Household sector

Household sector M4 grew by 5.4% in the year to 2000 Q2, a lower rate than in the previous quarter. The interest rate paid on M4 deposits tends to vary inversely with the maturity of the deposit, which determines the ease with which such deposits can be used for spending. Divisia M4 is a measure that weights deposits according to the likelihood that they will be used for spending rather than saving—proxied by the inverse of the interest rate paid—and should therefore have a closer relationship to nominal consumption than aggregate household M4. Growth in household Divisia has weakened over the past six months, consistent with a slowdown in consumption in the near term (see Chart 1.4).

Annual growth in total lending to individuals (lending by banks, building societies and other specialist lenders)

(1) All M4 lending data discussed here exclude the effects of securitisations and other loan transfers.

Chart 1.5
Total lending for consumption and household financial confidence



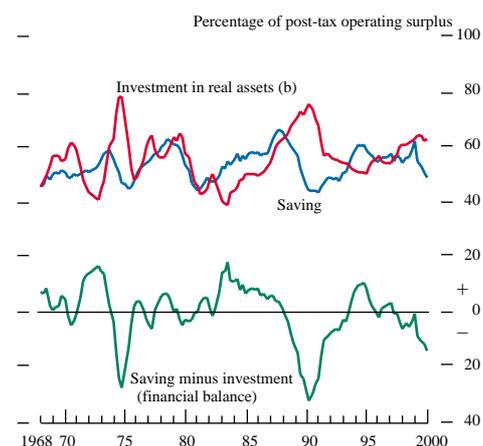
Sources: ONS, Bank of England and GfK.

(a) Percentage balance responses to the question: 'How do you think the financial situation of your household will change over the next twelve months: improve/remain the same/worsen?'

remained robust at 9.8% in 2000 Q2. Within the total, annual growth in net secured lending to individuals was 8.9%. The majority of secured lending is used to finance house purchase or home improvements. The difference between net lending secured on housing and investment in housing is termed mortgage equity withdrawal (MEW). MEW can be used to finance consumption. Bank estimates suggest that MEW has fallen back since its recent peak in 1999 Q3.

Consumer credit and MEW together provide a proxy for total borrowing for consumption. Borrowing on this measure has fallen a little relative to disposable income since 1999 Q3. This decline is consistent with indications from surveys that households are slightly less confident about their future financial situation than they were at the same time last year (see Chart 1.5).

Chart 1.6
PNFCs' saving and investment^(a)



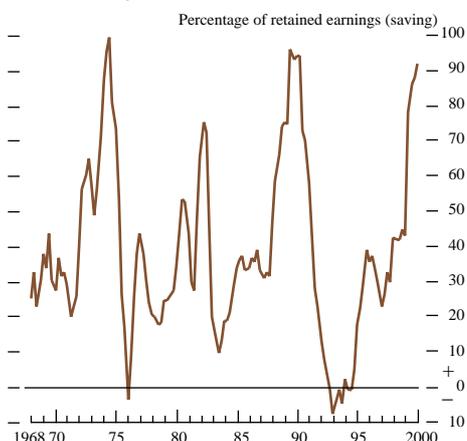
(a) Backward-looking four-quarter moving average.
 (b) Fixed assets plus inventories.

Private non-financial corporations

Annual growth in PNFCs' M4 rose sharply to 9.0% in 2000 Q2, from 1.2% in the previous quarter. Deposit growth in 2000 Q1 was very weak, perhaps because some firms unwound deposits built up as a precautionary measure in advance of the millennium date change. The robust growth in deposits in 2000 Q2 is consistent with the BCC survey for Q2, which indicated that cash flow in the service sector increased sharply. But a breakdown of sterling bank deposits by industry indicates that manufacturers also increased their deposits in 2000 Q2.

PNFCs' M4 borrowing rose by 12.7% in the year to 2000 Q2. Borrowing has picked up sharply since the autumn of last year. Chart 1.6 shows that one reason for the increase in borrowing is the imbalance between PNFCs' investment in real assets (fixed assets and inventories) and their retained earnings, or saving. But companies also borrow, from capital markets as well as banks, to finance the acquisition of other assets. Important recent examples are the purchases of the third-generation mobile telecommunications licences from the Government.

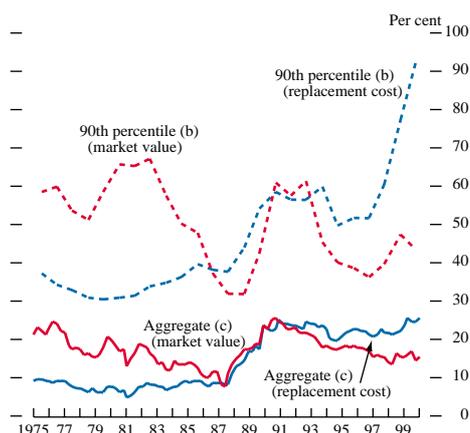
Chart 1.7
Flow of borrowing from banks and debt markets by PNFCs^(a)



(a) Backward-looking four-quarter moving average.

PNFCs' use of debt finance relative to retained earnings has reached relatively high levels (see Chart 1.7). That may indicate confidence in future profitability on the part of lenders and borrowers. Despite moderating recently, PNFCs' expectations about future profitability remain at relatively high levels according to the BCC survey. And relatively high equity price-earnings ratios

Chart 1.8
Corporate gearing^(a)



- (a) Measured as the ratio of net debt to either the market value of corporate debt and equity or to the replacement cost of corporate fixed assets plus inventories.
(b) Based on quoted company information from Primark Datastream.
(c) Based on ONS data for PNFCs.

suggest that investors are also optimistic about future profits. So while there has been a significant increase in borrowing by PNFCs, the market valuation of their assets has also been increasing. One measure of gearing, net indebtedness relative to the market valuation of PNFCs, therefore shows a reasonably benign picture (see Chart 1.8). But expectations about future profitability, and hence market valuations, may be subject to sudden adjustments, so other indicators of gearing may also be relevant. For example, net debt relative to the current replacement cost of PNFCs' tangible assets is at historically high levels.

Moreover, the aggregate data for PNFCs may conceal a wide dispersion in the degree of indebtedness of individual firms. Chart 1.8 shows that on the replacement cost measure, the upper decile of quoted companies is much higher than it was in the late 1980s. But that is not the case using the market value based measure of gearing.⁽¹⁾

Other financial corporations

OFCs have continued to increase their sterling deposits at UK banks and building societies, reversing the run-down that occurred during 1999: OFCs' M4 rose by 9.0% in the year to 2000 Q2. Much of the increase has been accounted for by securities dealers, whose deposits tend to be a by-product of their financial intermediation business and have no obvious implications for nominal spending. Growth in M4 borrowing by OFCs remained high, at 13.7%, in 2000 Q2.

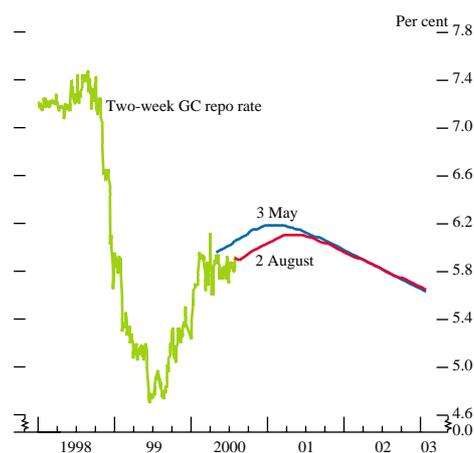
1.2 Interest rates and asset prices

Short-term interest rates

The Bank of England's repo rate remains at 6%, unchanged from its level at the time of the *May Report*. The official rate has not been changed since February 2000. By contrast, official rates overseas have been raised since the *May Report*. The European Central Bank and the US Federal Open Market Committee have each increased their official rate by 50 basis points, to 4.25% and 6.5% respectively. The official rate is now higher in the United States than in the United Kingdom, which has not been the case for any length of time since 1984.

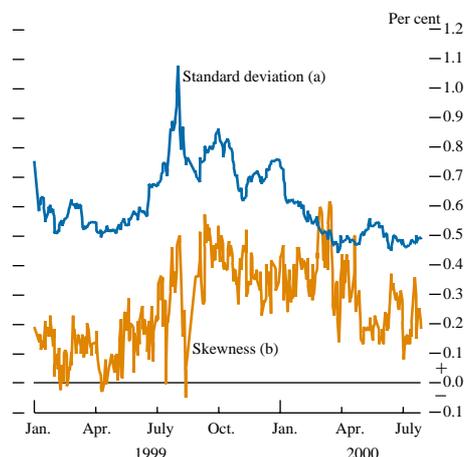
(1) For a more detailed discussion of the financial situation of the corporate sector see 'Stylised facts on UK corporate financial health: evidence from micro-data', Benito, A and Vlieghe, G, in the *Financial Stability Review*, June 2000.

Chart 1.9
Two-week forward rates



Source: Bank of England.

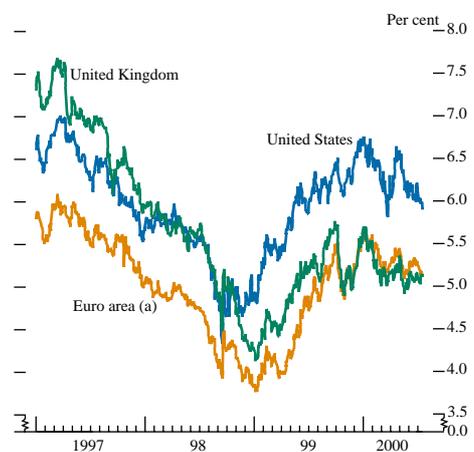
Chart 1.10
Distribution of three-month interbank rates in six months' time implied by options prices



Sources: LIFFE and Bank of England.

- (a) A measure of the dispersion of views about three-month interest rates at a constant six-month horizon derived from options prices.
- (b) A measure of the balance of risks between large upward and downward movements in interest rates. A positive number indicates that the balance of risks is on the upside of the most likely level of interest rates.

Chart 1.11
Ten-year nominal spot interest rates



Source: Bank of England.

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

While the UK official rate has remained unchanged, market expectations about future official rates over the coming year have declined since the *May Report*. The Bank implements monetary policy directly by affecting short-term rates of interest. Chart 1.9 shows the two-week interest rates expected to prevail over the next two years, as implied by the prices of government bonds and gilt repo rates on 3 May and 2 August. This suggests that the market expects two-week rates to peak around the spring of next year. The historical relationship between these market rates and the official repo rate implies a peak in official rates of around 6¹/₄%. Market uncertainty about the level of future short-term interest rates has generally declined since the beginning of the year, as has the implied upside risk to the level of interest rates (see Chart 1.10).

Long-term interest rates

The cost of borrowing for households and businesses also depends on longer-term interest rates, which are influenced by an average of current and expected short-term interest rates. The ten-year nominal government bond yield in the United Kingdom was 5.2% on 2 August, similar to its level at the time of the *May Report*, and slightly lower than just prior to the increases in official interest rates that began a year ago (see Chart 1.11). Ten-year bond yields in the United States and the euro area have fallen since the *May Report*, by around 50 and 25 basis points respectively.

Household borrowing rates

Many household borrowing rates have tended to be related more closely to short-term than to long-term interest rates. The official repo rate has been raised by 100 basis points since August 1999. But over the past year average unsecured lending rates are estimated to have fallen slightly (see Table 1.B). Most of the decline has occurred in the period since February, during which official rates have remained unchanged. The decline may reflect greater creditworthiness of households, or increased competition in the credit card market. The cost of variable-rate mortgages also tends to vary with short-term interest rates. Standard variable rates on mortgages have risen by almost 100 basis points since August 1999. But some mortgage products offer discounts to the standard variable rate for a limited period. These discounts have increased over the past year, possibly because of an increase in the degree of competition between mortgage lenders. For example, two-year discounted mortgage rates have risen by approximately half as much as the official repo rate.

Table 1.B
Changes in household borrowing rates

	Change since February 2000 (basis points)	Change since August 1999 (basis points)
Repo rate	0	100
Average unsecured (a)	-20	-4
Standard variable mortgage rate (b)	26	93
Two-year discounted mortgage rate (b)	29	55
Two-year fixed mortgage rate (b)	-39	30
Average secured (a)	8	52

Sources: Bank of England and Moneyfacts.

- (a) Difference between monthly estimates for June 2000, and February 2000, or August 1999. The rates are averages across new and existing loans by banks.
 (b) Difference between monthly estimates for July 2000, and February 2000, or August 1999. Rates are for new loans by banks and building societies without redemption penalties.

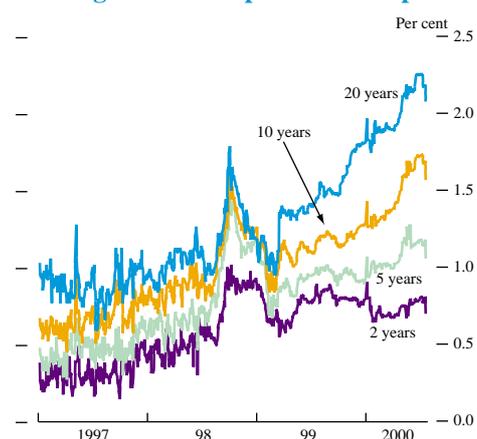
Table 1.C
Changes in corporate borrowing rates

	Change since February 2000 (basis points)	Change since August 1999 (basis points)
Repo rate	0	100
Average bank loan rate (a)	7	78
5-year bond yield (b)	-49	-3
20-year bond yield (b)	9	54

Sources: Bloomberg and Bank of England.

- (a) Difference between monthly estimates for June 2000, and February 2000, or August 1999. The rates are averages across overdrafts and other corporate loans by banks.
 (b) Difference between sterling A-rated corporate bond yields on 2 August, the day of the MPC decision in February 2000, and the day prior to the MPC decision in September 1999.

Chart 1.12
Sterling A-rated corporate bond spreads^(a)



Sources: Bloomberg and Bank of England.

- (a) Spread over government par yields.

Longer-term rates also affect the cost of household borrowing through their impact on fixed-rate mortgages. Mortgage lenders who offer fixed-rate mortgages are potentially exposed to interest rate risk as they typically pay a floating rate of interest on their deposits. To hedge their exposure to interest rate changes they may purchase swaps that allow them to convert fixed-rate receipts into floating-rate receipts. So fixed mortgage rates tend to be related to swap rates, which themselves depend on expected future short-term interest rates. Since August 1999 swap rates have risen by less than official interest rates and, in addition, the spread of two-year fixed mortgage rates over swap rates has become negative. Two-year fixed mortgage rates have therefore increased by around a third of the 100 basis point rise in the official repo rate (see Table 1.B).

These effects on rates for new fixed and variable-rate mortgages mean that the average rate across new and existing housing loans is estimated to have risen by around 50 basis points over the past twelve months.

Corporate borrowing rates

Historically, UK companies have tended to rely more on bank finance than on bond finance: in 2000 Q1 bank debt accounted for around 65% of PNFCs' total stock of bank and bond finance. Bank estimates suggest that corporate lending rates have increased broadly in line with the official repo rate since August 1999 (see Table 1.C).

The cost of bond finance will depend on perceptions about the creditworthiness of the borrower, as well as the default-free rate represented by government bond yields. The spread between corporate bond yields and default-free rates may be affected by the degree to which corporates rely on debt finance rather than internally generated funds. As discussed earlier, corporates are at present unusually reliant on debt finance. At some maturities the spread over UK government bond yields has widened considerably since the beginning of 1999 (see Chart 1.12). But interpretation of this widening is complicated by the fact that government bond yields at longer maturities may have fallen because of increased demand for long-dated assets by pension funds and life assurance companies, associated with regulatory requirements.⁽¹⁾ At shorter maturities, which should be

(1) For a more detailed discussion of factors specific to the gilt market see Brooke, M, Clare, A and Leekos, I, 'A comparison of long bond yields in the United Kingdom, the United States, and Germany', *Bank of England Quarterly Bulletin*, May 2000, pages 150–58.

less affected, there has been little change in the spread, suggesting that increased corporate indebtedness has not had a substantial effect. Because five-year default-free rates have fallen slightly since August 1999, the cost to corporates of borrowing in the bond market at that maturity has changed little since then (see Table 1.C). But there has been more of an increase at the 20-year maturity.

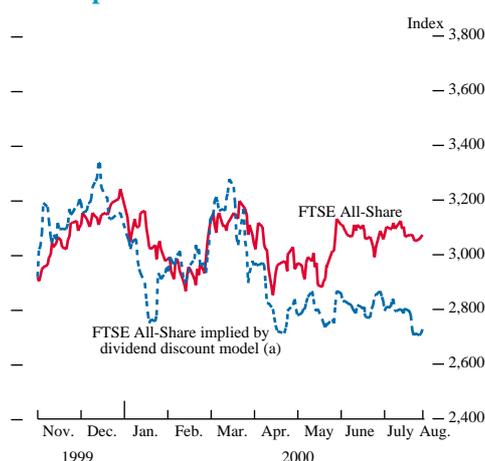
Real interest rates

Monetary policy seeks to influence spending by firms and households by affecting real interest rates. The impact on spending of the nominal rate changes discussed above therefore partly depends on developments in inflation expectations. The Consensus Economics survey indicates that the expected average rate of RPIX inflation over the next two years has remained virtually unchanged over the past year, and is very close to the 2½% target. Longer-run survey-based inflation expectations have also remained close to the inflation target. So there has been some increase in the real rates of interest faced by the corporate and household sectors, although not by as much as suggested by the change in the official repo rate. The increase in real rates may be acting to slow domestic demand growth.

Equity prices

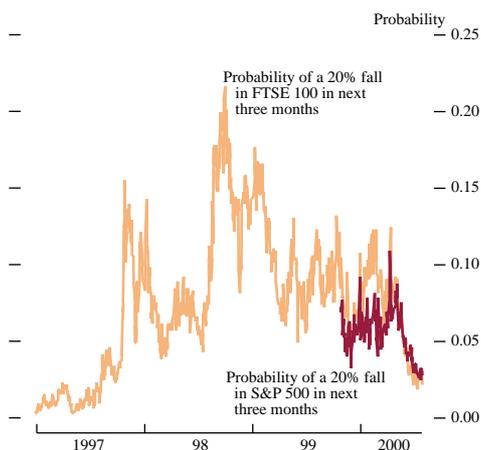
The FTSE All-Share index averaged 3082 in the 15 working days to 2 August, about 2% above the central projection for August implied in the *May Report*. The value of equity can be thought of as the discounted stream of dividend payments derived from that equity. So share prices should reflect the prevailing level of dividends, and changes in either expectations about future real corporate earnings, or in the discount factor. The discount factor is made up of a risk-free real rate and a risk premium. Chart 1.13 assesses the extent to which movements in share prices may be explained by movements in expected risk-free real rates, as embodied in the index-linked gilt market. Risk-free real rates have not changed significantly in recent months. That suggests that the increase in share prices reflects either slightly higher expected future real dividend growth, and/or a lower risk premium required for holding equity. The combinations of expected future real dividend growth and equity risk premia implicit in current UK and world stock market values are extreme relative to past experience. Consistent with that, option prices continue to suggest that the balance of risks to equity prices is on

Chart 1.13
Decomposition of FTSE All-Share



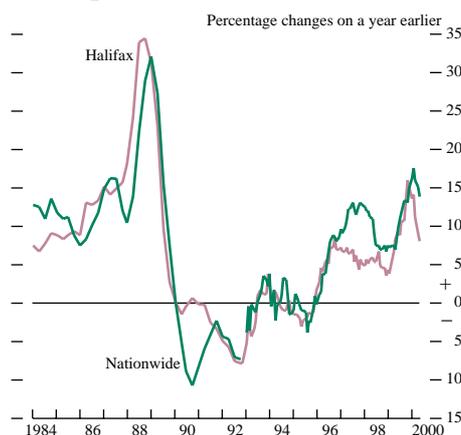
(a) The FTSE All-Share has been projected forward from its level on 1 November 1999 using the dividend discount model. The inputs used are the prevailing level of dividends and real yields and the equity risk premium/dividend growth rate combination implicit in valuations on 1 November 1999.

Chart 1.14
Downside risk for FTSE 100 and S&P 500^(a)



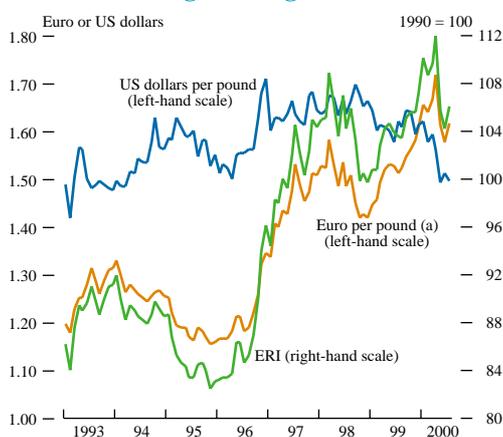
(a) These probabilities are equal to the areas under the lower tails of probability distributions (PDFs) derived from options on equity indices. The method for deriving PDFs produces risk-neutral probabilities. To the extent that agents are risk averse this measure may overstate the market's assessment of the likelihood of a decline in equity prices. But the extent of this difference over a three-month period is unlikely to be large.

Chart 1.15
House price inflation



Sources: Halifax plc and Nationwide Building Society.

Chart 1.16
Selected sterling exchange rates



Source: Bank of England.

(a) Rates before 1 January 1999 are calculated as a synthetic euro exchange rate based on a weighted average of the component currencies.

the downside. But the market may now attach a lower probability than earlier in the year to a significant decline in prices (see Chart 1.14).

Property prices

House price inflation has started to decline, and more quickly than anticipated in the *May Report*. The Halifax index of house prices fell by 0.3% in the three months to July compared with the previous three months, and the annual inflation rate fell to 8.0%. The Nationwide index rose by 13.9% in the year to July, but its rate of increase has also moderated (see Chart 1.15). Forward-looking surveys indicate some further moderation in average UK house price inflation: in the RICS survey for June, the percentage balance of estate agents expecting house prices to rise over the next three months was -12. There has not yet been a material downturn in the number of mortgage approvals, but more forward-looking indicators of activity have weakened. Activity in the housing market is discussed in more detail in the box on pages 18–19 in Section 2.

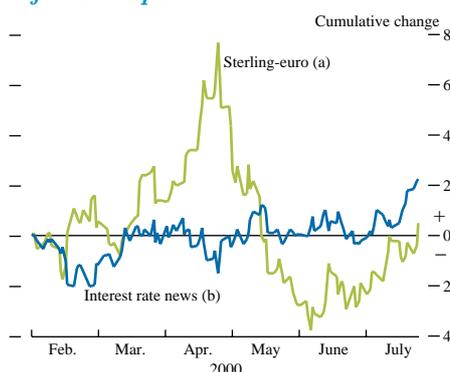
Exchange rates

The sterling effective exchange rate index has depreciated significantly since the *May Report*. The 15 working day average of the ERI up to and including 2 August, used as the starting-point for the current projections, is 106.1, around 4% below the central path assumed in the *May Report*. Sterling has depreciated against the euro and the dollar to a similar degree (see Chart 1.16).

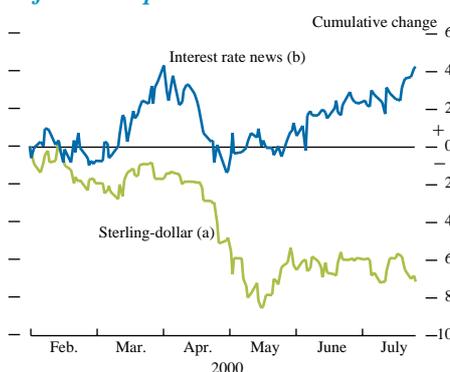
The expected risk-adjusted returns from holding assets in different currencies should be identical. Otherwise there would be profitable trading opportunities worth exploiting. That means that the expected path of the exchange rate should correspond to the expected differential between interest rates in each country, plus any risk premium that investors require for holding that currency. That path, and hence the spot rate, will be affected by changes in views about the long-run equilibrium rate. Within this theoretical framework, unexpected changes in the exchange rate should be explained by revised expectations about interest rate differentials, risk premia, or equilibrium exchange rates.

Chart 1.17 shows that despite the rise in official rates overseas relative to those in the United Kingdom, the recent depreciation of sterling against the dollar or the euro cannot be explained by revised views about future

Chart 1.17
Change in sterling-euro exchange rate and
relative interest rates since the February
Inflation Report

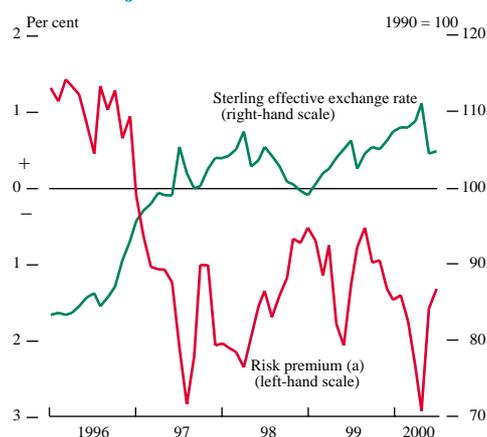


Change in sterling-dollar exchange rate and
relative interest rates since the February
Inflation Report



(a) Cumulative percentage change in the exchange rate.
 (b) Cumulative percentage point change in differentials between expected UK and overseas nominal interest rates up to ten years ahead.

Chart 1.18
Estimated risk premium on sterling
versus major six currencies



Source: Bank of England.

(a) The risk premium is the compensation that investors require, in addition to interest rate differentials, for holding a currency. It is estimated by comparing exchange rate forecasts from Consensus Economics surveys with market interest rate differentials. It is expressed as an annualised rate.

relative interest rates. This was also true of sterling's earlier appreciation. Surveys can be used to assess whether the sterling risk premium, or agents' perceptions about the long-run or equilibrium exchange rate, have changed. Previous *Reports* suggested that some of the earlier appreciation might be explained, in terms of the framework above, by a decline in sterling's relative risk premium and an increase in sterling's perceived equilibrium exchange rate.

Risk premia are not directly observable and are very difficult to measure. However, by comparing surveys of expected exchange rate movements with market expectations about interest rate differentials, it is possible to estimate the risk premium required for holding sterling rather than other currencies. Chart 1.18 shows that an estimate of the relative sterling risk premium versus the major six currencies, derived in this way, has increased since May, consistent with the depreciation. But this estimate assumes that there has been no change in the long-run exchange rate.

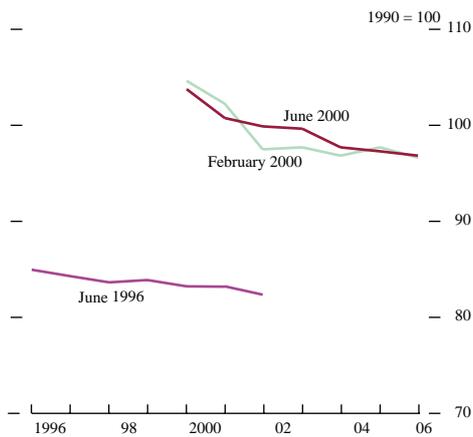
Consensus Economics surveys can also be used to assess whether perceptions about the long-run exchange rate may have changed. Chart 1.19 shows that the recent depreciation has not been associated with a change in view about the exchange rate in five years' time. That suggests that the depreciation has not occurred because of a marked change of view about the equilibrium exchange rate, which supports the hypothesis that there may have been some recent increase in the relative risk premium.

1.3

Summary

Narrow money growth has eased, in line with the slowdown in retail sales growth since the end of last year. Growth in household M4 and household Divisia has also weakened, and total borrowing for consumption is estimated to have slowed slightly since 1999 Q3. House price inflation has moderated. This is consistent with a slowdown in consumption growth, which may partly reflect the increase in real interest rates faced by the household sector since August 1999. Growth in borrowing by corporates has picked up further, and their borrowing has reached historically high levels relative to internally generated funds. But profit expectations remain high, and share prices have risen at a slightly faster rate than was incorporated in the *May Report*.

Chart 1.19
Consensus survey for the sterling nominal exchange rate versus major six currencies



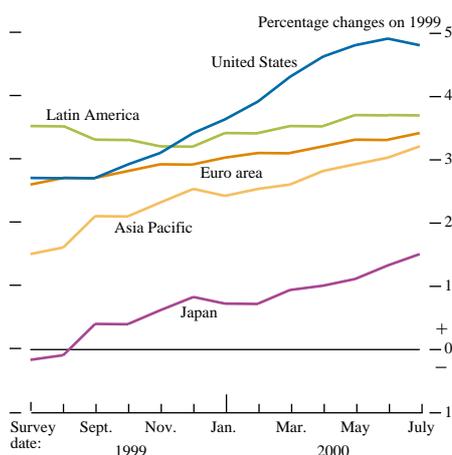
Source: Consensus Economics.

Sterling has depreciated significantly since the May *Report*. The depreciation cannot be explained by revised views about future interest rates in the United Kingdom relative to overseas. Survey evidence suggests that an increase in the sterling relative risk premium may be one contributory factor. The depreciation does not appear to have been associated with any change in the market's perception of the exchange rate likely to prevail in five years' time.

The preliminary estimate is that real GDP rose by 0.9% in 2000 Q2 on a quarter earlier. Growth in the first quarter was somewhat weaker, at 0.5%, reflecting much slower domestic demand growth following exceptional strength in the run-up to the new millennium. However, revisions in the National Accounts on 29 June have raised the estimated level of GDP in 2000 Q1 by 0.6%, largely due to stronger consumer spending in recent years than previously thought. Despite a possibly erratic positive contribution to growth in 2000 Q1, the net trade position has been adversely affected by the high level of the exchange rate. But looking ahead, strong overseas demand and the recent fall in sterling may lessen existing imbalances between external and domestic demand.

In the short-to-medium term, inflation prospects will be affected by the level of nominal demand in relation to supply capacity. Annual nominal GDP growth rose to 5.8% in Q1 from 5.2% in the previous quarter. But quarterly growth decelerated to 1% from high rates in the second half of 1999.

Chart 2.1
Evolution of Consensus forecasts for 2000 GDP growth



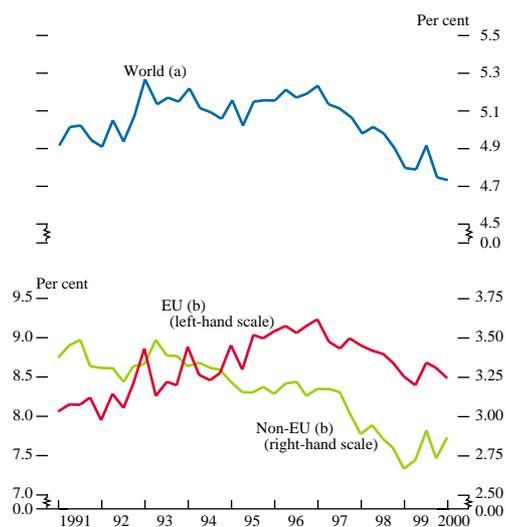
Source: Consensus Economics.

2.1 External demand

Strong world activity has raised external demand for UK goods and services over the past year, despite opposing effects from the high level of sterling.⁽¹⁾ Recent estimates point to higher world growth in 1999 than was thought three months ago, and forecasts for 2000 have been revised up further (see Chart 2.1). In the United States, the pace of expansion has surprised forecasters for some time. US GDP growth was again above expectations in 2000 Q2, with output rising by 1.3% on the quarter and by 6.0% on a year earlier. Although the near-term outlook is stronger, the MPC continues to expect US growth to ease in response to higher interest rates and slower growth in private sector wealth. Indeed, less rapid recent increases in retail sales and private sector employment provide tentative signs that US economic growth may now be easing. Euro-area GDP rose by 0.9% in the first quarter and by 3.4% on a

(1) For a more detailed discussion of international economic developments, see 'The international environment' article in the *Bank of England Quarterly Bulletin*, August 2000, pages 233–46.

Chart 2.2
UK export market shares



Sources: ONS, NIESR and Bank estimates.

- (a) UK goods and services export volumes as a share of world imports of goods and services, scaled to actual market share in 1994.
- (b) Proxied by UK goods export volumes as a share of EU and non-EU imports of goods and services, scaled to actual market shares in 1994.

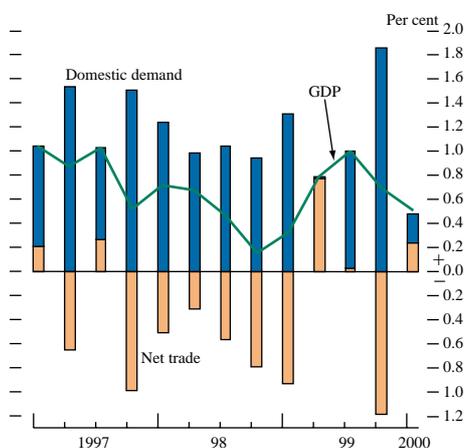
Table 2.A
Composition of UK import volume growth^(a)

Percentage changes on a quarter earlier

	1999			2000 Q1
	Q2	Q3	Q4	
Imports of goods and services	0.2	4.8	2.0	1.4
Contributions of:				
Manufactured goods	-0.1	4.2	1.4	1.0
of which: <i>Semi-finished goods</i>	0.1	1.5	-0.4	0.3
<i>Consumer goods</i>	0.1	0.3	0.3	0.3
<i>Intermediate goods</i>	0.1	1.2	1.1	0.4
<i>Capital goods</i>	-0.1	1.0	0.8	0.0
<i>Other</i>	-0.3	0.3	-0.4	0.0
Non-manufactured goods	0.0	0.5	0.2	0.2
Services	0.2	0.1	0.4	0.2

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

Chart 2.3
Contributions to quarterly GDP growth^(a)



(a) At constant 1995 market prices.

year earlier. Rising employment and strong industrial production suggest that growth may have gained further momentum in recent months. In Japan, rising corporate profitability has prompted higher investment and there are some signs that household spending may now be starting to recover slowly in line with incomes. Robust activity in industrialised countries has added impetus to growth in emerging market economies. However, the pace of expansion in these countries now appears to be easing from the rapid rates earlier in their recoveries from the financial turbulence of 1997 and 1998. Overall, the MPC judges that the prospects for world activity in 2000 are now slightly stronger than projected in the *May Report*, although world growth is still likely to slow in 2001.

Robust overseas demand continues to boost UK export volumes. Total exports rose by 2.4% in 2000 Q1 and were 9.5% higher than a year earlier. Growth was more than accounted for by higher exports of goods, which rose by 13.7% over the past year, their fastest growth rate since 1980. By contrast, services export volumes fell by 2.3% over the same period. Goods exports to countries outside the European Union (EU) have risen particularly strongly over the past year and were 5.6% higher in 2000 Q2 than a quarter earlier. However, monthly data suggest that exports to the EU have been somewhat less buoyant in Q2: export volumes to the EU were flat in the three months to May compared with the previous three-month period.

Since the sharp appreciation of sterling in 1996, UK export volumes have tended to grow more slowly than overseas demand and the share of UK exports in world trade has fallen (see Chart 2.2). Consistent with the particularly large rise of sterling against the euro, the turnaround in UK export performance has been most marked in EU markets, where export share had previously been rising. However, the surprising strength of exports over the past year has meant that the UK share of world trade has fallen somewhat less rapidly than previously. In particular, the UK share of exports to countries outside the EU appears to have stabilised, perhaps suggesting that the fall in sterling over the past year against non-EU currencies, such as the US dollar (see Chart 1.16 in Section 1), has offset competition in these markets from EU producers.

Import volume growth eased to 1.4% in 2000 Q1, and 8.6% on a year earlier, with weaker investment and industrial production slowing demand for imports of capital goods and intermediate products (see Table 2.A).

Table 2.B
UK export outlook^(a)

Series	1999			2000		
	average (b)	Q2	Q3	Q4	Q1	Q2
BCC export orders						
Services	+12	+4	+15	+5	+10	+14
Manufacturing	+9	-3	+10	+11	+8	-7
CIPS new export orders (c)						
Manufacturing	49.6	50.8	54.7	52.9	52.0	48.3
CBI quarterly industrial trends						
Export orders, past four months	-13	-24	-14	-3	-8	-18
DHL quarterly export indicator						
Export confidence, next three months	+32	+26	+29	+28	+38	+34

Sources: BCC, CIPS, CBI and DHL.

- (a) Numbers reported are percentage balances of respondents reporting "higher" relative to "lower".
 (b) BCC since 1989; CIPS since 1996; CBI since 1975; DHL since 1993.
 (c) A reading above 50 suggests expansion, a reading below 50 suggests contraction.

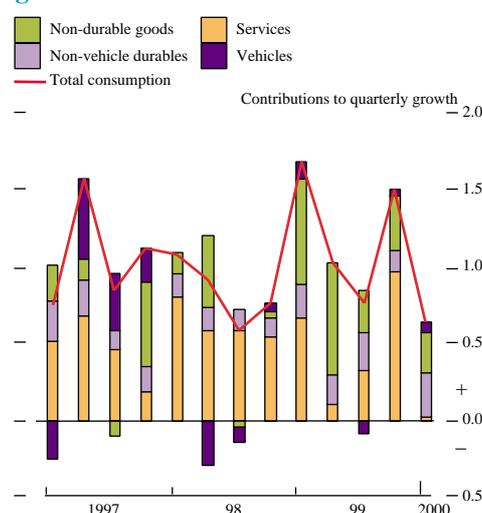
Table 2.C
GDP and expenditure components^(a)

Percentage changes on a quarter earlier

	1999			2000
	Q2	Q3	Q4	Q1
Consumption:				
Households	1.0	0.8	1.5	0.6
Government	0.0	0.2	0.3	-0.6
Investment	1.2	0.6	1.1	-1.1
of which, business investment	1.6	0.1	1.0	-0.7
Final domestic demand	0.9	0.5	1.3	0.1
Change in inventories (b)	-0.9	0.4	0.5	0.2
excluding alignment adjustment (b)	-0.1	0.5	-0.3	0.9
Domestic demand	0.0	0.9	1.8	0.2
Net trade (b)	0.8	0.0	-1.2	0.2
GDP at market prices	0.8	1.0	0.7	0.5

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

Chart 2.4
Household consumption expenditure growth^(a)



- (a) At constant 1995 market prices.

Lower import growth, combined with stronger export growth, resulted in a positive contribution from net trade to GDP growth in 2000 Q1 of 0.2 percentage points, in contrast to a large negative impact in the previous quarter (see Chart 2.3). But the continuing large trade deficit on goods and services—£4 billion in 2000 Q1 (about 1³/₄% of GDP)—indicates that the underlying external position remains weak. Consistent with that, more timely data suggest that import volumes have picked up in recent months, pointing to a weaker net trade contribution to growth in Q2.

Looking ahead, the slightly stronger world outlook and the recent depreciation of sterling suggest an improved outlook for UK external demand compared with prospects at the time of the *May Report*. Surveys in Q2 provided little evidence of any improvement in export demand in the manufacturing sector, with responses pointing to falling export orders (see Table 2.B). However, the July CIPS index reported a modest rise in foreign demand for UK exports, and contacts of the Bank's regional Agents have recently noted some pick-up in external demand, particularly from Europe. But consistent with the continuing high level of sterling, the MPC expects net trade to make further negative contributions to GDP growth over the next two years.

2.2 Domestic demand

Domestic demand has been volatile in recent quarters, perhaps reflecting unusual factors relating to the millennium. Following rapid growth of 1.8% in 1999 Q4, real domestic demand grew by just 0.2% in 2000 Q1 (see Table 2.C). Final domestic demand—which excludes investment in inventories—also grew slowly in Q1, reflecting lower consumption growth and falls in fixed investment and government consumption.

Household sector consumption

Consumer spending volumes rose by 0.6% in 2000 Q1, following robust growth of 1.5% in 1999 Q4 (see Chart 2.4). Spending on services accounted for much of the fall in household consumption growth in Q1, rising by only 0.1%, following abnormally high growth of 2.1% in 1999 Q4. Non-durable goods spending growth was steady at 0.6% but durable goods consumption growth increased to 3.2% in Q1, partly due to a pick-up in spending on high-technology goods, such as computers and digital televisions.

Chart 2.5
Volume of retail sales

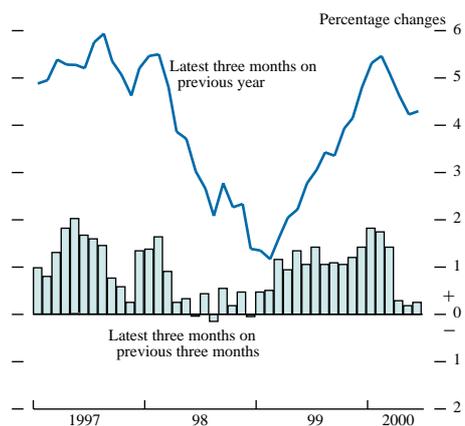
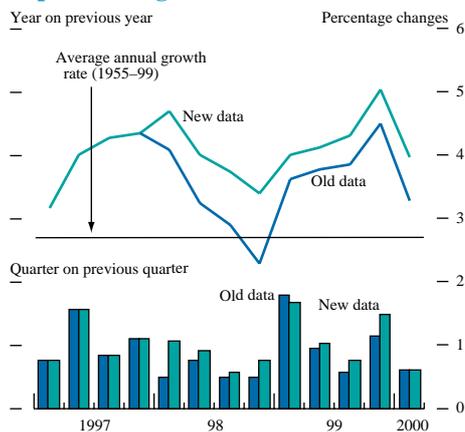
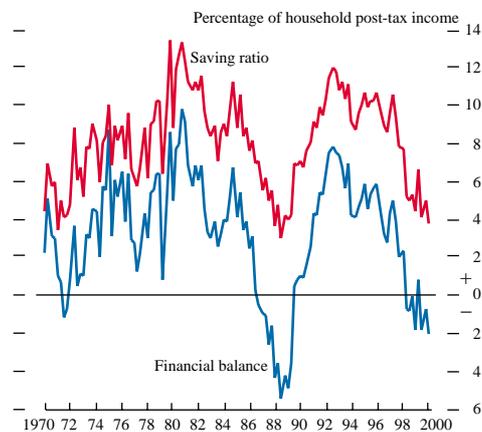


Chart 2.6
Revisions to household consumption expenditure growth^(a)



(a) At constant 1995 market prices.

Chart 2.7
Saving ratio and household financial balance

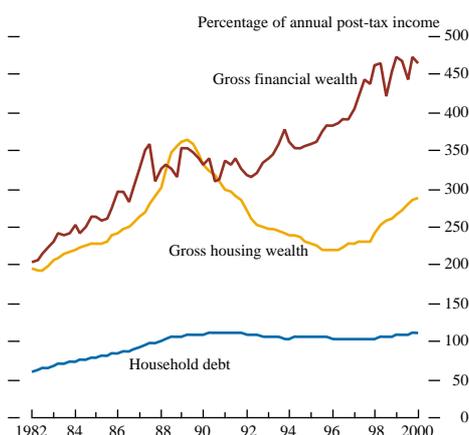


In the second quarter, spending on services is likely to have picked up from erratically weak growth in Q1, but that may have been offset by weaker growth in goods spending. Following unusually high sales around the new millennium period, retail sales volumes grew by only 0.3% in 2000 Q2 (see Chart 2.5), consistent with some weakening in growth of other indicators of spending, such as notes and coin and household Divisia money (see Section 1). Recent survey evidence on consumer spending has been somewhat mixed, but overall perhaps pointed to a slight slowdown in consumption growth further ahead. The July CBI distributive trades survey reported a fall in retailers' expectations of future sales growth and the GfK index of consumer confidence has fallen in recent months, reflecting lower optimism about the general economic situation. By contrast, the latest MORI and Consumers' Association surveys reported modest improvements in consumer sentiment. And a survey by the Bank's regional Agents showed a small recovery in retailers' expectations of sales in coming months.

Despite slower growth in the first quarter than in 1999 Q4, upward revisions in the National Accounts mean that household consumption has risen more rapidly over the past two years than previously thought (see Chart 2.6). Over this period, spending growth has tended to outpace growth of household real incomes. In 2000 Q1 annual growth in real post-tax income remained firm at 3.3%, but fell by 0.6% on a quarter earlier as weaker dividend receipts more than offset strong labour income growth. As a result, the saving ratio fell further, reaching its lowest level since 1988 (see Chart 2.7). And taking into account spending on housing investment, the household sector was a net borrower in 1999 for the first time since the late 1980s.

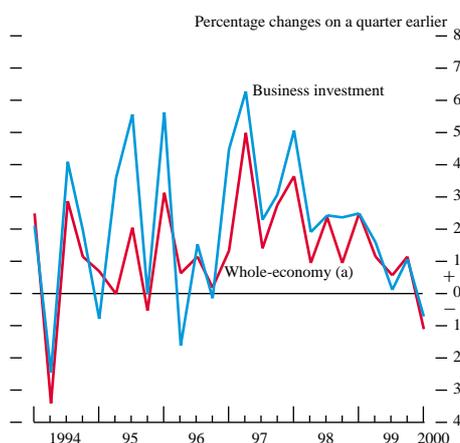
In recent years, declining saving out of income has been more than compensated for by sharp rises in household wealth, underpinning strong consumption growth. In the year to 2000 Q1, household financial wealth has remained broadly stable as a share of income. Housing wealth has increased strongly, reflecting rising house prices, and has more than offset slightly higher household debt (see Chart 2.8). But recent data point to more moderate future increases in wealth. Equity prices are little changed so far this year. And house price inflation and housing market activity appear to have moderated in recent months, as discussed in the box on the housing market on pages 18–19.

Chart 2.8
Household assets and liabilities



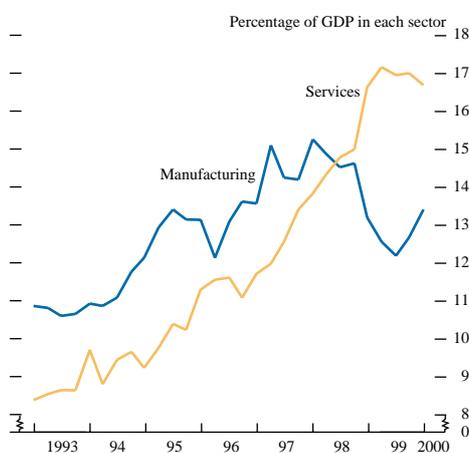
Sources: ONS and Bank of England.

Chart 2.9
Gross domestic fixed capital formation



(a) Includes business investment, investment by government, private dwelling investment and transfer costs.

Chart 2.10
Business investment by sector^(a)



(a) At constant 1995 prices.

As in the May central projection, the MPC expects consumption growth to moderate from its high levels in recent years, reflecting the continued effects of past increases in interest rates and the impact of sterling strength on output and employment. In addition, slower growth in household wealth, if sustained, might prompt some rebuilding of the saving ratio from its current low level. As such, the Committee anticipates slightly weaker consumption growth over the next two years than in the *May Report*.

Investment demand

Investment growth has weakened over the past year and in 2000 Q1 whole-economy investment fell by 1.1%, the first quarterly decline in the aggregate series since 1995 (see Chart 2.9). Across the sectors, business investment fell by 0.7%; general government investment, which is particularly erratic, was 4.2% lower; and private sector investment in dwellings declined by 1.5%.

The fall in business investment in the first quarter reflected weaker service sector investment more than offsetting higher manufacturing investment. In recent years, the ratio of investment to output in the service sector has risen sharply (see Chart 2.10), perhaps partly due to higher investment in short-lived assets such as computers. The ratio was particularly high in 1998 and 1999, possibly as service sector companies invested heavily to ensure Y2K compliance. Recent falls may reflect some unwinding of that effect. Over the past year, manufacturing investment intensity has recovered somewhat but remains well below levels in the service sector.

Firms invest to adjust their current capital stocks towards desired levels. Desired capital stocks will be affected by factors such as existing capacity utilisation, expected future demand and profits, changes in technology, the availability of internal sources of finance and the real cost of capital.

Recent developments in these factors suggest that the fall in business investment in the first quarter is unlikely to persist. The BCC's latest quarterly economic survey recorded a rise in capacity utilisation rates in the manufacturing and service sectors (see Chart 2.11). Other things being equal, a higher proportion of companies operating at full capacity might be expected to raise the demand for capital and current rates of investment. Consistent with this, the BCC survey

The housing market

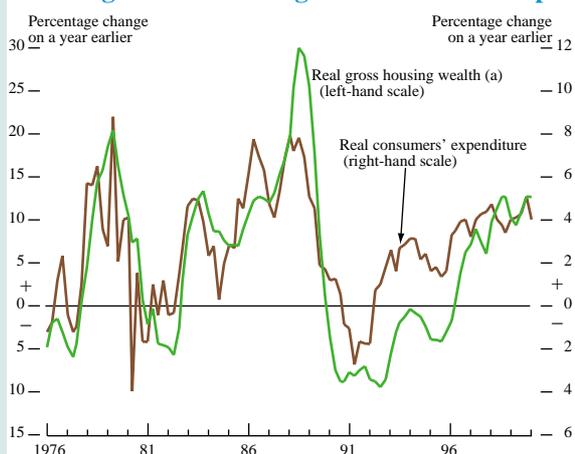
The MPC sets interest rates to achieve the Government's 2½% target for inflation on the RPIX measure. Monetary policy therefore aims at retail price inflation and not house prices or other asset prices. But the housing market is an important sector of the economy and is closely monitored by the MPC as part of its continuous assessment of all factors affecting the inflation outlook. This box outlines why the housing market is relevant to monetary policy and reviews the data analysed by the MPC.

Housing in the wider economy

Housing investment accounts for around 15% of whole-economy investment, and housebuilding represents around a third of all construction output. Consumer spending on housing services (imputed rents) accounts for around 8% of total consumption, and purchases of specific household goods typically closely related to turnover in the housing market, such as carpets and furniture, represent a further 6% of consumption. Gross housing wealth is about a half of all household wealth. And house prices also affect the RPIX index through the calculation of housing depreciation and the RPI through mortgage-servicing costs.

Beyond these direct effects, the housing market may also signal developments in, or impact on, the economy more broadly. Gross housing wealth and total consumption tend to move together (see Chart A). One reason may be that house prices respond to some of the same influences that affect consumption, such as expectations of (and uncertainty about) future incomes and wealth. So house prices may provide early information on future spending, and may corroborate evidence from other forward-looking indicators of consumption, such as consumer confidence surveys.

Chart A
Annual growth of housing wealth and consumption



(a) Deflated by household expenditure deflator.

House prices can also affect spending by influencing credit constraints faced by borrowers. Higher housing equity provides collateral for home-owners who wish to borrow for

consumption. Mortgage equity withdrawal (MEW)—borrowing secured on, but not invested in, the housing stock—provided finance for spending in the late 1980s and has been positive again recently.⁽¹⁾ In the past, MEW was typically associated with moving house or with new loans, but accessibility to housing wealth might be strengthened in the future as more flexible equity-release products develop.

Housing market data

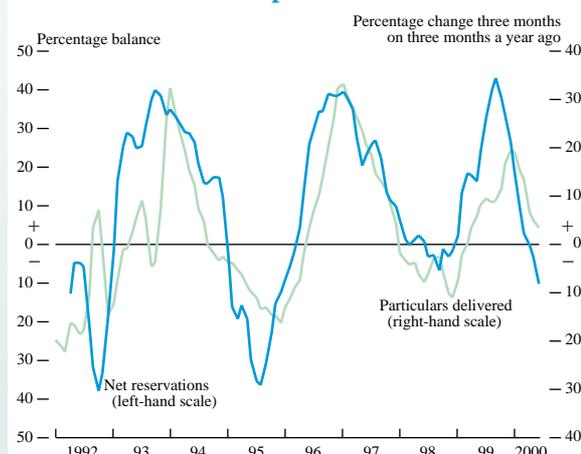
The MPC regularly reviews a range of measures of housing market activity from surveys and official sources. The table shows indicators from different stages of the house purchase process.

A stylised house purchase timeline

Stage of transaction	Indicator	Indicative time to completion
Decide to buy a house	Site visits Net reservations Enquiries at estate agents	3 to 5 months
Sale agreed	Loan approvals	1 to 4 months
Exchange contracts	RICS survey	Up to 1 month
Completion	Mortgage lending	Coincident
Land registration	Particulars delivered	Up to 1 month later

Long-leading indicators of housing demand, such as site visits and net reservations of new properties, can provide information about future transactions, as measured by particulars delivered. For example, they may be useful in giving an early indication of turning-points in activity, as perhaps was the case when they began to turn down at the end of 1999 (see Chart B).

Chart B
Net reservations^(a) and particulars delivered



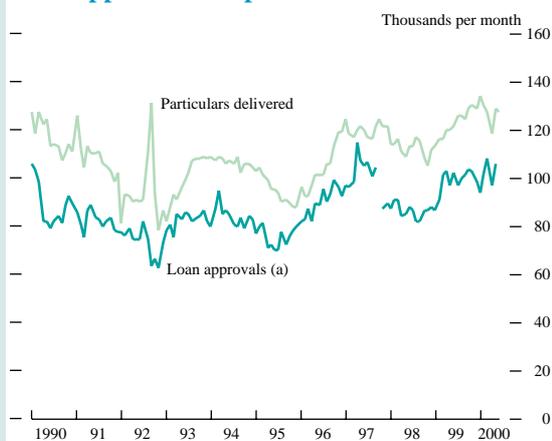
(a) Three-month moving average of the net balance of housebuilders reporting a greater number of net reservations than a year ago.

Loan approvals provide information about future lending for house purchase over a shorter time horizon. And although loan approvals data do not cover cash purchases, which

(1) See www.bankofengland.co.uk/mew.htm for details of the construction of the Bank's estimates of MEW.

account for about a quarter of all house purchases, the number of approvals also gives an indication of future transactions (see Chart C).

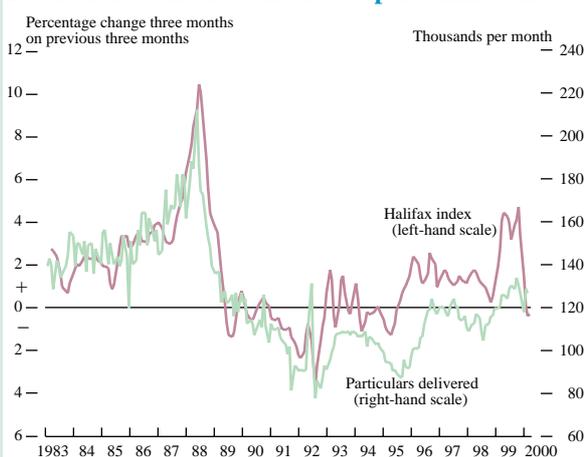
Chart C
Loan approvals and particulars delivered



(a) A break in the series was introduced when inconsistencies between bank and building society data were removed. Since October 1997 both data series now include only approvals for house purchase net of cancellations and remortgages.

As well as being of interest in their own right, the number of transactions is correlated with house price inflation (see Chart D). The MPC regularly analyses a range of indicators of house price inflation. Considering several measures can be particularly helpful when their growth rates differ, as in the first half of this year (see Chart E). Also, some indicators may be more forward-looking than others. For instance, Bank analysis suggests that the price balance in the Royal Institute of Chartered Surveyors (RICS) survey helps to predict Halifax and Nationwide house price inflation in the next month.⁽¹⁾

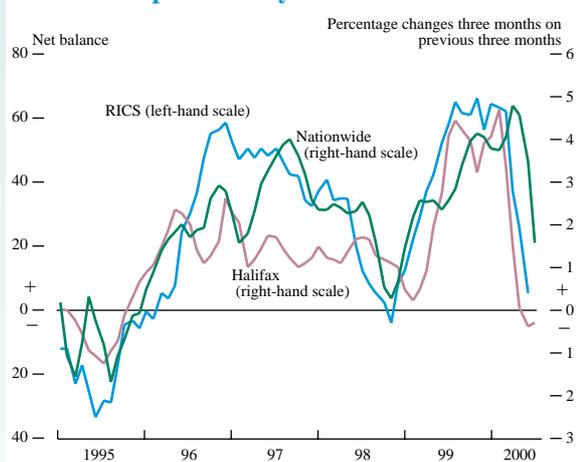
Chart D
Particulars delivered and house price inflation



Moreover, different indices are calculated using information gathered at distinct stages of the house purchase process shown in the table. RICS' survey data are derived largely from property prices advertised by estate agents. The Halifax and Nationwide indices are based on

information from loan approvals, while the DETR and Land Registry series are calculated using data at the completion stage.

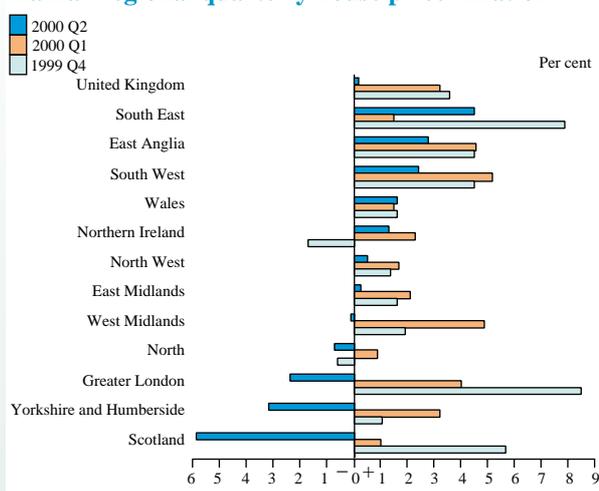
Chart E
Halifax and Nationwide house price indices and RICS house price survey^(a)



(a) Net balance of respondents reporting house price rises over the past three months.

House price data are also available at a regional level (see Chart F). These data, combined with evidence from the Bank's Agents, can provide useful information on regional conditions in the housing market, and help in assessing the picture in the United Kingdom as a whole.

Chart F
Halifax regional quarterly house price inflation

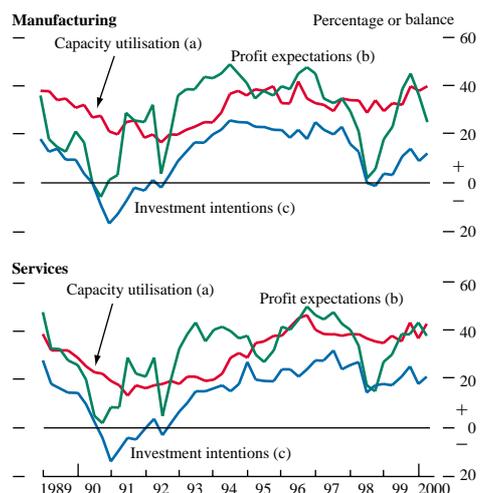


Recent developments

Long-leading indicators of activity, such as site visits and net reservations, have weakened since the autumn of 1999, suggesting softer activity later this year. But medium and short-term indicators, such as loan approvals, have remained relatively robust. House price inflation is now easing in most regions and at the national level, although the pace of slowdown varies across alternative measures.

(1) RICS introduced a price expectations series in October 1998. As yet, the sample is too short to use in estimation work.

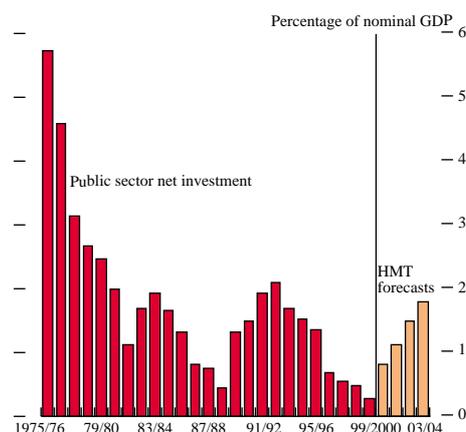
Chart 2.11
Influences on investment



Source: BCC.

- (a) Percentage of companies operating at full capacity.
- (b) Balance of responses to the question: 'Do you believe that over the next twelve months profitability will improve/remain the same/worsen?'
- (c) Balance of responses to the question: 'Over the past three months, which changes have you made in your investment plans for plant and machinery: revise upwards/no change/revise downwards?'

Chart 2.12
Public sector net investment



Sources: ONS and HM Treasury Spending Review 2000.

balance of investment intentions rose slightly on the previous quarter. However, investment intentions remained somewhat weaker in manufacturing than in the service sector, perhaps partly reflecting falls in profit expectations in manufacturing in recent quarters. Profit expectations in the service sector remain high.

Internal funds are an important source of investment finance for many firms. Retained earnings of private non-financial corporations rose by 4.1% in 2000 Q1, but were 10.1% lower than a year earlier, reflecting higher payments of dividends, interest and tax. As a result, companies have borrowed extensively over the past year to finance their investment spending and the sector as a whole has remained in substantial financial deficit. However, there is little evidence to date that rising corporate indebtedness has led to a significant tightening in the supply of external finance to firms and constrained their investment decisions (see Section 1).

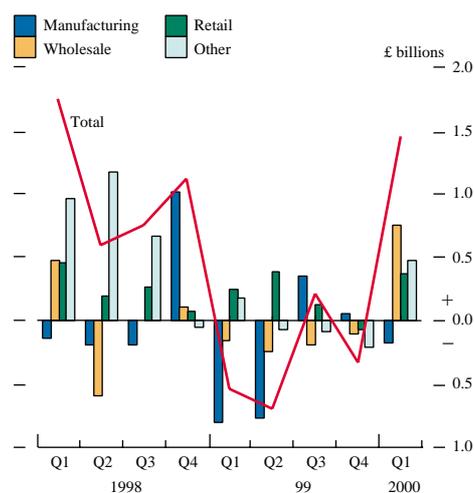
Government investment fell by 4.2% in the first quarter. In the Budget on 21 March the Government set its medium-term target for public sector net investment as a share of GDP at 1.8% by financial year 2003/04 (see Chart 2.12). Since net investment was only 0.3% of GDP in financial year 1999/2000, government capital expenditure is likely to rise sharply in coming years. Taking into account the outlook for government and private sector spending, the MPC expects a moderate recovery in overall investment over the forecast period.

Public sector consumption

Total government current expenditure in the 1999/2000 financial year was about £2 billion lower than envisaged in the Budget on 21 March. The 2000 Spending Review on 18 July announced that £1.5 billion of this underspend would be carried forward as additional departmental spending, spread evenly between this financial year and next. The Review also forecast that government debt interest payments would be lower in coming years than projected in the Budget, partly as stronger-than-expected receipts from the sale of third-generation mobile telecommunications licences were used to reduce the level of public sector net debt. In addition, lower projected unemployment would reduce future benefit spending. These savings in debt interest and in benefit payments would be made available for spending departments.

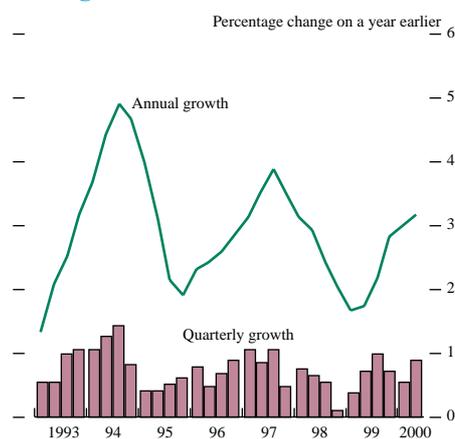
In assessing the outlook for the public finances, the MPC has taken the nominal spending plans set out in the

Chart 2.13
Change in inventories^(a)



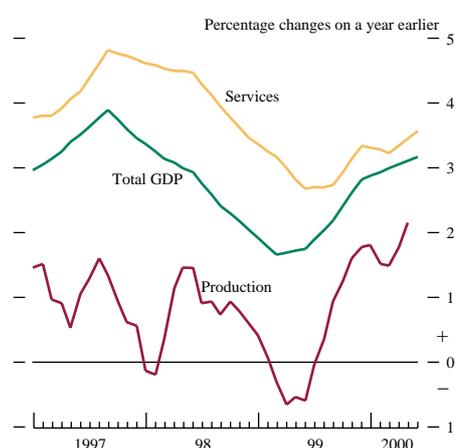
(a) At constant 1995 prices, excluding the alignment adjustment.

Chart 2.14
GDP growth^(a)



(a) At constant 1995 market prices.

Chart 2.15
Sectoral GDP growth^(a)



(a) GDP at 1995 market prices, production and service sector output at 1995 basic prices.

Spending Review as its central case. The net impact on final demand of the changes to spending was hard to gauge, and depended partly on judgments on relative propensities to consume out of different categories of spending and on whether there might be further shortfalls in spending in future years. Overall, the Committee judged that these plans pointed to slightly higher real government spending growth than in the *May Report*.

Inventories

Whole-economy inventories (excluding the alignment adjustment) rose by £1.4 billion in 2000 Q1 (see Chart 2.13), contrary to an anticipated rundown of stocks after the turn of the millennium. Retail and wholesale stocks rose unusually sharply—by the largest amount since records began. But there is little evidence of a marked involuntary build-up in stocks. Retail goods sales were strong in 2000 Q1 and the CBI distributive trades survey reported that stocks were not unusually high relative to sales. Moreover, a recent survey by the Bank's Agents found that most stockbuilding in the distribution sector had been voluntary. One potential explanation was pre-emptive stockbuilding of tobacco products to pay duty in advance of rises in the Budget.

Forward-looking surveys pointed to some rundown in stocks in Q2. In the medium term, the MPC has maintained the assumption that the stock-output ratio across the economy as a whole will resume its decline, reflecting further improvements in stock management techniques.

2.3

Output

According to the preliminary estimate, real GDP rose by 0.9% in 2000 Q2, and by 3.1% on a year earlier, following quarterly growth of 0.5% in Q1 (see Chart 2.14). Nominal GDP rose by 1.0% in Q1 and by 5.8% on a year earlier. The National Accounts release on 29 June revised up past estimates of real GDP. As a result, measured output in Q1 was 0.6% higher than previously estimated. Revisions to nominal GDP were much smaller. As a consequence, the GDP deflator is now around 0.5% lower than previously thought (see Section 4).

Production sector growth remained below growth in the service sector in 2000 Q1, although the gap has narrowed over the past year (see Chart 2.15). In Q1

Table 2.D
Manufacturing output prospects^(a)

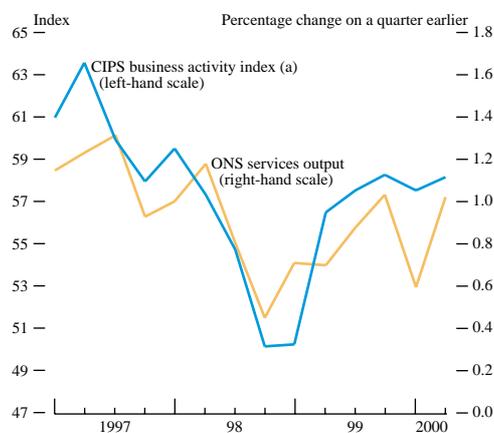
Percentage balances

	Series average (b)	1999			2000	
		Q2	Q3	Q4	Q1	Q2
CBI total new orders past four months	-1	-19	-5	9	-4	-8
CBI volume of output next four months	+8	-4	12	11	1	3
CIPS new orders index past month (c)	52.9	52.9	58.6	56.7	52.4	51.4
BCC home orders past three months	+6	5	19	20	15	5
EEF volume of new orders past three months	+7	-20	4	7	8	-7

Sources: BCC, CIPS, CBI and EEF.

- (a) Numbers reported are survey balances. An increase suggests a rise in the proportion of respondents reporting 'higher' relative to 'lower'.
- (b) CBI since 1975; CIPS since 1992; BCC since 1989; EEF since 1994.
- (c) Average of monthly balances. A reading above 50 suggests expansion, a reading below 50 suggests contraction.

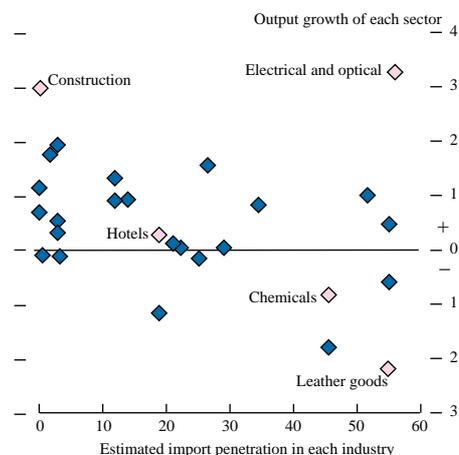
Chart 2.16
Measures of service sector output



Sources: ONS and CIPS.

- (a) Average of monthly balances. A reading above 50 suggests expansion, a reading below 50 suggests contraction.

Chart 2.17
Import penetration and recent output growth of the main UK industries^{(a),(b)}



- (a) Import penetration is defined as import sales in each sector expressed as a share of gross domestic output plus imports, as measured by UK input-output tables. Production and service sector industries are disaggregated to the level available in the ONS Index of Production and National Accounts respectively.
- (b) Output growth rates for the production industries refer to growth in the three months to May 2000, compared with the previous three months. Output growth rates in industries within the service, construction and agriculture sectors refer to growth in the three months to March 2000, compared with the previous three months.

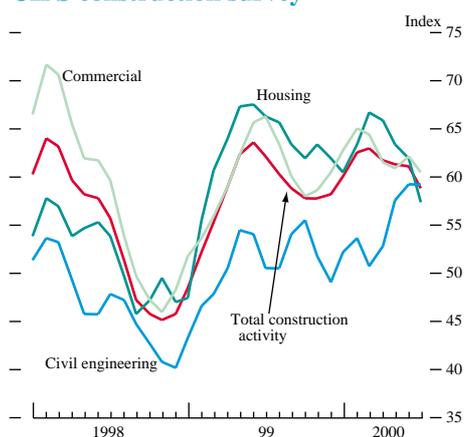
service sector growth slowed to 0.7% (3.3% higher than a year earlier), as growth in the post and communications and other business services sectors eased from high rates. And production sector output fell by 0.8%, leaving output 1.5% higher than a year earlier. The decline in Q1 partly reflected a fall in output of energy-related sectors, perhaps linked to unseasonably warm weather. But manufacturing output growth also fell by 0.5% in 2000 Q1.

More recent monthly data point to a moderate recovery in industrial output in the second quarter. Industrial production rose by 0.9% in the three months to May (2.1% higher than a year earlier), with a strong bounceback in output in energy-related industries. Despite further falls in production in the chemicals and transport equipment sectors, overall manufacturing output rose by 0.3% over the same period. Looking forward, survey evidence points to sluggish manufacturing output growth in coming months (see Table 2.D). Output expectations picked up slightly in the latest CBI quarterly industrial trends survey, and the CIPS new orders index rose in July. But other surveys, and reports from the Bank's regional Agents, pointed to flat or weaker output. In the service sector, output growth picked up to 1.0% in 2000 Q2 (3.6% higher than a year earlier). The increase was somewhat larger than suggested by the modest rise in the CIPS index of business activity in Q2 (see Chart 2.16) and intelligence gathered by the Bank's regional Agents.

Relatively slower growth in the production sector than in the service sector in recent years has partly reflected the effects of the appreciation of the exchange rate. The May 2000 Report noted that industries that export a high proportion of their output had tended to experience somewhat weaker output growth than sectors more orientated towards domestic markets. Manufacturing surveys and contacts of the Banks' regional Agents have also reported intense competition from imports.

Import competition is likely to vary across industries, reflecting differences in the tradability of goods and services and in the presence of established foreign competitors. Estimates of import penetration may offer insights on the most exposed sectors. Chart 2.17 shows that there has been some tendency for output to rise more slowly in recent months in industries with historically high import penetration, such as chemicals, leather goods and the tourism-affected hotels and catering sector. By contrast, output grew more rapidly in construction, which

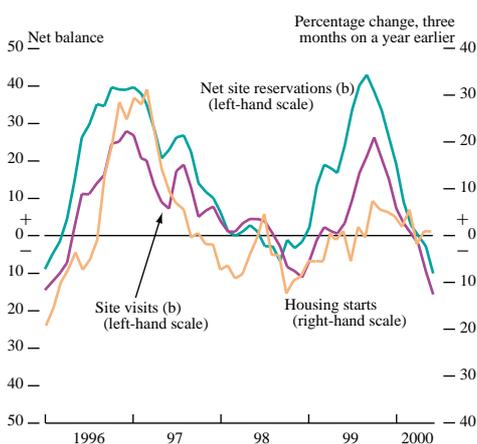
Chart 2.18
CIPS construction survey^(a)



Source: CIPS.

(a) A reading above 50 suggests expansion, a reading below 50 suggests contraction.

Chart 2.19
Private housing starts, net site visits and reservations^(a)



Sources: DETR and House Builders' Federation.

(a) Three-month backward-looking moving average.

(b) Net balance of survey respondents reporting an increase in site visits or reservations compared with a year earlier.

faces less direct competition from overseas. However, the chart also shows the importance of sector-specific developments. For example, growth in the high-technology electrical and optical equipment sector has remained robust, despite its historically high exposure to import competition.

Construction output rose by 3.0% in 2000 Q1, the largest quarterly rise since 1990. In Q2 new construction orders rose by 8.5%, but these data tend to be rather volatile and were boosted by a small number of large contracts. Survey evidence pointed to less rapid activity in the second quarter. The July CIPS survey suggested that construction activity continued to rise, but more slowly than in March, in large part due to slower growth in housing activity (see Chart 2.18). Other indicators confirm the picture of softer activity in the housing sector. Private housing starts fell by 3.7% in Q2 compared with the previous quarter. And recent House Builders' Federation surveys have reported that net reservations and site visits are falling compared with a year earlier (see Chart 2.19); the latter at its fastest rate for almost five years.

2.4

Summary

Prospects for growth have remained favourable since the *May Report*. Revisions to the National Accounts have raised the estimated level of output, and particularly consumption. However, less rapidly increasing household wealth and attempts to rebuild savings from current low levels may point to slower consumption growth in coming quarters. Survey data on investment intentions suggest that the fall in investment in 2000 Q1 is likely to prove temporary. The near-term outlook for world demand has improved since the *May Report* and sterling has depreciated by around 4% on a trade-weighted basis. Looking forward, that suggests some easing of current imbalances between domestic and external demand. Overall, the MPC expects annual GDP growth to soften in coming quarters to around 2½%—near trend—before rising slightly in the second year of the projection.

The demand for labour remains strong. Total hours worked and LFS employment continue to rise, and surveys suggest that further growth in employment is likely. Unemployment has continued to fall on both the LFS and claimant count measures—the latter to its lowest rate since 1975. Skill shortages remain high. Despite the strength of labour demand, however, measured earnings growth has slowed substantially. The headline measure of average earnings growth fell from 6.0% in February to 4.6% in May, partly due to the ending of millennium-related payments. But that decline also reflected falling bonuses, particularly in private sector services. Regular pay growth has fallen less sharply than headline earnings. Wage settlements are little changed. Productivity growth has increased to slightly above its long-run average and unit labour cost growth has slowed.

Chart 3.1
Growth in LFS employment and hours worked

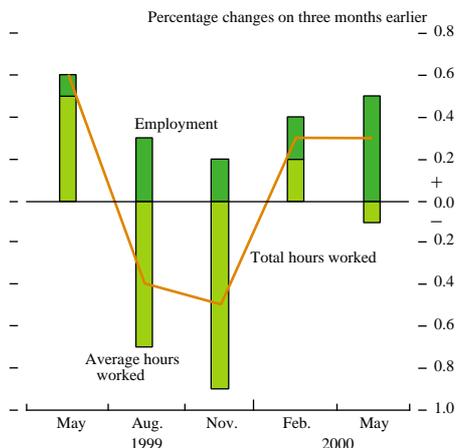
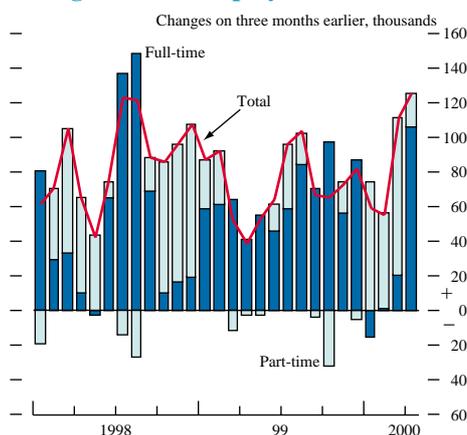


Chart 3.2
Changes in LFS employment

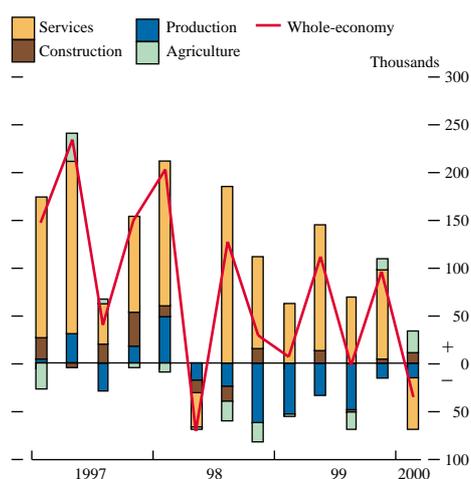


3.1 Employment and unemployment

Total hours worked, in principle the most comprehensive measure of labour usage, rose by 0.3% in the three months to May (see Chart 3.1). Changes in total hours worked reflect both variations in the number of people in employment and the average hours that they work. The recent increase in total hours worked is accounted for entirely by higher employment. Average hours worked declined by 0.1% in the three months to May and by 1.6% over the past year—largely reflecting a reduction in the average hours of full-time workers. Compliance with the Working Time Directive (WTD) may have been a factor. LFS employment rose by 126,000 (0.5%) in the three months to May—the largest rise since the three months to June 1997—mainly due to increased full-time employment (see Chart 3.2). Increases in part-time employment made larger contributions to LFS employment growth earlier in the year, raising the proportion of part-timers in LFS employment to just under 25%.

LFS employment measures the number of people in work, based on the responses to a rolling three-month survey of households. Another source of employment data is the Workforce Jobs survey, which records the number of jobs in different firms on a single day towards

Chart 3.3
Quarterly changes in Workforce Jobs



the end of each quarter. This sampling method means that the Workforce Jobs survey tends to be more volatile than the LFS measure. In contrast to the recent upward trend in LFS employment, the number of Workforce Jobs fell by 35,000 (0.1%) in 2000 Q1 (see Chart 3.3). This mainly reflected a 52,000 (0.2%) reduction in the number of service sector jobs, as employment in finance and business services fell significantly. The trend in service sector employment remains upward, however; over the past year the number of service sector jobs has risen by 242,000 (1.2%). Employment in the production sector has continued to decline. The number of production industry jobs fell by 16,000 (0.4%) in Q1 and by 111,000 (2.5%) over the year.

More timely indicators suggest continued employment growth. The CIPS employment index has risen gradually since the turn of the year and is currently slightly above its long-run average. The increases suggested in construction and services employment outweigh the decline indicated in manufacturing employment. The latest CBI/Deloitte & Touche and CBI/PricewaterhouseCoopers surveys reported continued growth in service sector and financial services employment.

Table 3.A
Surveys of employment intentions^(a)

Percentage balance of employers planning to recruit in next period ^(b)

	Series average ^(c)	1999				2000	
		Q1	Q2	Q3	Q4	Q1	Q2
Services							
BCC	13	12	16	21	21	25	28
Manufacturing							
BCC	3	-5	2	6	12	4	11
CBI	-16	-26	-22	-15	-10	-15	-13

(a) Seasonally adjusted by the Bank.

(b) Next three months for BCC; next four months for CBI.

(c) CBI from 1972; BCC from 1989.

Forward-looking indicators also generally suggest continued whole-economy employment growth, driven by the service sector (see Table 3.A). The latest BCC, Manpower and CBI/Deloitte & Touche surveys indicated continued strong employment intentions in the services sector, although some slowdown was apparent in the Manpower survey. The most recent CBI/PricewaterhouseCoopers survey, however, reported a large fall in employment intentions in financial services. The latest BCC and CBI surveys suggested an improved outlook for manufacturing employment—although the CBI survey continued to indicate reductions in manufacturing jobs.

The balance between the demand for, and the supply of, labour is an important influence on pay pressures. One measure of this balance is the number of people who are searching for work, and are available to start. This is measured by LFS unemployment, which fell by 47,000 in the three months to May compared with the previous three months. This reduced the LFS unemployment rate to 5.6%, the lowest rate recorded since the series began in 1984.

The claimant count—a narrower measure of unemployment based on the number of people receiving

Chart 3.4
Changes in LFS unemployment by duration

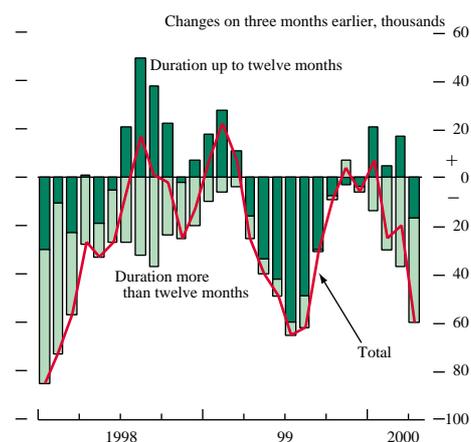
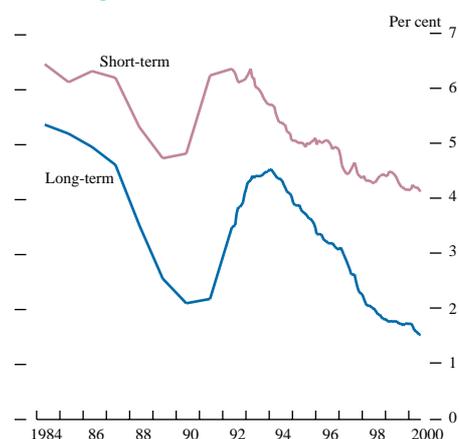
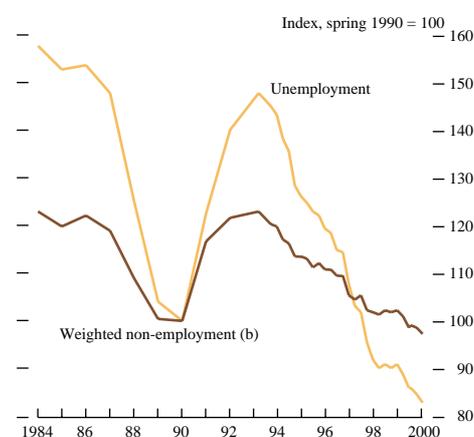


Chart 3.5
LFS unemployment rates: short-term and long-term (a)(b)



(a) Number of unemployed for up to/more than twelve months as percentages of the economically active.
 (b) Monthly UK data after May 1992, annual GB data before.

Chart 3.6
Measures of labour market tightness (a)



Sources: ONS and Bank of England.

(a) Pre-1993 figures based on yearly observations.
 (b) The weighted non-employment series is a weighted average of the number of people in each of seven different categories of non-employment. The weights are based on the average proportion in each category who found employment in the next three months, relative to the proportion of the short-term unemployed who found employment in the next three months.

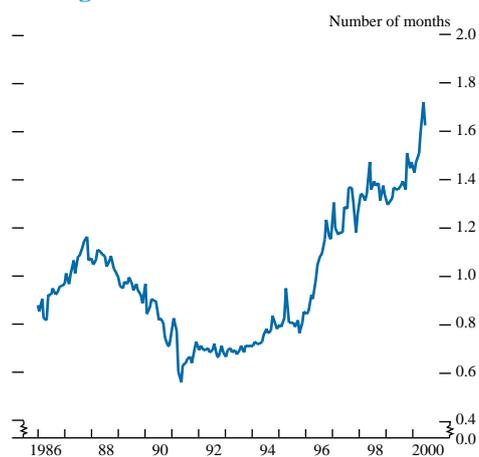
unemployment benefits—fell by 42,600 between March and June. The claimant count unemployment rate has declined to 3.8%, the lowest rate since November 1975.

A large proportion of the recent fall in LFS unemployment was accounted for by a decline in the number of people unemployed for more than twelve months (see Chart 3.4). Moreover, the number of long-term unemployed has declined significantly in recent years, with the long-term unemployment rate falling from 4.6% in January 1994 to 1.5% in May 2000 (see Chart 3.5). The short-term unemployment rate has fallen by much less, declining from 5.7% to 4.1% over the same period. It is possible that various labour market reforms, including more recently the New Deal, have played some role in the fall in long-term unemployment. This change in the composition of the unemployed could have helped to reduce the upward pressure on earnings generated by the strong demand for labour. The short-term unemployed tend to enter employment more readily than the long-term unemployed, and so may exert a greater restraining influence on pay negotiations. A fall in long-term unemployment may thus have less significance for pay pressures than a corresponding decline in short-term unemployment.

Individuals in different categories of economic inactivity also tend to enter employment at varying rates—and so may exert different restraining influences on pay negotiations. Chart 3.6 presents an index of weighted non-employment, which may be a useful summary measure. It is calculated by weighting seven categories of non-employment—ranging from the short-term unemployed to the economically inactive who currently do not want a job—by the average rate at which they move into employment. Weighted non-employment tends to change by less than an index of LFS unemployment, because inactivity changes more slowly. Given this, the declines in weighted non-employment and LFS unemployment indicate a substantial tightening of labour market conditions in recent years. Weighted non-employment, however, has not fallen as far as LFS unemployment relative to its previous trough in 1990.

Developments in job vacancies provide another metric of labour market conditions. New vacancies notified to Jobcentres exceeded the number of vacancies filled in Q2, continuing a trend apparent since around 1993. This has led to a significant rise in the stock of unfilled

Chart 3.7
Average duration of Jobcentre vacancies^(a)



(a) Defined as the stock of Jobcentre vacancies divided by monthly outflows.

Table 3.B
Survey indicators of labour market tightness

	Series average	1999				2000	
		Q1	Q2	Q3	Q4	Q1	Q2
REC availability (a)							
Permanent staff	44.9	58.6	52.5	47.3	43.3	45.3	42.3
Temporary/contract staff	45.7	60.9	54.0	47.4	44.3	47.6	41.9
BCC recruitment difficulties (b)(c)							
Manufacturing	55	71	71	69	69	70	69
Services	49	64	62	61	62	61	60
CBI manufacturing labour shortages (c)(d)							
Skilled	14	6	8	10	14	14	15
Unskilled	3	2	6	5	3	3	2

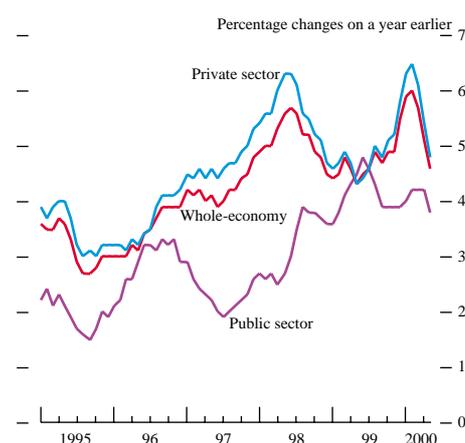
(a) Change in availability of staff from previous month. Less than (more than) 50 represents a decrease (increase) in staff availability. Average since 1997 Q4.

(b) Percentage of respondents experiencing recruitment difficulties. Average since 1989 Q1.

(c) Seasonally adjusted by the Bank.

(d) Balance of respondents expecting labour availability to limit output over next four months. Average since 1972 Q1.

Chart 3.8
Headline growth in nominal earnings^(a)



(a) Backward-looking three-month average of annual growth in the AEI.

vacancies and in the average time taken to fill them (see Chart 3.7). Although some of the upward trend may be associated with changes in the proportion of people finding employment in other ways, such as through recruitment agencies, some of it is likely to reflect a general increase in the difficulty faced by firms in filling vacancies by whatever means.

Survey indicators also suggest that the labour market is tight (see Table 3.B). The Recruitment and Employment Confederation (REC) surveys have reported continued reductions in the availability of temporary/contract and permanent agency staff in recent months. The BCC measures of recruitment difficulties in manufacturing and the service sector were little changed, albeit at relatively high levels, in Q2. The CBI measure of shortages of skilled labour in manufacturing edged up further in the latest survey, to slightly above its long-run average. Contacts of the Bank's regional Agents report little change in skill shortages in recent months, although they remain at high levels.

3.2 Earnings and settlements

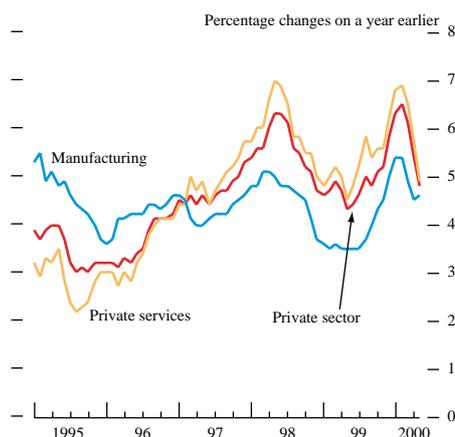
Earnings growth, as measured by the Average Earnings Index (AEI), has been weaker in recent months than expected at the time of the *May Report*. The AEI headline rate of annual earnings growth fell to 4.6% in May, compared with the 6.0% figure for February reviewed in the *May Report*.⁽¹⁾ Earnings growth has slowed in both the private and public sectors (see Chart 3.8). The slowdown was most pronounced in the private sector, mainly reflecting private services headline earnings growth falling from 6.9% in February to 4.9% in May (see Chart 3.9). Manufacturing headline earnings growth also fell over the period, but by less.

Table 3.C shows ONS estimates of the split of annual earnings growth into regular pay growth and the contribution of bonuses since February.⁽²⁾ Bonuses made a strong contribution to whole-economy earnings growth in February and March. But bonuses made a -0.7 percentage point contribution to annual earnings growth in May, as bonus payments were significantly lower than a year earlier. This pattern particularly reflected developments in private sector services. Whole-economy regular pay growth also fell between February and May, but by less than headline earnings

(1) The February estimate reviewed in the *May Report* was actually 6.1%. It was subsequently revised down to 6.0%.

(2) This decomposition of earnings growth cannot be estimated between February 1999 and January 2000 because of a change in the scope of the bonus data in February 1999.

Chart 3.9
Headline growth in nominal earnings^(a)



(a) Backward-looking three-month average of annual growth in the AEI.

Table 3.C
Components of earnings growth^(a)

2000	Whole-economy		Private sector		Public sector	
	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)
February	5.1	0.6	5.1	0.8	4.8	0.0
March	4.7	0.9	4.9	1.1	4.2	0.0
April	4.4	0.0	4.4	0.0	4.4	0.1
May	4.6	-0.7	4.9	-0.9	3.3	0.0

(a) Annual changes. Not seasonally adjusted.
(b) Percentage points.

growth. And regular pay growth recovered somewhat in May.

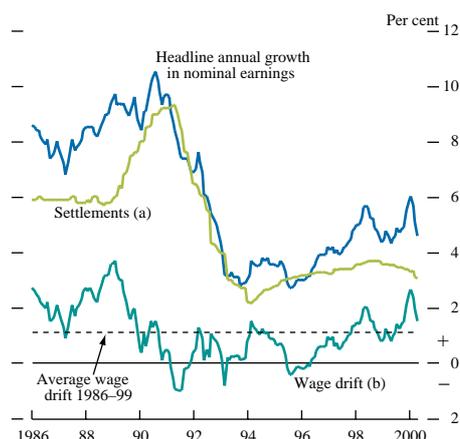
As noted in the previous *Report*, the MPC judged that the rise in earnings growth around the New Year was likely to be temporary; and that earnings growth would slow markedly once the major bonus months and payments for millennium work had passed. In practice, earnings growth has slowed even more quickly than the Committee expected.

It is possible that special payments around the millennium were larger than was previously thought. The magnitude of such payments cannot be directly measured—factors unrelated to the millennium could also have contributed to the rise in earnings growth around the New Year. But simple illustrative estimates based on smoothing actual AEI growth suggest that special payments could have raised earnings growth by up to 1/2 percentage point in 1999 Q4 and by up to 1 percentage point in 2000 Q1. Such estimates imply that underlying earnings growth, which abstracts from the one-off millennium payments, may have fallen a little from rates of just below 5% in the autumn to just above 4 1/2%.

The AEI measures earnings per employee. Another way of examining pay developments is to estimate the growth rate of earnings per hour worked—by subtracting the growth of average hours worked from AEI growth. This measure is, however, subject to considerable uncertainty because average hours worked are measured imprecisely and the calculation fails to take account of any compositional changes across different sectors. Inferred earnings per hour have generally grown faster than earnings per employee since the second quarter of 1999—because average hours worked fell over that period. Estimated headline earnings per hour growth reached a peak of around 7% in March, before falling to just over 6% in May—reflecting the decline in headline AEI growth over the period.

Another way of examining earnings growth is to express it as the sum of wage settlements and wage drift. Wage drift includes factors such as overtime payments, bonuses, profit-related pay, individual merit awards, and compositional changes in the workforce. The Bank collects a sample of settlements and weights them to make them consistent with the AEI sample. Importantly, however, not all firms use settlements in the remuneration of their staff, which reduces the

Chart 3.10
Settlements, nominal earnings growth and wage drift



Sources: ONS, Bank of England and Industrial Relations Services (IRS).

- (a) Based on IRS data until 1994, thereafter Bank of England estimates, which draw on information from the CBI, Incomes Data Services, Industrial Relations Services, Labour Research Department and the Bank's regional Agents.
(b) Difference between earnings growth and settlements.

information content of the settlements and estimated wage drift series. The Bank's estimate of three-month mean settlements edged up in April before flattening out. The estimate of twelve-month mean settlements has edged down since February (see Chart 3.10), but by much less than headline AEI growth. So estimated wage drift fell between February and May, but remains above its 1986–99 average. More recently, however, there have been reports that settlements may be beginning to edge up.

There is considerable uncertainty about developments in the various sources of estimated wage drift. Official data only provide information on overtime payments and bonuses. But these components usually only partly account for estimated wage drift movements. So developments for which no official data are available, such as profit-related pay, individual merit awards and compositional changes in the workforce, also have important effects on wage drift.

Another indicator of pay developments is the trend in wages and salaries paid to households, which is published quarterly as part of the National Accounts (early estimates of which are based partly on the AEI). Annual growth in wages and salaries per head rose slightly to 5.2% in 2000 Q1—0.5 percentage points lower than headline AEI earnings growth at that time. The REC survey, which covers the segment of the labour market using recruitment and placement agencies, reports sharp rises in salaries for both permanent and temporary/contract staff in recent months.

Table 3.D
Survey-based inflation expectations^(a)

Percentage increase in prices

RPI inflation rate one year ahead	1999				2000	
	Q1	Q2	Q3	Q4	Q1	Q2
Academic economists	2.3	2.3	2.5	2.2	2.4	2.6
Business economists	2.1	2.2	2.4	2.4	2.5	2.5
Finance directors	2.3	2.3	2.4	2.3	2.4	2.5
Trade unions	2.7	2.5	2.5	2.6	2.4	2.6
General public	4.1	4.0	3.7	3.9	3.9	3.8

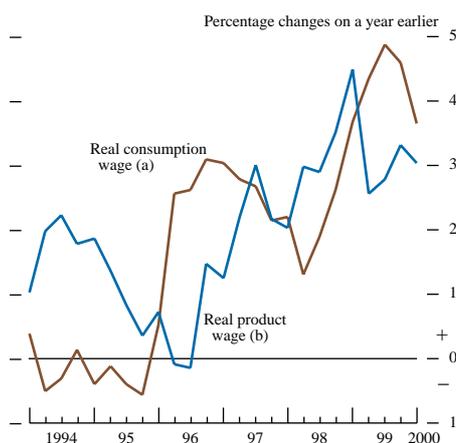
Source: Barclays Basix survey.

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

Although wages are typically agreed in nominal terms, firms and employees care ultimately about expected real wages, which depend also on expected inflation. Lower expectations of future inflation tend to result in lower nominal earnings growth. RPI inflation expectations according to the Barclays Basix survey have fallen since 1998, although there were some slight increases for most groups at some time during the first half of 2000 (see Table 3.D). Inflation expectations of trade unions and the general public were, however, no higher in 2000 Q2 than in 1999 Q4.

When involved in wage negotiations, employers care about the real product wage, which is their total labour costs per employee in relation to the prices of the goods and services that they sell. Employees, on the other hand, care about their real consumption wage—the real purchasing power of their post-tax earnings. Differences

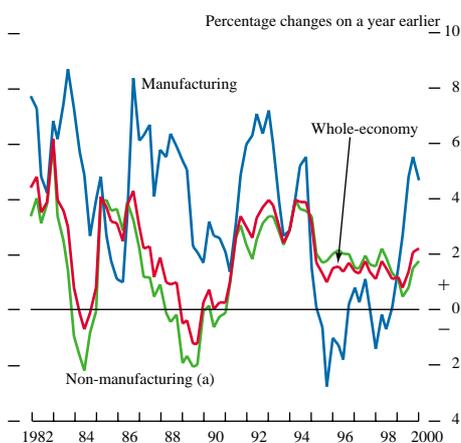
Chart 3.11
Growth in real earnings



Sources: ONS and Bank of England.

- (a) Wages and salaries per head divided by tax and prices index.
(b) Wages and salaries and employers' social security contributions per head divided by GDP deflator at basic prices.

Chart 3.12
Labour productivity growth



Sources: ONS and Bank of England.

- (a) Based on official measures of whole-economy and manufacturing labour productivity growth.

between these measures of real wages reflect two main factors: the terms of trade, and taxes on employment income and consumers' expenditure. Other things being equal, overall wage pressures tend to fall when the real consumption wage is growing more quickly than the real product wage. Employees' real wages are then being boosted by relative falls in import prices or tax rates, so they require smaller increases in nominal earnings to raise their effective purchasing power. The real consumption wage has grown faster than the real product wage since the start of last year (see Chart 3.11). But that difference narrowed in 2000 Q1, as real consumption wage growth slowed more sharply than real product wage growth. That suggests smaller falls in wage pressure from this source.

3.3

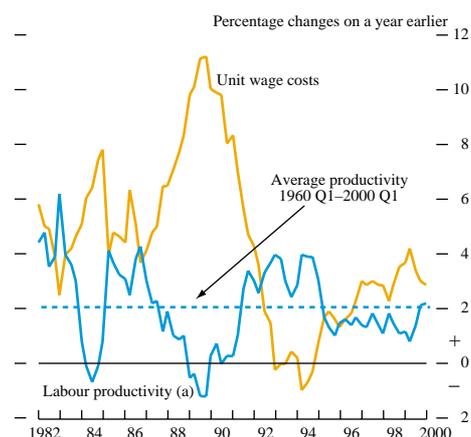
Labour productivity and unit wage costs

Labour productivity growth has risen in recent quarters as output growth has strengthened more than employment growth. Annual growth in the official measure of whole-economy productivity per worker, which is based on the Workforce Jobs employment measure, rose to 2.2% in 2000 Q1 (see Chart 3.12), slightly above the average growth in productivity since 1960. The ONS revised up estimated productivity growth over the past two years when it released the Q1 National Accounts, reflecting upward revisions to GDP growth. Those upward revisions lessen the extent to which productivity growth was lower than expected over that period.

Productivity growth in manufacturing rose sharply in 1999 as manufacturing output turned up, while employment fell substantially. The productivity rise was probably partly cyclical, and productivity growth has recently slowed somewhat—from 5.5% in 1999 Q4 to 4.7% in Q1 (see Chart 3.12). Manufacturing productivity growth, however, remains above the average annual increase since 1969 (when the sectoral data start). Productivity growth outside the manufacturing sector rose to 1.7% in the year to Q1, the strongest growth since the end of 1997 and around the average rate since 1969.

An alternative measure of whole-economy productivity can be calculated using LFS employment data. Because LFS employment grew by more than Workforce Jobs in the year to Q1 (see Section 3.1), productivity growth on the LFS basis has risen by less than the official measure.

Chart 3.13
Growth in labour productivity and unit wage costs



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

Specifically, LFS-based whole-economy productivity per person rose by 1.7% in the year to Q1. Firms are also concerned about the productivity per hour of their employees, which can be estimated using LFS data. As average hours worked fell sharply in the year to Q1 (see [Section 3.1](#)), estimated annual productivity per hour growth rose to 3.0% in 2000 Q1.

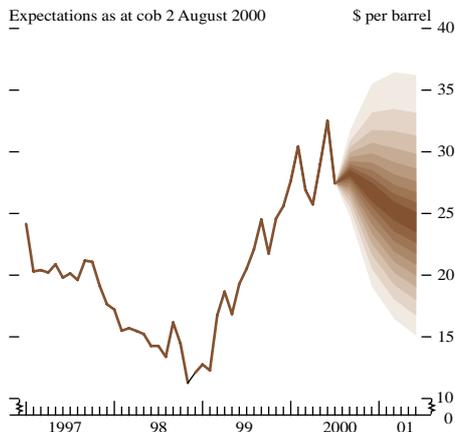
Labour productivity growth is an important determinant of the growth of the economy's supply capacity. It affects the degree of inflationary pressure from the labour market: productivity growth tempers the effect of nominal earnings growth on firms' unit wage costs. The rise in productivity growth in recent quarters was associated with annual whole-economy unit wage cost growth falling to 2.9% in 2000 Q1 (see [Chart 3.13](#)). The recent slowdown in manufacturing productivity growth has been associated with a rise in manufacturing unit wage costs, which were falling previously. Annual manufacturing unit wage cost growth rose from -0.6% in 1999 Q4 to 0.2% in 2000 Q1.

3.4

Summary

Employment has continued to grow strongly and unemployment has fallen further—to its lowest rate on the claimant count measure for nearly 25 years. Skill shortages remain high. But earnings growth as measured by the AEI has slowed substantially—and by more than expected—following the millennium-related boost to pay around the turn of the year. The outlook for unit labour cost growth is uncertain, and depends on whether the recent falls in earnings growth and pick-up in productivity growth are sustained.

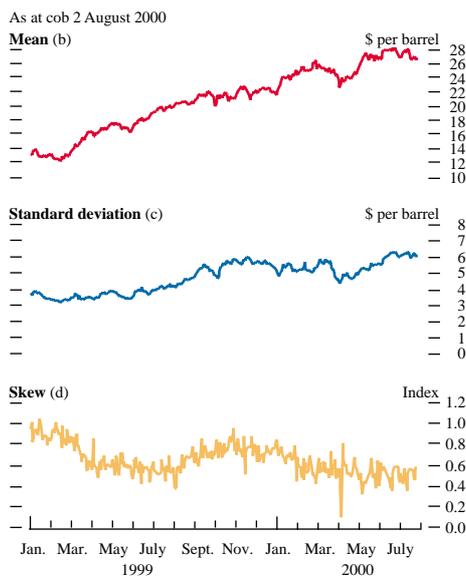
Chart 4.1
Implied distribution for oil prices^{(a)(b)}



Sources: NYMEX and Bank of England.

- (a) Derived from option prices for West Texas Intermediate oil (WTI). Prices for WTI tend on average to be around \$1 per barrel higher than those for Brent crude oil.
- (b) The chart depicts the probability distributions for oil prices, and 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 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.

Chart 4.2
Information from futures prices about the oil price six months ahead^(a)



Sources: NYMEX and Bank of England.

- (a) Derived from option prices for West Texas Intermediate oil (WTI). Prices for WTI tend on average to be around \$1 per barrel higher than those for Brent crude oil.
- (b) The expected price in six months' time.
- (c) A measure of the spread of views about the expected price in six months' time.
- (d) Skewness reflects the balance of risks around the central, most likely, path for oil prices. A positive skew indicates that the balance of risks is on the upside.

World commodity prices, notably for oil, have risen. This has put further upward pressure on UK manufacturers' input prices, which have continued to increase rapidly. And manufacturers' output price inflation has picked up, although the CBI monthly industrial trends survey shows that the balance of firms expecting to cut prices remains relatively high. Surveys suggest that service sector input and output prices have increased. The gap between retail goods and services price inflation has narrowed. RPIX inflation has risen slightly since the *May Report*, although it remains below the Government's 2½% target.

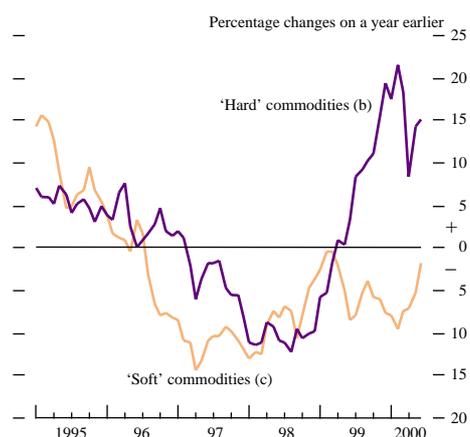
4.1 Raw materials and commodity prices

Oil prices have risen since the *May Report* (see Chart 4.1). The one-month forward price of Brent crude rose above \$30 per barrel in mid-June. On 21 June, OPEC members agreed to raise production by a further 0.7 million barrels per day, equivalent to around 1% of daily world production in 1999. And in July, Saudi Arabia announced a prospective production increase. Oil prices have fallen back somewhat in recent weeks, in response to this prospective increase in oil production.

The average price of oil in Q2 was just above \$27 per barrel, around \$4 per barrel higher than assumed at the time of the *May Report*. Oil prices are expected to fall back further and, consistent with futures prices, the MPC has assumed in its central projection that the price of oil declines to around \$21 per barrel in two years' time—somewhat higher than the profile assumed at the time of the *May Report*. Market uncertainty, as measured by the standard deviation of the distribution of oil prices implied by futures contracts, has risen in recent months (see Chart 4.2). Although the market expects prices to be lower in six months' time, the positive skew suggests that the balance of risks lies on the upside.

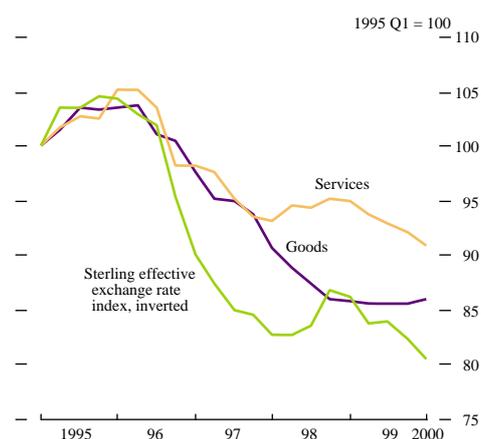
Sterling non-oil commodity prices in Q2 were higher than expected at the time of the *May Report*. In the year to June the Bank's sterling non-oil commodity price index rose by 5.2%. The prices of hard commodities such as metals and non-oil fuels have been quite variable

Chart 4.3
Bank's sterling non-oil commodity price index^(a)



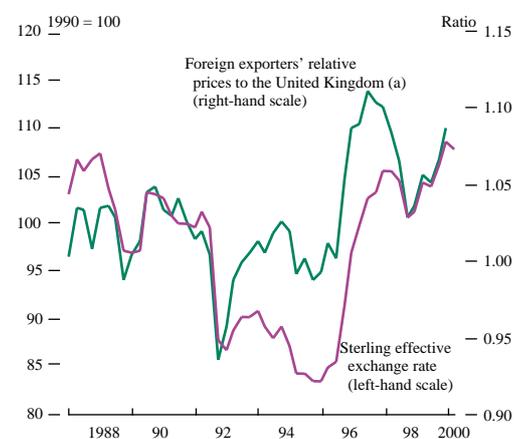
- (a) Monthly average of prices of primary commodities, weighted by their shares in UK demand.
- (b) Includes prices of non-oil fuels and metals.
- (c) Includes prices of domestically produced and imported foodstuffs and non-food agricultural products.

Chart 4.4
UK sterling import prices and the exchange rate



Sources: ONS and Bank of England.

Chart 4.5
Foreign exporters' relative prices to the United Kingdom and the exchange rate



Sources: ONS and Bank of England.

- (a) Estimated as sterling import prices (ie the sterling price of exports to the United Kingdom) divided by average sterling export prices of the major six overseas countries.

in recent months, although they remain well above their levels of a year earlier (see Chart 4.3). The annual rate of decline in the prices of soft commodities such as food products has slowed since February.

4.2 Import prices and the exchange rate

Sterling import prices of goods and services rose by 0.2% in Q1, but were 0.8% lower than a year earlier. Within the total, goods import prices rose by 0.2% in the year to Q1, partly reflecting the rise in oil prices, while services import prices fell by 4.2% over the same period (see Chart 4.4).

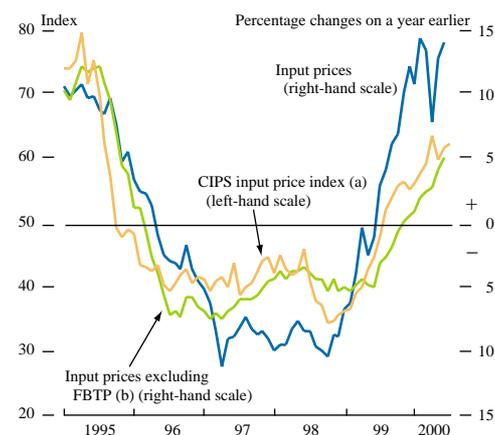
Sterling import prices reflect a number of influences: average world export prices in local currencies; the profit margin on overseas sales to the United Kingdom relative to sales to other markets; and the sterling exchange rate. In the year to Q1 the exchange rate appreciated by 7.2%. World export prices (UK trade-weighted) rose by 0.7% in Q1, which was more than expected, and were 1.4% higher than a year earlier. The MPC has assumed that world export prices will rise more quickly than in the May projection in the near term because of the impact of the rise in oil prices and stronger world demand.

As discussed in the *May Report*, sterling import prices have been higher in recent quarters than previous relationships would imply, given the levels of average world export prices and the sterling effective exchange rate. Chart 4.5 shows that foreign exporters' prices in the United Kingdom have increased relative to their prices in other markets. That is consistent with a rise in the profitability of exporting to the United Kingdom. Such a rise may have been associated with perceptions that the strength of sterling was in part temporary, and hence that gains from switching supplies to UK markets would be short-lived. But competition is likely to erode this increase in the profitability of exporting to the United Kingdom over time. The MPC has continued to assume that the ratio of sterling import prices to average world export prices in sterling terms declines over the forecast period. The speed of decline is quicker than in the May projection.

4.3 Costs and prices in manufacturing

Manufacturers' input price inflation has risen further since the *May Report*: the annual rate of inflation was 14.1% in June. However, the inflation rate has been

Chart 4.6
Manufacturing input prices



Sources: ONS and CIPS.

- (a) Survey responses to question asking how prices compare with the same month a year ago. Readings above 50 suggest that prices are rising, readings below 50 indicate falling prices.
- (b) Food, beverages, tobacco and petroleum.

Table 4.A
Manufacturers' costs and prices

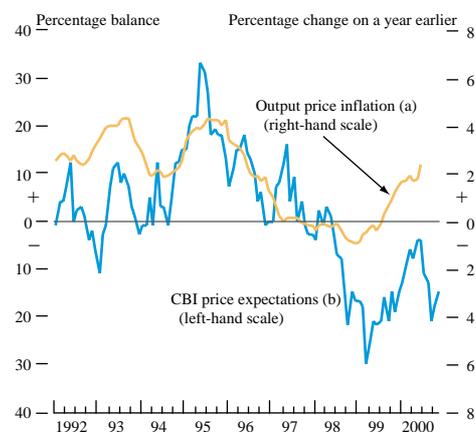
Percentage changes on a year earlier

	2000				
	Feb.	Mar.	Apr.	May	June
Weighted costs (a)	4.6	4.4	2.7	4.5	n.a.
Unit labour costs (46.8%)	-0.1	0.1	0.2	0.7	n.a.
Materials and fuels (30.1%) (b)	14.3	13.4	7.9	12.9	14.1
Imports of finished goods (6.9%)	0.0	0.0	0.6	0.9	n.a.
Bought-in services (16.2%)	2.2	1.7	1.5	1.3	1.1
Output prices (excl. duties)	1.7	1.9	1.7	1.8	2.4

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.

Chart 4.7
Manufacturing output price inflation and CBI average price expectations



Sources: ONS and CBI.

- (a) Excluding excise duties.
- (b) Balance of manufacturers expecting to increase prices over the following four months minus those expecting to reduce prices, adjusted for seasonal variation. This series has been advanced by four months, as it relates to producers' expectations of future prices.

volatile in recent months, mainly reflecting quite sharp movements in oil prices. But excluding petrol and other volatile components such as food, drink and tobacco, annual input price inflation has also continued to rise, to 5.0% in June (see Chart 4.6). In particular, hard commodity prices, notably of metals, are significantly higher than their levels of a year ago. The input price index in the CIPS manufacturing survey remains well above the no-change level of 50.

During much of 1999, manufacturing productivity rose rapidly as output increased while employment declined. Productivity growth outpaced earnings growth, leading to a fall in manufacturers' unit labour costs. But productivity growth has slowed below earnings growth in recent months and so unit labour costs have risen. Taking into account the sharp increase in materials inputs, manufacturers' weighted costs are estimated to have risen by around 4½% in the year to May (see Table 4.A).

The annual rate of manufacturers' domestic output price inflation (excluding excise duties) picked up to 2.4% in June, from 1.8% in May. That increase mainly reflected the rise in oil prices: petroleum products prices rose by 3.3% between May and June. However, with domestic output prices continuing to increase at a slower rate than weighted costs, domestic margins are likely to have continued to decline. Surveys suggest that pressures to contain prices remain high. For example, the CBI monthly industrial trends survey shows that the balance of firms who expect to reduce their domestic output prices over the next four months remains relatively high (see Chart 4.7). And the output prices balance in the BCC survey has fallen in recent quarters.

4.4 Costs and prices in the service sector

Unit labour costs in the service sector are estimated to have risen by nearly 4% in the year to Q1. The rate of increase has been broadly constant in recent quarters, as a rise in earnings growth has been broadly matched by an increase in productivity growth. The CIPS survey indicated a further increase in service sector input cost pressures in Q2 (see Table 4.B), with rising staff costs cited as the main factor. And the survey's measure of output prices also increased in Q2. But the latest BCC survey shows a fall in the balance of firms who expect to increase their prices over the next three months. The ONS is developing an official quarterly producer output

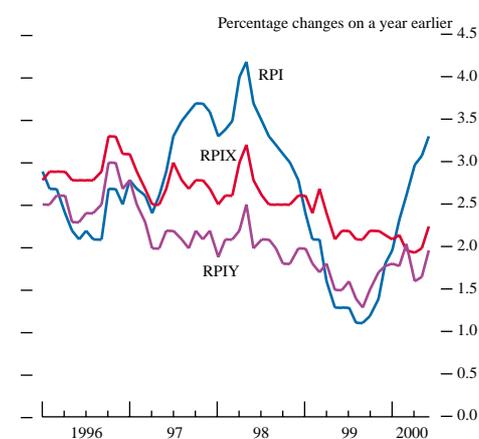
Table 4.B
BCC and CIPS surveys of service sector prices

	1999			2000	
	Q2	Q3	Q4	Q1	Q2
BCC prices balance (a)	11	22	24	26	21
CIPS input price index (b)	55.5	54.8	57.6	59.3	61.7
CIPS selling price index (b)	50.9	49.2	52.6	53.6	54.3

Sources: BCC and CIPS.

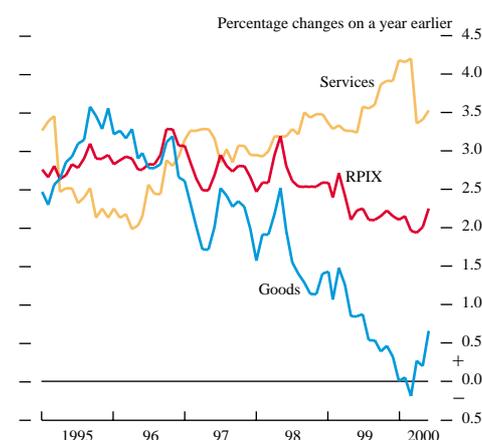
- (a) Percentage balance of responses to the question: 'Over the next three months, do you expect the price of your services to increase/remain the same/decrease?'
 (b) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices. The CIPS survey is monthly, and the quarterly values shown are averages over the relevant three months.

Chart 4.8
Retail price inflation



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

Chart 4.9
Goods and services price inflation



price index for corporate services.⁽¹⁾ At present, data are available for only around a half of the sectors to be covered. An example is the freight road transport sector, where the ONS estimates that output price inflation was around 4% in Q1, partly reflecting a rise in fuel costs.

4.5 Retail prices

Annual RPIX inflation has risen, to 2.2% in June, from 2.0% in March (see Chart 4.8). RPIX inflation was 2.1% in Q2, slightly higher than the *May Inflation Report* projection, mainly reflecting higher-than-expected oil and petrol prices. RPI inflation rose to 3.3% in June, as mortgage interest payments increased relative to a year earlier. In contrast, RPIY inflation, which excludes mortgage interest payments and indirect taxes, was 2.0% in June, slightly lower than in March.

While RPIX inflation has risen slightly, the gap between retail goods and services price inflation has narrowed: the differential in June was 2.8 percentage points, compared with 4.4 percentage points in March (see Chart 4.9). But it remains well above the average for the past ten years. That may partly reflect the past appreciation of the exchange rate, because of the higher import content of goods and the greater exposure of the goods sector to international competition.

Retail services price inflation fell from 4.2% in March to 3.5% in June. That decline mainly reflected cuts in utility prices, following implementation of the latest price control reviews in April. Retail goods price inflation rose to 0.7% in June from its recent low point of -0.2% in March. That rise largely reflected an increase in petrol prices: petrol price inflation contributed around 0.7 percentage points to annual RPIX inflation in June. Used cars, which comprise around 6% of the RPIX basket, continue to make the largest negative contribution to annual RPIX inflation (-0.3 percentage points in June), although used car prices were higher in June than in March. The annual rate of decline in seasonal food prices has fallen since February.

There is evidence from contacts of the Bank's regional Agents that an intensification of competitive pressure is putting unusual downward pressure on retail prices in some sectors. Moreover, the CBI distributive trades survey shows that the balance of retailers (mainly goods

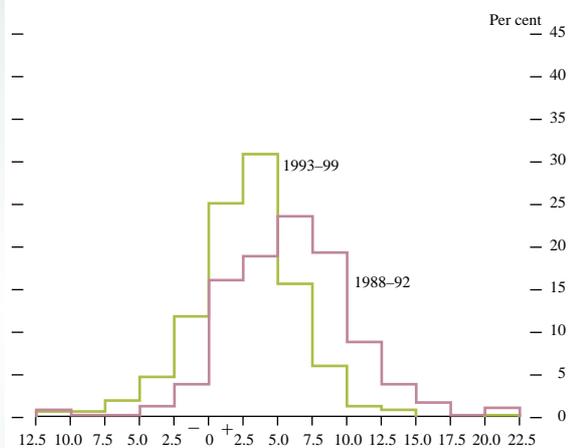
(1) For more information, see 'Corporate services prices: publication of prototype index', *Economic Trends*, July 2000, ONS.

The distribution of price changes

Some information about the distribution of price changes of the components of the RPIX basket is conveyed by summary measures such as the ‘trimmed mean’, which is discussed on [page 37](#) of this *Report*. This box presents additional information on the distribution of inflation rates, and how this has changed over time. This can provide useful information on relative price movements and price flexibility.

Chart A presents the distribution of annual inflation rates of the 85 components of RPIX, weighted by their share in expenditure, averaged over different time periods. The height of a curve indicates the percentage of the distribution that is contained within each inflation band (shown in 2.5 percentage point ranges). For example the ‘1993–99’ curve peaks at 31% for the 2.5%–5% inflation range. This means that between 1993 and 1999, on average, 31% of weighted annual inflation rates were within the 2.5%–5% range. As the overall inflation rate has fallen since 1988, the whole distribution has tended to shift to the left over time. And the width of the distribution, which measures the variance of inflation rates, fell between the 1988–92 and 1993–99 periods. A decline in the variance of inflation rates implies a decline in relative price variability. That has coincided with the introduction of inflation targeting and greater macroeconomic stability. Relative price changes are necessary for the efficient allocation of resources. But uncertainty about the general rate of

Chart A
Distribution of weighted annual price changes within RPIX^(a)

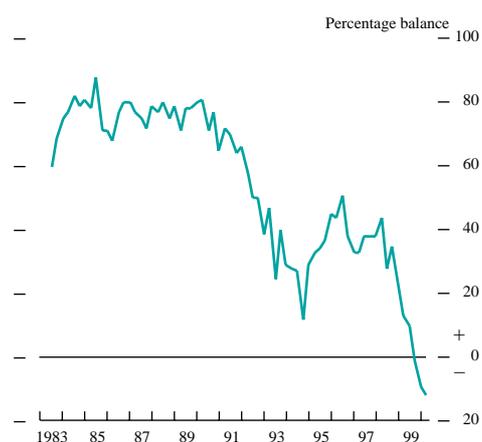


(a) Share of weighted inflation rates falling within a given range. For a given category the data could lie anywhere in the range.

inflation can lead to price variability that is costly to the economy.

There have been quite distinct changes occurring to the inflation rates of the goods and services components underlying the movements in aggregate inflation. Distributions for goods (around 55% of RPIX in 1999) and services (45% of RPIX) are shown in Charts B and C; both are re-scaled so that the areas under each distribution

Chart 4.10
Retailers' selling price expectations^(a)



Source: CBI.

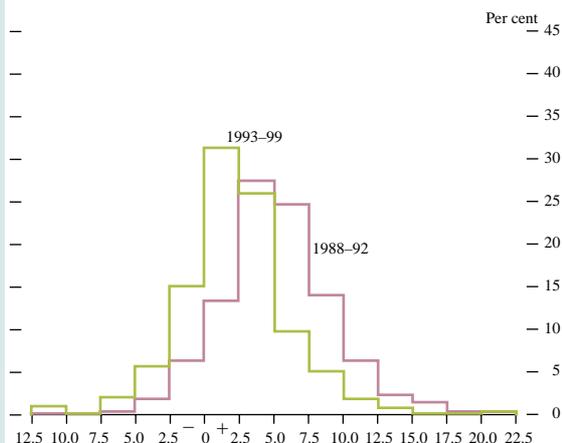
(a) Balance of retailers expecting to raise prices over the next month minus those expecting to reduce prices.

retailers) expecting to raise prices fell to -12 in May, the lowest since the survey began in 1983 (see Chart 4.10). Given the rise in manufacturers' output price inflation and an increase in service sector output prices indicated by the CIPS survey, that suggests downward pressure on retail mark-ups.

Given these developments and evidence that manufacturers' domestic margins are falling, the MPC has maintained its view that the prospective increase in competitive pressure is likely to be more widespread than has been experienced in the past. The Committee has therefore continued to assume that there will be some overall compression of whole-economy margins over the forecast period, which will put downward pressure on retail prices.

Chart 4.11 shows that for the economy as a whole, the share of profits in GDP has fallen back from the relatively high levels of the mid-to-late 1990s, although it remains above its 1963–99 average.

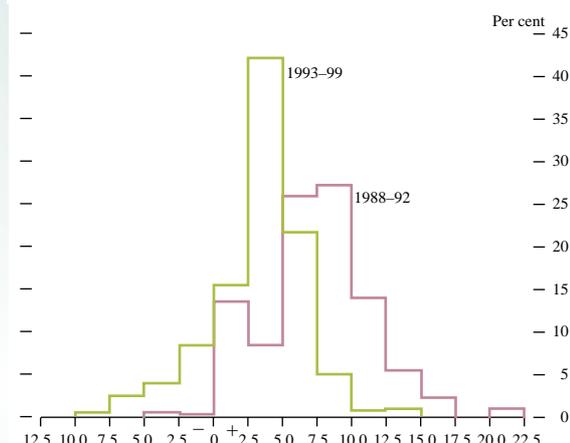
Chart B
Distribution of weighted annual price changes within RPIX goods



sum to 100%. The distributions of both goods and services inflation rates have shifted to the left, as the mean inflation rates have fallen.

An interesting feature of the changing shape of the distributions is the increasing proportion of components showing price falls. The table shows how much more widespread price cuts were in 1999 than in earlier years, and how much more marked this development has been for goods than for services. That is likely partly to reflect the strength of the exchange rate over the past few years. But, in addition, some sectors, for example car and food retailing, have been

Chart C
Distribution of weighted annual price changes within RPIX services

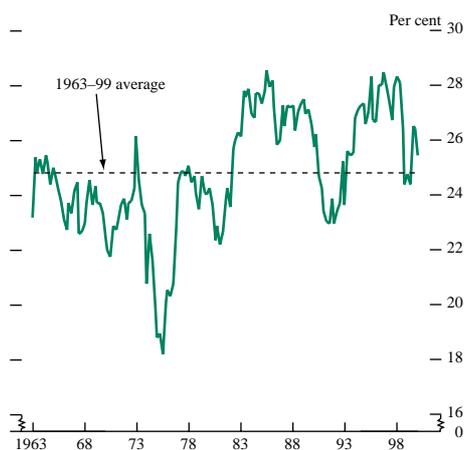


subject to official price investigations, which may also have exerted downward pressure on prices. The increasing prevalence of price cuts suggests that the efficient allocation of resources in a low-inflation environment has not been hampered by a lack of downward flexibility in prices.

Price falls as percentage of distribution

Per cent	Total	Goods	Services
1988-92	6.3	9.2	1.1
1993-97	17.7	20.2	15.1
1998	20.5	27.2	13.6
1999	28.6	40.9	14.4

Chart 4.11
Profits as a share of GDP^(a)



Source: ONS.

(a) Defined as the gross operating surplus of corporations (excluding the quarterly alignment adjustment) as a percentage of current price GDP at factor cost.

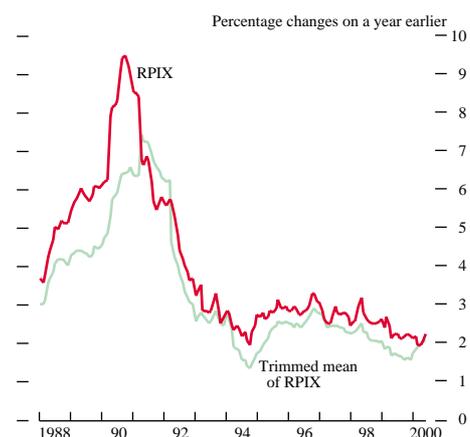
4.6

Other price indices

The trimmed mean measure of RPIX inflation has risen since the turn of the year, to 2.1% in June. This measure excludes the largest and smallest weighted price changes in the individual components of the RPI, to provide an indicator of underlying inflation that excludes major shifts in relative prices. In April and May, the trimmed mean measure was higher than the overall inflation measure for the first time in more than eight years (see Chart 4.12)—the sharp falls in utility prices in April and May were excluded from the trimmed mean measure. The box above presents additional information on the distribution of inflation rates.

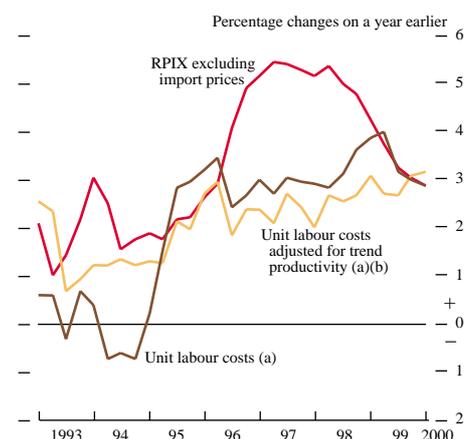
Overall retail price inflation is affected by a combination of imported and domestically generated inflationary factors. In recent years the weakness of import prices has exerted downward pressure on retail price inflation. To the extent that such pressure reflects the past

Chart 4.12 [Click here for erratum](#)
Trimmed mean of retail price inflation^(a)



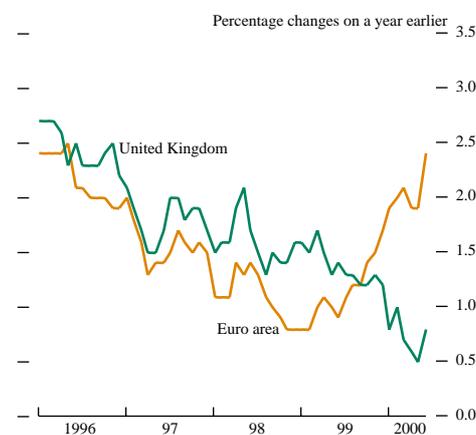
(a) The trimmed mean measure of RPI inflation is calculated by removing the largest 15% and smallest 15% of monthly price changes in the components of the RPI. The calculation takes account not only of the size of price changes in different items which are included in the RPI, but also the weights of each item in the index.

Chart 4.13
Measures of domestically generated inflation



(a) Using National Accounts measures of employee compensation and productivity growth.
 (b) Adjusted using long-run trend productivity growth of 2%.

Chart 4.14
HICP inflation



appreciation of sterling, it may be expected to wear off. Measures of domestically generated inflation (DGI) provide information on the pressure being exerted on prices domestically—in the labour market and elsewhere. One measure is calculated by adjusting RPIX inflation for the share of direct and indirect imports in consumption. That measure of DGI declined further in Q1 to around 3% (see Chart 4.13). Other measures of DGI, based on unit labour costs, are also around 3%. Annual inflation in the GDP deflator, a measure of whole-economy inflation, rose to 2.7% in Q1, from 2.3% in Q4, although the level of the GDP deflator was revised down in the latest set of National Accounts. Inflation in the deflator for final consumption expenditure increased to 2.1% in Q1, from 2.0% in Q4.

The annual rate of change in the monthly retail sales deflator has been negative since May 1999. It has been markedly weaker than retail goods price inflation in recent years, despite the fact that the deflator is based on detailed retail goods price data. This largely reflects differences in weights attached to the components of the two indices, and some divergence in coverage. For example, the retail sales deflator does not include petrol.

Annual inflation in the Harmonised Index of Consumer Prices (HICP) rose to 0.8% in June (see Chart 4.14). This measure of inflation is lower in the United Kingdom than in any other country in the European Union—partly reflecting the appreciation of sterling relative to the euro. The *May Report* discussed several reasons why UK HICP inflation is below RPIX inflation: most of the difference is attributable to the different treatment of housing (HICP does not currently include an owner-occupied housing component), and to the different approaches used to weight components of the indices at the lowest level of aggregation (RPIX uses an arithmetic mean, whereas the HICP uses a geometric mean).

4.7 Summary

World commodity prices, notably for oil, rose in Q2 by more than expected at the time of the *May Report*. That has put further upward pressure on UK manufacturers' input prices, and manufacturers' unit labour costs have also risen in recent months. Manufacturers' output price inflation has picked up, although the CBI monthly industrial trends survey shows that the balance of firms expecting to reduce prices remains relatively high. Manufacturers' margins are likely to have fallen further.

Surveys suggest that service sector input and output prices have increased. The gap between retail goods and services price inflation has narrowed, but it remains relatively high by historical standards. Measures of domestically generated inflation remain at around 3%. RPIX inflation has risen slightly since the *May Report*, mainly reflecting the recent rise in oil prices, although it remains below the Government's 2½% target.

5

Monetary policy since the *May Report*

This section summarises the economic developments and 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 repo rate was maintained at 6% in June, July and August.

In the *May Report*, the MPC's central projection was for RPIX inflation to remain below target for the next year, before rising to around the 2½% target in the second year of the forecast. Annual real GDP growth was judged most likely to ease from around 3% to the 2½%–2¾% range. Relative to the central projection, some members would have preferred to assume a steeper decline in the exchange rate and less structural compression of margins, while others would have preferred to assume a constant nominal exchange rate and more downward pressure on prices on account of greater competition and higher productivity growth. Alternative combinations of assumptions could have raised or lowered projected inflation by up to ½% at the two-year forecast horizon.

At its meeting on *6–7 June*, the Committee discussed prospects for the world economy. Growth prospects for the euro area seemed little changed since the previous meeting. For the United States the signs were mixed. Markets seemed to be expecting a moderate slowdown without much further monetary policy tightening. However, there were some indications that growth remained buoyant, and it remained unclear whether a 'soft landing' would be achieved. OECD projections for G7 growth were slightly stronger for 2000 and slightly weaker for 2001. There were signs that growth was slowing in Asia, and any further tightening of monetary policy in the United States could affect developing countries, especially in Latin America.

The exchange rate had depreciated significantly since the previous meeting. The sterling ERI had fallen about 5% below the *May Report* profile and about 7½% below the level at the time of the *May* meeting. The Committee agreed that there could be no mechanical link between exchange rate changes and interest rate decisions, but the impact of the exchange rate on inflation prospects had to

be assessed carefully, as a lower exchange rate would inevitably put some upward pressure on prices. It was agreed that a more thorough assessment of this impact should be conducted during the August forecast round.

There were signs that house price inflation was easing and that housing market activity was weakening. Mortgage approvals had slowed in April and mortgage equity withdrawal was lower in 2000 Q1 than in 1999 Q4. These data were consistent with a prospective slowdown in consumption growth. Company borrowing appeared strong, but it was not clear how much this was to finance investment or to cover weaker cash flow. Total investment had been weaker than expected in Q1, but business investment appeared to have been resilient.

Final domestic demand appeared weaker in Q1 than had been expected at the time of the *May Report*, and a key question was how persistent this slowdown would be. Consumption growth data might have been erratically low, in the light of retail sales data and other indicators. Growth in wealth had been lower but real earnings growth continued to support household spending. Recent data showed that government spending in Q1 had undershot (and revenue had overshot) the projections made in the March Budget; prospects for future government spending would be updated in the August forecast round. Inventories had made a stronger-than-expected contribution to GDP growth in Q1, but it was possible that this would be reversed in Q2. There had been a slightly weaker-than-expected contribution to GDP growth from net trade in Q1, though both export and import volumes were unexpectedly high. The output, expenditure and income-based measures of GDP were hard to reconcile, so the picture would only become clear as more information became available.

Employment growth had moderated and hours worked had probably fallen in Q1, but a further fall in unemployment pointed to a slight tightening of the labour market. Settlements had picked up slightly but headline earnings growth had fallen more sharply than expected. Productivity growth had been rising, but whole-economy unit labour costs were some 4% higher than a year earlier and had been rising in real terms. This entailed a squeeze in the share of profits in national income. On this evidence the labour market continued to look tight.

RPIX inflation had fallen to 1.9% in April, and the gap between goods and services inflation had narrowed. The

short-term prospects were for higher RPIX inflation than expected at the time of the *May Report*, mainly due to higher oil prices. But the main news on the month was the marked fall in the exchange rate, which would tend to push inflation higher. But inflation was currently below target and the fall in sterling to date was welcome as it might help to rebalance the economy.

On the immediate policy decision, there were two broad views. One was that there was no reason to change the official rate from 6%. While the lower exchange rate would put upward pressure on inflation, pass-through could be weak and was highly uncertain. Other indicators, such as demand growth, house prices and earnings growth, were all pointing to softer inflation prospects. The rebalancing of the economy likely to result from a lower exchange rate was welcome. The costs of waiting for more information were low compared with those likely to follow from higher rates and a potential renewed overvaluation of sterling. The alternative view was that the lower exchange rate had raised medium-term inflation prospects significantly and this was not offset sufficiently by any other forces. On this view an immediate rise in the official rate by 25 basis points was necessary. The Committee voted by a majority of 6 to 3 to leave the official rate unchanged.

At its meeting on **5–6 July** the Committee started by discussing UK demand and output. The level of GDP had been revised up, but most of the revisions to growth rates related to 1998. The estimated growth rate for 2000 Q1 remained 0.5%. Domestic demand growth had weakened in Q1, with consumption, investment and government spending all slowing, while net trade had made a positive contribution to growth. The weakness of investment and the strength of net trade were both somewhat puzzling. Preliminary estimates of demand growth in Q2 indicated growth slightly above that in Q1. However, lower house price growth might signal slower consumption growth in future. Survey and production data suggested that output growth in some parts of the economy was moderating, though there remained some buoyant sectors, including energy production. Measures of optimism in financial services were sharply down. Public spending seemed likely to support growth in the medium term, with the government's three-year spending review due to be announced in mid-July.

The labour market seemed surprisingly benign. While employment had risen and unemployment had fallen further, the rate of increase of earnings as measured by

the AEI had fallen sharply. Much of the rise in employment was accounted for by a reduction in long-term unemployment and a decline in the inactivity rate, suggesting an increase in supply of those available for work. The present strength of employment growth did not suggest that employers expected a sharp slowdown in activity. The Bank's Agents had reported little change in skill shortages, and these continued to concern many employers. The sharp drop in AEI growth was partly due to the passing of the bonus season and millennium-related payments, but was larger than expected in the May projection. Settlements might rise, for example because of the pick-up in RPI inflation, but there had not been much sign of this so far. The share of employment earnings in national income had continued to rise, but had flattened off slightly and had not reached its early 1990s peak.

Growth in monetary aggregates was modest but M4 lending was buoyant. Lending to households was growing at about 10% per annum, though estimates of lending for consumption appeared to have slowed since the second half of 1999. M4 lending to PNFCs had also picked up in May, though this was partly to finance mobile phone spectrum auction payments. Some of this borrowing could have reflected financial difficulty in parts of the corporate sector, and, while there were few signs of this as yet, the combination of heavy borrowing with lower investment remained a puzzle. The sterling ERI had moved little over the past month since its sharp fall in May. At around 105, the index was close to its average for the past three years. The Committee discussed the extent to which the previous fall in sterling might affect its inflation projections.

There were more signs of a slowdown in the US economy in recent months, whereas the recovery in the euro area seemed to be strengthening, with inflation close to 2%. Japanese activity seemed to be a little stronger than previously expected, which might affect the timing of the end of the zero interest rate policy. But any change in Japanese monetary policy was unlikely to have much effect on the United Kingdom. The annual growth rate of output in many emerging economies seemed to have peaked, but activity was generally stronger than a year earlier.

The oil price was higher than had been assumed in the *May Report*, so there could be a higher short-term impact on RPIX. But some of this was already in the data and there were some prospects that the price would

fall or stabilise in coming months, though second-round effects of past rises were possible.

RPIX inflation had been 2.0% in the year to May. Inflation excluding erratic items such as food, tobacco and oil was lower, but it was not clear what message this conveyed for future inflation. Surveys indicated both downward pressures on retail prices and upward pressures on costs, but it was unclear whether the implied squeeze on margins could be sustained. Given higher oil prices, inflation seemed likely to move closer to the 2½% target sooner than expected at the time of the *May Report*, but it was unclear what implications this slightly higher inflation level in the short term had for inflation further out. There was little expectation of a rate change this month, and neither the FOMC nor the ECB were expected to raise rates this month.

With regard to the immediate policy decision, the news on the month had mainly been on the downside for prospective inflation with weaker demand and lower earnings growth. Members who had previously voted for no change in rates saw nothing in the data to suggest that a rise was now needed, but neither was there evidence of a sufficient slowdown that a cut in rates was yet warranted. Those members who had voted for a rate rise at the June meeting were persuaded by the softer data that it was safe to wait for the August *Inflation Report* round in order to reassess inflation prospects. The Committee voted unanimously in favour of leaving the Bank's repo rate unchanged at 6%.

At its meeting on **2–3 August**, the Committee voted to leave the Bank's repo rate unchanged at 6%.

6.1 The inflation projection assumptions

This *Report* was approved by the Monetary Policy Committee on 4 August. It contains the Committee's assessment of developments in the economy since May and prospects for the medium term. Projections of GDP growth and RPIX inflation over the next two years are presented below in Charts 6.1 and 6.2, together with the uncertainties surrounding them. These projections are based on the assumption that the Bank's repo rate remains unchanged at 6% during the next two years. Alternative projections conditioned on market interest rate expectations are shown in Charts 6.6 and 6.7. The key assumptions on which the projections are based are described below.

Prospects for world economic growth remain favourable. Output growth in the United States once again outstripped expectations in the first half of the year, but there are some signs that the economy may be slowing towards a more sustainable pace. Growth in the United States is expected to moderate, as tighter monetary policy dampens demand and the stimulus from earlier increases in equity wealth diminishes, and the central assumption remains a slowdown in output growth to a little below the likely trend growth in supply capacity over the next two years. Recent indicators suggest that the recovery in the euro area has gained further momentum: the euro area is likely to see the strongest growth for a decade. Rising employment and household incomes should encourage further increases in consumer spending, while net trade is also likely to support growth following the marked depreciation of the euro over the past year. There are further signs of recovery in Japan, underpinned by an improvement in corporate profits, private investment and business confidence. Consumer spending prospects remain subdued, however, and a moderate cyclical recovery in the Japanese economy remains the most likely prospect over the next two years. Emerging market economies continue to benefit from growth in North American and European markets, although output growth in some Asian economies has slowed from the exceptional rates recorded as they recovered from the period of financial turbulence.

The central projection for the level of overall world activity is slightly firmer than in May, primarily reflecting higher-than-expected growth in the United States and Asia in the early part of this year and a slight upward revision to expected growth in the euro area. World GDP growth is likely to peak in 2000, slowing gradually over the next two years in response to tighter monetary policy in the United States and the euro area. World trade has been particularly strong in recent months, and annual growth in UK-weighted world import volumes may now peak at close to 10% this year, up from 6½% in 1999, and around 1 percentage point higher than projected three months ago.

The Committee continues to judge that the balance of risks to the central projection for world activity is weighted to the downside. The US equity market remains one such source of risk. Although share prices are down from peak levels, valuations remain stretched by historical standards. A sharp fall in equity prices could be associated with a faster-than-expected slowdown in the United States. Under such a scenario, world growth could also be affected by falls in asset prices in other financial markets, including the United Kingdom.

World prices have been stronger than expected three months ago. Oil prices in the second quarter were around \$4 per barrel above the central projection in the *May Report*, supported by a combination of stronger world demand, low inventory levels and OPEC production restraints. Higher oil prices have put upward pressure on producer and consumer prices, which have risen more quickly than previously projected.

Although near-term pressures on world prices are rather stronger than envisaged in the *May Report*, the Committee judges that the most likely change in global inflation prospects over the next two years is relatively small. OPEC agreed to raise production in June and oil prices have fallen back from peak levels in recent weeks. The central projection assumes that the Brent price falls to around \$21 per barrel over the next two years, broadly in line with futures prices. The path of oil prices projected now is rather higher than in the *May Report*, but the difference is less in the medium term than in the near term. Hence, oil prices are assumed to fall at a faster pace than expected in May, which limits the inflationary impact at a two-year horizon. Moreover, non-oil commodity prices in dollar terms rose less quickly than expected in the first half of this year and the

outlook is rather weaker than assumed in May. Central banks have responded to counteract emerging inflationary pressure by raising interest rates further, with increases of 50 basis points in both the United States and the euro area over the past three months. Monetary tightening should slow demand growth, and as the impulse from higher oil prices fades and then reverses, inflation in the major overseas economies is likely to remain low over the next two years. In sum, relative to expectations in May, short-term pressures on world inflation are rather stronger, but these additional pressures should soon dissipate.

In the medium term, sterling import prices will tend to match movements in the prices of traded goods set in global markets, converted into sterling at the prevailing exchange rate. But this relationship is not precise in the short run. For example, the currency of invoicing may affect the response of import prices to a change in exchange rates, or there may be costs to entering or switching markets that may also slow the responsiveness of prices. As noted in the *May Report*, sterling import prices have been rather higher in recent quarters than a measure based on average world export prices translated into sterling. That is consistent with a view that foreign firms' profit margins on UK sales may have widened as sterling appreciated. Such a widening is unlikely to persist in the medium term, as competition from new suppliers will gradually erode any abnormal profit. The Committee, having re-examined the empirical evidence, judges that margins on sales to the United Kingdom are likely to be squeezed more quickly than assumed in the *May Report*. This will offset some of the near-term upward pressure on UK import prices from higher world prices and from the fall in the sterling exchange rate over the past three months.

There was a sharp depreciation of sterling in the second half of May. By the June MPC meeting, the effective exchange rate index (ERI) was some 5% below the profile assumed in the *May Report*, as the rise in sterling over the previous six months was reversed. Sterling was broadly stable around the lower level during June and early July, but has edged up slightly in recent weeks reflecting renewed weakness of the euro. The ERI averaged 106.1 in the 15 working days up to and including 2 August, consistent with bilateral sterling exchange rates of \$1.50 and 62 pence against the euro. This is the starting point for the exchange rate profile assumed in the current projection. It is significantly lower than the starting point of 110.7 in the *May Report*

and an implied level of 110.4 for August in the May central projection.

In line with recent *Reports*, the Committee agreed to base the central projection on the average of a constant nominal exchange rate and a path implied by the pattern of market interest rate differentials, with the latter adjusted for the conditioning assumption of constant UK interest rates. Following this approach, the sterling ERI declines to 104.6 by 2002 Q3, consistent with bilateral sterling exchange rates of \$1.51 and 63 pence against the euro (equivalent to DM3.08). The decline is more gradual than in May, as market interest rate differentials have narrowed over the past three months. If the central projection were based on the assumption that the exchange rate moves fully in line with interest rate differentials, and again adjusting for the assumption of constant UK interest rates, the inflation projection at the two-year horizon would be some 0.1 percentage points higher than in the central case. Alternatively, assuming a constant nominal exchange rate would lower inflation by a similar amount. Some Committee members prefer different benchmarks from that in the central projection when assessing exchange rate prospects. But these differences are currently relatively small, especially in the context of the large uncertainty surrounding the outlook for the exchange rate.

The Committee noted in the *May Report* that there was a risk of a sharp correction in the sterling-euro exchange rate but that it was very difficult to anticipate both the timing and extent of such a correction. This risk was not reflected in the fan charts in the *May Report*. The Committee has reviewed this decision and has agreed that all major risks should in principle be included in the projections (see the box on page 49 for a description of the forecast process). Although the depreciation of sterling since the *May Report* has reduced the risk of a further sharp fall in the exchange rate, the Committee continues to judge that the balance of risks to the exchange rate profile is weighted to the downside. This balance has been reflected in the current projection shown in the fan charts. In the view of some Committee members, such a risk was most likely to materialise in the event of a major correction to global equity prices and might therefore not be associated with higher inflation.

Developments in household wealth have an important influence on the prospects for consumer spending. The central assumption for financial wealth is a little higher than in the May projection, largely reflecting the rise in

The forecast process

Fan charts represent a convenient visual summary of the inflation and GDP projections that are produced for each quarterly *Inflation Report*. This box describes the forecast process and how the fan charts are generated from this process.

The projections are based on a number of uncertain assumptions and relationships. After identifying the main economic developments since the previous *Report*, the Committee reviews the individual assumptions in turn, drawing on information from its suite of models, official data, financial market intelligence, business surveys and Agents' reports, and by applying economic judgment. The central projections are built up, as an iterative process, from the decisions reached on the individual assumptions, with review in the light of the provisional outcomes for output growth and inflation.

On some assumptions members may hold different views. In some cases, these differences are not material in the context of the general uncertainty attached to the projections, which is reflected in the variance of the fan charts. But for other judgments, differences of views may be significant. In such cases, the assumptions incorporated in the central projection represent the best collective judgment—the centre of gravity of opinion on the Committee—and illustrative calibrations of the possible effects of alternative assumptions preferred by some Committee members are shown in Table 6.B of the *Report*.

As well as incorporating judgments on the most likely outcome or modal projection, the fan charts also illustrate the Committee's collective assessment of the degree of uncertainty—the variance of the distribution of likely outcomes—and the balance of risks or skew. Where the balance of risks around the most likely outcome is judged to lie on the upside, a greater probability is given to outcomes above the mode than to those below. The variance is currently estimated on the basis of the past ten years of forecast errors. The Committee could choose to increase or lower its assumed variance but does not often do so. The

forecast round accordingly focuses on establishing a central projection and the skew.⁽¹⁾

There are two broad kinds of event that might be incorporated into the skew. First, there are events that have occurred, or that may be in train, which are judged to affect the balance of risks to prospective inflation or growth. An example is the 1997 windfall payments from building society conversions. The uncertainty related to how much of the windfall would be spent. The MPC incorporated an upside skew to allow for the possibility that spending would be greater than the annuity value of the windfall which was assumed in the modal projection. Second, there are contingencies that have not occurred, and are not incorporated in the central projection, but whose occurrence would shift inflation prospects. Examples include the possibilities of sharp falls in equity prices or the exchange rate.

The latter kind of contingency has sometimes, but not always, been incorporated into the skew shown in *Inflation Report* fan charts. Having discussed the matter, the MPC has decided that such contingencies, where material, should in principle be incorporated in the fan charts.

It is important to note, however, that some contingencies, though reflected in the fan charts, need not affect the appropriate current setting of monetary policy. It may be more appropriate to react to them if and when they occur, for example, where they would not materially affect inflation within the period that it takes for monetary policy to have a countervailing impact.

In short, the fan charts show the best judgment of the Committee as a whole about inflation and growth prospects, conditional on assumed interest rates, but this may not be the best judgment of each individual member of the Committee. While the link between the fan chart and policy is not mechanical, the inflation projection is a key input to policy decisions.

(1) See the box on page 52 of the February 1999 *Inflation Report*.

equity prices in recent months. In the 15 working days to 2 August, the FTSE All-Share index was some 2% higher than the central path assumed three months ago. The Committee has maintained the central case assumption that equity wealth rises from the current level in line with nominal GDP.

There are clear signs of a moderation in the rate of increase of house prices in recent months and correspondingly in gross housing wealth. Indeed, the slowdown in house price inflation appears somewhat sharper than expected three months ago, and the Committee has lowered the projection in the light of this news. The central assumption is that annual house price inflation will fall to about 8% by the end of this year declining further to around 7% by the end of 2001 and then remaining around that level.

The assumptions for public spending and tax receipts in the May projection were based on the fiscal plans accompanying the March Budget statement. The Government recently provided more detail on spending plans in the 2000 Spending Review (SR). The overall envelope for public spending was unchanged from the Budget announcement. Within this envelope, the main changes were a decision to carry forward £1.5 billion of the £2 billion underspend on current spending in fiscal year 1999–2000 relative to Budget expectations, and a reallocation within total public spending from debt interest and benefit payments to expenditure by government departments. No changes were made to revenue projections at the time of the SR.

The Committee has incorporated the information from the SR in the current projection. The impact of the changes relative to the Budget are small. On balance, domestic demand growth over the next two years will be boosted a little following the decision to carry over a proportion of last year's shortfall. The effects of this carry-over have been built into the forecast.

Other possible effects are highly uncertain and point in opposite directions. It is possible that a change in the composition of public spending from debt interest to departmental spending could have a small positive effect on aggregate demand. But it is also possible that there could be further shortfalls in spending over the next two years, given the rapid increase in planned investment in particular and the likelihood of delays in finalising projects and disbursing funds. Moreover, it is possible that government revenues could be stronger than previously projected. The Committee judged that the

balance of these factors is highly uncertain. The Committee has not altered the central projection in respect of these factors, but will continue to monitor developments in public spending carefully. Some Committee members, however, considered that the net impact of these factors could counteract the small stimulus from the carry-over of last year's spending shortfall.

6.2 The output and inflation projections

Recent trends in activity are hard to assess, but are consistent with some slowing in underlying GDP growth in the first half of 2000. GDP growth rose by an average of 0.7% per quarter in the first half of 2000, down from an average increase nearer to 0.9% per quarter in the second half of last year. RPIX inflation has edged up to 2.2% in June. Recent outturns have been above expectations in the previous *Report*, principally reflecting the unanticipated resilience of world oil prices. The Committee reviewed the prospects for output and inflation against this background.

There have been extensive revisions to National Accounts data since the previous *Report*. The level of real GDP in the first quarter of 2000 has been revised up by 0.7%, largely reflecting new information on the level and composition of consumer spending in 1998 and 1999. The Committee reviewed the possible implications of higher past GDP growth for inflation prospects. One possible interpretation was that a higher level of output implied that there were additional pressures on supply capacity which could lead to higher future inflation. But it was highly unlikely that the effects of stronger activity two years ago would have such a delayed impact. An alternative explanation, favoured by the Committee and incorporated in the projections, was that the combination of stronger past activity with unchanged inflation may signal that a corresponding rise in the level of supply capacity has occurred. Adopting this view, there was no implication of the higher level of GDP for future inflation. A third possibility, noted by some Committee members, was that the revisions to past output and productivity growth could be an indication of a rise in the sustainable long-term growth rate of the economy, which could lead to somewhat lower inflation prospects than in the central projection.

The National Accounts release confirmed that GDP growth in the first quarter was 0.5%, slightly above the preliminary estimate available at the time of the May

Report. The composition of demand was rather different from expectations three months ago. In particular, final domestic demand was little changed on the fourth quarter level, and output growth was supported by a positive contribution from net trade and an unexpected increase in inventory levels. Consumer spending growth was a touch weaker than expected in May, while fixed investment volumes and government consumption both declined on the quarter against earlier expectations of an increase. The latter two components are quite erratic from quarter to quarter, and the positive quarterly contribution from net trade was at odds with the broad trend towards a weakening trade position.

According to the preliminary estimate, GDP rose by 0.9% in the second quarter—rather stronger than projected three months ago, and also rather higher than suggested by recent survey data. The rebound from weaker-than-expected growth in the first quarter in part reflects a bounce-back in energy consumption from weather-related low levels. Furthermore, the recent quarterly pattern of growth may also have been affected by unusual changes in spending and production patterns around the millennium.

The ONS reported an increase in service sector output of 1.0% in the second quarter, a similar pace to the growth recorded in the second half of last year. Manufacturing output was reported to have risen after falling in the first quarter, in contrast to survey information and reports from the Bank's regional Agents suggesting weakening manufacturing activity. Recent surveys suggest a widening divergence between the performance of companies selling predominately into domestic markets and facing relatively limited international competition—typically in the service or construction sectors—and companies that depend heavily on export markets—typically in manufacturing or agriculture. In terms of demand components, recent monthly trade data are consistent with a negative contribution to aggregate demand growth in the second quarter, so it seems likely that there was a rebound in final domestic demand after the unusual weakness in the first quarter.

The trend in household consumption is hard to gauge, given the distortions in spending patterns around the millennium. Interpretation of consumption patterns has been further complicated by the substantial upward revision to the level of consumer spending in recent years in the June National Accounts release—by 2000 Q1 the level of household spending was some

1.8% above the previous estimate. There was an associated downward revision to the saving ratio, which fell to 3.8% in the first quarter, the lowest level since 1988. Strong growth in consumer spending in recent years has been supported by rapid increases in wealth and by gains in employment and real wages, but following the data revisions there are signs that the strength over the past two years has been exceptional in relation to the typical determinants of consumption.

Will this strength of consumption persist? Or will consumers gradually rebuild their balance sheets? The Committee concluded that some of the unusual strength of consumption was likely to unwind over the forecast horizon, as savings rise towards a more normal level in relation to income and wealth. The rise in the saving ratio will tend to moderate prospective consumer spending growth.

Recent indicators are consistent with a slowdown in consumer spending growth from the exceptional pace at the end of last year. In particular, retail sales growth has slowed, consumer confidence has weakened somewhat, house price inflation has moderated, and the growth in households' money holdings has eased. Equity prices have been broadly flat over the past six months and real earnings growth has fallen back as millennium payments have ended. The most likely prospect is that the growth in consumers' expenditure moderates further in the coming quarters and then stabilises at a little below its long-run average rate.

Whole-economy fixed investment fell in the first quarter of the year—the first quarterly decline since 1995. There were reductions in each of the main sectors: business, residential and government. Although business investment growth—some three-quarters of the total—has slowed over the past two years from high rates, the fall in the first quarter was surprising. The decline may in part reflect temporarily weak IT investment after the millennium. The ONS reported a return to relatively strong growth in business services and computing output in the second quarter, which may herald a recovery in investment. Corporate borrowing growth has also remained strong in recent months, particularly in the service sector. Profit expectations in the service sector remain at high levels, suggesting that the increase in borrowing may reflect higher investment. The central expectation is that there will be some pick-up in business investment in the second quarter and that business

investment will then rise at a moderate pace, broadly in line with the projection in the *May Report*.

The rise in inventory investment in the first quarter was not expected at the time of the *May Report*, when some rundown in precautionary stocks built up in advance of the millennium was thought likely. A number of unusual factors account for some of the rise in inventories, but the recent trend remains quite hard to assess. Looking forward, no change has been made to the central assumption that firms are likely to economise further on inventories in the medium term, assisted by continued improvements in production processes and stock management techniques.

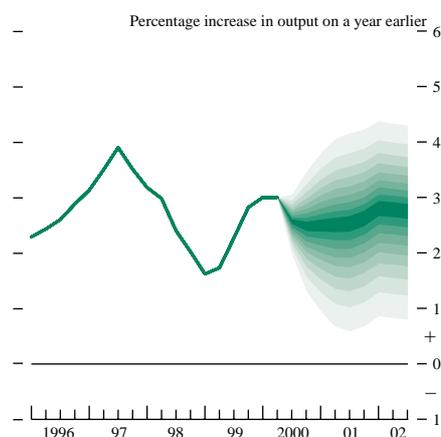
Export volumes have risen more quickly in recent months than projected in May. Indeed, goods and services exports rose some 2½% in 2000 Q1 and were almost 10% higher than in the same quarter a year earlier. The strong rise has been facilitated by rapid growth in overseas demand. Over the past twelve months the growth in UK exports has been almost as strong as the increase in world trade, following several years of falling market share. It is too soon to conclude that the loss of market share has ended: firms have limited the impact of the strength of sterling on sales volumes by cutting prices and by squeezing profits. But as the high level of sterling has persisted, some companies have withdrawn from the market or have switched production overseas. The further appreciation of sterling in the spring was associated with a weakening in surveys of export sales and orders. Although sterling has subsequently fallen back, there are as yet only tentative signs of an improvement in export prospects. It seems likely that UK firms will lose further market share in the near term, although export growth over the next two years is expected to be a little stronger than the *May* projection, reflecting the lower exchange rate profile and a more buoyant outlook for world trade.

Although import growth slowed a little in the first quarter, as domestic demand growth moderated, imports have risen more rapidly in recent months and the underlying trend remains firmly upward. Bank Agents' contacts continue to report intense competition from imports across a wide range of goods and services. The depreciation of sterling since the *May Report* is likely to ease the pressure on UK producers somewhat. But, as noted earlier, the Committee expects that foreign suppliers may partly compensate by cutting the relatively high margin on UK sales more quickly.

Nevertheless, import penetration may rise less rapidly in the near term than projected three months ago.

The overall outlook for net trade is a little stronger than in the *May Report* because world trade is projected to be somewhat stronger and the exchange rate path is lower. Nevertheless, further weakening in the net trade position is likely in the near term as the past appreciation of sterling has continuing effects.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 6%



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.

The outlook for GDP growth over the next two years is shown in Chart 6.1.⁽¹⁾ The projection is conditioned on the assumption of unchanged UK interest rates.⁽²⁾ Four-quarter GDP growth has remained around 3% in the first half of this year, a little stronger than expected in May. But there are signs of a slowdown, comparing growth in the first half of the year to the second half of 1999, and output growth may slow further in the second half of the year as consumer spending softens and as the net trade position weakens. Public spending will support overall activity over the forecast horizon, and GDP growth may edge up a little in the second year of the projection as the impact of the rise in interest rates in late 1999 and early 2000 gradually wears off. In the central projection, the annual growth rate slows to about 2½% around the turn of the year before rising slightly in the second half of the projection. The broad picture is little changed from May.

There is no simple mapping between the near-term prospects for output growth and the outlook for inflation. Indeed, in the long run, output growth is determined by the growth in supply capacity—by the rise in the labour force and improvements in productivity—while the rate of inflation is determined by the stance of monetary policy. In the short-to-medium term, inflation prospects will be affected by the level of nominal demand in relation to supply capacity.

Nominal GDP at market prices rose by 5.8% in the year to 2000 Q1. Monetary indicators provide additional information on the trends in nominal demand. Broad money growth has recovered from low levels around the turn of the year, although movements in the aggregate have been dominated in recent years by swings in deposits held by non-bank financial corporations, which may have less direct implications for economic activity than holdings by households and firms. Excluding this

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

(2) An alternative projection assuming that the UK interest rates follow market interest rate expectations is shown in Chart 6.7 below.

component, broad money growth edged up to just over 6% in the year to 2000 Q2 as deposits of non-financial companies have risen sharply. Aggregate sterling lending growth has risen further. Corporate borrowing has increased rapidly in recent months and lending to households has so far remained robust. But the balance of evidence from monetary indicators is consistent with some easing in nominal demand growth. Narrow money growth has slowed in recent months, which together with slower growth in household deposits and in the Divisia measure of households' money signals a weaker outlook for nominal consumer spending. Moreover, although the rise in corporate borrowing may reflect higher investment, future investment growth may be reined back if profit expectations deteriorate or companies become concerned about the build-up in debt.

Pay trends are particularly hard to assess at present, given the marked volatility in the measured growth rate of nominal earnings. Headline annual earnings growth rose from just below 5% in the autumn of last year to a peak of 6% in February, but has subsequently fallen sharply to 4.6% in May. As noted in the *May Report*, earnings around the turn of the year were boosted by one-off payments for millennium working and by high bonus payments in some sectors. Although these payments represent costs for firms and income for employees, the concentration of special payments into a few months distorted estimates of the underlying trend in nominal earnings growth. It is not easy to make an accurate correction for the effects of these payments. But a reasonable estimate is that underlying earnings growth may have slowed a little since the autumn, from just under 5% to just over 4½%. As inflation expectations appear to have changed little over this period—and if anything have edged up rather than down—this easing represents a reduction in real as well as nominal pay growth.

A fall in measured earnings growth was projected in the *May Report*, as millennium-related distortions unwound, but the decline has been more pronounced than expected three months ago. Furthermore, the apparent deceleration in underlying earnings growth over the past six to nine months has occurred against the background of a tight labour market. Employment has risen by 0.7% over the past six months according to the Labour Force Survey. Moreover, forward-looking surveys suggest continued employment growth in the coming months. Unemployment has fallen to 5.6% on the LFS measure and to 3.8% on the claimant count measure—the lowest

level for nearly 25 years. Skill shortages are at high levels. And while pay settlements have on average remained in the region of 3%, there have been more reports that settlements may be beginning to edge up.

The recent indications of rather weaker-than-expected earnings growth combined with falling unemployment provide some evidence that underlying labour market performance is better than previously judged. Although pressures on real pay growth in recent years have been eased by gains in the terms of trade, recent data may indicate a lower estimate of the level of unemployment that is consistent with stable inflation. While considerable uncertainty remains, and there are risks in both directions, the Committee judges that pressures on real earnings growth over the next two years could be somewhat weaker than estimated in the *May Report*.

Labour cost pressures on prices depend on productivity growth as well as the growth in earnings. Measures of whole-economy productivity growth have risen over the past year, and the upward revision to output growth over the past two years has been associated with a corresponding increase in estimates of productivity growth. Even so, productivity growth has only recently edged above its average over the past 40 years of around 2% per annum: indeed, productivity growth was below this long-term average throughout the 1995–99 period. The Committee has maintained the assumption in the central projection that the long-term trend growth in labour productivity will remain around 2% per annum and that actual productivity growth will remain close to this rate over the next two years. Noting the improvement in productivity growth in the United States over the past five years, some Committee members prefer to base the projection on an assumption that the rate of technical progress will rise gradually towards recent US rates, as technological gains are emulated by companies in the United Kingdom.

Reports from the regional Agents' contacts and surveys of pricing trends are consistent with the view that many companies are facing unusual constraints in passing on cost increases in the form of higher prices.

Technological advances may be facilitating greater price transparency and an intensification of competition both domestically and internationally. The Committee has maintained the assumption from previous *Reports* that an increase in competitive pressures will lead to a fall in prices relative to costs. Such a reduction in profit margins will have a temporary effect on inflation as the

adjustment occurs. On account of this margin squeeze over the forecast horizon, the central assumption, unchanged from May, is that RPIX inflation will be reduced by around 0.25 percentage points in the first year, and by some 0.3 percentage points in the second year of the projection. Utility prices fell sharply in April 2000, in line with the cuts stipulated by regulators and incorporated in previous projections. The temporary effect on inflation of these lower prices, which will end in Spring 2001, is factored into the projection.

There is considerable uncertainty surrounding the possible magnitude of changes in price-cost margins and of the impact of supply-side developments more generally on inflation prospects. As in the previous *Report*, some Committee members consider that changes in price-cost margins will have a smaller and more temporary effect on inflation than under the central assumption. Other members maintain the judgment that supply-side improvements, facilitating additional gains in productivity and stronger competitive pressures on prices, could lead to stronger downward pressures on inflation than reflected in the fan chart projection.

The Committee forms an overall judgment on the outlook for inflation and output growth, and the risks to that outlook (see the [box above on page 49](#) for a description of the forecast process and the annex box on [pages 63–65](#) for an assessment of the recent forecasting record). Taking account of all the factors discussed above, 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 6%—is shown in Chart 6.2.⁽¹⁾ It is shown alongside the projection from the May *Report*, which was also based on the assumption of constant interest rates at 6% (see Chart 6.3).

As in May, the broad picture is of a gradual increase in inflation over the next two years. The most likely outcome is for inflation to rise, from just below the target at present, to just above the target at the end of the forecast. Inflation edges up as pressures on domestic supply capacity build gradually over the projection period. In the first year of the projection these pressures are offset by the assumed intensification of competition and associated cuts in price-cost margins, by the fall in utility prices, and by the steady unwinding of the

(1) Also shown as Chart 2 in the Overview. An alternative projection based on the assumption that official rates follow market interest rate expectations is shown in Chart 6.6.

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 6%

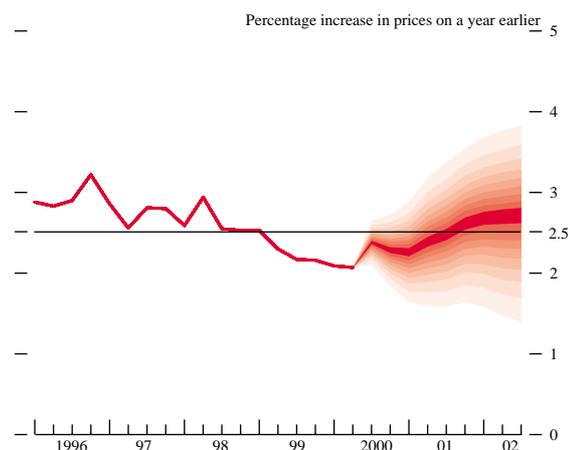
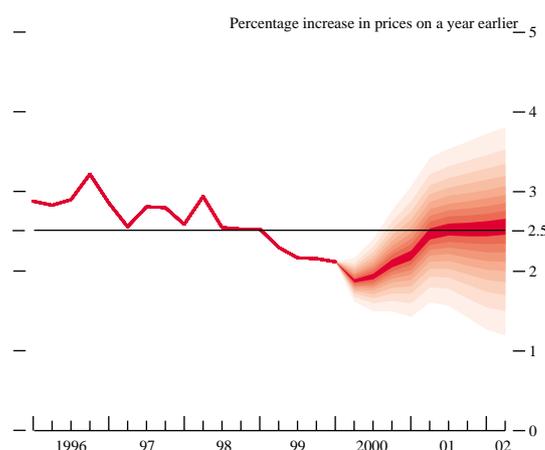


Chart 6.3
RPIX inflation projection in May based on constant nominal interest rates at 6%



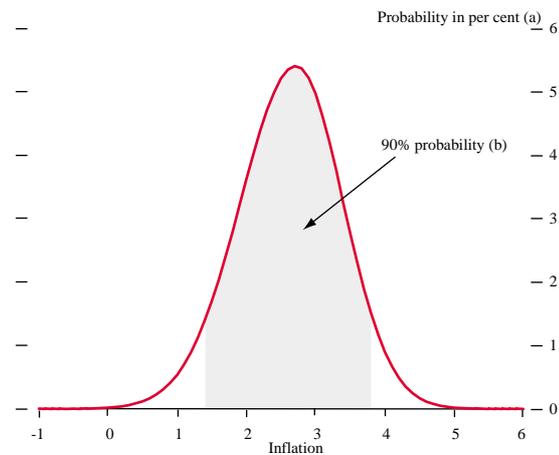
The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. The darkest band includes the central (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*.

inflationary impulse from higher oil prices which has led to higher-than-expected outturns for RPIX inflation in recent months. Compared with the May projection, the changes in the influences on the outlook for inflation at a two-year horizon are largely offsetting. The main upside influences on inflation prospects are the lower profile for the sterling exchange rate and a stronger impact from global activity and inflationary pressures. These factors are counterbalanced by the downside influences of a faster compression of margins on foreign suppliers' sales to the United Kingdom, a weaker outlook for consumer spending growth, and lower pressures on earnings following the assumption of an improvement in the structural performance of the labour market.

Risks around the central projection for output growth are broadly balanced. The principal downside risk is of a sharper fall in world growth, most likely to be associated with a marked correction in US equity prices. Such a correction could also spillover to asset prices in other countries, including the United Kingdom. There are upside risks from the possibility that sterling could depreciate more rapidly than in the central case and from developments in demand and the labour market.

Inflation risks are also broadly balanced. Charts 6.4 and 6.5 show the overall balance of risks to inflation at the two-year horizon. Table 6.A provides the Committee's

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2002 Q3



Source: Bank of England.

- (a) Probability of inflation being within ± 0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (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 *Inflation Report*.

Chart 6.5
May projection for the percentage increase in RPIX in the year to 2002 Q2

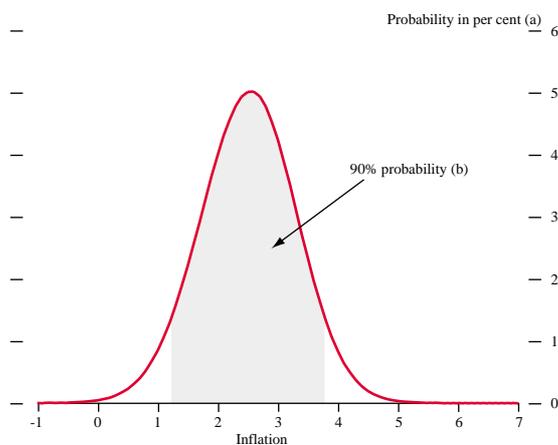


Table 6.A
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates^(a)

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%
2000 Q4	<1	15	64	21	<1	<1
2001 Q4	3	12	28	33	19	6
2002 Q3	7	13	22	26	20	11

GDP growth

Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
2000 Q4	<1	2	25	56	17	<1
2001 Q4	1	8	23	36	25	7
2002 Q3	1	7	22	36	27	8

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

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

Difference from the central projection, percentage points

RPIX inflation

	Improvement in UK supply-side performance	Weaker downward pressure on margins
2001 Q3	-0.1	0.1
2002 Q3	-0.4	0.2

GDP growth

	Improvement in UK supply-side performance	Weaker downward pressure on margins
2001 Q3	0.0	0.0
2002 Q3	0.1	-0.1

best collective judgment of the probabilities of various outcomes for inflation and GDP growth.

As noted above, there remain a number of major uncertainties in the outlook. The probability distributions for prospective output growth and inflation, shown in the fan charts, illustrate the general uncertainty around the central projections. For a few key judgments, certain Committee members prefer to make different assumptions from those incorporated in the central case. These assumptions, on price-cost margins and supply-side performance, are shown in Table 6.B, which provides illustrative calibrations of the possible effects of the alternative assumptions. Based on the alternative assumptions calibrated in the table, the profile for inflation at the two-year horizon could be some 0.2% higher or around 0.4% lower than in the central projection pictured in Chart 6.2.

Market rates suggest that investors expect official interest rates to rise over the next year. But an accurate quantification of these expectations is not easy to obtain. Since the November 1999 *Report*, market expectations have been derived from interest rates on gilt-edged securities used as collateral in short-term sale and repurchase agreements and from the gilt-edged yield curve. These rates provide a more direct guide to market expectations of the future path of official interest rates

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

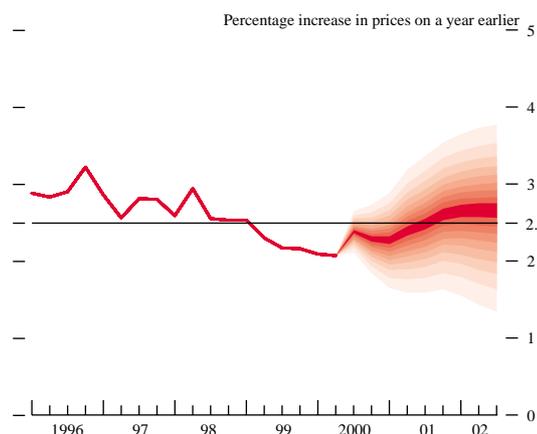


Chart 6.7
Current GDP projection based on market interest rate expectations

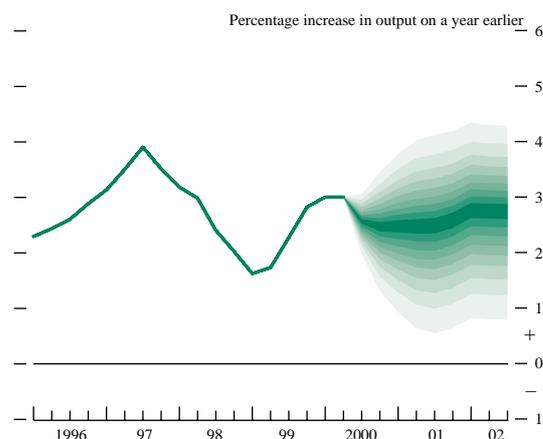


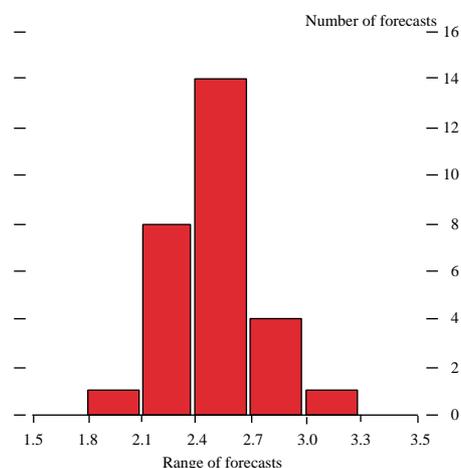
Table 6.C
Market expectations of the Bank's official interest rate^(a)

Per cent

2000		2001				2002		
Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
6.0	6.1	6.2	6.2	6.2	6.1	6.1	6.0	5.9

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repo contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 2 August.

Chart 6.8
Distribution of RPIX inflation forecasts for 2002 Q3



Source: Survey of 28 outside forecasters as of 21 July 2000.

than short sterling futures rates, which had been used previously (see November 1999 *Inflation Report* for more details).

The latest evidence from the gilt-repo curve implies that the market expects official rates to rise only slightly over the next year, peaking at around 6.25% in spring 2001 (see Table 6.C). As a result, the MPC's projections under the assumption that official rates move in line with market expectations are close to those conditioned on the assumption of constant interest rates (see Charts 6.6 and 6.7). It should be noted that if short sterling futures rates were instead used to gauge market expectations, they would imply a slightly higher profile for the path of official rates over the next year or so.

6.3

Other forecasts

In late July, the Bank asked a sample of external forecasters for their latest projections of inflation and output. Based on this survey, the mean forecast for the twelve-month rate of RPIX inflation in 2000 Q4 was 2.1% (with a range of 1.5% to 2.7%), rising to 2.5% in 2002 Q3 (with a range of 1.9% to 3.0%). The distribution of central projections in 2002 Q3 is shown in Chart 6.8. Compared to the survey results in the May *Report*, the mean forecast for inflation two years ahead is slightly higher, and forecasts have become a little more dispersed around the average. On average, external forecasters see a 46% probability of inflation being

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

RPIX inflation

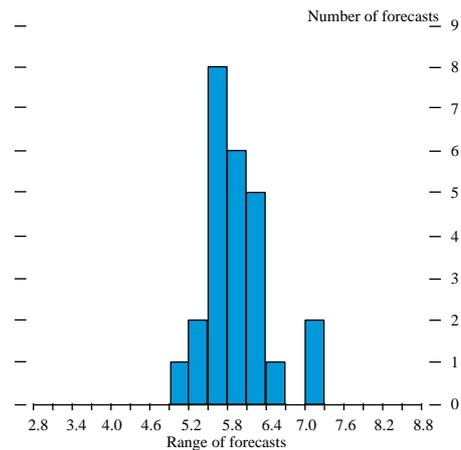
Probability, per cent	Range:					
	less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
2000 Q4	12	23	40	18	6	2
2001 Q4	8	16	34	27	11	5
2002 Q3 (b)	8	14	32	28	12	6

GDP growth

Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
2000 Q4	1	3	14	45	33	4
2001 Q4	3	9	27	40	16	5
2002 Q3 (c)	5	11	27	39	15	4

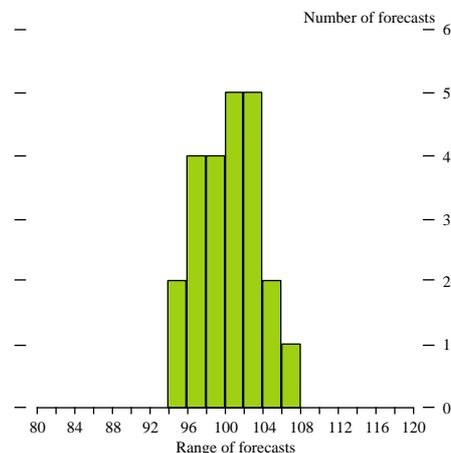
(a) 29 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table shows the means of the responses for each range. For example, on average, forecasters assign a probability of 8% to inflation turning out to be less than 1.5% in 2002 Q3.
 (b) 28 forecasters.
 (c) 25 forecasters.

Chart 6.9
Distribution of repo rate forecasts for 2002 Q3



Source: Survey of 25 outside forecasters as of 21 July 2000.

Chart 6.10
Distribution of sterling ERI forecasts for 2002 Q3



Source: Survey of 23 outside forecasters as of 21 July 2000.

above 2.5% in 2002 Q3, and a 54% probability of it being below (see Table 6.D).

The forecasters' average projection for four-quarter GDP growth in 2000 Q4 was 2³/₄% (with a range of 2% to 3¹/₂%) down from the 3% average forecast reported in May. Growth is expected to slow to 2¹/₄% (with a range of 1¹/₂% to 3%) by 2002 Q3.

The mean forecast for the official interest rate in 2000 Q4 was 6¹/₄% (with a range of 5³/₄% to 6³/₄%), falling to 6% by 2002 Q3 (with a range of 5% to 7%) (see Chart 6.9). This is slightly lower than the survey results reported in May. On average, forecasters assume that the sterling ERI will be 104 in 2000 Q4 (with a range of 101 to 110) and then fall to 100 (with a range of 94 to 108) by 2002 Q3 (see Chart 6.10).

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 forecasting record

Forecasts are central to the conduct of monetary policy given that it takes time for interest rates to affect inflation. This box compares the MPC's past projections with outturns for RPIX inflation and GDP growth, and considers which risks highlighted in past *Inflation Report* forecasts have materialised. The Committee's projections are conditioned on assumptions about economic variables, such as the exchange rate and the world economic outlook, and about structural economic relationships. If these assumptions prove to be accurate then ideally the projections themselves should be relatively close to outturns. However, should circumstances or structural relationships change unexpectedly then it is likely that the eventual outcomes will differ from the projections.

The Committee's projections are presented as fan charts, rather than point forecasts, because the outlook is highly uncertain. The fan charts represent the probability distributions of likely outcomes for inflation and GDP which reflect this uncertainty. The central projection (the modal or most likely path) always lies in the darkest band of the fan chart. If the balance of risks around the modal forecast is judged to be on the upside, the mean projection (ie average expected outcome) will lie above the mode, and if the risks are weighted to the downside, the mean will lie below the mode.

In the eight fan charts published between August 1997 and May 1999, three quarters of the time the inflation outturn has been within the five central bands which cover 50% of the probability distribution around the modal projections. Half of the time the outturn has been within the three central bands covering 30% of the distribution. The fan chart variances are based on forecast errors made over the previous ten years. Because outturns have tended to lie close to the centre of the fan charts, this suggests that forecast errors since August 1997 have been smaller than in the past.

Over that period inflation has been unusually stable.

In the August 1999 *Inflation Report*, an assessment was made of the MPC's first four projections (from the *Inflation Reports* published between August 1997 and May 1998). The assessment found that inflation outturns four quarters ahead had been broadly in line with the MPC's mean projections, but 0.2% higher than the projected modes. This was consistent with the Committee's belief that the risks, relative to their central (modal) projection, were on the upside. There were offsetting influences over that period in terms of the main assumptions. The effective exchange rate had been consistently above the MPC's expectations (putting downwards pressure on price inflation), while growth in earnings had tended to be stronger than forecast (putting upwards pressure on inflation). There were no systematic errors in the MPC's one-year-ahead GDP mean (and mode) projections. But domestic demand had been stronger than expected, offset by weaker-than-expected net trade.

Updating this analysis for the eight projections made between August 1997 and May 1999, on average the inflation outturn was 0.3% below the one-year-ahead mean projections (eg the August 1997 *Inflation Report* forecast of inflation in 1998 Q3), and 0.1% below the mode projections. (See Charts A and B for mean projections compared with outturns.) We can only compare the two-year-ahead forecasts with outturns for four forecasts (August 1997 to May 1998). For this small sample of forecasts, actual inflation was 0.7% below the two-year-ahead mean projection and 0.4% below the mode.

In general, the modal inflation forecast has been closer to actual outturns than the mean projection. This is because the MPC judged the risks to the central projection to be on the upside, largely because of the risk that the

Chart A
August 1997–May 1998 Inflation Report mean RPIX inflation projections and outturns

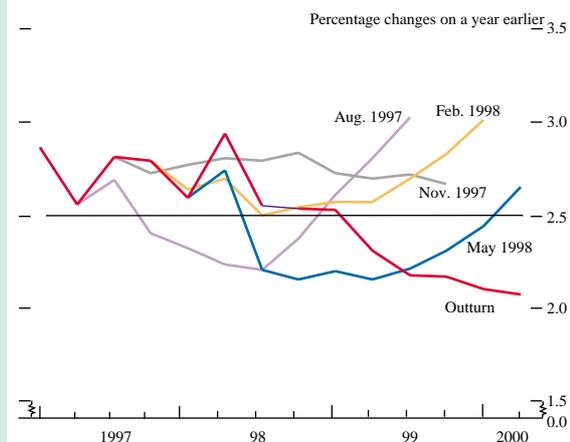


Chart C
August 1997–May 1998 Inflation Report mean GDP projections and outturns

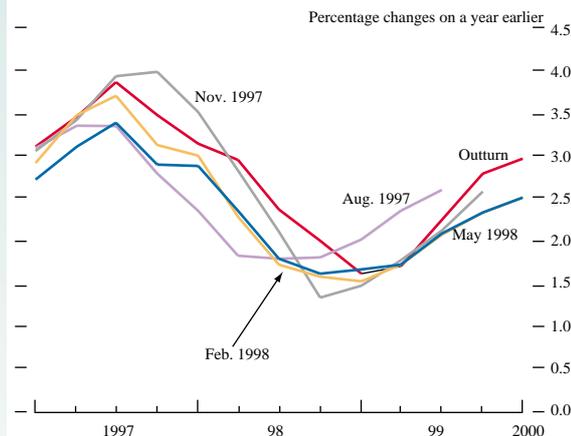


Chart B
August 1998–May 1999 Inflation Report mean RPIX inflation projections and outturns

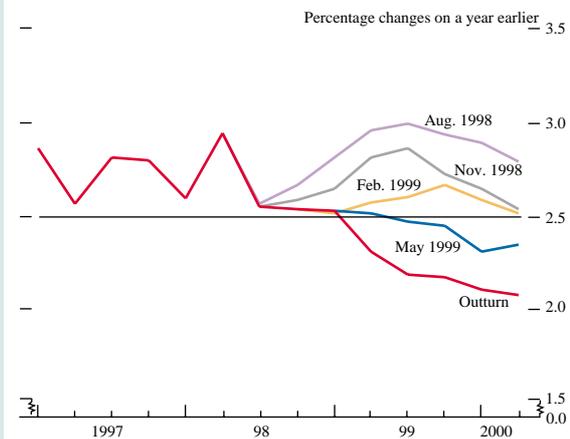
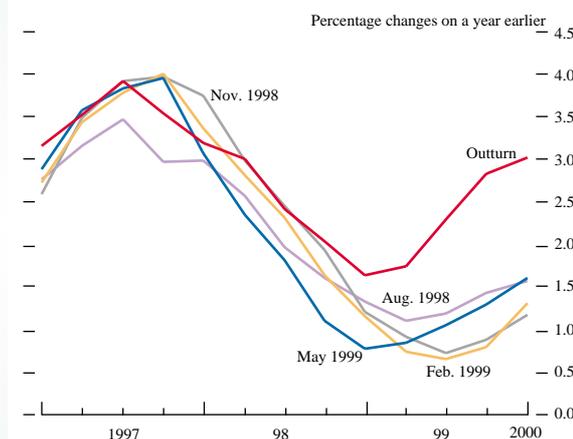


Chart D
August 1998–May 1999 Inflation Report mean GDP projections and outturns



sterling exchange rate might depreciate sharply. Up to 2000 Q2 this did not occur; indeed, the exchange rate tended to be higher than the central assumption.

Charts C and D compare mean projections for annual GDP growth with outturns. Modal projections were close to mean projections, as risks to growth were generally fairly evenly balanced. Chart C shows that projections made between August 1997 and May 1998 gave a good indication of future GDP growth, although growth was stronger than expected towards the end of 1999. However, Chart D shows that projections made between August 1998 and May 1999 under-forecast GDP growth during 1999. Revisions to data account for a proportion of the apparent error.

In terms of demand components, the stronger-than-expected GDP growth was due to the unexpected strength of consumption and to a lesser extent private investment. In contrast, net trade was weaker than had been projected.

What were the main determinants of these errors? Can they largely be accounted for by unpredictable shocks to the conditioning assumptions? Or do they indicate that the relationship between the conditioning assumptions and inflation and output has changed? These questions are hard to answer definitively; they matter because it is important to learn from past forecasting experience in order to improve future forecast performance.

Some forecasting errors are easier to identify than others. The forecasts considered in this box were based on the assumption that the future path for the sterling exchange rate moves in line with interest rate differentials.⁽¹⁾ The effective exchange rate (ERI) index has generally been stronger than under this assumption, with a mean error across all forecasts and forecast horizons of 4%. The unexpected strength of the sterling ERI reflected strength against the euro, while the exchange rate against the dollar was broadly in line with the Committee's assumption. Sterling's unexpected strength partly explains why net trade has contributed more negatively to GDP growth than had been forecast by the MPC. But the unexpected strength in domestic demand, which boosted import growth, was also a factor.

UK retail price inflation reflects domestic and international inflationary pressures. One measure of domestic inflationary pressure is the growth in unit labour costs, which is measured by earnings inflation less productivity growth. Earnings growth in early 1999 was weaker than assumed in most of the projections. But unit labour costs have been broadly in line with the projections over the past two years. However, UK import prices were considerably weaker than projected. This reflected the unexpected strength of sterling and, despite the recent doubling of oil prices, generally weaker-than-expected world commodity and manufactured goods prices.

The MPC base the projections on a conditioning assumption of constant official interest rates (projections based on market interest rates are also shown). But as different shocks hit the economy, the Committee may change interest rates. For the forecasts considered here, actual official interest rates were generally lower than was assumed in the projections. This was because the MPC responded to the substantial deterioration in prospects for world growth and the related weakening in external pressures on inflation by reducing interest rates in late 1998 and early 1999 by 2½%. This can help explain why consumption growth in 1999 was stronger than had been projected on the basis of unchanged nominal interest rates. A further reason for the strength in consumption was the stronger-than-expected growth in equity and house prices over this period.

It is too early to draw strong conclusions about the Committee's forecasting record. It is clear that output was stronger and inflation was weaker than expected in 1999, and at the start of 2000, with weaker-than-anticipated imported inflation a major, though not the only, factor. The Committee will continue to monitor forecast performance carefully to learn from past errors. However, to date, average errors have been small relative to past experience, and outturns have generally been well within the range of uncertainty suggested by the Committee's fan charts.

(1) Since November 1999, the Committee has assumed that the future path of the effective exchange rate will be an average of a constant nominal rate and a path related to the pattern of market interest rate differentials.

BANK OF ENGLAND

AGENTS' SUMMARY OF BUSINESS CONDITIONS

AUGUST 2000

This publication is a summary of monthly reports compiled by the Bank of England's Agents,⁽¹⁾ following discussions with around 1,700 businesses in the period between mid-April and mid-July. It provides information on the state of business conditions, from firms across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular firm or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions.

- Manufacturing output growth slowed further during the period in most regions—partly reflecting an easing in demand from domestic firms. Within manufacturing, the divergence between the performance of high-tech and traditional firms widened further.
- Overall, construction growth eased slightly—reflecting a slowdown in residential construction activity, particularly in the southern regions of the United Kingdom. Growth in commercial construction was said to have been maintained.
- Service sector growth remained strong, but eased slightly compared with the previous period. Most areas of business services continued to record strong growth, but there appeared to be a slowdown in consumer services—particularly for UK tourism.
- Annual growth in retail sales values was reported to have moderated slightly in most regions during the period. Sales of used cars remained depressed, although significant discounting appeared to improve new car sales volumes slightly. Most other areas of consumer spending remained robust.
- Compared with the previous *Agents' Summary*, export volume growth weakened in most regions. The Agents suggested that import growth remained stronger than reported in official data.
- Investment intentions in the manufacturing sector deteriorated further in most regions—largely reflecting lower profitability. By contrast, service sector investment remained strong. Significant IT investment was reported in both sectors.
- Input price inflation strengthened compared with the previous period, as earlier rises in the oil price fed through to related products. Although competitive pressures remained, there were increased reports of input price increases being passed up the supply chain. There continued to be little change in existing retail prices trends. But it was suggested that discounting during the summer 'sales' was heavier than last year. House price inflation slowed markedly, particularly in the southern regions of the United Kingdom.
- Recent pay settlements were similar to levels three months ago, although there were reports of negotiations becoming more difficult. But pressures on the total pay bill varied considerably by sector—increasing in services and construction and slowing in manufacturing. Labour market conditions remained tight, but skill shortages were no worse than in the previous period. Earlier trends of declining manufacturing employment, alongside growth in construction and service sector employment, continued.

(1) The Bank of England has Agencies for Central Southern England, the East Midlands, Greater London, the North East & Cumbria, the North West, Northern Ireland, Scotland, the South East & East Anglia, the South West, Wales, the West Midlands, and Yorkshire & the Humber.

OUTPUT

Primary production

Agricultural sector output was reported to have broadly stabilised during the period. But farm incomes remained depressed. Dairy farming continued to be cited by many Agencies as one of the weakest sectors, reflecting considerable import penetration from continental Europe. Reports of farm consolidation (to achieve economies of scale) and business failures increased during the period. In addition, reports of agricultural weakness flowing through to ancillary firms persisted. However, there were indications from some contacts that confidence in the sector had improved following the recent sterling depreciation.

Utilities output was reported to have increased during the period, mostly reflecting the cool and wet weather. The level of mining production was said to have been little changed from a year earlier.

Manufacturing

Reports suggested that manufacturing output growth continued to slow during the period in most regions. In particular, the recent slowdown was said to have largely reflected an easing in demand from domestic firms—exacerbated by the increasing trend of customers obtaining inputs from overseas firms. By contrast, export performance appeared to strengthen slightly in some regions recently, reflecting buoyant international demand. The recent depreciation in sterling was reported to have had little impact on orders or volumes so far, reflecting the forward nature of most contracts (see Exports and imports).

Agencies continued to stress the diverse nature of manufacturing performance and, if anything, the divergence increased during the period. While most high value-added sectors, such as chemicals and telecommunications, continued to record strong growth, output weakened further in traditional manufacturing (for example textiles and parts of heavy engineering). The decline in production in these sectors highlights the increasing trend for standard production processes to be relocated to regions with lower costs (notably for labour) such as Eastern Europe and Asia.

Construction and housing

Overall, construction growth was reported to have eased during the period in most regions—reflecting a slowdown in residential construction activity. This was

particularly noticeable in the southern regions of the United Kingdom. As well as reported supply-side constraints (for example land availability, planning delays and skill shortages), caution regarding the high level of house prices resulted in an easing in demand. Some contacts reported fewer site visits and increased cancellations of reservations.

By contrast, growth in commercial construction was said to have been maintained, with greater strength in some regions. Commercial construction activity remained strongest in the retail and leisure sectors—although capacity constraints (for example office space) in professional services also boosted demand. Public construction activity appeared to have remained strong in most regions. But a further slowing in construction of industrial buildings was noted.

Services

Although service sector growth was reported to have remained strong in almost all regions, an easing was noted towards the end of the period—particularly in consumer services. Most areas of business services continued to record robust growth—particularly professional services. IT activity, which had slowed following the build-up to Y2K, appeared to pick up again recently. In addition, the increased use of temporary and contract labour boosted demand for employment agency services. It was noted that growth in some areas of business services was the result of many manufacturing firms trying to reduce overheads by outsourcing. But Agencies suggested that a downturn had occurred in transport services (notably road haulage), as a result of strong price competition from continental Europe. And capacity constraints in many professional services firms (notably from skill shortages—see Employment) resulted in some easing in output growth.

The slowing in consumer services during the period was relatively more marked. One area of clear slowing was domestic tourism. Lower turnover was reported by many UK tourist attractions and other related services (for example hotels). But the pace of activity in most other areas of leisure services remained strong.

DEMAND

Consumption

On balance, the Agents suggested that annual retail sales value growth eased slightly over the period. Growth remained strongest for household goods (particularly electronics and telecommunications). But

although value growth eased only slightly, it appeared that volume growth picked up recently as a result of earlier-than-usual summer 'sales'. Many retailers reported that the discounts were necessary to move higher-than-normal stocks (particularly for clothing), which had built up due to the poor weather.

Other areas of consumer spending remained strong during the period. For example, growth in leisure spending appeared to be maintained. In addition, many Agencies noted a pick-up in spending on foreign holidays. However, this had been offset somewhat by lower spending on UK holidays—said to be the combined result of the high level of sterling and poor weather. Many Agencies (particularly those reporting a significant slowing in manufacturing) reported a deterioration in overall consumer confidence recently—as consumers expect to spend more on petrol and mortgage repayments.

New car sales to individuals remained depressed during the period, although there was some evidence of a pick-up in volumes during a period of stock clearance by dealers. But many contacts believe that significant pent-up demand exists, which may result in a rebound in future sales. There had been little evidence of any improvement in used car sales.

Exports and imports

Compared with the previous *Agents' Summary*, export volume growth weakened in most regions. However, an improvement in export demand was reported in recent weeks in some regions. The recent improvement was said to be the result of strengthening external demand, rather than a product of the recent depreciation. To date, the depreciation was said to have had little impact on orders (given contacts' views that the exchange rate will only affect volumes in the medium to longer term). Due to the fixed nature of many export contracts, any impact was seen in higher margins. But generally the level of sterling was still a concern for most manufacturing firms.

Export volumes to the European Union are reported to have improved recently in some regions. Improvements in demand from France and Germany were most commonly cited. Asia was also reported to have improved further as an export market.

Import growth remained strong during the period—much stronger than suggested by official data. Firms continued to increase purchases of relatively cheap overseas materials to alleviate margin pressures. While reports of these practices have existed for some time,

many Agencies suggested that retailers and consumers have now also begun to source more products directly from overseas suppliers.

Investment

Investment intentions in the manufacturing sector deteriorated further during the period—mostly reflecting lower profitability. Where investment has taken place, it is mostly to improve productivity rather than to expand capacity. Moreover, any investment has tended to be limited to high value-added production technology, as routine processes continue to be relocated overseas.

Service sector investment remained strong during the period, although a slight easing was reported in some regions. Firms reportedly invested heavily in new office space and leisure facilities. But there were some suggestions of an easing in retail investment. IT investment (particularly developing e-commerce) had strengthened again more recently in many regions.

EMPLOYMENT

The labour market picture remained similar to the previous *Agents' Summary*. While conditions remained tight (particularly in the southern regions), the incidence of skill shortages remained broadly unchanged in recent months. Skill shortages continued to be reported in construction, engineering, managerial and professional positions.

Earlier trends of declining manufacturing employment, alongside growth in construction and service sector employment, continued. There was little evidence to suggest any change in the pace of sectoral employment growth during the period. Within the manufacturing sector, there appeared to be great diversity in performance. Most sectors continued to shed staff, although some strong-growth sectors increased their employment levels. Many manufacturing firms indicated that even if output was increasing, productivity improvements meant that they were unlikely to increase staff numbers. In addition, there were further reports of the increased use of part-time and temporary staff in the sector.

Growth in the services and construction sectors continued, but appeared to be constrained by the limited availability of suitably skilled labour. Strong demand was said to have resulted in a rise in call-centre employment creation. However, it was noted that this was partly offset by the displacement of employees in other areas.

COSTS AND PRICES

Input prices

Input price inflation appeared to strengthen during the period, as earlier rises in the oil price fed through to increases in the prices of related products. For example, there were increased reports of rises in the price of petrol, plastics and some rubber products. While in the past contacts had been able to resist many price increases by importing from overseas (gaining from the high level of sterling), this opportunity diminished slightly recently, following sterling's depreciation. In addition, firms continued to cite concern about other input cost increases. For example, rising commercial rents and insurance premiums were noted. But many firms continued to resist price increases through actions such as centralised purchasing, consolidation and outsourcing. In addition, firms benefited from significant productivity improvements.

Pay

Settlement trends remained similar to those reported in recent *Agents' Summaries*. Most Agencies continued to suggest that manufacturing settlements were lower than in services and construction—and most remained equal to or lower than a year ago. But there had been an increase in the number of contacts indicating that negotiations had become more difficult to resolve recently. There were more reports of offers being rejected—in some cases, as employees reacted to higher petrol prices. The outlook for future negotiations also appeared to worsen.

Growth in the total pay bill was reported to have slowed in manufacturing in most regions. Firms reported that slowing output, coupled with higher productivity, had led to cuts in overtime payments. And lower profitability reduced bonus payments relative to last year. But most Agencies suggested that total pay increased at a faster rate in the services and construction sectors (mostly as a result of skill shortages).

Output prices

Although competitive pressures remained intense, there were more reports of rising manufacturing output prices during the period. Evidence of input price increases being passed up the supply chain remained

limited, although oil-related increases became increasingly evident. For example, higher prices for transport and distribution services were cited. In addition, many firms suggested that the rate of pass-through would intensify as the year progressed. Other reports of increased prices included paper-related products (for example packaging). But there is widespread consensus that only a small proportion of input price increases can be passed on, due to competitive pressures.

By contrast, service sector firms noted relatively little difficulty in passing on cost increases. Higher legal fees were commonly cited. Advertising rates and insurance premiums also increased. However, less-specialised aspects of professional services (for example audit) experienced downward pressure.

Retail prices

There was little change to the trend of flat or falling goods prices reported in previous *Agents' Summaries*. And according to some Agencies, retail stores began summer 'sales' earlier than usual this year (particularly for clothing). In most cases, greater competition was said to have resulted in heavier discounting than last year.

Service sector prices continued to rise during the period, although it appears that the rate of increase slowed. Downward pressure was noted for UK tourism-related activities (for example hotels). In addition, lower utilities and telecommunications prices were reported. But there were some reports of rising overseas holiday prices—possibly as a result of the recent currency depreciation and also increased list prices due to higher fuel costs. Motor vehicle servicing and insurance premium increases were also cited.

During the period, Agencies noted a marked slowing in house price inflation—particularly in the southern regions of the United Kingdom, where price levels reportedly stabilised. The sharp slowdown is reported to reflect an easing in demand and an increase in the supply of established houses for sale. In other regions (where house price inflation had been relatively low), prices continued to rise but at a slower pace than before.

Agencies reported a further decline in new car prices during the period. Used car prices also came under further downward pressure as stocks of used cars rose.

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



Minutes of the Monetary Policy Committee meeting on 3–4 May 2000

1 Before turning to its immediate policy decision, the Committee discussed the world economic outlook; exchange rates; money and asset prices; demand and output; labour market conditions; and prices and costs; reviewed the May projections for output and inflation; and considered the implications for policy of robust domestic inflationary pressures versus the disinflationary effects of sterling's appreciation against the euro.

The world economic outlook

2 The most significant news concerned the US, where recent output growth had again been surprisingly strong: 1.3% in 2000 Q1 after 1.8% in 1999 Q4. Final domestic demand growth had risen to 2.1%, with negative contributions to GDP from net trade and stockbuilding. There had also been more marked signs that the strength of demand was feeding through to prices and costs. Quarterly growth in employment costs had been 1.4% in Q1, up from 1.0% in 1999 Q4; the month-on-month rate of increase in the CPI had risen from 0.2% in January to 0.5% in February and to 0.7% in March; core CPI inflation had risen too, above expectations. The market was firmly expecting the FOMC to raise interest rates at its 16 May meeting, with some looking for an increase of 50 basis points.

3 Equity markets in the US, and perhaps in consequence elsewhere, had been highly volatile over the month. The NASDAQ was now substantially off the levels reached early in the year. Whereas the possibility of a large and disorderly equity price fall remained one of the key risks to the world economy, the equity market had risen so far over the past few years that an orderly correction need not give rise to concerns about the macroeconomic outlook; some correction was welcome, and indeed could usefully contribute to restraining US domestic demand growth.

4 If a further correction were to occur, which was far from certain, the implications for output and inflation would depend on the nature of the underlying shock. There would be an important difference between, on the one hand, a greater-than-expected tightening of US monetary policy in response to excess demand but with the story of significantly improved supply-side performance basically intact; and, on the other hand, news that the economy's prospective supply capacity had not improved by as much as seemed to be built into current equity valuations and borrowing decisions. In the latter case, output growth could potentially fall back as prices accelerated. It was not possible to be confident about which, if either, of an aggregate demand or an aggregate supply shock was the more likely.

5 Against this background, the Committee incorporated in its central projections an assumption that the outlook for world economic growth had again strengthened, but with the balance of risks on the downside.

Exchange rates

6 The euro had fallen by around 5% on its effective exchange rate index over the month; and by 6% against sterling, including 2% in the days immediately before the Committee's meeting. Given the significance of sterling's further appreciation for the UK economic outlook, the Committee debated a series of possible reasons for euro weakness that were being canvassed in the markets.

7 One possible explanation was the gap between US and euro-area supply-side performance. If US trend productivity growth had risen relative to that of the euro area, it was to be

expected that investment capital would flow to the US, accompanied by an adjustment in the real exchange rate. There was some support for that view in capital account data for the past few years. However, it was difficult to see how relative supply-side performance could explain the euro's sharp depreciation over recent months, particularly as there had been some positive news about structural reform in euro-area economies. Moreover, this story was not easily reconciled with the strength of euro-area equity markets.

8 A second possible explanation was the suggestion that some market participants felt that the ECB was 'behind the curve'. But looking at, for example, unemployment levels in the euro area as a whole, it was also possible to argue that policy was 'ahead of the curve'. Overall, given the news about the outlook and the ECB's objectives, policy seemed to be within the range which would generally be expected. Consistent with that, bond yields had not risen in a way that suggested that medium-to-long run inflation expectations were out of line with the ECB's goals, and so did not suggest that ECB policy lacked credibility. There had, though, been some market comment about the recent pace of money (and credit) growth, which was now well above the ECB's quantitative reference value. It was conceivable that the market was uncertain about the relative importance of this factor in the ECB's broader strategy of medium-term price stability. But it was not easy to see how this could explain such a large and persistent fall in the external value of the euro.

9 A third possible explanation was that some market participants were concerned about the diverse range of official commentary on euro-area monetary policy, from finance ministries, national central banks and the ECB. Related to that, it was conceivable that there were concerns that communication—and perhaps even the formulation—of ECB policy would become still more complicated as membership of the euro area expanded. More broadly, the market had apparently been concerned about recent political developments in some euro-area countries.

10 The Committee could not identify a compelling economic explanation for the recent euro weakness. Some members were inclined to believe that the recent falls had reflected momentum, or what might be called 'psychological factors'. There was anecdote suggesting that some large trades had had a more persistent impact than usual.

11 The Committee concluded that the current levels of the euro-dollar and euro-sterling exchange rates were unlikely to be sustained. But while sterling was expected to fall at some point against the euro, it was impossible to predict the timing or size of any such adjustment. A likely trigger could be a large fall in global equity markets, led by the US; that could prompt a fall in the dollar against the euro, and possibly therefore in the sterling-euro rate. Alternatively, it was possible that sterling might decouple from the dollar in the event of greater market awareness of differences in the relative cyclical positions and in supply-side prospects for the US and the UK.

12 The Committee decided to assume in the central projection that sterling's path over the next two years would lie halfway between a constant nominal rate and a depreciation in line with interest rate differentials. Although some members preferred the former and some the latter, a majority preferred an average between the two.

13 The Committee's projections used as the starting point a 15 working-day average of sterling's exchange rate index, which

was 110.7, around 1½% higher than on the path assumed in the February *Inflation Report*. By the time of the Committee's meeting, sterling had risen further, to around 113½ and so was materially above the starting point assumed in the *Report* projections.

Money and asset prices

(i) Household and corporate sector borrowing

14 M0 had grown by 8.2% in the year to April and, adjusting for millennium-related effects, had now been in a 8%–9% range for the past six months or so. Household credit growth had again been strong, at 9.9% in March—the fastest rate since 1991. Net secured lending had risen quite sharply, following an earlier pick up in mortgage loan approvals. The approvals data had also risen in the latest month. The household money and credit data therefore presented a contrasting picture to the recent survey evidence of a fall in consumer confidence.

15 Private non-financial corporate sector (PNFC) borrowing—from banks and from capital markets—had also been robust. In 2000 Q1 PNFC total external finance had been stronger than at any time since 1989 Q3 (adjusting for the boost to borrowing in 1999 Q2 caused by changes to Advance Corporation Tax). There was little evidence of distress borrowing. Sectoral data showed that the manufacturing sector had been repaying bank borrowing in Q1. The Bank's regional Agents had earlier suggested that recent borrowing was largely for investment; over a slightly longer period, it had also financed merger and acquisition activity.

16 Overall, the money and credit data presented a different picture from the weaker-than-expected outturn for GDP growth in Q1. Taking the monetary data at face value might suggest that either output would pick up again or that the Q1 figure could be revised up.

(ii) The housing market

17 Recent data on the housing market were somewhat mixed. The Nationwide price index had risen by 1.6% in April, compared with 2.3% in March, and the twelve-month rate had risen from 16.2% to 17.5%. The Halifax index had risen by 0.8% in April, having fallen by 0.4% and 0.9% in March and February respectively. The twelve month rate was 14.2% in April. A quite different picture was presented, though, by a preview of the April Royal Institute of Chartered Surveyors' measure of house price pressure. The number of particulars delivered had fallen slightly in March, but were still well up on a year ago. The House Builders' Federation site visits balance had fallen slightly over the month, but the net reservation balance had risen slightly.

18 Put together with the lending data and with anecdote of financing terms being eased over recent months in the face of intense competitive conditions, the overall evidence of the housing market having peaked was perhaps slightly weaker than in the previous month. It was possible, however, that the regional pattern was changing, with slightly slower growth in London and the South East than a few months ago. Looking further ahead, the Committee judged that house prices rises would moderate, but by slightly less than assumed in its February central projection.

Demand and output

19 The Q1 GDP data presented an important puzzle. Growth was recorded at 0.4%, which was below the Committee's February central assumption. Official data suggested that output growth might have been accounted for entirely by net trade, which had apparently bounced back: in particular, exports to non-EU countries had grown by 7.1% over the quarter. If so, domestic demand growth had been zero. But growth in retail sales had clearly been positive, and other indicators also pointed to continued

consumption growth. If so, other components of domestic demand must have fallen quite sharply.

20 While business investment intentions had recently weakened, this survey evidence was about periods beyond Q1. Earlier surveys, which were more relevant to Q1, had suggested positive business investment growth. Recent survey evidence might be consistent with a fall in stockbuilding in Q1, perhaps reflecting an unwind of a millennium-related build up, but this did not sit comfortably with the robust corporate sector borrowing data. There was clearer evidence that government consumption had been weak in Q1. Another possible factor was that energy production had been weak during the quarter. Bank staff estimates suggested that, excluding energy, GDP growth had been somewhat stronger than 0.4%. If so, it was possible on the expenditure side that the energy-related component of consumption had been weak.

21 Overall it would probably be some time before the picture was clearer. The Committee thought that the Q1 GDP data contained limited information about the future path of output, but agreed that it would be a mistake to give them no weight in the immediate policy decision. Looking back over a longer period, it did now seem that output growth had peaked in 1999 Q3.

22 Recent forward-looking survey data contained mixed signals. Survey evidence did not seem to point to a fall in manufacturing output, although the outlook had clearly weakened given sterling's strength; and indicators of service sector and construction activity, while slightly weaker, were still clearly pointing to growth. Other surveys implied that export orders had fallen, as had business optimism and, in particular, consumer confidence.

23 There seemed to be somewhat clearer news on the fiscal position. The 1999/00 surplus had been even larger than the Government had forecast at the time of its March Budget, with both weaker-than-expected departmental spending and higher-than-expected revenues. On spending, it seemed that departments were making greater-than-anticipated use of their ability to roll over unspent amounts into the next fiscal year. It was therefore an important question whether that would continue in future years or whether, as the Committee assumed, annual nominal spending would rise to the budgeted amount in the current year. On the revenue side, the question was whether output had been stronger than measured or whether the effective tax yield had risen, so that there had in effect been a further unanticipated tightening of fiscal policy.

Labour market conditions

24 The wedge between the earnings and settlement data remained. The increase in the headline Average Earnings Index had risen to 6.0% in the three months to February, the fastest since July 1992. This figure was affected by millennium-related payments, and so was judged to overstate underlying earnings growth. The twelve month rate of earnings growth in February was 5.5%. There was a major difference between earnings growth and settlements: settlements over the same period had been 3.3%. Members differed in their interpretation of these data. Some, noting that on any reasonable assumptions earnings growth in the UK was well above the rate of productivity growth, were concerned about consequent upward pressures on prices. The recent very strong earnings increases would most likely have some impact on prices, including via the effect on demand of higher incomes: that was assumed in the central projection. Others believed that settlements had a bigger impact than earnings growth on prices, and that unmeasured productivity improvements would help to offset rapid earnings growth. They preferred an assumption that the recent spike up in earnings growth would have a smaller effect on prices than had been assumed in the central projection.

25 The Labour Force Survey measure of employment had increased by 59,000 (0.2%) in the three months to February, in line

with recent quarters. The number of people unemployed had fallen slightly. Evidence from surveys and the Bank's regional Agents suggested that skill shortages remained a concern, but had perhaps stabilised.

26 Overall the labour market remained tight. While it was not obviously tightening further, there was not much evidence of conditions easing.

Prices and costs

27 RPIX inflation was 2.0% in March, with the fall of 0.2 percentage points on the month being slightly larger than expected. There continued to be a large divergence between goods price inflation, which at -0.2% was the lowest on record; and services inflation, which had remained at 4.2%.

28 Some members did not think that the size of the sectoral divergence was significant for the overall inflation outlook, although it was an unwelcome sign of imbalances in the economy. Overall, the Committee agreed that there was little if any news in the latest data relevant to the outlook.

29 In terms of the outlook for prices, an important consideration was the impact of any supply side changes in the economy. The Committee decided to retain in its central projection February's assumptions about structural pressures on domestic margins (and the latest projections had also incorporated a downward adjustment to margins on imports). Also as in February, some members preferred to assume a smaller effect, and some preferred a larger effect. In addition, some members preferred to assume that trend productivity in the UK would rise towards the levels achieved in the US, which would reduce the rate of increase in prices for any given rate of earnings growth.

The May output growth and inflation projections

30 The Committee agreed the projections to be published in the *Inflation Report* on Wednesday 10 May.

31 On the assumption of an official repo rate of 6.0% over the next two years, the central projection was for output growth to slow slightly from 3% to a rate at or a little above trend. The profile was slightly stronger than in the February *Report*. The balance of risks was on the downside, principally on account of the possibility of a setback to world economic growth.

32 On the central projection, RPIX inflation rose to around the 2½% target over the coming year or so and then stabilised at around that level. The profile was much the same as in the February *Report*, with the effects of sterling's appreciation broadly offsetting those of slightly stronger world and domestic demand and a higher profile for earnings growth. The balance of risks was slightly on the upside in the first year and on the downside in the second year.

33 The fan chart projections did not incorporate a risk of a sharp fall in sterling's exchange rate against the euro, since the timing and size of any such correction were both extremely uncertain. Nor did the projections reflect a risk, seen by some members, of earnings growth being higher than assumed.

34 As described above, there was a range of preferred assumptions for the path of the nominal exchange rate, price-cost margins, trend productivity, and the impact on prices of the unwinding of the recent rise in earnings growth; these were presented in Table 6.B on page 62 of the May *Inflation Report*. Different members preferred different combinations of these assumptions, with the effect of either reducing or raising the inflation projection at the two-year horizon by up to half a percentage point.

The implications for policy of strong domestic inflationary pressures versus the disinflationary effects of sterling's further appreciation

35 The Committee discussed the challenges which monetary policy faced on account of, on the one hand, the domestic inflationary pressures generated by strong final domestic demand growth and a tight labour market; and, on the other hand, the downward pressures on inflation from the prospective effects on net trade and import prices of sterling's further appreciation against the euro. There seemed to be material risks to the outlook whatever the Committee's immediate policy decision.

36 A risk if interest rates were raised was that inflation could fall further below target if, for example, the Q1 GDP estimate turned out to be an accurate guide to underlying developments and output growth continued to slow. Moreover, in the view of some members, a policy tightening could put further upwards pressure on sterling, which could aggravate the downward pressures on inflation and output. As well as materially undershooting the inflation target for a while, some viable businesses might be unnecessarily damaged. In addition, a further rise in sterling could increase the risk of sterling falling sharply later. Hence, tightening now could increase the deviation of inflation from target, both in the short run and further out.

37 If, however, interest rates were maintained at 6%, there was a risk that policy might prove to be too easy if, for example, tight labour market conditions were to lead to persistently high earnings growth. That could end up being a classic case of acting too late to head off accumulating inflationary pressures, and that too could damage the real economy. In addition, it was likely that sterling would fall back at some point, given that its rate against the euro in particular seemed unsustainable. If domestically-generated inflation had not been checked by then, policy might need to be tightened quite sharply in order to bring about a material slowdown in output growth. This was not certain, however. For example, if a fall in sterling were prompted by a global equity market correction, which on one view was the most likely trigger, there might be partly offsetting influences on the inflation outlook, although the inflationary effects of a depreciation would tend to come through rather more quickly than the disinflationary effects of a fall in wealth.

38 Views differed on the relative risks depending on assessments of the current conjuncture and individual members' preferred central projection assumptions. There was, however, agreement that it was relevant that inflation was currently below the inflation target, and that sterling was materially higher at the time of the meeting than the 15 working day average used as the assumed starting point in the *Inflation Report* projections. The actual exchange rate at the time of the meeting was judged to be more relevant to the immediate policy decision.

Tactical issues

39 The Committee discussed two tactical issues.

40 First, the Federal Open Markets Committee (FOMC) was expected by the market to increase the Fed funds target by at least 25 basis points, perhaps by 50 basis points, on 16 May. Assuming that the FOMC did tighten, it was conceivable that sterling might decouple somewhat from the dollar, and so perhaps fall slightly against the euro, if UK rates had not been raised again this month, since that might help to signal that the US and UK did not face the same conjunctural issues.

41 Second, the Committee discussed a suggestion that, if the repo rate were maintained at 6%, the Bank should intervene in the foreign exchange markets, ideally as part of concerted intervention to strengthen the euro. A majority of members did not want to contemplate intervention in the current circumstances.

The immediate policy decision

42 A variety of arguments were identified for maintaining interest rates at 6%. The central projection for inflation was broadly in line with the target in the second year of the forecast period, with the level of output around most estimates of trend. While some members had preferred assumptions producing a somewhat higher inflation projection, this was offset by the fact that sterling was, at the time of the meeting, nearly 3% above the starting point assumed in the May projections. For those members who had favoured a tightening of policy in the previous month, the balance of argument had shifted to leaving rates unchanged this month. This was partly because of the Q1 GDP figure, but it was also on account of sterling's sharp appreciation since then and the implications which these developments, if they persisted, would have for the inflation outlook. On the economic analysis there was no need to change rates this month, and as a matter of tactics doing so might compound the problem of sterling's appreciation.

43 There was, however, a wider range of views on the underlying picture. Some members remained very concerned about the strength of domestically-generated inflationary pressures, reflecting the tight labour market and still-buoyant final domestic demand growth. There were upside risks to inflation from earnings and the possibility of a decline in sterling's exchange rate. Sterling's level against the euro was unlikely to be sustainable; the most likely resolution of this was a rise in the euro's nominal exchange rate against sterling, but the timing was extremely uncertain. Taking these things together, there was a general need to restrain domestic demand growth. This would also guard against having to tighten policy more aggressively later if, for example, sterling fell sharply. While it was therefore more likely than not that policy would need to be tightened again in due course, a tightening was not needed this month; the immediate outlook provided time to see more evidence on output and expenditure and on exchange market developments. Some members taking this view were concerned that economic agents and commentators may have concluded from the recent macroeconomic performance that the Committee could, as a general matter, achieve the inflation target and stabilise the path of output with a series of fairly small changes in interest rates. That was by no means assured. The uncomfortable current combination of internal and external conditions suggested that the operation of policy in the period ahead might easily be considerably more difficult than over the past three years.

44 While agreeing that the conjuncture was particularly challenging, other members did not agree that, other things being equal, policy was more likely than not to be tightened further. First, taken at face value the Q1 GDP numbers and the fall in

several survey indicators might suggest that the earlier interest rate increases had had a faster and larger effect than expected. Second, to tighten policy would tend to put further upwards pressure on sterling, compounding the problem of economic imbalances. Attempting to slow domestic demand growth below trend by tightening now in anticipation of a fall in sterling would run the risk both of increasing the degree of undershoot of inflation relative to the target in the short run, and of increasing the size of any inflation overshoot later, by exacerbating the size of sterling's overvaluation now. Third, sterling was most likely to fall in response to a global equity market correction, which would tend to reduce domestic demand and so help to offset upward pressures on inflation from depreciation. In such circumstances, policy might not need to be tightened aggressively. Fourth, inflation was still materially below target, and was set to remain so for a while, which provided a cushion against a short-term inflationary shock from a fall in sterling. Fifth, to the extent that movements in sterling proved to be erratic, they had no necessary implications for policy. Sixth, some members placed greater weight on downward price pressures from changes in the supply-side of the economy, which would interact with and at least partly offset the inflationary pressures from strong domestic demand.

45 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. The Committee voted unanimously in favour of the proposition.

46 Finally, on behalf of the Committee the Governor expressed his profound thanks to Willem Buiter and Charles Goodhart for their enormous contributions to establishing the MPC process and for the open-minded way in which they had participated in the Committee's discussions and decisions. On behalf of the Chancellor of the Exchequer, the Treasury representative expressed warm thanks for the contribution they had both made to establishing the credibility of the UK's new institutional framework for monetary policy.

47 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

48 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 Bank staff to the Monetary Policy Committee on 28 April in advance of its meeting on 3–4 May 2000. 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 this Annex.

I The international environment

2 The advance estimate of US GDP had risen by 1.3% in Q1, with growth continuing to be driven by consumer spending. Investment had also increased strongly, probably partly reflecting the effect of preparations for the century date change on the profile of investment spending in recent quarters. Industrial confidence had fallen further in April, but was still robust. Non-farm payrolls had risen by 416,000 in March, boosted by temporary hiring for the US 2000 Census, the end of the Boeing strike, and a five week March survey period. Employment costs had picked up in Q1, rising by 1.4% on the quarter. Benefit costs had risen by 2%, possibly reflecting bonus payments associated with the century date change, as well as higher healthcare costs.

3 In the euro area, industrial production had risen by 1.2% in February, and industrial confidence had increased again in March. Although the western German IFO survey of business confidence had fallen in March, this had reflected a decline in sentiment in the retail and wholesale sectors, since manufacturing sector confidence had risen. German data had also shown strong industrial orders growth in recent months, especially in the external sector. Euro-area consumer confidence had remained unchanged in March. Annual euro-area M3 growth had risen to 6.5% in March, from 5.9% in February.

4 Japanese industrial production had risen by 2.8% in the first quarter, boosted partly by the effect of the leap year. Machinery orders had strengthened in recent months, as had construction orders, particularly in the private sector. Workers' expenditure rose by 0.7% in Q1, though it remained 1.4% below its level a year earlier. The unemployment rate had remained at 4.9% in March, and new job offers had risen by 6.4% in the first quarter.

5 The one-month Brent crude oil futures price had risen slightly since the previous meeting, to around \$25 per barrel. Other industrial commodity prices had declined, however. Earlier rises in oil prices had boosted both US CPI and euro-area Harmonised Index of Consumer Prices (HICP) inflation, to 3.7% and 2.1% respectively in March. US core CPI inflation (excluding energy and food) had risen to 2.4%. In the euro area, however, core HICP inflation had remained flat at 1.1% in March, and preliminary estimates of German CPI inflation had shown a 0.4 percentage point fall in April. The rate of consumer price deflation in Japan had continued to moderate.

6 The ECB had increased the official interest rate by 25 basis points on 27 April. Interest rates implied by futures contracts had risen on the month for both the United States and euro-area. US bond yield volatility had increased, perhaps because of the effects of US Treasury repurchases. In equity markets, the volatility of the major technology indexes had increased markedly, though index levels had partly recovered after large falls earlier in the month (the largest fall was in the US-based NASDAQ, down by around 11% since the April meeting). Both the volatilities and levels of broader stock market indices had changed by much less on the month; for example the Wilshire 5000, a broader measure of US stocks, had fallen by about 4%.

II Monetary and financial conditions

7 The twelve-month growth rate of notes and coin had fallen slightly from 8.4% in March to 8.2% in April, still within the underlying (excluding Y2K effects) range of 8%–9% observed over the past 6 months.

8 The stock of M4 had risen by £13.8 billion (1.7%) in March. The exceptional strength of M4 had been concentrated mainly in the other financial corporations (OFC) sector, though non-OFC M4 growth had ticked up as well, primarily because of the household sector component. Aggregate M4 lending (excluding the effects of securitisations) had also been very strong in March, rising by £18.3 billion (1.9%). Much of the increase on the month had reflected activity in the OFC sector, although borrowing by the non-OFC sectors had also risen. In fact, the annual growth rate in Q1 of M4L, excluding OFCs, was at its highest level since 1991 Q1, at 9.0%.

9 Households' M4 deposits had risen by £4.6 billion (0.9%) in March. M4 lending to households (excluding the effects of securitisations) had remained robust, increasing by £5.2 billion (0.9%) in March. The annual growth rate in Q1 was at its highest level since 1991 Q2, at 10.1%.

10 Within total lending to individuals, net secured lending to individuals had increased sharply in March by £4.1 billion (0.8%). The value of loan approvals had also risen further to £10.5 billion. Both loan approvals (numbers and values) and secured lending were above their peak levels reached in 1999.

11 Net M4 borrowing (borrowing less M4 deposits) by private non-financial corporations (PNFCs) had risen substantially in 2000 Q1, largely reflecting an increase in PNFCs' bank borrowing, which had grown by £7.4 billion (3.7%) on the quarter. A broader measure of PNFCs' external borrowing (which included capital issues and foreign currency borrowing) had also risen strongly on the quarter (up by £15.8 billion).

12 OFCs' M4 and M4 borrowing had risen exceptionally strongly in March, by £9.0 billion (5.0%) and £8.6 billion (4.0%) respectively on the month. But much of this rise had reflected matched financial transactions between securities dealers and the banking sector which had been outstanding over the month end.

13 Since the previous MPC meeting, short interest rate expectations, as measured by the two-week gilt repo curve, had fallen slightly at the short end (one year out), but had risen 2–3 years out. Longer nominal interest rates (15–25 years) had also risen slightly, in line with yields in international government bond markets.

14 Within retail interest rates, there had been little change in secured rates or in savings rates. However there had been significant increases in unsecured rates, though these rates had still registered a net fall since August 1999—a period over which the official repo rate had risen by 100 basis points.

15 Surveys of expected inflation in 2000 and 2001 had remained below target. Longer-term Consensus forecasts of inflation over the next ten years had risen slightly. Survey measures of ten-year real interest rates had fallen marginally between October and April.

16 Since the previous MPC meeting, sterling had appreciated by 6.3% against the euro, but had depreciated by 1.8% against the dollar. The sterling effective exchange rate index (ERI) had risen

by 4.3% over the same period to 113.6, taking the index to its highest level since November 1985.

III Demand and output

17 The preliminary Office for National Statistics (ONS) estimate of GDP growth in 2000 Q1 had shown growth slowing to 0.4% from 0.8% in Q4. The annual growth rate had fallen slightly to 2.9%. Service sector output had grown by 0.8% in Q1 and had been 3.2% up on a year earlier. Within services, the distribution, hotels and catering sector had grown by 0.5%. The ONS had said that growth in the transport and communications sectors was strong and that growth in business services had been more moderate. Industrial production had fallen by 0.8% on a three-month basis in February, and manufacturing output had fallen by 0.5% over the same period.

18 Although there had been no new national accounts data, the ONS had reported that construction output had risen at a similar rate to that in earlier quarters. New construction orders had risen by 5.8% in the three months to February. And the Chartered Institute of Purchasing and Supply (CIPS) index of construction activity had risen to 63.9 in March, its highest level since early 1998.

19 The deficit on trade in goods and services had narrowed slightly to £1.4 billion in February from £1.7 billion in January. The EU goods deficit had widened to £0.6 billion but the non-EU goods deficit had narrowed to £1.8 billion. The non-EU goods deficit had narrowed to £1.5 billion in March. Excluding oil and erratics, the volume of goods exports had fallen by 0.2% in the three months to February compared with the previous three months, and imports had risen by 1.6%. Total import volumes had risen by 1.7% over the same period.

20 Retail sales volumes had risen by 0.5% in March and by 1.5% on a three-month basis. The GfK consumer confidence index had fallen to -3.8 in April, its lowest level since December 1998 and below its historical average. The quarterly Consumers' Association survey of confidence had been +33 in April compared with +41 in January.

21 Private car registrations in the three months to March had fallen by 3.8% on a year earlier. Total registrations had risen by 3.9% over the same period.

22 House prices had risen by 1.6% in April according to the Nationwide measure, and annual house price inflation rose to 17.5%. The Halifax price index had risen by 0.8% in April, and annual inflation had fallen to 14.2%. Particulars delivered had fallen by 0.8% in March. The Royal Institute of Chartered Surveyors (RICS) survey had shown continuing strength in sales in March.

23 The public sector net borrowing requirement had been -£1.5 billion in March. For financial year 1999-2000 as a whole, it was -£15.0 billion, compared with the Budget projection of -£11.0 billion.

24 The Confederation of British Industry (CBI) and the British Chambers of Commerce (BCC) quarterly surveys had shown a fall in their indices of manufacturing investment intentions in Q1. The CBI investment intentions balance fell to -21 in 2000 Q2 from -9 in Q1, the lowest since 1999 Q2. The BCC had shown a deterioration in manufacturing investment intentions (plant and machinery) to 9 in Q1 from 14 in Q4. The BCC survey had also shown a fall in service sector investment intentions back to mid-1999 levels, the balance falling to 18 from 25 in Q4.

25 The CBI Industrial Quarterly Trends stock balance had risen to +3 in Q2 from -10 in Q1. The CIPS survey of manufacturing had shown that stocks of finished goods had

been gently eroded through Q1 and into April. The CBI Distributive Trades Survey had reported a rise in retailers' stocks in April.

26 Looking ahead to 2000 Q2, survey evidence suggested slower GDP growth than in Q1. The CBI Industrial Quarterly Trends Survey had shown a notable fall in manufacturing sector new orders in Q1. The BCC survey for Q1 had shown declines in domestic orders in both the manufacturing and service sectors, and overseas orders in manufacturing had also fallen, but had increased in the service sector. The CIPS purchasing managers' survey of manufacturing showed a fall in the headline index to 50.6 in April from 51.4 in March. The CIPS services measure had been broadly flat, while construction had fallen slightly.

27 Other surveys such as those by the Institute of Directors, Euler Trade Indemnity and Dun & Bradstreet had suggested continued strength in sales and optimism in 2000 Q2.

28 The Bank's regional Agents had conducted a survey of UK firms regarding business growth and profit margins in 2000 Q1. Output growth was reported to have been widespread in Q1, but there were notable sectoral differences. Construction and non-retail services had shown the strongest growth. Domestic demand was cited as the main driver of non-retail services growth, but price competition was reported to have held back manufacturing and retail growth. Overall, profit margins had narrowed slightly in Q1, but there were substantial sectoral differences. Construction and non-retail services firms had reported wider margins, while manufacturers' margins had narrowed considerably. Retail margins had narrowed slightly.

IV The labour market

29 Employment had continued to grow steadily. Labour Force Survey (LFS) employment had increased by 59,000 (0.2%) in December to February, compared with the three previous months. The increase had been more than accounted for by higher part-time employment, which had risen by 75,000. So employment growth had been lower in full-time equivalent terms. Despite the shift towards part-time work, average hours worked had increased by 0.2%. As a result, total hours worked had risen by 0.3% in December-February compared with the previous three months, although they were unchanged compared with the same period last year.

30 Survey-based evidence had indicated that employment conditions continued to differ between the manufacturing and service sectors. The CIPS survey in April had indicated faster employment growth in the service sector than in March, slightly slower growth in construction, and a continued decline in manufacturing employment. Both the BCC Quarterly Economic Survey and the CBI Industrial Trends Survey had indicated that employment intentions in the service sector had remained strong in Q1, but had weakened in manufacturing.

31 The latest data suggested that labour shortages persisted. The CBI survey had reported that shortages of both skilled and unskilled staff had increased slightly in Q1. According to the BCC survey, recruitment difficulties had also remained high. The Recruitment and Employment Confederation (REC) survey in April had shown a deterioration in the availability of permanent and temporary agency staff. The Bank's regional Agents had reported that skill shortages remained a concern, though overall they might have lessened slightly.

32 Unemployment had fallen on both the LFS and claimant count bases. LFS unemployment had fallen by 25,000 in three months to February compared with the previous three months, with the rate falling 0.1 percentage points to 5.8%. Claimant count unemployment had fallen by 7,700 in March compared with the previous month, with the rate unchanged at 4.0%. The fall in LFS

unemployment had been more than accounted for by lower long-term unemployment.

33 Inactivity had been broadly flat, rising by only 3,000 in three months to February compared with the previous three months. An increase of 36,000 in male inactivity had more than offset a fall of 34,000 in female inactivity.

34 All LFS data from autumn 1993 onwards had been revised to incorporate more up-to-date population estimates. Estimates of the population aged sixteen and above had been revised up by 0.5% by autumn 1999. However, quarterly growth rates, participation, employment and unemployment rates had been little changed.

35 Earnings growth had remained strong. Whole-economy headline earnings growth had risen by 0.1 percentage points in February to 6.0%, with higher growth in both the private sector (up by 0.2 percentage points to 6.5%) and the public sector (up by 0.2 percentage points to 4.2%). Earnings growth in the private services sector (a newly published series) had risen by 0.1 percentage points in February to 6.9%. Manufacturing earnings growth had fallen by 0.1 percentage points, to 5.3%. Data on the bonus contribution to earnings growth that were not distorted by the change to the Average Earnings Index (AEI) questionnaire in February 1999 had become available for the first time. Bonuses had contributed around 0.5 percentage points to whole-economy earnings growth in February. Earnings growth, excluding bonuses, had been 5.1%. However, interpreting recent earnings data had remained problematic, since it was difficult to estimate the impact of millennium-related payments.

36 Settlements had stopped falling and were now broadly flat. The Bank's twelve-month AEI-weighted mean had been 3.3% in March, unchanged since January. Public and private sector means were also unchanged. A majority of settlements in Q1 had been lower than during the same period last year: of the 138 settlements that could be matched, 28 had been higher, 16 had been the same and 94 had been lower. In real terms, however, settlements had continued to grow. Wage drift, the difference between annual earnings growth and pay settlements, had continued to rise in March, though it had remained below the levels seen in the late 1980s.

V Prices

37 The Bank's oil-inclusive commodity price index had risen by 1.8% in March, taking the annual inflation rate from 22.6% down to 20.7%. The effects of last year's rise in oil prices had largely accounted for the fall in the annual rate. So given the sharp rise in oil prices between March 1999 and February 2000, annual commodity price inflation may thus have peaked in February.

38 Seasonally adjusted manufacturing input prices had risen by 0.8% in March, taking the annual inflation rate from 14.2% to 13.8%. Again, the decline in the annual rate of change reflected the sharp fall in the annual inflation rate of oil prices. The annual rate of change of seasonally adjusted total output prices excluding excise duties (PPIY) had risen slightly to 1.8% from 1.7% in February. The latest CBI expected output price balance for Q2 had weakened to -13 from -4.

39 Prices of total imported goods had risen by 1.0% in the three months to February compared with the previous three months. Excluding oil and erratics, prices of imported goods had risen by only 0.3%. Total export prices had remained broadly flat over the same period.

40 Annual RPIX inflation had fallen by 0.2 percentage points to 2.0% in March, largely owing to last year's rise in tobacco and petrol duties dropping out of the annual comparison and a smaller rise in household goods prices than in March 1999. Service price inflation had continued at an annual rate of 4.2% in March.

VI Reports by the Bank's Agents

41 The Bank's regional Agents had reported that manufacturing growth, although continuing, had moderated recently. The exchange rate had been reported as a greater concern and the outlook for orders had weakened in most regions. Service sector output growth had remained strong, and there had been some evidence of a strengthening in business services growth. The demand for housing had remained strong, but was not accelerating, and growth had eased in some regions. Agents had reported broadly unchanged annual retail sales growth in April, although the retail sector remained difficult to read in many regions. The Agents had noted that moderate export growth was continuing. Import growth was reported to have strengthened again, and import penetration was expected to rise further in coming months. Investment in the retail and leisure sectors had remained strong, but manufacturing investment intentions had weakened with an increased number of firms cancelling investment plans or switching to overseas locations.

42 With the exception of some pass-through from higher oil prices, manufacturers had continued to find it difficult to pass on increases in input prices. There had been further downward pressure on retail goods prices, while service sector inflation was thought to have remained stable. Contacts had remained concerned about skill shortages in the labour market, although most Agents suggested that concerns were no worse than in recent months. Some contacts had reported expectations of increasing pressure on pay in some sectors in 2000 H2.

VII Market intelligence

43 Expectations of short-term interest rates implied by short sterling futures and gilt repo yields had fallen slightly over the month, notwithstanding volatility within the period. Over the second half of the month, the appreciation of sterling against the euro had led some market participants, who had previously expected the MPC to increase official rates in May, no longer to expect such an increase. Market participants subscribing to this view had also noted that there were signs that the rate of increase in domestic asset prices had stabilised. Expectations of interest rates implied by futures contracts and derived from SONIA swaps had suggested that a majority of market participants did not expect an increase in official rates. However, a poll of economists conducted by Reuters had found that a majority expected an interest rate increase in May. Those participants who expected an increase in official interest rates had attached importance to the robustness of domestic demand and labour market indicators over the period since the MPC last increased interest rates in February.

44 Since last October the broad US and UK equity indices had risen and then fallen, but these fluctuations had been more restrained than those in high-tech stocks, and had not been unusual. Volatility and uncertainty had increased to unprecedented levels for the NASDAQ, but did not look out of the ordinary for either the FTSE or S&P. There had also been an inverse relationship between the level of the NASDAQ and both implied volatility and skewness. The further the NASDAQ had fallen, the more uncertain investors had become, but also the less inclined they had been to believe that subsequent price movements would be downward rather than upward.

45 Although the high-tech indices had fallen, their contribution to the fall in the broader indices had been small; in terms of market capitalisation they remain a small part of the broader indices. A more important contributor to the fall in the FTSE All-Share index than the IT sector (4.8% weight) had been non-cyclical services (20.5% weight). This had mostly reflected a fall in telecoms, which had perhaps been influenced by the same factors as IT, but it was possible that the recent UK spectrum auctions had also played a role.

46 Sterling had strengthened by 4.3% over the month in effective terms, with a 1.8% depreciation of sterling's exchange rate against the dollar outweighed by a 6.3% appreciation against the euro. The euro's weakness over the month had been broadly based: it had also depreciated against the yen and dollar, and in effective terms. Expected correlations between exchange rate pairs implied by options prices suggested that the exchange rates for the euro against both the dollar and sterling were expected to move together, but that the exchange rates for sterling against the dollar and the euro were not expected to move together. Over the month, the euro had depreciated notwithstanding an increase in market interest rates relative to those outside the euro-area. Market participants had suggested that euro-area political and economic developments had been a factor behind the depreciation of the currency. Another influence was the stability of the dollar in

response to large falls on certain days in the NASDAQ and Dow indices, contrary to the expectation of many market participants who had believed that the dollar would depreciate against the euro following falls in US equity markets. Surveys had suggested that forecasters continued to expect the euro to appreciate against sterling over the next twelve months.

47 The government's prospective receipts from the auction of third-generation mobile phone licences had not had any observable impact in the money or gilt markets. It was possible that the spread between secured and unsecured money might widen, at least temporarily, depending on how quickly liquid collateral could be mobilised. In the foreign exchange markets, some participants expected sterling to be supported in the short term by inflows related to payment for the licences.

Minutes of the Monetary Policy Committee meeting on 6–7 June 2000

1 Before turning to its immediate policy decision, the Committee discussed the world economic outlook; exchange rates; money and asset prices; demand and output; the labour market; prices and costs; tactical considerations; and the overall conjuncture. The Committee had also received 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.

The world economy

2 The latest estimates of growth in the euro area had been broadly in line with the Committee's forecast. In the United States, there had been a rise in consumer confidence in May. Non-farm payrolls had risen in May, although this may be a temporary effect because the rise was entirely accounted for by an increase in the number of those working on the national census. The unemployment rate had risen by 0.2 percentage points in May. There had also been a rise in equity prices over the past month. But the purchasing managers' index in April and the latest data on retail sales seemed to be a little weaker. Developments on prices and costs appeared more benign than in recent months. The reaction of some analysts, and in press reports, to the latest US data seemed quite marked and was perhaps a little surprising in the light of these mixed indicators. Commentators no longer expected a sharp rise in interest rates—and this could explain why equity prices had risen. But the latest indicators might be interpreted as suggesting that the US economy was returning to the previous pattern of strong demand growth and benign price pressures. The imbalances in the US economy—for example between domestic demand and net trade—remained, and so the question was still whether the economy would experience a 'soft' or 'hard' landing.

3 Since the previous meeting, the OECD had published its latest forecasts. These projections were for slightly stronger growth overall in the G7 compared with the December projections. The broad picture was for stronger growth in 2000 and slightly weaker growth in 2001 than the Committee had assumed in producing the *May Inflation Report* projections. But these differences were not particularly large. However, the latest OECD projections of slower growth in 2001 than in 2000 did highlight the broader question of whether 2000 would prove to be the peak in world growth during the current cycle. Over the past six months there had been significant monetary policy tightening in a number of countries, and that might support a view that world growth would slow. Looking at financial market conditions more generally, there had been a rise in shorter-dated bond yields in many of the major industrial countries, although not the US, and equity prices had fallen somewhat since the peaks reached in the first quarter. Of course, it was possible that a rise in bond yields reflected market expectations of higher inflation, rather than a view that monetary authorities would tighten real interest rates more than previously thought. There were also signs that growth was slowing in various countries in Asia, and any further tightening by the US Federal Reserve was likely to have some effect on many developing economies, especially in Latin America.

4 The oil price had risen over the past month, but this did not seem primarily to reflect a stronger world demand picture. The Committee noted that there was an OPEC meeting towards the end of June. The rise in oil prices would put some upward pressure on UK inflation in the near term, relative to what had been assumed in preparing the *May Inflation Report* projections.

The exchange rate

5 The sterling effective exchange rate had fallen by around 5% compared with the profile assumed in the *May Inflation Report*, which used a 15 day average as its starting point. Since the time of the May meeting, there had been a larger fall of more than 7½%, reversing the rise in sterling over the previous six months. Apart from the period when sterling left the Exchange Rate Mechanism in 1992, it was the largest one-month change in the ERI since 1986. It was noted that the risks of a large or rapid depreciation in the exchange rate had been explicitly recognised, but not been built into the May fan chart projections.

6 Staff analysis suggested that the size of the depreciation over the month could not be accounted for by a change in interest rate differentials. The markets now expected no change in UK interest rates this month and there remained some expectation of interest rate increases in the euro area and in the United States. Looking along the yield curve as a whole however suggested that there was little monetary news over the month. It was possible that the decision not to raise interest rates in May would have lowered short-run interest rate expectations, but that this might have been masked because the large fall in sterling led to expectations of higher interest rates further out. Large transactions related to mergers and acquisitions could have pushed sterling down at least temporarily on the day of the MPC decision, and the no change decision might have triggered further momentum-based sales, which might account for the size of the depreciation.

7 The Committee agreed that there could be no mechanical link between changes in the exchange rate and the decision on interest rates. The exchange rate change had to be taken into account, however, when assessing the prospects for inflation. Calibrating the magnitude of what appeared to be a real exchange rate depreciation on inflation over the next two years was difficult, just as it had been difficult to calibrate the effects of sterling's earlier appreciation. To the extent that the earlier rise in the exchange rate had not yet fed through to domestic prices, the recent fall might likewise have correspondingly less effect on prices.

8 In its May projections the Committee had taken into account the rise in the exchange rate and had assumed that the pass-through to retail prices would be somewhat slower than its historical average—although the eventual effect on the price level would be the same. There was great uncertainty about this, but applying the same procedure to the recent fall would on the face of it imply a rise in the inflation projection two years ahead on account of the exchange rate shift—of around half of a percentage point compared with the *May Report* projections. If the comparison was with the level of the exchange rate immediately prior to the Committee's May meeting rather than the 15 day average used in the forecast then the impact on future inflation would be correspondingly larger. However, these estimates were extremely sensitive to the assumptions made and it was possible that the effect on inflation would be smaller or larger than this. In particular it was suggested that, given the depreciation, the Committee might review the assumptions earlier made on overseas exporters' margins to the UK, and on retail margins in the UK. Some members thought that the recent depreciation was likely to have a smaller effect on prospective inflation, since overseas producers' margins to the UK might fall back faster than had previously been assumed. These issues would be reviewed in the August *Inflation Report* round.

Money and asset prices

9 Both the Halifax and Nationwide measures of house prices had fallen by 0.4% in May, and suggested that house price inflation was slowing at least as rapidly as had been assumed in the *Inflation Report* projections. This reduced the risk that domestic demand would grow faster than had been built into the central projection. The latest provisional Royal Institute of Chartered Surveyors' (RICS) survey pointed to a further reduction in the balance of estate agents reporting price increases in May, although the balance remained strongly positive. The recent pattern of slower growth in southern regions relative to the north had continued, in contrast with the picture a few months ago.

10 The mortgage approvals data had weakened in April. However, the figures might be affected by the number of working days in April and, therefore, the fall might be reversed in May, just as the weakness in December had been reversed in January. The House Builders' Federation survey of site visits and reservations still pointed to a slight fall in particulars delivered later in the year. The provisional estimate of mortgage equity withdrawal for Q1 was weaker than in Q4, and was consistent with some slowdown in consumption growth.

11 Corporate borrowing growth had again been strong, but it was unclear quite why this was so. One possibility was that it reflected a shift between sources of financing, away from bonds and equities towards bank lending. Another possibility was that the higher borrowing could also reflect a squeeze on profits and hence a tighter liquidity position. Profits had fallen in the first quarter according to the preliminary estimate by the Office for National Statistics (ONS). A fall in final demand, and hence company income, could be consistent with a rise in stocks—but the relationship between the stock-output ratio and corporate borrowing had not been particularly close over recent quarters. In addition, the recent special survey by the Bank's regional Agents had found little evidence of higher borrowing because of worse cash flow. A third possibility was that higher borrowing was being used to finance current or prospective investment. Although total investment had been a little weaker than expected in Q1, business investment had grown quite strongly.

Demand and output

12 Final domestic demand in Q1 had been weaker than expected at the time of the *Report*. The annualised six month growth rate was now running at around 3½% compared with about 4½% at the same time last year—a significant slowdown but still robust. The weakness was broadly based across consumption, investment and government spending. The key question was how persistent the slowdown in the Q1 figures would prove to be.

13 In the case of consumption, the Q1 figures looked a little low in the light of the retail sales data and other indicators, although the continuing weakness of car registrations through Q1 might explain part of the difference between retail sales and total consumption growth. At some point household spending on vehicles would recover, and hence the current growth rate might be erratically low. More recently, retail sales had been weak in April. But the latest CBI distributive trades survey and evidence from the British Retail Consortium suggested that retail sales in May would be stronger. The Bank's regional Agents' contacts reported early signs of an easing in retail sales growth while consumer services growth remained strong. Both the GfK and MORI consumer confidence indicators had risen slightly—though they were not far from their long run averages once seasonal factors were taken into account. Although slower house price growth and recent movements in equity prices suggested a prospective weaker contribution from household wealth to consumption growth than had been the case over the past few years, this had already been incorporated into the Committee's projections. Real earnings growth continued to support consumption growth.

14 On government spending, some weakness in the first quarter had been expected in the light of recent monthly data, and a return to positive growth would be needed if Government spending plans were to be met. There had, more generally, been some recent revisions to the fiscal numbers, with spending having undershot and revenue having overshot the projections made in the March Budget. More revisions to the estimates of real and nominal government spending were possible when the National Accounts are published on 29 June. The revised data and any possible implications for future government spending and revenue projections would need to be incorporated into the August *Inflation Report* forecast.

15 Inventories had made a much stronger than expected contribution to GDP growth in Q1, and this had been broadly spread across the manufacturing, wholesale and distribution sectors. It could reflect weaker-than-expected demand and indicate weaker output growth ahead, but it was too early to say. There were no signs of widespread stockbuilding from either the Agents' contacts or surveys. No details of the alignment adjustments had yet been published by the ONS, but it was possible that these adjustments, or other temporary factors, were contributing to a stronger contribution from inventories in Q1. If so, the positive contribution might well be reversed in Q2, with little consequence for output growth in the first half of the year as a whole.

16 The positive contribution from net trade to GDP growth was only slightly weaker than expected in Q1, although both export and import volumes had been stronger than expected. There seemed to be little news on the month and the puzzle remained of why net trade was so strong given the previous strength of sterling. The quarterly figures were nonetheless volatile from quarter to quarter, so that caution was needed in placing weight on the Q1 figures.

17 The picture for GDP growth was further complicated by the weakness of energy output in the first quarter, which may have reflected the weather. This suggested that the underlying pace of output growth was stronger than recorded in headline GDP growth. The industrial production numbers for April showed manufacturing moving broadly in line with expectations, but there had been a sharp rise in energy output. That seemed consistent with stronger Q2 GDP growth, all other things being equal.

18 There were significant discrepancies between the estimated Q1 growth rates of the output, income and expenditure measures of GDP, which were difficult to reconcile. The release of the National Accounts for Q1 and the annual rebalancing exercise for the ONS *Blue Book* might help resolve this.

19 Overall, the pace of final domestic demand had slowed more than expected in Q1, but it was too early to judge whether this would be sustained into Q2.

The labour market

20 There had been a slight moderation in employment growth, and it seemed likely that average hours worked had fallen in the first quarter. But other data pointed to a slight tightening in labour market conditions. The Recruitment and Employment Confederation survey had shown an intensification of labour market shortages. While the Labour Force Survey measure of unemployment had been unchanged, there had been a further fall in the claimant count measure.

21 There had been a slight pick up in pay settlements, with the three-month mean measure rising to 3.0% in April. The twelve-month mean measure had, however, continued to fall and was now at 3.2%. Average earnings growth had fallen back to 5.8% in March on the headline measure, and was below the figure for Q1 in the May *Inflation Report* central projection. If the fall persisted it might imply a slightly lower profile for earnings growth

and hence a slightly lower central projection for inflation over the next two years. At the least, it appeared that the upside risks to the May projection had diminished. However, taken at face value, the latest hours data implied that hourly earnings were rising even more rapidly in Q1, by around 7¼% at an annual rate, although it was recognised that this calculation was particularly subject to considerable measurement error.

22 Productivity growth had been rising, and the annual rate of growth of output per head had probably risen to around 1¾% in Q1, while the estimate of growth in productivity per hour was around 3%. This month's special survey by the Bank's regional Agents suggested that many companies planned to purchase and sell on the Internet over the next few years, and this might support future productivity growth.

23 The real product wage (on the basis of the GDP deflator) was growing at around 2½% and was currently above estimates of average historical productivity growth. Whole economy unit labour costs had been rising by around 4% per annum, and were rising in real terms. This entailed a continuing squeeze on the profit share of GDP over recent years, which was unsustainable in the long run. On these measures the labour market continued to look tight. One way in which the tension could be resolved would be a continued fall in earnings growth.

Prices and costs

24 RPIX inflation had fallen to 1.9%, consistent with the central projection in the *May Inflation Report*. The gap between goods and services inflation had narrowed, primarily due to the reductions in utility prices and the timing of duty increases on goods. The latest Bank estimates suggested that there had been a further squeeze on both manufacturing and retail margins. That was supported by the Bank's regional Agents' contacts reporting that they were still having difficulty passing through rises in input costs to their output prices. In the case of manufacturing, in particular, the squeeze on margins was reported as having increased the pressures on firms to raise productivity growth over recent quarters.

25 The short-term outlook was for rather higher RPIX inflation than at the time of the *Inflation Report*. This was partly on account of the rise in the oil price, but this had no obvious implications for the medium term projections. But the main news on the month had been the sharp fall in the exchange rate, which would tend to push inflation back up towards the 2½% target faster than had been expected in May.

26 The British Retail Consortium's shop price index showed retail prices falling 1.2% in the year to May. The CBI Distributive Trades survey quarterly questions on reported and expected movements in retail prices also showed a marked decline in the balances between February and May, and the level of the balances was now at a record low. However, these indicators primarily related to retail goods price inflation, which continued to be much weaker than that for services. The latest Chartered Institute of Purchasing and Supply (CIPS) services survey indicated a sharp rise in the price index in May. But since the CIPS services survey primarily reflected business-to-business transactions, such strength might take some time to feed through to retail prices.

Tactical considerations

27 There was little expectation in financial markets that the Committee would raise interest rates this month, although there was still an expectation of higher rates in the future. So a decision to raise interest rates this month would come as a surprise to the markets and might change expectations. In such circumstances it would be necessary to consider possible effects on the exchange rate and hence the likely consequences for inflation in the medium term.

28 Previously when the markets had been surprised by a change in interest rates, there had sometimes been a marked change in the exchange rate in the weeks that followed. This might suggest that the exchange rate would appreciate significantly even in response to a 25 basis point rise in interest rates this month. But, in these past examples, it was difficult to isolate the effects of the interest rate decision from the flow of other news affecting market perceptions. It also mattered what market expectations were concerning the decisions at the next ECB and FOMC meetings. If one, or both, surprised the market by raising interest rates more than expected, and UK interest rates were not changed this month, then sterling might depreciate further.

The overall conjuncture

29 An important question was how far the evidence over the month suggested that a rebalancing of the economy was in prospect. There were signs of slowing domestic demand and stronger net trade in the first quarter. There was also the prospect of somewhat stronger net trade in the future given the depreciation of sterling over the past month. So the depreciation of sterling from an unsustainable level was welcome. The important issue for the Committee was what this past and prospective rebalancing of the economy implied for inflation over the next two years or so. How large an effect on inflation would be caused by the exchange rate depreciation? This was especially difficult to know given the uncertainty in gauging pressures on profit margins. Were the signs of slower domestic demand and lower earnings growth sufficient to indicate that domestic inflationary pressures were weaker than previously thought?

30 The effects of real exchange rate changes would typically first be seen on prices and only later on net trade. A weakening in domestic demand would take some time to feed through to lower inflation. So, taken at face value, the recent rebalancing might, other things being equal, raise the prospect of inflation moving closer to target over the next few quarters, assuming the fall in sterling was sustained. Further out, the effects on inflation of the exchange rate depreciation and a possible weakening of domestic demand would need to be carefully weighed.

31 Other indicators, such as the gap between service sector and industrial production growth in the first quarter, suggested that the economy was far from being in balance. Indeed, the sterling ERI had only fallen back to its November 1999 level. There was also uncertainty about whether sterling had truly decoupled from the dollar and hence was being influenced by domestic factors, and therefore about how far it would move if the dollar/euro exchange rate changed significantly. The evidence from options markets suggested that the implied correlation between the dollar and sterling was expected to be stronger twelve months ahead than one month ahead, suggesting that the markets anticipated a degree of recoupling.

The immediate policy decision

32 One view was that interest rates should be maintained at 6% this month. The most significant development over the month had been the fall in sterling. Treating the recent exchange rate depreciation in the same way as the previous appreciation suggested that inflation would be higher than projected in May. However, in the view of some, not all of the fall in sterling should be treated as an exogenous fall in the real exchange rate, and some of the depreciation might be attributed to changes in the market's expectation of future UK inflation. The overall effect of the exchange rate depreciation on inflation was highly uncertain, especially if overseas exporters' margins to the UK fell more sharply than previously expected and if retail margins were squeezed further. Raising interest rates this month might push sterling up again and exacerbate the undershoot of inflation against

the target in the near-term, while simultaneously aggravating the potential size of the inflationary shock further out as sterling would fall from a more elevated level.

33 Some of the other indicators suggested that domestic inflationary pressures might be showing signs of easing more than expected. For example, final domestic demand growth had been weaker than previously expected in Q1. Retail sales had also been weak in April, although indicators pointed to a resumption in growth in May. The housing market seemed to have slowed, which appeared consistent with slowing consumption growth. The release of the National Accounts data for Q1 on 29 June might help clarify the extent of the slowdown. Earnings growth had so far turned out weaker than in the central projection—although other indicators suggested that the labour market remained tight. While the depreciation would, other things being equal, lead to higher inflation looking further out, inflation was still below target and likely to be so for some time. There was no need for a rise in interest rates this month, and for some members no presumption that a further rise would be needed. The depreciation of sterling would help bring about a rebalancing of the economy, and that was welcome even if it meant that at some point higher interest rates were needed. Even those members who thought that a further rise in interest rates might eventually be necessary noted that the costs associated with waiting were low in comparison to the costs that would be incurred by moving now and potentially exacerbating sterling's overvaluation.

34 The alternative view was that, on balance, the data this month required a rise in interest rates of 25 basis points. The effect of the depreciation of the exchange rate on prospective inflation was significant and was not offset by the other news. The slowdown in final domestic demand in the first quarter was probably partly erratic and should not significantly change the outlook, although the upside risks seemed to have diminished since the *May Report*. The bounce-back in industrial production at the start of Q2 was consistent with a recovery in demand and output growth in Q2. The latest evidence was still consistent with consumption growing close to trend, as projected in May. The labour market was tight on most measures. It was not sensible to place too much weight on the fall

in earnings growth in March and there was still a risk that earnings could turn out stronger than the deceleration in the May central projection. Given the recent depreciation of sterling, the downward pressure on retail prices from the past appreciation of sterling would cease. Although measures of domestically generated inflation had fallen they remained above the 2½% target, so that a slowdown in private sector domestic demand growth was still required. Against this background, the data pointed to higher inflation than thought a month ago. Were there, nevertheless, reasons for waiting? The exchange rate depreciation could reverse; there was a risk that a rise in interest rates would be misinterpreted as being linked to the exchange rate depreciation in a mechanical way; a rise in rates might lead to an appreciation of sterling if it surprised the markets; and some of the demand and output puzzles might get resolved through the release of the *Blue Book* data. While these outcomes were all possible, none seemed sufficiently compelling to delay action warranted by the data. For these reasons a rise in interest rates of 25 basis points was desirable this month.

35 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. Six members of the Committee (the Governor, David Clementi, Christopher Allsopp, DeAnne Julius, Ian Plenderleith and Sushil Wadhvani) voted for the proposition. Mervyn King, Stephen Nickell and John Vickers voted against, preferring a rise in rates of 25 basis points.

36 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
 Christopher Allsopp
 DeAnne Julius
 Stephen Nickell
 Ian Plenderleith
 John Vickers
 Sushil Wadhvani

37 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 Bank staff to the Monetary Policy Committee on 1 June in advance of its meeting on 6–7 June 2000. Bank staff also briefed the Committee on the latest outside forecasts available as of 1 June. 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 this Annex.

I The international environment

2 US industrial production had grown strongly during April, and consumer confidence in May had been strong. The National Association of Purchasing Managers' (NAPM) index had fallen in May, largely because of a sharp fall in the new orders component of the index from 56.3 to 51.1, though the production index had also fallen. The indices for inventories and employment had risen slightly in the month. Retail sales had fallen slightly in April, the first monthly fall since August 1998. The US trade deficit had widened further in March. Trade volumes had risen strongly, with export growth slightly higher than import growth. The unemployment rate in May had risen to 4.1%, from 3.9% in April. Non-farm payrolls had risen by 231,000, although this had been boosted by an additional 357,000 workers recruited for the Census. Unit labour costs had increased in the first quarter, partly due to a slowing in productivity growth.

3 GDP in Germany and France had grown by 0.7% in Q1. In the euro area as a whole both business and consumer confidence had remained at historically high levels. The euro-area unemployment rate had fallen to 9.2% in April, its lowest rate since September 1992.

4 In Japan, many estimates of GDP in Q1 had pointed towards strong growth, following negative growth in Q3 and Q4 of 1999. In April, industrial production had risen by 7.8% on a year earlier. A sharp fall in public construction orders during April had indicated that the fiscal package may have been front-loaded into Q1. Nominal retail sales had declined in the year to April. The trade surplus had widened in April. Exports had risen slightly faster than imports, driven by strong demand in Asia and the United States. On an unadjusted basis, nominal wages had increased in the year to April by 1.4%. The unemployment rate had fallen to 4.8% in April, but inactivity had risen as employment fell.

5 Oil prices had risen during the month, with Brent crude oil trading within a \$25–\$30 range. Prices for non-oil commodities had also risen in the month.

6 In the United States, the CPI price index had remained unchanged on the month in April although the annual rate of CPI inflation had fallen from 3.7% to 3.0%, mainly reflecting a fall in energy prices. Core CPI inflation (which excludes food and energy) had fallen to 2.2%, while headline producer price inflation had fallen to 3.9%. The level of average hourly earnings had increased by 0.1% in May, following a 0.4% increase in April. Euro-area headline inflation had fallen to 1.9%, although core inflation (which excludes energy, food, alcohol and tobacco) had risen slightly. Euro-area headline producer price inflation had risen to 6.2% in March. In April, Japanese consumer price inflation fell to -0.8%.

7 M3 in the euro area had remained buoyant in April, increasing by 6.5% on the year, while credit to the private sector had increased by 11.4%. The three-month moving average of M3 growth had reached its highest rate since the introduction of the euro. Japanese M2 including CDs had increased by 2.9% in the

year to April, a pick-up from March, partly due to a slight reversal in the decline of bank lending.

8 Since 3 May, the euro and yen effective exchange rate indices had appreciated by around 6% and 1% respectively, while the dollar effective exchange rate index had depreciated by around 3%. Over the same period the Wilshire 5000 index—a broad measure of the US stock market—had increased by just under 3% and the NASDAQ index, which has a higher proportion of technology stocks, ended the month close to its value on 3 May. In Japan the Topix index had fallen by over 6%. Interest rates implied by futures contracts had fallen on the month in the United States. In the euro area, there had been little change in rates implied by futures contracts maturing this year.

II Monetary and financial conditions

9 The twelve-month growth rate of notes and coin had continued to fall slightly from 8.2% in April to 7.9% in May. This figure was just below the underlying 8%–9% range that had been observed over recent months.

10 M4 had risen by £5.1 billion (0.6%) in April, compared with £13.8 billion (1.7%) in March, remaining strong despite the unwinding of large repo transactions that took place in March. The increase had been driven by continued growth in M4 excluding Other Financial Corporations (OFCs). Aggregate M4 lending (excluding the effects of securitisations) had also been strong in April, rising by £6.7 billion (0.7%), despite the unwinding of March reverse repos.

11 The gap between M4 lending and M4 had continued to rise in April and was close to historical highs at just under 6% of GDP. The main factor financing this rising gap had been net inflows from overseas residents.

12 Household M4 lending (excluding the effects of securitisations) increased by £4.2 billion (0.7%) in April, compared with an average monthly increase of £4.8 billion in 2000 Q1. Both loan approvals and net secured lending to individuals had declined markedly in April.

13 Provisional estimates by Bank staff had suggested that mortgage equity withdrawal in 2000 Q1 was down slightly from the estimates for the previous few quarters. Total lending for consumption (mortgage equity withdrawal plus unsecured lending) was also estimated to have fallen.

14 Net new bank borrowing (bank borrowing minus bank deposits) by PNFs (private non-financial corporations) had been negligible in April, although there had been significant increases in both deposits and borrowing. A broader measure of PNFs' external borrowing (including capital issues and foreign currency borrowing) had increased further in April following the strong borrowing in 2000 Q1.

15 Since the previous MPC meeting, short interest rate expectations, as measured by the two-week gilt repo curve, had fallen slightly at the very short end. Longer nominal interest rates had remained broadly unchanged. Corporate bond spreads had continued to widen this month, with corporate bond yields up at all maturities.

16 There had been little change in short or medium-term inflation expectations. Fixed end-point surveys of expected inflation for 2000–04 had remained slightly below the inflation target.

17 The FTSE All-Share index had risen by 5.4% since the previous MPC meeting. The rise on the month had been mainly attributable to the non-cyclical services, resources and financials sectors. Despite declining significantly since the beginning of the year, the FTSE IT sectoral index had outperformed the All-Share over the previous twelve months.

18 Since the previous MPC meeting, sterling had depreciated by 9.3% against the euro and by 2.5% against the dollar. The sterling effective exchange rate index (ERI) had fallen by 7.7%. The recent declines in the sterling-euro and sterling-dollar exchange rates could not be accounted for by changes in interest rate differentials over the month.

III Demand and output

19 GDP growth in Q1 had been revised up to 0.5% (from 0.4%). The annual growth rate had risen to 3.1%, the fastest rate since 1997 Q4. Total industrial production had fallen by 0.8% in 2000 Q1, with manufacturing output down by 0.5%. Service sector output had risen by 0.8% and construction output by 0.5%. Agricultural output growth had fallen by 1.1%.

20 The expenditure breakdown showed that domestic demand had risen by 0.4% in Q1. Final domestic demand had risen by 0.3%.

21 There had been an unusually large discrepancy in Q1 between the growth of GDP as measured by expenditure compared with the average measure, with the expenditure measure stronger.

22 Private consumption (including that of non-profit institutions serving households) had grown by 0.6% in Q1 and had increased by 3.2% in the year to 2000 Q1. Government consumption had fallen by 0.4% in Q1. Total investment (including acquisitions less disposals of valuables) had decreased by 0.1%. Business investment had increased by 1.9%. Within this, manufacturing investment had increased by 4.9% in Q1, while private service sector investment had risen by 2.7%. By implication the government and private sector dwellings components of investment had been weak. The gross operating surplus of corporations had decreased by 1.8%.

23 Inventories had made a small positive contribution to GDP growth in 2000 Q1. Including the alignment adjustment, inventories had risen by £0.6 billion. Most sectors had experienced an increase in their inventories. The CBI Monthly Trends survey in May had reported that manufacturers still perceived their stocks to be more than adequate, though their balance was below the long-run average.

24 Net trade had contributed 0.3% to GDP growth in 2000 Q1. Total exports of goods and services had increased by 3.2%, and imports had increased by 2.0% in Q1. Exports of goods had risen by 2.3% in March, and imports were also 2.3% higher. Goods exports to and imports from non-EU countries had both risen by around 3% in April.

25 Turning to indicators of Q2 activity, manufacturing output had fallen by 0.2% in April. But total industrial production had risen by 0.8%, reflecting a large rise in energy sector output. Retail sales volumes had fallen by 0.3% in April but had risen by 4.5% on a year earlier in the three months to April. The CBI Distributive Trades survey had shown a total balance of +45 retailing respondents reporting higher sales in April compared with a year ago and further growth was expected in May. The British Retail Consortium survey had reported an increase in May. The MORI measure of consumer confidence had risen to -11 in May while the GfK confidence index had increased to +2.7 from -3.8 in April. Private new car registrations in the three months to April had fallen by 3.5% on a year earlier, while total new registrations had increased by 1.1%.

26 The housing market indicators had shown signs of a slowdown. Both the Halifax and Nationwide Prices indices had fallen by 0.4% in May. Annual rates, though still high, had fallen, as had three-month rates. The Nationwide three-month rate had only fallen a little and remained high at 5.0%, but the Halifax three-month rate had fallen sharply to zero. A preview of the Royal Institute of Chartered Surveyors (RICS) survey of estate agents for May had shown a fall in the balance reporting house price rises. The balance in April had fallen to 37 from 60 in March. The House Builders' Federation (HBF) survey balance for house price inflation had shown a fall to 33 in April from 52 in March. Particulars delivered had fallen by 8.7% in April and were 3.3% on a year earlier. HBF site visits and reservations had fallen in April. Private housing starts had risen by 5.3% in March, but completions had fallen by 1.4%.

27 The public sector net cash requirement had been -£6.7 billion in April (a surplus). Net investment and net borrowing had been revised down by £2.2 billion for 1999/00.

28 The manufacturing output expectations balance in the CBI Monthly Trends survey had decreased to -6 in May from +1 in April. The total orders balance had increased to -10 in May but the export orders balance had decreased to -35.

29 The headline index of Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey output had been 50.9 in May. The growth in new orders had slowed to 51. The DHL survey had eased to +34 in May from +38 in February. The headline CIPS services survey balance had been +59.2 in May. The CIPS construction index had risen to 62.2 in May.

IV Labour market

30 Employment had continued to grow steadily. Labour Force Survey (LFS) employment had increased by 55,000 (0.2%) in 2000 Q1 compared with 1999 Q4. The increase had been accounted for by higher part-time employment, which had risen by 54,000. So employment growth had been lower in full-time equivalent terms. The working-age employment rate had risen by 0.1 percentage points to 74.4%.

31 Hours worked by full-timers had fallen steeply in Q1 (by 1.1%), though those of part-time workers were broadly unchanged. Average hours worked had fallen by 1.0%. Total hours worked had fallen by 0.8%, despite the increase in the headcount, and were 0.3% lower than in the same period a year earlier.

32 The CIPS surveys in May had indicated continued strong employment growth in both services and construction, and a slower decline in manufacturing employment. The Recruitment and Employment Confederation (REC) survey had indicated that shortages of both temporary and permanent agency staff had intensified in May. According to the Bank's regional Agents skill shortages remained a concern, especially in the Greater London area.

33 Unemployment had fallen on both the ILO and claimant count measures. LFS unemployment had fallen by 20,000 in Q1, with the rate down 0.1 percentage points to 5.8%. Claimant count unemployment had fallen by 28,800 in April, lowering the rate to 3.9%. The fall in ILO unemployment had been more than accounted for by lower long-term unemployment: short-term unemployment had risen by 17,000.

34 Inactivity had been broadly flat, rising by only 1,000 in Q1 compared with the previous three months. An increase of 24,000 in male inactivity had offset a fall of 23,000 in female inactivity. Female working-age inactivity had fallen steadily since 1995, while male inactivity had been broadly stable for the previous two years.

35 Annual manufacturing productivity growth had slowed to 3.8% in March. Unit wage costs in manufacturing had started to increase again. Annual growth in whole-economy productivity and unit wage costs in 2000 Q1 was estimated, using LFS data, to be 1.7% and 4.0% respectively.

36 Earnings growth as measured by the average earnings index (AEI) had fallen back slightly. Whole-economy headline earnings growth (three-month average of annual growth rates) had fallen by 0.2 percentage points in March to 5.8%. The private sector accounted for all of this decrease (down 0.3 percentage points to 6.2%). Headline earnings growth had fallen in both private services and manufacturing, to 6.6% and 4.9% respectively. Headline public sector earnings growth had been unchanged at 4.2%.

37 Annual earnings growth had edged down by 0.1 percentage points to 5.4% in March. This was accounted for entirely by public sector earnings growth, which had returned to pre change in millennium rates. Growth excluding bonuses (not seasonally adjusted) was 4.7%, down from 5.1% in February, with a bonus contribution of 0.9 percentage points. The Bank's estimate of annual growth in earnings per hour had continued to rise in Q1 and was now above 7%. The widening gap with the headline earnings growth figure was accounted for by the fall in average hours worked, which were 1.3% lower than the previous year.

38 The REC survey had pointed to a slowdown in the rate of growth of permanent placement salaries in May. Growth rates for temporary staff had picked up a little.

39 Settlements had picked up but remained lower than a year ago. The Bank's three-month AEI-weighted whole-economy mean had risen by 0.2 percentage points to 3.0% in April, reflecting a rise in private sector settlements. Settlements in Q1 had generally been lower than during the same period last year: of the 56 settlements that could be matched, 18 had been higher, 11 had been the same and 27 had been lower. The Bank's twelve-month mean had fallen by 0.2 percentage points to 3.1%. Public and private sector means were also 3.1%.

V Prices

40 The Bank oil-inclusive commodity price index had fallen by 7.0% in April, the largest fall since the start of the series in 1990, taking the annual inflation rate from 20.5% down to 8.9%. The large monthly decrease had reflected large falls in the prices of fuels and metals. The fuels component of the index had fallen by 11.9% in April, largely accounted for by the fall of around 15% in the oil price in April. Non-oil commodity prices had fallen by 3.1% in April, and by 0.2% over the past year.

41 Seasonally adjusted manufacturing input prices had fallen by 3.2% in April, taking the annual inflation rate from 13.1% to 7.1%. The large monthly fall had mainly reflected the decline in the price of crude oil in April. There had also been falls in the prices of metals and of imported materials as a whole. The CIPS manufacturing survey input price index had fallen significantly in May. Seasonally adjusted total output prices excluding excise duties (PPIY) had fallen by 0.1% in April. The annual inflation rate had been 1.6%, slightly down from 1.8% in March. As in previous months, petroleum product prices had risen, but this had been more than offset by small falls in the prices of a large number of components. May's CBI Industrial Trends Survey output price balance had fallen significantly from -13 to -21. The Corporate Services Price Index had risen by 0.7% in 2000 Q1 compared with a rise of 1.1% in 1999 Q4, taking the annual inflation rate to 3.6%, slightly down from 3.9% in the previous quarter.

42 The prices of imported and exported goods had risen by 1.1% and 0.3% respectively in the three months to March compared with the previous three months. Excluding oil, the price of

imported goods had risen by 0.5%, while the price of exported goods had fallen by 0.9% over the same period.

43 RPIX inflation had fallen to 1.9% in April, down from 2.0% in the previous month. This had largely reflected lower petrol price inflation and cuts in utilities prices. RPI inflation had risen from 2.6% to 3.0%, following the abolition of MIRAS in April. RPIY inflation had fallen to 1.6% in April, while HICP (harmonised index of consumer prices) inflation had fallen from 0.7% to 0.6%. The difference between RPIX and HICP inflation had remained constant at 1.3 percentage points.

44 The British Retail Consortium (BRC) Shop Price Index had fallen by 0.2% in May, taking the annual inflation rate to -1.2%, down from -0.7% in April. The CBI Distributive Trades retailers' reported average selling price balance had fallen from -4 in February to -6 in May, its lowest on record.

VI Reports by the Bank's Agents

45 The Bank's regional Agents had reported that growth in manufacturing output and orders, although still continuing, had slowed further. Service sector output growth had remained strong, particularly in professional services, IT and telecommunications. Moderate export growth was still being recorded. In contrast to recent official data, the Agents reported that import growth had continued to strengthen. Construction activity remained strong, although growth had eased slightly in recent months. Within the sector, demand for housing and industrial property was reported to have eased. Agents had reported early signs of an easing in annual retail sales growth, although the sector remained difficult to read in many regions. Manufacturing investment intentions had weakened further, but those in the services sector had remained strong.

46 Downward pressure on manufacturers' output prices and margins had continued, particularly in export markets. But stronger pay pressures in some areas of the service sector had been passed through to prices. Retail goods prices were reported to have continued to fall slightly. The Agents suggested that house price growth in the southern regions of the United Kingdom had slowed markedly recently, although in other regions (where the pace of house price growth had been relatively slower), growth remained stable. Contacts remained concerned about skill shortages in the labour market, although the incidence of shortages had remained broadly unchanged in recent months.

47 The Bank's regional Agents had conducted a survey of UK firms regarding e-commerce. More than 80% of firms reported that they already had a web site, and all others were planning to develop one within two years. Most companies commented that their site was used as a marketing tool and was not used to conduct sales. Only a small proportion of firms reported that any of their input purchases were conducted via the Internet at the moment, but many reported that they already used EDI (electronic data interchange) technology. Of existing Internet sales, business-to-business (B2B) volumes were reported to vastly outweigh those of business-to-consumer (B2C). Purchases and sales over the Internet were expected to increase over the next two years, particularly in areas such as purchases of construction and manufacturing materials and business travel. However many firms stated that transactions would continue to take place in the conventional way.

VII Market intelligence

48 Expectations of short-term UK interest rates in the rest of 2000 and for 2001, implied by short sterling futures, had fallen by 5–13 basis points since the May MPC meeting and by 17–20 basis points for contracts maturing in 2002 and 2003. Weaker-than-expected domestic and international data had contributed to the fall. The market consensus was for UK official rates to be left unchanged in June. In reaching this view, most market participants had referred to the weaker-than-expected

average earnings and retail sales data for March and April respectively, as well as survey evidence suggesting a slowdown in house price inflation. But the market continued to expect at least one more 25 basis point rate rise, perhaps two, in 2000. The fall in sterling, higher oil and commodity prices and the continued high *level* of average earnings growth lay behind these expectations.

49 Sterling's effective exchange rate had fallen by 7.7% since the previous MPC meeting, to below its level at the start of the year. Sterling had depreciated against both the dollar and the euro. Changes in UK interest rate expectations this month had not been

significantly different from those in the euro area and the United States, indicating that other factors lay behind the sharp movement in sterling. Economic prospects in the United States and euro area had remained strong, and the market may have regarded the level of sterling reached in early May as an aberration. There were also shorter-term factors cited by market participants. First, merger and acquisition flows had, on balance, been negative for sterling this month. Second, it appeared that some overseas investors may have had overweight positions in sterling and reduced them slightly. Third, technical and momentum traders may have accelerated the fall in sterling once the change in direction of the currency was clear, having previously accelerated the rise.

Treasury Chambers, Parliament Street, London, SW1P 3AG
020-7270 5000

25 May 2000

**Eddie George Esq
Governor
Bank of England
Threadneedle Street
London
EC2R 8AH**

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 beginning on the anniversary of the day the Act came into force. I last wrote to you on this matter on 18 May last year.

As you know, I re-confirmed the target of 2.5 per cent for RPIX inflation in this year's Budget. In accordance with the Act, I confirm that the MPC's remit remains unchanged. I attach a copy of the remit, as first set out in 1998 (after the Act came into force), 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 7 June 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

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

Minutes of the Monetary Policy Committee meeting on 5–6 July 2000

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

Demand and output

2 In the latest National Accounts, the level of real GDP at market prices had been revised up by 0.6% in 2000 Q1, with the GDP deflator lowered by almost as much. The revisions principally reflected higher figures for household consumption, following the Annual Retailing Inquiry. Most of the changes had been to growth in 1998; indeed real GDP in 1998 Q4 was now 0.8% higher than earlier estimated. The recent revisions showed quarterly growth peaking in 1999 Q3. The slowdown since then had been marginally more rapid than on the earlier data, but might not continue in Q2.

3 Upwards revisions to the level of GDP might imply greater pressure on capacity in the economy. However, since most of the changes dated back to 1998, and in the absence of other indications of such pressure, it was also possible that the economy's capacity for non-inflationary growth was higher than previously believed, or that the short-run trade-off between output and inflation was more favourable than indicated by previous data. In practice it was difficult to distinguish between these hypotheses. In accounting terms, measured productivity had improved in line with the increase in estimated output, with the rather puzzling slowdown a couple of years ago now less apparent. Whether this suggested any improvement in trend productivity growth which could be extrapolated into the future was unclear.

4 Estimates for GDP growth in 2000 Q1 were unchanged, at 0.5% on the quarter, with final domestic demand now thought to have grown by only 0.1%, or by 2.8% on a year earlier, compared with 4.6% in the year to 1999 Q4. Quarterly growth in household consumption was still put at 0.6% in Q1, having been revised up in the previous quarter from 1.1% to 1.5%. The household saving ratio, at 3.8% in Q1, was now at its lowest level since 1988 Q3. Investment had been revised down sharply, to show a fall of more than 1% in Q1. The latest figures for net trade continued to suggest a positive contribution to growth in Q1, despite the strength of the exchange rate, while government consumption was now estimated to have fallen by 0.6%.

5 The fallback in investment was puzzling, although investment was an inherently volatile series, representing as it did the rate of change in the capital stock. Government and business investment had both fallen in Q1, in particular in transport equipment, although manufacturing investment had risen somewhat for the second quarter in succession after a long period of decline. It was possible that the path of business investment in recent quarters had been influenced by a clustering of projects ahead of the new millennium. On the one hand, the share of investment in GDP had been abnormally high and might revert to more normal levels, especially given the continuing squeeze on margins and low profitability in some sectors. On the other hand, it was noted that the high share of investment might persist if, for example, the relative price of some capital goods—for instance information technology—continued to fall.

6 Stockbuilding had been rather faster than expected in 2000 Q1, but the National Accounts estimates suggested it had fallen in manufacturing, in contrast to the results of a survey by the Bank's regional Agents. The picture was therefore confused, but in any case stockbuilding was a volatile series which was particularly prone to revision. In Q1 it also included a large (and negative)

alignment adjustment, and it would be unwise to put too much weight on the data yet.

7 The net trade picture remained puzzling, although export volume growth appeared to reflect the strength of demand in overseas markets. On the basis of data currently available, however, net trade seemed unlikely to make a positive contribution to GDP growth in 2000 Q2.

8 Preliminary indicators for final domestic demand in Q2 suggested rather moderate growth, if not as low as in the previous quarter. Retail sales volumes in May had risen by less than expected and were now $3\frac{1}{2}\%$ up on a year earlier, compared with 6.3% in January, when the pattern of spending might have been distorted by millennium-related effects. The CBI Distributive Trades Survey showed the balance on retail sales volumes falling from +45 in May to +15 in June, which was below its long-run average for the first time since October 1999. Consumer confidence, as measured by the GfK survey, had also fallen back, although this might well reflect seasonal factors.

9 Recent movement in asset prices might also lead to some moderation in consumption growth. In particular, most indices of house prices had decelerated by more than had been expected, with little if any increase in prices reported in the most recent months. The preliminary survey balance for house prices produced by the Royal Institute of Chartered Surveyors (RICS) had fallen, on the basis of a 90% sample, from +26 in May to single figures in June, having been at +61 as recently as March. There were some signs that housing activity might be slowing, with the House Builders' Federation reporting that net reservations and site visits had fallen in May, in the latter case to the lowest level since August 1995.

10 Survey data for manufacturing output suggested a further slowing in growth. The Chartered Institute of Purchasing and Supply (CIPS) survey had fallen to just above the 'no change' 50 level, and the output expectations balance was slightly lower in the June CBI survey. The Engineering Employers' Federation had reported a sharp fall in its output survey, with signs that growth was slowing in parts of the 'new' economy. Nevertheless, manufacturing and industrial production data from the Office for National Statistics had been stronger than expected in May, with manufacturing output up 0.4% on the month, and with energy output falling less than expected after April's strong rise. Both series were around 2% higher than a year earlier, despite sterling's strength over that period.

11 There were some signs that growth might be moderating elsewhere in the economy, with the business activity index in the CIPS services survey having fallen, as had the CIPS new orders index for construction, although both remained well above the 50 level. The CBI/PriceWaterhouseCoopers measure of optimism in financial services was down sharply, from +36 in March to -6 in June. There were also reports from the Bank's regional Agents of a slowdown in business travel and road haulage, although financial services, IT and telecommunications remained robust.

12 Public spending seemed likely to support growth over the medium term. The Treasury representative said that the government's three-year spending review would be concluded later in July, and the Committee would be briefed in detail on its contents ahead of its August meeting. At this point it was clear that current spending would grow within the $2\frac{1}{2}\%$ envelope, and capital spending would rise to 1.8% of GDP as announced in the Budget. There would be a switch away from Annually Managed Expenditure (reflecting lower unemployment and debt interest

payments, as a result of lower market interest rates and the decision to use the mobile phone spectrum auction proceeds to reduce debt) and towards spending subject to Departmental Expenditure Limits. It was unclear how quickly, and to what extent, departmental underspends from earlier years would be reversed, which would slightly change the path of total spending within the Budget envelope.

13 The Committee agreed that some slowing in domestic demand growth had been required; earlier rates had been unsustainable, especially since net trade could not continue to act as a drag on GDP growth for the indefinite future. Prospects for external demand now seemed rather stronger than they had at the time of the *May Inflation Report*, following the fall in sterling, and so the question was whether domestic demand growth would fall back faster than had been assumed in the *Report*. To date, the evidence of a slowdown in the underlying growth of consumption appeared more compelling than for investment, where the Q1 data might have been erratic.

The labour market

14 The Committee discussed the recent surprisingly benign labour market data. According to the Labour Force Survey (LFS), employment had increased by around 110,000 in the three months to April compared with the previous three months (although the increase was less in full-time equivalent terms, at around 60,000). Over the same period, LFS unemployment had fallen by 0.2 percentage points to 5.7%; the claimant count measure was also lower. But despite this evidence of an apparently tightening labour market, the Average Earnings Index (AEI) showed earnings growth falling sharply, from 5.7% to 5.1% on the three-month 'headline' basis, and from 5.2% in the year to March to 4.4% in the year to April.

15 Much of the rise in employment was reflected in a reduction in the numbers of the long-term unemployed and a decline in the inactivity rate. Since 1995 short-term unemployment rates had fallen from around 5% to 4%, while long-run unemployment had declined from nearly 4% to around 1½%. This might suggest that the various labour market reforms over this period had increased the supply of those available for work, allowing rather faster employment growth for any given rate of wage inflation. If this pool of labour should become depleted, however, and the short-run unemployment rate dropped steeply, there might be increased pressure on earnings growth. More generally, although changes in employment tended to lag changes in output, the present strength of employment did not suggest that employers expected a sharp slowdown in the economy.

16 Not all of the quantity indicators for the labour market pointed in the same direction. The Workforce Jobs measure of employment had fallen in Q1, but this was a more volatile series, and was based on a single day's sample. Total hours worked had risen in April, but over the past two years average hours worked had fallen by around 2% for those in full-time employment, pushing up estimates of the growth in productivity and pay per hour relative to the 'per head' measures.

17 The Bank's regional Agents reported little change in skill shortages over the past month, although these remained a concern to many employers. The Recruitment and Employment Confederation suggested that these shortages had intensified in June, but the NatWest SBRT quarterly Small Business Survey indicated an easing over the past two quarters, albeit from rather high levels, and other surveys suggested a largely unchanged picture.

18 The AEI data showed an unexpectedly sharp slowing in earnings growth in April. In part this was due to bonus payments, which had reduced earnings by 0.2 percentage points in the year to April, but growth in regular pay had also slowed, from 5.1% in the year to February to 4.4% in April. The most recent data were

consistent with the view that the pick-up in earnings around the end of the year might have been even more influenced by bonuses and millennium-related payments than had been thought at the time. The Committee had noted at its previous meetings that the rise in earnings around the year-end might well reflect temporary factors, and therefore needed to be treated with caution; so too did the latest figures. While there seemed to be some news in the recent data, which were lower than assumed in the *May Inflation Report* for 2000 Q1, and in all likelihood for Q2, the *Report* had assumed that earnings growth would fall back quickly and have little impact on inflation two years out. Looking back over the past two years, there now appeared to have been two peaks in earnings growth which had since been reversed, giving a rather flatter picture for underlying earnings growth than the steady increase seen from 1995 to 1998.

19 As usual, there were relatively few new pay settlements in May. There continued to be reports that the pay round this year might be more difficult with RPIX and, more particularly, RPI increasing more rapidly than last year, and the labour market remaining tight. But as yet there was little evidence of this in the twelve-month numbers, although on a three-month basis settlements were no longer below 3%.

20 Productivity growth per head based on the Workforce Jobs numbers was now somewhat above its previous trend, at 2.2%, with unit labour costs growing at just below 3%. But using LFS employment figures, growth in productivity per head was lower, at 1.7%. The share of labour in national income had continued to rise, although this seemed to be flattening off a little and had not yet reached its early 1990s peak.

Monetary and financial conditions

21 Notes and coin had grown by 7½% in the year to June, with growth now clearly below the underlying 8%–9% range seen since November 1999. The three-month annualised rate was a little lower, at just below 7%. Such a slowdown in narrow money growth could be consistent with a moderation in nominal retail sales growth.

22 A rather different picture emerged from the figures for M4 lending. While household M4 had been weak in May, M4 lending to households had continued to grow by around 10% on a year earlier. Growth in both secured and unsecured borrowing had increased, with the number of mortgage approvals also higher over the month. As a result of the new set of National Accounts, estimates of mortgage equity withdrawal had been revised up to £2.3 billion in Q1, but total lending for consumption, which included unsecured lending as well as mortgage equity withdrawal, had nevertheless slowed since the second half of 1999.

23 Although there had been no further acceleration in household borrowing over the past few months, its continuing strength raised doubts about the extent of the slowdown in consumption. The financial balance for households was now in deficit, and at its lowest levels since the late 1980s; gearing measures were, however, rather low, with income gearing reflecting relatively low interest rates and capital gearing the sharp increase in wealth in recent years. While household borrowing might increase if the economy slowed suddenly, this would usually be in response to higher unemployment; 'distress borrowing' of this type did not seem to be significant at present. It was possible that some borrowing might have been on the basis of expected increases in wealth, either in equities or (more especially) housing, which might not now materialise; surveys on house prices and housing market activity increasingly suggested that the peak in growth had now passed.

24 The Committee noted that since February, when it had last raised the repo rate, fixed-rate yields had fallen by around 50 basis points at five years, although longer yields, particularly on

corporate paper, had moved by less. Similarly, while the repo rate had increased by 100 basis points since last August, rates on retail borrowing and deposits had typically risen much less. For mortgages, however, the standard variable rate had risen by almost as much as the repo rate.

25 M4 lending to the private non-financial sector had also picked up in May, although much of this was to finance mobile phone spectrum auction payments. Some members noted that part of the borrowing might reflect pressures within the corporate sector, with evidence of greater dispersion than usual in company profitability and capital gearing, as set out in the June issue of the Bank's *Financial Stability Review*. The numbers needed to be looked at carefully; for instance where intangible assets were important, capital gearing measured on a market-value basis might be very different from that on a replacement-cost measure. To the extent that the differences in profitability reflected greater competition, and resources from less successful companies were absorbed by those which were more successful, the macroeconomic effects over the medium term should not be damaging. But over the shorter term there was a risk of greater fragility than was apparent from data for the corporate sector as a whole. While there was little sign yet of widespread corporate distress, the combination of heavy borrowing with low investment in the aggregate figures remained a puzzle.

26 Sterling's exchange rate index had moved very little over the past month after its sharp fall in May, which had taken it back to its levels of early November 1999. Sterling remained relatively strong against the euro, but by recent standards was rather weak against the dollar. The exchange rate index—at around 105—was now close to its average over the past three years, but remained well above the levels of 1993–96.

27 Implied interest rates from forward curves suggested that the market expected higher official rates in the euro area, the United States and Japan later in 2000. Official rates were now lower in the United Kingdom than the United States; this had not been the case for any length of time since 1984. If rate expectations overseas changed *vis-à-vis* the United Kingdom, this might lead to further movements in sterling. It was also possible that a sharp move in the euro against the dollar would itself influence sterling's exchange rate index, with the size of the effect depending on how far sterling followed the dollar as opposed to the euro, and on the relative weightings of the dollar and the euro in the index.

28 The Committee noted that sterling's exchange rate index was based on trade in manufactures, and that the euro had a weight in it four times that of the dollar. To some, this seemed somewhat overstated. Much of UK trade which was not invoiced in sterling was invoiced in dollars, and this might have some effect on import prices, if only in the short term. Earlier work by Bank staff had suggested that altering the weights to take account, for instance, of trade in services did not make a great difference to the index. The Committee agreed to look at these calculations again in the coming months.

29 The impact of the lower exchange rate on RPIX depended in part on how much of the earlier appreciation had fed through into import and retail prices, and on how far this differed from the assumptions made in the *May Inflation Report*. To the extent that the market had correctly anticipated that the earlier rise in the exchange rate would be reversed rapidly, the feedthrough into prices might be less than otherwise. That said, non-oil commodity prices had risen sharply in sterling terms in May.

The international environment

30 There was some evidence that the US economy was beginning to slow, on the basis of the non-farm payrolls data, retail

sales and industrial confidence, as measured by the National Association of Purchasing Managers. Such a slowdown had long been expected, but growth in the United States seemed likely to remain relatively robust by historical standards, with core CPI inflation so far remaining subdued. The recovery in the euro area also appeared to be on track, with private sector forecasters now expecting growth of around 3¼% this year, with the harmonised index of consumer prices rising by close to 2%.

31 In Japan the Tankan survey had been, if anything, a little stronger than expected, with much speculation about when the zero interest rate policy might end. While a change in monetary policy, in Japan as elsewhere, inevitably brought with it the risks that markets would extrapolate any move unduly and hence react in an exaggerated fashion, the move when it came was unlikely to be a surprise. In any case, the direct effects on the United Kingdom would probably not be large, and would depend on the reaction of the yen to any change in interest rates.

32 Among the emerging market economies there were signs that growth in industrial production had peaked, after a rapid recovery in several of these countries, but the level of output remained well above that of a year earlier.

Prices and costs

33 The oil price had stayed higher for longer than assumed in the *May Inflation Report*, averaging around \$27 per barrel in 2000 Q2, as against just over \$23 per barrel assumed in May. To the extent that the proceeds from higher oil prices were not spent by the producers, or by governments which enjoyed higher oil-related tax revenues, this would reduce demand, in a similar way to an increase in indirect taxes.

34 The direct impact on RPIX was more obvious, with higher petrol prices contributing 0.5 percentage points to the annual inflation rate in May. While the outlook for oil prices remained uncertain, it was possible that recent announcements of increased production would lead to a fall in prices, although perhaps not to the levels assumed in the *May Inflation Report*.

35 To the extent that higher oil prices had already fed through into retail prices, or would do so shortly, the effect might be to raise the short-term profile of RPIX inflation closer to target, while reducing pressure on prices further ahead. This might be more likely if the rise in oil prices indeed proved short-lived, although it was possible that there would nevertheless be second-round effects from higher oil prices, in which case the effects would be less benign.

36 RPIX had risen by 2.0% in the year to May. This included upwards effects from higher oil prices and house price inflation, and dampening effects from lower utilities prices and the exchange rate. Some members noted that some measures of core inflation were below actual inflation, suggesting that inflation would fall for a time. For example, the twelve-month change in RPIX excluding food, drink, tobacco, petroleum and other energy products had now fallen to 1.7%. But it was unclear how much information about the prospects for inflation could be gleaned from such a disaggregation; the aggregate price level should not be affected in the medium term by relative shifts in its components.

37 There was some evidence from the CBI Distributive Trades survey that downward pressures on retail prices had intensified, with the balance in 2000 Q2 at -6, as against +18 in 1999 Q2. By contrast, surveys of manufacturing and services prices by the British Chambers of Commerce suggested that output price pressures were much stronger in 2000 Q1 than in 1999 Q2. It remained to be seen whether this pressure on margins would be sustained.

38 As a result of higher oil prices and a weaker exchange rate, the Committee agreed that inflation over the rest of this year might move closer to the 2½% target than had seemed likely at the time of the *May Inflation Report*. If inflation over the medium term were likely to be above its target, rather higher inflation now might mean that the Committee had less time to wait before it needed to raise rates. But it was unclear whether the risks to inflation over the medium term were on the upside, or indeed whether higher-than-expected retail prices in the short term had significant implications for inflation further ahead.

Tactical considerations

39 The Committee noted that there was very little expectation in the market of a change in the repo rate this month, and that neither the FOMC nor the European Central Bank was expected to move rates in the immediate future. Against that background, there was a risk that any change in UK rates would lead to a larger movement in interest rate expectations than would be warranted, with a corresponding effect on the exchange rate. While this might be a reason for leaving rates at 6%, it did not of itself preclude a change in rates this month if there were good reasons to move in terms of the outlook for inflation. As always, if rates were to be changed unexpectedly, it would be necessary to set out clearly the reasons for the Committee's decision.

40 The Committee agreed that it was difficult to calibrate the effects of the recent slowdown in domestic demand on inflation prospects over the medium term. By comparison some felt that the effects of the weaker exchange rate and lower-than-expected average earnings would be easier to calibrate, although even in these cases it would be necessary to re-examine some of the assumptions made about the pass-through into prices over the medium term. The forthcoming forecast round provided an opportunity to assess the relative impacts of these developments in some detail, and the August *Inflation Report* a means of explaining how this analysis had influenced the views of the Committee.

The immediate policy decision

41 The Committee agreed that the news on the month was weaker than expected, with signs of a slowdown in domestic demand, for instance in retail sales and the housing market, and lower-than-expected, although possibly erratic, average earnings numbers. The question for some was rather whether the news in the two months since the *May Inflation Report* warranted an increase in interest rates to keep prospective inflation in line with the target over the medium term.

42 Various arguments were advanced by members for leaving the repo rate unchanged at 6% this month. Many of the determinants of consumption (such as house prices and earnings) appeared to be slowing, while the buoyant borrowing figures for households and corporates, although they needed to be watched carefully, might not in the short run be a reliable guide to consumption or investment. Upwards revisions to the level of GDP, for a given rate of inflation, suggested to some members that the disinflationary forces in the economy might be rather greater than previously supposed. The slowdown in the housing market appeared broadly based, being reflected not just in the house price indices, but also in the more forward-looking RICS survey and in measures of activity at the start of the housing chain, such as site visits and net reservations. The average earnings figures were much lower than expected, even allowing for the erratic nature of the series, with little sign yet of much of an increase in pay settlements during a period in which they had been expected to come under upward pressure.

43 So far as external influences were concerned, if oil prices fell from their recent peaks, this would, other things being equal, reduce inflation in the short term. The fall in the exchange rate since May would tend to increase inflation, but to the extent that it represented a rather rapid reversal of a short-run spike it might have less of an

effect, while the long-term negative impact on investment decisions of sterling's appreciation since 1996 may not yet have been fully felt. It also appeared to some that the current monetary policy stance was slightly contractionary and that this might no longer be appropriate; with nominal rates at 6%, given most current measures of inflationary expectations, real interest rates were 3½% or more. With little expectation of an immediate move in rates either here or in the UK's major trading partners, it was best to leave the repo rate unchanged at 6% this month.

44 For some other members, given the news since May, while there was no need to raise the repo rate this month, it might be necessary to raise rates later to keep prospective inflation on track. While there was some evidence of a slowdown in the growth of domestic demand and average earnings, the latter series remained erratic. Little weight had been placed on the acceleration in the AEI in previous months, and little should be placed on its deceleration; the labour market remained tight and, if anything, pay settlements were creeping up. The fall in investment was puzzling, especially given heavy borrowing by the corporate sector, and might prove temporary. Borrowing by households remained strong, which did not seem consistent with a sharp fall in consumption; nor did the recent pick-up in the growth of employment. Much of the apparent slowdown in domestic demand might represent an unwinding of end-year effects, which now appeared to have boosted retail sales, average earnings and investment, if only temporarily, by more than had previously been thought. Looking forward, given the likely increases in public spending over the next two years, private sector spending needed to slow further if the inflation target were to be met.

45 The exchange rate had not fallen any further over the past month, but was 5% lower than in the *Inflation Report*. This provided some much-needed relief for the externally-exposed sectors, and with it the prospect of a better-balanced economy but, taken by itself, it added to pressures on inflation in the medium term. As a result, for these members it was important that measures of domestic inflationary pressures fell back from their present levels of around 3% for the inflation target to be met. While it now seemed rather more likely that domestic demand growth would slow, it was less clear that this would be by more than assumed in the *May Inflation Report*, as it needed to be given the improved prospects for net trade. The August *Inflation Report* provided an opportunity to assess the extent of the slowdown in domestic demand (and the weakness of consumption and investment in relation to their underlying determinants) and weigh this against the effects of higher oil prices and lower sterling. While the position might have been more comfortable if rates had been raised a little higher earlier it was now best to wait until August for more news, and analysis, in the context of the *Inflation Report*. For these members too, the repo rate should stay at 6% this month.

46 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. The Committee voted unanimously in favour of the proposition.

47 The Committee congratulated the Governor on his being made a Knight Grand Cross of the British Empire in the Birthday Honours List.

48 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
 Christopher Allsopp
 DeAnne Julius
 Stephen Nickell
 Ian Plenderleith
 John Vickers
 Sushil Wadhvani

49 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 Bank staff to the Monetary Policy Committee on 30 June in advance of its meeting on 5–6 July 2000. 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 this Annex.

I The international environment

2 Evidence of a slowdown in US domestic demand growth remained inconclusive. Industrial production in May had risen by 0.4% on the previous month, and by 5.8% on a year earlier. But industrial confidence, as measured by the National Association of Purchasing Managers' index, had fallen to 51.8 in June from 53.2 in May. New house building permits had fallen by 9% in the year to May, and the Federal Reserve Senior Loan Officer Survey had indicated a tightening in lending standards. Consumer confidence had fallen, from 144.7 in May to 138.8 in June, but had remained at a historically high level. Real consumption had risen by 0.2% in the month to May, but nominal retail sales had fallen by 0.3%—the second consecutive monthly fall. GDP growth had slowed in Q2 in each of the two previous years. Some commentators had suggested that this might reflect an emerging seasonal effect from higher income tax payments. But an expenditure breakdown gave little support to this hypothesis. Private non-farm payrolls had fallen by 126,000 in May, but total payrolls had risen by 231,000, partly reflecting extra employment by the national census authorities. Annual consumer price inflation had been 3.1% in May.

3 Euro-area GDP had increased by 0.7% in Q1, according to the first estimate. Consumption had been flat on the quarter, somewhat weaker than confidence surveys and the improving labour market might have suggested. Consumer confidence had fallen by two percentage points in June, though it remained high by historical standards, and industrial confidence had risen by four percentage points. Industrial production had risen by 0.7% in April. The unemployment rate had remained unchanged in May. Import and export trade volumes in the euro area had continued to increase strongly in Q1. HICP inflation had remained at 1.9% in May, and core inflation had not increased. Hourly nominal labour costs in Q1 had been 3.5% higher than a year earlier.

4 Japanese GDP had increased by 2.4% in Q1, driven by net trade and private investment, after two consecutive quarters of negative growth. Corporate profits—a leading indicator of future investment—had risen by 38% on a year earlier. Retail sales had declined by 2.4% in the year to May, while employees' wages had risen by 0.5% in the same period. Consumer prices had declined by 0.7% in the year to May. The Tankan survey results had been better than expected, confirming that the corporate sector was healthy. Business conditions had continued to improve, though concerns had remained for some sectors, particularly small non-manufacturing firms.

5 One-month and six-month Brent oil price futures had increased in June to an average of \$29.55 per barrel and \$26.33 per barrel respectively, from \$27.41 per barrel and \$25.12 per barrel in May. Stocks of oil and petroleum were lower than average.

6 Since the previous MPC meeting the S&P 500 index had fallen by 0.6%, and the DJ Euro Stoxx index had fallen by 2.5%. By contrast, the Nikkei 225 had increased by 1.5% and the NASDAQ Composite had risen by 1.7%. Policy interest rates implied by futures contracts in the United States had decreased for July and August, but had risen for the period after October. Implied policy rates in the euro area had fallen.

II Monetary and financial conditions

7 The twelve-month growth rate of notes and coin had fallen from 7.9% in May to 7.5% in June. The three-month annualised rate had been lower still, at 6.9%.

8 M4 had increased by £5.4 billion (0.7%) in May, raising the twelve-month growth rate to 5.0%. But the pick-up in growth had been mostly driven by other financial corporations (OFCs). Annual growth in M4 excluding OFCs had softened in May.

9 By comparison, aggregate M4 lending (excluding the effects of securitisations) had been very strong in May, increasing by £15.4 billion (1.5%) on the month, and raising the twelve-month growth rate to 12.1%, its highest since February 1991. The rise had partly reflected strong borrowing by OFCs. But borrowing by private non-financial corporations (PNFCs) had also risen further, and household borrowing had rebounded.

10 Household M4 had been weak in May. Although recent outturns had been erratic, there were now fairly clear signs of slower growth since the start of the year in a range of household money measures, including notes and coin, retail M4, households' M4 and households' Divisia.

11 M4 lending to households (excluding securitisations) had bounced back in May, though the annual growth rate had remained broadly stable at around 10%. Both secured lending and mortgage loan approvals had rebounded after a weaker April, perhaps reflecting the relatively low number of working days in April. Total unsecured lending had also been relatively strong in May, driven by a sharp rise in net credit card borrowing. But credit card borrowing could be volatile month to month, and other types of unsecured lending had been slightly weaker. A broader measure of total lending for consumption, which included mortgage equity withdrawal (MEW), was still estimated to have fallen in 2000 Q1 compared with the second half of 1999, though the Bank's staff estimate of Q1 MEW had been revised up, from £1.8 billion to £2.3 billion, following the National Accounts release.

12 Total external finance raised by PNFCs had been strong again in May, increasing by £7.4 billion on the month. Some £4 billion of the £4.7 billion rise in bank borrowing had been publicly identified as reflecting finance for 3G licence payments. PNFCs' deposits had also risen in May by £2.5 billion, partly offsetting the impact of stronger gross borrowing on firms' net recourse to banks. The latest National Accounts had suggested that PNFCs' net financial deficit had been broadly unchanged in Q1, though strong subsequent borrowing might suggest a higher deficit in Q2.

13 Annual growth rates of OFCs' M4 and M4 lending had risen in May, to 4.6% and 16.5% respectively.

14 Since the previous MPC meeting, interest rate expectations, as measured by the two-week gilt repo curve, had fallen a little at the short end. Longer nominal interest rates had risen only slightly. The term structure of corporate yields had also flattened. Retail rates had been little changed in June, though two-year fixed-rate mortgage rates had returned to April levels after a small fall in May.

15 One-year inflation expectations from the Consensus survey had risen from 2.2% in March to 2.4% in June. There had been a slight easing in survey-based real rates in the latest quarter, a period in which the official repo rate had remained fixed.

16 The FTSE All-Share index had fallen by 1.7% since the previous MPC meeting, although the Small Cap index had risen by 3.1%. The IT sector and non-cyclical services (mainly telecommunications) had fallen by around 11% and 8% respectively over the same period.

17 Since the previous MPC meeting, the sterling ERI had been little changed. Despite the depreciation in May, longer-term Consensus forecasts suggested that the expected value of the sterling ERI six years out had been little changed since February, though the expected sterling/dollar rate was now somewhat lower, and the sterling/euro rate somewhat higher, than before.

III Demand and output

18 The National Accounts, published on 29 June, had included revisions to GDP and its components, the cumulative impact of which had been to increase the estimated level of GDP at market prices in 2000 Q1 by 0.6%. Most of the upward revisions had been to 1998 growth, reflecting higher estimates of consumption as a result of the latest Annual Retailing Inquiry. Annual GDP growth in 1998 had been revised up to 2.6% from 2.2%, and the level of household consumption in 2000 Q1 had been revised up by 1.7%, reflecting the cumulative effect of revisions to growth rates in previous periods. GDP growth in 1999 had remained unchanged at 2.1%. Revisions to nominal GDP had been smaller than those for real GDP.

19 Revisions to the income measure of GDP had been relatively small. Estimates of employees' compensation had been revised downward, particularly in 1998, while gross operating surpluses had been revised up. Due to the relatively larger upward revisions to nominal consumption, there had been a marked downward revision to the household sector saving ratio. Turning to the output measure of GDP, the level of manufacturing output had been revised up in 1998 by 0.2%, and the level of services output had been revised up by 0.5%. But there had been very little change to the pattern of growth through 1999. The unusually large discrepancy between the output and expenditure measures of GDP in 2000 Q1, seen in the earlier estimate, had been revised down.

20 Estimated GDP growth in 2000 Q1 had been unrevised at 0.5%. The overall pattern of expenditure in recent quarters had remained broadly intact, although domestic demand had been revised down slightly in Q1, from 0.4% to 0.2%. Final domestic demand growth had also been revised down, and was now shown to have been broadly flat between Q4 and Q1. Household consumption growth had remained unchanged in Q1 at 0.6%, but growth in investment and government consumption had both been revised downward. The new government consumption profile was also flatter through 1999. The contribution to GDP growth from net trade in Q1 had been fractionally weaker than previously estimated, while that from stockbuilding had been slightly stronger.

21 Turning to indicators of Q2 activity, overall industrial production had increased by 0.1% in May. Manufacturing output had risen by 0.4%, but had been mostly offset by a decline in energy output, which had unwound following particularly strong growth in April. But recent survey evidence had suggested a continuation of weaker manufacturing output in coming months. The manufacturing output expectations balance in the Confederation of British Industry (CBI) Monthly Trends survey had fallen slightly further, to -7 in June from -6 in May. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey output index had fallen to 50.5 in June from 50.9 in May, and the June Engineering Employers' Federation (EEF) manufacturing output balance had fallen to -2, from +8 in March.

22 In the services sector, retail sales volumes had risen by 0.4% in May, but annual growth had slowed considerably, to 3.6% from 4.7%. Looking ahead, the CBI Distributive Trades survey had shown a considerable slowing in reported annual retail sales growth

in June, with the total balance falling to +15, from +45 in May. The GfK confidence index had eased to +0.1 in June from +2.7 in May. Private new car registrations in the three months to May had fallen by 2.1% on a year earlier, while total new registrations had increased by 4.8%. There had also been some indications of slowing activity in other areas of the services sector. The CBI/PriceWaterhouseCoopers financial services optimism balance had fallen to -6 in June, from +36 in March.

23 Earlier evidence of a slowdown in house price inflation had been confirmed. Although the Nationwide price index had risen by 0.4% in June, annual growth had continued to ease to 15.1%. Annual growth in the Halifax house price index had also slowed in June, to 9.2% from 11.2% in May. The Royal Institute of Chartered Surveyors (RICS) survey balance for house price inflation had fallen to +26 in May from +37 in April, and the House Builders' Federation (HBF) inflation balance had fallen from +33 to +21. Indicators of housing activity growth had also shown a further slowdown. The HBF site visits and net reservations balances had fallen in May—site visits to their lowest level in almost five years.

IV Labour market

24 According to the Labour Force Survey (LFS), there had been an increase in employment of 112,000 (0.4%) in the three months to April, following growth of 82,000 (0.3%) in the previous three months. The rise in the three months to April had been the largest since September 1998. Workforce Jobs—a more volatile series, sampled on a single day in each quarter—had fallen by 35,000 in Q1, largely accounted for by a decline in service sector jobs of 52,000. As in the previous two months, most of the increase in LFS employment had been in part-time employment, which had risen by 92,000 (1.3%). Full-time employment had grown by 20,000. As a result, although employment growth in full-time equivalent terms had picked up, it continued to be much slower than growth in the number of those employed.

25 The strong growth in employment had contributed to the 0.3% rise in total hours worked in the three months to April. Average working hours had declined slightly, largely accounted for by lower average hours worked by people in second jobs.

26 CIPS survey measures of employment growth had been little changed in June. The surveys had indicated that employment growth in construction and services had slowed slightly, while manufacturing employment had declined at a slightly faster rate than in previous months. The Recruitment and Employment Confederation (REC) survey had indicated that shortages of both temporary and permanent staff had intensified in June, but the Bank's regional Agents had reported little change in overall skill shortages. The CBI/Deloitte & Touche Service Sector survey and the CBI/PriceWaterhouseCoopers Financial Services Survey had also suggested a largely unchanged picture.

27 New vacancies notified to Jobcentres and Jobcentre placings had both fallen sharply in May. However, this had been affected by three closely spaced public holidays in the accounting period, as well as a change in the criteria for including a notified vacancy in the official figures. The underlying falls were probably much smaller.

28 Unemployment had continued to fall on both the LFS and claimant count measures. LFS unemployment had fallen by 60,000, and the unemployment rate by 0.2 percentage points, in the three months to April compared with the previous three months. Claimant count unemployment had fallen by 8,600 in May from the previous month, leaving the rate unchanged at 3.9%. As in Q1, the fall in LFS unemployment had been largely accounted for by lower long-term unemployment. Dispersion of unemployment across regions had risen slightly in Q1, but county-level dispersion had continued to decline.

29 Inactivity had fallen by 15,000 in the three months to April compared with the previous three months, reflecting a 24,000 decline in female inactivity. Male inactivity had risen by 8,000.

30 Headline earnings growth, as measured by the Average Earnings Index (AEI), had declined sharply in most sectors. Whole-economy headline earnings growth had fallen by 0.6 percentage points in April to 5.1%, with the private sector accounting for all of this decrease (down by 0.8 percentage points to 5.3%). Within the private sector, headline earnings growth had fallen in both private services and manufacturing, to 5.6% and 4.3% respectively. Headline public sector earnings growth had risen by 0.1 percentage points to 4.3%.

31 Actual earnings growth had declined by 0.8 percentage points to 4.4% in the twelve months to April. The private sector had accounted for all of this decrease (down by 0.8 percentage points to 4.4%): public sector earnings growth had risen by 0.9 percentage points to 4.7%. Growth in regular pay, ie, excluding bonuses, had fallen to 4.4% in April from 4.7% in March (not seasonally adjusted). Bonuses had reduced earnings growth by 0.2 percentage points in April (not seasonally adjusted), compared with a positive contribution of 0.9 percentage points in March. The Bank's estimate of growth in earnings per hour had also fallen back, to below 6% in April, with the increase in average hours narrowing the gap between heads and hours-based measures.

32 The REC survey had indicated a pick-up in the rate of growth of permanent agency placement salaries in June. Growth rates for temporary staff had also increased.

33 The growth of wages and salaries per head, calculated from the National Accounts, had increased slightly to 5.2% in Q1, broadly in line with the AEI over the period. But the growth rate of unit wage costs had fallen slightly, reflecting the offsetting influence of whole-economy productivity growth, which had been 2.2% in Q1. The broad trend of the labour share of national income had continued upwards, though it had yet to reach the early-1990s peak.

34 As was usual for this time of the year, there had been little new information on settlements. The Bank's AEI-weighted twelve-month mean was flat at 3.1% in May. The public and private sector means were also unchanged.

V Prices

35 The Bank oil-inclusive commodity price index had risen by 6.4% in May, the second largest monthly rise since the start of the series in 1990. This had taken the annual inflation rate from 8.9% up to 16.4%. The increase had reflected large rises in the prices of all the components of the index except domestic food. The fuels component of the index had risen by 12%, largely accounted for by the rise of more than 20% in the sterling oil price in May. The sterling oil price had risen by a further 8% in June. The Bank oil-exclusive commodity price index had risen by 2.2% in May, and by 3.1% over the past year.

36 Manufacturing input prices had risen by 3.6% in May, taking the annual inflation rate from 7.9% to 12.9%. The large monthly rise had mainly reflected the sharp increase in the price of oil in May, though there had also been rises in the prices of metals and of imported materials. Input prices excluding food, drink, tobacco and petroleum had risen by 0.7% in May, taking the annual rate of inflation to 4.0%, its highest since November 1995. The CIPS manufacturing survey input price index had risen to 61.4 in June, up from 59.7 in the previous month. Output prices excluding excise duties (PIY) had risen by 0.2% in May, taking the annual inflation rate to 1.7%, slightly up from 1.6% in April. The output price balance in the June CBI Industrial Trends survey had risen slightly, to -18 from -21 in May.

37 The prices of imported and exported goods had risen by 0.4% and 0.8% respectively in the three months to April compared with the previous three months. Excluding oil, the price of imported goods had risen by 0.2%, while the price of exported goods had fallen by 0.1% over the same period.

38 Annual inflation in the GDP deflator at market prices in 2000 Q1 had remained unrevised at 2.7%. But there had been revisions to the components. The annual inflation rates of the investment and government consumption deflators had been revised upwards in 2000 Q1, offset by downward revisions to the annual inflation rate of the household consumption deflator.

39 RPIX inflation had risen to 2.0% in May, up from 1.9% in the previous month. This had largely reflected higher contributions from non-seasonal food prices, car prices and housing depreciation. RPI inflation had risen from 3.0% to 3.1% in May. RPIY inflation had risen to 1.7% in May from 1.6%, while HICP inflation had fallen from 0.6% to 0.5% in May. The difference between RPIX and HICP inflation had widened to 1.5 percentage points.

VI Reports by the Bank's Agents

40 The Bank's regional Agents had reported that growth in manufacturing output had eased further, although high-technology sectors remained strong. It was still too early for the depreciation of sterling to be seen in higher orders. Construction growth had slowed, mostly accounted for by weaker residential construction. There were signs that service sector growth had peaked. The financial services and IT sectors had remained strong, but business travel and in particular UK tourism, had been weaker. Agents' contacts had reported a more modest easing in annual retail sales growth than the official figures. New car sales were reported to be weaker after earlier stock clearances.

41 The pass-through from the higher oil price to related products had been more evident recently. Downward pressure on manufacturers' domestic output prices had continued, although there were some signs of the fall in export prices easing and more firms were expecting to raise prices in the second half of the year. The recent depreciation of the exchange rate was not yet reported to have been passed through into retail prices. The level of house prices was reported to have peaked in some areas, though there was concern from some contacts that these levels remained too high. There had been little change in the profile of employment, and skill shortages had been broadly unchanged. Pay pressures in manufacturing had remained relatively muted but pressures in the service sector had strengthened.

42 The Bank's regional Agents had conducted a survey of UK firms regarding stockbuilding in 2000 Q1. A net balance of about a fifth of firms reported that their stock levels had risen in Q1. At a sectoral level, the balance was highest in the manufacturing and motor trade industries. The majority of stockbuilding was reported to be voluntary across most sectors. Stocks in Q2 were expected to be broadly unchanged from Q1 levels.

VII Market intelligence

43 Market participants were not expecting a change in the Bank's repo rate at the July MPC meeting. Two-week forward rates going out to spring 2003 derived from the gilt market had fallen by up to 20 basis points since the June MPC meeting. Furthermore, short-term interest rate volatility had declined, perhaps reflecting increased market confidence about the level at which interest rates would peak. Expectations derived from the latest Reuters poll of private sector economists, together with rates implied by both short-sterling futures and overnight interest rate swaps, all suggested little expectation of a rise in interest rates in July. The expected peak in the Bank repo rate had fallen slightly

over the month, to around 6¼%. More generally, market participants were waiting to see whether domestic demand growth had slowed, and if so, by how much.

44 The sterling trade-weighted exchange rate had remained largely unchanged over the month. Implied correlations derived from options prices had suggested that a recoupling between sterling and dollar exchange rates had some way to go, and that sterling continued to be pulled by movements in both the dollar and the euro, with the effect on the trade-weighted exchange rate

determined in part by the greater weighting for the euro in the index. The rise in the euro:dollar exchange rate over the past two months had been greater than that predicted by the Consensus forecasts. The narrowing of interest rate differentials following the ECB's unexpected 50 basis point rate rise in June, and the continued economic recovery in the euro area, had both supported the euro. But other more technical factors, such as positioning and prospective flows relating to mergers and acquisitions activity and mobile phone spectrum auctions, had also helped the recovery in the euro over the past two months.

Text of Bank of England press notice of 6 July 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

The minutes of the meeting will be published at 9.30 am on Wednesday 19 July.

Text of Bank of England press notice of 3 August 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

The *Inflation Report* will be published on Wednesday 9 August.

The minutes of the meeting will be published at 9.30 am on Wednesday 16 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, plus all sterling deposits (including certificates of deposit) held at UK banks and building societies by the non-bank, non building society private sector.

M4 lending: sterling lending by UK monetary institutions (MFIs) to all UK residents other than the public sector and MFIs. M4 lending includes loans and advances as well as investments, acceptances and reverse repo transactions.

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

ACT: Advance Corporation Tax.

BCC: British Chambers of Commerce.

CBI: Confederation of British Industry.

CIPS: Chartered Institute of Purchasing and Supply.

CML: Council of Mortgage Lenders.

cob: close of business.

DETR: Department of the Environment, Transport and the Regions.

DMO: Debt Management Office.

ECB: European Central Bank.

EEF: Engineering Employers' Federation.

EU: European Union.

FOMC: Federal Open Market Committee.

FTSE: Financial Times Stock Exchange.

GDP: Gross domestic product.

GfK: Gesellschaft für Konsum, Great Britain Ltd.

HMT: Her Majesty's Treasury.

ICPFs: insurance companies and pension funds.

IMF: International Monetary Fund.

IT: information technology.

LAPFs: life assurance and pension funds.

LFS: Labour Force Survey.

MEW: mortgage equity withdrawal.

MORI: Market and Opinion Research International.

MPC: Monetary Policy Committee.

NIESR: National Institute of Economic and Social Research.

Non-EU: Countries outside the European Union.

NYMEX: New York Mercantile Exchange.

OECD: Organisation for Economic Co-operation and Development.

OFCs: other financial corporations.

OFIFAs: other financial institutions and financial auxiliaries.

ONS: Office for National Statistics.

OPEC: Organisation of Petroleum Exporting Countries.

PNFCs: private non-financial corporations.

PSNB: public sector net borrowing.

PSNCR: public sector net cash requirement.

REC: Recruitment and Employment Confederation.

RICS: Royal Institute of Chartered Surveyors.

S&P: Standard and Poor's.

UIP: uncovered interest parity.

WTD: Working Time Directive.

Y2K: Year 2000.

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.