

Publication date: 22 September 1999

MINUTES OF MONETARY POLICY COMMITTEE MEETING

7 and 8 September 1999

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

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9909.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 6 and 7 October will be published on 20 October 1999.



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

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

The world economy

2 The Committee discussed whether recent news might cause an upward revision to the projections for world activity and prices. In the United States, domestic demand was still strong, but had started to slow. Indeed, it was possible that US growth would be lower than assumed in the August *Inflation Report* projections. There were signs in the non-farm payroll data of slower employment growth. Final domestic demand had, however, slowed less sharply. There were also some signs of incipient inflationary pressures: some commodity prices had risen, hourly compensation had accelerated and there had been a pick-up in producer prices. The Federal Reserve had recently raised official interest rates by 0.25%.

3 Some of the activity data for the euro area were perhaps a little stronger than had been expected a month ago. They supported the strengthening recovery built into the forecast.

4 In Japan, there was evidence of a sharp fall in corporate investment in the second quarter. Despite this weakness, which was thought likely to be reflected in the forthcoming Q2 GDP release, other forecasters' projections for Japanese GDP growth in 1999 continued to be revised up. There was also a perception that the authorities would take further fiscal action if needed – as an insurance policy if the recovery faltered. There were signs that deflationary pressures might be easing – the rate of change of the core CPI was essentially flat.

5 The recovery in the rest of Asia had been stronger than had previously been expected, and activity in Brazil and Russia somewhat less weak; though offset to some extent by events in some smaller South American countries. But the environment continued to be fragile, with interest rate spreads remaining at high levels.

6 One question was whether the likely pattern of trade balances in the major industrial countries would give rise to significant exchange rate movements. For example, would the growing US trade deficit lead to a depreciation of the dollar? It was possible that the markets might test the level of the yen against the dollar, with the yen rising and possibly taking the euro with it. Since one of the factors behind the recovery in confidence and activity in the euro area had been the depreciation of the exchange rate, such a move might risk a weaker outlook for the euro area. This in turn would have implications for the United Kingdom, though it would depend in part on what happened to sterling if the dollar depreciated against the yen and the euro. But the link between trade accounts and exchange rates was far from automatic.

7 The Committee noted that other forecasters' projections for world activity had generally continued to be revised up over the past few months, bringing them broadly into line with the Committee's August *Inflation Report* projections. Although the recent data might not point to a significantly stronger outlook for world activity than assumed in August, there were now signs that gave the Committee greater confidence in its projection of a robust recovery in world activity.

Monetary and financial conditions

8 Broad money growth was now at its lowest since 1993. This was largely accounted for by falls in other financial corporations' (OFC) deposits, rather than changes to money holdings of households or non-financial corporations. The fall in money holdings of other financial corporations was also reflected in a fall in their bank borrowing - both sides of the balance sheet were shrinking. However, the sector was heterogeneous and there seemed to be no single explanation. Although there might be lags, the adjustment did not seem well correlated with a possible reduction in the appetite for risk following the events of last summer and autumn. Another possibility was that the recent falls in deposits were in part a reaction to heavy borrowing through bond markets in advance of the Millennium. In any event, the rapid rise in these deposits and loans in earlier years had been difficult to explain. Overall, the changes to OFC money balances were not well understood and warranted continued investigation. As in the past, the Committee judged that developments in OFC money holdings were likely to have little impact on inflation. As well as focusing on growth in non-OFC money, it was noted that Divisia money continued to grow at around 7%.

9 Narrow money had been growing at around 8%, and this seemed somewhat faster than could be explained entirely by earlier reductions in interest rates. The question was whether the

signs were of faster growth than thought a month ago. Recent money growth probably presaged faster growth in consumer spending over the next few months, or was at least consistent with the pace of consumer spending growth that had already been seen.

10 Household credit growth had been strong, with short-run growth rates exceeding 8% on an annual basis. Estimates of mortgage equity withdrawal in Q2 were the highest since Q2 1991, but were considerably below the levels of the late 1980s. House prices had risen sharply again in August, and the annual rate of increase was now nearly 10% on both the Halifax and Nationwide measures. Although there remained many regional differences, it was no longer correct to describe the rise as being accounted for by a few isolated hot spots. It was difficult to estimate exactly how much the previous reductions in interest rates had fed through to house prices – some rise was to be expected despite the forthcoming abolition of tax relief on mortgage interest payments. For the recent rise in house prices to be accounted for by lower interest rates, people would need to have focused primarily on recent movements in short-term interest rates.

11 It was possible that the transmission mechanism was faster than previously thought, and that the recent rise in house prices simply reflected a more rapid adjustment to a new level following previous reductions in interest rates. But if it were not faster, then it was likely that there was more to come from previous reductions in interest rates, and that other factors had been responsible for the current rapid rate of increase. For example, employment had continued to grow – and with it labour income – and consumer confidence had increased.

12 The current level of the house price to average earnings ratio was only slightly above its long term average. Financial liberalisation probably raised the level of house prices through the 1980s, while the reduction in mortgage interest relief since the mid-1980s might have somewhat reduced the level of house prices. It was possible that the fall in the average level of nominal interest rates in recent years would, over time, lead to a rise in the house price to average earnings ratio. So it was difficult to know what the equilibrium house price to earnings ratio should be. Of more concern than the current level of house prices was the recent rate of increase. If the current rate of increase continued, the ratio would soon be well above the profile assumed in the August *Inflation Report*. There was also uncertainty about the size of the effect on domestic demand associated with the current strength of house prices and activity. As measured by indicators such as particulars delivered, activity was now stronger than at any time since the early 1990s. There remained a big stock of, as yet unused, mortgage approvals. Although the current state of the housing market was not like that reached in the late 1980s, the

recent indicators meant that the Committee's concern about the possible implications for inflation of housing market developments was rising.

13 Turning to other financial prices, the gilt yield curve was now sharply downward sloping at maturities of five years and beyond. It was likely that the level of long term interest rates partly reflected the effects of the minimum funding requirement. The sterling effective exchange rate index was very close to its level at the time of the August meeting.

Demand and output

14 GDP growth had been unchanged from the preliminary estimate in Q2, at 0.5%. A breakdown of the expenditure components had now become available. Final domestic demand growth had turned out somewhat stronger than expected in the *Inflation Report* central projection. This was largely accounted for by stronger consumption growth. Part of this strength might be explained by the change in practice concerning new car registration dates this year, but the strength in consumption seemed more widespread than this. The latest indicators seemed to suggest that strong consumption growth had continued into the third quarter.

15 One possible explanation for stronger consumption was that there had been deeper than expected price discounting, reflecting the previous slowdown in activity after last summer. This might lead to an increase in the level of real consumption, but it did not necessarily imply that strong consumption growth would continue. There was, however, little direct evidence of deeper than expected discounting, although this would be consistent with the weaker than expected outturns for RPIX and the retail sales deflator. However, it was possible that as the economy recovered any such discounting would be reversed. In that case the time profile of profit margins would be a little different from what had been expected in August, so there would be only a temporarily depressing effect on inflation. There was little direct evidence available on the behaviour of profit margins across the economy, so it was particularly difficult to distinguish between these two possibilities.

16 Inventories had made a much larger negative contribution to GDP growth than had been expected a month ago. That seemed consistent with the stronger outturn for consumption, and might indicate an involuntary reduction in stocks. However, the survey data from the CBI and CIPS had shown few signs of a substantial involuntary reduction. If the reduction in inventories had been in response to stronger than expected consumer demand, then the implication might be stronger demand and output growth through the second half of the year than assumed in the

central projection of the August *Inflation Report*. Although there was uncertainty about the appropriate level of the stock-output ratio, it seemed likely that the larger than expected negative contribution in Q2 reduced the risk of significant destocking in the future.

17 Although consumption had turned out stronger than expected, this had been offset to some extent by weaker investment. Public sector investment was continuing to undershoot spending plans, although this should be made up either later this year or in future years and in any event was a fairly small percentage of total investment. Most of the investment weakness was in private business investment, especially in the manufacturing and distribution sectors. There was a possibility of a Millennium-related slowdown in investment growth and the Bank's regional Agents had found some evidence of a 'Millennium pause' in IT-related investment.

18 Net trade had made a slightly stronger contribution to Q2 growth than had been expected at the time of the August meeting. This reflected weaker than expected imports and somewhat stronger exports. It was difficult to read too much into these figures given their volatility from quarter to quarter.

19 Surveys seemed to be pointing to a slight rise in the quarterly growth rate of GDP in the third quarter, which was consistent with the central projection in the August *Inflation Report*. But the current annualised rate of growth of final domestic demand of around 4½% was unsustainable. It was noted, however, that the growth of nominal domestic demand had, slowed in recent quarters. At some point final domestic demand would have to moderate to allow room for an improvement in the external environment feeding through to net trade.

Labour market

20 Employment growth had continued to slow, but unemployment was still falling. The Labour Force Survey measure of unemployment had now reached its lowest rate since the series started, at 6.0%, while the claimant count had fallen to its lowest level since 1980. The FRES survey pointed to increasing shortages of permanent and temporary staff in August. The Bank's regional Agents had also noted tightness returning even in some lower skilled areas. But not all the quantity indicators pointed to greater tightness. It was noted that there had been a reversal in the path of inactivity, which had risen in Q2.

21 The latest earnings figures had been difficult to interpret. The Average Earnings Index (AEI) had shown a marked pick up to 5.2% in June compared with 4.1% in May and 4.0% in

April, with the three-month headline rate consequently at 4.4% in June. The latest outturn for the AEI meant that earnings growth had turned out somewhat higher than the starting point used in the August inflation projections. That need have little consequence for inflation looking forward, unless the recent outturn affected the view of the future profile for earnings. It was noted that the Committee's best collective judgment of the central projection for earnings growth made at the time of the August *Inflation Report* was now towards the bottom end of the range of other forecasters.

22 It was difficult to know what was the underlying trend in earnings growth. The higher June figure was influenced by bonuses. But the change in the ONS form for the reporting of bonuses earlier this year meant that an unaffected year-on-year comparison would not be available until early next year. By contrast with the AEI, the Reward index had shown earnings growth continuing to slow. Settlements also continued to fall gently on the twelve-month employment-weighted measure, to around 3½% in July. However, after allowing for changes in inflation expectations, real settlements and earnings growth had probably continued to increase.

Prices and costs

23 Turning to prices and costs, some input prices were now moderately stronger, while output and retail prices remained weak. RPIX, for the fourth consecutive month, had been below the target.

24 The Brent oil price had averaged over \$20 per barrel in August, and was well above \$21 by the time of the meeting. That compared with an assumption of \$17 for the price over the next two years, which was the best collective judgment in the August *Inflation Report*, although some members had opted for a higher assumption of \$19 in August. The forward price was somewhat below the spot price, but had continued to be well above \$17. However, the forward price had not typically been a good predictor of the future spot price. If the oil price remained at its current level it would imply higher retail prices than incorporated in the August projections.

25 The Bank's commodity price index had recently been reweighted and this had led to a slight reduction in the level of the index. The reweighted index, like the old, showed an increase in commodity prices over recent months. Commodity prices rose again in July on both the aggregate and non-oil indices.

26 Manufacturing input prices were now rising in annual terms for the first time since 1996, as the downward pressure from sterling's past appreciation and falling world commodity prices had largely worn off. Manufacturing output prices had also been rising gently, but were still falling after stripping out food, beverages, tobacco and petroleum. The rate of increase of the GDP deflator had turned out at historically low levels in Q2, at 1.5%. Retail price inflation excluding mortgage interest payments had been constant at 2.2% in July, a little below the rate in the central projection. The headline inflation rate had fallen further to 1.3%, its lowest rate since 1993. These recent low inflation outturns could have some effect on inflation expectations going forward, but it was unclear how much or how long-lasting they would be.

27 There was a risk that commodity prices might turn out higher than assumed a month ago if world demand strengthened and if the rise in the oil price was sustained. In addition, some of the unexpected weakness in retail price inflation over the past few months had been accounted for by seasonal food prices, which were hard to predict. However, the prospect of increasing competition, for example in food retailing, might work to reduce the price level. There were also prospective regulatory effects in the water and electricity industries. Overall, there seemed no strong reasons for changing the general shape of the short-term saucer-shaped projection for inflation made at the time of the August meeting.

Other considerations

28 There had been some discussion outside the Bank of whether, in the run-up to the end of the year, concern about Y2K problems would impose a constraint on monetary policy authorities adjusting interest rates. This debate seemed to be more widespread in the press than in the financial markets, whose main focus remained on the provision of liquidity. The Committee could see no reason why this should constrain UK monetary policy setting, and monetary policy would continue to be set, on the basis of the news from month to month, with a view to achieving the inflation target.

29 The Committee noted that the markets were attaching a low probability to a change in interest rates this month. In that context, the Committee discussed the pros and cons of moving interest rates by less than 25 basis points. Smaller changes might signal, in appropriate circumstances, the Committee's concern with the outlook for inflation, but with less of an effect on the exchange rate. Continuing the practice of changing interest rates in units of 25 basis points might make it increasingly difficult ever to change that practice. But a smaller

change in interest rates might be seen as excessive fine-tuning. Markets might also expect that a further move in interest rates would follow such a small change.

The immediate policy decision

30 In focusing on the data it was difficult to see many indicators, at least on the output side, that were not generally stronger than they appeared a month ago. The question was the extent to which these data affected members' forecasts and how they judged the relationship between output and inflation in the medium term.

31 Some members preferred no change in interest rates this month. In August they had favoured a lower central projection than the best collective judgment shown in the *Inflation Report* fan chart. On one view, there had been little news since then to alter this judgment. The international situation was developing much as expected, though perhaps a bit weaker in the US and stronger in Japan. UK output growth was recovering, but was still growing below trend, investment was weak and manufacturing output had not even recovered to its level of a year ago. Furthermore, RPIX remained below target and broader price measures such as the deflators for retail prices, for consumption and for GDP were all lower than expectations or recent history. This supported the view that competitive pressures on prices and margins were exerting a stronger downward pressure on inflation, even during conditions of robust domestic demand, than in the past. The recent rise in house prices was unlikely to develop into the type of consumption boom seen in the late 1980s, given the overheated position of the economy then and the stimulus to housing from financial liberalisation and fiscal changes. On this view to raise interest rates now would be premature, and could have adverse effects on the exchange rate and thus damage the recovery in growth that was necessary to return inflation to target.

32 A second view among those favouring no change this month was that the news on the month had probably shifted the central projection up a little towards August's best collective judgment, primarily because of stronger labour market data and the change in tone of the Agents' reports. The risks of higher inflation from the effect of the strong housing market on domestic demand had also increased. But against this there was an argument that sterling might be stronger than assumed in August. The possibility of growth surprises in the UK relative to overseas might now imply some additional upward risk to sterling, even relative to the random walk convention. Business confidence was still fragile. A rate rise would probably be associated with a larger-than-normal appreciation of sterling. It would therefore be preferable to wait to give growth a chance to get established. In recent years, the US had

experienced high rates of GDP growth and a significant rate of appreciation in the stock market, without it yet leading to the higher CPI inflation that might have been expected from standard historical relationships. It might therefore be inappropriate to assume that the higher GDP growth and increase in house prices that we were seeing in the UK would necessarily lead to as much of an increase in RPIX inflation as was predicted by historical relationships. The saucer-shaped inflation projection, and the fact that forward-looking indicators of output prices were still benign, allowed time to see how the activity-price relationship was evolving before contemplating any action.

33 A majority of members favoured an increase in interest rates of 25 basis points this month, although one of them saw some attractions in a smaller increase. Various arguments were identified for a rise. Since the August meeting, new data showed that the pace of final domestic demand growth in 1999 Q2 was faster than expected. The current pace of final domestic demand growth could not be sustained indefinitely, and action would be needed to restrain that growth in order to meet the inflation target in the medium term. Consumption growth, together with the fall in inventories, probably indicated faster demand and output growth than previously expected in the second half of the year. The recent strength of the housing market and associated credit data were reasons to believe that consumption growth would remain strong. Growth in narrow money had continued to pick up and the labour market had continued to tighten, with the tone of reports from the Agents on conditions in the labour market reflecting this. Real wages had continued to grow increasingly strongly on most measures. It was recognised that an increase in interest rates now carried some risks. It might damage consumer and business confidence. Given that there was little expectation of an interest rate rise in the markets, there could be a further appreciation of sterling, which would tend to depress further activity in the tradable sectors of the economy. The saucer-shaped projection for inflation provided some time to see how some of the puzzles about the short-run trade-off between nominal and real variables might be resolved. But there was an argument for an early increase in interest rates because there was merit in seeking to adjust expectations now rather than later, when more might otherwise need to be done to have the same effect in slowing domestic demand in order to achieve the inflation target.

34 Of those Committee members favouring an increase, some had taken the view in August that prospective inflation was likely to be somewhat stronger than the profile in the *Inflation Report* fan chart. The news over the past month – including developments in the oil price, consumer demand, the housing market and the labour market – had together further strengthened the medium-term inflation outlook. In the absence of compelling tactical

considerations to the contrary, these members shared the view that a 25 basis point increase in interest rates was needed now to keep prospective inflation in line with the target.

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

36 The following members were present:

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

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 3 September, in advance of its meeting on 7-8 September 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 US outlook had remained robust, despite a slowdown in GDP growth in Q2. Forward-looking indicators for the euro area had picked up, and there were signs of a more stable outlook in Japan. Growth projections for Asia and Brazil had been revised upward.

A3 In the United States, the Federal Open Market Committee had raised both the federal funds target rate and the discount rate by 25 basis points, to 5.25% and 4.75% respectively on 24 August, but had maintained a neutral stance on the outlook for policy in the near term. The preliminary estimate of quarterly GDP growth in Q2 had been revised down to 0.4%, though final domestic demand growth had remained robust, as reflected by a further widening of the trade deficit in June. The three-month on three-month growth rate of retail sales had fallen to 1.5% in July, and consumer confidence had fallen in August, though it remained strong. The outlook for industrial activity had improved, with both production and durable goods orders strengthening and industrial confidence remaining robust. The business inventories to sales ratio had fallen to an historically low level. Quantities data had suggested that the labour market remained tight, but evidence of rising labour cost pressures had been mixed. In Q2, hourly labour compensation growth had risen, and productivity growth had fallen. Annual average hourly earnings growth had fallen in August. Consumer price inflation had remained subdued, though there had been some evidence of higher pressures on producer prices.

A4 French preliminary GDP had risen by 0.6% in Q2. Industrial production data had pointed to weak GDP growth in Q2 in Germany and Italy. But industrial confidence in the euro area had risen in July, with the west German IFO index rising for the third consecutive month. In both Germany and Italy, domestic orders had been recovering, and foreign orders had improved. And, for the euro area as a whole, export expectations had risen. Euro-area consumer confidence had

rebounded in July, reflecting an improvement in expectations of the future general economic situation. Annual M3 growth had remained not far from the European Central Bank's reference value of 4.5%. Credit growth had moderated somewhat but remained strong, rising at an average twelve-month growth rate of 10.5% during May to July. Euro-area consumer price inflation had risen to 1.1% in July from 0.9% in June, mainly due to food and energy price rises.

A5 Japanese economic data had, for the most part, been weak during the month, though the outlook appeared to be stabilising. The Ministry of International Trade and Investment's GDP proxy measure had fallen by 0.4% in Q2 after a 1.3% rise in Q1 (the official measure of GDP had risen by 2.0% in Q1, after a 0.1 percentage point upwards revision). The Ministry of Finance's capital spending survey had shown a 13.4% fall in corporate investment on a year earlier in Q2. Construction orders by both the private and public sector had weakened. Consumer confidence had fallen in Q2, though it remained higher than in 1998. Household spending had risen by 0.7% in July, but this had failed to reverse the 2.3% decline in June. The outlook for consumption remained constrained by continued falls in employment. Inventory levels had fallen to their lowest level since 1991, suggesting that inventory adjustment might be nearing completion, and increasing the likelihood that industrial production would rise in Q3. There had been evidence that deflationary forces might be diminishing: base money growth had risen, and the annual rate of domestic wholesale price deflation had fallen.

A6 In the financial markets, the yen had appreciated over the month, by around 3% against the dollar and 5% against the euro. The Nikkei-225 index had been little changed over the month, despite continued net foreign purchases of Japanese assets. In contrast, equity prices had increased in the euro area. US bond yields had been little changed over the month. Swap spreads (and to a lesser extent corporate spreads) over Treasury bond yields had risen in recent months, though it seemed likely that at least part of this rise reflected factors other than a rise in perceived credit risk. Spreads on government bonds in emerging markets had been little changed since the August MPC meeting.

II Monetary and financial conditions

A7 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 7.7% in

August. The three-month and six-month annualised growth rates had remained high, at 8.2% and 8.0% respectively.

A8 M4 had fallen by £3.3 billion (0.4%) in July, and the annual rate of growth had slowed to 3.6%, its lowest since October 1993. M4 lending (excluding securitisations) had also been weak in July, with the annual rate of growth falling to 6.6%. The slowdown in both M4 and M4 lending had mainly been accounted for by other financial corporations (OFCs), though private non-financial corporations' (PNFCs) M4 deposits and borrowing had also been weak. OFCs' M4 deposits had fallen by £6.3 billion in July and the annual rate of growth had become negative (-5.6%) for the first time since 1992 Q1. Lending to OFCs had also fallen sharply in July, by £3.3 billion (1.7%). PNFCs' M4 deposits had fallen by £0.1 billion (0.1%) in July, and lending to PNFCs had fallen by £0.1 billion. However, while PNFCs had repaid sterling bank borrowing in each of the last three months, their total borrowing, including capital issues and foreign currency borrowing as well as domestic currency borrowing from banks, had increased in 1999 relative to 1998.

A9 The M4 deposits of the household sector had risen by £3.1 billion (0.6%) in July, and M4 lending to households (excluding securitisations) had risen by £4.3 billion (0.8%). The annual growth rate of M4 lending to households had risen to 8.2%, its highest rate since 1991 Q4. This had reflected the strength both of the housing market and of total lending for consumption (defined as unsecured lending plus mortgage equity withdrawal). The monthly flow of total lending secured on dwellings had risen to £3.4 billion, compared with an average of £2.8 billion in the first half of 1999. Monthly consumer credit growth had been 1.2% in July, resulting in an increase of 14.5% on a year earlier. According to provisional Bank estimates, mortgage equity withdrawal had increased sharply in Q2 to around £2.5 billion from £0.8 billion in Q1. On the basis of these estimates, total lending for consumption had been the largest in real terms since 1990 Q1.

A10 Interest rate expectations implied by longer-dated short-sterling futures contracts had fallen by around 10 basis points since the previous MPC meeting, though they had been volatile over the month. Medium and longer-term nominal forward rates had risen by around 10-25 basis points.

A11 UK swap spreads had risen in August. The ten-year swap spread had risen to around 0.9 percentage points, close to its highest rate since October 1998. However, corporate bond spreads had increased only marginally and were well below October 1998 levels.

A12 Real interest rates derived from the index-linked gilt market had risen by around 25 basis points since the previous MPC meeting, to just over 2%. A measure of the expected real interest rate in the year 2000, constructed using the Merrill Lynch survey of fund managers' inflation expectations, had risen by 40 basis points, to 3.8%, between the beginning of July and the beginning of August. Survey-based measures of inflation expectations had been broadly unchanged in August.

A13 The FT-SE All-Share index had risen by 1.5%, to 2975, since the August MPC meeting. Small-capitalisation stocks had continued to outperform the FT-SE 100. The sterling effective index had fallen by 0.1% since the August MPC meeting, to 103.2. Sterling had fallen by 1.0% against the dollar and had risen by 0.6% against the euro.

III Demand and output

A14 Quarterly GDP growth at constant market prices had been unrevised, at 0.5% in Q2. The annual growth rate had also been unchanged at 1.2%.

A15 Manufacturing output had grown by 0.3% in Q2, the first rise since 1998 Q2, but the level of output had still been more than 1% lower than a year earlier, and had fallen by 0.2% in June. Construction output had grown by 0.7% in Q2, but had still only been 0.5% above its level a year earlier. The weakness of the official construction data relative to the strength of the survey evidence had been a puzzle. Services output had grown by 0.4% in Q2, revised down from 0.5% in the first release, with annual growth at 2.3%, the lowest rate since 1992 Q4. Within services, the output of the distribution, hotel and catering, and business and finance sectors had been weak. But there had been continuing strength in transport and communications, mainly due to telecommunications.

A16 The expenditure breakdown of GDP had shown domestic demand growing by 0.3% in Q2, but changes in inventories had reduced growth by 0.8 percentage points. Growth in final domestic demand had been strong at 1%.

A17 Consumers' expenditure had grown by 1.3% in 1999 Q2, and annual growth had been 4%. Consumer confidence had risen further in Q2, and income and wealth had been robust. A breakdown of consumption growth had not yet been published, but retail sales had grown by 0.9% in Q2, and utilities output had risen by 1.4%. Within retail sales, household goods had been the fastest growing sector, possibly related to the pick-up in housing activity. The data had appeared to suggest a rise in the demand for cars, but caution was required because the pattern of spending on cars had been heavily affected by the changes to registration dates. New private car registrations had increased by 21% in Q2 on a year earlier. The Society of Motor Manufacturers and Traders had said that demand had been stronger than expected so far in 1999, partly stimulated by deals and incentives, but they still expected registrations for 1999 as a whole to be similar to those in 1998.

A18 Total investment had grown by 0.4% in Q2. Business investment had fallen by 0.7%, but had remained 10.1% higher than a year earlier. Within this, manufacturing investment had fallen by 4.2% and service sector investment had fallen by 0.3%. The corporate operating surplus had risen by 1.3% in Q2, but had fallen by 9.5% on a year earlier.

A19 Including the alignment adjustment, inventories had fallen by £1.8 billion in Q2, led by manufacturing and other industries. It had not been clear whether the decline in manufacturing stocks had been voluntary. The 1998 H2 rise in stocks had been more than unwound in 1999 H1. The Confederation of British Industry (CBI) quarterly survey in July had indicated a fall in stocks, with a balance of -20 reporting a rise in finished goods stocks, the lowest since 1991 Q4. The CBI monthly survey had reported that stocks were still more than adequate.

A20 Net trade had contributed 0.2 percentage points to GDP growth in Q2, the first positive contribution since 1997 Q3. Total exports had grown by 0.6%. The 1.1% rise in exports of goods had been more than accounted for by growth in exports to non-EU countries; exports to

the EU had fallen by 1.2%. UK imports of goods and services had fallen by 0.2% in Q2, despite the strength of final domestic demand.

A21 Turning to indicators of Q3 activity, manufacturing output had risen by 0.3% in July and retail sales volumes had risen by 0.1%. On a slightly longer view, retail sales growth appeared to be above trend. Retail sales had growth by 1.3% on the three months to July compared with the previous three months, and 2.9% compared with a year earlier. There had been far less of an upturn in retail sales values, which may have accounted for the more downbeat retail sentiment and the more subdued picture from the Agents. The CBI Distributive Trades survey had shown a balance of +33 respondents reporting higher growth in August, and the outlook for September had been for further growth. The GfK consumer confidence index had increased in August to +4.9, but the MORI measure of confidence (which was more volatile and had a smaller sample) had fallen to -12.

A22 House prices had risen strongly in August, with the Halifax measure rising by 1.1%, and the Nationwide measure by 2.5%. Housing activity had also continued to recover. Particulars delivered had risen by 5.8% in July and had been 11.3% up on a year earlier, to the highest level since September 1992 (but still well below the level of the late 1980s). The July House Builders' Federation survey had shown a net balance of +37 respondents reporting an increase in net reservations, and the Royal Institute of Chartered Surveyors sales balance had remained high at +31. Loan approvals data had been flat in the three months to July compared to the previous three months, but remained at a high level. Private housing starts had risen by 4% in July, but had fallen by 2% on a year earlier.

A23 Survey balances of manufacturing investment intentions had remained well below their average levels. The CBI Industrial Trends survey had shown output expectations balances up to +17, the highest level since October 1997. Orders had been around their average, at -22, but well below 1997 levels, and export order books had remained weak at -37. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey had shown continued growth in output, with the index at 57.2 in August. The survey had also shown modest growth in export orders, with the index at 52.6. The CIPS services survey had remained strong, at 57.3 in August, with financial services strongest, but computing and IT weaker. The CIPS construction index had also been strong at 60.8, with housing and commercial orders rising. Construction new orders had shown

slight growth over the latest three months (0.6%), but had been 2.6% below their level in the same period in 1998.

IV The labour market

A24 Employment growth had continued to slow. According to the Labour Force Survey (LFS), employment had grown by 43,000 (0.2%) in Q2, compared with Q1. This increase had been more than accounted for by a rise in full-time employment. The total number of hours worked had increased by 0.2% between Q1 and Q2, but average hours worked per person in Q2 had still been 0.7% lower than a year earlier.

A25 The August CIPS surveys had suggested that the rate of decline of manufacturing employment had slowed, but that employment growth in services and construction had eased slightly. The Federation of Recruitment and Employment Services (FRES) survey had indicated increasing shortages of permanent and temporary staff in August. But the latest reports by the Bank's regional Agents had suggested little overall change in labour and skill shortages. The stock of Jobcentre vacancies (adjusted for recent data problems) had remained broadly flat in July.

A26 Both official measures of unemployment had fallen. LFS unemployment had decreased by 62,000 in Q2, and the rate had fallen to 6.0%, the lowest since the series started in 1984. The fall had been largely accounted for by lower short-term unemployment; long-term unemployment had remained broadly flat. The claimant count unemployment rate had fallen from 4.4% in June to 4.3% in July.

A27 Labour market inactivity had risen by 58,000 in Q2, about half of which had reflected an increase in the number of people who said that they did not want a job. In an accounting sense, employment growth had been associated with falling inactivity over the past year or so. But in Q2, inactivity had risen, associated with falling unemployment. Recent movements in inactivity had been hard to explain in terms of economic factors.

A28 Whole-economy headline average earnings growth, a three-month moving average, had risen to 4.4% in June. The twelve-month growth rate of earnings had risen sharply, to 5.2% in

June, from a revised 4.1% in May and 4.0% in April, as private service sector earnings had increased markedly. The upturn between April and June had been affected by bonus payments. First, slower earnings growth in April and May 1999 had been to some extent the counterpart of unusually large bonuses in April and May 1998. Second, earnings growth in June had been boosted by bonuses paid by firms in the telecommunications sector, some of which had been paid in different months in previous years. A smoothed measure of earnings growth, generated using a statistical filter, had been 4.7% in June, although the profile of this measure tended to be sensitive to the arrival of new data.

A29 The August FRES survey had indicated a further rise in the earnings growth of permanent staff supplied by job agencies. But earnings growth as measured by the Reward index had fallen further in July. The Bank measure of twelve-month whole-economy settlements had been falling since the end of 1998, and had reached 3.5% in July. The three-month whole-economy measure had been relatively stable, at 3.2%, but service sector settlements had continued to fall. Other published measures had been somewhat lower than the Bank's in recent months, but some of these differences could be explained by the fact that outside measures were not employment-weighted. In contrast to nominal measures of settlements, estimates of the real value of settlements had been increasing.

V Prices

A30 The oil price had continued to rise. The one-month future price of Brent crude oil had reached \$21 at the end of August, over 100% higher than in December 1998. The average price in August had been about 9% higher than in July. Recent price rises had been driven by OPEC supply cuts, though stronger world demand had also been a factor. The Consensus Economics forecast was for prices to fall from these levels over the following months. In the past, oil price rises had normally been passed on quickly and fully to both output and retail petroleum prices.

A31 Excluding oil, there had been little change in the underlying picture for commodity prices. The Bank's index of commodity prices including oil had risen by 4.5% in the year to July; excluding oil, it had fallen by 2.7%. The index had been reweighted to reflect the pattern of UK demand in 1995. This has brought down the growth rates slightly in recent months, but overall had made little difference to the profile. Metals prices had increased markedly over the month.

A32 Producer input prices had risen sharply in July, by 3.4% compared with June, mainly due to oil prices, but also because of higher imported material prices. Annual input price inflation had become positive for the first time since 1996. Annual output price inflation had risen to 1.1%. The rise in output prices since the beginning of the year had been more than accounted for by rising petroleum product prices (reflecting both oil price and duty effects). Annual output price inflation excluding food, tobacco, beverages and petrol had remained negative. The CBI Industrial Trends survey had suggested that output price inflation would remain muted in the near future.

A33 The GDP deflator had increased by 1.5% in the year to Q2, its second lowest annual rate of increase since 1963. The annual inflation rate of household expenditure, which accounted for close to two thirds of GDP, had continued to slow, as had inflation in the domestic demand deflator. Both the import and export deflators had risen in the second quarter, but the annual inflation rates had remained negative. The retail sales deflator had been unchanged in July, on both a month and a year earlier. The RPIX and GDP-based measures of domestically generated inflation had fallen in the second quarter, to 3.6% and 1.7% respectively.

A34 RPIX inflation had remained unchanged at 2.2% in July. RPIY inflation had increased slightly to 1.6%. HICP inflation had fallen by 0.1 percentage points to 1.3%. Insurance and tobacco prices had made the largest positive contributions to the change in RPIX inflation; household goods, housing depreciation and food prices had made the largest negative contributions.

VI Reports by the Bank's regional Agents

A35 The Bank's regional Agents reported that, overall, the pace of recovery had been gathering some speed, but the picture had remained uneven, both sectorally and geographically. The recovery had appeared to be stronger in the south of England. Agriculture had remained weak. Growth in manufacturing output had been positive, but varied from sector to sector. IT and communications-related output had shown the strongest growth; most other sectors had recorded only modest growth. Construction output had remained at a high level, although in

some areas, growth appeared to have levelled off. Demand for housing had been rising in the south of England and in pockets elsewhere. Business and professional services activity had been strong. Overall, consumer demand had continued to grow steadily. The retail picture had been mixed: discount stores had continued to record stronger growth than department stores. Firms had reported that the worst had passed in overseas markets, although import competition had remained a problem. Order levels had improved as world demand had picked up.

A36 There had been evidence that, after a slight easing, labour markets in some areas had begun to tighten again. In parts of the South East and London, the demand for labour remained high. Any renewed pressure had not yet shown through in pay, although there was an expectation of higher settlements in the future. Recent wage settlements had been, on the whole, lower than a year ago, at around 2%-3% for manufacturing and 3%-5% for services. There had been some pay freezes, but also some significantly higher rises.

A37 Input prices had generally flattened out, although there had been evidence of increasing raw materials prices of metals and oil. There had been little change in manufacturing output prices. By contrast, upward pressure on services prices had remained noticeable at the higher value-added end. Retail price inflation had stayed low, kept down by competition and consumer spending behaviour. House prices had been rising, particularly sharply in areas such as London and the South East.

VII Market intelligence

A38 Short-term market interest rates had fallen a little since the August MPC meeting. But there had been larger intra-month movements, mainly reflecting US data releases and the publication of the *Inflation Report* and the minutes of the August MPC meeting. Rates implied by short sterling futures had continued to exceed those implied by surveys of economists' forecasts, but many fewer economists now expected any further reduction in official rates. And evidence from options suggested, if anything, an upside rather than a downside risk to market interest rates over the next year or so. Two main views of the likely future path of official interest rates had been expressed in the market, with one expecting a rise in rates this year and the other expecting no rise until next year, if at all. Particular issues highlighted had included the housing market, the divergence of the paths of real and nominal wages, the composition of GDP, and the expected

future path of interest rates in the United States and the euro area. Implied volatilities on short sterling futures had fallen on the days of publication of the *Inflation Report* and the minutes of the August MPC meeting.

A39 Movements in sterling over the month had been relatively small. Although some domestic data releases had differed from market expectations, these appeared to have had little influence on the exchange rate. Implied volatilities had been slightly higher than a month earlier. Survey projections for sterling against the euro had again suggested a higher degree of sterling depreciation than implied by the UIP path, based on relative interest rate differentials. But survey projections for sterling against the dollar had been broadly in line with the UIP path. Particular factors identified by market participants as influencing the prospects for sterling had included relative growth and monetary policy developments in the major economies, the UK trade figures and the volume of mergers and acquisitions flows.

A40 Bank staff explained that over the next few months the Bank's stock of refinancing was forecast to grow, reflecting the normal seasonal increase in the market's need for liquidity and the Millennium change. The Bank intended to introduce a temporary three month repo facility to supplement the usual two week operation. This facility had no significance for monetary policy. Any change by MPC in the official rate would result in a matching adjustment to the rate charged on outstanding three month repos.