

# Inflation Report

## November 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.

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

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## Overview

The United Kingdom has continued to experience above-trend growth and low inflation. Output in the third quarter is provisionally estimated to have been 2.9% higher than a year ago, while RPIX inflation was 2.2% in the year to September, marginally below the 2½% target. World growth has been rapid, but is beginning to slow, and higher oil prices point to a further slight deterioration in the outlook for global activity and inflation. At home, the growth rate of final domestic demand picked up a little in the second quarter, though growth has eased since last year. Private consumption growth has been strong, but shows signs of slowing. The level of investment was little changed in the first half of the year. Export growth has been strong despite further appreciation of the exchange rate, but has been outpaced by import growth. Unemployment has continued to fall rapidly and the labour market appears tight. In spite of this, earnings growth has remained subdued. Allied to a pick-up in productivity growth this has ensured that labour costs have not been a recent source of inflationary pressures, while the strong exchange rate has helped contain imported inflation.

World output and trade have continued to grow strongly, underpinned by the robust performance of the US economy. However, there are now clear signs that US growth is slowing, with third-quarter growth only half that of Q2. Growth in the euro area has remained firm, although here too there are some signs of softening. Recovery seems under way in Japan. The emerging market economies have continued their recovery from the crisis of two years ago.

The price of oil has increased further since the August *Inflation Report*, with futures prices up by \$3–\$4 per barrel. The MPC judges, like most observers, that the impact of this latest increase on global growth and inflation prospects should be modest. However, further sustained increases in oil prices could add to the downside risks to activity associated with a potential fall in financial asset prices. In the euro area the impact of higher energy prices on inflation has been exacerbated by additional depreciation of the euro and the ECB has raised official interest rates to 4.75% to combat inflationary pressures.

Output in the United Kingdom is provisionally estimated to have risen by 0.7% in the third quarter compared with 0.9% in the previous quarter. Recent survey data are also consistent with growth slowing towards trend. The sectoral pattern of growth has been diverse. Energy output grew strongly in the second quarter but has since eased. Manufacturing output growth has generally picked up, but has been concentrated in high-technology sectors. Growth in the service sector has remained robust, although surveys point to some easing in the coming months.

The rate of growth of consumer spending was slightly higher in the second quarter than expected in the August *Report*, although in the first half of this year it was down noticeably on the high rates experienced in 1999. Retail sales volumes were robust in the third quarter, but moderating household income growth, cooling in the housing market, and broadly stable equity prices all point to further modest easing in consumption growth. Investment recovered in the second quarter, but only enough to reverse the fall in Q1. Nevertheless, the share of business investment in GDP remains historically high. Government spending rose strongly in Q2 and will continue to rise more quickly than in recent years in line with announced plans. On balance, the Pre-Budget Report is expected to have little net effect on growth and inflation, although the one-year freeze of fuel duties will temporarily slightly reduce RPIX inflation.

Exports have continued to grow quickly, despite the strength of sterling, on the back of the rapid growth in world output and trade. However, imports have grown even more strongly and the net trade contribution to the growth of GDP has been negative. The exchange rate has strengthened against the euro, but weakened against the dollar. The effective exchange rate index has been somewhat higher than expected at the time of the August *Report*.

Money and credit continue to grow strongly. Narrow money has accelerated, but has been distorted by the effects of the petrol crisis. Corporate borrowing has been strong, but much of this has been used to purchase financial assets—acquisitions of other companies, including overseas, and third-generation mobile telecommunications licences. Household borrowing remains strong, but growth has moderated slightly.

The Bank's official interest rate has remained at 6% since February. The short-term yield curve, which

provides a guide to market expectations of future official interest rates, has flattened out to around 6%. Long-term bond yields have been broadly stable and equity prices are roughly unchanged.

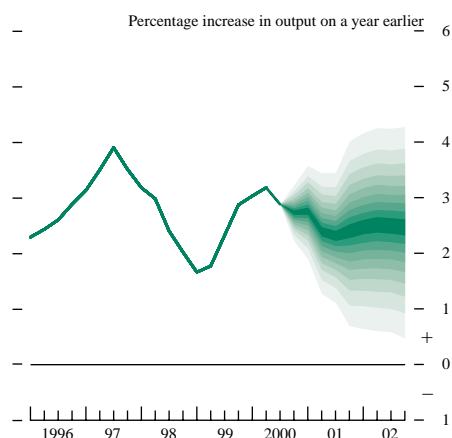
Official data since the previous *Report* continue to paint a benign picture of developments in the labour market, with earnings decelerating slightly despite continued falls in unemployment. Employment on the LFS measure grew by 0.7% in the past six months and employment intentions remain strong, especially in the service sector. Unemployment has fallen sharply in recent months, with the LFS rate declining to 5.3%. Jobcentre vacancies have increased and exceed levels reached at the previous business cycle peak. Survey data also suggest that companies are experiencing difficulties recruiting skilled labour, a view that is confirmed by the Bank's regional Agents.

In spite of this tight labour market, the headline measure of average earnings growth has continued to moderate, from 4.6% in May to 3.9% in August. This recent weakness largely reflects lower bonus payments, with regular pay growth slowing much less. Wage settlements have been broadly stable at around 3.0%. Set against the background of low and stable consumer price inflation, this combination of a relatively tight labour market and stable earnings growth suggests that the sustainable level of unemployment may be lower than previously thought. The MPC will continue to monitor developments in this area closely.

Data for the second quarter indicate that the recovery in the growth of labour productivity—which had been weak by historical standards during the previous four years—has continued, rising to slightly above its average over the past 40 years. The combination of benign earnings growth and higher productivity meant that wage costs per unit of output in the second quarter were just 1.1% higher than a year earlier, the slowest growth in over five years. Import prices rose slightly in the second quarter, but the subsequent appreciation of sterling has kept the imported component of inflation in check. Manufacturers' output prices have risen less than costs suggesting that margins have been compressed. RPIX inflation dipped in August, but rose to 2.2% in September.

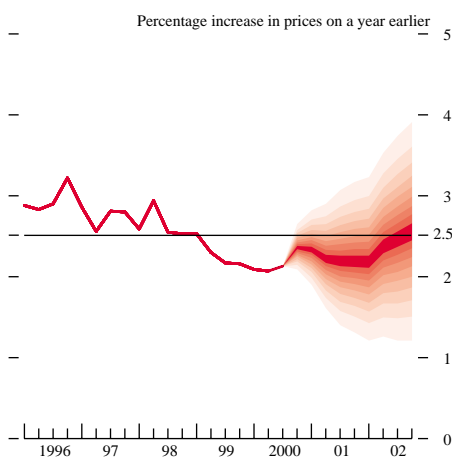
The MPC's projections have been prepared under the benchmark assumption that the official interest rate remains at 6% and with a starting-point for the effective

**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.

exchange rate profile of 107.5, this being the average value over the five working days<sup>(1)</sup> to 8 November. Chart 1 shows the Committee's assessment of the outlook for GDP growth. In the central projection, annual growth eases towards trend next year and remains there into 2002. This projection incorporates sufficient easing in the growth of private final domestic demand to accommodate a firmer contribution from the public sector. The overall growth projection for the second year of the forecast is slightly weaker than in the August *Report*.

Chart 2 shows the corresponding projection for RPIX inflation. In the central projection inflation stays slightly below the target level of 2½% during 2001, but thereafter edges up to around target at the two-year horizon. The outlook for inflation is also a little softer than in the August *Report*, with the effects of a firmer exchange rate and lower earnings growth more than offsetting the impact of higher energy prices.

As always, considerable uncertainties surround the projections for inflation and growth, and not every Committee member shares all the assumptions that underlie them. Some members prefer alternative assumptions about supply-side and labour market developments. In combination these could raise or lower the inflation profile by up to ¼% at the forecast horizon.

The central projection is for steady growth at around the trend rate with inflation close to target. In the Committee's judgment, the risks to this projection are evenly balanced. But doubts about the speed of the slowdown in the world economy, the evolution of oil prices, the pace of the deceleration in private sector demand and the likelihood of continued benign outcomes in the labour market have made the Committee more uncertain about prospects than in August. As ever, the Committee's evaluation of the evolving prospect for future inflation will determine whether further changes in policy are required in order to meet the target.

(1) Because of sharp movements in the exchange rate prior to its November meeting, in this instance the MPC decided to base its projections on an average for asset prices over the previous five working days rather than fifteen as in recent *Reports*. See pages 51–2 in Section 6.

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Inferring market interest rate expectations from money market rates

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Markets and operations

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### Section 2

The international environment

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### Section 6

Inferring market interest rate expectations from money market rates

Quarterly Bulletin, November 2000, pages 392–402.

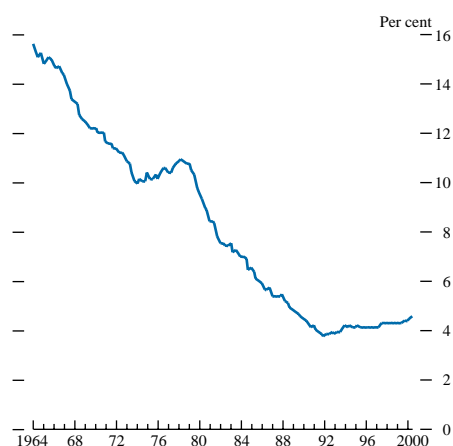
**Table 1.A**  
Growth rates of notes and coin, M4, and M4 lending<sup>(a)</sup>

Per cent		3 months (b)	12 months
Notes and coin (c)	2000 July	6.5	7.1
	Aug.	6.7	6.9
	Sept.	11.1	8.8
	Oct.	9.9	8.0
M4	1999 Q4	8.6	4.1
	2000 Q1	8.5	5.3
	Q2	8.6	6.6
	Q3	10.7	9.1
M4 lending (d)	1999 Q4	12.9	9.3
	2000 Q1	13.1	10.8
	Q2	11.9	11.5
	Q3	15.3	13.3

Source: Bank of England.

- (a) Seasonally adjusted.
- (b) Annualised.
- (c) Growth rates based on an average of weekly observations in the month.
- (d) Excluding securitisations.

**Chart 1.1**  
Notes and coin held by households as a percentage of households' M4



Source: Bank of England.

Narrow money growth remains robust. Deposit growth has picked up, mainly reflecting trends in the corporate sector, although household deposit growth also rose in 2000 Q3, boosted by the Scottish Widows windfall payouts. Aggregate lending growth has risen further, driven by more buoyant lending to corporations. Household credit growth has moderated slightly, but remains strong.

The Bank of England official interest rate remains at 6% and was last changed in February. The market has continued to revise down its expectations of the level of future UK official interest rates. Since the August *Report*, official interest rates have remained unchanged in the United States, but have risen in the euro area by 50 basis points. The sterling effective exchange rate has been higher than in the August central projection, with appreciation against the euro more than offsetting depreciation against the dollar. Equity prices have been a little weaker than projected in August, and house price inflation has moderated.

## 1.1

## Money and credit

### Narrow money

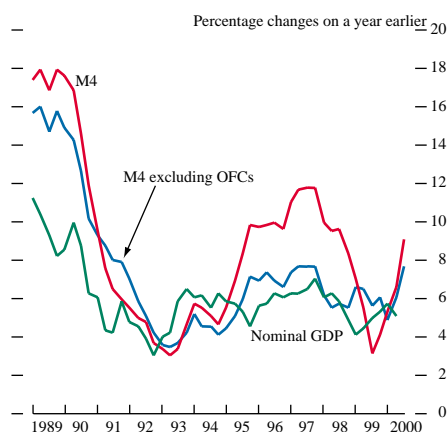
Narrow money (M0) consists mainly of notes and coin in circulation held by the household sector, but also includes cash held by banks at branches and in ATMs. The petrol crisis in September led banks to hold higher than normal levels of notes as a precautionary measure, so annual growth in notes and coin picked up sharply in that month (see Table 1.A). Growth has fallen back subsequently as this effect has unwound, but the underlying rate remains high. Notes and coin have accounted for a relatively constant percentage of households' broad money holdings (M4) since the mid-1990s (see Chart 1.1). That contrasts with a trend decline over the preceding quarter-century, and may reflect the lower opportunity cost of holding money in non-interest bearing form in a low and stable inflation environment.

### Broad money and credit

Annual growth in sterling deposits held by the UK private sector (M4) rose to 9.1% in 2000 Q3, from 6.6%

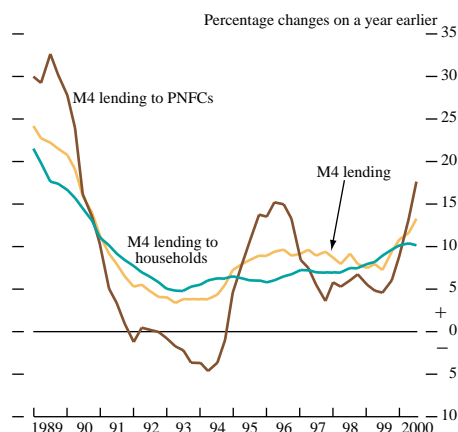


**Chart 1.2**  
**Growth in M4, M4 excluding OFCs, and nominal GDP**



Sources: ONS and Bank of England.

**Chart 1.3**  
**Growth in M4 lending**



Sources: ONS and Bank of England.

**Table 1.B**  
**Accounting for the M4 lending-M4 gap**

Average monthly flows, £ billions

	Fiscal year	
	1999/00	2000/01 (a)
M4 lending-M4 (b)	4.3	3.5
<i>Accounted for by:</i>		
Net non-resident deposits	2.9	-3.4
Net public sector deposits	0.7	3.5
Net private sector foreign currency deposits	-0.6	0.5
Other (c)	1.2	3.0

Note: Columns do not sum due to rounding.

Source: Bank of England.

- (a) April to September 2000.
- (b) Includes securitisations and other loan transfers.
- (c) Includes banks' capital and reserves.

in the previous quarter (see Table 1.A). Other financial corporations' (OFCs) deposits rose sharply. But growth in M4 excluding OFCs, which tends to be more closely related to aggregate spending on goods and services in the economy, has also increased to its highest level for two years (see Chart 1.2). That points to continued relatively firm growth in nominal GDP in the near term.

UK bank and building society sterling lending<sup>(1)</sup> to the UK private sector (M4 lending) rose by 13.3% in the year to 2000 Q3, the highest growth rate since 1990 (see Chart 1.3). Lending to OFCs rose most sharply, but annual growth in lending to private non-financial corporations (PNFCs) continues to pick up. Household credit growth remains strong.

The flow of M4 lending continues to exceed that of sterling deposits placed with UK banks and building societies by the UK private sector. During much of 1999 this gap was accounted for by rising net deposits from overseas. More recently the gap has been accounted for by other sources (see Table 1.B), in particular by higher net public sector deposits. These partly reflect government receipts from the sale of third-generation mobile telecommunications licences.

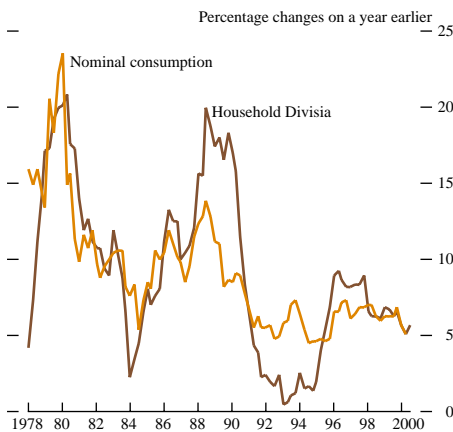
### Household sector

Households' M4 deposits grew by 6.3% in the year to 2000 Q3, a higher rate than in the previous quarter. Deposits in 2000 Q3 are likely to have been boosted by windfall payments of £5.8 billion to Scottish Widows policyholders in August. The windfall is smaller than those resulting from the demutualisations of building societies in 1997-98, which were worth £37 billion in total.

The relationship between an increase in deposits and consumer spending will partly depend on the liquidity characteristics of those deposits. Divisia is a measure of money holdings that weights each component by a measure of its liquidity and hence the likelihood that it will be used for consumer spending. Chart 1.4 shows that on average there has been a positive relationship between growth in household Divisia and nominal consumption. Growth in household Divisia picked up in 2000 Q3 but remains below rates seen during 1999, and nominal consumption growth has moderated since the end of 1999.

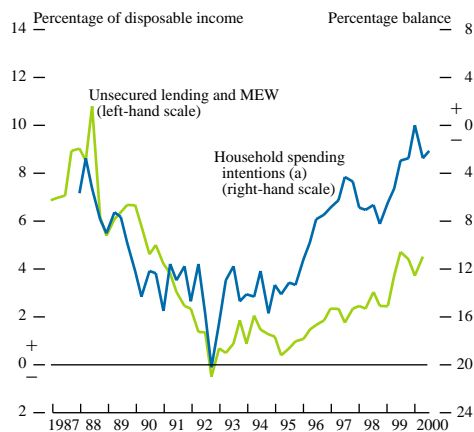
(1) Unless otherwise stated, all M4 lending data discussed here exclude the effects of securitisations and other loan transfers.

**Chart 1.4**  
**Household Divisia and consumption**



Sources: ONS and Bank of England.

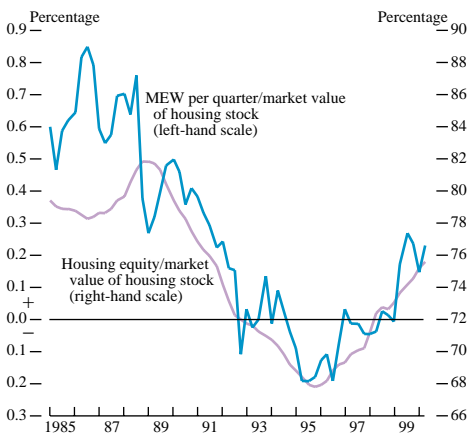
**Chart 1.5**  
**Total lending for consumption and household spending intentions**



Sources: ONS, Bank of England and GfK.

(a) Percentage balance of responses to the question: 'Over the next twelve months how do you think the amount of money you will spend on major purchases will compare with what you spent over the last twelve months: up/same/down?'

**Chart 1.6**  
**Mortgage equity withdrawal and the housing equity<sup>(a)</sup> ratio**



Sources: ONS and Bank of England.

(a) Housing equity is defined as the market value of the housing stock minus the value of debt secured on houses.

Annual growth in total net lending to individuals (by banks, building societies and other specialist lenders) has slowed slightly from 9.8% in 2000 Q2, to 9.3% in 2000 Q3. Annual growth in unsecured lending has fallen from 13.8% in 2000 Q2 to 12.7% in 2000 Q3. Consumption may also be funded by lending secured against housing wealth. Bank estimates suggest that the portion of secured lending not accounted for by investment in housing, termed mortgage equity withdrawal (MEW), picked up in 2000 Q2, raising total estimated borrowing available for consumption (see Chart 1.5). MEW is particularly likely to be used for purchases of high-value consumer durables, and the GfK survey indicates that households' spending intentions for major purchases remain relatively robust, despite a downturn since the beginning of the year in their confidence in the general economic situation.

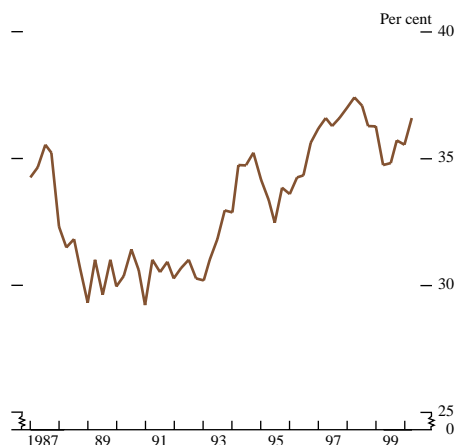
Chart 1.6 shows that MEW has become positive again following a period in which home-owners rebuilt the level of equity in their houses. It is likely that MEW will continue to support consumption. Moreover, recent innovations in mortgage products have reduced the fixed and marginal costs to home-owners of borrowing against their housing equity to fund consumption. That may lead to some increase in aggregate borrowing for consumption, as secured borrowing tends to carry a lower interest rate than unsecured borrowing. Annual growth in net lending secured against dwellings remained strong in 2000 Q3, at 8.5%, but has fallen slightly from 8.8% in the previous quarter.

*Private non-financial corporations*

Annual growth in private non-financial corporations' (PNFCs) M4 deposits rose sharply to 13.4% in 2000 Q3, from 8.8% in Q2. The strength of deposits could be related to the recent high level of mergers and acquisitions (M&A) activity, if funds raised from sales of subsidiaries have been placed on deposit temporarily. In addition deposits may have been boosted earlier in the year by greater repatriation of overseas profits by PNFCs ahead of tax changes.<sup>(1)</sup> The extent to which companies are willing to hold additional deposits rather than use them to increase expenditure on other financial or real assets, or to reduce indebtedness, may depend on their existing liquidity position. Chart 1.7 indicates that in aggregate liquidity is now at a relatively high level.

(1) In the March 2000 Budget it was announced that the tax treatment of profits repatriated from overseas subsidiaries by UK companies would change from 1 July 2000, although implementation of the changes was subsequently delayed until next year.

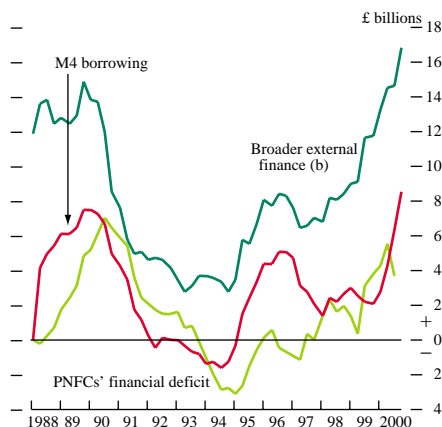
**Chart 1.7**  
**Liquidity of PNFCs<sup>(a)</sup>**



Sources: ONS and Bank of England.

(a) Defined as the ratio of deposits to the sum of bank loans, bonds issued and trade debt.

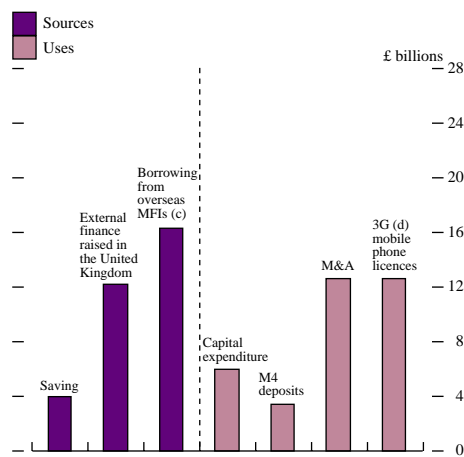
**Chart 1.8**  
**PNFCs' borrowing and the financial deficit<sup>(a)</sup>**



Sources: ONS and Bank of England.

(a) Four-quarter moving averages.  
(b) M4 borrowing plus capital issues and foreign currency borrowing from UK banks and building societies.

**Chart 1.9**  
**Changes in PNFCs' main sources and uses of funds<sup>(a)(b)</sup>**



Sources: ONS and Bank of England.

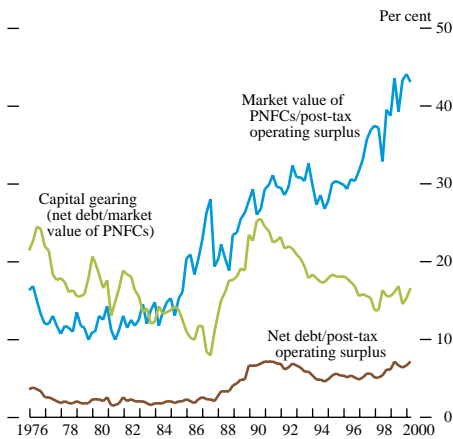
(a) Excludes equity-financed M&A deals.  
(b) Four quarters to 2000 Q2 compared with previous four quarters.  
(c) Monetary and financial institutions.  
(d) Third-generation.

PNFCs' M4 borrowing has risen further, taking the annual rate of increase to 17.5%. PNFCs have also raised substantial funds from UK capital markets in recent quarters (see Chart 1.8). For some time PNFCs' capital expenditure has exceeded their internal sources of finance or saving, the deficit being met by external finance. But since 1999 Q3 the financial deficit has been broadly constant whereas the amount of external finance raised in the United Kingdom has increased sharply. The divergence is because of higher expenditure on financial assets: in particular, acquisitions of other companies, some overseas, and mobile telecommunications licences. The telecommunications sector accounted for about half of the total external finance raised in the United Kingdom by PNFCs during 2000 Q3. There was a similar divergence between external finance raised and the financial deficit in the late 1980s, a time when M&A expenditure was also high. In fact, as Chart 1.9 illustrates, the increase in expenditure on financial assets, combined with the increase in expenditure on real assets, has substantially exceeded internal and external finance raised in the United Kingdom. So borrowing from overseas has increased.

The increase in borrowing by corporates has raised the ratio of their net debt stock to post-tax profits to levels reached in the early 1990s (see Chart 1.10). But the market valuation of future profits relative to current profits has increased significantly since then. So capital gearing, measured in market value terms, is still relatively benign. The relatively high ratio of market valuations to current corporate profits may reflect an expectation of faster growth in real profits than in the past, or a lower discount rate. Future profits may be discounted at a lower rate because of a decline in the risk premium that investors require for holding shares in companies rather than risk-free assets.

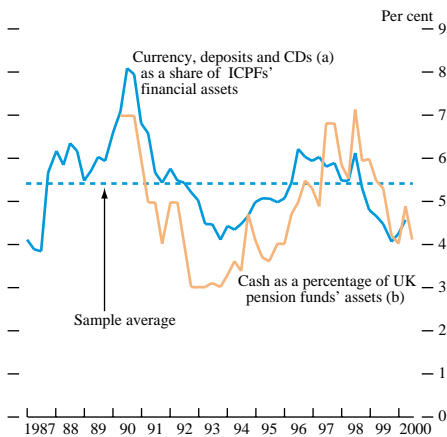
While corporate liquidity currently seems strong, the sharp increase in indebtedness may embody relatively optimistic assumptions on the part of borrowers and lenders about growth in future profits and the degree of risk in the corporate sector. Expectations about future profitability, and hence the market valuations that support current levels of indebtedness, may be subject to sudden adjustments. Indeed, there are some indications that perceptions about future profitability have moderated recently, and equity prices have been slightly weaker than projected in the August *Report*.

**Chart 1.10**  
Measures of PNFCs' gearing



Sources: ONS and Bank of England.

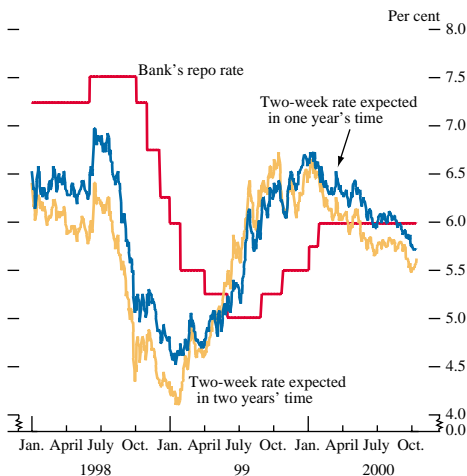
**Chart 1.11**  
Money as a share of UK insurance company and pension funds' (ICPFs) assets



Sources: ONS and Merrill Lynch.

(a) Certificates of deposit.  
(b) Merrill Lynch Fund Manager Survey.

**Chart 1.12**  
Bank's repo rate and two-week rates expected in one and two years' time<sup>(a)</sup>



Source: Bank of England.

(a) Forward rates are derived from GC repo rates and gilts, adjusted upwards by 15 basis points to reflect the average historical spread between the GC repo rate and the Bank's repo rate.

## Other financial corporations

OFCs' deposits have risen further, taking the annual growth rate to 14% in 2000 Q3. The OFC sector comprises institutional investors such as insurance companies and pension funds (ICPFs), and other financial institutions such as securities dealers. An increase in deposits held by institutional investors has accounted for around half of the increase in OFCs' deposits over the past year.<sup>(1)</sup> Institutional investors' desired money holdings are likely to vary with the overall market value of their portfolios and the expected rate of return on money relative to other assets. Chart 1.11 shows that towards the end of 1999, the share of money in ICPFs' total financial assets had fallen to a relatively low level. Recent growth in ICPFs' deposits may therefore be associated with a desire to re-balance their portfolios. Growth in lending to OFCs has also increased. In 2000 Q3 there was a significant effect on lending to OFCs from the purchase by Lloyds TSB of Scottish Widows.

## 1.2 Interest rates and asset prices

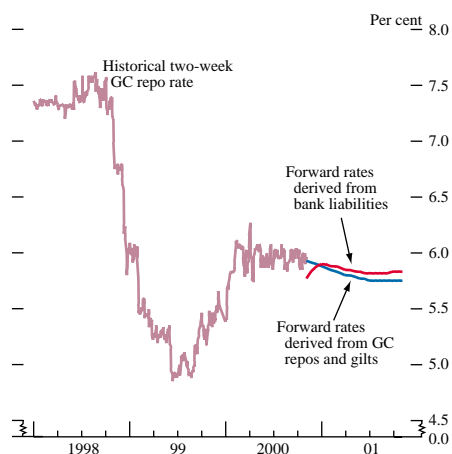
### Short-term interest rates

The Bank of England's official rate remains at 6.0%, unchanged from its level at the time of the *August Report*. The official rate has not changed since February 2000. The official federal funds rate in the United States has also remained unchanged since the *August Report*, at 6.5%, but the European Central Bank has increased its official rate by 50 basis points to 4.75%. Market expectations about the level of future official UK rates have declined further since the *August Report*. There are several ways of measuring market expectations of future official interest rates.<sup>(2)</sup> The Bank performs the vast majority of its monetary operations via two-week sale and repurchase (repo) agreements. Chart 1.12 shows estimates of two-week interest rates expected to prevail one and two years from now, as implied by the prices of government bonds and gilt repo rates. Official interest rate expectations measured in this way have fallen since the beginning of the year. And Chart 1.13 indicates that official interest rates are expected to remain close to their current level over the next year. That is true of expectations derived from rates on commercial bank liabilities (also shown in the chart), the

(1) Institutional investors are defined as ICPFs, investment and unit trusts, money market mutual funds, and institutions engaged in other fund management activities.

(2) Discussed in the article on pages 392–402 of the *November Quarterly Bulletin*.

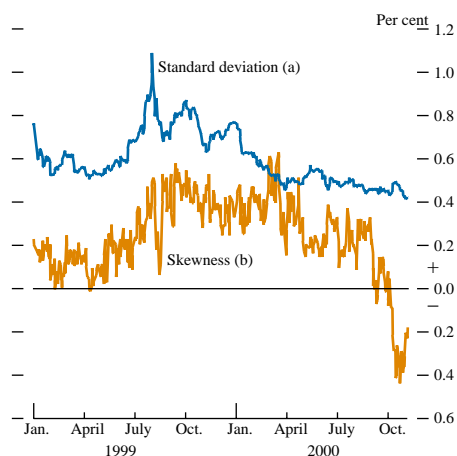
**Chart 1.13**  
**Two-week forward rates<sup>(a)</sup>**



Source: Bank of England.

(a) Historical GC repo rates and GC repo/gilt forward rates have been adjusted upwards by 15 basis points to reflect the average historical spread between the GC repo rate and the Bank's repo rate. The forward rates derived from bank liabilities, which contain credit risk, have been adjusted downwards by 20 basis points.

**Chart 1.14**  
**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 forward interest rates at a constant six-month horizon.  
(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 are on the upside of forward rates. For a description of the techniques used to derive these statistics see Clews, R. Panigirtzoglou, N and Proudman, J. 'Recent developments in extracting information from options prices', *Bank of England Quarterly Bulletin*, February 2000, pages 50–57.

**Table 1.C**  
**Changes in household borrowing rates**

Basis points	Change since	Change since
	March 2000 (a)	August 1999
<i>Bank's repo rate</i>	0	100
Average unsecured (b)	-12	-28
Standard variable mortgage rate (c)	-3	88
Two-year discounted mortgage rate (c)	15	56
Two-year fixed mortgage rate (c)	-19	20
Average secured (b)	-1	49

Sources: Bank of England and Moneyfacts.

(a) Some rate increases announced in February following the change in the repo rate did not take effect until March.  
(b) Difference between monthly estimates for September 2000, March 2000, and August 1999. The rates are averages across new and existing loans by banks.  
(c) Difference between monthly estimates for October 2000, March 2000, and August 1999. Rates are for new loans by banks and building societies without redemption penalties.

Reuters survey of economists and the survey of outside forecasts conducted for this *Report* (see Section 6.3). Options on short sterling futures contracts imply that market uncertainty about the level of future short-term interest rates has generally declined since the beginning of the year (see Chart 1.14). And they suggest that investors now assess the balance of risks around their short-term interest rate expectations to lie on the downside.

### Household borrowing rates

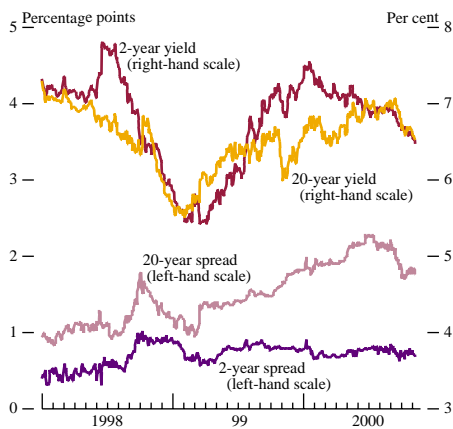
Interest rates charged on household borrowing have changed little in recent months. The picture remains one of limited pass-through to secured borrowing rates from past increases in the repo rate (see Table 1.C). That is partly because fixed mortgage rates have declined since the repo rate was last changed in February, as expectations about future short-term interest rates have fallen. There may also have been an increase in the degree of competition among lenders over the past year, reducing the spread between mortgage rates and the repo rate. Unsecured borrowing rates have fallen relative to a year ago. But unsecured rates are typically significantly higher than secured borrowing rates. So the marginal cost of financing consumption will vary significantly depending on whether marginal funds are obtained on a secured or unsecured basis. Flexible mortgage products launched recently have reduced the fixed and marginal costs of borrowing for consumption on a secured basis by withdrawing housing equity. And the increase in house prices in recent years has raised the level of housing equity. While these new mortgage products probably account for less than 10% of the total mortgage stock at present, their use is growing rapidly. So there may have been a reduction in the marginal cost of financing consumption for some home-owners.

### Corporate borrowing rates

The cost of debt to companies depends on perceptions about the creditworthiness of the borrower as well as default-free rates on government debt. Earlier in the year there had been an increase in the spread of corporate bond yields over government yields at long maturities (see Chart 1.15). But government bond yields at longer maturities may have been reduced by a combination of lower issuance and increased demand linked to pension fund solvency requirements (the Minimum Funding Requirement, MFR).<sup>(1)</sup> So it was

(1) This requires pensions already in payment to be discounted using a 15-year government bond yield.

**Chart 1.15**  
Sterling A-rated corporate bond yields and spreads<sup>(a)</sup>



Sources: Bloomberg and Bank of England.

(a) Spread over government par yields.

difficult to attribute the increase in spreads solely to an increase in expected default rates, following the build-up in corporate indebtedness. Spreads at longer maturities have declined in recent months. That may partly reflect the review of the MFR, published on 14 September by the Faculty and Institute of Actuaries (see the box on [page 334 of the November \*Quarterly Bulletin\*](#)). As anticipated, the review proposed that pension liabilities be discounted using the yield on a composite bond index that includes investment-grade corporates. That would raise institutional demand for corporate bonds relative to gilts, reducing the spread between their yields. Spreads over gilts at short maturities remain similar to their level at the time of the *August Report*, which is also true of spreads relative to swap rates, which should be less affected by the MFR. So because expected future short-term default-free interest rates have fallen, yields on corporate bonds with a constant credit rating have fallen since the *August Report* (see Chart 1.15), despite the increase in aggregate corporate indebtedness. Bonds issued by telecommunications companies have been downgraded, but their yields have also fallen slightly.

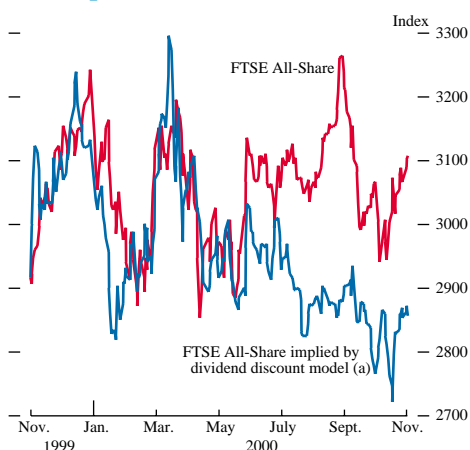
### Real interest rates

Spending decisions by firms and households should be affected by expected real interest rates. The decline in expected short-term nominal interest rates over the next two years has reduced two-year nominal rates of interest. Some survey measures of the expected rate of inflation over that period have picked up slightly since the beginning of the year.<sup>(1)</sup> That suggests that there has been a decline in expected real interest rates at that maturity. But index-linked gilt prices suggest that there has been a slight increase in expected real interest rates at longer maturities.

### Equity prices

The FTSE All-Share index averaged 3087 in the five working days to 8 November, close to its level at the time of the *August Report*, but about 2% below the central projection for November. Based on a 15 working day average (3056), share prices have been about 3% lower than projected. Share prices fell sharply in September (see Chart 1.16). The value of equity can be thought of as the discounted stream of dividend payments derived from that equity. The discount rates applied to expected future dividends will be affected by expected risk-free real rates of interest. Estimates of

**Chart 1.16**  
Decomposition of FTSE All-Share movements

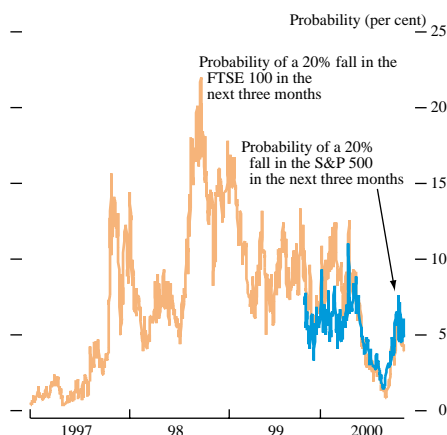


Source: Bank of England.

(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.

(1) Measures of inflation expectations are discussed in Section 3, see Table 3.D.

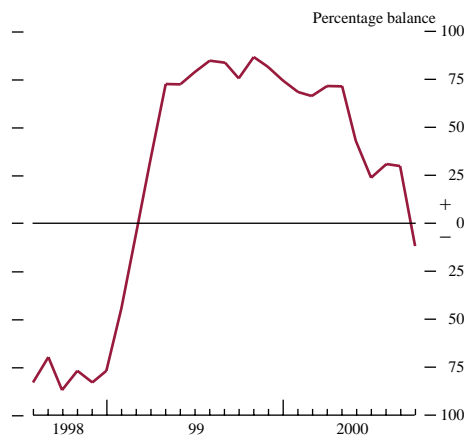
**Chart 1.17**  
**Downside risk for the FTSE 100 and S&P 500<sup>(a)</sup>**



Sources: LIFFE and Bank of England.

(a) These probabilities are equal to the areas under the lower tails of probability distribution functions (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 1.18**  
**UK fund managers' outlook on UK corporate profitability<sup>(a)</sup>**



Source: Merrill Lynch Fund Manager Survey.

(a) Percentage balance of respondents with a favourable outlook over the next twelve months.

these can be obtained from index-linked gilt prices, and investors know the current level of dividends. So a standard equity valuation model can indicate the extent to which movements in share prices reflect changes in these variables, or revised views about a combination of expected growth in real dividends, and the premium investors require for holding shares rather than risk-free assets. Chart 1.16 suggests that relatively little of the decline in share prices in September can be explained by changes in the prevailing level of dividends or expected risk-free real interest rates.

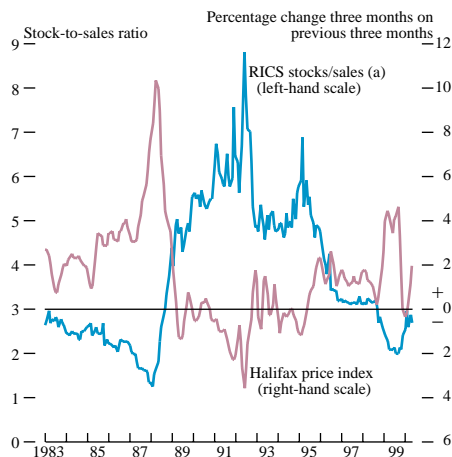
There is some evidence from options prices that uncertainty about the prospective returns from investing in the stock market has increased since the August *Report*, having fallen steadily over the previous six months. Corresponding to that increase in uncertainty, estimates of the probability investors attach to a significant (at least 20%) decline in share prices over the next three months have increased, but from a relatively low level (see Chart 1.17). Investors may increase the discount rate they apply to future dividends when uncertainty increases. According to Ernst & Young, the number of profit warnings issued by UK quoted companies rose in 2000 Q3, the first increase since 1998. And UK fund managers' outlook on UK corporate profitability has become less favourable (see Chart 1.18), which may have led them to revise down expected real dividend growth. The MPC continues to judge that the balance of risks to equity prices is on the downside.

*Property prices*

House prices have been broadly unchanged for the past six months, bringing down the annual rate of house price inflation. The rate of increase over the year to October was 9.9% on the Nationwide index and 5.7% on the Halifax measure. Particulars delivered, a measure of completed home sales, have weakened: in the three months to September they fell by 6.2% compared with the previous three months. That is consistent with the decline earlier in the year of measures of activity at the beginning of the house-buying process, for example net reservations of new houses (see Section 2).

In a perfectly competitive market, with no transactions or adjustment costs, the price of a house would be equal to the expected present value of the stream of future housing services provided by the house (net of depreciation and maintenance costs), if owner-occupied, or rents if let. So in this stylised framework there need

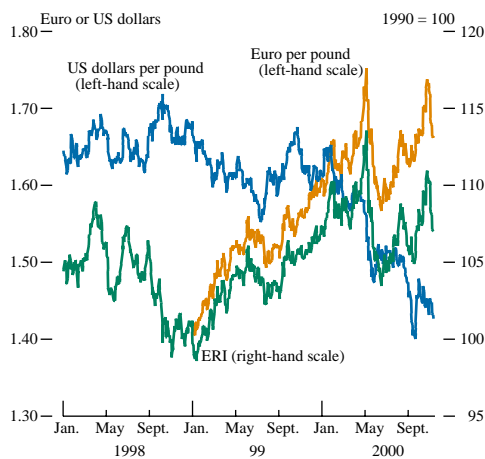
**Chart 1.19**  
**House prices and the RICS stock/sales ratio**



Sources: RICS and Halifax.

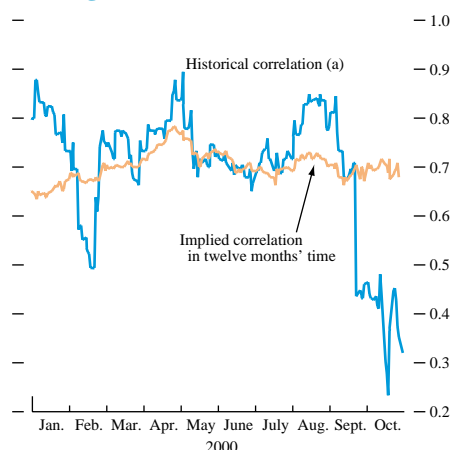
(a) Ratio of responses to RICS survey questions about the stock of houses on estate agents' books and sales in the previous three months.

**Chart 1.20**  
**Selected sterling exchange rates**



Source: Bank of England.

**Chart 1.21**  
**Implied and historical correlations between sterling and the dollar versus the euro**



Source: Bank of England.

(a) Exponentially weighted 20-day rolling window.

not be any link between the level of housing market activity, as measured by the volume of transactions, and house prices. But in practice there are many costs associated with searching for and then moving house, which may be affected by the level of activity. That could explain why there does appear to be a strong link between prices and the level of activity. Chart 1.19 shows a close correlation between house prices and information from the Royal Institute of Chartered Surveyors (RICS) on the stock of houses for sale relative to the flow of sales. The stock/sales ratio has risen since the beginning of the year, and that has been correlated with a moderation in price increases.

### Exchange rates

The sterling effective exchange rate index (ERI) has appreciated since the *August Report*. The five working day average of the ERI up to and including 8 November, used as the starting-point for the current projection, is 107.5, around 1½% above the central path assumed in the *August Report*. On a five working day average basis, sterling has appreciated by around 3½% against the euro, but depreciated by around 4½% against the dollar (see Chart 1.20). The sterling-dollar average of \$1.44 is well below the relatively narrow \$1.55–\$1.70 range it was trading in between 1997 and 1999. The 15-day average of the sterling ERI is 109.3, around 3% above the central path assumed in August.

The depreciation of sterling against the dollar has occurred during a period in which long-run forecasts of real GDP growth in the United States have increased significantly relative to those in the United Kingdom. Higher prospective real growth in the United States is consistent with higher expected real returns, measured in domestic currency, from investing in US assets relative to those in other countries. Those higher expected returns have attracted capital into the United States, to finance the gap between domestic investment and saving. If the expected returns from holding dollar assets relative to those in other currencies are to be equalised, then the dollar must appreciate to the point where its expected future depreciation offsets the different rates of return in domestic currencies. The October Consensus Economics survey suggests that the dollar is expected to depreciate against sterling over the next five years to a rate of \$1.59.

The correlation between movements in sterling and the dollar against the euro has fallen sharply recently (see Chart 1.21). The prices of options contracts on the



bilateral exchange rates can be used to infer how closely the market expects them to be correlated in the future. The expected correlation between the sterling-euro and dollar-euro exchange rates in twelve-months' time has changed very little and remains relatively high. So investors do not appear to associate the depreciation of sterling against the dollar in recent months with a change in the prospective relationship between sterling and the dollar *vis-à-vis* the euro.

### 1.3

### Summary

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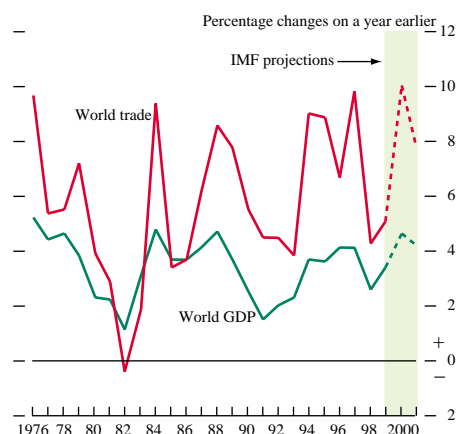
All measures of money growth have risen since the August *Report*, pointing to continued relatively firm growth in nominal demand in the near term. Household deposit growth picked up in 2000 Q3, boosted by the Scottish Widows windfall payouts. Total household borrowing for consumption is estimated to have risen in 2000 Q2, as mortgage equity withdrawal increased. House price inflation has moderated since then, but the significant increase in house prices over the past two years has raised the level of housing equity available as collateral for future borrowing. Corporates continue to borrow to meet the gap between their domestic capital expenditure and the amount of internal finance available. But, in addition, borrowing has increased to fund M&A activity and the purchases of mobile telecommunications licences.

Equity prices have been slightly weaker than projected in the August *Report*, perhaps partly because of lower expected growth in profits and an increase in the level of uncertainty. Despite that, there has not been any significant widening in credit spreads on corporate bonds. Default-free interest rates represented by government bond yields have fallen since the August *Report*, as expectations of future short-term interest rates have declined. Surveys and market prices indicate that official interest rates are expected to remain close to their current level over the coming year. And options prices appear to indicate that investors now assess the balance of risks around future short-term interest rates to lie on the downside. Combined with survey evidence on inflation expectations, the decline in nominal interest rates suggests that expected real interest rates have declined. The sterling effective exchange rate has been higher than in the August central projection, with appreciation against the euro more than offsetting depreciation against the dollar in trade-weighted terms.

Inflation prospects are affected by the level of nominal demand relative to the supply capacity of the economy. Nominal GDP at market prices rose by 1.0% in 2000 Q2, broadly in line with growth in the previous quarter. But annual growth eased to 5.0% from 5.8% in Q1.

Annual growth in real GDP has remained close to 3% so far this year. But quarterly growth has been more erratic, with unusual changes in spending and production around the millennium date change and large swings in primary sector output obscuring the underlying pace of growth. Following growth of 0.5% in 2000 Q1, real GDP rose by 0.9% in Q2 and the preliminary estimate is that GDP growth subsequently fell back to 0.7% in Q3. In the second quarter, final domestic demand growth bounced back from unusually subdued growth in Q1 in the wake of the millennium. Household consumption growth rose slightly, and investment and government consumption spending recovered from falls in Q1. Some of the strength in domestic demand in Q2 was offset by net trade, with rising imports outweighing buoyant world demand for UK exports.

**Chart 2.1**  
**World GDP and trade growth**



Source: IMF.

## 2.1 External demand

Strong growth in overseas markets continues to support UK exports.<sup>(1)</sup> Many forecasters, including the IMF, expect world output to rise at its fastest annual rate this year since the late 1980s (see Chart 2.1). Nevertheless, following unsustainably high growth as emerging markets in particular recovered from recession, there are now clear signs that world growth may be easing in response to past rises in interest rates, higher oil prices and weaker global equity markets.

Robust growth in the United States has boosted world output in recent years but the pace of expansion is now moderating. US GDP rose by 0.7% in Q3, following an increase of 1.4% in Q2, leaving output 5.3% higher than a year earlier. Employment growth also slowed in Q3 and industrial production rose less rapidly. Euro-area growth remains relatively robust: GDP rose by 0.8% in

(1) For a more detailed discussion of international economic developments, see 'The international environment' article in the *Bank of England Quarterly Bulletin*, November 2000, pages 339–50.

2000 Q2 and was 3.7% higher than a year earlier. Looking ahead, the near-term outlook for EU net trade appears stronger following the recent further depreciation of the euro. But recent falls in survey measures of consumer confidence from high levels, perhaps reflecting rising oil prices, might presage slower domestic demand growth. In Japan, the recovery continued in Q2 with growth supported by public and household sector spending. Despite a surprisingly weak outturn for private investment, strong growth in corporate profits and higher business confidence point to further increases in capital spending. Growth in emerging markets remains relatively strong. But the outlook for these economies is mixed and depends partly on their oil dependence, with prospects for growth in oil-producing countries in the Middle East and Latin America improved relative to many oil-importing countries. Overall, the MPC judges that world output growth is likely to peak in 2000 and then decline gradually over the next two years, broadly in line with the projection in the *August Report*. However, the Committee continues to assume that there are downside risks, including the possibility of sharp movements in equity prices or exchange rates.

Over the past two years, strengthening global production has raised demand for raw materials and boosted industrial commodity prices (see [Section 4](#)). Oil prices have increased especially sharply, reflecting the additional impact of earlier supply restrictions by OPEC producers. Higher oil prices raise production costs, particularly in economies or sectors with high oil usage, and reduce income available for spending on non-oil goods and services. In the short run, lower spending in oil-importing countries is likely to more than offset higher spending by oil-exporting countries. As such, rising oil prices have probably restrained international output growth in recent quarters. Looking ahead, the impact on world growth will depend on the future path of oil prices and in particular on whether recent increases are sustained. Overall the MPC judges that the most likely scenario is that oil prices will fall from current levels as global demand growth eases and new production capacity becomes available. The box on [page 15](#) reviews the recent rise in oil prices and considers potential impacts on demand and output.

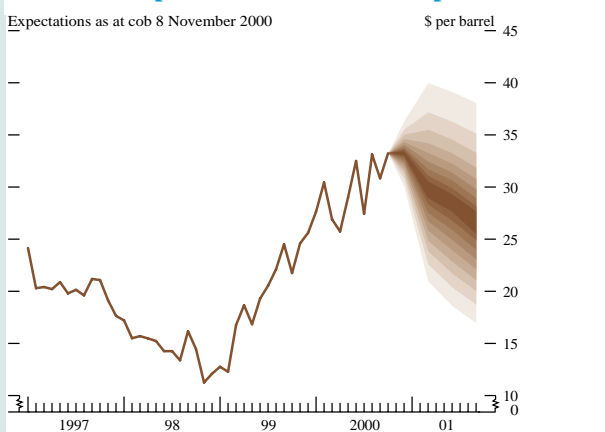
Strong world demand is likely to underpin rapid growth in international trade: Chart 2.1, for example, shows that the IMF expects world trade to rise by about 10% this year. The UK share of that trade will depend partly on

## Oil prices and economic activity

### Recent price developments

Oil prices have risen sharply over the past two years, reflecting developments in both the demand for and supply of oil (see Chart A). World oil consumption rose by 1.6% in 1999, partly due to strong demand growth in the United States and Asia. But global oil production fell by 1.9%,<sup>(1)</sup> as OPEC reduced output by almost 5%, and stock levels consequently decreased. Strong demand has continued this year, with world oil consumption growing by 2% in the year to 2000 Q3. Supply has also risen: OPEC announced several increases to production quotas, and with a smaller rise in non-OPEC production, world supply grew by around 5% over this period. Nevertheless, with stocks at low levels, and with the onset of winter in the Northern Hemisphere, prices have remained high.

**Chart A: Implied distribution for oil prices<sup>(a)</sup>**



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.

### International effects

Higher oil prices improve the terms of trade for countries that are net oil exporters. The opposite holds for net importers of oil. In the short run, oil demand is fairly price-insensitive, so higher prices will tend to bring about a transfer of income from oil importers to oil exporters. That is likely to reduce world demand temporarily if oil exporters have a lower marginal propensity to spend out of income than oil importers. But the negative shock will gradually dissipate, as oil exporters increase their spending on imports.

### Domestic effects

As a small net exporter of oil, the United Kingdom will tend to benefit slightly from terms of trade effects. Against this are a number of negative effects: on the supply side through higher domestic production costs; and on the demand side through lower real incomes due to higher fuel prices that dampen consumer spending. In addition, rising oil prices might lead to higher inflation expectations that could be costly to reverse.

Higher oil prices raise industry costs. In the first instance, producers face increased input costs for oil and refined petroleum products, which in 1995 accounted for about 10% of manufacturers' materials and fuel input costs. There may also be indirect effects as suppliers of non-oil inputs pass on their higher production costs. These negative effects may be partly offset by stronger growth in the oil industry, although the sector represents only about 6% of total industrial production.

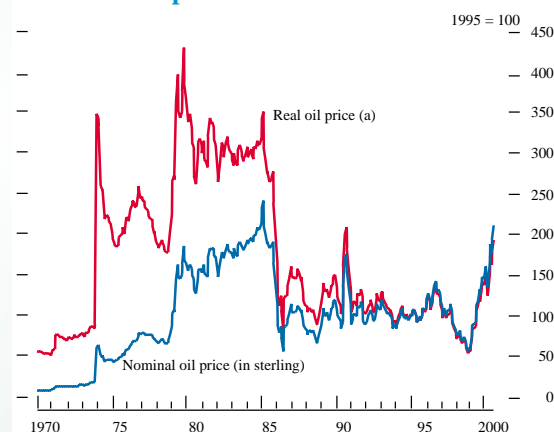
Higher oil prices may also affect consumer demand by raising the cost of living. Consumer prices will rise directly through higher prices of road fuel and heating oil, and indirectly as the higher oil costs are reflected in the prices of other retail goods.<sup>(2)</sup>

Moreover, it is possible that persistently high oil prices might have second-round effects on the wage-setting process. If workers misconstrue any rise in the aggregate price level caused by oil's relative price increase as a pick-up in underlying inflation, they may try to protect their real incomes by negotiating higher wages. In these circumstances, it is the role of monetary policy to prevent rising inflation expectations from becoming embedded in future wage and price trends.

### The likely impact on the UK economy

There are a number of reasons why recent oil price rises may have only a limited impact on UK economic prospects. First, it is important to consider oil prices in relation to the overall price level. In real terms oil prices are lower than during the oil shocks of the early 1970s and 1980s (see Chart B). In addition, like most other industrialised economies, the United Kingdom has become less reliant on oil for its energy needs. OECD economies now use about a third less oil per unit of output than in 1980.

**Chart B: Oil price**



Sources: Primark Datastream and ONS.

(a) Sterling oil price deflated by UK producer prices.

However, a key factor is that oil prices are likely to fall. The oil futures curve suggests that the market expects oil prices to decline over the next two years to around \$24 per barrel, although there is considerable uncertainty around the expected path (see Chart A). One reason for anticipating lower prices is increased oil supply, as high prices encourage investment in new capacity.<sup>(3)</sup>

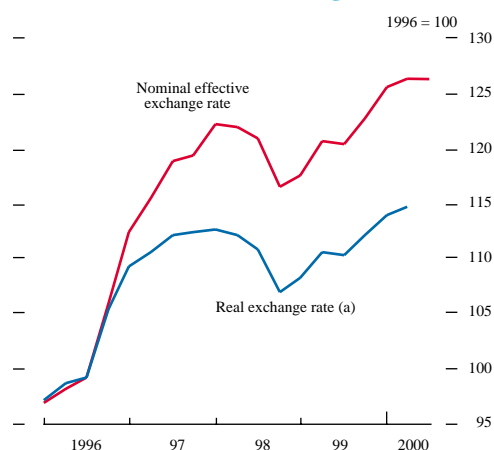
On balance, the MPC judges that the futures curve continues to offer the best indication of the prospective path for oil prices. If prices decline in line with these expectations, recent rises in oil prices are likely to have a relatively limited negative impact on prospects for UK domestic and external demand growth. And some of the first-round effects already seen in producer and consumer prices will soon dissipate. However, the outlook remains uncertain and the MPC will continue to monitor oil prices closely.

(1) Data are taken from the International Energy Agency's *Monthly Oil Market Report*, October 2000. Numbers for 2000 Q3 are estimates.

(2) These issues are discussed in more detail in the box on oil prices in the November 1999 *Inflation Report*, page 39.

(3) See 'The international environment' article in the *Bank of England Quarterly Bulletin*, November 2000, pages 339–50.

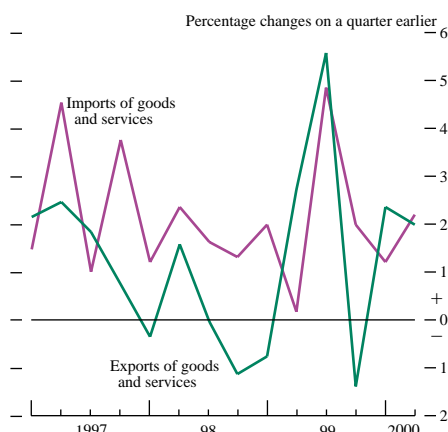
**Chart 2.2**  
**UK nominal and real exchange rates**



Sources: IMF and Bank of England.

(a) Estimated as UK export prices divided by a trade-weighted combination of export prices for the major six overseas economies, in common currency terms.

**Chart 2.3**  
**Growth in export and import volumes**



**Table 2.A**  
**UK export outlook<sup>(a)</sup>**

Series	average (b)	1999		2000		
		Q3	Q4	Q1	Q2	Q3
BCC export orders						
Services	12	15	5	10	14	14
Manufacturing	9	10	11	8	-7	7
CIPS export orders (c)						
Manufacturing	49.6	54.7	53.0	51.9	48.5	51.2
CBI industrial trends						
Export orders	-13	-14	-3	-8	-18	-11
DHL manufacturing export indicator						
Export confidence, next three months	32	29	28	38	34	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) Average of seasonally adjusted monthly indices. A reading above 50 suggests expansion, a reading below 50 suggests contraction.

export price competitiveness. Since 1996, the sterling nominal effective exchange rate has risen sharply. But the real exchange rate, as measured by UK export prices relative to export prices in the major six overseas economies (in common currency terms), has risen by considerably less than the nominal exchange rate over this period (see Chart 2.2). That suggests that some UK exporters sought to retain established overseas customers by accepting lower sterling prices, perhaps in the belief that the appreciation was likely to be short-lived. These lower prices are likely to have reduced profitability, although some exporters may have relieved pressure on margins by seeking additional cost savings, which is consistent with relatively strong productivity growth in the manufacturing sector in the recent past (see Section 3).

Total export volumes rose by 2.0% in Q2 (see Chart 2.3), and were 8.7% higher than a year earlier. But growth eased from the previous quarter as a slower rise in goods exports outweighed a recovery in exports of services. Reflecting both the pattern of overseas demand growth and bilateral exchange rate movements in recent years, goods export volumes to non-EU economies continued to rise more quickly than exports to the EU. In contrast to slower growth in exports, imports rose more rapidly in Q2, increasing by 2.2% on the quarter (see Chart 2.3) and by 10.7% on a year earlier. As a result net trade made a negative contribution to GDP in 2000 Q2 of 0.2 percentage points (see Table 2.B).

Although surveys suggest little change in the near-term prospects for UK exports (see Table 2.A), recent monthly trade data point to a further negative net trade contribution in Q3. Over the forecast period, the high level of sterling, if sustained, will put continued pressure on UK export competitiveness at a time when world output and trade growth are likely to be easing. In addition, the high level of sterling, together with above-trend growth in overall domestic demand in the near term, will tend to support growth in import volumes. As such, the MPC continues to expect that net trade will exert downward pressure on GDP growth over the forecast period.

## 2.2 Domestic demand

Unusual patterns of spending around the millennium have clouded the underlying pace of demand growth (see Table 2.B). Final domestic demand—which excludes investment in inventories—grew by 0.9% in

**Table 2.B**  
**GDP and expenditure components<sup>(a)</sup>**

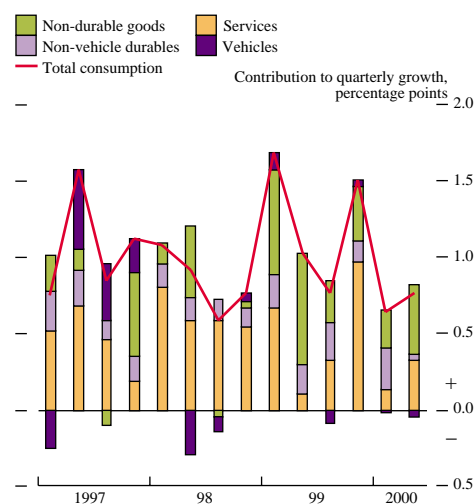
Percentage changes on previous quarter

	1999			2000	
	Average for H1	Q3	Q4	Q1	Q2
Consumption:					
Households	1.4	0.8	1.5	0.6	0.8
Government	1.1	0.0	0.3	-0.7	2.1
Investment	1.8	0.6	1.1	-0.8	0.9
<i>of which, business investment</i>	<i>2.0</i>	<i>0.1</i>	<i>1.0</i>	<i>-0.1</i>	<i>0.5</i>
<b>Final domestic demand</b>	<b>1.4</b>	<b>0.5</b>	<b>1.3</b>	<b>0.1</b>	<b>0.9</b>
Change in inventories (b)	-0.7	0.4	0.5	0.1	0.1
<i>Excluding alignment adjustment (b)</i>	<i>-0.5</i>	<i>0.5</i>	<i>-0.3</i>	<i>0.9</i>	<i>-0.7</i>
<b>Domestic demand</b>	<b>0.7</b>	<b>0.9</b>	<b>1.8</b>	<b>0.2</b>	<b>1.0</b>
Net trade (b)	-0.1	0.0	-1.2	0.3	-0.2
<b>GDP at market prices</b>	<b>0.6</b>	<b>1.0</b>	<b>0.7</b>	<b>0.5</b>	<b>0.9</b>

(a) At constant 1995 market prices.

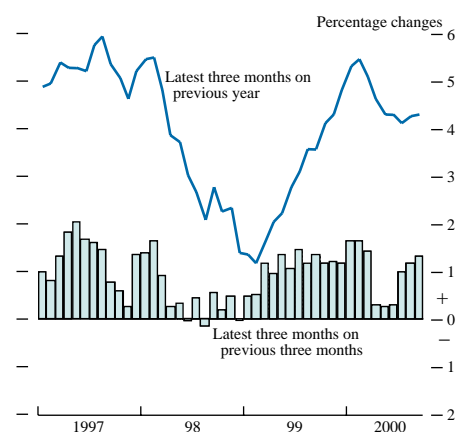
(b) Percentage point contribution to quarterly growth of GDP.

**Chart 2.4**  
**Household consumption expenditure growth<sup>(a)</sup>**



(a) At constant 1995 market prices.

**Chart 2.5**  
**Growth in retail sales volumes**



2000 Q2. The recovery in Q2, following weak growth of 0.1% in Q1, reflected stronger household consumption growth, rising investment and a pick-up in public sector spending. Abstracting from recent erratic quarterly growth rates, final domestic demand growth seems to have eased somewhat relative to 1999 H1 before the millennium distortions. Nevertheless, somewhat stronger-than-expected recent consumption growth and rising public sector spending growth suggest that domestic demand is likely to remain relatively robust over the forecast period.

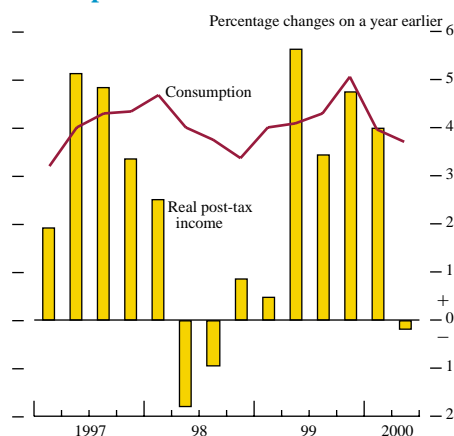
### Consumption

Consumer spending growth picked up to 0.8% in 2000 Q2, although the pace of growth so far this year remains somewhat below rates seen in 1999. Growth in spending on services recovered to 0.7% from sluggish growth in Q1. In addition, higher spending on non-durable goods contrasted with a slight fall in spending on durable goods due to a further decline in purchases of vehicles (see Chart 2.4). Continued weakness of vehicles spending perhaps reflected ongoing uncertainty about the final extent of price reductions in response to the recent report on car prices by the Competition Commission.

More timely indicators point to steady household consumption growth in Q3. Goods purchased from retailers account for about 40% of consumer spending. Retail sales volumes recovered from weak growth in Q2, rising by 1.3% in 2000 Q3 (see Chart 2.5). Goods sales appear to have been largely unaffected by the fuel supply disruptions in September, although reports from the Bank's regional Agents and the Chartered Institute of Purchasing and Supply (CIPS) suggest that the fuel shortages may have had some impact on sales of services. Recent monetary data are also consistent with firm spending growth in Q3. Household borrowing remains strong and household M4 was boosted by windfall payments to Scottish Widows policyholders (see Section 1). Looking further ahead, however, early indicators for sales in October, such as the latest CBI distributive trades and BRC surveys, point to some easing in spending growth, perhaps partly related to recent severe weather conditions.

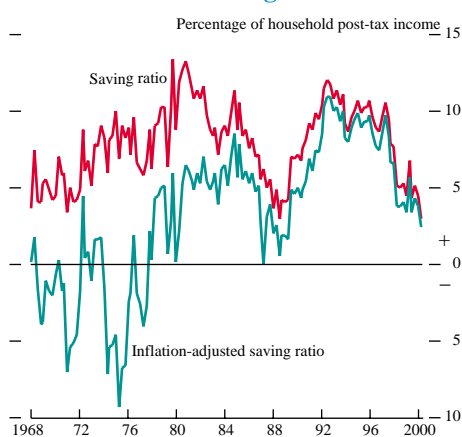
In recent years, growth in household post-tax income has generally failed to keep pace with spending growth (see Chart 2.6). In 2000 Q2, real household post-tax income fell slightly, reflecting both slower growth in labour income and a sharp fall in the property income

**Chart 2.6**  
**Real household post-tax income and consumption<sup>(a)</sup>**



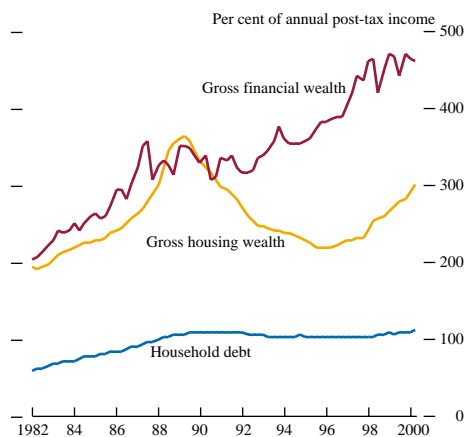
(a) Deflated by the household consumption expenditure deflator.

**Chart 2.7**  
**Household sector saving ratios**



Sources: ONS and Bank of England.

**Chart 2.8**  
**Household assets and liabilities<sup>(a)</sup>**



Sources: ONS and Bank of England.

(a) Using a four-quarter moving sum of income.

component, which tends to be volatile. As a result, household gross savings—the surplus of current income over consumption—fell sharply, reducing the saving ratio to 3%, equal to its previous lowest level in 1988 Q3 (see Chart 2.7).

Low saving out of current income in recent years might partly reflect the impact on household financial wealth of lower inflation. Inflation erodes the real value of financial assets that are fixed in nominal terms and requires households to save more of their current income simply to maintain the real value of their wealth. High inflation in the 1970s and 1980s meant that household saving out of current income was often offset by falls in the real value of existing assets. By contrast, low inflation since the early 1990s has meant that new saving has generally translated into increases in real financial wealth. A measure of the saving ratio, adjusted for the impact of inflation on net financial wealth, suggests that despite lower nominal saving rates in recent years, household real saving rates remain above their levels in the 1970s and late 1980s (see Chart 2.7).<sup>(1)</sup>

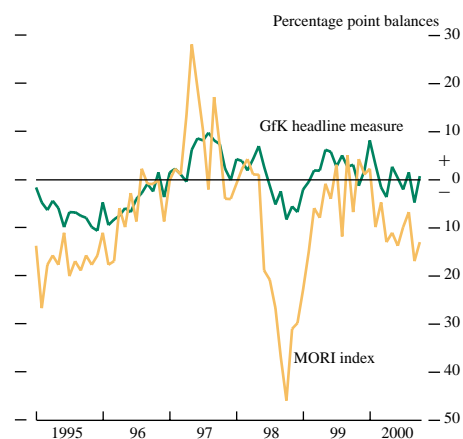
In addition, households may have saved less of their current income, and borrowed more heavily, because of capital gains on existing wealth holdings. In recent years, rising asset prices have boosted aggregate household wealth to income ratios by considerably more than the increase in the aggregate household debt to income ratio (see Chart 2.8). Future prospects for spending depend partly on whether these asset price rises are sustained. Since the *August Report*, equity prices have changed little and house price inflation has moderated further. Less rapidly rising wealth and slower growth in real incomes may partly explain the drift down in consumer confidence measures over the past year (see Chart 2.9). These developments suggest that consumption is likely to slow. However, spending has been stronger than suggested by its standard determinants for some time and given a more robust growth outturn in Q2 than anticipated in August, the MPC judges that consumption growth will ease somewhat less rapidly than expected at the time of the *August Report*.

### Investment demand

Investment has risen more slowly than anticipated so far this year. Whole-economy investment rose by 0.9% in 2000 Q2, following a fall in the previous quarter.

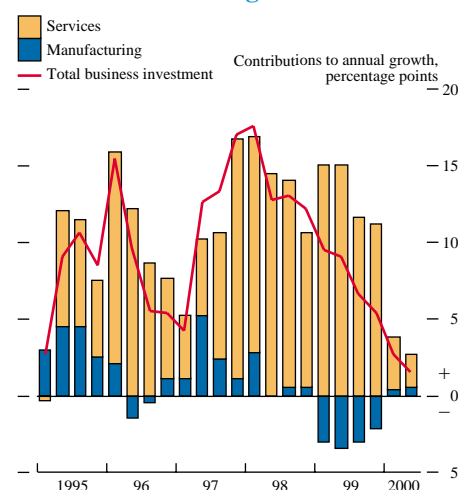
(1) Based on a method developed by Taylor, C T and Threadgold, A R in 'Real national saving and its sectoral composition', *Bank of England Discussion Paper*, No 6, 1979.

**Chart 2.9**  
**Consumer confidence**



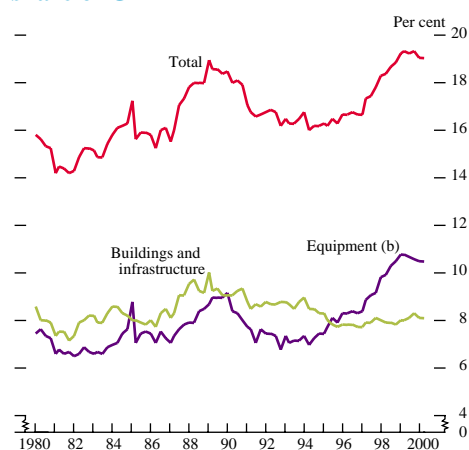
Sources: GfK and MORI.

**Chart 2.10**  
**Business investment growth<sup>(a)</sup>**



(a) At constant 1995 prices. Contributions to business investment by the agriculture, utilities, extraction and construction industries are not shown.

**Chart 2.11**  
**Whole-economy investment by asset as a share of GDP<sup>(a)</sup>**



(a) At constant 1995 prices.  
(b) Equipment comprises plant and machinery, vehicles, ships and aircraft.

General government investment increased sharply, consistent with large planned increases in public sector capital spending. But business investment was only 0.5% higher in 2000 Q2 than a quarter earlier, and annual growth at 1.5% was the lowest since 1994. The service sector represents around three quarters of business investment and has accounted for much of the slowdown in aggregate investment over the past year (see Chart 2.10). Annual service sector investment growth was 3% in 2000 Q2, compared with average growth of more than 20% in 1999. By contrast, annual manufacturing investment growth has recovered a little from falls in 1999.

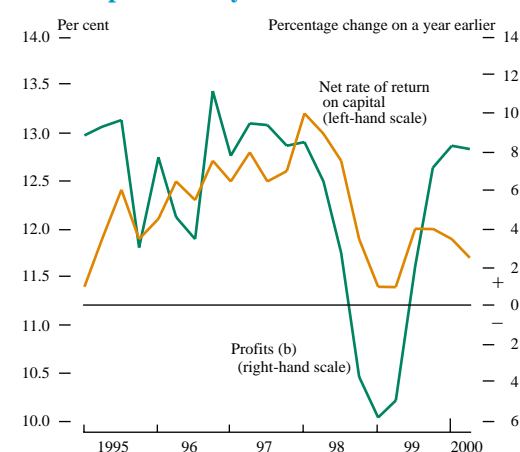
A number of factors might explain weak investment growth so far this year. One possibility is that previous strong investment growth has moved companies closer to desired capital stock levels, which would tend to lower current rates of investment relative to the recent past. Chart 2.11 shows that investment as a share of GDP rose to historical highs from 1996 to 1999, and remains near these levels despite slower growth. Investment in machinery and equipment, which includes purchases of information and communications technology capital, has increased particularly strongly in recent years, perhaps boosted by falling relative prices and corporate concerns about year 2000 compliance. Anecdotal evidence from the Bank's regional Agents suggests that computer systems investment slowed in 1999 and remained weak early in 2000, perhaps as companies delayed investment until uncertainties related to the transition to the new millennium had been resolved.

Weaker domestic investment in physical capital might also partly reflect buoyant corporate spending on financial assets in recent quarters. As noted in [Section 1](#), corporate borrowing has increased rapidly this year as companies have financed purchases of third-generation mobile telecommunications licences and mergers and acquisitions activity.

A further possibility is that subdued investment, particularly in the service sector, might be a lagged response to weaker profits and lower rates of return on capital early last year (see Chart 2.12). Profits provide a source of finance for new investment, and some companies may use average realised rates of return on existing capital as an indicator of potential returns from new investment. Profit growth subsequently picked up in 1999 H2, although not by enough to raise rates of return on capital significantly. In 2000 Q2, the gross

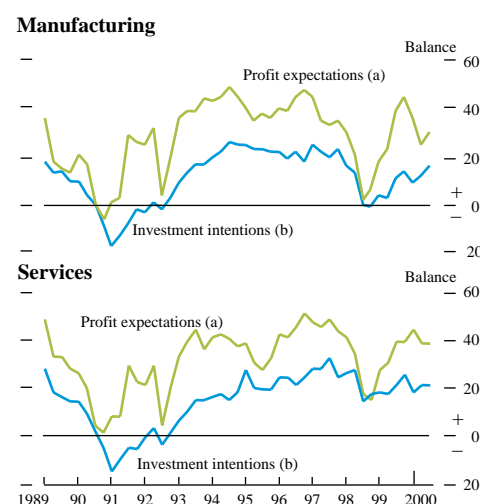


**Chart 2.12**  
PNFCs' profitability<sup>(a)</sup>



(a) Private non-financial corporations excluding companies operating on the UK continental shelf.  
(b) Excluding statistical alignment adjustment.

**Chart 2.13**  
Influences on investment



Source: BCC.

(a) Balance of responses to the question: 'Do you believe that over the next twelve months profitability will improve/remain the same/worsen?'  
(b) 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?'

trading profits of non-oil private non-financial corporations rose by 1.3% on the quarter and were 8.2% higher than a year earlier (see Chart 2.12).<sup>(1)</sup>

Looking forward, lower corporate profit expectations (as measured, for example by the Merrill Lynch Fund Manager and Euler Trade Indemnity Quarterly Financial Trends surveys), and broadly flat equity prices perhaps point to slower profit growth. By contrast, the latest BCC quarterly economic survey reported that profit expectations had risen further in the manufacturing sector and remained at high levels in the service sector (see Chart 2.13). Overall investment intentions in the BCC survey were robust and considerably stronger than evidence on the manufacturing sector alone from the CBI quarterly trends survey. Drawing the picture together, the MPC judges that subdued fixed capital spending growth in recent quarters probably overstates the underlying weakness of business investment. As such, the Committee expects a moderate recovery in business investment over the forecast period, maintaining a relatively high share in terms of GDP. Nonetheless, the near-term outlook for the level of business investment is a touch weaker than in the *August Report*.

### Public sector consumption

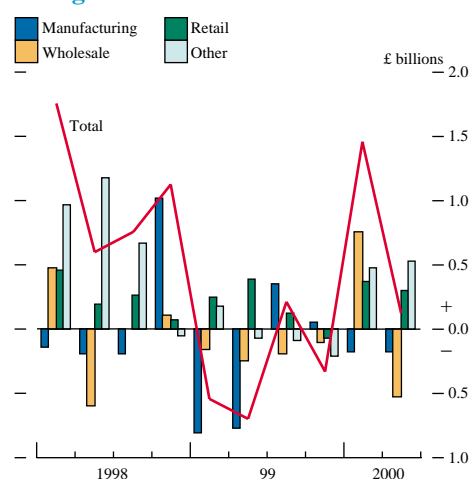
Real government spending grew by 2.1% in 2000 Q2, following a fall in the previous quarter. Nominal government spending in earlier quarters was revised up slightly in the National Accounts, but this has not affected government plans to carry forward some of the underspend in the 1999/2000 financial year into the current year. The MPC has assessed the outlook for the public finances using government expenditure plans set out in the 2000 Spending Review, updated to take account of measures announced in the Pre-Budget Report on 8 November, and estimates of effective tax rates drawn from the Pre-Budget Report forecast. Together with the MPC's forecast for inflation, these plans continue to imply robust growth in real government spending over the forecast period.

### Inventories

According to the headline measure of inventory investment in the National Accounts, stockbuilding contributed 0.1 percentage points to GDP growth in

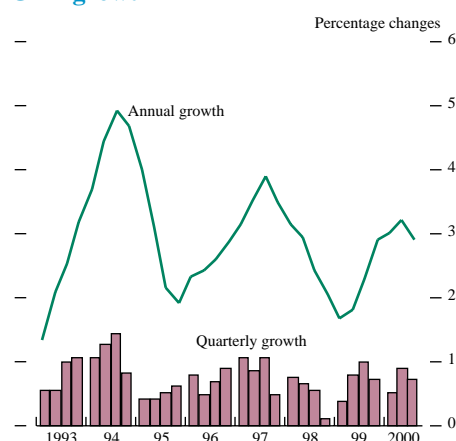
(1) Excluding an alignment adjustment, which is used by the ONS to reconcile any discrepancies in the growth rates of the income, expenditure and output measures of GDP, published in the National Accounts. In the income measure of GDP, the alignment adjustment is allocated to the gross operating surplus of private non-financial corporations. On the expenditure side of the National Accounts, the alignment adjustment is allocated to the stockbuilding component of demand.

**Chart 2.14**  
Change in inventories<sup>(a)</sup>



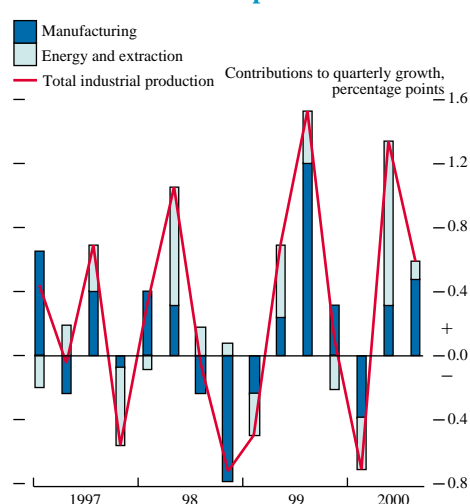
(a) At constant 1995 prices, excluding a statistical alignment adjustment.

**Chart 2.15**  
GDP growth<sup>(a)</sup>



(a) At constant 1995 market prices.

**Chart 2.16**  
Growth in industrial production<sup>(a)</sup>



(a) At constant 1995 market prices.

2000 Q2. But that estimate included a statistical alignment adjustment allocated to inventories. The underlying data suggested that inventories rose less rapidly (see Chart 2.14). In particular, stocks held by wholesalers fell back after a large build-up in the first quarter, which might have been related to stockpiling of tobacco products ahead of increases in duty in the Budget.

Fuel supply disruptions are likely to have affected stock levels in many firms in September. But survey evidence on stock levels in the economy as a whole is mixed. The latest CBI distributive trades survey reported that stocks held by retailers had fallen in Q3 although wholesalers' stocks had risen slightly. The CBI quarterly industrial trends survey suggested a modest rise in stocks held by manufacturers in Q3. The latest CIPS survey suggested a less rapid fall in stocks in Q3 but noted that many companies continued to seek cost savings through improved stock management techniques. Consistent with these reports, the MPC continues to expect the ratio of inventories to output to decline over the medium term.

## 2.3

## Output

According to the preliminary estimate, GDP growth slowed to 0.7% in 2000 Q3, reducing the annual growth rate to 2.9% (see Chart 2.15). The profile of GDP growth has been erratic in recent quarters with large fluctuations in the output of primary sectors, which are often volatile, obscuring the underlying pace of growth. In particular, weak energy sector output depressed GDP growth in Q1, bounced back strongly in Q2 with growth of more than 5%, and growth then eased in Q3. In contrast, construction output was unusually strong in Q1 but fell in the second quarter. The box on [page 22](#) considers the potential impact of the weather on output growth in these industries. Excluding these volatile sectors, quarterly growth in GDP slowed from an average of 0.9% in 1999 H2 to 0.6% so far in 2000.

Strong growth in energy industries raised overall production sector growth in Q2 to 1.4% (see Chart 2.16), and annual growth of 2.2% was the highest since 1995 Q1. Manufacturing output growth resumed in Q2, with output rising by 0.4% on the quarter. The recovery in manufacturing continued in Q3 but was more than offset by slower energy sector output growth, reducing quarterly industrial production growth to 0.6%. Forward-looking surveys (see Table 2.C) and reports

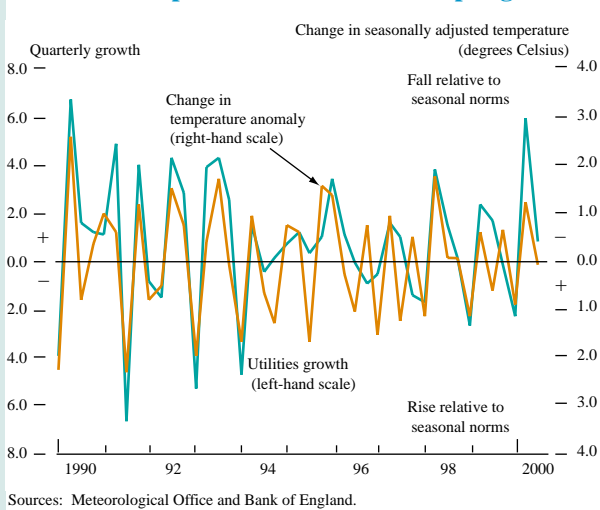
## Output and the weather

Exceptionally high rainfall has recently led to severe flooding. As well as the devastating effects on many local economies, these floods potentially have wider implications for aggregate demand and output. Weather can also have less dramatic, but more regular impacts on economic activity in sectors sensitive to weather conditions. For instance, output in many primary sectors and construction varies through the year with seasonal changes in the weather: agricultural output will fluctuate with growing seasons and harvest times; energy demand typically rises in the winter, boosting utilities output, and falls back in the summer months; and in construction, outdoor projects may be more concentrated in periods of warmer weather.

ONS adjust raw output data to remove these regular seasonal fluctuations. But seasonal adjustment does not eliminate the effects of exceptional weather such as unusually warm (or cold) temperatures for the time of year. So a fall in temperature below seasonal norms in winter months might raise both the level and growth rate of even seasonally adjusted utilities sector output. And if colder than normal temperatures persist, output will remain at a higher level until temperatures return to their seasonal norm.

Chart A relates seasonally adjusted utilities output growth to quarterly changes in a measure of temperature anomalies.<sup>(1)</sup> Output growth has tended to weaken in periods when temperatures have risen relative to seasonal norms and strengthen when they have fallen. The table confirms a historic negative correlation between abnormal temperature changes and utilities output. It also reports tentative evidence that unusually warm temperatures have been negatively related to output of other parts of the energy sector, such as mining, gas and oil extraction, and positively associated with construction

**Chart A: Temperature and utilities output growth**



Sources: Meteorological Office and Bank of England.

(1) This anomalies series is based on a central England temperature series supplied by the Meteorological Office and seasonally adjusted by the Bank to remove normal seasonal variations in temperature. The Meteorological Office publishes a temperature anomalies series but it has too short a sample at present to be used in statistical analysis.

**Sectoral output growth and the weather<sup>(a)</sup>**

	Correlation of output growth with:	
	Rise in temperature (seasonally adjusted)	Rise in rainfall (seasonally adjusted)
Agriculture	-0.18	0.04
Industrial production,	-0.27 (b)	-0.04
of which:		
<i>Manufacturing</i>	0.17	-0.16
<i>Mining and energy extraction</i>	-0.44 (b)	0.11
<i>Utilities</i>	-0.80 (b)	0.20
Construction	0.27 (b)	-0.07
Services	0.16	0.10
GDP	0.01	0.03

Sources: ONS and Meteorological Office.

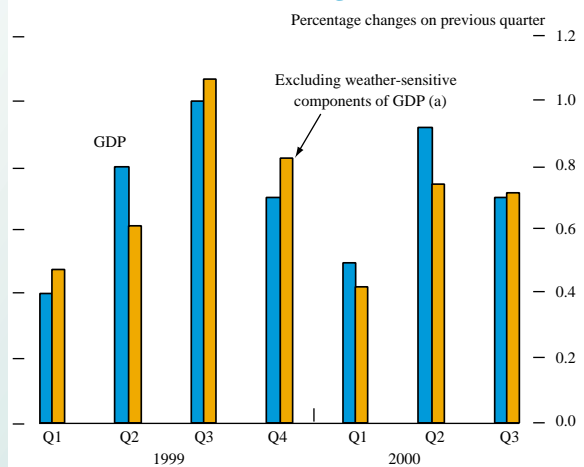
(a) Based on quarterly output data since 1990. Temperature and rainfall data are adjusted by the Bank to remove normal seasonal changes.

(b) Significantly different from zero at 5% level.

output. Agricultural output seems to have had little regular relationship with unusual temperatures or rainfall patterns although it is likely that severe weather at times has substantially affected output in the sector. Similarly, although the table suggests that there has been little regular association between rainfall and output in other sectors, exceptional rainfall, such as in recent weeks, or prolonged drought, can potentially have a marked impact on output.

Evidence of a link between temperature and output in energy and construction industries might help to explain swings in total output growth so far this year. An unusually warm Q1 may have contributed to weaker energy and stronger construction output. And a return to more normal temperatures for the time of year in Q2 might explain stronger energy and weaker construction growth. Energy sector output growth subsequently weakened in Q3 when temperatures remained near seasonal norms. That suggests that a measure of GDP excluding potentially weather-sensitive sectors might sometimes give a clearer signal of underlying trends in overall output growth (see Chart B).

**Chart B: Measures of GDP growth**



(a) Shows growth in manufacturing and services. Excludes agriculture, mining, utilities and construction industries from aggregate GDP.

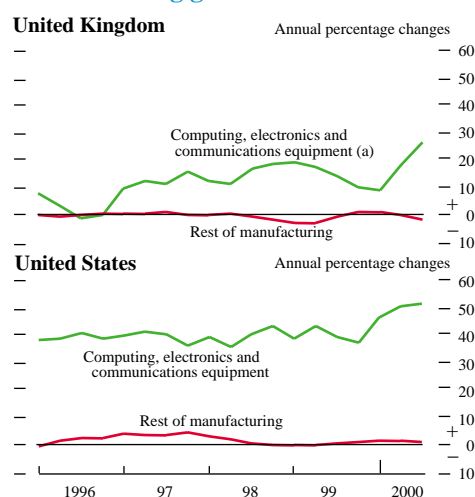
**Table 2.C**  
**Manufacturing output prospects<sup>(a)</sup>**

Series	average (b)	1999		2000		
		Q3	Q4	Q1	Q2	Q3
CBI total new orders, past four months	-1	-5	9	-4	-8	-9
CBI volume of output, next four months	8	12	11	1	3	3
CIPS new orders index, past month (c)	52.9	58.6	56.7	52.4	51.4	52.8
BCC home orders, past three months	6	19	20	15	5	11
EEF volume of new orders, past three months	6	3	8	6	-8	5
Dun & Bradstreet expected net sales, next quarter	35	45	47	51	47	38

Sources: BCC, CIPS, CBI, EEF and Dun & Bradstreet.

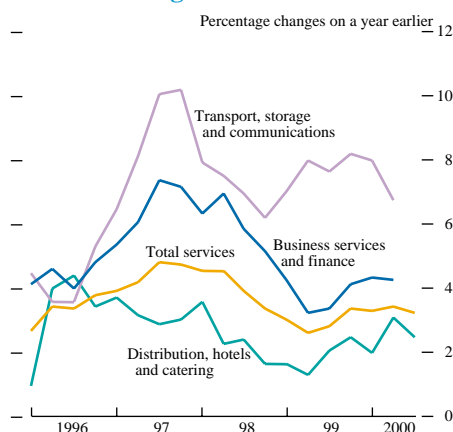
- (a) Numbers reported are survey balances. An increase suggests a rise in the proportion of respondents reporting 'higher' relative to 'lower'.  
 (b) CBI since 1975; CIPS since 1992; BCC since 1989; EEF since 1994; Dun & Bradstreet since 1989.  
 (c) Average of seasonally adjusted monthly indices.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

**Chart 2.17**  
**Manufacturing growth**



- (a) Defined to be broadly comparable with the US computers and communications sector. Includes manufacture of computer, electronics and communications equipment, which together account for about 6% of UK manufacturing output.

**Chart 2.18**  
**Service sector growth**



from the Bank's regional Agents generally point to continued moderate manufacturing growth in the near term. However, recent CIPS surveys have noted that fuel supply disruptions perhaps depressed manufacturing output in September and that growth slowed further in October.

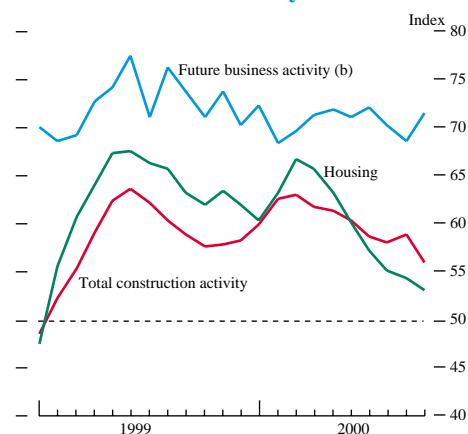
Previous *Reports* have noted that output in recent years has tended to be strongest in sectors primarily orientated towards domestic markets. By contrast, sectors heavily exposed to international competition have generally fared less well, reflecting the impact of the sharp appreciation of sterling on their competitiveness. But sectoral growth patterns indicate that other forces have also been at work. For example predominantly high-technology sectors within manufacturing, such as computing, electronics and communications equipment industries, have grown rapidly recently despite being exposed to strong international competition (see Chart 2.17).

This trend has been even more marked in the United States, which has also seen a large appreciation in its exchange rate in recent years. That may partly reflect the relatively lower dependence of the US manufacturing sector on international trade. It is also possible that international variations in measured growth in these sectors might partly reflect cross-country differences in the measurement of real output. The United States deflates nominal computer output using 'hedonic' price indices to take account of the impact of quality improvements, whereas UK price deflators make alternative quality adjustments. A recent National Statistics review has noted that if UK indices have underestimated quality change, output growth would be stronger, particularly in the computing sector.<sup>(1)</sup> Nevertheless, variations in growth within UK manufacturing suggest that structural change, as well as ongoing effects from sterling's appreciation, has helped to explain the diverse pattern of growth within UK manufacturing in recent years.

Preliminary estimates suggest that service sector output rose by 0.7% in 2000 Q3 and by 3.3% on a year earlier (see Chart 2.18), slightly slower growth than in Q2. Continuing recent trends, service sector growth in the second quarter was strongest in the business services and transport and communications sectors. Looking forward, surveys suggest further easing in growth. The BCC survey for Q3 recorded a lower balance of service

(1) 'Review of short-term output indicators', *National Statistics Quality Review Series*, No 1, October 2000.

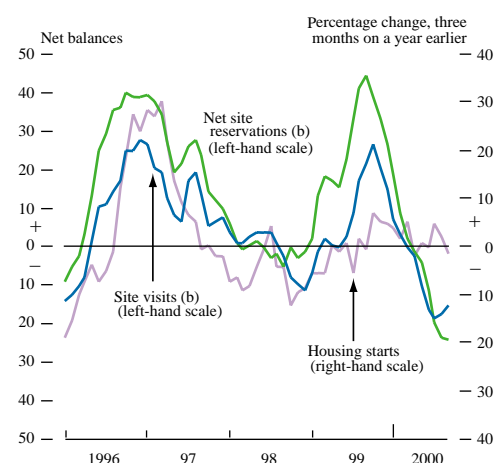
**Chart 2.19**  
**CIPS construction survey<sup>(a)</sup>**



Source: CIPS.

- (a) A reading above 50 suggests expansion, a reading below 50 suggests contraction.
- (b) Not seasonally adjusted.

**Chart 2.20**  
**Private housing starts, net site visits and reservations<sup>(a)</sup>**



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.

sector orders and business confidence in future turnover. In addition, the latest CIPS survey noted that growth in new business had eased from levels seen prior to the fuel supply disruptions in September.

Construction sector output has been particularly erratic this year and fell by 1.7% in Q2 following an unusually strong rise of 3.1% in the first quarter, perhaps reflecting abnormal fluctuations in the weather. Survey indicators and evidence from the Bank's regional Agents point to a bounce-back in growth in the third quarter. The Euler Trade Indemnity Quarterly Financial Trends survey reported a marked rise in construction activity in Q3. The CIPS survey of construction also pointed to robust growth in output although the index has fallen recently, driven by weaker expansion in housebuilding activity (see Chart 2.19). Other indicators of housing market activity remain subdued compared with the recent past. For example, recent House Builders' Federation survey balances suggest that site visits and net reservations remain well below levels a year earlier (see Chart 2.20).

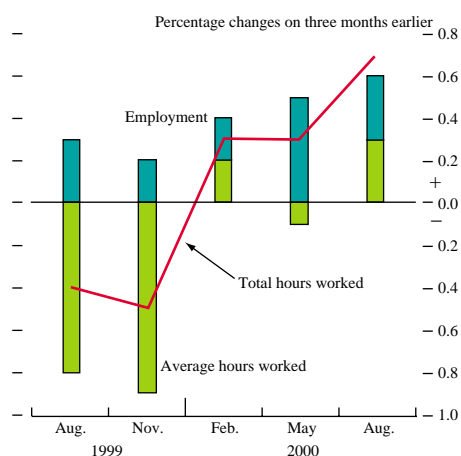
## 2.4

## Summary

Overall prospects for UK demand and output are little changed from the August *Inflation Report* projections. Despite erratic quarter-to-quarter fluctuations in GDP growth, its underlying pace seems to have eased. Final domestic demand grew relatively robustly in 2000 Q2, supported by strong private and public sector consumption spending growth. But factors contributing to strong private consumption in recent years—rising wealth and incomes—seem less likely to boost spending over the next two years. Investment levels were little changed in the first half of 2000. Continuing robust investment intentions in surveys point to higher growth in coming quarters, although relatively subdued profit expectations in some surveys suggest only a moderate recovery.

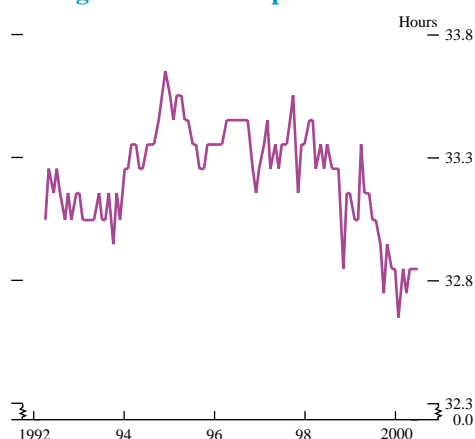
The international outlook remains strong and world output and trade are set to grow rapidly. However there are clear signs that growth has peaked and risks remain weighted to the downside. Buoyant world demand has boosted UK exports over the past year. But looking forward, the high level of sterling is likely to continue to depress net trade and, together with slowing private sector demand growth, that more than offsets more rapid growth in public sector spending. As such, the MPC continues to judge that real annual GDP growth is likely to slow slightly over the forecast period to around 2.5%.

**Chart 3.1**  
Growth in LFS employment and hours worked<sup>(a)</sup>



(a) Growth of employment plus growth of average hours worked may not equal growth of total hours worked because of rounding.

**Chart 3.2**  
Average hours worked per week



Recent developments in earnings growth are surprising given trends in employment, unemployment and skill shortages. Total hours worked and LFS employment continue to rise quickly, and surveys suggest that further growth in employment is likely. There have been large falls in LFS unemployment, and claimant count unemployment has hit fresh 25-year lows. Reports of skill shortages and recruitment difficulties are increasing. Yet headline earnings growth has fallen to its lowest level in four years, partly reflecting falling bonuses. Wage settlements are little changed on a year ago, although indications of upward pressure have increased. Productivity growth has increased to slightly above its long-run average and unit labour cost growth has slowed to its lowest rate in more than five years.

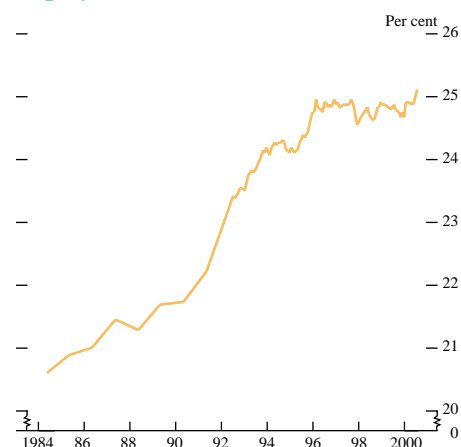
## 3.1 Employment and unemployment

Labour demand has continued to grow strongly. Total hours worked, the most comprehensive measure of labour usage available, rose by 0.7% in the three months to August (see Chart 3.1), up from the 0.3% increase in the three months to May. Within that, average hours worked rose by 0.3% in the three months to August, and may be stabilising following reductions over the past two and a half years (see Chart 3.2). Those falls may partly reflect the effects of structural factors such as the Working Time Directive (WTD).

The future path of average hours worked is difficult to judge and depends on the balance between structural factors, which have lowered average hours worked in recent years, and cyclical influences, which may be putting upward pressure on average hours worked. While considerable uncertainty remains, the MPC judges that average hours worked are likely to remain around their current levels over the next two years.

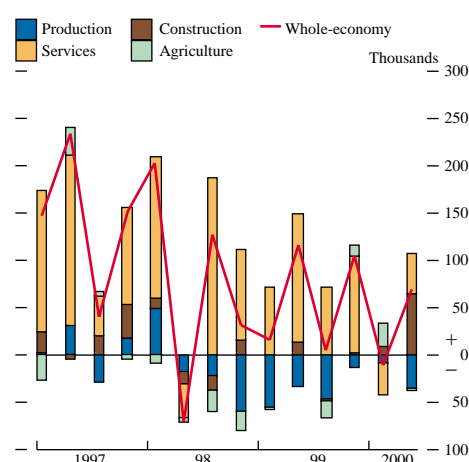
LFS employment growth has eased a little in recent months, although it remains strong. In the three months to August LFS employment rose by 80,000 (0.3%), compared with the 0.5% rise in the three months to May. The recent growth reflected a sharp rise in part-time employment, with full-time employment falling slightly.

**Chart 3.3**  
**Proportion of part-timers in LFS employment<sup>(a)</sup>**



(a) Annual data before 1992.

**Chart 3.4**  
**Quarterly changes in Workforce Jobs**



**Table 3.A**  
**Surveys of employment intentions<sup>(a)</sup>**

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

Series	1999				2000			
	average (c)	Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>Whole economy</b>								
Manpower	10	8	7	15	14	14	14	18
<b>Services</b>								
BCC	13	12	16	21	21	25	28	28
Manpower	12	12	11	15	14	18	16	21
CBI/Deloitte & Touche (d)	23	21	21	12	43	29	31	32
<b>Manufacturing</b>								
BCC	3	-5	2	6	12	4	11	9
CBI	-16	-26	-22	-15	-10	-15	-13	-7
Manpower	14	5	9	14	12	13	11	14

(a) Seasonally adjusted by the Bank.  
 (b) Next three months for all series except for CBI; next four months for CBI.  
 (c) CBI from 1972; Manpower from 1981 (whole economy) or 1988 (sectoral); BCC from 1989; CBI/Deloitte & Touche from 1998 Q4.  
 (d) Unweighted average of consumer services, and business and professional services.

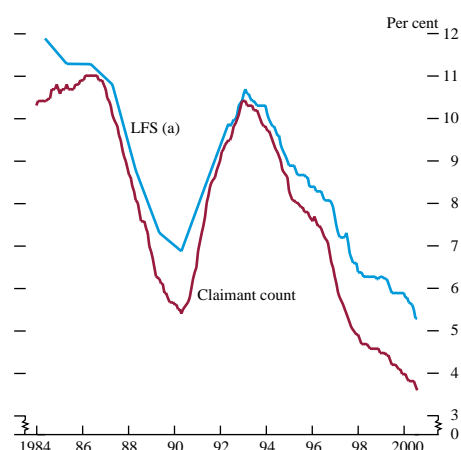
This fall is unusual: full-time employment declined only once in the previous two years. These developments raised the proportion of part-timers in LFS employment to its highest level since the series began in 1984 (see Chart 3.3). Within this, the proportion of women working part-time has been rising for around a year, perhaps reflecting strong demand from the service sector, where employment growth has been robust. In contrast, the proportion of men working part-time has remained fairly flat over the past year, and at a substantially lower level than for women.

LFS employment measures the number of people in work, based on the responses to a rolling three-month survey of households. By contrast, the Workforce Jobs survey records the number of jobs on a single day towards the end of each quarter. The Workforce Jobs employment measure tends to be rather more volatile than its LFS counterpart and is consequently assigned less weight by the MPC. Workforce Jobs have grown more slowly than LFS employment this year. The number of Workforce Jobs rose by 69,000 (0.2%) in Q2, following a 10,000 fall in Q1 (see Chart 3.4). The Q2 rise was driven by a record increase in the number of construction jobs, following strong growth in construction output in Q1 (see Section 2.3). This was reinforced by a rise in the number of service sector jobs, which reversed an unusual decline in Q1 (service sector employment has grown strongly in recent years). Employment in the production sector continued to decline in Q2, and manufacturing employment fell more rapidly than in the previous six months.

Survey indicators suggest that employment has continued to grow in recent months, with some measures recording their highest levels for two years. Forward-looking employment indicators also generally suggest continued strong employment growth, particularly in the service sector (see Table 3.A). The outlook for manufacturing employment appears little changed.

The unemployment rate influences pay pressures in the economy through several channels. First, because people who are currently unemployed can potentially satisfy employers' demand for labour, they act as a restraining influence on the pay negotiations of people in work. Second, the pay claims of people in employment may take account of the expected costs of a potential spell of unemployment. These costs tend to rise as the unemployment rate increases, because it then becomes

**Chart 3.5**  
**Unemployment rates**



(a) Backward-looking three-month moving averages. Annual data before 1992.

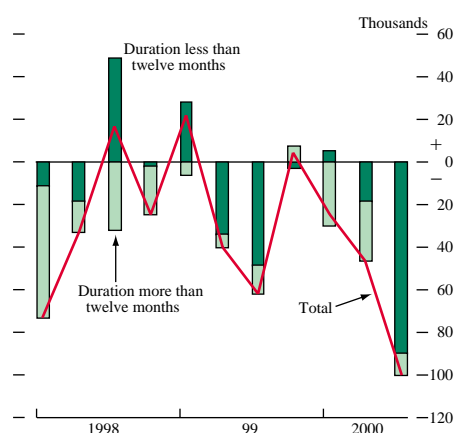
more difficult to obtain another job. Both effects suggest that a lower unemployment rate is likely to be associated with stronger pay pressures.

The MPC pays particular attention to the LFS measure of unemployment, which records the number of people who want a job, have been searching for work recently and are available to start shortly. LFS unemployment has fallen sharply in recent months: the drop of 100,000 on the latest three-month comparison is the largest for nearly three years. These falls, which have been larger than expected by the MPC, reduced the LFS unemployment rate to 5.3%, the lowest rate recorded since the series began in 1984 (see Chart 3.5).

The claimant count—a measure of unemployment based on the number of people receiving unemployment benefits—has also fallen in recent months. The decline of 57,200 in the three months to September reduced the claimant count unemployment rate to 3.6%, the lowest rate since September 1975. The recent falls are also larger than those earlier in the year, although the change of pace is less pronounced than for the LFS measure.

The effect on pay pressures of a given level of, or change in, unemployment is likely to depend on its composition. Because the short-term unemployed tend to enter employment more easily than the long-term unemployed, they tend to exert a greater restraining influence on pay negotiations. So a fall in short-term unemployment may have more impact on pay pressures than a corresponding decline in long-term unemployment.

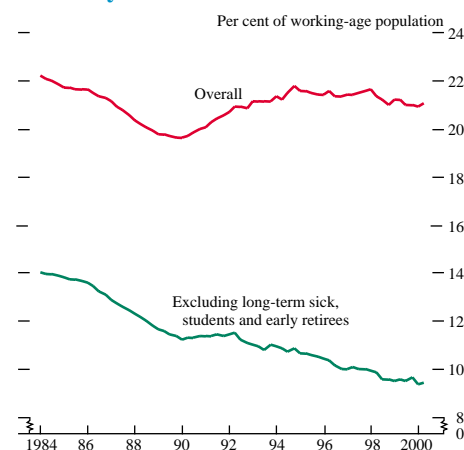
**Chart 3.6**  
**Quarterly changes in LFS unemployment by duration**



A large proportion of the fall in LFS unemployment earlier in the year reflected a decline in the number of people unemployed for more than twelve months (see Chart 3.6). This continued an established pattern: two thirds of the fall in LFS unemployment in the six years to May 2000 reflected declining long-term unemployment. By contrast, almost all of the large falls in LFS unemployment in recent months reflect reductions in the number of people unemployed for less than twelve months: the short-term unemployment rate fell from 4.1% in May to 3.8% in August, while the long-term unemployment rate remained at 1.5%. So the recent decline in unemployment may be associated with stronger incremental pressure on earnings than the fall earlier in the year, both because of this compositional change and because the recent fall is larger.

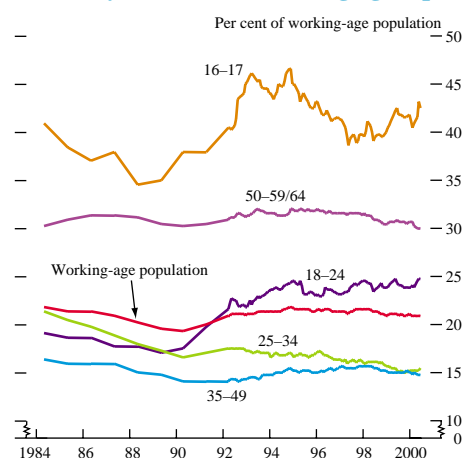


**Chart 3.7**  
**Inactivity rates<sup>(a)</sup>**



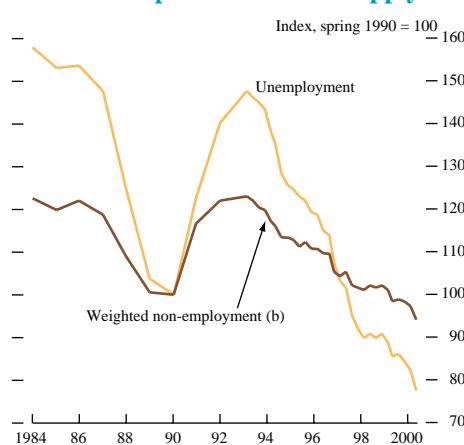
(a) Drawn from the LFS, adjusted for a discontinuity in 1992. Annual data before 1992.

**Chart 3.8**  
**Inactivity rates of different age groups<sup>(a)</sup>**



(a) Annual data before 1992.

**Chart 3.9**  
**Measures of potential labour supply<sup>(a)</sup>**



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.

The pool of inactive people<sup>(1)</sup> is another potential source of additional labour supply. The inactivity rate has been declining gradually for several years and reached a low of 20.9% in April (see Chart 3.7). Inactivity has, however, edged up in recent months, although that is probably an erratic movement. While the aggregate inactivity rate remains significantly above the previous trough in 1990, this reflects rising numbers of long-term sick, early retirees and students—who tend to have relatively low participation rates. Chart 3.7 shows that when those components are excluded the inactivity rate is around its lowest level since the series began in 1984.

The future path of inactivity (or its obverse, participation) will be affected by several factors. The currently inactive are likely to be encouraged to participate if labour demand continues to grow. And the incentives associated with Government initiatives such as the Working Families Tax Credit (WFTC) will also tend to raise participation. Demographic factors are also likely to play some role. Chart 3.8 shows that different age groups have tended to have different inactivity rates. And men have lower inactivity rates than women, although female inactivity has fallen in recent years whereas male inactivity has risen. Developments in the microeconomic influences on the decision to participate, such as educational qualification levels, are also likely to have important effects on inactivity rates. While there remains considerable uncertainty surrounding this issue, the MPC considers that the inactivity rate will continue to edge down over the next two years. The increase in the available supply of labour generated by rising participation will tend to restrain earnings growth.

Different categories of the inactive also tend to enter employment at varying rates—and so, like different categories of unemployed people, may exert different pressures on pay. Chart 3.9 presents an index of weighted non-employment, which may be a useful summary measure of potential labour supply. 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 typically become employed. Weighted non-employment tends to fluctuate less than an index of LFS unemployment, partly because inactivity is less variable than unemployment. Weighted non-employment has not

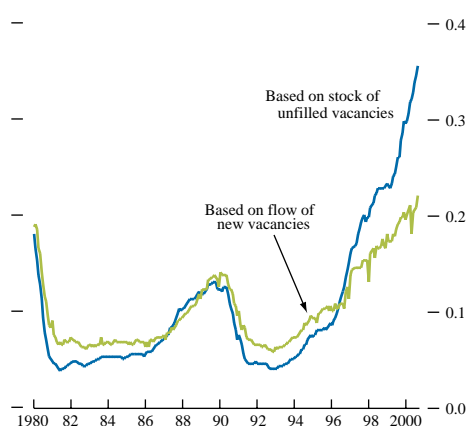
(1) People who do not want a job, people who want a job but are not searching for work, and people searching for work but who are not available to start shortly.

**Chart 3.10**  
Average duration of Jobcentre vacancies<sup>(a)</sup>



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

**Chart 3.11**  
Ratio of Jobcentre vacancies to unemployment<sup>(a)</sup>



(a) Claimant count unemployment.

**Table 3.B**  
Survey indicators of labour availability

	Series average	1999			2000			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>REC staff availability</b> (a)								
Permanent staff	44.3	58.6	52.5	47.3	43.3	45.3	42.3	38.7
Temporary/contract staff	45.3	60.9	54.0	47.4	44.3	47.6	41.9	40.8
<b>BCC recruitment difficulties</b> (b)(d)								
Manufacturing	56	71	71	69	69	70	69	73
Services	49	64	62	61	62	61	60	66
<b>CBI manufacturing labour shortages</b> (c)(d)								
Skilled	14	6	8	10	14	14	15	16
Unskilled	3	2	6	5	3	3	2	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) Balance of respondents expecting labour availability to limit output over next four months. Average since 1972 Q1.

(d) Seasonally adjusted by the Bank.

fallen as far as LFS unemployment relative to the previous trough in 1990. And the recent rises in inactivity mean that weighted non-employment suggests a more gradual tightening of labour conditions in recent months than does LFS unemployment.

Developments in job vacancies suggest that the labour market remains tight. The Recruitment and Employment Confederation (REC) index of national press recruitment advertising and the number of unfilled Jobcentre vacancies have both risen to record highs in recent months. The average time taken to fill vacancies also remains at historically high levels, although it has shown some signs of stabilising in recent months as the number of vacancy outflows has increased (see Chart 3.10). The continued falls in unemployment also mean that the ratio of the stock of unfilled Jobcentre vacancies to the number of unemployed people has risen to its highest recorded level since the series began in 1980 (see Chart 3.11). Existing unfilled vacancies are, however, more likely to be filled by the newly-unemployed than by people already out of work, who may have already exhausted their search of existing vacancies. By contrast, both categories of unemployed people can potentially fill new vacancies. The ratio of the flow of new vacancies to unemployment is currently at less of a historical high than the ratio based on the stock of unfilled vacancies (see Chart 3.11).

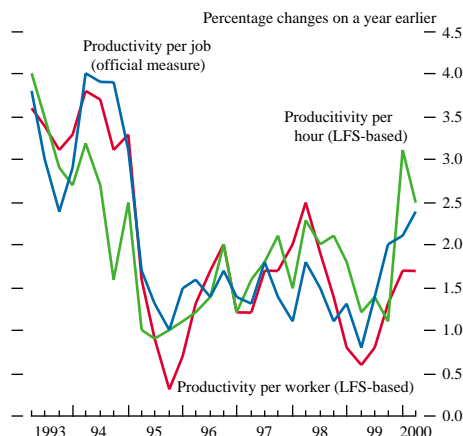
Survey indicators suggest that labour market conditions have tightened in recent months. The REC reports that the availability of temporary/contract and permanent agency staff have fallen to their lowest levels for more than two years (see Table 3.B). Moreover, the BCC measures of recruitment difficulties in manufacturing and the service sector ticked up to their highest levels in two years in Q3, and the CBI measure of skill shortages in manufacturing edged up further. Contacts of the Bank's regional Agents also report an intensification in skill shortages in recent months. Moreover, in October the Agents asked a sample of around 200 of their business contacts about their experience of recruitment difficulties. More than 70% of these contacts reported that recruitment difficulties were greater this year than last year and few thought that the situation was likely to improve over the next six months.

## 3.2

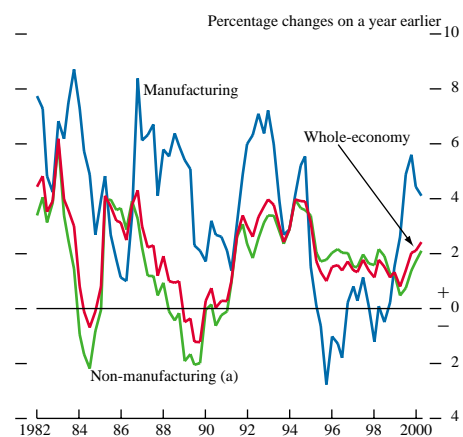
## Labour productivity

Labour productivity growth has strengthened this year, following four years of weak growth (see Chart 3.12).

**Chart 3.12**  
**Whole-economy labour productivity growth**



**Chart 3.13**  
**Labour productivity growth**



Sources: ONS and Bank of England.

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

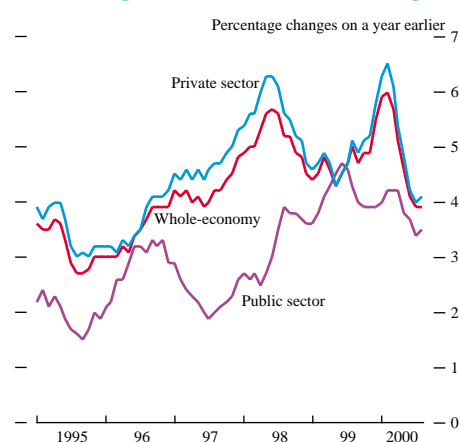
The precise profile, however, varies across different measures. Annual growth in the official measure of whole-economy productivity per job, which is based on the Workforce Jobs employment measure, rose in Q2 to a little above its average of the past 40 years. It grew faster than productivity per worker because Workforce Jobs rose more slowly than LFS employment, the basis of productivity per worker. Productivity per hour worked grew more quickly than productivity per worker in the year to Q2 because average hours worked fell over that period.

Turning to sectoral developments, manufacturing productivity growth has slowed from the high levels recorded at the end of 1999 (see Chart 3.13). The 4.1% growth in manufacturing output per job in the year to Q2 however, continued to exceed the average rise over the last 30 years. Productivity growth outside the manufacturing sector rose to 2.1% in the year to Q2, which also exceeded its long-term average.

The MPC judges that growth in productivity per worker is likely to remain around trend over the next two years. And growth in productivity per hour is thought likely broadly to match that of productivity per worker. There is, however, considerable uncertainty surrounding productivity developments. The pattern of growth in productivity per worker and productivity per hour reflects two judgments. First, that average hours are likely to remain around their current level (see [Section 3.1](#)). Second, that the recent increase in the level of productivity per hour, over a period when average hours worked have fallen, will persist.

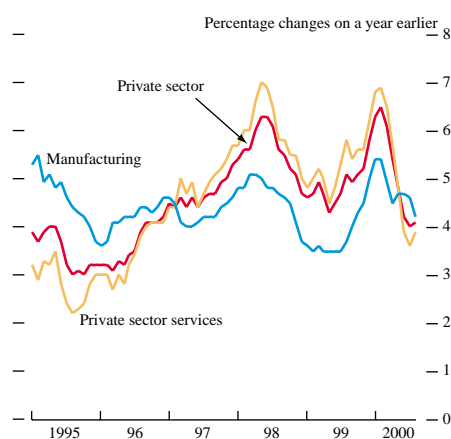
Productivity growth may, however, have been particularly difficult to measure in recent years. The increased use of information and communication technology (ICT) has tended to shift activity to knowledge-based sectors of the economy, where output tends to be more difficult to measure. And it is difficult to take full account of the effects of quality changes on computer prices: any underestimation of their effects would have led output growth, and hence productivity growth, to be understated in recent years (see [Section 2](#)). There is also considerable uncertainty about the potential impact of supply-side improvements such as increased ICT usage on future productivity and inflation. Some Committee members prefer to make different assumptions on this issue from those incorporated in the central projections. Section 6 discusses this in more detail.

**Chart 3.14**  
Headline growth in nominal earnings<sup>(a)</sup>



(a) Annual growth in backward-looking three-month average of the AEI.

**Chart 3.15**  
Headline growth in nominal earnings<sup>(a)</sup>



(a) Annual growth in backward-looking three-month average of the AEI.

**Table 3.C**  
Components of earnings growth<sup>(a)</sup>

2000	Whole economy		Public sector		Manufacturing		Private sector services	
	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)
February	5.1	0.6	4.8	0.0	5.1	-0.5	5.3	0.9
March	4.7	0.9	4.2	0.0	5.1	-0.6	4.9	1.5
April	4.4	0.0	4.4	0.1	4.7	-0.2	4.4	0.0
May	4.6	-0.7	3.6	-0.3	4.7	0.5	5.1	-1.7
June	4.4	-0.7	3.2	0.0	4.7	-0.1	4.7	-1.5
July	4.2	-0.6	3.7	-0.2	4.4	0.0	4.2	-0.9
August	4.3	-0.2	3.6	-0.1	3.6	0.2	4.9	-0.3

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

### 3.3 Earnings, settlements and unit wage costs

Earnings growth, as measured by the Average Earnings Index (AEI), has been weaker in recent months than expected by the MPC at the time of the *August Report*. The AEI headline rate of annual nominal earnings growth fell from 4.6% in May to 3.9% in July and August (see Chart 3.14), the lowest rate for four years. That slowdown is difficult to reconcile with the low and falling rate of unemployment, continued strong growth of employment, and growing reports of skill shortages and recruitment difficulties.

Headline earnings growth has slowed in both the private and public sectors since May, although both rates edged back up in August (see Chart 3.14). The private sector slowdown mainly reflected falling earnings growth in the services component (see Chart 3.15). Manufacturing earnings growth has been more stable, at a higher level. That is surprising given the relative employment developments in the two sectors.

Earnings growth edged up in the raw annual growth rates for August (the final of the three observations used to calculate the headline rate for August). Specifically, annual whole-economy earnings growth rose from 3.8% in July to 4.1% in August, reflecting a significant rise in the private sector services component. But it is too early to discern whether these rises presage higher earnings growth: raw annual growth rates can be volatile and such growth rates remain weak outside private sector services.

Earnings growth can be expressed as a combination of growth in regular pay and the contribution from bonus payments. Table 3.C reports ONS estimates of this split for the raw annual growth rates of earnings. It shows that the weakness in earnings growth in recent months partly reflects regular pay growth edging down to around 4<sup>1</sup>/<sub>4</sub>% to 4<sup>1</sup>/<sub>2</sub>%, from the 4<sup>1</sup>/<sub>2</sub>% to 4<sup>3</sup>/<sub>4</sub>% range recorded earlier in the year. This slowdown in regular pay growth is again surprising given the strong demand for labour discussed in [Section 3.1](#).

The recent weakness of earnings growth in recent months, however, mainly reflects bonus payments being smaller this year than last year—bonuses made negative contributions<sup>(1)</sup> to whole-economy earnings growth

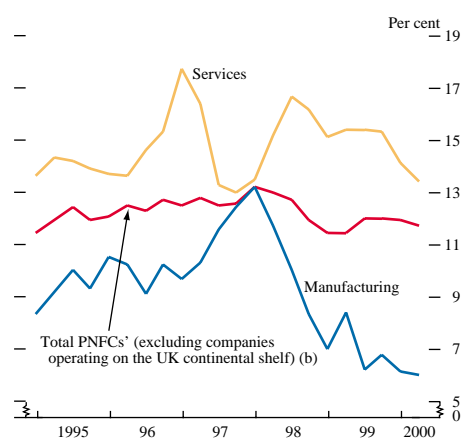
(1) Bonuses make a negative (positive) contribution to earnings growth if they grow more slowly (more quickly) than regular pay.

between May and August. The negative bonus effects were concentrated in the private sector, particularly within private sector services.

Employers pay bonuses for a range of reasons, including to reward their employees for improvements in productivity and profitability and to help recruit and retain staff. Payments are likely to reflect both developments over the previous year and anticipation of future trends. Bonuses are often paid annually, rather than being spread across the year. In contrast, regular pay growth tends to be more closely linked to wage settlements and to be steadier from month to month.

Bonuses have generally added to earnings growth over the past few years, as the importance of this form of remuneration has increased. For example, there was only one negative bonus effect recorded between March 1997 (when the bonus data start) and February last year. So the negative bonus contributions over the past few months appear unusual in a recent historical context.<sup>(1)</sup>

**Chart 3.16**  
PNFCs' net rate of return<sup>(a)</sup>



- (a) Gross operating surplus (less capital consumption at current replacement cost) divided by gross capital employed (less accumulated capital consumption at current replacement cost).  
 (b) The total includes PNFCs outside services and manufacturing, although no separate data are available on these components.

There is some uncertainty about what factors underlie the recent negative bonus effects. They do not appear to reflect productivity developments—productivity growth has strengthened this year after four years of low growth (see Section 3.2). And it is difficult to detect a strong link between private sector bonuses and aggregate trading profits or gross operating surpluses—which have strengthened this year after falling last year (although lagged effects of those falls cannot be ruled out). There are, however, some tentative signs of links with firms' rates of return (which take account of the capital used to generate profits). The net rate of return of non-oil private non-financial corporations (PNFCs) has fallen slightly from the peak in early 1998, with falls in both services and manufacturing (see Chart 3.16). It is, however, unclear how closely bonus effects are related to profitability developments in general—not least because data on bonus effects are available for such a short, and interrupted, period of time.

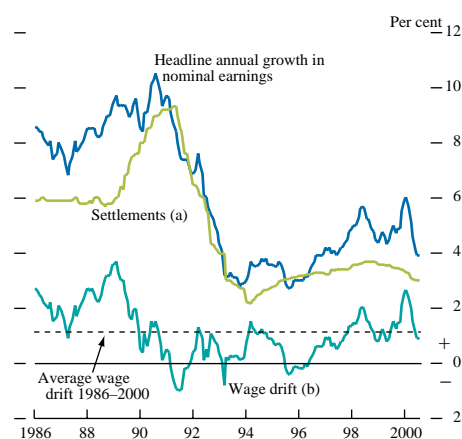
Developments in specific sectors are also likely to have contributed to the negative bonus effects in recent months. For example, there have been reports of weaker profitability, and consequently lower bonus payments, in the retail sector. An alternative explanation is that firms are raising incentive thresholds relating to bonuses—

(1) This comparison is hampered by the unavailability of reliable bonus data between February last year and January this year because of a change in the scope of the bonus data in February last year.

which will change the relationship between profits and bonus payments. For example, some contacts of the Bank's regional Agents report that the levels of profits required to trigger bonus payments are higher this year than last. And the Incomes Data Services (IDS) survey of pay prospects reports several large employers reducing the proportion of profits paid out in bonuses.

These factors do not completely resolve the uncertainty surrounding the recent negative bonus contributions. Those contributions have, however, been less pronounced in recent months than earlier in the year, especially in private sector services (see Table 3.C). And bonuses may grow more in line with regular pay in future months. An additional factor here, however, is that tax breaks on profit-related pay, which may have contributed to the rise in the proportion of earnings paid through bonuses over the last few years, are in the process of being phased out.<sup>(1)</sup> This suggests that this incentive to raise the proportion of earnings paid in bonuses may not continue to rise as strongly as in the past. Contacts of the Bank's regional Agents, however, report a continuing desire to move to more flexible remuneration packages. Other taxation changes could also affect remuneration and measured AEI growth. For example, tax breaks on employers remunerating employees with company shares have recently been expanded. Such payments are not, like other non-cash elements of remuneration (eg holiday entitlements), captured in the AEI data.

**Chart 3.17**  
Settlements, nominal earnings growth and wage drift



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

- (a) Based on IRS data until 1994, then Bank of England, which draws 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.

Wage settlements are an important component of earnings growth. The Bank collects information on settlements and weights it by sector to match the AEI sample. The average settlement recorded in the previous twelve months edged down between 1998 and the spring of this year, before stabilising at 3.0% in recent months (see Chart 3.17). The average settlement recorded in the previous three months has, however, edged up recently—from 3.0% in May to 3.2% in September. And there have been growing reports of prospective upward pressures on settlements. Such pressures are reported to reflect factors such as the tightness of the labour market and RPI inflation, the basis of many settlement negotiations, running at a higher rate this year than last (see Section 4.5). Earnings growth will, however, be most affected if settlement pressures persist into early next year: settlements in January to April each

(1) Profit-related pay schemes were only eligible for tax breaks if they started before 31 December 1999, and the tax breaks available then were lower than in previous years.

year cover a much larger proportion of the workforce than those in the rest of the year.

The portion of aggregate earnings growth not accounted for by settlements is often referred to as wage drift. Wage drift includes factors such as overtime payments, bonuses, profit-related pay, individual merit awards, and compositional changes in the workforce. There are few official data on these components. But the profile of wage drift can be inferred by subtracting estimated wage settlements from measured earnings growth. The combination of falling earnings growth and unchanged settlements means that the decline in wage drift apparent since the end of 1999 has continued in recent months (see Chart 3.17). Indeed, wage drift has dropped below the average level of the past 15 years.

Other indicators of pay developments are generally consistent with the earnings slowdown apparent in the AEI. Annual growth in wages and salaries per head slowed from 4.8% in 2000 Q1 to 3.6% in Q2. The consistency with the AEI slowdown is, however, unsurprising given that the wages and salaries data are based partly on the AEI. The New Earnings Survey (NES), which is based on a 1% sample of employees in PAYE schemes, reports average gross weekly earnings rising by 2.0% in the year to April 2000. This is likely, however, to understate actual earnings growth—because this year's NES sample included a higher than normal proportion of manual workers,<sup>(1)</sup> who tend to earn less than non-manual workers. The earnings of employees appearing in both the 2000 and 1999 NES samples grew by 6.0% in the year to April 2000—although this comparison typically overstates earnings growth because, for example, no adjustment is made for the increase in the age of the matched sample. The REC survey, which covers the segment of the labour market using recruitment and placing agencies, shows salaries for permanent and temporary/contract staff rising less sharply in recent months than earlier in the year. In contrast, the Reward index of private sector pay has risen significantly since April, although that rise brought it into line with the AEI.

Although wages are typically agreed in nominal terms, firms and employees care ultimately about expected real wages, which depend also on expected inflation. Expectations of higher inflation tend to result in stronger nominal earnings growth. RPI inflation expectations

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(1) Unlike the AEI, the NES data are not weighted to replicate the characteristics of the labour force.

**Table 3.D**  
**Survey-based inflation expectations<sup>(a)</sup>**

Percentage increase in prices

RPI inflation rate one year ahead	1999				2000		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Academic economists	2.3	2.3	2.5	2.2	2.4	2.6	2.6
Business economists	2.1	2.2	2.4	2.4	2.5	2.5	2.7
Finance directors	2.3	2.3	2.4	2.3	2.4	2.5	2.8
Trade unions	2.7	2.5	2.5	2.6	2.4	2.6	2.9
General public	4.1	4.0	3.7	3.9	3.9	3.8	4.2

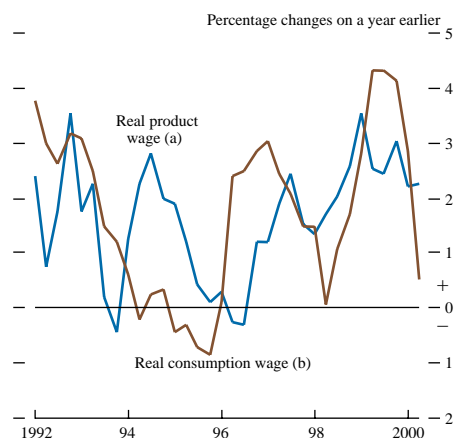
Source: Barclays Basix survey.

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

according to the Basix survey generally rose in Q3 (see Table 3.D). Indeed, the inflation expectations of most groups were at their highest levels for around two years. It is unclear whether that pick-up will persist, and whether it will affect forthcoming wage settlements. The rise may, for example, reflect a reaction to the disruption of petrol supplies in the first half of September, and so could prove temporary. Indeed, monthly data from the GfK survey of consumer confidence suggest that inflation expectations fell back in October from the September peak.

When involved in wage negotiations, employees aim to enhance the real purchasing power of their post-tax earnings, the real consumption wage. Employers, on the other hand, wish to control their total labour costs per employee relative to the prices of the goods and services that they sell, the real product wage. So factors such as changes in the terms of trade and in the taxes faced by employees and employers, which drive a wedge between these two measures of real wage growth, tend to affect the relative bargaining intensity of these two groups in wage negotiations, and hence potential wage pressures. For example, when employees' real wages are being eroded by relative rises in import prices or tax rates they will tend to press harder for increases in nominal earnings to attempt to maintain their effective purchasing power. The real consumption wage grew more slowly than the real product wage in 2000 Q2 (see Chart 3.18). This reversal of the pattern of the previous year suggests some increase in wage pressure from this source.

**Chart 3.18**  
**Growth in real wages**



Sources: ONS and Bank of England.

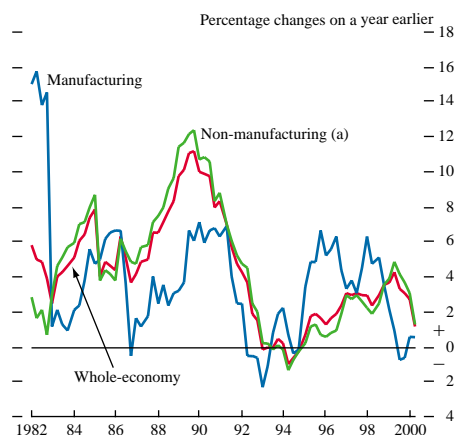
(a) Wages and salaries and employers' social security contributions per head divided by GDP deflator at basic prices.

(b) Wages and salaries per head divided by the tax and prices index.

There are considerable uncertainties about the future path of earnings growth. The MPC's best collective judgment is that temporary factors have played a significant role in the slowdown in earnings growth in recent months. For example, the negative effects on earnings growth of bonus payments may be transient. And factors that may have helped moderate the pay pressures associated with the tight labour market—lower unemployment mainly occurring through falling long-term unemployment and relative movements in employers' and employees' real wage growth—appear to be abating. Moreover, there are growing indications of upward pressures on settlements. So the MPC expects that earnings growth will edge up a little, reflecting the tightness of the labour market. However, the MPC also views the combination of falling unemployment and low earnings growth in recent months as indicating some fall in the rate of unemployment consistent with stable earnings growth and inflation. While considerable



**Chart 3.19**  
**Unit wage cost growth**



Sources: ONS and Bank of England.

(a) Based on official measures of whole-economy and manufacturing unit wage cost growth.

uncertainty remains, the MPC judges that pressures on earnings growth over the next two years could be somewhat weaker than estimated in the *August Report*. But, reflecting the considerable uncertainty about the outlook, some Committee members prefer to make alternative judgments to those incorporated in the central case on supply-side and labour market developments. Section 6 discusses the implications of these alternative judgments for inflation.

The inflationary pressures generated by the labour market are determined by both nominal earnings growth and productivity growth. Productivity growth tempers the effect of nominal earnings growth on the growth of firms' unit wage costs—which is what matters for inflationary pressures. Reflecting rising productivity growth and declining earnings growth, annual whole-economy unit wage cost growth fell sharply to 1.1% in Q2 (see Chart 3.19), the slowest growth in more than five years. The slowdown was driven by a marked decline in unit wage costs growth outside the manufacturing sector. Manufacturing unit wage cost growth, which has a smaller weight in whole-economy developments, was unchanged in Q2. But, because of the strong growth in manufacturing productivity, this was at around half the level outside manufacturing. Section 4 discusses developments in other components of firms' costs.

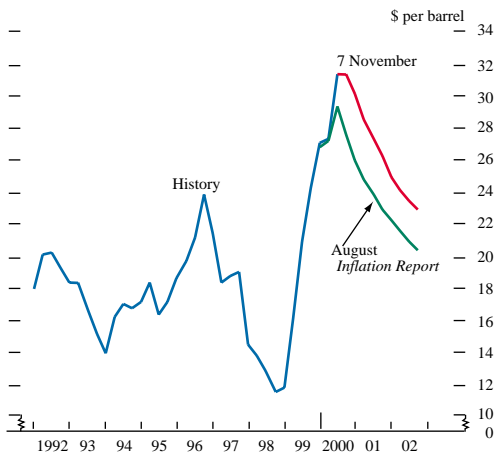
### 3.4

### Summary

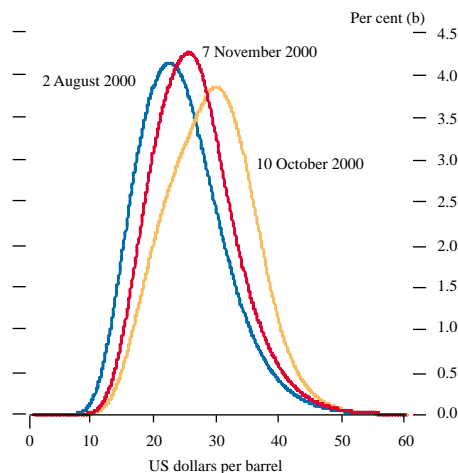
Labour demand has continued to grow strongly and unemployment has continued to fall—to its lowest rate on the claimant count measure for 25 years. And reports of skill shortages and recruitment difficulties are rising. Yet headline earnings growth has edged down to its lowest level for four years, partly reflecting lower bonus payments. The outlook for unit labour cost growth is uncertain, and depends on whether the recent low growth in earnings and upturn in productivity growth are sustained. The MPC's best collective judgment is that nominal earnings growth is likely to edge up from its recent low levels and that productivity growth will remain at around trend.

# Costs and prices

**Chart 4.1**  
Brent oil futures in August and November



**Chart 4.2**  
Probability distribution for the  
December 2001 oil price<sup>(a)</sup>



- (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) Probability of price of oil being within 35 cents of any given price, expressed as a percentage.

Higher oil prices have continued to exert upward pressure on costs. The price of crude oil has fallen from its September peak, but it has remained well above the levels generally seen in the first half of the year. Other upward pressures on UK costs have come from higher prices of imported materials, especially metals. But the growth in whole-economy unit wage costs slowed in Q2, partly as a result of a moderation in earnings growth in recent months and partly as a result of higher productivity, and manufacturing unit wage costs have been flat for around two years. There appear to be continued competitive pressures on producers and retailers that limit their ability to pass on cost increases. The outturn for RPIX inflation in Q3 was a little below the August projection and inflation remains below the  $2\frac{1}{2}\%$  target.

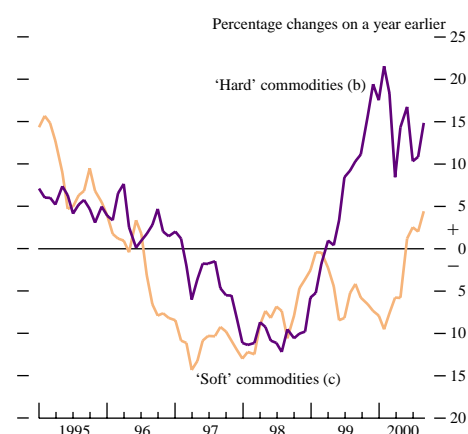
## 4.1 Raw materials and commodity prices

There has been an upward trend in crude oil prices since February 1999, so successive recent *Inflation Reports* have been reporting higher oil prices. This *Report* is no exception, though the spot prices seen in late October and early November have generally been below the peaks seen in September. The average price of Brent crude in Q2 was just over \$27 per barrel, while in Q3 the comparable figure was \$31.4. Chart 4.1 shows the upward shift in Brent futures prices between the August and November MPC meetings. Chart 4.2 shows the probability distributions for oil prices in December 2001 implied by option contracts (based on the price of West Texas Intermediate (WTI) crude) as at the time of the August and November MPC meetings, and at the peak price for this contract in early October.<sup>(1)</sup> The mean of this distribution rose from around \$25 per barrel on 2 August to around \$29 on 10 October and then fell back to around \$27 on 7 November. The MPC has revised up its projection for the Brent oil price at a two-year horizon to around \$24 per barrel.

The Bank's sterling commodity price index rose sharply in September, though this index is volatile and greatly influenced by oil prices. The oil-inclusive index rose by

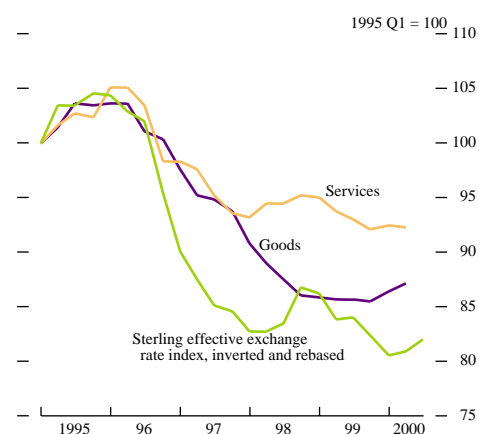
(1) While the spot prices of both Brent crude and WTI peaked in early September, the December 2001 futures contract peaked in early October.

**Chart 4.3**  
**Bank's sterling non-oil commodity price index<sup>(a)</sup>**



- (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.

21.7% on a year earlier in September, while the oil-exclusive index rose by 8.8% over the same period. Sterling prices of commodities have been affected by the fall in the sterling-dollar exchange rate, particularly since May, as the world prices of many commodities are denominated in US dollars. For example, the average daily price of Brent crude in September was 42% higher than a year earlier in US dollar terms but 61% higher in sterling terms.

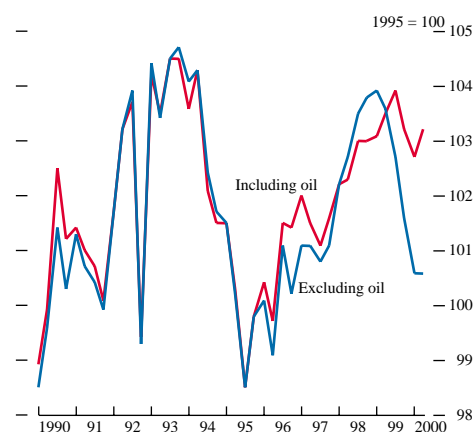
Higher dollar oil prices over the past 18 months have probably been driven by a combination of demand and supply factors: robust world growth has raised the demand for energy, while supply has been affected by OPEC supply decisions (see the box on page 15).

One way of distinguishing between the influence of demand and supply factors is by examining the contrasting price behaviour of 'hard' and 'soft' non-oil commodities. Hard commodity prices rose by nearly 15% in September on a year earlier while prices of soft commodities rose by just over 4% (see Chart 4.3). The strength of metal prices (a major component of the 'hard' commodity category), which rose by 21.4% in sterling terms in the year to September, suggests that some of the driving force behind the strength of hard commodity prices is coming from demand growth in the world economy. The prices of hard commodities, such as metals, that are used as inputs in industrial production tend to move pro-cyclically with world activity, rising when world demand is high. In contrast, agricultural commodity prices, especially foods, are not so closely correlated with world industrial activity, as demand for food is relatively stable throughout the cycle. Moreover, agricultural production is particularly subject to specific supply influences such as those resulting from abnormal weather and changes in global trading arrangements.

## 4.2 Trade prices and the exchange rate

Prices of goods imports rose in Q2, associated both with the rise in oil prices and a slight decline of the sterling effective exchange rate. Prices of services imports have changed little over the year to Q2. Sterling import prices have tended to fall since 1996 (see Chart 4.4), following the appreciation of sterling, but less far and less fast, as importers' margins increased on UK sales (for given foreign currency costs). Goods import prices fell for three years or so before stabilising in 1999 and rising in 2000 H1. Services import prices have been broadly flat

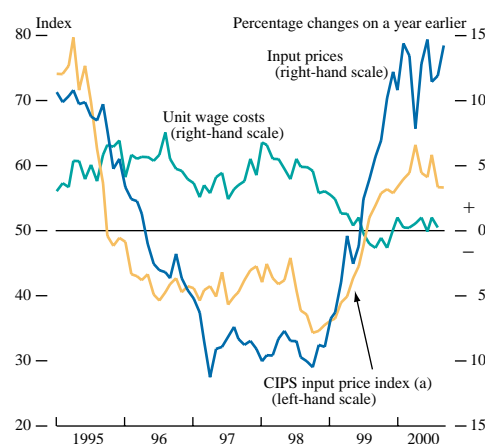
**Chart 4.5**  
**UK terms of trade<sup>(a)</sup>**



Source: ONS.

(a) Export price deflator as percentage of import price deflator.

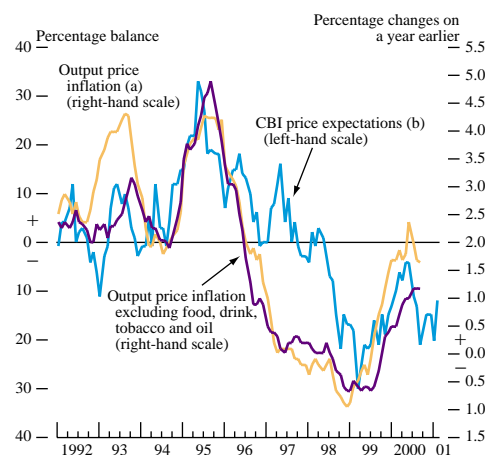
**Chart 4.6**  
**Manufacturing input prices**



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.

**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.

since 1997, but the gap between goods and services import prices has narrowed recently.

Previous *Reports* have discussed an imbalance in the UK economy, arising from the strength of sterling, between sectors that depend heavily on sales to export markets and/or which are exposed to import competition and those less affected by international competition. Another imbalance has arisen over the past year or so due to differences between the oil and non-oil sectors. Chart 4.5 shows the UK terms of trade, measured as export prices as a percentage of import prices. Export prices have risen relative to import prices since 1996 when sterling began to appreciate, and until 1999 the picture looked the same whether oil prices were included or not. However, oil has a bigger weight in UK exports than in imports, and, while the non-oil terms of trade have fallen sharply in the past year, the oil-inclusive level has remained high. The falls in the non-oil terms of trade are consistent with the existence of a relative squeeze on profit margins of UK non-oil exporters, as these prices have returned to around 1996 levels (relative to import prices) despite a much higher exchange rate (see [Chart 2.2](#) on page 16).

### 4.3 Costs and prices in manufacturing

Manufacturing input prices of materials and fuels rose by 2.8% in September, though month-to-month changes can be very volatile. Input prices in Q3 were 12.5% higher than a year earlier, up from the 11.7% growth in Q2. These cost increases were largely oil related, though metals and other imported materials also contributed. Excluding food, beverages, tobacco and petrol, manufacturing input prices rose by 4.2% in Q3 on the corresponding quarter a year earlier.

Manufacturing unit wage costs, in contrast, have been broadly constant for about two years, as productivity growth has matched the rise in earnings over this period. The CIPS survey has indicated a lower balance of respondents in recent months reporting that input prices are rising. However, the October CBI quarterly industrial trends survey showed a small shift towards a positive balance of firms reporting an increase in average unit costs over the past four months, and a similar shift in the balance expecting them to rise in the next four months.

Producer output prices (excluding excise duties) rose by 1.7% in the year to September, the same annual rate as in August but down from 2.4% in the year to June (see

**Table 4.A**  
**Manufacturers' cost and prices**

Percentage changes on a year earlier

	2000						
	Mar.	Apr.	May	June	July	Aug.	Sept.
Weighted costs (a)	3.3	2.3	3.7	3.6	3.4	n.a.	n.a.
Unit labour costs (46.8%)	0.0	0.5	1.0	0.0	1.0	0.1	n.a.
Materials and fuels (30.1%) (b)	13.4	7.9	12.9	14.7	11.4	11.9	14.3
Imports of finished goods (6.9%)	0.0	-1.1	1.1	1.1	1.1	1.1	n.a.
Bought-in services (16.2%)	1.7	1.5	1.3	1.1	1.1	n.a.	n.a.
Output prices (excluding duties)	1.9	1.7	1.8	2.4	2.0	1.7	1.7

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.

**Table 4.B**  
**BCC and CIPS surveys of service sector prices and corporate services price index**

	1999		2000		
	Q3	Q4	Q1	Q2	Q3
BCC prices balance (a)	22	24	26	21	23
CIPS input price index (b)	54.8	57.6	59.3	61.7	61.7
CIPS selling price index (b)	49.2	52.6	53.6	54.1	53.4
Corporate services price index (c)	3.3	3.9	3.6	4.1	n.a.

Sources: CIPS and BCC.

(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.

(c) Percentage change on a year earlier.

Chart 4.7). This suggests that there is little sign so far of higher costs of materials and fuels leading to higher output prices. Output prices excluding food, drink, tobacco and oil rose by 1.2% in the year to September, indicating little impact to date of possible second-round effects on output prices from higher oil prices. Indeed, some survey evidence suggests that manufacturers continue to experience strong downward pressures on their output prices. For example, the balance of manufacturers reporting in the monthly CBI industrial trends survey that they expected to lower prices in the following four months increased in September. This balance narrowed in the October survey, but there has been a persistent majority expecting future price falls since early 1998. In contrast to the CBI responses, the BCC survey over the past year has shown a small majority of manufacturers expecting price rises, and this positive balance increased slightly in Q3 from +6 to +10.

An approximate indicator of the pressure on manufacturing margins can be constructed by adding the various cost components of production using suitable weights and comparing the resulting weighted costs with actual output price increases (see Table 4.A). The weights used may no longer be accurate (as they are based on 1990 input proportions) but a range of plausible weights would yield a broadly similar picture, which shows that output prices have been rising less fast than weighted costs. In addition, as discussed above, export margins appear to have been squeezed even more than domestic margins. This picture of margins pressure for manufacturers, especially in export markets, is supported by reports from the Bank's regional Agents.

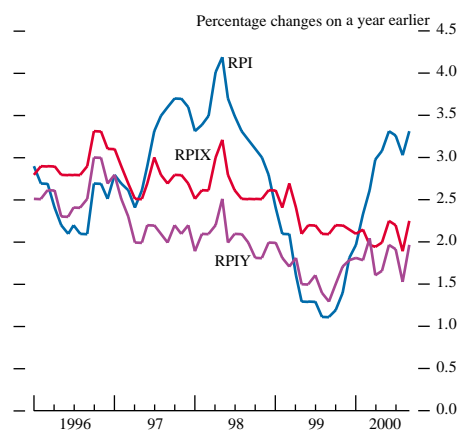
#### 4.4 Costs and prices in the service sector

Annual unit wage cost growth in the service sector slowed to an estimated 1.3% in Q2 from 4% in Q1. Some of this may reflect an ending of special millennium payments affecting Q1, and hence the change between the two quarters may exaggerate the underlying movement. Nevertheless, service sector unit wage cost growth averaged nearly 4% for the calendar year 1999, so the recent slowdown appears substantial. Survey evidence, however, provides a slightly different picture. The CIPS services survey for September reported rising staff costs as contributing to the highest rise in input costs during its four-year existence, though the quarterly average for input cost inflation was the same for Q3 as for Q2 (see Table 4.B) and fuel prices were also a major contributory factor. The October CIPS

services survey also reported that: ‘... higher demand for staff and a tight labour market continued to drive up average wage costs’.

The CIPS output price balance for services fell slightly in Q3, though this was up sharply in September after a dip in August. The BCC survey reported a slight increase in the balance of service sector firms expecting higher output prices over the next three months. The ONS prototype corporate services prices index (CSPI)—which aims to measure movements in the prices of business-to-business services—rose by 1.4% in Q2 and was 4.1% higher than a year earlier, up from 3.6% in the year to Q1. The main contributions to this rise came from charges for road freight and property rental payments. The CSPI is still under development and currently covers about 45% of business-to-business services.

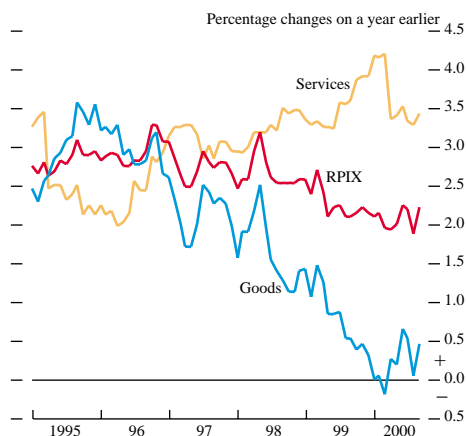
**Chart 4.8**  
**Retail price inflation**



Source: ONS.

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

**Chart 4.9**  
**Goods and services price inflation**



Source: ONS.

## 4.5 Retail prices

Annual RPIX inflation was 2.2% in June and July, but it dipped unexpectedly to 1.9% in August before returning to 2.2% in September (see Chart 4.8). This swing was largely a product of petrol and other fuel price changes, as retail petrol prices fell by 4.2% in August but rose by 2.0% in September. The August fall in petrol prices was mainly due to greater price competition on the forecourts, though partly reflected the pass-through of temporarily lower oil prices in July. In addition to the effects of high and volatile oil prices, there have been some other notable developments affecting RPIX. Seasonal food prices, for example, have behaved in an abnormal way, rising sharply in July and falling back in August (the reverse of the normal pattern). There has also been greater-than-expected weakness in used car prices, and in the prices of clothing and footwear.

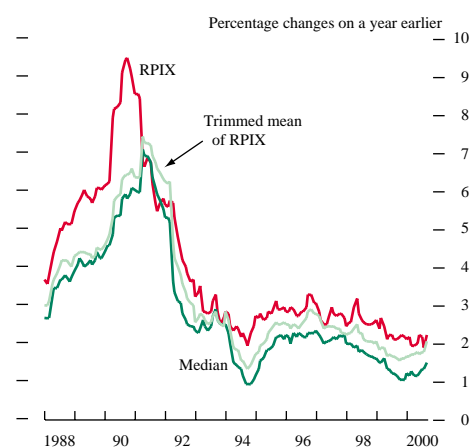
RPI inflation was 3.3% in September, higher than the 3.0% level in August but the same as in June and July. In the absence of further official rate changes, the gap between RPI and RPIX will probably start to narrow from now on, as the interest rate rises of September 1999 to February 2000 start to drop out of the annual inflation rate. RPIY, which excludes the effects of indirect tax changes and mortgage interest payments, was 2% higher in September than a year earlier.

The gap between goods and services price inflation (see Chart 4.9) has narrowed somewhat in recent months, but remains wide by the standards of the early 1990s. In

general, services that have a high labour input are likely to exhibit higher average price rises than manufactured goods (as the potential for productivity increases is more limited). But the appreciation of sterling since 1996 has contributed to the widening of the gap, as most services are domestically produced while many goods are imported (or face stronger competition from imports). Goods prices rose by 0.5% in the year to September, but prices of goods other than food, drink, tobacco and oil (including petrol) fell by 2.8% on a year earlier. The services component of RPI rose by 3.4% in the year to September. Non-shop services prices rose by 7.2% over the same period, with a significant contribution from travel costs and the price of holidays (indirectly affected by higher fuel costs). But there was an offsetting 4.4% fall in utility prices, though this decline, which took effect in April, was expected in advance as it had been announced by the relevant regulatory agencies.

Survey evidence shows continued downward pressure on retail goods prices. The CBI distributive trades survey shows a substantially higher balance of firms reporting lower average selling prices (-25 in Q3 from -6 in Q2). In the same survey there was also an increased balance of firms expecting prices to fall further in future (-23 in Q3 from -12 in Q2). The BRC shop price index recorded a decline of 1.1% in August on the same month a year ago. The September figure showed an annual increase of 0.4%, the first positive figure in this series since April 1999, but this fell back to a decline of 0.2% in October. The Bank's regional Agents report continued significant competitive pressures on retail goods prices. Their reports on retail services prices are more mixed. There are some reports of rising price inflation in advertising, legal services and health insurance, but competition in the tourism sector is creating downward price pressure. Overall, the Agents suggest that retail services price inflation appears to have eased slightly in recent months.

**Chart 4.10**  
**Trimmed mean of RPIX inflation<sup>(a)</sup>**



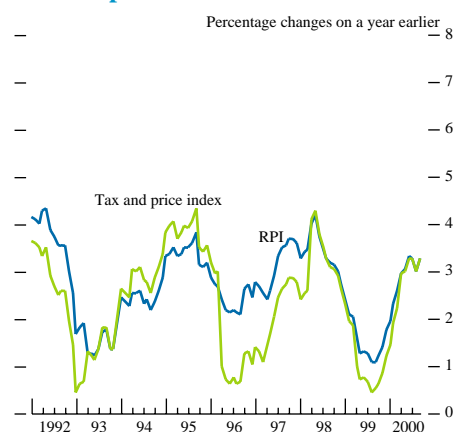
(a) The trimmed mean measure of RPIX inflation is calculated by removing the largest 15% monthly price changes in the components of the RPIX. The calculation takes account not only of the size of price changes in different items that are included in the RPIX, but also the weights of each item in the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

## 4.6 Other price indices

It is sometimes helpful to look at an index of 'core inflation' that excludes volatile items and extreme upward or downward movements in individual components. One such measure is the trimmed mean (see Chart 4.10), which excludes the highest and lowest 15% of weighted price changes in RPIX.<sup>(1)</sup> In

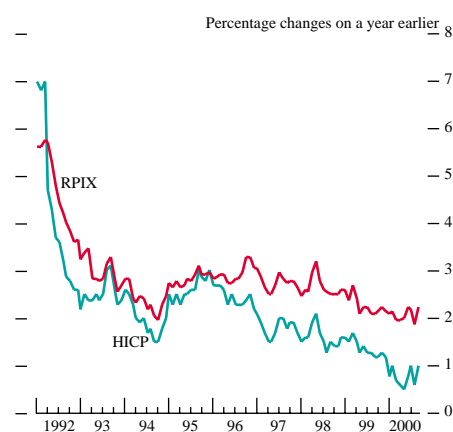
(1) Please note that there was an error in Chart 4.12 of the August 2000 *Inflation Report* relating to estimates of the trimmed mean inflation rate for the months in 2000. The correct values do not pick up sharply in 2000, as erroneously indicated in August.

**Chart 4.11**  
**Tax and price index**



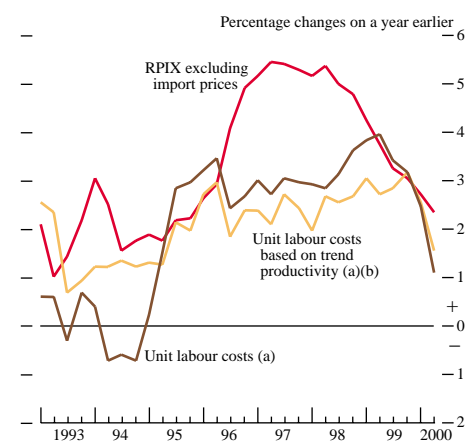
Source: ONS.

**Chart 4.12**  
**HICP and RPIX**



Source: ONS.

**Chart 4.13**  
**Measures of domestically generated inflation**



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

September, trimmed mean inflation was 2% while RPIX inflation was 2.2%. As is evident from the chart, the trimmed measure of inflation has generally been below RPIX inflation. Also shown is the median inflation rate of the RPIX components. This is the inflation rate of the 'middle' weighted element, chosen such that there are an equal number of higher and lower individual components in the basket. The median has generally been below RPIX and the trimmed mean in recent years.

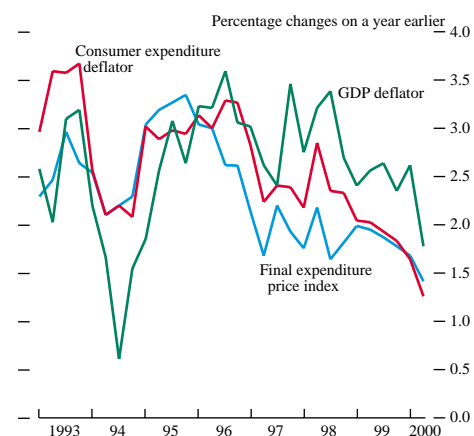
Weights in the retail price index change once a year to reflect changes in the pattern of household expenditure. However, there are other factors that influence household spending power that can be used to adjust retail prices in order to derive a measure closer to a cost of living index. The tax and price index (TPI) (see Chart 4.11) does this by adjusting for changes in direct taxation. Thus, if the share of household incomes taken in direct taxation falls the TPI will show inflation below RPI, and if the direct tax take rises it will be above RPI. As the chart shows, TPI inflation has typically been below RPI since 1996, and sometimes substantially so, though it has been virtually identical to RPI for most of 2000.

Another index of UK inflation is provided by the harmonised index of consumer prices (HICP). HICP inflation (see Chart 4.12) rose in September to a 1% annual rate, and recent movements have broadly paralleled RPIX inflation but at a lower level. The main differences between RPIX and HICP have been discussed in earlier *Reports*; these relate to the different treatment of housing costs, other differences of coverage, and the use of an arithmetic mean to calculate the average price of different types of goods and services from individual price quotes in the former and a geometric mean in the latter.

Attempts are sometimes made to separate out the domestically generated component of inflation (DGI) from the influences of world prices and the exchange rate. There is no unique or reliable way of doing this, but the Bank calculates several measures that may provide some information. Chart 4.13 shows three alternative measures of DGI. All three measures have fallen in 2000 H1 and are now all below 2.5%. RPIX inflation excluding import prices has fallen steadily since 1998, while the growth rate of whole-economy unit labour costs (and unit labour costs calculated using trend productivity growth) has fallen sharply during the current year.



**Chart 4.14**  
**Expenditure price indices**



Source: ONS.

Further indicators of domestic price inflation are provided by the GDP and consumer expenditure deflators, implied by the comparison between nominal and real National Accounts estimates. These are shown in Chart 4.14. The GDP deflator is quite volatile, but both deflators indicate that the annual rate of price increase fell sharply in Q2. The annual increase in the GDP deflator was below 2% in Q2 for the first time since 1995, and the annual increase in the consumer expenditure deflator in Q2 was below 1.5% for the first time since the early 1960s. Also shown in the chart is an experimental index of final expenditure prices,<sup>(1)</sup> which shows a price index for the basket made up of the weighted sum of the components of total final domestic spending (consumption, fixed investment and government consumption). This also showed the annual inflation rate below 1.5% in Q2.

## 4.7

## Summary

The world price of oil has increased since August. This has had a further impact on production costs for both manufacturing and services, and it has partly fed through into retail prices. This has not just been via the direct cost of petrol and heating oil, but also indirectly via higher distribution and travel costs, and holiday price increases. Higher prices for materials and fuels have been partly offset by more benign unit wage costs. Goods price inflation remains low and services price inflation is below the highs seen earlier this year. Price competition remains strong and the squeeze on retailers' and manufacturers' margins has probably continued, especially for the latter in export markets. RPIX inflation remains below target but is projected to rise to around the target level over the next two years.

(1) See *Economic Trends*, ONS, September 2000, pages 21–26.

This section summarises the economic developments and monetary policy decisions taken by the MPC since the August Report. The minutes of the August, September and October meetings are attached as an Annex to this Report. The Bank's repo rate was maintained at 6% in September, October and November.

In the August Report, the MPC's central projection was for RPIX inflation to rise from slightly below the 2½% target to just above the target over the two-year period. Annual real GDP growth was thought likely to ease slightly towards its trend level of around 2½% before rising slightly in the second year of the projection. Relative to the central projection, some members preferred alternative assumptions about factors such as competitive pressures and productivity growth, which in combination raised or lowered the inflation profile by up to ½% at the two-year forecast horizon.

At its meeting on 6–7 September, the Committee first discussed domestic demand and output. GDP had risen by 0.9% in Q2, up from 0.5% in Q1, but much of this increase reflected a pick-up in energy production, which had been unusually weak in Q1. Manufacturing and industrial production had both fallen slightly in July but were growing slowly over the latest three-month period. Service sector output had risen by 0.9% over Q2, but survey evidence suggested that consumer services had slowed while business and professional services were still strong.

Household consumption growth had risen in Q2 but it was lower than the average quarterly rate during 1999, and an important issue was whether it would continue to moderate in line with the projection. The underlying determinants of consumption seemed a little less buoyant than at the start of the year. And most indicators of housing activity pointed to a slowdown in that market. Private investment was weak but government investment and consumption were both strong. The Committee agreed that there was now less of an upside risk to domestic demand growth than a few months earlier. Net trade was little changed in Q2, with export volumes aided by rapid growth in world demand.

World activity in Q2 appeared to have been a little stronger than expected at the time of the *August Report*. Oil prices had risen sharply, which would put upward pressure on retail prices in the short term, but might also depress demand. There was little sign so far of effects on wages from higher oil prices.

M4 lending to households was still growing at 10% per annum, but secured lending growth had fallen sharply in July. Lending growth to PNFCs had increased dramatically. It was possible that distress borrowing had risen but this was not supported by deposit data. It was also possible that the extra lending was to finance investment, but business investment had not shown any significant increase, so the combination of higher borrowing and slow investment growth remained a puzzle. Sterling had depreciated against the dollar but appreciated slightly against the euro, and the effects on the overall trade balance would be broadly neutral.

The labour market had continued to tighten on most measures of employment and unemployment, but earnings growth had fallen further. A negative contribution from bonus growth accounted for much of the fall in the AEI in May and June, but it was hard to judge whether a continued moderation in earnings growth was likely, or whether pressures for higher wages would pick up.

RPIX inflation had remained at 2.2% in July. The ONS advance estimate was for RPIX to fall in August. Retail petrol prices had fallen in August but this was likely to be reversed in later months as higher oil prices worked through. Survey evidence and Agents' reports were consistent with subdued price pressure in the short term. Inflation expectations remained close to the 2½% target.

On the immediate policy decision, most members felt that there had been little news overall on the month. Hence the positions of MPC members were broadly the same as in the previous month. One group continued to take the view that the balance of risks pointed to the need for an immediate rise of 25 basis points in the repo rate, because projected demand growth was likely to take RPIX inflation above target in the second year of the projection. However, another group noted that inflation in the short term was well below target and an immediate increase in the repo rate was not necessary. In their view there were signs of moderating demand combined with an absence of any clear signs of rising inflationary pressures, and there was time to act later if

this turned out to be incorrect. The Committee voted by 5 to 4 to leave the Bank's repo rate unchanged.

At its meeting on 4–5 October, the MPC discussed the latest inflation data. RPIX inflation had fallen to 1.9% in August and measures of domestically generated inflation were at or below 2½%. Short-term prospects for RPIX inflation were below those projected in August. There were some indications that inflation expectations might have picked up but this could have been a temporary reaction to the disruption to petrol supplies.

Oil prices had fallen since the previous MPC meeting but futures prices were indicating an oil price profile substantially higher than assumed in August. It was noted that the United Kingdom was better placed than some other countries for monetary policy to accommodate the first-round effects of the oil price shock, with the economy close to capacity and inflation below target. In addition, high oil prices would affect the UK current account and fiscal balance positively. There was, however, a greater risk of a sharper slowdown in world growth than seemed likely at the previous meeting. These risks would need to be examined carefully in the context of the November forecast round.

Money data showed stronger growth, though notes and coin had been affected by the petrol supply disruption, and broad money growth had been affected by the Scottish Widows windfall and telecoms licence auction. Credit growth was strong and mortgage equity withdrawal seemed likely to support household spending. Further analysis had shown that strong corporate borrowing was probably related to M&A activity and funding of telecoms licence payments, so was not inconsistent with weak business investment. Overall monetary data seemed stronger than in September, but broadly consistent with expectations at the time of the August *Report*. Equity prices had fallen by about 5% on the month, while the sterling ERI was about 2% above the level assumed in August and 1% higher than at the time of the September meeting.

The domestic demand picture remained broadly in line with the August projection. National Accounts data confirmed real GDP growth of 0.9% in Q2. Government spending was stronger than previously estimated, but fiscal outturns to date were in line with the Government's budget projections. Consumer confidence had fallen sharply, equity prices were lower, and house

prices had been broadly flat for six months, so consumption growth seemed unlikely to be much stronger than projected. Survey evidence on activity was generally weaker. The petrol supply disruption seemed unlikely to have a large direct effect on the economy, but it may have a more persistent effect on business and consumer confidence. Staff estimates of GDP growth in Q3 continued to be in line with the August projections.

Employment continued to grow and there had been a sharp further fall in unemployment. However, earnings growth had fallen back sharply, and it was unclear how long the benign conjunction of strong quantities and modest earnings growth could continue. Claimant count unemployment had fallen to levels not seen since the early 1970s, but the headline AEI figure for earnings growth had fallen from 4.1% to 3.9%. The Bank's regional Agents reported little evidence of increasing pay pressures, despite reports earlier in the year of imminent difficulties. It was noted that earnings growth now seemed likely to be below the level projected in August, but some MPC members cautioned that the latest earnings data might be erratic, and in any event it was necessary to remain alert for any signs of rising wage pressures.

On the immediate policy decision, the August *Inflation Report* projections seemed to be broadly intact, though the balance of news was a little weaker. In particular, earnings growth remained subdued and the near-term prospects for RPIX inflation were now lower than had been expected at the time of the previous meeting. The oil price had fallen and sterling had appreciated over the month. On one view, the arguments made at the previous meeting for a rate rise were no longer decisive, though a rise may still be required in future. Weaker earnings and inflation data, combined with a higher exchange rate and lower confidence, suggested that it was sensible to wait until new data and the November projections were available before considering any further tightening of monetary policy. On another view, the balance of weaker data made an even stronger case that a rate rise was not needed. Downside risks were greater than a month ago owing to the potentially greater impact on the world economy of an oil price shock, and possible repercussions in equity markets. The Committee voted unanimously to maintain the Bank's repo rate at 6%.

At its meeting on **8–9 November**, the Committee again voted to maintain the Bank's repo rate at 6%.

## 6.1 The inflation projection assumptions

The Monetary Policy Committee approved this *Report* on 10 November. It provides the Committee's assessment of developments in the economy since August and prospects for the medium term. Projections of GDP growth and RPIX inflation over the next two years are shown 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. The key assumptions on which the projections are based are described below.

World GDP growth once again exceeded expectations in the first half of the year, although there are clear signs more recently that growth is moderating. Output growth in the United States in the first half-year was even higher than projected three months ago, with GDP increasing by more than 6% in the year to Q2. Data for the third quarter and beyond indicate a slowdown from this exceptional pace. Moreover, in tandem with the impact of the earlier monetary tightening, a combination of a stronger dollar exchange rate, a higher profile for oil prices, tightening credit conditions and weaker equity prices has tended to dampen prospective US growth. The central projection remains that US output growth will slow over the next two years, perhaps to a little below the likely trend growth in supply capacity. Output in the euro area rose by nearly 4% in the year to Q2, as strong as seen at any point in the past decade. Forward-looking indicators have softened, however, and growth in the euro area over the next two years is expected to ease a little from recent rates. An improvement in corporate profitability is underpinning the cyclical recovery in Japan, although growth is likely to remain moderate given still quite low levels of consumer confidence. Growth rates in many emerging market economies in Asia have slowed a little in recent months, and equity prices have fallen further, signalling a weaker outlook for profitability. The deterioration in the terms of trade associated with higher oil prices may have been a contributory factor. Prospects for major oil-exporting economies have correspondingly improved. At the global level, the additional income

accruing to oil producers will gradually encourage higher spending and boost their demand for imports. But such spending is unlikely to compensate fully or immediately for lower expenditure by oil consumers.

Drawing the global picture together, world output growth this year may be more than 4½%, the highest rate since 1988. The central assumption is that world GDP growth slows gradually over the next two years, to around 4% in 2001 and to just below that rate in 2002. This outlook is little changed from the August *Report*. Prospects for world trade growth, however, are a little stronger. Recent data suggest that trade growth has been even higher than expected, with import volumes in the United States, the euro area and Japan all rising at double-digit rates. World trade volumes (weighted by UK export market shares) may rise at around 11% this year, around 1 percentage point higher than expected three months ago. Trade growth is projected to ease to around 8% next year, similar to the assumption in August.

The Committee, in common with outside forecasters, continues to assume that the most likely prospect is for a slowdown in world growth to a more sustainable pace, though the risks to this outlook are judged to lie firmly on the downside. A number of factors could trigger a less sanguine outlook, for example a change in sentiment on the strength of underlying productivity growth in the United States, instability in the oil market, and/or sharp movements in asset prices and exchange rates in response to rising domestic and international financial imbalances.

There has been a substantial increase in the expected profile of world oil prices since the August *Report*. The price of Brent crude rose sharply during the second half of August and early September to a peak of just under \$38 per barrel, although the price subsequently eased to around \$30 per barrel following the announcement of the release of strategic oil reserves in the United States and increases (and indications of possible further increases) in OPEC production quotas. Since the August *Report*, market participants' expectations of future oil prices over the next two years have risen by around \$3–\$4 per barrel. Market participants continue to expect falling prices, as additional production is gradually brought onstream and investment to expand future supply capacity is stimulated. The Committee has maintained the assumption that the futures market provides the best guide to the outlook for the oil price.

Higher oil prices have put upward pressure on producer and consumer prices in the major overseas economies, with 'headline' rates of inflation running well ahead of 'core' rates, which exclude energy (as well as food) costs. There are few signs to date, however, of higher headline rates becoming embedded through increased wage claims. The rise in headline inflation in the euro area in September to close to 3% has led the ECB to raise interest rates further to mitigate this threat.

Moreover, although industrial commodity prices have picked up quite sharply over the past month, the rise since August was slower than expected, and, placing additional weight on information from futures' markets, commodity prices may increase less rapidly over the forecast period than assumed in the previous *Report*.

The outlook for inflation in the major overseas economies remains relatively benign, with inflationary pressures projected to dissipate gradually over the next two years as oil prices decline and growth slows in response to earlier monetary tightening. Nevertheless, rates of inflation in the major overseas economies are likely to be a little higher than projected in August.

The outlook for sterling import prices depends on the local currency prices of traded goods set by exporters to the United Kingdom as well as on the sterling exchange rate. As noted in previous *Reports*, sterling import prices have recently been rather higher than a measure based on the average price of overseas exports translated into sterling using relevant trade weights. Over time these two measures are likely to move closely together, as competitive pressures erode any abnormal profit margin on sales to the United Kingdom. But given costs of entering markets and of switching sales between locations, it is possible that overseas suppliers may have temporarily widened their margins on sales to the United Kingdom, particularly if they thought that the strength of sterling was unlikely to persist. The Committee has maintained the assumption from the previous forecast that these margins are likely to be gradually eroded.

The sterling effective exchange rate index (ERI) has appreciated since the August *Report*. Although sterling has weakened further against the dollar, this movement is outweighed in trade-adjusted terms by the rise against the euro. Sterling has, however, been quite volatile over the past month, with the ERI appreciating significantly through much of October and then falling back more recently to levels close to those prevailing around the time of the October MPC meeting. In interpreting recent exchange rate developments in the November MPC



meeting, the Committee judged that temporary factors may have accounted for this hump, and that greater weight should be attached to more recent levels of the exchange rate as a starting-point for the assessment of inflation and growth prospects. The Committee judged that, in this instance, greater transparency would be achieved if the starting-point for asset prices in the projections were based on the average over the previous five working days, rather than fifteen as in recent *Reports*. Alternative fan charts based on the usual fifteen working day convention are shown in [Charts 6.6](#) and [6.7](#) below.

The ERI averaged 107.5 in the five working days up to and including 8 November, consistent with bilateral sterling exchange rates of \$1.44 and 60 pence against the euro. This forms the starting-point for the exchange rate profile assumed in the current projection. It is above the starting-point of 106.1 in the August *Report* and the implied level of 105.9 for November in the August central projection.

The Committee based 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. Adopting this approach, the sterling ERI declines a little to 106.6 by 2002 Q4. The Committee continues to judge that the balance of risks to the sterling exchange rate profile is weighted to the downside, and indeed has increased the scale of the downside risk relative to the August *Report*.

Household wealth is one of the key influences on the outlook for consumer spending. Equity prices are little changed from their levels three months ago. Given that a small rise was expected, the FTSE All-Share index in the five working days to 8 November was some 2% below the central path assumed in the August *Report*. As the Committee has maintained the assumption in the central projection that equity wealth increases from the current level in line with nominal GDP, the lower starting-point leads to a slightly weaker outlook for financial wealth over the forecast period.

Activity in the housing market has moderated and house price inflation continues to decline broadly in line with expectations three months ago. The outlook for gross housing wealth is little changed from the August projection, with house prices likely to rise a little more quickly than earnings over the next two years.

The assumptions on fiscal policy have been updated in the light of the Chancellor's Pre-Budget Report (PBR) on 8 November. The central projection for the volume of public spending is based on the Government's published cash plans, modified by the Committee's assessment of inflation prospects. The assumption on public sector revenues draws on HM Treasury's latest estimates of average tax rates from the PBR, which are then applied to the Committee's economic forecast. The Committee judges that the PBR has little impact on the medium-term outlook for growth and inflation—the additional spending measures are counterbalanced by higher revenue estimates. There will, however, be a slight, temporary, reduction in inflation as a result of the one-year freeze in fuel duties. No account is taken of any measures under consultation.

## **6.2 The output and inflation projections**

According to the preliminary estimate, GDP rose by 0.7% in the third quarter, a touch stronger than projected three months ago, but in line with the average growth rate in the first half of the year. Output growth has slowed from the rapid pace in the second half of 1999, to a rate perhaps around or a little above trend. RPIX inflation stood at 2.2% in September, and so remains just below target. Recent inflation outturns have been a little softer than projected three months ago. The Committee reviewed the prospects for output and inflation against this background.

Recent data on demand and output have not altered the overall picture substantially from that expected at the time of the *August Report*. The National Accounts release estimated that GDP growth in the second quarter was 0.9%, in line with the preliminary release available three months ago. A marked bounce-back in energy output from the weather-affected low level in the first quarter was a major factor accounting for the rise in GDP growth—adjusting for this erratic influence, output growth was little changed between the two quarters.

As noted in previous *Reports*, a marked slowdown in private final demand growth is necessary to prevent overall demand pressures running ahead of supply capacity as public spending increases more rapidly. The second-quarter developments were broadly on the track expected three months ago. Private final domestic demand growth recovered from the unusually weak rate in the wake of the pre-millennium spending spurt, but the rate of growth of private spending has eased

somewhat this year from the rapid pace in 1999. Household expenditure was a little stronger than had been projected in the second quarter and, although business investment was substantially weaker, information from surveys suggests that this may partly have been erratic. Public spending volumes rose quite sharply, a first indication of the faster growth in government spending planned for the next few years.

No data are yet available for the components of demand in the third quarter to match the preliminary output-based estimate of GDP. However, it seems likely that overall domestic demand growth was rather stronger than projected three months ago, as GDP growth was a little above the August projection and monthly trade data are consistent with a more negative contribution to output growth than previously projected. The contributions of private final demand, public sector demand and changes in inventories to the firmer third-quarter picture remain uncertain.

One possibility is that consumer spending growth is slowing less rapidly than projected in August. The outturn for the second quarter was a little above expectations, and monthly data on retail sales, money holdings and household credit expansion are consistent with continuing firm growth in consumer spending in the third quarter.

Strong consumer spending growth in recent years has been supported by rapid gains in wealth and by rising employment and real incomes. Indeed, expenditure growth has generally outstripped that of household income, with the household saving ratio falling to 3% in the second quarter, the lowest level since 1988, but above typical effective rates of saving in the 1970s and late 1980s once an allowance for the impact of inflation on wealth is made. Moreover, household consumption has been stronger than expected over the past two years on the basis of the estimated statistical relationship with real income, wealth and interest rates. This may suggest a more powerful or more rapid impact of changes in wealth than on average in the past.

The Committee continues to project a further slowdown in consumer spending over the coming quarters. Although the high level of household wealth may support expenditure levels for some time, the growth in wealth has slowed, and the stimulus from the rapid increase in recent years is likely to fade gradually. Household real incomes may rise less quickly than in the

recent past, and the impact of previous interest rate increases has yet to feed through fully. Moreover, the housing market—often quite a good barometer of consumer sentiment—continues to cool. However, in the light of the recent evidence suggesting a more robust outturn for consumer spending than envisaged in August, the Committee judges that the slowdown may be less pronounced. Household consumption expenditure may be somewhat stronger than projected three months ago, with the saving ratio rebuilt only slowly.

Whole-economy fixed investment growth this year has been weaker than expected. Business investment—some three quarters of the total—rose by only 0.5% in the second quarter, following a slight dip in the first quarter. Service sector investment—in turn some three quarters of business investment—has decelerated sharply. The growth in service sector investment was running at annual rates of around 20% through 1998 and the first half of last year, but dropped to around 3% in the year to the second quarter.

Companies invest to bring their capital stocks into line with desired levels. So rates of investment are determined by a variety of factors such as output and profit expectations and the real cost of capital. As capital stocks are built up from investments that have been made over a number of years, and are large in relation to flows of new investment, relatively small changes in desired capital stocks may translate into large changes in investment plans. Business investment consequently tends to be a volatile component of final demand. In recent years, rapid business investment growth has raised the share of investment in GDP; a lower user cost of capital and relatively high marginal returns for some investments may have raised the desired capital stock and stimulated additional investment to bridge the gap. It is possible that this adjustment is coming to an end, which would tend to lower the growth of business investment relative to the recent past. Nevertheless, the slowdown in business investment in the first half-year was sharper than projected, although, given the distortions to the timing of investment around the turn of the millennium and reports of firm spending intentions in the service sector, the Committee judges that the pause in growth does not reflect the underlying trend. The Committee expects a moderate recovery in business investment in the second half-year with growth thereafter broadly in line with GDP. However, the level of business investment is projected to be a little weaker in the near term than in the August projection. Investment in

the economy as a whole will rise a little more quickly than business investment as public investment increases rapidly.

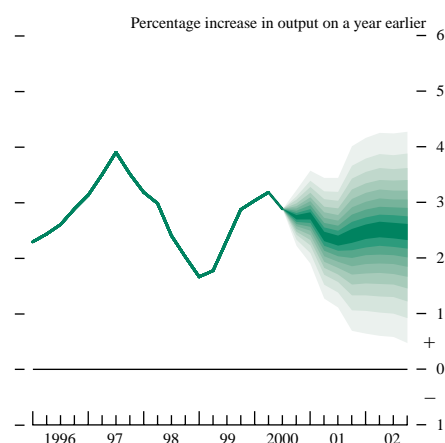
Inventories allow firms to smooth production schedules by providing a buffer to absorb sudden changes in demand for their output. It is likely that stockholdings of some companies were significantly affected by the disruptions to fuel supply in September. The impact at the level of the whole economy is quite difficult to gauge, however, and surveys point in different directions. On balance, it seems more likely that aggregate inventory holdings may be a little higher than otherwise in the very short term, although firms are likely to reduce any excess stock levels relatively quickly once fears of future disruption have passed. In the medium term, the Committee has maintained the assumption that companies will continue to improve production and distribution systems to achieve further economies in the costs of holding stocks, so that the ratio of inventories to output is projected to decline gradually.

Rapid growth in world trade has been associated with sharp increases in both UK export and import volumes. Indeed, flows of both exports and imports have been stronger than expected. Exports of goods and services were almost 9% higher in the second quarter than a year earlier, with particularly swift growth in sales to non-EU countries. Export growth is likely to slow over the next two years, as world demand and trade decelerate.

Import growth continues to outpace that of exports, with volumes up by about 11% over the past year. A combination of strong growth in domestic demand—some 4% over the past year—and a high exchange rate, has stimulated rapid increases in imports. Import growth is also likely to slow somewhat over the forecast period as overall domestic demand growth eases. The strength of sterling and the projected compression of import margins are, however, likely to lead to a further increase in import penetration. Contacts of the Bank's regional Agents continue to report intense competition from imports across a wide range of markets.

The net trade contribution to GDP growth is likely to remain negative over the next two years as imports rise more quickly than exports. The weakening in the net trade position is likely to be broadly similar to that assumed in the *August Report*, reflecting the offsetting forces of the higher expected profile for the exchange rate and the slightly stronger prospect for world trade growth.

**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.<sup>(1)</sup> This projection is conditioned on the assumption of unchanged UK interest rates at 6%.<sup>(2)</sup> Four-quarter GDP growth peaked at 3.2% in the second quarter, easing to just below 3% in Q3 according to the preliminary estimate. The recent outturns are a little stronger than projected in the *August Report*. Output growth is likely to slow slightly from recent rates as consumer spending growth eases and the net trade position weakens. These factors outweigh the support from strong public spending growth over the forecast period. In the central projection the annual growth rate slows to around 2½% early next year, and continues to grow at around trend in the second year of the projection and beyond. By the end of the second year both world demand and total domestic demand are projected to grow at around trend, with below-trend growth in private demand counterbalancing above-trend growth in public sector spending. Projected growth in the second year is marginally weaker than assumed three months ago but the broad picture over the next two years is little changed.

The near-term outlook is broadly in line with recent information on sectoral performance from business surveys and reports from the Bank's regional Agents. These suggest that service sector growth has slowed a little in recent months—a pattern supported by the provisional ONS estimate of service sector growth in the third quarter. By contrast, manufacturing output has picked up a little, although surveys remain relatively weak and growth is particularly concentrated in the output of high-technology products. The outlook for construction activity remains quite buoyant, boosted by rising commercial orders and strengthening spending on public infrastructure projects, although housebuilding activity continues to weaken.

As explained in previous *Inflation Reports*, there is no simple relationship between the outlook for output growth and the prospects for inflation. In the long run, output growth is determined solely by developments in the supply capacity of the economy—by the rate of growth of the labour force and by the improvement in productivity—while inflation is determined by the stance of monetary policy, which is set to control the level of nominal demand in relation to supply capacity.

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

(2) An alternative projection assuming that UK official interest rates follow market interest rate expectations is almost identical to the constant interest rate projection. It is available on the Bank of England's web site at [www.bankofengland.co.uk/inflationreport/mark0004.htm](http://www.bankofengland.co.uk/inflationreport/mark0004.htm) and on request from Publications Group, telephone 020-7601 4030.

In the long run, a loosening of the monetary policy stance—which facilitated more rapid growth of nominal spending—would simply be associated with higher inflation, with no impact on output volumes. In the short-to-medium term, however, monetary policy affects output as well as inflation, because it is costly and takes time to adjust prices and quantities in response to changes in economic signals and stimuli. Expectations of future outcomes, which affect behaviour today, may also be slow to adapt. The future trend of nominal demand and the sustainable pace of growth of supply capacity are both uncertain and require policy-makers to form judgments on the basis of evidence that may prove unreliable.

Nominal GDP at market prices rose by 1.0% in the second quarter and was 5.0% higher than a year ago, a slowdown from the pace in the first quarter. Looking ahead, monetary indicators suggest a rather firmer outlook for nominal demand. Narrow money growth has edged up in recent months after slowing in the spring and early summer. Broad money growth has also risen significantly, even after making an allowance for the sharp rise in deposit holdings by non-bank financial corporations, which may have little direct effect on economic activity. Aggregate credit growth has also gathered pace, with total M4 lending some 13% higher in the third quarter than a year earlier—the fastest increase for more than ten years. Household credit growth remains brisk, consistent with the firm near-term outlook for consumer spending, but if anything has slowed a little. Credit demand from non-financial corporates has increased substantially: PNFCs' sterling borrowing has risen by more than 17% over the past year. The marked rise in both corporate deposits and borrowing appears to be associated in part with increased merger and acquisition activity. Nevertheless, both faster deposit growth and higher borrowing could presage faster growth in business investment, and provide support for the central expectation of some recovery in investment spending growth in the second half of this year. Overall, given the volatility of monetary indicators, the Committee judges that the recent pick-up in broad money and credit growth corroborates the view that nominal demand is likely to rise steadily in the coming quarters, rather than providing a strong signal of rather faster growth.

Making judgments on the level and prospective growth of aggregate supply potential is extremely difficult. A wide range of microeconomic factors affects the overall

efficiency and growth capacity of the economy, and their impact on macroeconomic performance is uncertain. Long-run historical trends often provide a useful benchmark for the future. But such trends will, of course, not capture changes in structural performance that occur at a faster or slower pace than the average in the past. The evidence from the United States of much faster productivity growth over the past five years indicates the potential hazards of relying too heavily on historical data as a guide.

The evidence in recent years is consistent with some improvement in the supply-side performance of the UK economy. In general, the outcomes for nominal variables such as wages and prices have tended to be somewhat weaker than projected on the basis of historical relationships with indicators of nominal demand pressures and outcomes for output. Although the unexpected strength of the exchange rate has had a major influence in recent years, pushing down import prices and boosting real incomes through the gains in the terms of trade, the more favourable short-term relationship between inflation and output outturns could also indicate that there may have been additional gains in potential supply. For example, the pressure on real earnings associated with a particular level of unemployment has been less than in the past. That suggests that the sustainable rate of unemployment consistent with stable inflation has fallen, and that aggregate supply capacity has improved.

In recent forecasts, the Committee has made adjustments to the projection for inflation that are consistent with an improvement in the supply capacity of the economy relative to previous trends. Three broad hypotheses have been considered. First, policy changes over a number of years may have improved the functioning of the labour market, enabling unemployment to fall to lower levels without putting upward pressure on real earnings. Assumptions on the rate of unemployment consistent with stable inflation were lowered in the August 1999 and the August 2000 projections. Second, product market competition may have increased, reflecting a range of factors such as changes in regulations and competitive practices, the growth in electronic commerce, and much greater price transparency and openness to international competition. Since the November 1999 *Report*, the Committee has included an assumption that intensifying competition will lead to a compression of price-cost margins, which will temporarily lower inflation as the adjustment to a lower



level of margins takes place. The third hypothesis is that underlying productivity may increase, as companies exploit opportunities provided by advances in information and communication technology in particular and raise investment to supply additional capital to each employee. Given the relatively weak productivity outturns in recent years, no specific adjustments have been made to previous central projections to reflect the possibility of faster productivity growth, although some Committee members have favoured making some adjustments on the grounds that UK companies would gradually emulate some of the gains observed in the United States.

The Committee monitors developments in the supply-side performance of the economy very carefully, but has to rely on a range of indicators that are very difficult to quantify. For example, it is difficult to measure improvements in the quality of information technology investment over time. Statisticians in the United States use a different approach to that currently adopted by the ONS and it is possible that this accounts for some of the difference in recent measured productivity trends. In addition, the range of indicators that is available may not correspond particularly closely to the simplifying concepts used in economic theory. The level of unemployment consistent with stable inflation cannot be measured in practice. Moreover, it is very difficult to discriminate between alternative economic hypotheses that may have quite similar near-term effects on inflation and on labour market outturns. For example, it is uncertain whether more favourable labour market outcomes are temporary or permanent, and whether they are linked directly to the performance of the labour market or indirectly to other structural developments such as improvements in product market competition or gains in underlying productivity.

Committee members assign different weights to the alternative hypotheses on supply-side performance and to their likely impact on the near-term inflation outlook. But all members judge that the outturns for output growth, wage costs and price inflation over the past year are consistent with some improvement in supply performance. It is difficult given available data to distinguish clearly between the alternative hypotheses outlined above. The Committee consequently decided to maintain an adjustment to the central projection for inflation equivalent in magnitude to the correction to price-cost margins in the August *Report*, namely a

reduction in inflation of 0.25 percentage points in the first year and some 0.3 percentage points in the second year of the projection, but decided that this should be best identified as a reflection of a general improvement in the supply-side performance of the UK economy relative to the past. In interpreting this overall adjustment, to differing degrees, Committee members prefer to assign some weight to the possibility of improved labour market performance or to stronger growth in technical progress, rather than, as in August, putting all the weight on a squeeze in profitability.

There is considerable uncertainty surrounding the overall judgment on supply-side trends that is incorporated in the fan chart projection. Some Committee members consider that the impact could be larger and that recent and prospective supply-side improvements are consistent with greater downward pressure on inflation over the next two years. Other members think that the downward adjustments to the central projection are too large, and hold the view that more of the recent benign developments in labour market outcomes could reflect transitory factors and that the prospective impact of any unusual intensification of competitive pressures on inflation is small.

The Committee will monitor and analyse developments closely in order to improve the assessment of supply-side performance and prospects. Against this background, the Committee developed the current projection for inflation by reviewing recent trends in cost and price pressures in the United Kingdom, given the outlook for nominal demand and output and the assumptions on world prices and the sterling effective exchange rate.

Nominal pay growth has been surprisingly weak in recent months. Headline earnings growth slowed to less than 4% in the three months to August from a rate of 4½% in May and a millennium-distorted 6% in February. In part, the benign outcome reflects a fall in bonus payments from levels a year ago. Lower bonus payments may reflect a tightening in the terms of incentive schemes and pressures on profits in some sectors, but it is difficult to gauge the underlying trend given the pronounced volatility in bonus payments over the past year. The fall in earnings growth also reflects a slowdown in regular pay growth to a range of 4¼% to 4½% from rates between 4½% and 4¾% at the time of the *August Report*. Other indicators of pay growth remain relatively subdued: settlements continue to rise

at around 3%, although there are some warnings of higher rates in the next annual pay round.

Since the recent slowdown in nominal earnings growth has coincided with flat or rising inflation expectations, it represents a fall in real earnings pressure. When undertaking wage negotiations, employees aim to enhance the purchasing power of their post-tax income in terms of consumer goods, while employers wish to control the costs of production in relation to the price of their output. So a change in wage bargainers' expectations of inflation is likely to affect nominal outcomes. A sustained increase in inflation expectations would be of concern as it might then feed through into higher wage claims.

Demand for labour remains strong. According to the Labour Force Survey (LFS), employment has risen by 0.7% over the past six months while the unemployment rate has fallen by 0.5 percentage points to 5.3%, with the recent decline concentrated in those unemployed for less than twelve months. On the claimant count measure, which is available for a longer period than the LFS, unemployment has fallen to its lowest rate for 25 years. Surveys of employment intentions and trends in vacancies suggest continued robust demand. A range of surveys and contacts of the Bank's regional Agents report an intensification of skill shortages in recent months.

A key judgment for the Committee is whether the favourable conjunction of weaker-than-expected real earnings growth and lower-than-expected unemployment is a temporary phenomenon, or whether it represents a more permanent additional improvement in UK labour market performance relative to the assumptions incorporated in the *August Report*. In the central projection, it was agreed that a small further adjustment should be made to the relationship between real earnings growth and unemployment, implying that real wage pressures would be lower for any given unemployment path. But much of the recent surprising fall in real earnings was assumed to be transitory and hence would be likely to reverse. However, that reversal could be quite slow, such that the lower-than-expected level of nominal earnings growth in recent months will reduce costs and inflationary pressures over the next two years relative to the August projection. Committee members hold differing views on the risks to the inflation outlook from labour market pressures. Some members judge that inflationary pressures could be stronger than in the

central case, given the tightness of the labour market and their view that the overall adjustments to reflect the impact of supply-side improvements on inflation could be too large. Other members consider that supply-side gains could be larger than embodied in the central projection and hence that labour cost pressures may be more benign.

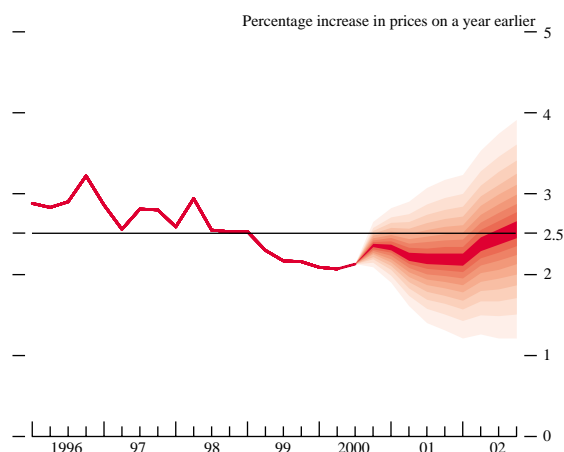
The supply capacity of the economy may be increased by a rise in the labour force or by an improvement in productivity. The Committee has reviewed the recent evidence on trends in labour force participation at a disaggregated level, and now judges that the aggregate participation rate is more likely to continue to rise slightly over the next two years than to remain unchanged as previously assumed. Adjusting this assumption lowers the projection for real earnings growth a little as the new entrants to the labour force add to the available supply of labour.

Whole-economy productivity growth per employee has strengthened in recent quarters and, for the first time in five years, is above a benchmark set by the average rate of growth since 1960. In the short-to-medium term, faster productivity growth dampens pressures on unit labour costs from rising earnings. Given the rise in productivity growth, as well as the slower growth in nominal earnings, unit labour cost growth has correspondingly slowed over the past year. Over the long run, however, higher productivity growth will tend to sustain faster growth in real earnings and living standards.

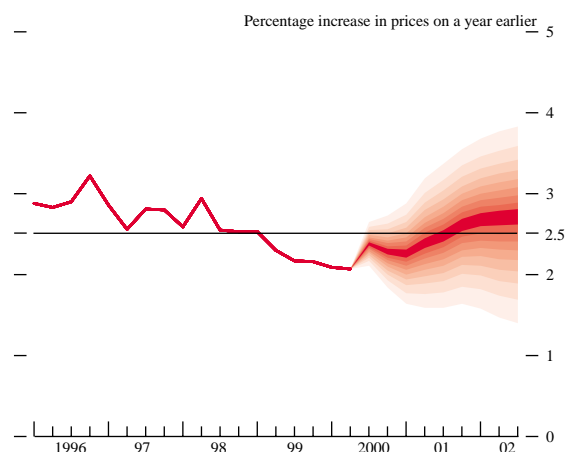
It is as yet unclear whether the prospective trend growth rate of productivity is likely to be quicker than in the past. Estimated productivity growth has risen markedly in the United States, but it is uncertain to what extent such gains are likely to be emulated in the United Kingdom and other countries and over what time-scale these improvements would take place. The Committee has made no specific change to the central projection for underlying productivity growth, although the general adjustments to reflect better supply-side performance encapsulate a temporary rise in productivity growth among the other possible explanations.

Taking account of all the influences discussed above, the Committee's best collective projection for the twelve-month RPIX inflation rate, conditioned on the assumption that nominal interest rates remain unchanged

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



**Chart 6.3**  
**RPIX inflation projection in August 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*.

at 6%, is illustrated in Chart 6.2.<sup>(1)</sup> It is presented alongside the projection from the *August Report*, which was also based on the assumption of constant interest rates at 6% (see Chart 6.3).

After a temporary spike in the coming months as the impact of higher oil prices feeds through, the broad picture remains of a gradual rise in inflation over the next two years. The most likely outcome is that inflation will increase from just below the target at present, to around the target after two years. Inflation edges up because of the recent intensification of pressures in labour markets and on domestic supply capacity. Over the next twelve to eighteen months this pressure is offset by: adjustments to reflect a stronger supply-side performance; weaker import price inflation, reflecting the appreciation of the exchange rate and the compression of importers' margins on sales to the United Kingdom; falling oil prices once the near-term impulse has passed through; and the temporary effect on inflation from the freeze in fuel duty.

The profile for inflation is softer than in the August projection, although the latest assessment is that pressures may be continuing to build at the two-year horizon, in contrast to expectations three months ago. The main downside influences on inflation relative to the

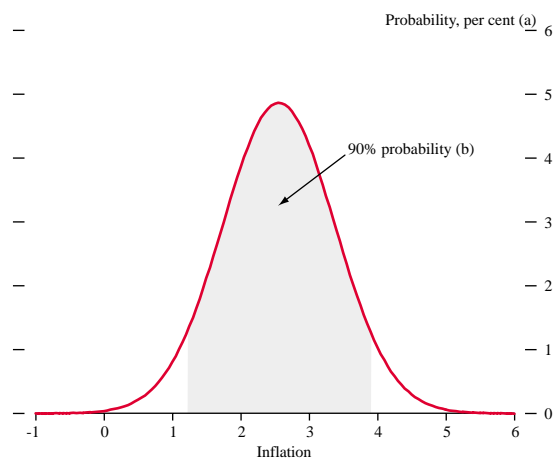
(1) Also shown as Chart 2 in the Overview. An alternative projection based on the assumption that official rates follow market interest rate expectations is available on the Bank's web site at [www.bankofengland.co.uk/inflationreport/mark0004.htm](http://www.bankofengland.co.uk/inflationreport/mark0004.htm) and on request from Publications Group.

August *Report* are the weaker outlook for earnings, reflecting both lower-than-expected nominal outcomes and the assumptions of a lower sustainable unemployment rate and higher labour force participation, as well as the higher exchange rate profile. These effects outweigh the principal upside influences of a stronger outlook for consumer spending and a higher path for oil prices.

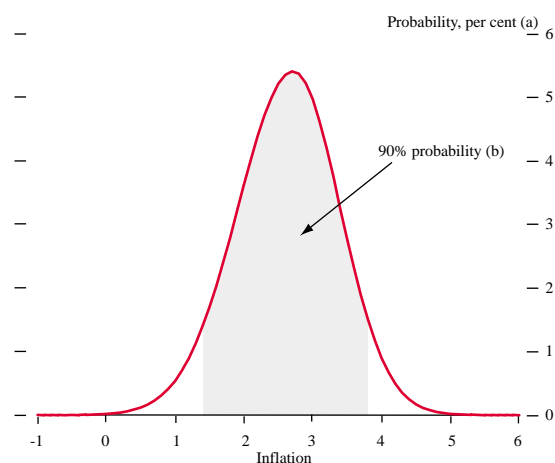
The fan charts provide an illustration of the uncertainty surrounding the outlook for inflation and output growth and of whether the balance of risks around the most likely outcome is weighted to the upside or the downside. The latest assessment is that risks around the central projection for output growth are weighted slightly to the downside, while the risks to inflation are broadly balanced. The main downside risk to activity is that the global economic environment is less benign, with a sharper slowdown in world activity than assumed in the central projection. Weaker world demand would reduce the demand for UK exports and would lower global inflationary pressures: under such a scenario asset prices would also tend to fall, which could have additional effects on domestic demand. The downside impact on inflation from this risk is counterbalanced by the upside risk from the possibility of a more rapid depreciation of sterling than in the central case. Such a depreciation would stimulate export demand and reduce imports, but the effect on UK output is outweighed by the downside risk of weaker global growth.

Although overall risks are broadly balanced, the Committee considers that the range of overall uncertainty surrounding output growth and inflation prospects has increased. The estimate of the level of uncertainty shown in the fan charts is based on a ten-year rolling window of average forecast errors. As forecasting errors in recent years have tended to be lower than previously, the variance of the fan chart has tended to narrow in successive projections. The Committee decided that this approach is tending to underestimate the current degree of uncertainty, and consequently agreed to increase the estimated variance to the level prevailing a year ago in the August 1999 projection. Using the updated estimate of uncertainty, Chart 6.4 shows the overall balance of risks to inflation at the two-year horizon. Chart 6.5 shows the corresponding balance from the August *Report*. The Committee's best collective judgment of the probabilities of various outcomes for inflation and GDP growth are shown in Table 6.A.

**Chart 6.4**  
Current projection for the percentage increase in RPIX in the year to 2002 Q4



**Chart 6.5**  
August projection for the percentage increase in RPIX in the year to 2002 Q3



Source: Bank of England.

- (a) Probability of inflation being within  $\pm 0.05$  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*.

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

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	1	77	22	<1	<1
2001 Q4	9	25	34	23	8	1
2002 Q4	10	15	22	23	17	13

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	<1	1	81	18	<1
2001 Q4	1	8	27	38	21	5
2002 Q4	2	10	25	33	22	8

(a) These figures are from the same distributions as the GDP and RPIX 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 central projection in percentage points

	Improvement in UK supply-side and labour market performance
<b>RPIX inflation</b>	
2001 Q4	-0.1 to +0.1
2002 Q4	-0.25 to +0.2
<b>GDP growth</b>	
2001 Q4	0.0
2002 Q4	+0.1 to -0.1

As emphasised above, there remain a number of major uncertainties in the outlook. The probability distributions incorporated in the fan charts show the general uncertainty around the central projections. However, certain Committee members prefer to make different assumptions on the possible impact of general supply-side improvements on inflation prospects and on risks to the earnings outlook. Based on their preferred alternative assumptions, which are shown in Table 6.B, individual Committee members judge that the profile for inflation at the two-year horizon could be up to 1/4% higher or lower than in the central projection portrayed in Chart 6.2. The range of views is narrower than three months ago.

In making their individual assessments of the appropriate setting for interest rates, Committee members draw on their judgment of the prospective profile for inflation and output, paying particular attention to the uncertainties and risks. As outlined in the box opposite, there is no mechanical mapping between the outlook for inflation at any particular fixed horizon and the appropriate setting of interest rates.

Financial market participants form judgments on the likely path of future official interest rates. There is no unique quantification of these expectations.<sup>(1)</sup> The

(1) See the article by Brooke, M, Cooper, N and Scholtes, C, 'Inferring market interest rate expectations from money market rates' in the *Bank of England Quarterly Bulletin*, November 2000, pages 392–402.

## The forecast and monetary policy

The fan charts are a visual summary of the projections that are produced for each quarterly *Inflation Report*. They show the Committee's best collective judgment of the most likely outturns for inflation and GDP, conditional on the assumption that interest rates remain unchanged over the forecast period. In addition, fan charts are produced conditional on the assumption that official interest rates follow market expectations. The fan charts show the degree of uncertainty and the balance of risks around the central projection.<sup>(1)</sup> They summarise the MPC's views about the outlook for inflation and growth. But there is no mechanical link between the central projection at the two-year horizon and monetary policy. This box explains why that is so.

Changes in interest rates typically affect demand with a lag, while changes in the level of demand also typically affect inflation with a further delay. It can take up to two years for the bulk of the effect of a change in interest rates to feed through to inflation. As a consequence, monetary policy decisions can do little to affect inflation in the near term, but can seek to affect inflation only one year or more ahead. The choice of the two-year forecast horizon for the *Inflation Report* projections is intended to illustrate the lags in the transmission of monetary policy to inflation. It is not the case that if the central projection for RPIX inflation—which lies in the deepest red band in the fan chart—exceeds the target of 2½% in two years' time then interest rates should necessarily be raised, and *vice versa*. There are a number of reasons why the policy decision is more complex than this.

First, the central projection represents the Committee's best collective judgment on the single most likely—or modal—outcome. It does not reflect the balance of risks—or skew—about that central projection. When the balance of risks lies in one direction, the average expected inflation rate will differ from the central projection. In such circumstances, Committee members will assess how much weight to assign to these risks, and indeed to the whole distribution of outcomes, in forming their policy judgment.

Second, the Committee's remit is to aim for inflation of 2½% at all times. So the Committee does not focus exclusively on inflation prospects just at the two-year horizon, but will also bear in mind prospects before and after that date. For instance if the central projection for inflation was near target for most of the forecast period, but was rising above target beyond the two-year horizon, the Committee might decide to tighten policy pre-emptively. By the same token inflation prospects before the horizon may also influence decisions.

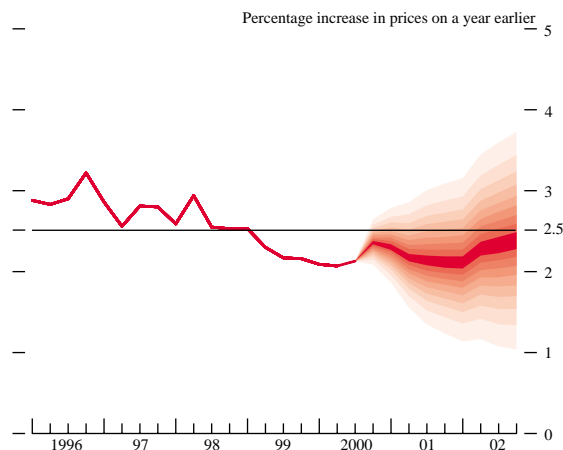
Third, the assumption that interest rates remain unchanged over the forecast period is merely a convenient benchmark against which to describe the prospects for growth and inflation. But in general there are many other paths for interest rates that would yield the same central projection for inflation at some given future date. In choosing between alternative interest rate profiles, Committee members will take into account a number of factors. One of these will be the impact on the profile of activity. So if inflation is currently above target, the Committee will recognise that seeking to bring it back quickly may require excessively sharp increases in interest rates that could destabilise the economy. Another consideration is uncertainty about the current conjuncture or about the impact of any policy change, both of which tend to encourage more cautious decisions.

In sum, the fan charts show the best judgment of the Committee as a whole about inflation and growth prospects, conditioned either on the assumption of constant interest rates or on the basis that interest rates follow market interest rate expectations. Given the significant lag between a change in the official interest rate and its full impact on inflation, it is convenient to focus on the two-year horizon as a useful guide for assessing inflation prospects. The inflation projection is a key input to policy decisions. However, there is no mechanical link between the projected level of inflation in two years' time based on constant interest rates and the appropriate current setting of monetary policy.

(1) See the box on page 49 of the August 2000 *Inflation Report* for an explanation of the forecast process and the fan charts.

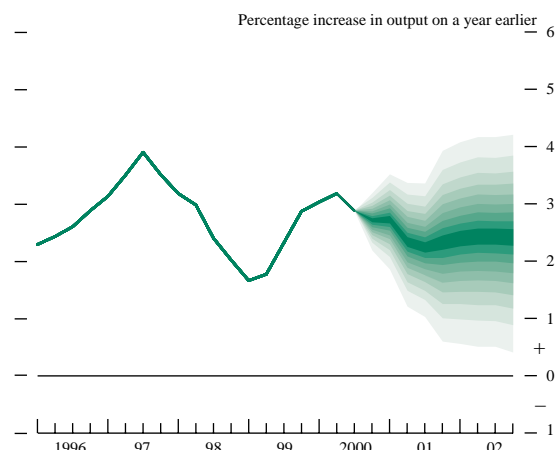


**Chart 6.6**  
**Current RPIX inflation projection based on alternative asset price assumption<sup>(a)</sup>**



(a) Starting-point for asset prices based on 15-day averages to 8 November 2000. Assumes official interest rates constant at 6%.

**Chart 6.7**  
**Current GDP projection based on alternative asset price assumption<sup>(a)</sup>**



(a) Starting-point for asset prices based on 15-day averages to 8 November 2000. Assumes official interest rates constant at 6%.

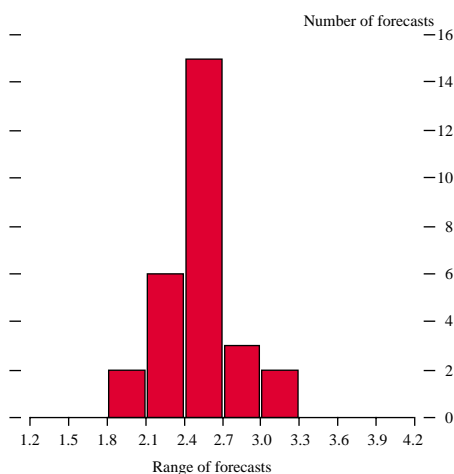
**Table 6.C**  
**Market expectations of the Bank's official interest rate<sup>(a)</sup>**

Per cent

2000	2001				2002				
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
6.0	5.9	5.8	5.8	5.8	5.8	5.8	5.7	5.7	

(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 five-day averages to 8 November 2000.

**Chart 6.8**  
**Distribution of RPIX inflation forecasts for 2002 Q4**



Source: Survey of 28 outside forecasters as of 6 November 2000.

Committee currently pays the most attention to estimates 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. Market expectations of the future level of official interest rates implied by these securities have fallen further over the past three months: the latest evidence suggests that the market expects official rates to remain at current levels over the next year or so and then fall to around 5.75% by the end of 2002. Given this evidence, the MPC's projections under the assumption that official rates move in line with market expectations are almost identical to those conditioned on the assumption of constant interest rates. As a result, the Committee decided not to publish those fan charts in this *Report*, but to make them available on the Bank of England's web site.<sup>(1)</sup>

As discussed above, the central projection for this *Report* is based on a profile for asset prices based on a starting-point averaging the five working days up to and including 8 November, rather than the fifteen working day average used in recent *Reports*. For transparency, alternative fan charts constructed on the previous basis are shown in Charts 6.6 and 6.7. Given the much higher profile for the exchange rate using the alternative assumption, the outlook for inflation and GDP growth would be somewhat weaker than in the main case.

### 6.3

### Other forecasts

In late October, the Bank asked a sample of external forecasters for their latest projections of inflation and

(1) At [www.bankofengland.co.uk/inflationreport/mark0004.htm](http://www.bankofengland.co.uk/inflationreport/mark0004.htm)

**Table 6.D**  
**Other forecasters' expectations of RPIX inflation and GDP growth<sup>(a)</sup>**

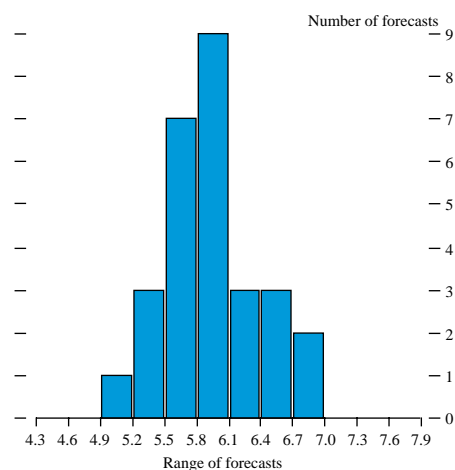
RPIX inflation						
Probability, per cent	Range:					
	less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
2000 Q4	3	21	58	16	2	1
2001 Q4	7	15	38	29	8	3
2002 Q4 (b)	7	14	33	30	11	5

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	1	6	50	41	2
2001 Q4	2	6	22	48	19	3
2002 Q4 (b)	3	6	23	45	18	4

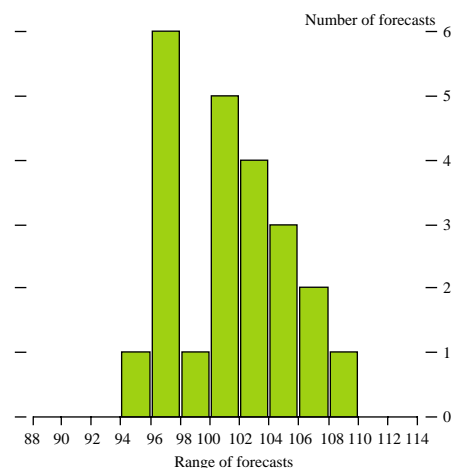
(a) 28 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table shows the means of the responses for each range. For example, on average, forecasters assign a probability of 7% to inflation turning out to be less than 1.5% in 2002 Q4.  
 (b) 27 forecasters.

**Chart 6.9**  
**Distribution of repo rate forecasts for 2002 Q4**



Source: Survey of 28 outside forecasters as of 6 November 2000.

**Chart 6.10**  
**Distribution of sterling ERI forecasts for 2002 Q4**



Source: Survey of 23 outside forecasters as of 6 November 2000.

output. Based on this survey, the mean forecast for the twelve-month rate of RPIX inflation in 2000 Q4 is 2.2% (with a range of 1.8% to 2.4%), rising to 2.4% in 2001 Q4 (with a range of 1.5% to 2.8%) and 2.5% in 2002 Q4 (with a range of 1.9% to 3.1%). The distribution of central projections of inflation in 2002 Q4 is little changed from August. On average, external forecasters see a 46% probability of inflation being above 2.5% in 2002 Q4, and a 54% probability of it being below (see Table 6.D).

The forecasters' average projection for four-quarter GDP growth in 2000 Q4 is 3% (with a range of 2<sup>1</sup>/<sub>4</sub>% to 4%) up from the 2<sup>3</sup>/<sub>4</sub>% average forecast reported in August. Growth is expected to slow to 2<sup>1</sup>/<sub>2</sub>% (with a range of 1<sup>1</sup>/<sub>2</sub>% to 3<sup>1</sup>/<sub>4</sub>%) in 2001 Q4, and then remain at that rate in 2002 Q4 (with a range of 1<sup>1</sup>/<sub>2</sub>% to 3<sup>1</sup>/<sub>4</sub>%).

The mean forecast for the official interest rate is flat at 6% from 2000 Q4 to 2002 Q4, slightly lower than the survey results reported in August. The dispersion of forecasts increases from 6% to 6<sup>1</sup>/<sub>2</sub>% in 2000 Q4, to a range of 5% to 6<sup>3</sup>/<sub>4</sub>% by 2002 Q4 (see Chart 6.9). On average, forecasters assume that the sterling ERI will be 107 in 2000 Q4 (with a range of 104 to 110) and will then fall to 101 (with a range of 95 to 108) by 2002 Q4 (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*.**

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# BANK OF ENGLAND

## AGENTS' SUMMARY OF BUSINESS CONDITIONS

November 2000

*This publication is a summary of monthly reports compiled by the Bank of England's Agents,<sup>(1)</sup> following discussions with around 1,700 businesses in the period between mid-July and mid-October. 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 picked up moderately during the period in most regions—predominantly reflecting an improvement in external demand. Within manufacturing, the diverging performance between industries remained a prominent theme.
- Overall, construction growth remained firm. In many regions, a slowdown in residential construction was offset by stronger growth in commercial and public construction.
- Service sector growth eased slightly during the period, driven by a further slowdown in consumer services, particularly UK tourism. Most areas of business services continued to record strong growth.
- Annual growth in retail sales values was reported to have eased slightly in most regions during the period. Despite further price cuts, sales of new cars remained subdued. Growth in most other areas of consumer spending remained steady.
- Compared with the previous *Agents' Summary*, export volume growth strengthened in most regions, particularly to the United States. But despite the improvement, most Agencies suggested that import growth continued to outstrip export growth.
- Investment intentions in the manufacturing sector deteriorated further in most regions—largely reflecting lower profitability and the increased attractiveness of alternative overseas locations. By contrast, service sector investment remained strong.
- Input price inflation increased further during the period. Oil-related price increases continued to dominate discussions. But material cost increases remained difficult to pass along the supply chain. However, some firms suggested that continued improvements in productivity had eased pressure on margins to some degree. Service sector inflation softened slightly, while the trend of flat or falling goods prices was maintained. Further falls were reported in new and used car prices. House price inflation continued to slow in most regions.
- Skill shortages intensified in most regions during the period, after remaining broadly unchanged since the beginning of the year. Settlements remained stable in most regions, although there were early signs of higher settlements late in the period—particularly in the southern regions. Total earnings growth slowed during the period in both the manufacturing and service sectors, mostly as a result of lower bonus payments relative to last year. There was little change in employment trends. Construction and service sector employment continued to rise steadily, while manufacturing employment declined further.

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(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 remained lower than a year ago, but was broadly unchanged compared with the previous quarter. But within the sector, there was much diversity in performance. The Agents suggested that livestock production recovered from a low base, although pig production in East Anglia was affected by swine fever restrictions. The quality of certain crops (eg potatoes and soft fruit) was affected by poor weather during the period. Looking forward, there are concerns that the continuation of the recent wet weather may have an adverse effect on crops to be harvested early next year. Many Agencies continued to cite dairy farming as one of the weakest sectors. Reports of farm consolidation (to achieve economies of scale) and business failures continued. Contacts continued to stress that farm incomes remained at historically low levels.

Contacts in Scotland reported that oil and gas extraction remained lower than a year ago and had been constrained during the period by restructuring within the industry and summer maintenance.

### *Manufacturing*

Reports suggested that manufacturing output growth picked up modestly throughout the period in most regions, after slowing since the beginning of the year. In most cases, this was predominantly driven by a recovery in exports, though domestic demand also strengthened recently in some regions. The majority of contacts reported that the petrol disruption in mid-September had minimal impact on production. Order books also improved during the period in most regions, particularly for exports. But confidence remained fragile in most regions (particularly in Yorkshire, the Midlands and the North East), with increased reports of cash-flow problems and margin pressure resulting from overseas competition.

The divergence between the performance of industries within manufacturing remained a prominent theme. Most Agencies continued to report that high value added industries, such as electronics and telecommunications, continued to record the strongest growth—although a slight easing was noted in some regions. Output growth in the aerospace industry also remained strong. Growth in these industries outweighed declining output in more traditional industries such as automotive-related and basic metal production.

### *Construction and housing*

Overall, construction growth was reported to have remained firm during the period. In most regions, a slowdown in residential construction activity was offset by stronger growth in commercial and public construction. The slowdown in residential construction was particularly noticeable in the southern regions of the United Kingdom, where activity had been relatively stronger.

By contrast, growth in commercial and public construction rose in many regions. Commercial activity remained strongest in the retail, leisure and professional services sectors. Some Agencies noted increased infrastructure construction (eg the extension of telecommunications networks) and a pick-up in the construction of public buildings such as schools and hospitals. Contacts suggested that strong construction output growth was likely to continue for several quarters, given solid commercial order books and expected further substantial public spending. But Agencies suggested that the pace of growth was unlikely to increase further, given continued supply-side constraints (notably skill shortages).

### *Services*

Service sector growth was reported to have eased overall in almost all regions—driven by a slowdown in consumer services activity. Most areas of business services continued to record robust growth—particularly professional and financial services, which were boosted by mergers and acquisitions activity. In addition, demand for IT and telecommunications continued to increase. But many firms suggested that output growth was being constrained by the availability of suitably skilled staff. Employment agencies also remained areas of strong activity—as firms increased their use of part-time and temporary staff, and as many manufacturers tried to reduce overheads by outsourcing non-core services.

Consumer services continued to slow during the period. Tourism-related activity slowed during the summer—thought to be the result of poor weather and the relatively weak euro. Lower turnover was reported by many UK tourist attractions and other related services. There had been some reports of an improvement towards late summer, but this had been more than offset by the negative impact of the fuel disruption—business that was unlikely to be recouped. Demand for housing-related services, such as estate agents and conveyancing, also slowed during the period. Leisure services growth remained buoyant, particularly for restaurants, pubs and fitness centres.

## DEMAND

### *Consumption*

On balance, annual retail sales value growth eased slightly over the period. But overall, consumer confidence was said to have remained relatively steady in most regions. Demand remained strongest for household goods (particularly electronics and telecommunications), although there were reports of a slowdown in some regions towards the end of the period. There was some indication of an improvement in clothing sales, possibly because sales of autumn fashions had been boosted at the beginning of the season by the poor weather. Growth in most other areas of consumer spending remained broadly unchanged during the period. Spending on overseas travel rose strongly in many areas, though this was partly offset by lower spending on domestic travel.

Despite announcements of price cuts by several manufacturers during the period, new car sales to individuals remained depressed—even during the new registration period in September. Most motor vehicle traders suggested that consumers were unlikely to return to the market until there was more certainty regarding the extent and timing of future price cuts. Specifically, most believe that the pick-up is unlikely to occur until early next year—after measures to require manufacturers to pass on fleet discounts to retail dealers are enforced in December. There was also little evidence of any improvement in used car sales.

### *Exports and imports*

Compared with the previous *Agents' Summary*, export volume growth strengthened in most regions, reflecting stronger external demand. Most regions reported that demand from the United States remained robust and had been boosted by the recent depreciation of sterling against the dollar. Export growth to other markets in the Middle East and Asia also improved. But sales to Europe remained more difficult—most manufacturers suggested that export volumes to Europe were maintained only through intense downward margin pressure.

Import growth remained strong during the period. Most Agencies suggested that the growth in imports continued to run ahead of that of exports. Firms continued to increase purchases of relatively cheap overseas materials (for example from Eastern Europe and Asia) to alleviate pressure on margins.

## *Investment*

Service sector investment intentions remained steady at a high level during the period. Firms continued to invest in new office space, as well as building investment in the leisure and retail sectors. Increased public investment in health and education facilities was also frequently cited. IT investment remained strong, with little sign of any easing in growth.

By contrast, investment intentions in the manufacturing sector continued to deteriorate during the period in most regions. The further downturn in UK investment intentions was reportedly driven by lower profitability and the relative attractiveness of alternative overseas locations. In addition, significant spare capacity in the sector has reportedly mitigated the need for new investment. There is little evidence to suggest any improvement in the near term, as reports of firms locating new or existing plants overseas increased during the period. There were also increased reports of deferred projects recently. Moreover, while many firms reported that productivity-improving measures such as IT investment remained strong, this sometimes crowded out expenditure on plant and machinery. Investment to expand capacity tended to be limited to the higher value added sectors such as electronics.

There was little improvement in investment intentions in the primary sector, particularly in agriculture. But during the period, several major oil companies announced plans for substantial additional investment.

## EMPLOYMENT

Skill shortages intensified in most regions during the period, after remaining broadly stable since the beginning of the year. Severe shortages, which had previously been limited to the southern regions, appeared to have spread to several other regions. In addition, while in earlier periods the shortages had been limited mostly to specific skilled professions, there had been clear evidence that shortages had now spread to semi-skilled and unskilled positions (for example for retail and clerical staff).

There was little change to trends in employment growth. Manufacturing employment continued to decline at a similar pace to the previous period in most regions. Many sectors continued to shed staff, though some strong-growth sectors increased their employment levels. Overall, manufacturing firms continued to suggest that productivity improvements meant that they were unlikely to increase staff numbers.

Growth in the services and construction sectors continued at a steady pace, but still appeared to be constrained by the limited availability of suitably skilled labour. In many cases, firms have mitigated the impact of labour shortages to some extent through the increased use of overseas workers.

## COSTS AND PRICES

### *Input prices*

Input price inflation increased further during the period. However, there were offsetting influences. Oil-related and industrial gas price increases dominated discussions, although examples of relatively smaller rises in plastics, paper and steel prices also continued to be cited. Firms have become increasingly concerned about rising transport and distribution costs. In addition, there was some evidence of rising import costs for dollar-denominated commodities as a result of the depreciation of the sterling. However, firms continued to report lower prices for many products as a result of re-sourcing from relatively cheaper overseas suppliers and through centralised purchasing, consolidation and outsourcing. Moreover, many firms have been able to offset materials price increases by achieving reductions in unit costs, through significant productivity gains.

### *Pay*

Settlement trends remained similar to those reported in recent *Agents' Summaries*, although there were some early signs of higher settlements towards the end of the period. Almost all Agencies suggested that manufacturing settlements remained lower than in services and construction—and most remained equal to or lower than a year ago. However, recent reports suggested that many contacts were expecting stronger increases in upcoming pay rounds.

Growth in total earnings was reported to have eased in both manufacturing and services in most regions. Overtime payments declined in manufacturing in many regions as employers used flexible working-hour arrangements to meet variations in demand. Bonus payments also continued to decline relative to last year—reflecting lower profitability. Total earnings growth also slowed in the services sector—predominantly from lower bonus payments. But there

are indications that sustained skill shortages in the sector are beginning to be seen in higher underlying pay growth—although there appears to be a wider dispersion of rates. Companies are also making increased use of non-pay rewards such as additional holidays and flexible working-hour arrangements.

### *Output prices*

The pace of decline in manufacturers' output prices appeared to slow during the period. In recent months, some firms reported a degree of easing in margin pressure in export markets—especially those with dollar-denominated contracts. Despite the general inability to pass on any input price increases, some firms' margins are benefitting from improved productivity and lower overhead costs. However, the majority of firms in more traditional manufacturing sectors continued to report intense pressure as a result of competition from continental Europe.

By contrast, service sector firms noted relatively less difficulty in passing on cost increases. Transport and distribution costs were the most commonly cited examples of rising prices—linked mostly to fuel prices.

### *Retail prices*

On average, there was little change to the trend of flat or falling goods prices reported in previous *Agents' Summaries*. But within the period, it appeared that greater-than-normal discounting during the summer 'sales' at the beginning of the period (particularly for clothing) was balanced by slightly less-than-normal discounting towards the end of the period.

On balance, service sector inflation was slightly slower than reported in the previous *Agents' Summary*. Further downward pressure was noted for UK tourism-related activities (for example hotels).

During the period, Agencies noted a continued slowing in house price inflation. In the southern regions of the United Kingdom, price levels had fallen, but had subsequently stabilised. In other regions, house price inflation also slowed. However, in most cases, price levels continued to rise modestly.

Agencies reported further falls in both new and used car prices during the period.

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



## Minutes of the Monetary Policy Committee meeting on 2–3 August 2000

1 Before turning to its immediate policy decision, the Committee discussed demand and output; international economic developments; money, credit and asset prices; labour market conditions; and prices and costs; and then reviewed the August projections for output and inflation, and various tactical considerations.

### Demand and output

2 The first estimate of the quarter-on-quarter rate of GDP growth in Q2 had been 0.9%, considerably higher than expected at the time of the *May Inflation Report*. The increase in measured growth between Q1 and Q2 partly reflected a bounce back in energy production, which had been affected by the weather in Q1. But it was not solely an energy story. Services output was estimated to have grown by 1% in Q2 on Q1, compared with 0.7% in Q1 on 1999 Q4. Another contributory factor might have been a rebound in IT spending, following a post-millennium pause in Q1.

3 More important than the recent volatility in the quarterly output numbers was the changing prospect for the balance of demand in the economy. For the past few years one of the central elements of the Committee's analysis had been the need to restrain final domestic demand growth, and so domestic inflationary pressures, before the downward influences on net external demand and inflation from sterling's prolonged appreciation and the weakness in world commodity prices and traded goods prices wore off. Two developments had affected that analysis in recent months: the depreciation in sterling since May and the public expenditure increases announced in the Budget and confirmed in the recent Spending Review. A key question now was, therefore, whether private sector demand would decelerate sufficiently.

4 There had not been much change in aggregate public sector spending plans since the March Budget. The Chancellor's announcement since the Committee's previous meeting of the results of the Spending Review had, for the Committee's purposes, not substantially altered the overall picture, but it had added detail on two things: a carry forward of £1.5 billion of underspend from 1999–2000, and an increase in planned departmental spending on account of lower expected debt interest and social security payments. It was also noted that government revenue was coming in higher than projected, though views differed on the extent to which this would depress aggregate demand.

5 The Committee noted the considerable uncertainty about the possibility of future underspends. Much of the planned extra spending was earmarked for government investment programmes, many of which were subject to complex planning processes. More generally, it would be unclear for some years how the timing of departmental spending would be affected by the introduction of greater flexibility in carrying forward the unspent part of departmental budgets into subsequent financial years. Some members of the Committee saw a risk of government spending being lower than planned over the forecast horizon.

6 Separately, it was not clear whether the reduction in projected social security payments reflected the cyclical strength of the economy or lower social security payments for any given level of output. Whether cyclical or structural influences were at work would have some effect on the prospect for government spending if the economy slowed.

7 More generally, given that the economy was currently—and was set to continue—operating close to capacity, an increase in public sector spending could be accommodated only if resources

were released by a slowdown in private sector demand. A vital question, therefore, was whether that should be expected to occur autonomously at the current level of interest rates or whether a further tightening of policy might be needed to bring it about.

8 This would depend in good part on the outlook for private sector consumption. The indicators were mixed. On the one hand, some encouragement could be taken from developments in the determinants and indicators of household spending. House prices had decelerated faster than earlier expected, and the latest Royal Institute of Chartered Surveyors' survey showed a majority of estate agents expecting prices to fall. Domestic equity prices were hardly changed over the year so far. Wealth was, therefore, no longer rising at a rapid rate. Earnings growth had slowed and was expected to moderate further. The Bank's regional Agents reported that consumer demand seemed to be easing. On the other hand, the level of wealth was still high; household borrowing—secured and unsecured—remained strong; real incomes were expected to continue rising, and unemployment to remain low. It was also noted that a more moderate pace of house price growth need not of itself entail slower consumption growth, as 1997–98 showed. Overall, the Committee concluded that the saving ratio was likely to rise somewhat, reflecting both lagged effects from the past policy tightenings and also the assumption that households would want to strengthen their balance sheets. Consumption growth was, therefore, expected to moderate—only slightly compared with the first half of the year, but significantly compared to the past few years. Some members saw upside risks to the consumption profile.

9 Regarding other components of private sector demand, there was some discussion of the implications for private sector investment of the recent corporate sector profit numbers. Some members were struck by the fall in profits in 1999—to the lowest share of GDP for five years. Others thought that there had been only relatively small variations in a strikingly flat series.

10 Survey indicators provided what was generally seen as a mixed picture of the outlook. The July CBI Quarterly Industrial Trends Survey had recorded a fall in all activity balances, other than for expected output. Some members placed considerable weight on this survey series, suggesting that despite its focus on the manufacturing sector it had the longest and best leading indicator record for whole economy output—with its most prominent 'mistake' being the sharp falls in autumn 1998, where it was possible that the Committee's rapid easing of policy had made a difference.

11 The Chartered Institute of Purchasing and Supply's manufacturing survey showed a rebound in manufacturing activity, with the balances for output, orders and export orders all rising. The British Chambers of Commerce manufacturing indicators had not risen overall, however. Some members noted that the fact that not all the manufacturing survey indicators had risen, despite the recent fall in sterling's exchange rate, suggested that there was significant underlying weakness in that sector.

12 In the services sector, the main survey indicators had been stronger on the month and were pointing to continued robust growth. Given that services account for about two thirds of UK output, most members thought that the survey evidence overall was consistent with steady growth.

### International economic developments

13 The Committee briefly discussed international developments. The euro area continued to strengthen. Growth in the US had, yet again, been stronger than expected. There were, though, some



signs of moderation, partly reflecting tighter monetary policy and equity prices being slightly down on the year. There remained a risk of persistent strong growth being followed by a 'hard landing', possibly triggered by or leading to a sharp adjustment in asset prices.

14 Oil prices had been stronger than expected in May, which had fed into petrol prices and more generally into RPIX inflation. They had though fallen back in recent weeks and were now expected to fall at a quicker pace than assumed in the *May Inflation Report* projections.

15 Overall, the stronger world economic outlook and sterling's depreciation implied that, looking forward, external influences would probably bear down less on RPIX inflation than in recent years.

## Money, credit and asset prices

16 A number of indicators suggested that the housing market was slowing: for example, net reservations, site visits, and house prices. But mortgage lending growth and approvals remained strong, as did unsecured borrowing. It was possible that higher debt levels reflected the increases over recent years in household sector wealth brought about by rises in equity and house prices. It was suggested that strong borrowing might reflect more competitive conditions in the consumer credit industry, and that the implications for demand and inflation were unclear. On the whole, though, it was thought that some deceleration in household borrowing would probably occur if consumption growth was to slow in line with the Committee's projections. The two might come together if households tried to improve their balance sheets. The timing was, however, uncertain. The possibility of continued strong borrowing represented an upside risk to consumption.

17 The corporate borrowing and money numbers were a puzzle. Borrowing from banks and the capital markets was strong, but so was deposit growth. There were no clear sectoral stories to explain the aggregate data. Recent strength in services sector borrowing was not obviously associated with investment growth.

18 While sterling's effective exchange rate index had risen by around 2% over the month, it was still about 4% below the path assumed in the Committee's May projections. Looking over the year as a whole, sterling had fallen back from its sharp spike in the spring to around the levels prevailing at the end of 1999. Taking that longer view, it was not entirely a euro story; sterling was around 10 cents lower against the dollar than at the beginning of the year.

19 The recent movements did seem, however, to be attributable once again to euro weakness. This was not obviously explained by relative interest rate expectations. It was conjectured that net capital inflows into the euro area were weak, or negative, on account of the substantial accumulation of capital (and associated rise in capital relative to labour) over the past fifteen years or so in continental Europe. Some members thought that, at least in the short term, there was a risk that the euro would be weaker than had been assumed in the central projection.

## The labour market

20 Employment, on the Labour Force Survey (LFS) measure, had risen by 0.5% in the three months to May compared with the previous three months—the largest increase since June 1997. LFS unemployment had fallen by 47,000 over the same period, to 5.6%. Claimant count unemployment was, at 3.8%, the lowest for nearly 25 years.

21 Over the past couple of years, employment had risen by well over half a million. Around half of this was accounted for by population growth. Of the remainder, falls in inactivity accounted

for more than falls in unemployment. It was not clear whether that could continue, but some members were concerned that the latest projections agreed by the Committee did not allow for further falls in inactivity.

22 Another source of labour supply over the past few years had probably been immigration. For example, there were anecdotal reports of public sector health workers being hired from overseas. That might continue, in which case pressures on the labour market from an expanding public sector might be contained. This was, however, difficult to assess quantitatively. The most up-to-date data suggested that net immigration had reached around 175,000 in 1998—but the reliability of the data was uncertain. It was suggested that the 2001 census might cast light on this issue in due course.

23 Average hours worked by full-time employees had fallen steadily over the past 2–3 years. This was odd during a period of buoyant economic growth and a tight labour market. One possible explanation was that there had been an increase in the use of temporary agency workers in place of overtime working by full-time employees. It was suggested that that might add to labour market flexibility for the economy as a whole, as well as keeping labour costs down for some firms.

24 Headline (three-month moving average) whole economy earnings growth had fallen from 5.1% in April to 4.6% in May, partly on account of February's 5.5% annual growth rate dropping out of the three-month calculations. But that was not the whole explanation. Annual whole-economy earnings growth had fallen from 4.6% in April to 4.0% in May—the lowest rate of growth since September 1997. The contribution from bonuses in May had been -0.7 percentage points; regular pay growth had risen 0.2 percentage points to 4.6% (non seasonally adjusted).

25 Some members regarded the labour market news on the month as significant. First, the continued rise in employment and fall in unemployment over the past year or so had not been accompanied by accelerating earnings, which suggested that the supply side had improved. Government initiatives during the 1990s might help to explain this. For example, anecdote suggested that Jobcentres had become more active and effective in assisting job search. Second, the fall in bonuses was consistent with what was known about corporate sector profitability. It was suggested that bonuses might continue to fall.

26 Other members were less sure about the significance of the recent data. There had undoubtedly been millennium and bonus-related effects, which were now dropping out of the data, but the underlying position was not yet clear. Looking forward, most members thought that unit labour cost growth would have to fall significantly for inflationary pressures to be contained.

## Prices and costs

27 The consequences for inflation of wage cost growth depended in part on productivity. In the longer run, real wages and productivity should grow at the same rate. Over recent years, real wages had risen much faster, although the gap had recently started to narrow.

28 Accumulating cost pressures were apparent in a number of indicators. For example, manufacturers' input prices (excluding food, beverages, tobacco and petroleum) had risen by 5.0% in the twelve months to June—the fastest rate since October 1995. A major influence on costs was the rise in the oil price, but in addition the Bank's non-oil commodity price index was up 5.2% in the twelve months to June—the highest rate since December 1995. RPIX inflation had risen more than had been expected, so that it was set to be much closer to target in the short run than projected in the *May Inflation Report*. Views varied on the significance of this.

29 Some members stressed that oil prices were expected to fall back, so that the effect of the earlier price rises on RPIX inflation should be short-lived. Sterling's depreciation would also have only temporary effects. RPIX inflation excluding food, energy and tobacco had been edging down. Moreover, it was not at all clear that rising costs would feed through to prices given current and prospective developments on the supply side of the economy. These members argued that survey evidence pointed to increasing pressure on margins over the past few years. Businesses should be expected to respond to increased competitive pressure by increasing productivity and reducing bonuses. In any case, it was plausible that productivity growth was set to rise because of a variety of factors involving the potential benefits of business-to-business e-commerce and the likelihood that those who had recently obtained jobs after a long spell of unemployment or inactivity would become more effective as they gained experience. These influences were, on this view, not well reflected in the structure of the main forecasting model. In order to capture such supply side improvements in the projection for inflation, these members favoured incorporating a materially larger downward effect on inflation from the gains in productivity and cost cutting than assumed in the best collective projection shown in the fan charts.

30 Some other members preferred a smaller effect than was incorporated in the best collective projection. There was not much sign of the strength in business investment that would plausibly be needed to deliver an improvement in productivity growth relative to the past trend. Nor was there much evidence of price-cost margins being systematically compressed. Experience in the US did not suggest that margin compression was an inevitable part of the ICT revolution. An assumption of price-cost margin compression had already been made in the past few forecasts and incorporated again in the August projections. It could not sensibly be rolled forward indefinitely.

### The August output growth and inflation projections

31 The Committee agreed the projections to be published in the *Inflation Report* on Wednesday 9 August.

32 On the assumption of an official repo rate of 6.0% over the next two years, the central projection was for output growth to ease slightly to around 2½% (around trend) before rising slightly during the second year. On the central projection, RPIX inflation was just below the 2½% target during the first year and then rose to slightly above the target—a slightly higher profile than in May.

33 As in previous quarters, there was a range of views about the inflation outlook. The main difference in assumptions about, in particular, price-cost margins and productivity growth were presented in Table 6.B of the August *Inflation Report*.

### Tactical considerations

34 Three tactical considerations were noted. First, the market was expecting rates to rise again but not yet. Market views of the outcome of the meeting were not uniform, but were thought to be 70/30 weighted to 'no change', but with the probability assigned to a policy tightening having increased somewhat as the meeting approached. In consequence, a tightening would come as less of a surprise than would have been the case at either of the previous two meetings. That suggested that any consequent upward pressure on sterling might be limited. However, tightening sooner than the market expected might lead to the view that rates would eventually go up by more than currently expected. That might increase any upward pressure on sterling, adding to the downward influences on inflation.

35 Second, the *Inflation Report* would provide an opportunity to explain any change in the repo rate.

36 Third, the Committee's meeting was to be followed fairly shortly by meetings of the ECB, the Bank of Japan and the FOMC. Their decisions would also affect the exchange rate and the external environment more generally. The market was not expecting rises from either the ECB or FOMC.

### The immediate policy decision

37 Various arguments were advanced in favour of maintaining the repo rate at 6.0%. For some preferring 'no change' the position was finely balanced. On the one hand, the signs that the economy was slowing were less compelling following the first estimate of Q2 GDP, the world economy remained strong, and there would be upward pressures on inflation from sterling's depreciation since May. On the other hand, the determinants of consumption were consistent with slowing private sector demand, and the outlook for earnings was more benign than at the time of the May *Inflation Report*. Moreover, there did seem to have been some improvement in the economy's supply-side performance. Among other evidence, some members cited the tendency over the past few years for the Committee to underpredict output growth but overpredict inflation outturns, although lower import prices had played a part. Some allowance was made for this in the margins assumptions in the latest projections. The best collective projection—with inflation slightly below target in the first year and slightly above in the second year—reflected this balance of forces and was consistent with either 'no change' or a small policy tightening. An immediate move was not needed, and would risk the market concluding that there would be further tightenings, which through upward pressure on sterling would create unnecessary downward pressures on inflation. Publishing a fan chart with the central projection slightly above target at the two-year horizon might cause a modest tightening in money market conditions. That would not be unwelcome in itself and would avoid the risk of a larger market adjustment if the repo rate were raised.

38 Some other members preferred assumptions which would produce a lower central projection for inflation. In particular, improvements in the performance of the supply side of the economy would dampen inflationary pressures by more than assumed in the best collective projection. Looking forward, those pressures were in any case easing rather than increasing. The earnings data in particular were encouraging, and the oil price had recently fallen back somewhat. The deceleration in house prices and the likelihood that the oil price would not rise further would be negative influences on RPIX inflation for a while. The determinants of consumption were softening. While the risks to consumption were probably on the upside, the risks to business investment and government spending were on the downside. On one view policy was already contractionary: this could be seen in various leading indicators, in estimates showing that the short-term real interest rate was above the 'neutral' rate, and from a tightening in measures of monetary conditions that incorporated the rise in the exchange rate in recent years. Whereas a month ago there had been a case for moving to a more 'neutral' policy stance, the latest data pointed to a need to maintain slightly contractionary monetary conditions. But there was no case for a further rise. Any tightening would also put upward pressure on sterling's exchange rate. That was unnecessary in terms of restraining inflation, and it would also add to the risk of sterling's already-overvalued exchange rate falling sharply in the future—thus creating a risk of undershooting the target in the short run but overshooting it later on if and when sterling fell back.

39 Arguments were also advanced in favour of an immediate small increase in the repo rate. On this view, the news on the month pointed, on balance, to stronger conditions than had been apparent a month ago. If the GDP data for Q1 and Q2 were averaged, there was little sign of a significant slowdown. While most of the determinants of consumption had eased in recent months, household borrowing remained strong and it was not yet

clear that private sector demand would slow quickly enough to offset the effects of increased public sector spending; the risks to inflation from consumption were on the upside. Measures of earnings growth had fallen, but it was very difficult to assess the underlying rate of increase. It was clear, though, that the labour market had continued to tighten. Employment had increased by  $\frac{1}{2}\%$  in the three months to May, and unemployment was lower than for a quarter of a century. The central projection assumed decelerating unit labour costs. The risks to inflation from earnings were therefore also on the upside. Other indicators of short-term cost pressures were clearly increasing, and inflation was now likely to undershoot the  $2\frac{1}{2}\%$  target in the short run by rather less than had been projected in the *May Inflation Report*. While sterling had risen since the Committee's July meeting, it was still about 4% below the path projected in the *May Inflation Report*; and there remained a risk of further falls since the economy was still relatively uncompetitive at the current real exchange rate. It was conceivable that a structural shift in economy-wide margins was underway, but there was not much evidence of this yet; for this reason some members preferred a higher central projection for inflation than the best collective projection. While there were tactical arguments in favour of delay, given that the balance of risks to inflation was on the upside, and given that the market was expecting a modest tightening later in the year, the better course

was an immediate increase of 25 basis points. For some this was a finely balanced decision.

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

41 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

42 Andrew Turnbull was present as the Treasury representative.

## Annex: Summary of data presented by Bank staff

### I The international environment

1 Evidence of a slowdown in the United States had been mixed. GDP had risen by 1.3% in Q2 following a rise of 1.2% in Q1. Investment had grown by 3.6% in Q2 after 3.9% in Q1. But quarterly consumption growth had slowed to 0.7% in Q2 compared with 1.8% in Q1. Exports had risen by 1.8% in Q2, but imports had risen by 4.0%, reflecting continued strong domestic demand. Private non-farm payrolls had risen by 206,000 in June, but total payrolls had risen by only 11,000, as 190,000 workers who had been temporarily employed on the Census finished their work in June. The unemployment rate had fallen to 4.0% in June from 4.1% in May. The Conference Board index of consumer confidence had risen to 141.7 in July from a revised 139.2 in June, and had remained at a historically high level. Annual consumer price inflation had increased to 3.7% in June from 3.1% in May, primarily because of higher energy prices. Core consumer price inflation had risen only slightly, to 2.4% from 2.3%. The employment cost index had risen by 1.0% in Q2.

2 Recent data had shown further evidence of strong growth in the euro area. Euro-area GDP growth in Q1 had been revised up to 0.9% from 0.7%. Consumption growth, reported as flat in the first Q1 release, had been revised up to 0.7%. The revised data was more easily reconcilable with high levels of euro area consumer confidence and recent labour market trends. Available data for Q2 had pointed to a continuation of strong growth. Retail sales had grown by 0.2% in May after growing by 1.4% in April. Industrial production had risen by 0.8% in May, after growing by 0.6% in April. The unemployment rate had fallen to 9.1% in June from 9.2% in May. The German Ifo index had fallen to 100.4 in June from 102.0 in the previous month, but the euro-area business confidence balance had risen by three points in June. HICP inflation had risen to 2.4% in June from 1.9% in May, reflecting higher energy prices. Core inflation had risen to 1.3% in June from 1.1% in May.

3 Japan's industrial production had grown by 1.7% in June, bringing the increase on the quarter in Q2 to 1.6%. And tertiary activity had grown by 0.5% in May. Retail sales had grown by 1.5% in June, while employees' cash earnings had risen by 0.8% in the year to June. Unemployment had risen to 4.7% in June from 4.6% in May. Against this, the ratio of new job offers to applicants had risen from just under 1.0 to 1.1. Consumer prices had declined by 0.3% in June and by 0.7% in the year to June. In contrast, the wholesale price index had been flat on the month and was 0.3% higher on the year.

4 Since the previous MPC meeting the price of Brent crude had fallen by around \$3 to approximately \$27 a barrel. The price for Brent crude futures maturing in August had fallen by around \$1.60, to \$28 a barrel. At longer maturities the futures curve had remained little changed.

5 Since the previous MPC meeting the Wilshire 5000 and the DJ Euro Stoxx had fallen by 1.2% and 0.4% respectively, and the Topix had fallen by 7.4%. Short term interest rate expectations implied from futures contracts in the US had fallen slightly. In contrast, implied policy rates for the euro area had risen.

### II Monetary and financial conditions

6 The twelve-month growth rate of notes and coin had continued to fall, and was down from 7.5% in June to 7.1% in July.

7 M4 had risen by £8.2 billion (1.0%) in June. This had raised the twelve-month growth rate to 6.8%, the highest for more than a

year. Aggregate M4 lending (excluding the effects of securitisations) had remained strong in June, increasing by £5.4 billion on the month. The twelve-month growth rate had fallen slightly to 11.5% from the peak of 12.1% in May.

8 Households' M4 had increased by £3.9 billion (0.8%) in June. That had reflected a recovery from the weak growth in May. The twelve-month growth rate in June, at 5.5%, was still below the average growth rate during 1999.

9 Households' M4 lending (excluding securitisations) had continued to be strong in June, increasing by £5.0 billion (0.9%). Within total lending to individuals, secured lending in June had been close to the strongest flow seen since the pick-up in the housing market last spring. Despite slightly weaker loan approvals figures in June, the number of approvals had remained robust.

10 Private non-financial corporations' (PNFCs') M4 had risen by £0.9 billion (0.7%) in June. The twelve-month growth rate had increased to 9.0% from 6.3% in May. PNFCs' M4 lending (excluding securitisations) had fallen by £0.9 billion (0.4%) in June. However, the twelve-month growth rate of PNFCs' M4 lending had remained strong at 12.7%.

11 The flow of external corporate finance had been £17.5 billion in 2000 Q2, up from £15.6 billion in 2000 Q1. The proportion of external corporate finance in the form of sterling bank borrowing had also risen in 2000 Q2. The quarterly industrial breakdown of bank lending showed that the majority of sterling bank borrowing by corporates in 2000 Q2 had been undertaken by service sector firms, continuing the trend seen since 1999 Q3.

12 Holdings of M4 by other financial corporations (OFCs) had increased by £3.4 billion (1.8%) in June. The twelve-month growth rate was 9.0%, having risen by more than 14 percentage points between 1999 Q3 and 2000 Q2. Since 1999 Q3, the majority of this growth had been due to the increased money holdings of other financial institutions and financial auxiliaries (OFIFAs) rather than insurance companies and pension funds (ICPFs). OFCs' M4 lending had grown by £1.4 billion (0.6%) in June—the twelve-month growth rate had been 13.7%.

13 Since the July MPC meeting, interest rate expectations, as measured by the two-week gilt repo curve, had risen by up to around 15 basis points. Longer-term nominal interest rates had risen by around 10 basis points since the July MPC meeting.

14 The term structure of corporate bond yields had remained fairly flat since the July MPC meeting. Data on corporate bond issuance in July had shown that there had been a reduction in the proportion of corporate bonds issued at longer maturities. The spread of corporate bond yields over gilts had been increasing steadily since the beginning of the year. But the spread of corporate bond yields over swap rates had been broadly flat, suggesting that factors affecting the gilt market were at least partly responsible.

15 Retail interest rates had been little changed since the July MPC meeting. It was noted that the structure of the mortgage market had been changing over recent years. For example, the average two-year discount offered on standard variable-rate mortgages had risen to around 170 basis points in July from an average of around 130 basis points in 1997–99.

16 Survey measures of inflation expectations had changed very little since the July MPC meeting.

17 The FTSE 100, the FTSE All-Share and the FTSE Small Cap indices had all remained broadly unchanged since the July MPC meeting. The UK IT sector, as measured by the FTSE techMARK index had risen by 4.1% over the month.

18 Since the previous MPC meeting, the sterling ERI had appreciated by 2.3%, reflecting a 3.4% appreciation against the euro. Interest rate differentials could explain almost all of sterling's appreciation against the euro on the month, but could not explain sterling's 3.2% depreciation against the dollar since the July MPC meeting. Over a longer period, interest rate differentials could not explain sterling's depreciation since the May *Inflation Report*.

### III Demand and output

19 The preliminary National Statistics estimate of GDP growth in 2000 Q2 had shown growth picking up to 0.9% from 0.5% in Q1. Service sector output had grown by 1% in Q2, to 3.6% higher than a year earlier. Within services, the distribution, hotels and catering sector had grown by 0.3%. Industrial production had grown by 0.9% in the three months to May, and manufacturing output had grown by 0.3% over the same period.

20 The total deficit on trade in goods and services had narrowed very slightly in May to £1.6 billion. Total export volumes had grown by 3.6%, and total import volumes by 2.7%, in the three months to May. Excluding oil and erratics, total export volumes had grown by 2.6% over the same period, and total import volumes had grown by 1.6%. Non-EU export volumes had risen by 5.6% in Q2, and non-EU import volumes had risen by 4.4%.

21 Retail sales had grown by 0.7% in June and by 0.3% in Q2. Total new car registrations in the three months to June had risen by 0.1% on a year earlier, while private new car registrations had fallen by 7.5% over the same period. The retail indicator of the CBI survey of distributive trades had increased to +24 in July from +15 in June. The quarterly Consumers' Association survey of consumer confidence had increased to +37 in July from +33 in April. Against this, the GfK consumer confidence index had fallen to -2.0 in July, from +0.1 in June. The MORI index had increased to -10 in July, from -14 in June.

22 The Nationwide house price index had fallen by 0.2% in July, but remained 13.9% higher than a year earlier. The Royal Institute of Chartered Surveyors (RICS) house price survey balance had fallen to +5 in June, from +25 in May. The survey had suggested that prices had continued to rise outside London and the South East, although the rate of increase had slowed in several regions. The House Builders' Federation (HBF) house price survey had been virtually unchanged in June at +21. HBF net reservations had fallen to -17 in June, from -11 in May. Particulars delivered had fallen by 1.6% in June, but remained 3.6% higher than a year earlier.

23 Public sector net borrowing in June had been £2.7 billion, compared with £2.6 billion in June 1999. Net borrowing had been £4.2 billion in 2000 Q2, marginally higher than in the same period last year. The Spending Review had included modest upward revisions to total managed expenditure reflecting a partial carry-forward of the underspend in the fiscal year 1999–2000.

24 Survey data on manufacturing investment intentions had been mixed. The British Chambers of Commerce (BCC) Quarterly Economic Survey had reported that the balance of investment intentions in manufacturing had increased to 12 in Q2 from 9 in Q1. On the other hand, the Confederation of British Industry (CBI) quarterly survey had reported a virtually unchanged balance of -21. BCC survey data for the service sector had showed that the balance of investment intentions had increased slightly, to 21 from 18 in Q1.

25 Survey evidence on trends in stocks had been mixed. The July CBI Industrial Trends Survey had indicated falling stocks

balances. The CBI distributive trades survey for the same month had suggested that stocks had remained steady in Q2.

26 The CBI and BCC surveys had shown a fall in orders to the manufacturing sector in Q2. However, there had been a rise in the headline index of the CIPS purchasing managers' survey of manufacturing to 51.8 in July from 50.4 in June. Other surveys, such as those by Dun & Bradstreet and Euler Trade Indemnity, had suggested slowing manufacturing activity in Q3. The Dun and Bradstreet and BCC surveys had also suggested weaker expected profitability in manufacturing. Survey data on services output had remained buoyant. The CIPS services activity index had risen slightly in July, while the BCC survey had reported an increase in orders to the service sector.

### IV Labour market

27 Employment growth had strengthened. LFS employment had increased by 126,000 (0.5%) in the three months to May compared with the previous three months. This was double the increase in the previous non-overlapping period, and also slightly higher than the growth in the three months to April. Most of the increased employment had been in full-time work, which had risen by 107,000 (0.5%); part-time employment had risen by 19,000 (0.3%). Higher employment had contributed to an increase of 0.3% in total hours worked in the three months to May, although average hours worked had fallen by 0.1%. During the past year, there had been a widening gap between employment growth and the growth in hours worked.

28 Survey evidence had suggested that employment growth would remain strong. The CIPS employment survey had indicated that employment growth in the service and construction sectors increased in July, and that the decline in manufacturing employment had slowed. In addition, responses to the questions on employment intentions in the BCC and CBI surveys both suggested that growth would remain strong in the next few months.

29 Survey evidence had also indicated that staff shortages and recruitment difficulties persisted. The CBI Industrial Trends Survey had reported that shortages of both skilled and unskilled staff increased in Q2, although the degree of the measured disparity between workers' skills and the skill levels demanded by firms was similar to historical averages. The BCC survey had shown that recruitment difficulties also remained high in Q2. The Recruitment and Employment Confederation survey had suggested that the shortage of agency staff continued to worsen in July.

30 The number of new vacancies notified to Jobcentres had increased in June (along with the number of placings). This had reversed part of the fall in May.

31 LFS unemployment had fallen by 47,000, with the unemployment rate falling by 0.2 percentage points to 5.6% in the three months to May compared with the previous three months. The fall in LFS unemployment had been fairly evenly split between the less-one-year unemployed (down by 20,000) and the long-term unemployed (down by 28,000). Claimant count unemployment had fallen by 11,900 in June, with the rate unchanged at 3.8%.

32 The LFS measure of inactivity had fallen by 42,000 in the three months to May compared with the previous three months. Amongst people of working age, inactivity had fallen by 65,000, the largest fall since the winter of 1998–99. The largest decline had been among people who did not want a job.

33 Whole-economy headline earnings growth had fallen by 0.5 percentage points to 4.6% in the year to May. Headline earnings growth had fallen in both the private sector (down by 0.6 percentage points to 4.8%) and the public sector (down by 0.4 percentage points to 3.8%). Within the private sector, headline earnings growth in service sector firms had fallen by 0.8 percentage

points to 4.9%, but had increased in the manufacturing sector by 0.1 percentage points to 4.6%. Actual earnings growth in the year to May had been 4.0%, down by 0.6 percentage points from the previous month. This decline was more than accounted for by weaker bonus growth. There had been significant revisions to earnings growth data for April, particularly in the manufacturing and public sectors.

34 There had been little new information on settlements. The Bank's AEI-weighted twelve-month mean settlement had fallen by 0.1 percentage points to 3.0% in June, but the three-month mean was unchanged. Most of the settlement data in June had related to workers in the construction industry.

## V Prices

35 The Bank's oil-inclusive commodity price index had risen by 3.8% in June, taking the annual inflation rate from 17.1% up to 22.3%. Higher fuel and domestic food prices had largely accounted for the rise in the annual rate. Excluding oil, commodity prices had risen by 5.2% in the twelve months to June, up from 2.6% in the previous month.

36 Seasonally adjusted manufacturing input prices had risen by 1.4% in June, taking the annual inflation rate from 12.9% to 14.1%. The rise reflected higher prices of oil and other raw materials including chemicals and domestic food. The annual rate of change of seasonally adjusted total output prices excluding excise duties (PPIY) had increased strongly, to 2.4% from 1.8% in May, largely on account of higher petroleum price inflation. Looking ahead, the latest CBI expected output price balance had strengthened to -15 in July from -18. This contrasted with the data from the BCC survey on manufacturing. The BCC price expectation balance for services had fallen to 21 in Q2 from 26 in Q1.

37 Prices of total imported goods had risen by 2.5% in May. Excluding oil and erratics, prices of imported goods had also risen by 1.6%.

38 RPIX had increased by 2.2% in the year to June, up from 2.0% in May, largely owing to higher petrol price and seasonal food price inflation.

## VI Reports by the Bank's Agents

39 The Agents suggested that manufacturing output growth had continued to slow in recent months. Against this, there had been clear signs of an improvement in export markets in some regions in recent weeks.

40 Most areas of business services had continued to record strong growth, although transport services (particularly road haulage) had appeared to slow recently. Demand for IT services, which had seen a dip since late-1999 was reported to have picked up in recent weeks. There had been a noticeable downturn in domestic tourism.

41 There had been further evidence of a slowing in residential construction activity—particularly noticeable in the southern regions of the United Kingdom. This was reported to have been the result of both supply-side constraints and a slowing in demand—evidenced by fewer site visits and increased cancellations. In contrast, growth in commercial construction was said to have been maintained in most regions.

42 Agents reported that there had been a further rise in input price inflation, as earlier rises in the oil price had fed through to stronger increases in the price of related products. In addition, there had been some indication of a recent increase in output price pressures.

43 House price growth appeared to have slowed further in most regions. In the southern regions, where inflation had slowed markedly recently, there had been reports of some small price falls.

44 The labour market picture had remained similar to recent months. Although little change to recent settlements had been reported, there had been an increase in the number of contacts indicating that negotiations had become more difficult to resolve recently. In some cases employees had reportedly reacted to higher petrol prices and tax increases. Pressures on the total pay bill had continued to increase in the construction and service sectors.

45 The Agents had conducted a survey of UK firms regarding the pace of consumer spending in recent months. The results had shown that more than half of those firms surveyed in the retail goods, service and motor vehicle sectors reported that recent sales value growth had been lower than expected. Motor vehicle sales had been the weakest relative to expectations. Reasons for the lower-than-expected outturn had included some temporary factors (such as poor weather), but had also indicated some weakness in consumer demand. For motor vehicles, the key factor had been the impact uncertainty surrounding the review of UK car prices. Firms had also been asked about their expectations for annual sales value growth over the next three months. On balance, the results of the Agents' survey had suggested very little change to the current pace of growth. Car dealers were expecting competition issues to be resolved in the near future.

46 Firms had also been asked about recent price discounting relative to a year ago. Over half of the respondents reported that the extent of summer 'sales' this year was slightly greater or significantly greater than last year. This was particularly evident for motor vehicles, but also for retail goods.

## VII Market intelligence

47 Market participants' expectations of official UK interest rates had risen slightly since the July MPC meeting. Two-week forward rates derived from the gilt market had risen by up to around 15 basis points at the 1–2 year maturity. The majority of those polled in the latest Reuters poll of City economists thought that the MPC would not raise rates in August, but the poll had shown a mean expectation that rates would be at or above 6¼% by year end.

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

1 Before turning to its immediate policy decision, the Committee discussed demand and output; the world economy; money, credit and asset prices; the labour market; and prices and costs.

### Demand and output

2 According to the latest estimate, GDP in Q2 had risen by 0.9% on the quarter, after increasing by 0.5% in Q1. Much of the pick-up reflected rapid growth in the primary sectors of the economy, such as mining and utilities output, following a fall in Q1; if these were excluded, growth in Q2 was at 0.7%, close to the average quarterly growth rate for GDP over the past eighteen months. The National Institute of Economic and Social Research projected GDP growth of 0.8% in the three months to August.

3 The central projection in the August *Inflation Report* was for consumption growth to moderate from its recent rapid pace. In Q2 household consumption had grown by 0.8%, after an increase of 0.6% the previous quarter; this compared with an average quarterly growth rate of 1.2% during 1999. The question was whether consumption growth would continue to moderate over the forecast period to a little below its long-run average rate, in line with the *Inflation Report* projections.

4 Retail sales had been flat in volume terms in July, which was consistent with some slowdown in consumption, although sales of clothing and footwear might have been affected by the weather. On a three-month basis volumes were around 4% higher than a year earlier, with growth rates having fallen steadily from the peak seen around the turn of the millennium. The CBI Distributive Trades Survey suggested a slowing in annual retail sales growth in August, and the three-month average balance had now fallen for the past four months, with a broadly similar picture shown by the British Retail Consortium retail sales monitor. But the Distributive Trades survey also reported a less negative balance for motor traders' sales volumes (although the improvement here might prove temporary) and wholesalers' volumes were stronger than expected.

5 Most indicators of housing market activity pointed to a moderation of growth in that sector in recent months. The number of particulars delivered and loan approvals had fallen in July, and the House Builders' Federation net reservations balance had reached its lowest level for almost five years. Net secured lending had also fallen sharply in July, although the Bank's first estimate of mortgage equity withdrawal in Q2 was for an increase to £3.3 billion, from £2.3 billion in the previous quarter. The latest Halifax and Nationwide house price indices, while continuing to show significant increases on a year earlier, were decelerating; indeed on these measures prices were virtually unchanged between April and August. The slowdown was sharper than had previously been expected, and was no longer confined to London and the South-East. Nevertheless, such a slowdown need not entail slower consumption growth in the near term, particularly if it were to take some time for past increases in housing wealth to feed through into household spending.

6 In the services sector, evidence was more patchy, although services output had risen by 0.9% in Q2. Optimism in consumer services, as measured by the CBI/Deloitte and Touche survey, had fallen between May and August, but optimism in business and professional services had risen slightly; this was consistent with the continuing growth in business services reported by the Bank's regional Agents.

7 The underlying determinants of consumption seemed on balance to be a little less buoyant than at the start of the year. Taking the average earnings numbers at face value, labour incomes now appeared to be growing less fast, even though employment growth was somewhat stronger. Both the GfK and MORI consumer confidence measures had risen in August, but were lower than at the start of the year. Household borrowing was still growing rapidly, but a little less fast than in previous months, and while equity prices were higher than a month ago, the growth in housing wealth had slowed.

8 The other components of GDP in Q2 were rather mixed. Investment growth was relatively weak, after a fall in the previous quarter: while services investment had recovered a little and investment by general government had risen strongly, manufacturing investment had fallen back. Government consumption in Q2 had also grown rapidly, both in real and nominal terms, having earlier been surprisingly weak; such an acceleration in spending had been foreshadowed in the plans set out in the Budget, but the numbers were erratic and it was too soon to draw firm conclusions from them. The same applied to the estimates for stockbuilding, which included an alignment adjustment and which at present did not show any contribution to growth during the quarter. The net trade position was also little changed in Q2, with export volumes aided by the rapid growth in world demand.

9 Survey evidence from the Chartered Institute of Purchasing and Supply (CIPS) was consistent with steady output growth across the economy. In manufacturing the output index was a little higher in August, and had remained above the 'no change' level of 50 for the seventeenth month in a row, while the business activity index for services was also stronger, at 58.4. There was little evidence from surveys that growth at this pace was leading to increasing pressure on prices. More generally, the buoyancy of government revenues suggested that activity remained quite strong.

10 Manufacturing output and industrial production were both slightly lower in July, although on a three-month basis they showed growth over the previous three months of 0.5% and 1.2% respectively. Comparing the past three months with a year earlier, manufacturing production was up by 1.5%, and industrial output by a little more, despite the lagged effects of sterling's earlier appreciation. The Bank's regional Agents had also reported a pick-up in manufacturing in recent months.

11 The Committee agreed that some of the uncertainties surrounding the path of output in general, and consumption in particular, had reduced over the past month. In the view of some members, this was particularly so with regard to the upside risks, and in consequence these members now felt rather more confident that domestic demand growth would ease back in line with the projections in the August *Inflation Report*.

### The world economy

12 Activity in the world economy in Q2 now appeared to have been a little stronger than expected in the August *Inflation Report*, in part as a result of continued rapid growth in the United States. More recently there had been some rather weaker numbers for US non-farm payrolls, and in the National Association of Purchasing Managers survey. As a result, the probability of a 'soft landing' in the United States seemed to have increased, with less risk of a more precipitous adjustment to activity but with perhaps rather slower growth than previously expected in the United States in the coming year.

13 Elsewhere, the German IFO index had fallen for the second consecutive month, and was now 3% below its level in May, with the fall in the forward-looking element of the index particularly marked. In the past, falls of this magnitude in the overall index had presaged a slowdown in growth in Germany. Industrial production in Japan had declined, although it was still well above the levels of a year ago, and growth rates in the Asian emerging market economies had generally fallen back a little, after a very rapid recovery during 1999.

14 Over the past month oil prices had risen sharply, with the Brent one month future more than \$5 higher, at over \$33 per barrel. This would have a direct short-term effect on retail prices. Over the medium term, higher oil prices would tend to restrain demand, if it took the oil producers longer to spend their additional revenue than it took those whose real incomes were squeezed to reduce their expenditure. However, the energy intensity of output was now much less than it had been twenty or thirty years ago, and as a result the effects both on inflation and output would be correspondingly less than in the 1970s. To date, there was little sign in most countries of any effects on wage demands from higher oil prices.

15 The Committee noted that the prospects for the oil price might be rather clearer after the OPEC meeting on 10 September, but that demand for oil produced by OPEC was very sensitive to fluctuations in world activity, which had recently been growing faster than expected. If the oil price were no longer expected to fall back sharply, there might be an attempt to rebuild stocks, though this could put further upward pressure on prices in the short run. Over the longer term, if oil companies believed that prices would remain higher for longer, the production of oil from non-OPEC countries would also increase.

### Money, credit and asset prices

16 M4 lending to the household sector was still growing at an annual rate of 10%, although within this figure secured lending had fallen sharply in July. Meanwhile M4 lending to private non-financial companies (PNFCs) had accelerated dramatically, with the annual growth rate in July reaching 14½% compared with less than 6% in 1999 Q4, and with PNFC finance from other sources also growing quickly. Deposits made by PNFCs had risen rapidly earlier in the year, possibly related to tax changes which made it less attractive to hold surplus funds overseas, and this increase in corporate balance sheets was something of a puzzle. Although net debt did not appear that high as a percentage of capital stock measured at market values, at replacement cost the net debt ratio was above that of the early 1990s.

17 One possibility was that 'distress' borrowing was increasing, but there was little evidence for this from the deposit figures. Another was that investment was buoyant, but this seemed difficult to square with the latest Q2 figures, although it was always possible that the investment numbers would be revised up. A third possibility was that although growth in investment had been sluggish so far in 2000, the level of investment remained high by historic standards; companies might have funded higher investment initially out of internal funds and later, as investment remained buoyant, by borrowing. However, when measured at current prices the share of investment in GDP was not as high as when measured at constant prices, and for these purposes the current-price measure was the more relevant. Finally, it might be that companies were borrowing in order to invest overseas, and that some of this borrowing was held on deposit in the UK ahead of a prospective acquisition. All in all, the continuing combination of heavy corporate borrowing and low reported investment remained a puzzle.

18 While sterling's exchange rate was little changed in effective terms over the past month, there had been some movement in the

bilateral rates. In particular, sterling had fallen to a seven-year low against the US dollar, perhaps because the market was becoming increasingly convinced that the recent rapid productivity gains in the United States were sustainable, and that the US economy was now less likely to undergo a 'hard landing'. The US dollar had been stronger against a wide range of currencies over the past month, so the weakness of sterling against the dollar was unlikely to have arisen for UK-specific reasons. Sterling had meanwhile appreciated a little against the euro, which had fallen to new lows against the dollar. While sterling had in general not moved with the dollar against the euro in recent weeks, the evidence of a more fundamental delinking of sterling and the dollar remained inconclusive.

19 To the extent that sterling's exchange rate index properly captured the relative importance of the United States and the euro area, the effects on trade flows of the recent movements in sterling (which had left the index broadly unchanged) should on balance be neutral. Firms which competed principally with US producers would benefit from the fall in sterling against the dollar, at the expense of those whose main competitors were from the euro area.

20 Over the longer term, it was far from clear that an appreciation of the dollar against the euro would be sustained, given the size of the US current account deficit. But for as long as relative rates of return on capital in the United States appeared high, the United States would continue to attract capital from the rest of the world. In that sense the present position might be sustainable for some time to come.

### The labour market

21 Employment growth had picked up in Q2, with the Labour Force Survey (LFS) measure up by 0.4%, compared with 0.2% in Q1. The estimate of average hours worked was 0.6% higher in Q2 and so, on the basis of that measure, whole-economy productivity growth on an hourly basis would be close to zero in that quarter. The increase in hours worked was consistent with signs that the labour market was tightening further, although the series was volatile, with average hours still 0.9% below the levels of a year ago.

22 Unemployment continued to fall rather steadily on the claimant count basis, but had fallen more rapidly on the LFS measure, from 5.8% of the labour force in Q1 to 5.5% in Q2. This partly reflected—in an accounting sense—a rise in male inactivity, but it was probably too soon to read anything significant into this.

23 CIPS survey data suggested a slower pace of decline in manufacturing employment, and steady growth in services employment, although in this case the balance was below that for business activity in services. The most recent Recruitment and Employment Confederation survey and reports from the Bank's regional Agents both indicated widespread skill shortages, but it was unclear to what extent these problems were increasing across the economy as a whole.

24 While the quantities data suggested that the labour market remained tight, and might be tightening further, there was little sign yet of this feeding through into higher nominal earnings. The Average Earnings Index (AEI) showed another fall in earnings growth, from 4.6% to 4.1% on the three-month headline basis, and from 4.0% in the year to May to 3.8% in the year to June. These figures were below those incorporated for Q2 in the August *Inflation Report*, but it remained to be seen how far they reflected one-off influences, and how far a continuing moderation in earnings growth.

25 The recent slowdown in earnings growth was accounted for by a substantial negative contribution from bonuses, both in May and June, most notably in the private services sector, where earnings in June were only 3.3% higher than a year ago, as against



4.4% in manufacturing. In as much as this deceleration reflected pressure on profits, this was consistent with the stock market underperformance of the retail sector and reports from the Bank's regional Agents of subdued high street activity. Whole-economy regular pay, ie earnings excluding bonuses, had been growing at around 4½% a year since March.

26 The Committee discussed the significance of these figures. Earlier in the year it had noted that millennium-related payments had pushed up earnings growth, and that as a result the figures needed to be interpreted with care. This was less of a problem now that the change of millennium was past, and in any case the main news was the surprisingly large fall in bonus payments; growth in regular pay was relatively stable. This could suggest welcome evidence of a more flexible wages structure. While some recovery in bonuses and thus AEI growth rates was quite likely, bonuses for many workers in 2000 Q4 and 2001 Q1 would not be as large as those paid around the turn of the millennium. This effect had been incorporated into the central projection of the August *Inflation Report*, but some members now thought it likely that over the next few quarters the AEI would grow more slowly than had been assumed in the forecast.

27 Despite the tightness of the labour market, nominal wage settlements had fallen back from close to 4% two years ago to around 3% now, during a period in which inflation as measured by the RPI (which included mortgage interest payments) had generally been very low. More recently RPI inflation had risen, and there were signs of a small pick-up in settlements when measured on a three-month basis, although this figure was susceptible to distortions from compositional and timing effects. Most firms still seemed able to achieve relatively low nominal settlements, and in many there was now no such thing as an annual settlement, with pay depending instead on the performance of the individual or of the division in which they worked.

28 In real terms the position was more complex. The strength of the exchange rate and the weakness of most commodity prices during 1998 and 1999 had enabled the real consumption wage (deflated by the taxes and prices index) to rise by 4% in 1999, compared with less than 2½% for the real product wage (measured using the GDP deflator). This gap had begun to narrow recently, but as import prices began to rise and the growth in the real consumption wage fell back towards 3% it remained to be seen whether pressure for higher nominal wages would increase, and whether unit labour costs would continue to moderate as in the *Inflation Report* projections.

## Prices and costs

29 RPIX inflation had remained at 2.2% in July, with increases in seasonal food prices offset by record monthly falls in the prices of clothing and footwear, reflecting greater discounting than normal in the July sales. Looking forward, the latest ONS advance estimate of RPIX, which was on this occasion available for the Committee's meeting, was for the inflation rate to fall in August. If so, this would be the seventeenth month in succession in which RPIX inflation had been below the 2.5% target. Petrol prices had fallen in August, partly as a result of greater retail competition, but it was unclear whether such falls would persist if the oil price itself remained strong.

30 Survey data were consistent with continuing subdued price pressures in the short term, despite the tightness of labour and product markets. The CBI Distributive Trades Survey showed a steep fall in the balance for average retail selling prices, from -6 in 2000 Q2 to -25 in Q3, and the 'prices charged' measure in the CIPS services survey had also fallen. Inflation as measured by the GDP deflator had declined sharply in Q2, to only 1.8%, but this was subject to revision when new estimates for the National Accounts were produced.

31 Views differed on the significance of the persistent undershoot of the inflation target. By historic standards RPIX inflation had been extremely stable in recent years, and had remained close to its 2.5% target since the establishment of the Committee. It was in any case unrealistic to expect inflation outturns very near 2.5% month after month, not least because of external shocks such as movements in oil and other import prices. Against this background the Committee should remain forward-looking and symmetric in its actions, aiming equally to avoid both overshoots and undershoots of the target, while acknowledging that it could do little to affect inflation over the very short term.

32 There were various possible explanations for inflation having recently been slightly below target. Some members thought that the short-term relationship between growth and inflation had become more benign, for instance because of structural changes to the supply side of the economy. They pointed out that the Committee's inflation forecasts of two years ago had been above the actual outturns while its forecasts for growth had been below. Other members thought that the recent inflation numbers might simply reflect continuing downward pressure from weaker-than-anticipated import prices, with the exchange rate remaining stronger for longer than had been projected in earlier forecasts. The Committee would continue to look at the information contained in the most recent inflation outturns, and compare this with its forecasts, to see how far the comparison cast any light on how much weight to put on each of these explanations.

33 The Committee noted that while inflation continued to run slightly below target, inflation expectations for 2001 remained very stable, and appeared anchored close to the 2.5% target, despite the sharp movements in the oil price and the exchange rate in recent months.

34 Surveys and reports from the Bank's regional Agents suggested that downward competitive pressures on prices continued to intensify, for example in areas such as cars and petrol retailing. But stories of fierce competition in product markets were by no means new, and while the profit share in GDP had fallen back since 1997, it was still close to its long-run average. As such, official and company accounts data provided little hard evidence yet of a structural reduction in margins on an economy-wide basis, although there was more evidence of a decline from surveys. For some members, the relative stability of the profit share suggested that the pressures on prices were being translated into pressure on nominal earnings on account of accompanying changes in the labour market, rather than a margins squeeze: if so an intensification of competition would be difficult to discern in reported profits.

## The immediate policy decision

35 Most members felt that there had been little news on balance over the month. Oil prices were higher than expected, and the AEI lower, but it was possible that movements in both would prove to be erratic. For this reason, the considerations underlying the immediate policy decision were similar to those the previous month, and for some members the position remained finely balanced.

36 On one view, the repo rate should be maintained at 6% this month. Various arguments were identified for so doing, to which different members attached different weights. First, there were now more signs that domestic demand growth in general, and consumption growth in particular, might indeed be moderating in line with the central projection in the August *Inflation Report*. Housing wealth and nominal earnings were both slowing rather faster than assumed there; most other housing market indicators (such as secured lending, net reservations and particulars delivered) were consistent with such a slowdown, as were retail sales, although the corporate borrowing figures were a puzzle. Second,

higher oil prices would tend to raise RPIX inflation in the short term, but it was questionable whether policy should react to any pick-up in inflation which was due solely to higher oil prices, particularly in the present conjuncture where this was likely to push RPIX inflation closer to target. In the longer term the oil price might fall back in line with market expectations, and if it did not it would tend to dampen domestic demand both here and abroad. Third, the prospects for the world economy might now be a little less buoyant than had been the case a month ago. Fourth, the latest figures for quantities and prices in the labour market—while very far from conclusive—suggested to some members that the rate of unemployment at which inflation tended to increase might have fallen, or at any rate that this was sufficiently uncertain for rates to be left on hold while the recent pattern of continued employment growth and moderate wage pressure persisted. Fifth, not only had some measures of inflation come in lower than expected, but some survey-based measures of price pressures continued to fall. Sixth, a rise in rates now, at a time when the euro was weak, might strengthen the perceived link between sterling and the dollar in an unhelpful way. Seventh, for some there remained upside risks from higher import prices and buoyant growth in some parts of the economy. But given the present benign picture on earnings and retail price inflation there was still time to react to inflationary pressures later; the risks to waiting were not great.

37 On a second view, the balance of risks pointed to the need for a further small increase in interest rates soon. Given that there were no pressing reasons to postpone such a move, an immediate increase of 25 basis points in the repo rate was warranted. On this view, while consumption growth had slowed from the rapid rates recorded during 1999, it was unclear whether it would moderate further, as was implied by the central projection in the August *Inflation Report*. The housing market had clearly slowed, but household borrowing remained buoyant, and borrowing by non-financial companies had risen rapidly, perhaps foreshadowing some recovery in business investment. Increases in public spending now seemed to be beginning to be reflected in the National Accounts data, and employment had risen rapidly in Q2, both in terms of heads and hours. There were therefore upside risks to output both in the short and medium term, even if net trade were to act as a drag on growth throughout the next two years, as had been forecast. The labour market was tight. Recent AEI figures had been lower than expected, but they perhaps reflected transitory

movements in bonuses. Moreover, until recently real consumption wages had been growing at around 4% a year, and the August central projection in the *Inflation Report* already incorporated a substantial fall in the growth of unit labour costs. There was little evidence for a marked structural shift in economy-wide margins, and whole-economy productivity growth had yet to strengthen significantly. Although oil prices might well fall back, they had remained stronger for longer than had been expected, and with sterling's exchange rate weaker since May, RPIX inflation would begin to rise above target unless domestically-generated inflation fell back to offset the effect of higher import prices. The risks were still that it might not do so sufficiently quickly to meet the inflation target in the medium term.

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

39 Finally, the Governor expressed his gratitude to John Vickers not only for his contribution to the Committee's discussion and decisions, but also for all he had done as Chief Economist and Executive Director of the Bank. On behalf of the Chancellor of the Exchequer, the Treasury representative also expressed his thanks for the contribution John Vickers had made to enhancing the credibility of the Committee, and thereby the institutional framework of UK monetary policy.

40 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

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

## Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 1 September in advance of its meeting on 6–7 September 2000. At the start of the 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 preliminary estimate of Q2 GDP growth in the United States had been 1.3%. Investment had remained strong, growing at 2.6% on the quarter, but quarterly consumption growth had slowed to 0.7%. Labour productivity had grown strongly in Q2, by 1.5%. The FOMC had noted that recent data indicated that more rapid advances in productivity had raised the US potential growth rate. Real personal consumption had strengthened in July, with the savings rate having fallen to its lowest recorded level. There had been signs of a slowdown in the labour market, where private payrolls growth had slowed further in August. Unemployment had risen to 4.1%. Furthermore, new orders had fallen sharply in July, albeit from a high level. The National Association of Purchasing Managers index had also declined further in August, and for the first time since January 1999 was below 50. But industrial production had risen in July, with high-tech sectors continuing to grow strongly.

3 GDP in Germany had grown strongly in Q2, by 1.1%, while French GDP had grown by 0.7%. In July, euro-area unemployment had remained unchanged on the month at 9.1%. German manufacturing orders had risen by 0.7% on a month earlier, but the German IFO index had fallen in July for the second consecutive month, with the fall in the forward-looking component of the index being more pronounced. Euro-area business confidence had fallen, but was still close to record high levels. Euro-area consumer confidence had risen in July, and was also close to its all-time high, with increases in both the French and Italian indices.

4 Japanese industrial production, seasonally adjusted, had declined by 0.7% in July, but had still risen by 5.7% on a year earlier. Investment indicators had remained robust; for example, machinery orders had risen in June by 23.5% on a year earlier. Nominal cash earnings had fallen in July, by 0.1% on a year earlier, following a rise of 1.8% in June, while contracted earnings and overtime payments had risen respectively by 0.9% and 3.9% on a year earlier. The unemployment rate had remained at 4.7% in July, and the ratio of new job offers to applicants had fallen back slightly to 1.08.

5 The oil price rose during August following its fall in July, and one-month oil price futures averaged around \$31 per barrel over the month. Prices for non-oil commodities fell in August.

6 Hourly compensation growth in the United States had risen by 1.3% in Q2, but unit labour costs had fallen by 0.1% on the previous quarter. Core inflation had remained unchanged at 2.4%, while CPI inflation had fallen to 3.6% in July. Japanese consumer prices had fallen by 0.2% in July.

7 In July, euro-area producer price inflation had risen by 5.5% on a year earlier, in part due to strong growth in energy prices. The harmonised index of consumer prices for the euro area had remained unchanged at 2.4% in July. Euro-area M3 had grown by 5.3% on a year earlier in July, following growth of 5.4% in June. The European Central Bank raised the minimum bid rate on its main refinancing operations by 0.25 percentage points, to 4.50% in July.

8 Since 2 August, the euro exchange rate index had depreciated by around 2.5%, while the yen ERI had appreciated by around 5%. The dollar ERI was broadly flat on the month. Over the same period, the Wilshire 5000 index (a broad measure of the US stock market) had risen by around 5%, while the NASDAQ index, with a higher proportion of technology stocks, had grown by 10%. The Euro Stoxx index was up by around 4%, but the Japanese TOPIX index had remained broadly unchanged. Interest rates implied by futures contracts had fallen on the month for the United States, but had risen somewhat for the euro area and Japan.

### II Monetary and financial conditions

9 The twelve-month growth rate of notes and coin had continued to fall slightly, from 7.1% in July to 6.9% in August.

10 M4 had been weak in July, rising by only £0.2 billion. The twelve-month growth rate had risen slightly to 6.7% as a weak outturn a year ago fell out of the calculation. But, excluding other financial corporations' (OFCs) deposits, twelve-month M4 growth had fallen to 5.3% in July. Aggregate M4 lending (excluding the effects of securitisations) had remained strong in July, increasing by £7.9 billion on the month. The twelve-month growth rate had risen to 11.9%, still close to its highest value since 1991.

11 Households' M4 had been unchanged in July, and the twelve-month growth rate had fallen to a five-year low of 4.6%. Timing factors and self-assessment tax payments may have contributed to the weakness in July, but a more general weakening trend had been apparent for the past year or so.

12 The twelve-month growth rate in households' M4 lending (excluding securitisations) had ticked down to 10.1% in July. Within total lending to individuals, net secured lending had been substantially weaker than in previous months, at £2.8 billion in July. The value of all loans approved in July had been £8.9 billion (down £0.9 billion from June), and the total number of approvals for house purchase had fallen by 8,000 to 93,000 in July, compared with an average of around 100,000 for the first half of this year. These latest falls had perhaps brought the monetary data more into line with other indicators suggesting that underlying housing activity would begin to fall in future months.

13 The Bank's first estimate of mortgage equity withdrawal in Q2 was £3.3 billion, compared with £2.3 billion in Q1 and a recent peak of £3.4 billion in 1999 Q3. The latest estimate had suggested that the flow of real borrowing for consumption had remained broadly flat over the past three quarters or so, following the sharp pick-up around the middle of 1999.

14 Private non-financial corporations' (PNFCs) M4 had fallen by £0.1 billion in July after strong growth in earlier months, possibly related to tax changes in the Budget reducing the incentives to hold surplus funds overseas. The twelve-month growth rate in PNFCs' M4 had declined to 7.9%. By contrast, M4 lending to PNFCs (excluding securitisations) had risen strongly by £3.2 billion in July after falling in June. The twelve-month growth rate of PNFCs' M4 lending had risen to 14.5%, continuing its recent strength. Total corporate financing had also been strong, at £7.0 billion in July. In real terms the average monthly flow of financing raised by PNFCs was now at the highest level since 1989.

15 Holdings of M4 by OFCs had increased by £0.3 billion (0.2%) in July. The twelve-month growth rate had been 11.8%. OFCs' M4 lending had increased by £0.2 billion (0.1%) in July, and the twelve-month growth rate had been 14%.

16 Since the August MPC meeting, shorter-term interest rate expectations, as measured by the two-week gilt repo forward curve, had fallen slightly. Longer-term rates had changed little. But corporate bond yields had risen slightly since the August MPC meeting. With the flattening of the corporate term structure, the maturity of bond issuance in recent months had become more evenly spread across the yield curve, and less concentrated at the long end.

17 Retail interest rates had been little changed since the August MPC meeting, and survey measures of inflation expectations were very close to the values reported at the time of the August MPC meeting.

18 The FTSE 100, the FTSE All-Share, the FTSE 250, and the FTSE Small Cap indices had risen by between 3.9% and 6.8% since the August MPC meeting, broadly in line with international markets. The UK IT sector, as measured by the FTSE IT Sector index, had risen by 16.4% over the month, reflecting the continued global rebound of IT stocks. The FTSE 100 implied volatility level had fallen sharply in August towards levels last seen in 1997.

19 Since the previous MPC meeting, the sterling exchange rate index had changed little, depreciating by 0.2%. Within the index, sterling had appreciated by 1.1% against the euro and depreciated by 2.9% against the US dollar. The \$/£ rate had been at its lowest level in seven years. Changes in interest differentials could not explain sterling's depreciation against the dollar.

### III Demand and output

20 Quarterly GDP had risen by 0.9% in Q2, unrevised from the previous GDP release, with growth up from 0.5% in Q1. Service sector growth had been revised down to 0.9% from 1.0%, while manufacturing output had increased by 0.4% on the quarter. Construction output had fallen by 0.7% in Q2. The increase in quarterly GDP growth had been partly accounted for by a sharp rise in the growth of mining and utilities output, reported to have been due to adverse weather conditions, which had contributed 0.3 percentage points to quarterly GDP growth in Q2. Excluding the primary sectors, GDP had risen by an estimated 0.7% on the quarter. Within manufacturing, the divergence between growth in the electrical/optical and chemical sectors and the rest of manufacturing had continued in Q2. Within services, business services at 1.5% had shown the strongest quarterly growth rate for two years. By contrast, growth in distribution output had weakened to 0.6% from 1.0% in Q1.

21 On the expenditure side, quarterly household consumption growth had been 0.8% in Q2. The ONS had reported strong increases in energy and communications, but a decline in sales of cars. Government consumption growth in Q2 had been strong at 1.9%. Investment had shown quarterly growth of just 0.2% in Q2 reflecting weak business investment growth of 0.4%. Manufacturing investment had fallen by 3.2%, but services investment had increased. Inventories had made no contribution to GDP growth in Q2. The ONS had said that the entire rise in stocks had been accounted for by the alignment adjustment; excluding the alignment adjustment, stocks were lower than in the previous quarter. Growth in both export and import volumes had picked up in Q2, to 2.6% and 2.3% on the quarter. Net trade had made no contribution to quarterly GDP growth.

22 Retail sales volumes in July had been broadly unchanged. Sales of clothing and footwear and food had declined on the month. But growth in the three months to July compared with the previous three months had risen to 0.9%, from 0.4% in June, as the high January figure had dropped out of the calculation. The CBI Distributive Trades Survey reported that the retail sales balance had fallen to 18 in August from 24 in July. The British Retail Consortium had recorded a decline in annual growth of total sales values to 4.3% in August from 4.7% in July. By contrast, the GfK

consumer confidence balance had risen in August to 1.4 from -2.0 in July. Private car registrations in July at -15.4% had continued to be lower than the previous year. Housing market activity had generally eased. Particulars delivered had decreased by 7,000 to 119,000 in July, while the (seasonally adjusted) HBF net reservations balance had fallen to -28, its lowest level since 1995. The Halifax house price index had shown a fall from 8.0% in July to 7.4% in August. Similarly, the Nationwide house price index had been 11.2% higher in August than a year earlier, compared with 13.9% in July.

23 The surplus on government net borrowing had been £6.6 billion in July, the largest July surplus since monthly figures started in 1993. This had reflected strong current receipts and weak current expenditure. The strength of current receipts had partly reflected special factors. The weakness of current expenditure had followed strong central government current expenditure in Q2, a pattern which may have reflected timing changes related to the introduction of end-year flexibility for departmental expenditure.

24 The CBI Monthly Trends survey had reported a rise in the orders balance in August, from -20 to -17. The Chartered Institute of Purchasing Supply (CIPS) manufacturing survey total orders balance had fallen back slightly in August to 52.7 from 53.9 in the previous month, but had remained well above the no-growth reading of 50. The CIPS services activity index had increased from 58.0 in July to 58.4 in August. But the CIPS construction activity index fell to 57.8 from 58.9 in July, indicating the slowest rate of monthly expansion since November 1999.

### IV The labour market

25 Employment growth had remained firm. LFS employment had risen by 106,000 (0.4%) in Q2. This growth rate had been higher than growth in Q1 (0.2%), though a little weaker than growth in the three months to May (0.5%). Average hours worked had risen by 0.6% in Q2, which meant that total hours worked had risen by 0.9%.

26 According to the CIPS survey, employment growth in the service sector had continued in August at rates broadly similar to those in the second quarter. Employment growth in construction had slowed but the index, at 60.6, had been significantly above the neutral level of 50. The reduction in manufacturing employment had been smaller than in recent months.

27 The Recruitment and Employment Confederation (REC) had reported a further deterioration in the availability of agency staff in August (notably for permanent rather than temporary staff). By contrast, the Bank's regional Agents had reported that skill shortages, while still high, appeared to have stabilised.

28 LFS unemployment had fallen by 91,000 in Q2, which meant that the LFS unemployment rate had fallen by 0.3 percentage points to 5.5%. That compared with an average reduction of 54,000 in the two most recent overlapping periods, and with a reduction of 20,000 in Q1. These movements had contrasted with the steadier reductions in the claimant count measure. Claimant count unemployment had fallen, on average, by 16,000 per month in Q2 and by a further 22,700 in July.

29 Inactivity had risen by 22,000 in Q2. This had been accounted for entirely by a rise in the number of inactive males.

30 Whole-economy productivity, based on LFS employment data and the first expenditure breakdown of GDP, was estimated to have risen by 1.9% in the year to Q2. This estimate was close to its long-run average growth rate.

31 Whole-economy headline earnings growth, a three-month moving average of the annual monthly rates, had fallen by 0.5 percentage points to 4.1% in June. Headline private sector

earnings growth had fallen by 0.6 percentage points to 4.2%, while headline public sector earnings growth had fallen by 0.1 percentage point to 3.7%. Headline earnings growth in the manufacturing sector had remained unchanged at 4.7%. For the first time in more than three years it was faster than headline earnings growth in the private services sector, which had fallen by 0.9 percentage points to 3.9%.

32 Annual whole-economy earnings growth had been 4.6% in April, 4.0% in May and 3.8% in June. During this period, regular pay growth had remained close to 4.5%. So the profile of annual earnings growth in the second quarter had reflected changes in the bonus contribution, which had fallen from 0.0 percentage points in April, to -0.7 percentage points in May and -0.8 percentage points in June.

33 The Bank's AEI-weighted twelve-month mean settlement measure had remained at 3.0% in July. Shorter-term measures from the Bank's database had increased since the start of the year, though by less than the increase in RPI inflation.

34 A Bank estimate of the growth in unit wage costs, based on the AEI and the first expenditure breakdown of GDP, had fallen from 3.8% in the year to Q1 to 2.2% in the year to Q2. This fall reflected weaker earnings growth rather than stronger productivity growth.

## V Prices

35 The Bank's oil-inclusive commodity price index had fallen by 0.4% in July, taking the annual inflation rate from 23.7% to 17.6%. The decline had mainly reflected a largely oil-related fall in the price of the fuels component of the index that more than offset a rise in the price of the domestic food component. The sterling price of oil had since risen by 6.3% in August and was therefore likely to affect commodity prices in August. The Bank's oil-exclusive commodity price index had risen by 0.5% in July, and by 5.1% over the past year.

36 Manufacturing input prices had risen by 0.4% in July, but due to base effects the annual inflation rate had fallen from 14.4% to 11.3%. The monthly increase had mainly reflected rises in the prices of domestic food and chemicals, which had been partially offset by the decline in the oil price. Input prices excluding food, drink, tobacco and petroleum had risen by 0.4% in July and the annual rate of inflation had fallen to 3.5% from 4.3% in June. The CIPS manufacturing survey input price index had fallen to 55.6 in August from 61.2 in the previous month. Output prices excluding excise duties (PIY) had risen by 0.1% in July, and the annual inflation rate had fallen to 2.1% from 2.4% in June. The output price balance in the August CBI Industrial Trends survey had remained unchanged at -15.

37 Prices of total imported goods had risen by 0.8% in June. Excluding oil and erratic items, prices of imported goods had risen by 0.6%. On the same basis, prices of exported goods had risen by 1.1% in June.

38 Annual inflation as measured by the GDP deflator at market prices in 2000 Q2 had fallen to 1.8% from 2.7% in Q1. The domestic demand deflator had fallen to 1.5% from 2.3%.

39 RPIX inflation had been 2.2% in July, unchanged from the previous month. Increases in seasonal food prices were offset by falls in clothing and footwear prices. RPI inflation had also remained unchanged at 3.3% in July. RPIY inflation had eased slightly to 1.9% in July from 2.0% in June, while HICP inflation had risen from 0.8% to 1.0% in July.

## VI Reports by the Bank's Agents

40 The Agents reported that manufacturing output growth in both domestic and export markets had picked up in recent months

in many regions. However, it was stressed that the recovery had remained modest and had not been broadly based across sectors.

41 Service sector growth was reported to have stabilised, following a reported easing in many regions last month. Most areas of business services continued to record strong growth, particularly IT and financial services. By contrast, there had been a noticeable downturn in domestic tourism, as well as in housing-related services such as real estate and conveyancing.

42 There had been evidence of a further slowing in residential construction in recent months. This was reported to have been the result of both supply-side constraints (eg limited availability of land and planning delays) and an easing in demand. House price inflation appeared to have slowed further in most regions. By contrast, growth in commercial construction was said to have been maintained, and had been even stronger in some regions. Moreover, the outlook had been for commercial construction activity to remain strong in coming quarters, reportedly as a result of the Comprehensive Spending Review and an expected increase in PFI projects.

43 Annual retail sales value growth continued to ease slightly, although discounting during the sales had reportedly strengthened volume growth. There had been little significant news about sales of motor vehicles.

44 The Agents had reported a stabilisation in input price inflation, although there had been offsetting influences. Contacts had reported that price increases in oil and related products had become more evident, as well as sharply higher gas prices. But these had been mitigated to some extent by increased importing, efficiency gains and more effective purchasing strategies. Competitive pressures on manufacturers' output prices continued to be reported, although there had been a slightly greater degree of input cost pass-through recently.

45 The labour market picture had changed little from previous months. Skill shortages remained a serious concern to contacts, but most suggested that these were no worse than in recent months. Although little change to manufacturing settlements had been reported, there had been some increased difficulties during negotiations, perhaps an indication of rising future settlements. While there had been some moderation in service sector earnings growth recently because of relatively lower bonuses compared to last year, upward pressures remained in many regions.

## VII Market intelligence

46 Expectations of interest rates, derived from both short sterling contracts and the gilt forward curve, had fallen over the month, and suggested that market participants were generally not anticipating a rise in the official interest rate in September. Nevertheless, the central expectation was for the MPC to raise the Bank repo rate to 6<sup>1</sup>/<sub>4</sub>% by the end of the year. In the most recent Reuters survey, 24 out of 31 economists had expected the MPC to leave the Bank repo rate unchanged in September, but the average probability attached to this outcome in the survey had been only 55%. Over the month as a whole, the major influences on short-term interest rate expectations had been policy-related announcements, although the impact of the publication of the minutes of the August MPC meeting might have been offset in part by the simultaneous publication of labour market data (in particular the weaker-than-expected average earnings figures). There had been little evidence from implied volatility data derived from options on short sterling contracts that market participants had become more uncertain about the interest rate outlook for the next three to six months. Those expecting 'no change' at the September meeting had cited signs of slower earnings and domestic demand growth as well as lower-than-expected RPIX data. Those expecting a rise had noted the continuing robustness of overseas demand, the

increase in oil prices and the closeness of the Committee's vote in August.

47 The sterling exchange rate index had depreciated by 0.2% since 2 August to a level a little above the August *Inflation Report* assumption. Sterling had reached seven-year lows against the dollar, but had appreciated by 1.1% against the euro. The general strength of the US dollar in part reflected expectations about the

likelihood of a 'soft landing' in the US economy and the release of stronger-than-expected productivity data. Expectations of future exchange rate volatility derived from options on foreign exchange suggested that, in the short run, expectations that sterling would follow movements in the dollar had fallen a little, but that in the longer term, the relationship was little changed. On that basis, evidence for a de-linking between sterling and the dollar was still somewhat limited.

## **Text of Bank of England press notice of 7 September 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 20 September.

## Minutes of the Monetary Policy Committee meeting on 4–5 October 2000

1 Before turning to its immediate policy decision, the Committee discussed prices and costs; the world economy; money, credit and asset prices; demand and output; and the labour market.

### Prices and costs

2 RPIX inflation had fallen to 1.9% in August, largely reflecting falls in the contribution of petrol prices but also a fall in seasonal food prices: by contrast with recent years, such prices had risen in July but fallen back in August. The near-term outlook for petrol prices and for petrol retailers' margins suggested a rather lower path for inflation over the next few months than had been expected at the time of the projections made for the August *Inflation Report*. Were margins to be restored, and the normal relationship between oil prices and petrol prices to apply, the recent fall in RPIX inflation might be reversed. But the timing of any such restoration of margins was unclear. The latest ONS advance estimate of RPIX inflation, which was again available for the Committee's meeting, suggested that August's fall had been reversed, although no information was yet available on what accounted for this.

3 The range of measures of domestically generated inflation available to the Committee were for the first time all at or below the inflation target of 2.5%: RPIX inflation excluding import prices stood at 2.5%; the GDP deflator excluding export prices at 1.9%; and the growth of unit labour costs, adjusted for trend and using actual labour productivity growth, stood at 2.2% and 1.7% respectively—though both reflected lower bonuses, which might not persist. Contrary to expectations at the time of the previous meeting, the GDP deflator had not been revised upwards.

4 There were some indications however that inflation expectations had increased, notably in the results of the most recent Basix surveys of the general public and of trades unions whose expectations of inflation had increased by 30–40 basis points since the second quarter. Looking twelve months ahead, inflation expectations of the general public (which had always remained well above the Government's target of 2.5%) now stood at 4.2% and those of trades unions at 2.9%. The extent to which this was a temporary effect, reflecting a reaction to the disruption of petrol supplies in the first half of September, was unclear. Other surveys of inflation expectations suggested little change. But it would be worrying, particularly in the context of the apparent tightness in the labour market, if this increase in inflation expectations were to persist as it could then affect wage bargaining in the coming settlement round.

### The world economy

5 Oil prices had fallen \$3 since the Committee's previous meeting, with the Brent one month future now just above \$30 per barrel. Oil price futures were indicating a fall in prices to about \$25 per barrel by the end of 2002, substantially above the projection in the August *Inflation Report*. It was unclear whether the factors determining the long-run level of the oil price had changed significantly, but the futures curve did at least suggest that the market's view of the horizon over which the price would return to more normal levels had lengthened in recent months.

6 Against this background, the Committee first reviewed the evidence on the likely source of the shock which had resulted in the sharp increase in the price of oil since the end of 1998. Most members felt that the initial shock could largely be attributed to the unexpectedly strong growth of the world economy, in particular the

rapid recovery of the Asian economies from the difficulties they had experienced in the second half of 1998. This had subsequently been reinforced by OPEC restraint on supply. Other commodity prices had been slower to respond, but were now beginning to do so. The OPEC countries had recently shown themselves willing to increase their supply of oil, which—together with the release of oil from the US strategic stockpile—had helped to stabilise the market but at a relatively high nominal price level.

7 Looking forward, the price path implied by the futures curve would reflect the market consensus on the outlook for demand, for non-OPEC supply and for the ability of the OPEC countries to sustain the cohesion which would be required to stabilise prices at around their chosen target range. It continued to represent a plausible central case. But it was recognised by the Committee that there were risks around this path. In particular, there was felt by some members to be an upside risk in the coming months as the Northern Hemisphere winter approached and downside risks further out—associated either with the build-up of non-OPEC supply or with a more rapid slowdown in world demand than was currently foreseen.

8 Though the experience of previous oil supply shocks was unlikely to be repeated, it was possible that further sharp movements in the price of oil could lie ahead. On this view, it could be a year or more before the non-OPEC supply response would begin to have a marked effect in restoring oil prices to more normal levels. In the meantime, prices could fluctuate quite sharply and this volatility could dampen world activity by denting confidence.

9 The Committee noted that the UK was better placed than some other countries to allow monetary policy to accommodate the first round effects of any supply-related shock to oil prices, with the economy currently operating at close to capacity and with inflation somewhat below target. In addition, in contrast to most OECD countries, the UK's position as a net oil exporter meant that the balance of payments and fiscal effects of an oil price rise were likely to be positive.

10 The consensus of outside forecasters was that the increases in the price of oil since the spring would reduce world activity by about half a per cent. This was a somewhat more muted effect than had followed similar price movements in the past, reflecting reductions in the intensity of oil use since earlier shocks and the fact that the real price of oil remained significantly below previous peaks. In any case, some slowing of the world economy had been expected, and indications that it was now occurring simply confirmed those expectations. In addition, it was possible now that the OPEC countries would spend more of the extra income generated by the higher oil prices, because of changes in their financial positions. This would provide a larger offsetting boost to world export growth than had previously been the case.

11 Some members of the Committee, however, assessed the recent news as pointing to a risk of a sharper slowdown in world growth than had seemed likely at the time of the previous meeting. Market expectations for interest rates in the G7 countries had fallen over the past month, and the OECD leading indicator had now been falling since January. Imbalances in the world economy persisted and might be increasing. The benign forecasts for the world outlook were predicated on a soft landing in the US together with stronger activity growth in Europe. There were some indications that that outturn might not be realised, with signs of slowdown in both the euro area and the United States. Second quarter growth in the euro area had been 0.9%, rather lower than was projected at the



time of the August *Inflation Report*. Retail sales data and confidence surveys suggested that growth in the euro area might have slowed significantly in the third quarter. In contrast, activity had been stronger in the United States. The risks to the world outlook might on balance therefore have increased. Higher oil prices might depress consumer and investment spending. The marked falls in equity prices over the month could be an early indication of further slowdown in prospect. The possibility of further sharp movements in oil prices suggested that confidence could weaken and could lead to delays in planned investment. These risks would need to be examined in the context of the forecast for the November *Inflation Report*.

### Monetary and financial conditions

12 Monetary data continued to show strong growth. Annual growth in notes and coin had increased by 1.8 percentage points to 8.7% in September, though perhaps a third of this increase reflected banks' precautionary build-up of cash holdings at the time of the disruption to fuel supplies. M4 growth in August had increased to 8.8%, its highest rate for two years, affected in part by transactions related to 3G telecommunications licences and to Lloyds TSB's takeover of Scottish Widows. Aggregate Divisia money growth was rising steadily and now stood at just under 6%. Total credit growth, at 13%, was the strongest since 1991 and though household M4 growth had eased a little it remained at levels last seen a decade ago. Secured lending to households had returned to the level established in the middle of 1999, reversing the dip in July. Mortgage equity withdrawal had been positive for two quarters and was expected to continue to support consumption in the coming months. Recent rapid growth in the level of corporate borrowing seemed to be related principally to the financing of merger and acquisition activity and to the purchase of 3G telecommunications licences, so was not inconsistent with the rather weak outturns for business investment growth in recent quarters. The overall picture was therefore somewhat stronger than a month ago, but remained broadly consistent with expectations at the time of the August *Inflation Report*.

13 Equity prices had fallen by about 5% over the month, across a range of countries, but the reasons for this were not entirely clear. In the UK, it was possible that part of the fall was related to the increase in longer term interest rates. But that was not the case in other countries which had experienced a similar fall in equity prices. Profit warnings, especially in the high-technology sectors, had increased. To some, the common factor was the recognition by these markets of the possibility of a sharper slowdown in the world economy than had previously been expected. The interaction between the oil price and the equities market was important and the market could recover if the oil price remained stable. But any further rise in the price of oil could precipitate a loss of confidence and prompt a sharp fall in equity prices.

14 Sterling's effective exchange rate was nearly 2% above the level assumed at the time of the August *Inflation Report* and a little over 1% above its level at the time of the Committee's previous meeting. Against this background, the Committee discussed recent developments in the foreign exchange markets. One explanation of the strength of the US dollar was that it reflected the pressure of capital flows. These, it was argued, were taking place in response to beneficial supply side developments in the US economy and the profitable investment opportunities they had created. On this view, the strong dollar exchange rate and the US current account deficit were necessary counterparts of the capital inflows and could be sustained until those profitable opportunities were exhausted. There was as yet little evidence to suggest any slowing in this process of the reallocation of capital, which some on the Committee felt gave greater credence to the view that a sustained period of faster US growth could be expected. Others however suggested that even quite small changes in expected productivity growth could have large effects both on equity prices and on capital flows, so were less confident that the dollar would remain strong. While

such effects might indeed account for the US dollar's strength against the euro, they were less convincing as an explanation of the weakness of the euro against sterling or the yen. It therefore remained difficult to find a satisfactory explanation of the current constellation of exchange rates.

### Demand and output

15 The Committee had assumed in its projections in the August *Inflation Report* that consumer spending growth would begin to slow, as households began to rebuild their balance sheets and savings returned to a more normal level in relation to income and wealth. This would be necessary if government expenditure was to increase in line with the plans outlined in the March Budget and the Chancellor's subsequent Spending Review, without putting undue pressure on the supply capacity of the economy. So the evolution of the balance between private sector demand and government spending was a key issue for the inflationary outlook.

16 The news over the month suggested that the domestic demand picture remained broadly in line with this projection. The National Accounts data for the second quarter confirmed earlier estimates of quarterly GDP growth at 0.9%, though the level of GDP in 1999 had been revised up by 0.1 percentage point. Government spending in the second quarter was rather stronger than previously estimated, but fiscal outturns were so far in line with the Government's budget projections. The net trade position was a little weaker. None of this represented a significant change to the overall picture.

17 More recent indicators were mixed. Equity prices in the UK had fallen by 5% on the month and there had been sharp falls in consumer confidence—probably associated with the disruption to petrol supplies. The MORI survey showed that consumer confidence had fallen by 10 points between August and September, which was consistent with the tick down shown by the most recent GfK survey. Retail sales volumes had grown 0.6% in August, somewhat faster than had been expected, but house prices had now been broadly flat for six months. Provisional results from the Royal Institution of Chartered Surveyors' survey of estate agents in September indicated that there would be no change in the balance reporting house price increases over the previous three months, though the balance for London had recovered sharply.

18 The survey evidence on activity was generally weaker: the CBI Distributive Trades survey showed further weakness in motor traders' reported sales in September (though wholesalers' sales were the highest since February 1998); surveys from the Chartered Institute of Purchasing and Supply showed weaker output growth in manufacturing and in services, but stronger in construction; and the CBI/PricewaterhouseCoopers survey of financial services suggested that activity in that sector was growing at its slowest rate since December 1997.

19 The disruption to petrol supplies had plainly affected the surveys and would also affect official statistics in both the third and fourth quarters. Its direct effects were, however, hard to gauge. Staff estimates suggested that output in the third quarter might be as much as 0.2 percentage points lower as a result of the disruption, but that the effect on the third and fourth quarters together was likely to be minimal. These estimates were essentially judgmental: there were as yet no hard data. Some of the demand effects—for example, journeys and leisure activities forgone—might represent a permanent loss of output in those sectors, but the expenditure might simply have been switched to other goods; and there would be offsets in stockbuilding. The Bank's regional Agents reported that the disruption had had little impact on their manufacturing contacts, but that some retailers and leisure businesses had experienced a significant loss of trade which was unlikely to be recovered.

20 Looking further ahead, the disruption might nevertheless have more persistent effects on both business and consumer

confidence. It was possible for example that there might be permanent effects on stock-holding levels, if businesses were to review their delivery strategies in the light of the disruption that had occurred (or might have done, had the shortages of fuel continued). Firms might be less willing to rely on 'just in time' delivery arrangements, leading to increased stock holding throughout the supply chain, or might wish to maintain larger stocks of fuel. There was also anecdotal evidence pointing to hesitancy over investment plans. So while the data seemed a little weaker overall, it was difficult to separate the effects of the petrol supply disruption itself and its effects on confidence from the underlying trend.

21 The updated staff central estimate, ahead of the Committee's meeting, had been for output growth in the third quarter of around 0.6%, in line with the forecast in the August *Inflation Report*. The available information on expenditure suggested that the risks were on the downside. However, the Index of Production for August, which was available to the Committee, showed production growth of 0.6% in August and included upward revisions of 0.4 percentage points to the index for July. Manufacturing growth of 0.8% in August was also stronger than had been expected, with very strong growth in the output of electrical and optical equipment (which included output of mobile phones and related infrastructure goods). This stronger industrial production would by itself probably add 0.1 percentage points to the estimate for output growth in the third quarter, putting it somewhat above the *Inflation Report* projection, though the effects of the disruption to petrol supplies could more than offset this.

### The labour market

22 Particular uncertainties surrounded the current conjuncture in the labour market. The continuing steady growth in employment, together with lower levels of claimant unemployment than had been seen since the 1970s, suggested that the market remained tight. Earnings growth on the other hand had fallen back sharply from its peak early in the year. It was unclear how long this benign conjunction of strong quantities and modest earnings growth could continue.

23 Employment growth had slowed a little in the three months to July, with the Labour Force Survey (LFS) measure up 0.3% compared with 0.4% in the three months to April. Average hours worked had increased by 0.1% over the same period. But LFS unemployment was down sharply, and by more than the increase in employment, lowering the unemployment rate by 0.3 percentage points to 5.3%. Inactivity had increased somewhat in each of the last two LFS data releases. Reports from the Bank's regional Agents did not suggest that there had been any further tightening in the market, though shortages persisted and the recent fall in unemployment had drawn particularly on the pool of short-term unemployed. It was noted that the Workforce Jobs measure of employment suggested rather slower employment growth over the first half of the year than the LFS measure along with more rapid growth in inactivity.

24 While quantities remained tight, the rate of growth of pay continued to be slower than expected. The Average Earnings Index (AEI) again showed a fall in the annual growth of earnings on the three-month headline basis, from 4.1% to 3.9%, while annual growth was unchanged on the month at 3.8% in July. Earnings growth in each of the last three months had included a substantial negative contribution from bonuses. These AEI data contrasted to some extent with those on rates of pay for agency staff, with Recruitment and Employment Confederation data for September showing further sharp increases in permanent salaries and rates for temporary staff, though they were now consistent with the rate of pay growth as measured by the Reward index. The Bank's regional Agents reported little evidence of increasing pay pressures and suggested that signs earlier in the year of imminent difficulties in pay negotiations had not materialised. So the dichotomy between strong quantities and weak prices persisted.

25 The Committee discussed how long this benign combination of steady and quite rapid employment growth with subdued earnings growth could continue. Some members felt that this welcome development could persist. Overall earnings growth as measured by the AEI had been slowing for five months, regular pay was growing at a steady rate and settlements were steady or falling over the past year taken as a whole. The recent negative contributions from bonuses were not surprising. In financial services, tougher performance targets were likely to have been set for this year than for 1999, when the outlook had seemed less promising; and recent bonus outturns were consistent with the weak performance of the retail sector. To the extent that millennium-related payments had contributed to the sharp movements in earnings growth at the start of this year, temporarily inflating the level of pay, earnings growth in the coming months would be correspondingly reduced. Labour productivity per head was growing at around trend rates, and productivity per hour comfortably above it. The rate of growth of unit labour costs was slower than for several years. It was noted that the projection in the August *Inflation Report* envisaged higher levels of earnings growth in the coming months, which now seemed less likely.

26 Other members were less sanguine, finding it harder to reconcile the earnings data with other information on the labour market which to them pointed to the possibility of intensifying pay pressures in the months ahead. It was suggested that the low pay settlements earlier in the year had reflected the very low outturns for the RPI in the months leading up to this year's main settlement round and that, since then, the average level of settlements had climbed steadily month by month. The short-term outlook for the RPI suggested that circumstances would be rather different for next year's main pay round. The slowing in the growth of unit labour costs was substantially driven by recent weak bonus outturns, which were unlikely to persist. It was important to remain alert for the first signs of emerging wage pressures and it was in this context that the recent uptick in inflation expectations would—if it was confirmed as more than a temporary reaction to the uncertainties surrounding fuel supplies—be a particular cause for concern.

### The immediate policy decision

27 Once again, there had been little decisive news over the month to alter the Committee's view on the underlying path of the UK economy. The projections in the August *Inflation Report* remained broadly intact, though the pace of earnings growth continued to be surprisingly modest given the rate of growth of employment and the pace at which unemployment was falling. Oil prices had eased in the past month and sterling had strengthened somewhat, but both were higher than expected at the time of the August projections. Nonetheless, the news on the month was on balance a little weaker. Despite the slightly stronger monetary, retail sales and index of production data, as well as the sharp fall in unemployment and the tick up in inflation expectations, equity prices had fallen significantly, earnings growth remained subdued, the survey evidence (including evidence on confidence) was on balance weaker and the RPIX inflation outturn was lower than had been expected at the time of the previous meeting.

28 On one view, while there remained arguments for an increase in the repo rate at some point these were not decisive. GDP was if anything growing a little more strongly than had been expected, though there were some signs that the growth of private demand was beginning to ease. This was necessary if the announced plans to increase government consumption and investment were not to place undue pressure on the productive capacity of the economy. Exports were remarkably buoyant, reflecting the strength of the world economy. Measures of domestically generated inflation were easing, but the downward external influences on UK inflation were now almost exhausted. The external factors which had allowed real wages to grow rapidly at a time of moderate growth in nominal earnings could not continue indefinitely. The evidence on labour shortages was

mixed, but the market remained tight and it was unclear how long the benign outturns on earnings growth could continue. While the Bank's regional Agents reported few signs of increasing pay pressure and previous indications that wage negotiations might be becoming more difficult had not materialised, wage settlements had picked up in recent months. Unemployment was falling sharply, particularly amongst the short-term unemployed, and this could not persist without putting upward pressure on wages. Signs that inflation expectations amongst the general public and wage negotiators had increased were worrying and reinforced the view that upward pressure on wages was a substantial risk to the inflation outlook. Labour market conditions would need to be monitored very carefully for early signs of inflationary pressure. Nevertheless, the weaker indicators in the past month were perhaps more forward-looking than the stronger. It remained to be seen whether the weakness in the activity surveys and the tick up in inflation expectations simply reflected a temporary lowering of confidence associated with the disruption to petrol supplies, or were indicative of an underlying weakening in sentiment which would persist. Another month's data would help to resolve this issue, and would cast further light on the puzzling behaviour of the labour market. Further information on the Government's fiscal plans would also probably become available in the pre-Budget Report. On balance therefore, and given also that any change in the repo rate this month would surprise the markets and put further upward pressure on a sterling exchange rate already nearly 2% higher than in the August *Inflation Report* projection, it was right to wait for some of these uncertainties to be resolved.

29 On another view, there was felt to be no case for a rise in interest rates now. The labour market picture was more encouraging, even though the recent negative contribution from bonuses was not expected to persist. More significant was the rate of growth of regular pay, which was not on this view inconsistent with current levels of tightness and with continued steady growth of employment. Recent outturns in earnings growth had been well below the projection in the August *Inflation Report* and the surge in pay growth associated with the millennium would not be repeated. The labour market did of course represent a risk to the outlook, but it had been tight—without generating inflationary pressures—for sufficiently long that it was better to react when there was clear evidence that those risks were beginning to materialise than to act

against them on the basis only of a forecast. More important, on this view, was whether the pace of productivity growth would remain above its historical trend. The fact that the various measures of domestically generated inflation were at or below the inflation target was also helpful as it suggested less risk of breaching the target if the exchange rate were to fall. In addition, the current stance of policy was already slightly contractionary on the basis of estimates of the neutral level of interest rates. Dynamic monetary conditions indices suggested also that the past and current levels of sterling and of interest rates would continue to provide tightening monetary conditions for up to two years. A more substantial uncertainty on this second view was the outlook for the oil market and for the world economy. The prospects for a soft landing in the US and for stronger growth in the euro area, the basis for the projected gentle slowdown in world growth, had reduced and were the main risks to the UK inflation outlook. It seemed more likely that instability in the oil market could persist and could be associated with equity market weakness. The euro area remained vulnerable to a further oil shock, with more fragile demand and greater current inflationary pressures than were faced in the UK. Though the UK economy was well-placed to weather a further shock, confidence had already been shaken here too. So the downside risk was larger than it had been a month ago.

30 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.

31 The following members of the Committee were present:

Eddie George, Governor  
 Mervyn King, Deputy Governor responsible for monetary policy  
 David Clementi, Deputy Governor responsible for financial stability  
 Christopher Allsopp  
 Charles Bean  
 DeAnne Julius  
 Stephen Nickell  
 Ian Plenderleith  
 Sushil Wadhvani

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

## Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 29 September in advance of its meeting on 4–5 October 2000. At the start of the 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 Q2 GDP growth in the United States had been revised up slightly to 1.4% on the quarter (from 1.3%). Consensus forecasts for US growth in 2000 and 2001 had also been revised upwards (to 5.2% for 2000, and 3.7% for 2001). Industrial production had been 0.3% higher on the month in August, but the three-month growth rate had slowed from its peak in Q2. Quarterly US consumption growth in Q2 had been revised up to 0.8%. Monthly consumption data for July and August had ticked up slightly to give a growth rate of 0.9% in the three months to August, and this was consistent with the recent pick-up in the US consumer confidence survey. Investment had risen by 2.7% in Q2, making a strong contribution to GDP, and recent new orders data for the United States, while somewhat weaker, supported the view that this could continue into Q3. The National Association of Purchasing Managers index had risen marginally in September to 49.9. Export volumes had fallen sharply by 2.4% on the month in July, with import volumes up by 0.1%.

3 Euro-area GDP had grown by 0.9% in Q2. Consumption had remained strong, contributing 0.6 percentage points to growth. Investment in Q2 had been flat, and net trade had made a negative contribution. As reported in the previous month, German GDP had grown strongly in Q2 at 1.1% on the quarter. But the German IFO index had fallen for a third consecutive month in August, albeit only moderately, and in contrast with continued positive German orders data. The French economy had grown at 0.7% on the quarter, and Italian growth in Q2 had been 0.3%. The euro-area unemployment rate had remained unchanged at 9.0% in August.

4 Japanese GDP had grown by 1% in Q2, having benefited from a strong contribution from public expenditure of 0.9 percentage points. Private consumption had made a 0.6 percentage point contribution to GDP growth. In contrast, investment had made an equivalent negative contribution, though this was not in line with either the monthly indicators or strong corporate profit growth, both of which had been on an upward trend since mid-1999. The Tankan survey had shown business conditions improving for the seventh consecutive quarter. Industrial production had risen by 3.3% on the month in August and by 8.3% on a year earlier.

5 In the emerging market economies, industrial production had been rising at an annual rate of about 8% since the start of the year. But equity indices in emerging markets had recently fallen back, particularly in Asia.

6 Futures prices were indicating a fall in oil prices to about \$25 per barrel in two years' time. OPEC production was now back at levels seen in 1998, though world demand had risen since then. Bank analysis of options price data had suggested that one outcome of the US government's announced release of part of its strategic oil reserves was to have reduced noticeably the probability the market attached to a rise in the oil price above \$40 per barrel in the coming months.

7 US import price inflation was below the rate at the start of 2000. US consumer prices had fallen by 0.1% on the month in August, probably reflecting a temporary dip in the oil price and

associated effects on petrol prices. Core inflation had risen by 0.2% on the month, leaving the annual rate slightly higher at 2.5%. Nevertheless, inflation expectations for the United States remained steady. Unit labour costs had eased, falling by 0.5% on a year earlier in Q2.

8 HICP inflation in the euro area had fallen slightly in August to 2.3%, while core inflation had remained at an annual rate of 1.3%. The September release of German annual CPI inflation at 2.4% (compared with 1.8% in August) implied that a pick-up would probably be evident in the September euro-area inflation rate.

9 The path of interest rates implied by futures contracts had moderated for the euro area, and in the case of the United States had converged to the current level of the Federal funds target rate. The euro-area current account was in deficit so far this year, and consistent with this the scale of combined net direct and portfolio capital outflows had fallen over the course of this year.

### II Monetary and financial conditions

10 The twelve-month growth rate of notes and coin had risen strongly, from 6.9% in August to 8.7% in September. Around 0.5 percentage points of this pick-up could be attributed to the petrol supply disruption, which had led banks to build up precautionary cash holdings.

11 M4 and M4 lending had both been stronger. August M4 had increased by £18.2 billion and the twelve-month growth rate of M4 had risen to 8.8%. Some of the strength of M4 had been due to other financial corporations' (OFCs) deposits. Three special factors had appeared to increase OFCs' M4: a large 3G licence-related transaction; financing transactions related to Lloyds TSB's takeover of Scottish Widows; and swings in the repo position of the OFC sector. Excluding OFCs, twelve-month M4 growth had been 7.5%. M4 lending excluding securitisations had remained strong in August and had increased by £19.4 billion. The twelve-month growth rate of M4 lending had risen to 13%. M4 lending excluding OFCs had increased by 11.5%, though OFCs had accounted for almost all of the pick-up in the growth of M4 on the month.

12 Households' M4 had risen by £4.4 billion, raising the twelve-month growth rate to 5.6%. Households' M4 lending excluding securitisations had been £4.1 billion; the twelve-month growth rate had fallen to 10%. Within total lending to individuals, net secured lending had recovered to more than £3.5 billion, and unsecured lending had fallen sharply to around £0.6 billion.

13 Compared with the windfalls in 1997, the Scottish Widows windfall had been relatively small, but with a much higher proportion in cash. It was not possible, however, to quantify precisely the impact on the monetary data, and in particular the extent to which households' M4 may have been boosted.

14 Particulars delivered and the number of mortgage approvals had both recovered from weaker July figures, consistent with evidence that housing market activity had stabilised. Following the National Accounts release, the Bank estimate of mortgage equity withdrawal in Q2 had been revised to £3.3 billion, or 2.1% of disposable income.

15 Private non-financial corporations' (PNFCs) M4 had picked up strongly in August (by £5.5 billion), raising the twelve-month growth rate to 15.3%. M4 lending to PNFCs (excluding

securitisations) had also increased, by £3.4 billion, with the twelve-month growth rate at 16%. The flow of external corporate finance had also remained strong in July/August, whereas investment by PNFCs had been largely flat. Comparing the changes in the full range of PNFCs' sources and uses of funds over the previous two years suggested that much of their increased borrowing had been used for mergers and acquisitions and the acquisition of 3G licences.

16 Since the September MPC meeting, short-term interest rate expectations, as measured by the two-week gilt repo forward curve, had fallen slightly with an expected peak in base rates of just above 6%. The yield curve had disinverted somewhat: yields at maturities beyond five years had increased, with yields around 25 years 14 basis points higher. However, long corporate yields had fallen slightly more than those of short corporate yields. Sterling corporate bond issuance had been strong in Q3 and was more evenly spread across maturities than in the first half of the year.

17 Survey measures of inflation expectations had shown a dichotomy between economist and finance professionals relative to the Basix survey of the general public and trade union secretaries. The former group's expectations remained largely unchanged, whereas the latter had shown a pick-up in expectations of inflation a year ahead of 40–50 basis points since a month ago. The general public survey had been carried out around the time of the petrol supply disruption. Retail interest rates had been little changed since the September MPC meeting.

18 UK equity market indices had fallen by between 5% and 6½% since the September MPC meeting, broadly in line with international markets. Profit warnings issued by UK firms in Q3 had been close to 1999 levels; earlier in the year, they had been substantially lower than twelve months before.

19 Since the previous MPC meeting, the sterling exchange rate index (ERI) had increased by 1.2% to 108.0. Sterling had appreciated against all major currencies; changes in interest rate differentials could have contributed to these movements. The risk premium on sterling, calculated using Consensus Economics' measure of expected nominal rates, had risen against the dollar, fallen against the euro and had remained little changed for the ERI.

### III Demand and output

20 In the National Accounts, quarterly GDP growth had been unrevised at 0.9% in Q2. The level of GDP had been revised up slightly by 0.1%, with annual growth correspondingly revised up from 3.1% to 3.2%. Revisions had brought the output-based measure of Q2 growth into line with the expenditure and income-based measures. Quarterly final domestic demand growth had been unrevised at 0.9% in Q2. The contribution of stockbuilding had been revised up slightly, to 0.1 percentage points in Q2, compared with zero in the previous GDP release.

21 Quarterly household consumption growth had been unrevised at 0.8% in Q2. Within that, non-durable goods consumption had grown by 1.1%. Durables consumption had fallen by 0.1% in Q2, partly depressed by continued weak vehicle expenditure, which had fallen by 1.1% in Q2. Spending on services had increased by 0.7% in Q2, compared with 0.3% in Q1.

22 Government consumption growth in Q2 had been revised up to 2.1% from 1.9%. Whole-economy investment growth in Q2 had been revised up from 0.2% to 0.4%. Excluding net acquisition of valuables, total investment growth had been revised up from 0.2% to 0.9%. Business, general government and dwellings investment had all risen on the quarter. Business investment in the service sector had grown by 2.2% in Q2 and by 3.0% compared with a year earlier.

23 Export growth in Q2 had been revised down from 2.6% to 2.0% and import growth from 2.3% to 2.2%. Accordingly, the net trade contribution to quarterly GDP growth had been revised down from zero to -0.2 percentage points in Q2. The current account deficit had been broadly unchanged in Q2 at £3.3 billion. Direct and portfolio investment outflows in Q2 had been broadly offset by an inflow of other investments, mostly accounted for by changes in bank deposits and lending.

24 Employees' compensation growth had been weak in Q2: the 0.1% increase on the quarter had been the smallest since 1967. The saving ratio had fallen to 3.0% in Q2, similar to its trough in 1988, though it had remained somewhat higher than its 1988 low on an inflation-adjusted basis. Private non-financial corporations' gross operating surplus had risen by 3.3% in Q2. But their financial deficit had been little changed at £3.6 billion, as increased dividend, interest and tax payments had offset the increase in profits and the moderate reduction in investment.

25 Turning to Q3, analysis by Bank staff had estimated that the negative effect of the petrol supply disruption on GDP growth in Q3 would be relatively small, and would to a large extent unwind in Q4. On the output side, leisure services, distribution and government output were identified as the sectors likely to be most significantly affected. On the expenditure side, any negative impact on consumption could be partly offset by higher stockbuilding.

26 Retail sales had grown by 0.6% in August following zero growth in July. The BRC weekly data had pointed to strong growth in early September but growth had subsequently been heavily affected by the petrol dispute. The CBI Distributive Trades survey had indicated that retail sales had been less buoyant than expected in September, with the net balance of respondents reporting an annual increase in sales falling to +14 from +18 in August. The aggregate GfK measure of consumer confidence had fallen to -5 in September, though this had also been negatively affected by the petrol supply disruption. The MORI measure of consumer confidence had weakened similarly, from -7 to -17 in September. Total new car registrations had weakened further, with registrations in July and August 5.8% lower than a year earlier.

27 House prices had been broadly flat over the previous six months. Despite a 0.4% rise in September, the annual growth of the Nationwide house price index had eased to 10.2% in September, from 11.2% in August. The Halifax index had risen by 1.6% in September, after a 0.5% rise in August, increasing the annual growth rate by 1.8 percentage points to 9.2% in September. Particulars delivered had risen slightly to 121,000 in August, slightly below the level a year earlier. The House Builders Federation (HBF) survey balances for the annual change in site visits and net reservations had remained strongly negative. But the Royal Institution of Chartered Surveyors (RICS) survey had reported an increase in the average number of sales per estate agent to 29 in August from 25 in July.

28 'Other' central government current expenditure in July and August had averaged £16 billion, compared with a monthly average of £16.7 billion in Q2 (not seasonally adjusted).

29 The volume of goods imported in the three months to July had risen by 3.5% compared with three months earlier and had increased by 2.3% in July alone. The volume of goods exported had grown more slowly: it had fallen by 1.1% in July, leaving three-month growth at 2.6%. But data for August showed a 7.9% increase in exports to the non-EU area. The CIPS manufacturing survey balance for export orders was 50.6 in September.

30 Total industrial production had grown by 0.6% in August. Within this, manufacturing output had grown by 0.8%, reflecting particularly strong growth in the electrical and optical sector of

engineering, which had grown by 4.1% on the month. Upward revisions to energy sector output in July had increased total industrial production growth in that month to +0.4% from -0.1%. The CIPS manufacturing survey activity balance had been 51.6 in September and had remained broadly stable since July, despite the impact of the disruption to petrol supply. In contrast, the CIPS services activity balance had fallen back to 55 in September after having risen slightly in August. The CIPS construction activity index had fallen to 58 in August but had picked up to 60 in September. And construction new orders in the three months to August had risen by 22% on the previous three months (compared with quarterly growth of 11.2% in Q2). In the CBI Monthly Trends Survey, output expectations had picked up to +5 in September from +2 in August. The National Institute of Economic and Social Research's estimate of GDP growth in the three months to August had been 0.8%.

#### IV The labour market

31 The Labour Force Survey (LFS) measure of employment had risen by 93,000 (0.3%) in the three months to July compared with the previous three months, slightly weaker growth than in the three months to April (0.4%) and in Q2 (0.4%). The rise in LFS employment had mainly reflected an increase in part-time employment (57,000), which had raised the part-time share slightly to 25.0%. Workforce Jobs (a more volatile series, which is sampled on a single day in each quarter) had increased by 59,000 in Q2, compared with a fall of 10,000 in Q1.

32 Average hours worked had increased by 0.1% in the three months to July. Both full-time and part-time average hours had increased, but there had been a decline in hours devoted to second jobs. Total hours worked had increased by 0.4% in the three months to July.

33 The CIPS construction and services employment growth balances had both suggested continued employment growth in September, though at a reduced rate for construction with a sharp drop in the index on the month, while the balance for manufacturing had suggested a continued decline in employment. The Recruitment and Employment Confederation (REC) had reported a fall in the availability of temporary staff in September. The CBI/Deloitte & Touche service sector survey had suggested slightly greater recruiting difficulties in the business and professional services category. By contrast, the Bank's regional Agents had reported that skill shortages had not deteriorated further.

34 LFS unemployment had fallen by 104,000 in the three months to July compared with the previous three months, slightly greater than the fall of 91,000 in Q2. The LFS unemployment rate had fallen by 0.3 percentage points to 5.3%. The claimant count had fallen by 48,300 over the same period, and by a further 18,000 in August. As in Q2, the fall in LFS unemployment had largely been accounted for by a decline in short-term unemployment.

35 Inactivity had risen by 46,000 in the three months to July compared with the previous three months, reflecting a 87,000 rise in male inactivity. The inactivity rate had remained at 21% of the population of working age.

36 The official National Statistics measure of productivity, based on Workforce Jobs, had increased by 2.5% in the year to Q2, compared with an increase of 2.1% in Q1. An alternative measure based on LFS employment had increased by 1.7%, unchanged from Q1. Productivity per hour had increased by 2.5% in the year to Q2, falling from 3.1% in Q1.

37 Headline earnings growth, a three-month moving average of the annual growth rates, had fallen by 0.2 percentage points to 3.9% in July. Headline private sector earnings growth had fallen by

0.2 percentage points to 4.0%, while headline public sector earnings growth had fallen by 0.3 percentage points to 3.4%. Headline earnings growth in the manufacturing sector had remained unchanged at 4.7% for the third consecutive month. Headline earnings growth in private sector services had fallen by 0.4 percentage points to 3.5%.

38 Actual earnings growth had been 3.8% in July, unchanged from June. Growth in regular pay, ie excluding bonuses, had also remained unchanged at 4.4% (not seasonally adjusted). Bonuses had reduced earnings growth by 0.8 percentage points (not seasonally adjusted), the third successive negative contribution to actual earnings growth. The Bank's estimate of growth in earnings per hour, based on a smoothed hours series, had fallen by 0.3 percentage points to 4.8% in July.

39 The annual growth of wages and salaries per head, calculated from the National Accounts, had fallen from 4.8% in Q1 to 3.6% in Q2, broadly in line with movements in the AEI over this period. Annual growth of the real product wage had exceeded that of the real consumption wage in Q2 for the first time since 1999 Q1. Largely reflecting the fall in the growth of wages and salaries, the annual growth rate of whole-economy unit labour costs had fallen to 1.1% in Q2 from 2.7% in Q1.

40 As was usual for this time of year, there had been relatively little new information on settlements. The Bank's AEI-weighted twelve-month mean settlement had remained unchanged at 3.0% in August. Most of the settlement data in August had related to workers in the public sector. The whole-economy three-month mean settlement had fallen by 0.1 percentage points to 3.2%, reflecting a 0.5 percentage point fall in the public sector mean.

#### V Prices

41 The Bank's oil-inclusive commodity price index had risen by 0.5% in August, which, due to base effects, had taken the annual inflation rate down to 15.3% from 16.8% in July. The small monthly increase had mainly reflected rises in the prices of the fuels and metals components of the index more than offsetting a fall in the price of domestic food. The rise of around 6% in the sterling oil price had largely accounted for the increase in fuels prices. The Bank's oil-exclusive commodity price index had fallen by 0.5% in August, mainly reflecting the fall in domestic food prices. This took the annual inflation rate down to 3.6% from 4.1% in the previous month.

42 Manufacturing input prices had risen by 0.6% in August, but the annual inflation rate had eased slightly to 10.7% from 10.8% in July. The monthly rise had mainly reflected rises in the prices of oil, chemicals and metals. These were partially offset, however, by a fall in domestic food prices. Input prices excluding oil (not seasonally adjusted) had fallen by 0.1% in August, but were 3.8% higher than a year earlier. The CIPS manufacturing survey input price index was broadly unchanged at 56.5 in September. Output prices excluding excise duties had fallen by 0.2% in August, largely driven by a fall in petroleum product prices. This had taken the annual inflation rate down to 1.7% from 2.1% in July. The output price balance in the September CBI Industrial Trends survey had fallen to -20, from -15 in the previous month.

43 Prices of imported goods had risen by 2.1% overall in the three months to July compared with the previous three months. Excluding oil and erratics, prices of imported goods had risen by 1.4% over the same period. On the same basis, prices of exported goods had risen by 2.5% overall, while those excluding oil and erratics had risen by 1.5%.

44 Annual inflation in the GDP deflator at market prices in 2000 Q2 had been unrevised at 1.8%.

45 Annual RPIX inflation had fallen by 0.3 percentage points to 1.9% in August. This fall had mainly reflected falls in the contributions of petrol and, to a lesser extent, seasonal food prices. RPI inflation had also fallen by 0.3 percentage points to 3.0% in August. RPIY inflation had fallen to 1.5% in August from 1.9% in the previous month, while HICP inflation had fallen to 0.6% from 1.0% in July.

## VI Reports by the Bank's Agents

46 The Agents suggested that the overall impact of the recent fuel supply disruption had been relatively small, but that a significant impact had been noted in certain sectors. Food sales during September had reportedly been unaffected, with panic buying in the week of the disruption offset by lower sales in the following week. But non-food sales had been heavily affected in some cases. While some of these lost sales were expected to be recovered in coming months, others were likely to represent a permanent loss of business. The effect on industrial production was reported to have been small and most losses were likely to have already been recovered. Oil refinery production had been unaffected. But the Agents had suggested that the level of precautionary stocks of fuel and other components held by firms may rise in the future. Within services, the most significant impact was reported for leisure sector activities, most of which was unlikely to be recovered. Most contacts had felt that if the disruption had lasted another 48 hours its effects would have been far more serious.

47 More generally, the Agents had reported a continuing recovery in manufacturing output growth, though the majority of this remained export-led. Many regions continued to report little improvement in domestic orders. While reports of manufacturing firms locating new capacity overseas continued, there had been announcements of substantial new investment plans in the energy sector, reflecting the higher oil price.

48 Annual retail sales value growth had continued to ease slightly according to the Agents, though volume growth had been maintained. Contrary to the expectations of some contacts, there had been little improvement in motor vehicle sales during September.

49 The Agents continued to report that the most significant input price increases had been for oil and gas. But most price rises continued to be mitigated to some extent by increased importing, efficiency gains and more effective purchasing strategies. Competitive pressures on manufacturers' output prices continued to be reported.

50 The labour market picture had remained similar to recent months. Skill shortages remained an important concern, but most contacts suggested that they had been no worse than in recent months. Pay growth in manufacturing was reported to have remained broadly unchanged, despite earlier concerns of rising pressures. Upward pay pressure on service sector pay growth remained, although annual growth had been restrained by lower bonus payments than last year.

51 The Agents had undertaken a survey of around 200 firms regarding their use of full-time labour, to try to explain the gradual decline in full-time average working hours seen since early 1998 in the official statistics. The majority of respondents suggested that the average working hours of their full-time staff had been broadly unchanged compared with a year earlier and there had been little evidence of any significant sectoral differences. Moreover, most companies had expected average hours to remain unchanged over the remainder of the year. With regard to the management of short-term fluctuations in labour requirements, widespread use of overtime had continued, particularly for small firms. Around a third of firms reported greater use of temporary and part-time labour, while around a quarter had made more use of flexible working hours. These trends were said to be particularly evident in the service sector, where labour market pressures had been relatively tight. Though only around 10% of firms reported an increase in the use of contracts based on annualised hours, many contacts suggested that the introduction of these types of contract was planned for the future.

## VII Market intelligence

52 Short-term interest rate expectations had fallen further since the previous meeting of the Committee. Rates implied by short sterling futures contracts, for example, had decreased by 10–17 basis points for contracts maturing in 2000–02. The main factors leading to lower interest rate expectations during the period included September's announcement of an unchanged Bank repo rate, and data on average earnings, industrial production and the CBI Distributive Trades survey, which were all weaker than the market had expected. Most market participants expected the MPC to leave the repo rate unchanged in October; economists in a Reuters poll had attached a 70% probability, on average, to such an outcome. In reaching these views, market participants had referred to the more benign price and earnings data, the expected slowdown in domestic activity (partly arising from oil price increases) and lower equity prices. Others believed that the economy was still growing robustly and that the arguments were finely balanced.

53 The sterling exchange rate index (ERI) had fallen in the first half of the period and then appreciated in the second half, to finish 1.2% higher at 108.0. The strength of the dollar against most other currencies in the first half of the month was a major factor in explaining sterling's initial depreciation. Sterling reached a 14-year low against the dollar, leading some market participants to question whether the recent strong correlation with the dollar had weakened, though neither short-term nor long-term implied correlations (derived from foreign exchange options contracts) had suggested this. The sterling ERI had more than reversed its fall in the second half of September, mainly reflecting an appreciation against the euro. This movement was related, at least in part, to actual and expected merger and acquisition activity. Coordinated G7 intervention on 22 September had supported the euro. Following the intervention, prices of euro call options had become more expensive relative to euro put options, suggesting that market participants had become more confident that the euro would appreciate rather than depreciate against the dollar.

## **Text of Bank of England press notice of 5 October 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 18 October 2000.

## **Text of Bank of England press notice of 9 November 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 Thursday 16 November 2000.

The minutes of the meeting will be published at 9.30 am on Wednesday 22 November 2000.



## Glossary and other information

### Glossary of selected data

**AEI:** Average Earnings Index.

**CSPI:** corporate services price 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.

**FEPI:** final expenditure price 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.

**TPI:** tax and price index.

### Abbreviations

**ATM:** automated teller machine.

**BCC:** British Chambers of Commerce.

**BRC:** British Retail Consortium.

**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.

**DHL:** DHL International (UK) Ltd.

**ECB:** European Central Bank.

**EEF:** Engineering Employers' Federation.

**EU:** European Union.

**FOMC:** Federal Open Market Committee.

**FTSE:** Financial Times Stock Exchange.

**GC:** generalised collateral.

**GDP:** Gross domestic product.

**GfK:** Gesellschaft für Konsum, Great Britain Ltd.

**HMT:** Her Majesty's Treasury.

**ICPFs:** insurance companies and pension funds.

**ICT:** information and communication technology.

**IDS:** Incomes Data Services.

**IMF:** International Monetary Fund.

**IT:** information technology.

**LAPFs:** life assurance and pension funds.

**LFS:** Labour Force Survey.

**LIFFE:** London International Financial Futures and Options Exchange.

**M&A:** mergers and acquisitions.

**MEW:** mortgage equity withdrawal.

**MFR:** Minimum Funding Requirement.

**MORI:** Market and Opinion Research International.

**MPC:** Monetary Policy Committee.

**NIESR:** National Institute of Economic and Social Research.

**NYMEX:** New York Mercantile Exchange.

**OECD:** Organisation for Economic Co-operation and Development.

**OFCs:** other financial corporations.

**ONS:** Office for National Statistics.

**OPEC:** Organisation of Petroleum Exporting Countries.

**PBR:** Pre-Budget Report.

**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.

**WFTC:** Working Families Tax Credit.

**WTD:** Working Time Directive.

**WTI:** West Texas Intermediate crude oil.

### Symbols and conventions

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

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

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