

Publication date: 18 August 1999

MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 August 1999

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 August 1999.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9908.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 7 and 8 September will be published on 22 September 1999.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 4-5 AUGUST 1999

1 Before turning to its immediate policy decision, the Committee reviewed developments in the world economy, monetary and financial market conditions, demand and output, the labour market, and prices and costs in the context of finalising its latest projections for inflation and output growth.

The world economy

2 The Committee discussed whether there had been any material changes to the world economic outlook, or in the balance of risks, since its *May Inflation Report*. Recent data suggested that the US economy was slowing; GDP growth had fallen from 1.1% in 1999 Q1 to 0.6% in 1999 Q2, a weaker outturn than widely expected. Taken together with a lower equity market and a slight fall in consumer confidence, this suggested that the probability of a ‘soft landing’ had increased. Some doubts were, however, expressed about this. First, much of the fall in output growth between Q1 and Q2 was accounted for by inventory changes, which might unwind. Second, whether or not a soft landing was achieved might depend on labour market developments. There were signs that recent benign outcomes for productivity and unit labour costs might be fading. That could in turn lead to a tightening of monetary policy. Taking these points together, there remained a risk of the US economy slowing more sharply than assumed in the Committee’s central projection, particularly if equity prices fell.

3 In the euro area, the backward looking data generally remained weak. Area-wide industrial production had fallen again in May, although output growth in a number of the smaller economies - for example Spain, Netherlands, Belgium - was stronger than had been expected by most commentators. Forward-looking indicators had strengthened somewhat, but were still mixed. On the one hand, there were signs that business sentiment had improved in the largest economies; for example, the IFO survey in Germany and the INSEE survey in France had both risen strongly in June. On the other hand, surveys for each of France, Germany and Italy suggested that orders were still falling, implying that some downside risks persisted. The Committee noted that various ECB statements had been taken by the market to suggest that monetary policy was more likely to be tightened than eased. It seemed that this was against a background of stronger growth in the monetary aggregates and rising energy prices, and could reflect a judgment that the amount of cyclical slack in the euro-area economy was smaller than might be inferred from the level of unemployment.

4 It now seemed less likely that Japanese GDP growth would fall by as much in 1999 Q2 as had been thought the previous month. More generally, the downside risks were not yet materialising. It was also possible that, if they did, the Japanese government would employ fiscal policy to try to offset any weakening in aggregate demand. However, worries remained. It was unclear how potential problems in the insurance sector might be resolved and whether and how they might affect the economic outlook. Market commentators had expressed concerns about the yen, which had risen against the dollar over the previous month after the earlier efforts to hold it down via exchange market intervention.

5 Taken as a whole the crisis-affected emerging market economies continued to recover. But the environment remained fragile, as evidenced by the generalised rise in interest rate spreads since the May *Inflation Report*. Financial markets were, in particular, discounting some possibility of a Chinese devaluation, although on the whole commentators seemed to think that unlikely this year. There also seemed to be renewed worries about Korea. Partly against a background of uncertainty about official policy towards corporate restructuring, the equity market had fallen around 10% following the announcement of problems at Daewoo, although the market had subsequently recovered. There remained a longer-term downside risk to the world economic outlook from the slow pace and gradual effect of corporate and financial sector reform in emerging market economies.

6 Overall, compared with May, the Committee had raised its central projection for world output growth, but the balance of risks was on the downside. Some risks to the outlook - for example, a sharp fall in world equity markets or a resumption of severe problems in emerging market economies - could not sensibly be anticipated by UK monetary policy, but rather the Committee would need to consider how to react if and when such contingencies occurred.

7 The Committee noted that world price inflation had typically been coming out lower than expected given the path of world output growth. This was partly attributable to there having for some time been stronger than expected falls in oil and commodity prices. That was less likely in the period ahead given the projected pick-up in world economic growth. Oil prices had already risen sharply.

Monetary and financial conditions

8 The twelve-month rate of aggregate broad money growth had fallen to 5.6% in June, the lowest since March 1995. However, the aggregate data masked considerable sectoral differences. Most of the slowdown was accounted for by a fall in sterling deposits held by other financial institutions. By

contrast, annual household M4 growth, at 6.8% in 1999 Q2, was the highest for almost two years. Household borrowing was also accelerating; the 8% growth in the year to 1999 Q2 was the highest since 1990 Q1. Mortgage lending had picked up and approvals were still strong.

9 The twelve-month growth rate of M0 had reached 7.3% in July, with the annualised three-month rate at 8.8%. In part this was attributable to the earlier reductions in nominal interest rates, which would be expected to reduce the velocity of circulation of non-interest bearing money balances. But, taken together with the broad money and credit numbers, it also seemed to corroborate the quickening pace of household sector spending growth seen in recent consumption data and in surveys.

10 There had still been only limited pass through into headline mortgage and deposit rates of the Committee's most recent interest rate reductions. Views differed on the reliability of headline rates as indicators of the interest rates at which lending and borrowing business was actually occurring, with some Committee members noting the apparent intensification of competition - and increases in special, non-headline deals - in these markets.

11 The sterling interest rate curve had continued to steepen out to around three years, so that it was now distinctly humped. Since April, the three-month interbank rate implied by the June 2001 short sterling futures contract had risen by about 150 basis points; the rate implied by the September 2000 contract had risen 50 basis points over the previous month. Market comment had suggested that the curve might have been distorted by some large transactions in thin markets, in which case it was possible that the effect would be temporary and that market rates were not accurately reflecting market expectations of the future path of official interest rates. Nevertheless, business was conducted at those rates, and so the steepening represented a degree of tightening in monetary and credit conditions.

12 In this connection, it was suggested that the effect on the economic outlook of the increase in medium maturity market rates might be greater than reflected in the Bank's projections; it was unclear how the term structure of interest rates affected consumption and investment spending. Separately, the Committee noted that a projection for inflation using market interest rates was on this occasion materially below the one assuming a constant official interest rate.

13 The sterling exchange rate index stood at 103.3, compared with 103.5 implied by the May projection modal path. The fifteen day average - the starting point for the August forecast - was 103.1. As had been discussed at the Committee's previous meeting, it still seemed that sterling was less tightly

tied to the dollar than a few months earlier. The euro had also continued to strengthen, for which two possible explanations were identified. First, expected euro-area monetary conditions might have tightened on account of stronger expected euro-area growth and ECB statements. Second, the euro's recent recovery might reflect a reduced risk premium. During 1998 the Committee had attributed part of sterling's strength against 'In' currencies to the inevitable uncertainties about how the single monetary policy would operate, with an expectation that some of this risk premium in sterling's favour would erode as familiarity with the ECB increased. If so, the euro might continue to strengthen against sterling, and by more than implied by interest rate differentials. In the view of some members, there were other reasons why sterling might depreciate by more than uncovered-interest parity implied. The increased UK trade deficit would put downward pressure on the real exchange rate which, given inflation prospects in the UK and abroad, implied the likelihood of a lower nominal rate.

14 However, views differed on the likely path of sterling. Most members supported continuing to use the convention of uncovered-interest parity in the central projection, under which the path of sterling would be linked to market interest rate differentials, adjusted for the forecast convention of a constant sterling interest rate. Some members, however, preferred to use the alternative convention of a constant sterling ERI over the forecast period, on a view that the least-bad hypothesis for forecasting exchange rate behaviour was a random walk. It was noted that no methods or conventions for forecasting the exchange rate had a good record. The alternative approach would reduce the central projection for inflation by around 0.4 percentage points at the two-year forecast horizon, and the output growth central projection by about 0.2 percentage points.

Demand and output

15 There had been some significant changes to the national accounts data. They now showed that the slowdown in 1998 Q4 and 1999 Q1, when output growth had been flat, was accounted for entirely by changes in stocks and net trade. Final domestic demand (ie excluding investment in stocks) had continued to grow strongly.

16 The quarterly rate of output growth was back to 0.5% in 1999 Q2, the same as from 1997 Q4 to 1998 Q3, and slightly faster than had been assumed in the Committee's May central projection. Manufacturing output had grown by 0.4% in Q2, the first quarterly increase for a year. Compared with May, there was thus harder evidence of the recovery since the winter. Forward-looking survey data had also continued to strengthen. The quarterly CBI Business Optimism balance had risen from -6 in April

to +5 in July, above the long term average. The CIPS manufacturing output index was 55 in July, the fourth consecutive month it had been above 50 and its highest level since March 1998. The CIPS services output index was 58 in July, the highest since April 1998. Indicators of household expenditure were robust. For example, retail sales were stronger than expected in the second quarter. House prices were rising faster than expected in May, although with considerable variation among the regions. For the country as a whole, the July Halifax index was up around 8% on a year ago, with most of the increase over the most recent period; the index was up 6% on a quarter ago and 2% on a month ago. Housing market activity indicators - particulars delivered and mortgage approvals - were also increasing. Not everything was strengthening, however. Consumer confidence, as measured by GfK, had fallen in July, for the first time since November 1998. The Bank's regional Agents had reported that their contacts indicated that consumer demand might not be as firm as suggested by recent official data.

17 The Committee discussed the possible implications of the very different picture that the official data now painted of the slowdown last year and the early part of this year. The persistent strength of final domestic demand was striking. It had earlier been thought that part of the background to the stock adjustment had been slowing consumer and business final demand. The latest data did not support that story. A number of possible explanations were identified. First, the latest data themselves might be revised. Second, monetary policy might have stabilised the path of final domestic demand growth. The tightening during 1997 and into 1998 might have dampened an acceleration otherwise underway; and the subsequent easing of policy in the US, UK and elsewhere might have offset the shocks from the emerging market crises and the sharp fall in business and consumer confidence in the autumn, by helping to prevent a credit crunch and restore confidence. Third, the monetary policy changes might not have had much effect at all, with confidence spontaneously recovering as the real economy adjusted to the autumn shocks. It was unclear which, if any, of these possible explanations was most plausible.

18 Connected to this, views differed on whether the evidence suggested that the lags in the monetary transmission mechanism were now shorter. On one argument, the greater credibility of the new monetary regime might mean that monetary policy changes have a stronger impact on confidence, which may translate more quickly into spending decisions and pricing behaviour. On another argument, it was difficult to conclude whether or not monetary policy changes had in fact made much difference to the recent path of the economy, let alone whether there was evidence of a permanent and general change in the transmission mechanism. The shocks to the economy last autumn had been highly

unusual. It was possible that monetary policy could work quickly in averting a credit crunch - restoring financial market stability and wider confidence - in those particular circumstances, but that the transmission mechanism had not changed more generally.

19 Views also differed somewhat about the implications of the latest data for the outlook. On the one hand, it was possible that the economy was now on an even keel, recovering nicely towards trend. On the other hand, the economy could overheat if a recovery in stockbuilding, the planned pick up in public expenditure, and a smaller negative contribution to aggregate demand from net trade coincided with persistent final domestic demand strength, fuelled by rising house prices and official interest rates being significantly lower than before last autumn's disturbance.

20 Overall, given the latest data, the Committee assumed faster consumption growth in its central projection than in May; and also faster house price growth, which would itself increase consumption growth somewhat. The balance of risks to the consumption profile were judged to be on the upside over the next year or so.

Labour market conditions

21 The Committee had been predicting falling employment, but that had not happened despite the slowdown in activity. The unemployment rate had been almost flat, at around 6.2% on the Labour Force Survey measure, since the middle of 1998. Inactivity levels continued to fall.

22 The labour market prices data posed some difficult and important puzzles against that background. The twelve month mean of private sector pay settlements was 3.5%, compared with 3.8% at the end of 1998, and 4.2% a year ago. Earnings growth, as measured by the twelve-month change in the Average Earnings Index, had fallen sharply in April and May, although it was difficult to assess the significance of this given that a lot of bonuses were paid in these months and bonuses were thought to be lower this year than last year. Data in subsequent months might provide clearer information on the underlying picture.

23 While nominal earnings growth had fallen, it seemed that real earnings growth had been rising. This divergence between the paths of real and nominal growth might be explained by a fall in ex ante inflation expectations or by lower inflation outturns than were expected when wage bargains had been struck. However, although real earnings growth had risen relative to nominal earnings growth, it had

still been lower than would have been predicted given the levels of employment and unemployment. This might suggest some degree of structural change in the labour market.

24 There was, however, a range of views on the outlook for earnings. While the Committee as a whole agreed that real earnings growth would be slower, for any given output path, than assumed in May, there were differences on the appropriate size of adjustment to the May projection assumptions, hinging on differences on the extent of any structural changes. On one view, the adjustment made in the best collective central projection was too big. Labour markets conditions were tight. The BCC had reported continuing recruitment difficulties. The CBI had reported a slight increase in skill shortages, and the balance of manufacturing companies reporting shortages of unskilled labour were at the highest since 1974. The Bank's regional Agents were also reporting that businesses were experiencing problems in hiring at the lower end of the skills range. On this view, the most likely outturn for RPIX would be 0.2 percentage points higher than the best collective central projection at the two year horizon.

25 Another view placed weight on the fact that neither nominal earnings growth nor RPIX inflation had picked up over the year or so during which unemployment had been stable at around 6.2%. This suggested that continuing structural reforms had had the effect of materially reducing the level of unemployment at which inflation would start to increase. In consequence, the outlook for earnings growth was more benign than assumed in the Committee's best collective central projection. On this view, the most likely outturn for RPIX at the two year horizon would be 0.2 percentage points lower.

Prices and costs

26 There had been continuing downward pressure on UK import prices from sterling's appreciation, but the rate of import price deflation was slowing. Non-oil commodity prices had, on the Bank index, risen by 0.6% in the year to June, so that there had now been price rises for three consecutive months after thirty-three months of falling prices.

27 Oil prices had increased by about 6% over the month to above \$19 per barrel, partly reflecting higher expected world economic growth. The Committee assumed a price of \$17 per barrel throughout the forecast period in the best collective central projection, higher than in May but with some unwinding of the most recent price increase. Some members preferred using \$19 per barrel either in the central

projection or as an upside risk. This would add 0.2 percentage points to RPIX inflation at the end of the forecast horizon.

28 The Committee debated the outlook for pricing behaviour in the economy. A majority did not want to make any changes to the assumptions made in the Committee's earlier projections. Some members, however, believed that there were significant changes underway in product markets via greater use of information technology in distribution, via the entry of large, low cost competitors, and via an intensification of competitive pressures driven by regulatory developments. They believed that these changes could bring about a structural reduction in the level of profit margins in some sectors. While the adjustment was occurring, inflation would be lower than would otherwise be the case for any given path of output growth and real earnings growth. On this view, RPIX inflation could be 0.2 percentage points lower at the two-year forecast horizon than on the best collective central projection.

The August inflation and growth projections

29 The Committee agreed the projections to be published in the *Inflation Report* on 11 August.

30 On the assumption of constant official interest rates of 5.0%, the best collective judgment of the central projection for output growth was for stronger growth than in the *May Report*. Growth was projected to get back to around trend by the end of this year, after which it continued rising to around 3%, where it levelled off.

31 The Committee's best collective projection for RPIX had broadly the same saucer shape as in May, but with a number of differences. There was a lower starting point, and the trough of slightly below 2% was lower than in May. Inflation was projected to rise to above the 2½% target by the end of the two-year forecast period, when it was still increasing. The balance of risks was slightly on the upside.

32 As already described, there was considerable uncertainty in the Committee about the inflation outlook, and there was a range of preferred assumptions for the central projection. Various members had different preferred assumptions for the path of the nominal exchange rate, earnings growth, pricing behaviour/profit margins, and the oil price; these were presented in Table 6.B on page 53 of the *Inflation Report* published on 11 August.

33 Different members preferred different combinations of these assumptions. Some preferred assumptions that would lower the central projection at the two-year horizon by between 0.2 and 0.6 percentage points. Some preferred an assumption (on earnings growth) which would raise the central projection by 0.2 percentage points at that horizon.

34 The Committee also reviewed the range of outside forecasts based on a variety of different assumptions. The mean forecast for RPIX inflation was 2.1% for the twelve months to 1999 Q4, 2.4% in 2000 Q4, and 2.6% in 2001 Q3. While the mean shorter run forecast was lower than in the April survey, the 2000 and 2001 forecasts were higher. The probability assigned to inflation being above 2½% in 2001 Q3 was just over 50%, higher than in May.

The immediate policy decision

35 The Committee agreed that there was much to welcome in the current conjuncture. Output growth was recovering back towards trend faster than had been expected. Unemployment was lower than for a long time. There was, however, great uncertainty in the Committee about the extent to which the recent improvement in the relationship between activity and price inflation would persist, and about whether the lags in the monetary transmission mechanism had become shorter. There was, accordingly, a wide range of views about the medium-term prospect for inflation, reflected in different members of the Committee having different preferred assumptions for the central projection; assuming a constant 5.0% repo rate, there was a difference of about 0.8 percentage points between the highest and lowest inflation rates which individual members of the Committee thought most likely at the two-year forecast horizon.

36 Against this background, different members of the Committee emphasised different aspects in reaching their policy judgments. Some members emphasised that the quarterly forecasting round was the occasion on which, notwithstanding the considerable uncertainties, all the factors influencing the inflation outlook could be weighed together and expressed in a coherent quantitative framework, with a disciplined - although not mechanical - link between a member's assessment of the outlook and their policy judgment, given the Committee's remit of an explicit inflation target. Others placed emphasis in addition on the increased uncertainty about the relationship between activity and price inflation, and about the transmission mechanism.

37 For some members of the Committee, the question was whether or not there was a case for a further reduction in rates now. While most features of the conjuncture were welcome, inflation was below the target and set to remain so for some time. On this view, the most likely outlook for inflation was, furthermore, even weaker than implied by the best collective central projection. Those members taking this view placed weight, in different degrees, on alternative assumptions: a constant nominal exchange rate together with either weaker earnings growth or a downward adjustment to profit margins. One such member would also have preferred a number of other adjustments to the best collective central projection: in particular, slightly higher oil prices and slightly stronger consumption, offset to some extent by tighter than assumed monetary and credit conditions on account of the incomplete pass through of previous rate reductions and the steep rise in medium maturity market interest rates. Taken together, these considerations pointed towards a further reduction in interest rates. However, various arguments against an immediate reduction were identified. First, in the view of one member, the current nominal rate was around neutral, and the case for changing rates therefore had to be more compelling than usual given the inherent self-correcting characteristics of the economy. Second, nominal interest rates were lower than for many years so that, if there were residual inflation illusion or if borrowers were credit constrained, the upside risks to consumption growth might be greater than assumed. Third, there was considerable uncertainty about the outlook. That pointed towards caution in changing policy. In particular, there was a case for waiting to assess the extent to which the performance of the labour market had improved. Fourth, an immediate rate cut, which would be unexpected, might have a much larger-than-normal effect on house prices and sterling, which could have a significant impact on the resulting modal projection of inflation. Fifth, although some members preferred a modal projection for inflation a little below 2½% in two years' time, for some of them the balance of risks was on the upside. Overall, the best course this month was to leave rates unchanged.

38 For some other members of the Committee, the question was more whether or not there was a case for tightening policy this month. Domestic demand growth was already stronger than expected and was projected to increase, with clear upside risks to consumer spending, particularly if house prices continued to rise sharply. It was unlikely that net trade would continue to make a negative contribution to output growth for much longer. There was a risk that output growth would not level off over the next year or so but would continue to increase. In any event, there could be upwards inflationary pressure at the end of the forecast period, when the best collective central projection was already above the 2½% target and rising. Some of the members who held these concerns about the risks to the inflation outlook would also have preferred a somewhat higher central projection for inflation as they

thought the most likely path for earnings growth was faster than assumed. However, even with that adjustment the central projection would be below the target until 2001 Q3. Moreover, monetary and credit conditions had already tightened somewhat through the rise in medium term market interest rates. Taking these considerations together, although it seemed more likely than not that there would at some point need to be a tightening of monetary policy in order to meet the inflation target, the Committee was in a position to wait for more evidence. That might help to resolve some of the uncertainties about consumption; about earnings, where there would be data less affected by bonus payments; and about the length of the transmission lags and about pricing behaviour; as well as more evidence on the exchange rate. In consequence, there was time to take any restraining action later, if and when it was more clearly needed. Overall, for these members too, the best course this month was to leave rates unchanged.

39 Other members placed less weight on the arguments for a further reduction or for a pre-emptive tightening. On the one hand, a cut would take imprudent risks with the pace of increase in household spending and with house prices. It could well be taken badly by the financial markets, leading to a rise in longer term inflation expectations and nominal bond yields. While inflation was set to be below the target for a period, that largely reflected the unexpected shocks to the world economy last autumn; monetary policy could not sensibly try to offset the short-run effects of all shocks as it had to be forward looking. It was conceivable that the relationship between activity and price inflation had become substantially more benign, but more evidence was needed; some past UK monetary policy mistakes had stemmed in part from over optimism about the possibility of permanent changes in the economy. On the other hand, a tightening would be premature and overly cautious, and could even prompt questions about whether the target was truly symmetric. The economy was recovering nicely, helped by the earlier easing of policy; and inflationary pressures were fairly muted in the short run. There were risks further out, but there was time to gather more evidence before any action was needed to dampen any incipient inflationary pressure. On this view too, the best course this month was to leave rates unchanged.

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

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

Willem Buiters

Charles Goodhart

DeAnne Julius

Ian Plenderleith

John Vickers

Sushil Wadhvani

Andrew Turnbull was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 30 July, in advance of its meeting on 4-5 August 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I The international economy

A2 GDP growth in the United States had slowed in the second quarter, according to the preliminary estimate. Following growth of 1.1% in the first quarter, GDP was estimated to have risen by 0.6% in the second, a weaker outturn than most commentators had been expecting. The recovery in industrial production had remained weak, although the twelve-month growth rate had picked up in June because of base effects from the 1998 strike at General Motors. Industrial orders and housing starts had also weakened, the latter possibly reflecting the rise in mortgage rates as well as earlier weather-related effects. Slowing retail sales growth had pointed to slower consumption growth. The labour market had continued to tighten however: employment growth had continued to be more rapid than growth in the working-age population, while employment costs had risen by 1.1% in 1999 Q2. This was the largest quarterly rise in employment costs since 1991 Q2 and was well above market expectations. However, this had followed much weaker growth in employment costs in 1999 Q1, and the two-quarter growth in employment costs still seemed subdued compared with the same two quarters of 1998. Broad money growth had weakened and producer price pressures had remained muted, but deflationary pressures from intermediate and crude producer prices had diminished.

A3 In May the twelve-month growth rate of euro-area industrial production had remained negative. However, there had been signs that production was nearing a trough and forward-looking indicators had improved: the German IFO index and the French INSEE survey had both risen strongly in June. With business confidence improving but consumer confidence falling, the gap between business confidence and consumer confidence had continued to narrow in June. Broad money had grown by an annual rate of 5.1% in the three months to June, not far from the European Central Bank's (ECB) reference value of 4.5%. But private sector credit had continued to grow strongly, at an annual rate of 10.9%. Euro area headline inflation had fallen slightly in June, but inflation differentials within the euro area had persisted.

A4 Japanese retail sales had remained weak, falling by 2.5% in the twelve months to June. However real disposable income had risen by 1.1% in the same period, and the fall in the annual growth rate of

retail sales had masked a 0.2% quarterly rise in 1999 Q2. Moreover, household expenditure had grown more strongly than retail sales. Industrial production had grown by 3.0% in June; while this growth had been much stronger than most commentators expected, industrial output had still fallen by 1.0% in the second quarter. The Tankan survey had shown that firms could in principle obtain credit more easily, but investment plans had remained subdued. This might have explained why bank lending had continued to slow in June. The twelve-month growth rate of M1 had risen to 12.2%, but base money growth had slowed. Moreover, simple monetary policy rules had suggested that monetary policy might still be too tight.

A5 In the financial markets the dollar had depreciated against the euro and the yen since the July MPC meeting. Equity prices in the United States, Japan and the euro area had fallen. Short-term yields had increased by around 25 basis points for the year 2000 in the United States over the month as a whole, and had risen in the euro area, with the ECB highlighting the consequences of stronger growth. The outlook for emerging markets had generally improved, although Argentina looked if anything more fragile and problems at Daewoo had affected financial markets in Korea.

II Monetary and financial conditions

A6 Narrow money growth had risen in July, notes and coin growing by 0.8% in the month. After adjusting for the introduction of the new 50 pence coin and the £2 coin, the twelve-month growth rates of notes and coin and M0 had risen, between June and July, from 7.0% to 7.4% and from 7.2% to 7.5%, respectively. In both cases, this had represented a rise of more than 2 percentage points since November 1998.

A7 The stock of M4 had fallen by £4.2 billion (−0.5%) in June. Although one-off factors had distorted M4 flows in May and June, the underlying growth rate had been weak in both months. The growth rate of M4 in the year to June had been 5.6%, its lowest since March 1995. In contrast, aggregate M4 lending (excluding securitisations) had been strong in June, rising by £9.6 billion (1.0%), its highest flow since February 1998. The twelve-month growth rate of M4 lending had risen to 7.7% in June, from 6.8% in May. The excess of M4 lending over M4 deposits had been financed predominantly by non-residents.

A8 The twelve-month growth rate of household sector M4 deposits had risen to 6.8% in Q2, a pick-up of 1 percentage point since 1998 Q2. Household M4 lending had also strengthened in Q2, rising by £3.7 billion (0.7%) in June and by an average of £3.6 billion a month (0.7%) during the quarter. The twelve-month growth rate had picked up from 6.9% in 1998 Q2 to 8.0% in 1999 Q2; stronger secured lending had more than accounted for this rise. The flow of total net secured lending to individuals had picked up in June to £3.0 billion (0.6%), and the twelve-month growth rate of net secured lending had

reached 6.8% in June, compared with 5.6% a year earlier. The value of loan approvals for house purchase in June was also strong at £10.6 billion. Total unsecured lending had continued to slow during Q2, the twelve-month growth rate falling to 14.4% in June, down from its late 1998 peaks. However, the June flow itself had been strong, with a one-month increase in lending of 1.2%.

A9 PNFCs' M4 deposits had been weak in Q2, with an average monthly flow of £0.2 billion (0.2%). Similarly, sterling lending by banks and building societies to PNFCs had also been weak in Q2, with a flow of only £0.1 billion in June and an average monthly flow of £0.3 billion (0.2%), leading to its lowest quarterly growth rate since 1997 Q1. However, PNFCs' total borrowing — including funds raised on the capital markets and foreign currency borrowing — had been extremely strong in Q2 at £18.3 billion, the highest flow in real terms since 1989 Q3.

A10 Other financial corporations' (OFCs') M4 deposits had fallen again in Q2, the twelve-month growth rate coming down to 1.1%, its lowest value since 1993 Q2. By contrast, OFCs' M4 lending (excluding securitisations) had risen strongly in Q2, the monthly flow averaging £2.1 billion (1.1%). The twelve-month growth rate of OFCs' lending had risen to 10.3% in 1999 Q2, fully reversing the decline in the growth rate observed for Q1.

A11 Turning to price indicators of monetary conditions, interest rate expectations implied by 2000/2001 short sterling futures contracts had risen by about 50-60 basis points since the previous MPC meeting. The release of the MPC minutes on 21 July, the Humphrey-Hawkins testimony by the Federal Reserve Chairman on 22 July, and the mid-month fall in sterling were all thought to have contributed.

A12 Nominal forward rates at maturities of three to five years had changed little in the month. Long rates had fallen, but this fall was believed to be related to the lack of liquidity in the long (30-year) end of the gilt market, rather than to economic fundamentals.

A13 Interest rates implied by short sterling futures had exhibited a 'hump' in May which became more pronounced in June and July. This hump suggested that in July the market had been expecting UK short-term interest rates to rise in 2000 and 2001, and to be at around 6.5% in late 2002.

A14 Real interest rates derived from the index-linked gilt market had been virtually unchanged since the previous meeting. Likewise, survey measures of inflation expectations for 1999 and 2000 were hardly changed in July compared with June. On the other hand, market expectations of inflation in the short to medium term (derived from a comparison of nominal and index-linked gilts, and based on 3 and 5 year bond rates) had risen, continuing an increase since the beginning of the year.

A15 The Bank's survey of advertised retail interest rates had suggested that the 25 basis point cut in the repo rate in June had not yet been fully passed through to standard variable mortgage rates. Fixed-rate mortgages in July had continued to rise; average five-year fixed mortgage rates (with no lock-in) had risen by about 20 basis points to around 6.4%.

A16 The FT-SE All-Share index had fallen by 4.5% since the previous meeting. The fall had been widespread, with the decline in utilities stock prices being especially large. Small capitalisation stocks continued to outperform the FT-SE 100, rising by 0.1% in value since the previous meeting.

A17 The sterling effective index had fallen by 1.2% since the May meeting to 103.3, approximately 0.2% below the modal path of the *May Inflation Report*. Since the July meeting sterling had fallen by 1.1% against the euro and risen by 4.0% against the dollar. Movements in sterling over the month had appeared to be largely unrelated to changes in UK yields relative to overseas.

III Demand and output

A18 There had been changes to the level and composition of GDP arising from the annual balancing exercise. The cumulative impact of these revisions had been to raise the level of the output measure of GDP by less than ¼% by 1999Q1; the levels of the expenditure and income measures of GDP had been revised up by around ½%. So the average measure of GDP at constant market prices had been revised up by 0.4%. The revisions had resulted in a flatter and stronger profile for quarterly GDP growth over the first three quarters of 1998 relative to previous estimates.

A19 Most of the upward revision to the expenditure measure had come from consumption and investment. The level of household consumption had been revised up by 0.9% reflecting the results of the 1998 retail sales enquiry. Investment had been revised up by 2.4% reflecting more computer spending. These revisions had been partly offset by downward revisions to the level of government consumption, reflecting new estimates of spending outside the health and education sectors. The cumulative revision to stocks had been small. Similarly, the contribution of net trade since 1996 had been slightly more negative than on previous estimates, but the difference was not large.

A20 There had been a significant upward revision to profits in 1997 and 1998. Average profits during 1998 had been around 4% (0.9% of GDP) higher than previous estimates. But the profile of declining profits over 1998 and in 1999 Q1 had remained. Turning to the output measure, the level of manufacturing output had been revised up by 0.4%. The level of services output had been revised up by 0.1% and construction output had been revised down.

A21 GDP growth at constant market prices in 1999 Q1 had been revised up to 0.1% from zero mainly because of a less negative contribution from net trade. The revision to growth at basic prices had been slightly larger — to 0.2% from zero — reflecting a less sharp fall in the output of the energy supply sectors. The preliminary estimate for Q2 had shown GDP growth at constant market prices picking up to 0.5%. The annual rate had been unchanged at 1.2%. Output of the service sectors had grown by 0.5% and, within this, distribution and retailing output had grown by 0.4%. The annual rate of services output growth had slowed to 2.4% from 2.7%.

A22 Industrial production had risen by 0.1% in June because of higher energy output. By contrast, manufacturing output had fallen by 0.2%; but it had risen by 0.4% over Q2 as a whole, following three consecutive quarterly declines.

A23 Retail sales volumes had been flat in June, following a rise of 1.1% in May. The level of sales had been revised up in April and May so that quarterly growth in Q2 had been similar to Q1, at 0.9% compared to 1.0%. Food stores had continued to report slower sales growth than other stores; sales were, respectively, 0.2% and 1.5% higher in the three months to June compared with the previous three months. According to the CBI distributive trades survey, the balance of retailers reporting a rise in annual sales growth in July had risen to +28 from +22 - its highest level since February 1998.

A24 The GfK measure of consumer confidence had declined in July to 2.4 from 5.8 in June, which had largely unwound the sharp rise in confidence in May. Both general and household-specific measures of confidence had fallen. A new quarterly survey by the Consumers Association had also shown a small fall in consumer confidence to +33 in July from +35 in April.

A25 New information on house price inflation had been mixed. The Nationwide index had risen by 0.4% in July, which had reduced the annual rate of house price inflation to 6.9% from 7.5%. The Halifax index had shown a sharper rise on the month of 2.2%, which had increased the annual rate to 8.2% from 6.9%. The number of housing transactions had continued to rise. The growth rate of particulars delivered had been 3.8% in the three months to June compared with the previous three months and the number of loans approved — a leading indicator of transactions — had been 7.5% over the same period. Net reservations for new homes had continued to rise, with the balance rising to +33 in June from +24 in May, though official data had suggested that increased demand had yet to feed through to housing starts.

A26 Monthly trade data had pointed to a stronger net trade position, consistent with the continued upward trend in survey indicators of export demand. Goods exports to non-EU countries had risen by 5.0% in Q2, compared with a fall of 1.9% in Q1. The recovery had been widespread, with exports

rising to both the United States and the Asian countries. Exports to EU countries had continued to be weak, falling by 1.3% in the three months to May.

A27 Survey evidence for Q3 had pointed to a continued recovery in manufacturing output and a pick-up in services output growth. The July Confederation of British Industry (CBI) survey had shown a further improvement in total and export orders, though the balances had remained negative at -19 and -24 respectively. Business optimism had risen to +5 from -6, the first positive reading since October 1998 and well above the average since 1972 of -5. The British Chambers of Commerce (BCC) survey had shown both manufacturing and services orders and sales picking up in Q2; domestic service orders had risen to +19 from +15. The Chartered Institute of Purchasing and Supply (CIPS) output balances in the manufacturing and service sector had been above the no-change level of 50 for the fourth and fifth month running in July. The CIPS construction activity index had declined slightly in July, to 62.9 from 63.7, but had remained well above 50.

IV The labour market

A28 According to the Labour Force Survey (LFS), employment growth had slowed since the second half of 1998, increasing by just 20,000 in the three months to May. The employment rate had fallen by 0.1 percentage points to 73.9%, as growth in the working-age population had outstripped growth in employment. Employment growth in the three months to May had been more than accounted for by full-timers; part-time employment had fallen, although it was still 90,000 higher than a year earlier. Total hours worked had been unchanged in the latest three months: the small rise in employment was offset by a 0.1% fall in average hours worked.

A29 Turning to survey data, after seasonal adjustment, the July CIPS survey had reported employment in manufacturing falling at around the same rate as in June, while employment growth in the services and construction sectors had increased slightly. The BCC survey had pointed to an improvement in employment intentions in Q3 for both manufacturing and services, while the CBI had reported an upturn in manufacturing employment intentions, though the balance remained negative.

A30 The CBI Industrial Trends survey reported a slight increase in skill shortages in Q2, though they had remained below their historical average. The net balance of manufacturers reporting shortages of unskilled labour had picked up to its highest level since 1974. The BCC had also reported continued recruitment difficulties.

A31 Job-centre vacancy data had recently been affected by a number of distortions, and the ONS had recommended looking at notifications rather than the stock of vacancies. But on both measures,

vacancies had been broadly flat in June. This contrasted with the NTC Press advertising index, which had been falling for several months.

A32 Claimant unemployment had fallen by 0.1 percentage points in June to 4.4%, the lowest rate since 1980; LFS unemployment had fallen by 36,000 in the three months to May, compared with the previous three months, taking the rate down to 6.2%. Both unemployment rates had been broadly flat since the middle of 1998. The recent fall in LFS unemployment had been broadly concentrated among those unemployed for under one year, a reversal of previous rises. LFS redundancies in spring 1999 had been around the same rate as a year earlier. Redundancy rates had remained highest in the manufacturing and construction industries.

A33 Revisions to GDP data had led to large upward revisions to productivity growth in recent quarters. Annual productivity growth in 1999 Q1 had been revised up from 0.5% to 1.0%. And the Institute of Management Services productivity index pointed to a sharp pick-up in Q2.

A34 Whole-economy headline average earnings growth, which is a three-month moving average of monthly outturns, had declined further in May to 4.3%, while private sector earnings growth had fallen by 0.5 percentage points to 4.2%. Turning to the individual monthly outturns, whole-economy earnings growth had been revised up to 4.0% in April and was unchanged in May. Recent upward revisions to the Reward index had brought it more into line with the Average Earnings Index (AEI). The latest data indicated a 0.2 percentage point fall in June to 3.6%. The Federation of Recruitment and Employment Services (FRES) surveys on temporary and permanent pay rates were among the few indicators pointing to rising earnings growth: both series had increased slightly in July.

A35 Growth in ONS wages and salaries per head, at 5.4%, had been higher than the 4.8% reported by the AEI in Q1. It was thought that the difference could largely be accounted for by differences between the industrial weights used for wages and salaries and for the AEI, and by reconciliation of the GDP income data with the expenditure and output data. The real product wage and the real consumption wage had both grown strongly in Q1.

A36 The National Minimum Wage (NMW) had been introduced on 1 April. The spring LFS, which covered responses between March and May, had shown a muted impact of the NMW on the distribution of earnings. But there could be several explanations for this. First, many responses would have been made in March, before the introduction of the NMW, and of those responding in April or May, many people may have been reporting pay for a period before 1 April. Second, the LFS was known to under-record hourly earnings. It was still too early to draw firm conclusions about its impact on earnings; this would not be possible until publication of the summer LFS and the 1999 New Earnings Survey in October.

A37 The method of weighting used in the Bank's settlements database had been changed. In the past, settlements had been weighted together using the employment weights of the Bank's sample. Now, in addition to being employment weighted, the four main sectors of the database were weighted together using fixed sectoral weights from the 1996 Annual Employment Survey. This had reduced the weight placed on the public and construction sectors, which had both been overweight in the Bank's sample, and increased the weight on private services.

A38 The twelve-month whole-economy settlement for June, calculated on the new basis, had been 3.6% for the sixth month in a row. Within that total, higher public settlements had been offset by lower private sector settlements. Three-month private sector settlements had increased to 3.4% in June, mainly because of a large construction sector settlement in August covering 600,000 employees.

V Prices

A39 The Bank's index of commodity prices excluding oil had risen by 0.7% in June; the index including oil prices had increased by 0.8%. Both series had now shown positive annual inflation for three consecutive months. Other measures of commodity prices had continued to show negative but moderating annual inflation.

A40 The oil price had risen sharply again in July. The rise had brought the one-month future price of Brent crude to \$19.38 on 28 July, 80% above its trough in December 1998. Producer price inflation had increased in June, total input prices by 0.6% (annual inflation had risen to -0.8%) and total output prices by 0.2% (1.0%). Excluding food, beverages, tobacco and petroleum, both series had remained markedly lower: annual inflation on those measures had been -4.2% and -0.5% respectively in June.

A41 The terms of trade had increased steadily since its most recent trough in 1995; the National Accounts revisions had made little difference. Manufacturers' margins for exports had continued to fall over the past year but domestic margins had been broadly flat. Retailers' margins had fallen during the winter, but had increased during the second quarter, to a level similar to that a year earlier. The retail sales deflator had fallen in June, on both an annual and a monthly basis. Annual inflation had been revised up to zero in May, which had meant that June's fall had been the first on record. Revisions to the GDP deflator had lowered the annual inflation rate in the first quarter. The new estimates had shown a sharp fall in annual GDP deflator inflation between Q3 and Q4 1998. But the level of the deflator by 1999 Q1 was very similar to the previous estimates.

A42 The annual rate of RPIX inflation had risen by 0.1 percentage points to 2.2% in June. The rate excluding taxes and excise duties (RPIY) and the all-items rate of inflation (RPI) had both remained unchanged in June, at 1.5% and 1.3% respectively. Ofwat, the water industry regulator, had announced

proposed cuts in water prices, due to start in April 2000. Most of the fall would occur in the first year, which if it were passed on in full would lower RPIX inflation by 0.2 percentage points for a year. The short-term outlook for RPIX inflation was that it would remain close to 2.2/2.3% for the next few months. That had represented a slight increase in expectations, primarily due to higher petrol and house prices.

VI Reports by the Bank's Agents

A43 The Bank's regional Agents reported on the pace of the recovery based on discussions with their contacts over the past month. There had been a further pick up in manufacturing orders and output in July. But the path of recovery in domestic demand had not been smooth, and had varied between the regions and between industries. Exports to some markets had picked up, particularly to the US and Asian markets. But the strength of sterling and the level of import penetration had continued to be perceived as a problem. Manufacturing firms had expected a stronger recovery in the second half of this year. Services output had continued to grow steadily. Within the service sector, retailing output had been a little stronger and IT, financial and businesses output had been quite buoyant.

A44 Consumer demand had picked up, but not strongly. There had been a slow recovery in retail sales, helped by early Summer sales and the opening of new shopping centres. The strength of the housing market did not seem to be feeding through into increased demand for goods related to house moves, at least not yet. Car sales had been reported to be rather sluggish. Overall, consumer demand had not been as firm as recent official data had suggested.

A45 There had been further easing in the labour market. Employment in the manufacturing and primary sectors had continued to contract, but had expanded further in the service sector. Skill shortages had eased, though there had been pockets of tightness in some sectors. There had also been some reports of quality problems at the bottom end of the skills distribution. Firms had continued to focus on improving productivity.

A46 The Bank's Agents presented a survey on productivity growth which they had carried out over the previous month. Of the 157 firms in the sample, nearly half had reported that their productivity growth over the past year had been above normal, compared with 20% who had reported growth below normal. Responses on future productivity growth had been more positive, with just 7% expecting productivity growth to be below normal. Reasons for expected improvements included the more efficient utilisation of the workforce during the economic upturn and new capital investment coming online. One possible explanation for the contrast between the relative weakness of official statistics on productivity and the more upbeat picture of the survey could have been a form of aggregation bias: firms who had contracted out services such as cleaning might have reported the same gross output

produced by fewer employees, and hence a rise in productivity. But if aggregate output and employment were unchanged, then aggregate productivity would not have been affected by such a move. Asked about spare labour capacity, the most common response – cited by nearly 40% of firms – had been that only zero to one percent of employees were currently underutilised. However, a quarter of manufacturing firms reported that 6% or more of the workforce were surplus relative to their current output.

VII Market intelligence

A47 Market expectations for UK interest rates in both the short and the long term had risen since the previous MPC meeting and the market now seemed confident that 5% would form the floor for official interest rates. Economists' views of future interest rates had, in contrast, been lower than those implied by short sterling futures – for example, the latest monthly poll by Reuters showed a lower path for interest rates than that implied by the futures market. It was possible that some large transactions had produced overshooting in markets that may have been seasonally thin.

A48 In the foreign exchange market, the main development over the month had been the across-the-board weakening of the US dollar: there had, in contrast, been relatively little sterling-specific market comment. The dollar had weakened against the yen on what the market saw as a change in the Bank of Japan's policy on intervention. It had also weakened against the euro, initially, according to market commentators, as short positions were closed out, with some subsequent support at the higher levels from stronger-than-expected economic data for the euro area. More recently, the Humphrey-Hawkins testimony and the renewed probability of rising US interest rates had affected both US asset markets and the dollar. Data from options markets suggested that the market saw the balance of risk on the downside for sterling against the euro but not against the dollar.