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MINUTES OF MONETARY POLICY COMMITTEE MEETING 7 and 8 July 1999

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 July 1999.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9907.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 4 and 5 August will be published on 18 August 1999.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 7-8 JULY 1999

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

The world economy

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

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

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

5 In Japan the recorded path of output was likely to be volatile. GDP figures indicated growth of 1.9% in the first quarter of 1999. Adjustments to reflect a variety of factors, such as seasonal adjustment techniques, might lead to the initial estimate of growth in Q1 being revised down, though it might still be above most earlier forecasts. Even if such a revision were made, GDP might contract in the second

quarter. Nevertheless base money growth continued to pick up, equity prices had risen again and business confidence was a little less weak.

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

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

Monetary and financial conditions in the United Kingdom

8 Growth in narrow money had risen, with notes and coin growing at their highest rate since end-1996. This appeared to be consistent with a pick-up in retail sales in Q2. While broad money growth had eased overall, this had not been reflected in the household component. It might be that the reductions in official rates were feeding through into broad money growth for households rather faster than expected, but this was by no means certain. Total household borrowing remained robust, despite some slowing in consumer credit growth.

9 Market expectations for interest rates at the shortest maturities were if anything a little lower than a month ago. However, at the two to three year horizon, interest rates implied by short-sterling futures contracts had increased by around 40 basis points. This might reflect a market view about the cyclical path of interest rates, particularly if market participants believed that the United Kingdom was now less likely to be part

of Economic and Monetary Union in the near future. Alternatively, the rise in expected UK interest rates might simply reflect the fact that euro rates had risen at the same maturity; it was not clear whether such a high correlation was warranted. Standard variable mortgage rates had moved little over the month; there was not yet much pass-through into retail rates from last month's reduction in official rates. With the steepening in the yield curve, further increases in fixed rates on new mortgages were possible.

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

Demand and output

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

unchanged. It was likely that the lower starting point for stock levels would represent a more secure base for output growth in the coming quarters.

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

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

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

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

The labour market

16 Data on labour market quantities were also consistent with a somewhat stronger path than had been expected for activity in Q2. Employment had continued to grow, if at a slower pace, with the increase more than accounted for by full-time workers.

Unemployment had again declined slightly, reflecting a fall in the numbers of the short-term unemployed. Despite the slowdown in GDP growth over the past year, the unemployment rate was little changed from its mid-1998 level. Overall, labour market conditions remained somewhat tighter than had been expected, and the possibility of a substantial rise in unemployment had diminished.

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

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

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

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

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

Prices and costs

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

and services inflation marginally stronger. The annual retail sales deflator had fallen in the year to May - the first fall since the series began in 1986.

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

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

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

Other issues

26 The Committee noted that the analysis and projections to be carried out for the August *Inflation Report* would allow it to reassess some of the puzzles in the data over the next month: in particular the contrast between activity, which was somewhat stronger than expected, and prices, which were somewhat weaker. In addition, later in July new national accounts data would be published, more information on earnings would become available, and it would be easier to assess the significance of sterling's recent movements, particularly against the dollar. While not of themselves conclusive, these were reasons for waiting another month to get a clearer picture of

the way in which the economy was developing.

The immediate policy decision

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

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

29 On another view, it might have been preferable last month to have left the repo rate unchanged for the reasons set out at the time. Developments over the month had probably strengthened that argument. Although cost increases were lower than expected, other indicators, such as domestic demand, money data and housing market activity, were pointing to a less benign inflation outlook further ahead, and the

exchange rate was back in line with the central assumption in the *May Inflation Report*. But there were two reasons for not reversing last month's reduction. First, to do so might affect business and consumer confidence disproportionately. A reduction followed by an immediate rise in interest rates, in the absence of significant news about the economy, did not necessarily have the same impact on confidence as a constant level of rates. Second, a reversal might wrongly be interpreted as a stronger signal of the future path of interest rates than was warranted. It was desirable, therefore, to leave the repo rate unchanged this month.

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

31 The following members of the Committee were present:

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

Gus O'Donnell 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 2 July, in advance of its meeting on 7-8 July 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I The international economy

A2 The international environment had improved a little over the month. Activity in the United States had remained strong, and survey data for the euro area had been largely positive. Growth forecasts for Asia had been revised up.

A3 The final estimate of Q1 GDP growth in the United States had been revised up to 1.1% quarter on quarter, reflecting a slightly less negative contribution from trade. In Japan, the estimate for Q1 GDP growth had been surprisingly strong, at 1.9% quarter on quarter. But this most probably overestimated underlying activity. Monthly activity data had suggested weaker growth, and it is possible that some of the public investment reflected orders booked in Q1 that would materialise in Q2. In the euro area, the preliminary estimate of Q1 GDP growth was 0.4% quarter on quarter, in line with the *May Inflation Report* projection. Consumption and investment had grown strongly, while net trade and destocking each subtracted from growth. In Italy, GDP had increased by 0.2% in Q1.

A4 The pattern of growth in the major industrialised economies reflected ongoing adjustment to the emerging market crises of the past two years: net trade had made a negative contribution to growth in the major industrialised economies over the past two quarters. Industrial production in the United States had remained steady at around 2% at an annual rate. Data for the euro area as a whole were available only to February. More timely data were available for some individual economies; German industrial production had risen by 1.0% in April, but that was still 1.3% lower than a year ago, while French industrial production had fallen by 0.3% in April, and had been flat on the year-on-year comparison. Retail sales data had showed no sign of a

slowdown in consumer spending in the United States. In Japan, retail sales had been stronger than last month, but still lower than a year ago. In the euro area, lack of timely data and distortions caused by the timing of Easter made retail sales data hard to read; German retail sales had risen by 4% in March and fallen by 4% in April.

A5 In the United States, the Federal Open Markets Committee (FOMC) had increased the Federal Funds target rate by 25 basis points to 5.0% on 30 June and reverted to a neutral stance towards monetary policy. Interest rates implied by futures contracts had fallen after the FOMC announcement. Short-term inflation expectations had picked up recently, possibly reflecting the rise in energy prices, but long-run inflation expectations had remained flat. Overall the data suggested that consumption had perhaps slowed a little in Q2, but nevertheless remained robust. Consumption had risen in May, but sales data suggested a slowdown in June. Consumer confidence and employment, however, had risen further in June. Some signs of slowing had been apparent in housing sales, but mortgage growth, which appeared to have fuelled consumption, had remained high.

A6 The forward-looking information available from surveys indicated a further narrowing of the gap between business and consumer confidence in the euro area in May and June. Business confidence had risen a little (from a low level) and consumer confidence had fallen slightly (from a higher level). The IFO survey of business confidence in western Germany and the French INSEE business survey had both risen in May, partly reflecting improvements in foreign orders. Italian orders had also picked up. In the United States, the National Association of Purchasing Managers Index had risen above market expectations in June, reflecting rises in the sub-indices for production and new orders. The export orders index had also risen. In Japan, the Tankan survey had shown a small improvement in business sentiment, reflecting better financial conditions.

A7 International data on consumer price inflation in May suggested that the pick-up in April had been temporary. In the United States, consumer price inflation fell to

2.0%, from 2.3% in April; for Japan, May's figure was -0.4%; and in the euro area inflation on the harmonised measure had fallen back to 1.0%.

A8 Turning to global financial markets, the yen had reached a high of 118 against the dollar around the time of the release of Q1 GDP. Since then, several rounds of intervention had brought it back into the 120-122 range. Implied volatility had subsequently fallen sharply. Japanese bond yields had risen slightly, and equities more markedly, over the month, following the strong GDP data. In the euro area, expectations of short-term interest rates had risen over the past month.

II Monetary and financial conditions

A9 Narrow money growth had remained robust. The twelve-month growth rate of notes and coin, after adjusting for the introduction of the new 50 pence and £2 coins, had risen to 7.0% in June, the highest rate since December 1996.

A10 M4 had risen by £3.4 billion (0.4%) in May. The annual rate of growth had slowed to 7.0%. The slowdown in aggregate M4 and aggregate M4 lending had been largely driven by Other Financial Corporations' (OFCs') M4 and M4 lending. OFCs' M4 deposits had fallen by £2.0 billion in May, and lending to OFCs had fallen by £1.8 billion in May.

A11 The M4 deposits of the household sector had risen by 0.6% (or £2.9 billion) in May. The growth rate of households' M4 deposits had increased generally since 1998 Q2. M4 lending to the household sector had remained strong; it had risen by 0.6% (or £3.1 billion) in May, leaving the twelve-month growth rate unchanged at 7.9%. Total lending secured on dwellings had fallen from £3.1 billion in April to £2.7 billion in May, although gross lending had remained strong. Approvals in May had been strong and, reflecting the current 'tight' state of the housing market, many banks and building societies were now allowing consumers to carry approvals forward if their offers were rejected. This had caused the stock of loan approvals outstanding to rise sharply, and could have altered the relationship between the stock of approvals and secured lending. Monthly consumer credit growth had fallen from 1.3% in April to 0.6% in May, though this in part could have reflected a switch to mortgage equity

withdrawal leaving total borrowing for consumption still strong in 1999 Q2. Compared with a year earlier, consumer credit growth remained robust at over 17%.

A12 Private Non-Financial Corporations' (PNFCs') M4 deposits had been strong in May, rising by 2.1% on the month (or £2.6 billion). However, this figure had been inflated by a large temporary item; adjusting for this, the flow in May was negative. Lending to PNFCs had fallen by 0.4% on the month (or £0.8 billion). The sharp rise in capital issues since the beginning of the year had continued.

A13 Turning to price indicators of monetary conditions, interest rate expectations implied by longer-dated short-sterling futures contracts had risen since the previous MPC meeting: the rate implied by the September 2001 contract had risen by close to 40 basis points to around 6.80%. Expectations of interest rates in the euro area and Japan had risen over the month, which might have contributed to the increase in interest rates implied for the United Kingdom.

A14 Nominal forward rates at maturities of 3 to 5 years had risen by between 35 and 45 basis points since the previous meeting; this rise had been in line with the rise in longer-dated short-sterling futures contracts. Longer rates (beyond about 9 years) had fallen by up to 55 basis points. This pattern had also been reflected in swap rates and corporate bond yields which rose by similar amounts at 3 to 7-year maturities.

A15 Real interest rates derived from the index-linked gilt market had been broadly unchanged since the previous meeting, suggesting that the rise in nominal rates largely reflected increased inflation expectations. Survey-based measures of inflation expectations available each month had also risen, but by less than those implied by yield curves. According to the survey measures, the rise in nominal interest rates could be split approximately half and half between a rise in real rates and a rise in inflation expectations.

A16 The Consensus Economics Forecasts measure of the expected average inflation rate over the next two years had risen since 1999 Q1 by 20 basis points, to 2.3% in 1999 Q2. But over the same time period, the Barclays Basix survey suggested that inflation expectations for the next two years had ticked down. In particular, trade union expectations for the year ahead had fallen from 2.7% in Q1 to 2.5%.

A17 The Bank's survey of advertised interest rates suggested that the 25 basis point cut in the repo rate in June had not been passed through to standard variable mortgage rates. Moreover, fixed-rate mortgages had risen over the month: for example, average 5-year fixed mortgage rates with no lock-in had risen by around 20 basis points to 6.20% in June. Furthermore, spreads between fixed-rate mortgages and swap rates had narrowed in recent months, suggesting that further increases in mortgage rates were possible. Unsecured loan rates and savings rates had been broadly unchanged on the month.

A18 The FT-SE All-share index had risen by around 3% to 3069 since the previous meeting, with small and mid-capitalisation stocks continuing to outperform the FT-SE 100. Information technology, resources and cyclical consumer goods stocks had performed relatively well over the month.

A19 The sterling effective index had fallen by 1.0% since the June meeting to 103.5, approximately 0.1% below the level implied by the central projection of the *May Inflation Report*. Sterling had fallen by 0.6% against the euro and 2.6% against the dollar. Movements in sterling over the month appeared largely unrelated to changes in UK yields relative to overseas.

III Demand and output

A20 According to the latest ONS release, quarterly growth of GDP at constant market prices had been unrevised at 0.0% in 1999 Q1. But the annual rate had been revised up by 0.1 percentage points to 0.7%, and there had been revisions to the expenditure composition of growth in Q1. No revisions had been made to previous quarters, pending the release of the full 1999 Q1 National Accounts. Stronger

household consumption and investment in Q1 had been offset by weaker contributions from net trade and stockbuilding. The difference between final domestic demand and GDP growth had widened in Q1.

A21 Quarterly growth of gross value added at constant basic prices had been revised up from -0.1% to 0.0%, with service sector growth revised from 0.2% to 0.4%, largely the result of an upward revision to the transport and communications sector (up from 0.2% to 1.3%). Excluding the erratic energy and agriculture sectors, the quarterly growth rate of GDP had been 0.2%.

A22 Household consumption growth in Q1 had been revised up from 1.1% to 1.4%, the highest quarterly growth rate since 1997 Q2. Within this, spending on vehicles, household goods, clothing and footwear, and financial services had been particularly strong. The strength of spending on vehicles had probably been affected by the timing change to new vehicle registrations. But this had not accounted for all the strength in spending in Q1.

A23 Government consumption growth had been unrevised at 1.4% on the previous quarter. Investment growth in Q1 had been revised up from an unexpectedly low -1.7% to 0.0%. Higher business investment, revised up from -2.0% to 1.7%, had offset a sharp fall in general government investment (-19.2%). The increase in investment had been concentrated in the service sector.

A24 On the income side of the accounts, the gross operating surplus of corporations had been revised up from -3.2% to -3.0%. The sharp fall in Q1 had been the largest since 1974 Q1, and was the result of a 4.2% fall in private non-financial corporations, only partially offset by a 4.8% rise in financial corporations. The fall in gross operating surplus had looked sharp, relative to survey evidence and profits warnings, but the inclusion of the alignment adjustment had had a downward effect on the growth of the gross operating surplus. Excluding the alignment adjustment, the gross operating surplus of private non-financial corporations was flat, although the annual rate was little different (at around 5%).

A25 The contribution from stockbuilding to GDP growth had been revised down

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

A26 The Bank's regional Agents had conducted a survey of their contacts about trends in stock-to-output ratios, both in the recent past and looking to the future. The contacts had been from the manufacturing, retailing and wholesale sectors. The Agents had asked how firms' stock-to-output ratios had changed over the last five years. The majority of respondents (56%) had reported falling ratios. When the responses had been weighted according to firms' turnover, the balance of those reporting rising and falling ratios had been more even. A majority of retailers had reported a rise in stock-to-output ratios on this basis, while manufacturers had continued on balance to show a fall.

A27 The Agents had also asked about the future trend of stock-output ratios over the next few years - excluding cyclical influences. A clear majority of respondents had expected their stock-output ratios to fall. This result had been seen across all three sectors. In the retailing sector, increased competition, pressure on profit margins and improvements in information technology had been seen as the drivers of the expected reduction in stock levels as a proportion of sales. A majority of respondents had expected future falls in stock-output ratios to be similar to those in the past, with the exception of retailers.

A28 The contribution of net trade to GDP growth had been revised down to -0.7 percentage points from -0.5 percentage points. This had reflected an upward revision to import growth, from 0.3% to 1.1%, which had more than offset the upward revision to export growth (from -1.4% to -1.0%). The Q1 net trade deficit, at 4.5% of GDP, had been the second highest on record.

A29 Retail sales volumes had risen by 1.0% in May, following a revised fall of -0.3% in April. The three month growth rate (on the previous three months) had risen from 0.6% to 1.1%. The CBI Distributive Trades survey had suggested continued strength in June with the balance on reported sales at +22, up from +11 in May. The GfK measure of consumer confidence had suggested robust spending growth in Q2;

the index had been broadly unchanged in June at 5.8.

A30 Most indicators had suggested continuing strength in the housing market. The Nationwide house price index had risen by 0.8% in June; the Halifax index had risen by 1.8%. The annual rates of the two indices had moved closer, at 7.5% and 6.6% respectively. Housing starts had continued to rise from their trough in the autumn of 1998, and the House Builders' Federation survey balance on net reservations had remained at a strong level despite a slight fall in May. The improvement in starts was expected to feed through to higher completions and investment in dwellings over time. Particulars delivered in the three months to May had risen by 3.5% compared with the previous three months, but were 5.4% up on a year earlier. The Royal Institute of Chartered Surveyors' survey had shown a rise in the number of sales per agent in May for the second consecutive month.

A31 Construction output had risen by 0.2% in 1999 Q1 and had been broadly flat over the last three quarters. The volume of orders for new work had been slightly weaker over the last two quarters, but was expected to underpin construction output in the short term. The Chartered Institute of Purchasing and Supply (CIPS) construction survey had indicated rising optimism and orders: the construction activity index had risen to 64.5 in June from 62.4. Within this, housing activity had risen faster than total construction, consistent with the pick-up in housing market indicators.

A32 The outlook for manufacturing output had improved in June. The CIPS activity index had been above 50 for the third consecutive month. The expected output balance from the CBI survey had been positive in June, for the second month running. The CBI new orders balance had fallen slightly in June, with manufacturers citing the strong pound and weak European demand. Industrial production had risen by 0.1% in May. The CIPS services activity index had been broadly unchanged in June at 56.6. The new business index, at 58.5, had been at its highest level since March 1998.

IV The labour market

A33 Employment growth, as measured by the Labour Force Survey (LFS), had

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

A34 Turning to survey information, the CIPS manufacturing survey for June showed that employment had fallen further during the month, though the rate of decline had slowed. In the construction and service sectors employment had expanded further, and at slightly faster rates than they had in May. The Manpower survey of employment prospects for Q3 had shown little change, with the service and public sectors weaker and the manufacturing sector stronger. Information from the Bank's regional Agents suggested that further manufacturing redundancies would be offset by job creation in services, especially in the hotel and transport sectors, where the Working Time Directive was having a significant impact.

A35 Data problems persisted with the stock of unfilled vacancies in Northern Ireland and the West Midlands. Notifications of vacancies had fallen by 15,700 in May, although the trend had been flat. Overall, there had been no clear news in the vacancies data.

A36 Both measures of unemployment had fallen. LFS unemployment had fallen by 23,000 to 6.2% in February-April, while the claimant count had fallen by 6,500 in May with the rate unchanged at 4.5%. On both measures, unemployment rates had changed little since mid-1998. The latest fall in LFS unemployment had been mainly among the short-term unemployed. Long-term unemployment had been flat. Changes in the regional pattern of unemployment had been consistent with the strong growth in service sector activity and the decline in manufacturing activity.

A37 Inactivity had risen by 25,000 in the three months to April compared with the previous three months, which represented the first increase since mid-1998. This increase had been driven by a rise of 50,000 in the number of people who did not want a job.

A38 Annual headline earnings growth for the whole economy had fallen from 4.8% to 4.6% in April. The fall in the headline rate was accounted for by private sector earnings growth, which had fallen by 0.4 percentage points. Public sector earnings growth had risen by 0.1 percentage points. The fall in private sector earnings growth had been particularly surprising given the introduction of the National Minimum Wage (NMW) in April, which had been expected to push up earnings growth. However, it was possible that some firms may have anticipated its introduction and had raised wages before the introduction date. The largest fall in earnings growth was in the services sector, where earnings had fallen 1.1 percentage points in the twelve months to April. In manufacturing, on the other hand, annual earnings growth had increased by 0.2 percentage points. The ONS had said that the fall in earnings growth was partly the result of a broadly based fall in bonuses in the business services sector, and partly the result of some firms paying their bonuses in Q1 rather than in April, as they had done last year.

A39 Information from private surveys had suggested that earnings growth was either flat or had fallen slightly. The Reward index had fallen from 3.9% in April to 3.6% in May. The Federation of Recruitment and Employment Services survey on salaries and wage rates in June indicated that earnings growth was unchanged, although the survey was based on a small sample.

A40 Wage settlements in May had changed little from the previous month. The twelve-month mean for the whole economy had been unchanged at 3.8%. The private sector mean had fallen by 0.1 percentage points to 3.7%, while the public sector mean had been unchanged at 4.1%. In a matched sample, the mean private sector wage settlement in April had fallen by 0.6 percentage points from the same time last year, somewhat less than the fall in inflation expectations over the same period.

A41 The annual growth rate in the ONS measure of labour productivity in Q1 had

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

V Prices

A42 The Bank's index of commodity prices including oil had risen by 0.6% in May, following strong rises in March and April. The index excluding oil had also risen, by 0.2%. But annual inflation in both indices had fallen: to 3.4% (from 4.0%) for the oil-inclusive index and 1.4% (1.7%) excluding oil. The oil price had risen slightly over the month and exceeded \$18 per barrel on 6 July.

A43 Producer input prices had fallen by 0.5% in May and the year-on-year inflation rate had fallen back to -2.6% from -1.1% in April. Imported materials prices had continued to fall. Evidence from the CIPS survey had suggested continued but slowing deflation in the near future. The output price level, whether including or excluding excise duties, had been unchanged in May. Total import prices had risen by 0.2% in April, but prices for imports from the non-EU countries had fallen by 0.1% in May. Export prices had risen more sharply - by 0.7% to all countries in April and by 0.5% to non-EU countries in May.

A44 The rate of GDP deflator inflation in the first quarter had been revised up by 0.1 percentage points on both a quarterly and annual basis (to 0.4% and 2.2% respectively) in the third release of the GDP data. The retail sales deflator fell for the third consecutive month in May, leading to negative annual inflation for the first time in the series' history. The annual rate of inflation on the harmonised index had fallen

by 0.2 percentage points to 1.3% in May, equalling its lowest rate since the series started in 1988.

A45 The annual rate of RPIX inflation had fallen sharply, to 2.1%, in May. The rates of RPIY and RPI inflation had also fallen to 1.5% and 1.3% respectively. The fall was largely due to lower food and other goods prices, and had continued the recent pattern where goods price inflation had fallen but services inflation had remained fairly constant. Inflation in April and May had been markedly weaker than the central projection in the *May Inflation Report* forecast. This was entirely because of goods price inflation.

VI Reports by the Bank's Agents

A46 The Bank's regional Agents had reported on their general discussions with contacts. The manufacturing recovery had been fragile, but business expectations had improved. And whereas business and financial services had shown ongoing growth, the outlook for consumer services had remained weak.

A47 Retail sales had stayed weak. Only discount stores had recorded significant strengthening in activity. Generally, discounting had continued to be widespread. The evidence for other non-retail consumer expenditure had been mixed.

A48 Exports to the United States had continued to be strong. The East Asian market on the other hand remained depressed, though the outlook had improved. Demand from Europe had remained weak, particularly from Germany and Italy. Sterling's persistent strength was seen as the main obstacle to rising European orders.

A49 Manufacturing employment had fallen further, in contrast to the service sector where employment intentions had firmed. Skill shortages and pay pressures had persisted.

A50 Overall, the view had been that activity in Q2 had turned out stronger than in Q1, though the latter had been perceived as very weak.

VII Market intelligence

A51 Short-term expectations for UK interest rates had fallen since the previous MPC meeting. For longer maturities, however, rates had risen by around 40 basis points, having been up by 70 basis points or so at one stage. Changes in the shape of the yield curve could be partially attributed to international influences, such as the decision by the FOMC to raise rates, and to shifts in the market's view on UK entry to EMU and hence the future path of UK rates. In the more immediate future most market participants did not expect a further cut in the repo rate this month, given the retail sales data, evidence from surveys and house price data, although some believed that it was possible in the next few months if inflation continued to be below expectations.

A52 Sterling had, over the last month, continued to depreciate against the dollar, reaching its lowest level since September 1996, with talk that it had moved into a new trading range. The changing pattern of differentials in official interest rates internationally was thought by many to be an important factor, as were signs of growth in other economies. For these reasons corporate demand for sterling had been less apparent at these levels than before. Data from options markets had suggested that the market saw risks as being on the downside for sterling against both the euro and the dollar.