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MINUTES OF MONETARY POLICY COMMITTEE MEETING 2 and 3 August 2000

These are the minutes of the Monetary Policy Committee meeting held on 2 and 3 August 2000.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0008.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 September will be published on 20 September 2000.



MINUTES OF THE MEETING OF THE MONETARY POLICY COMMITTEE HELD ON 2-3 AUGUST 2000

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

Demand and output

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

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

4 There had not been much change in aggregate public sector spending plans since the March Budget. The Chancellor's announcement since the Committee's previous meeting of the results of the Spending Review had, for the Committee's purposes, not substantially altered the overall picture, but it had added

detail on two things: a carry forward of £1.5 billion of underspend from 1999-2000, and an increase in planned departmental spending on account of lower expected debt interest and social security payments. It was also noted that government revenue was coming in higher than projected, though views differed on the extent to which this would depress aggregate demand.

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

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

7 More generally, given that the economy was currently – and was set to continue – operating close to capacity, an increase in public sector spending could be accommodated only if resources were released by a slowdown in private sector demand. A vital question, therefore, was whether that should be expected to occur autonomously at the current level of interest rates or whether a further tightening of policy might be needed to bring it about.

8 This would depend in good part on the outlook for private sector consumption. The indicators were mixed. On the one hand, some encouragement could be taken from developments in the determinants and indicators of household spending. House prices had decelerated faster than earlier expected, and the latest Royal Institute of Chartered Surveyors' survey showed a majority of estate agents expecting prices to fall. Domestic equity prices were hardly changed over the year so far. Wealth was, therefore, no longer rising at a rapid rate. Earnings growth had slowed and was expected to moderate further. The Bank's regional Agents reported that consumer demand seemed to be easing. On the other hand, the

level of wealth was still high; household borrowing – secured and unsecured – remained strong; real incomes were expected to continue rising, and unemployment to remain low. It was also noted that a more moderate pace of house price growth need not of itself entail slower consumption growth, as 1997-1998 showed. Overall, the Committee concluded that the saving ratio was likely to rise somewhat, reflecting both lagged effects from the past policy tightenings and also the assumption that households would want to strengthen their balance sheets. Consumption growth was, therefore, expected to moderate – only slightly compared with the first half of the year, but significantly compared to the past few years. Some members saw upside risks to the consumption profile.

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

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

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

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

International economic developments

13 The Committee briefly discussed international developments. The euro area continued to strengthen. Growth in the US had, yet again, been stronger than expected. There were, though, some signs of moderation, partly reflecting tighter monetary policy and equity prices being slightly down on the year. There remained a risk of persistent strong growth being followed by a ‘hard landing’, possibly triggered by or leading to a sharp adjustment in asset prices.

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

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

Money, credit and asset prices

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

17 The corporate borrowing and money numbers were a puzzle. Borrowing from banks and the capital markets was strong, but so was deposit growth. There were no clear sectoral stories to explain

the aggregate data. Recent strength in services sector borrowing was not obviously associated with investment growth.

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

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

The labour market

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

21 Over the past couple of years, employment had risen by well over half a million. Around half of this was accounted for by population growth. Of the remainder, falls in inactivity accounted for more than falls in unemployment. It was not clear whether that could continue, but some members were concerned that the latest projections agreed by the Committee did not allow for further falls in inactivity.

22 Another source of labour supply over the past few years had probably been immigration. For example, there were anecdotal reports of public sector health workers being hired from overseas. That might continue, in which case pressures on the labour market from an expanding public sector might be

contained. This was, however, difficult to assess quantitatively. The most up-to-date data suggested that net immigration had reached around 175,000 in 1998 – but the reliability of the data was uncertain. It was suggested that the 2001 census might cast light on this issue in due course.

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

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

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

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

Prices and costs

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

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

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

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

The August output growth and inflation projections

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

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

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

Tactical considerations

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

expected might lead to the view that rates would eventually go up by more than currently expected. That might increase any upward pressure on sterling, adding to the downward influences on inflation.

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

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

The immediate policy decision

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

38 Some other members preferred assumptions which would produce a lower central projection for inflation. In particular, improvements in the performance of the supply side of the economy would

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

39 Arguments were also advanced in favour of an immediate small increase in the repo rate. On this view, the news on the month pointed, on balance, to stronger conditions than had been apparent a month ago. If the GDP data for Q1 and Q2 were averaged, there was little sign of a significant slowdown. While most of the determinants of consumption had eased in recent months, household borrowing remained strong and it was not yet clear that private sector demand would slow quickly enough to offset the effects of increased public sector spending; the risks to inflation from consumption were on the upside. Measures of earnings growth had fallen, but it was very difficult to assess the underlying rate of increase. It was clear, though, that the labour market had continued to tighten. Employment had increased by ½% in the three months to May, and unemployment was lower than for a quarter of a century. The central projection assumed decelerating unit labour costs. The risks to inflation from earnings were therefore also on the upside. Other indicators of short-term cost pressures were clearly increasing, and inflation was now likely to undershoot the 2½% target in the short run by rather less than had been projected in the *May Inflation Report*. While sterling had risen since the Committee's July meeting, it was still about 4% below the path projected in the *May Inflation Report*; and there remained a risk of further falls since the economy was still relatively uncompetitive at the

current real exchange rate. It was conceivable that a structural shift in economy-wide margins was underway, but there was not much evidence of this yet; for this reason some members preferred a higher central projection for inflation than the best collective projection. While there were tactical arguments in favour of delay, given that the balance of risks to inflation was on the upside, and given that the market was expecting a modest tightening later in the year, the better course was an immediate increase of 25 basis points. For some this was a finely balanced decision.

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

41 The following members of the Committee were present:

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

Andrew Turnbull was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

I The international environment

A1 Evidence of a slowdown in the United States had been mixed. GDP had risen by 1.3% in Q2 following a rise of 1.2% in Q1. Investment had grown by 3.6% in Q2 after 3.9% in Q1. But quarterly consumption growth had slowed to 0.7% in Q2 compared with 1.8% in Q1. Exports had risen by 1.8% in Q2, but imports had risen by 4.0%, reflecting continued strong domestic demand. Private non-farm payrolls had risen by 206,000 in June, but total payrolls had risen by only 11,000, as 190,000 workers who had been temporarily employed on the Census finished their work in June. The unemployment rate had fallen to 4.0% in June from 4.1% in May. The Conference Board index of consumer confidence had risen to 141.7 in July from a revised 139.2 in June, and had remained at a historically high level. Annual consumer price inflation had increased to 3.7% in June from 3.1% in May, primarily because of higher energy prices. Core consumer price inflation had risen only slightly, to 2.4% from 2.3%. The employment cost index had risen by 1.0% in Q2.

A2 Recent data had shown further evidence of strong growth in the euro area. Euro-area GDP growth in Q1 had been revised up to 0.9% from 0.7%. Consumption growth, reported as flat in the first Q1 release, had been revised up to 0.7%. The revised data was more easily reconcilable with high levels of euro area consumer confidence and recent labour market trends. Available data for Q2 had pointed to a continuation of strong growth. Retail sales had grown by 0.2% in May after growing by 1.4% in April. Industrial production had risen by 0.8% in May, after growing by 0.6% in April. The unemployment rate had fallen to 9.1% in June from 9.2% in May. The German Ifo index had fallen to 100.4 in June from 102.0 in the previous month, but the euro-area business confidence balance had risen by three points in June. HICP inflation had risen to 2.4% in June from 1.9% in May, reflecting higher energy prices. Core inflation had risen to 1.3% in June from 1.1% in May.

A3 Japan's industrial production had grown by 1.7% in June, bringing the increase on the quarter in Q2 to 1.6%. And tertiary activity had grown by 0.5% in May. Retail sales had grown by 1.5% in June, while employees' cash earnings had risen by 0.8% in the year to June. Unemployment had risen to 4.7% in June from 4.6% in May. Against this, the ratio of new job

offers to applicants had risen from just under 1.0 to 1.1. Consumer prices had declined by 0.3% in June and by 0.7% in the year to June. In contrast, the wholesale price index had been flat on the month and was 0.3% higher on the year.

A4 Since the previous MPC meeting the price of Brent crude had fallen by around \$3 to approximately \$27 a barrel. The price for Brent crude futures maturing in August had fallen by around \$1.60, to \$28 a barrel. At longer maturities the futures curve had remained little changed.

A5 Since the previous MPC meeting the Wilshire 5000 and the DJ Euro Stoxx had fallen by 1.2% and 0.4% respectively, and the Topix had fallen by 7.4%. Short term interest rate expectations implied from futures contracts in the US had fallen slightly. In contrast, implied policy rates for the euro area had risen.

II Monetary and financial conditions

A6 The twelve-month growth rate of notes and coin had continued to fall, and was down from 7.5% in June to 7.1% in July.

A7 M4 had risen by £8.2 billion (1.0%) in June. This had raised the twelve-month growth rate to 6.8%, the highest for more than a year. Aggregate M4 lending (excluding the effects of securitisations) had remained strong in June, increasing by £5.4 billion on the month. The twelve-month growth rate had fallen slightly to 11.5% from the peak of 12.1% in May

A8 Households' M4 had increased by £3.9 billion (0.8%) in June. That had reflected a recovery from the weak growth in May. The twelve-month growth rate in June, at 5.5%, was still below the average growth rate during 1999.

A9 Households' M4 lending (excluding securitisations) had continued to be strong in June, increasing by £5.0 billion (0.9%). Within total lending to individuals, secured lending in June had been close to the strongest flow seen since the pick-up in the housing market last spring. Despite slightly weaker loan approvals figures in June, the number of approvals had remained robust.

A10 Private non-financial corporations' (PNFCs') M4 had risen by £0.9 billion (0.7%) in June. The twelve-month growth rate had increased to 9.0% from 6.3% in May. PNFCs' M4 lending

(excluding securitisations) had fallen by £0.9 billion (0.4%) in June. However, the twelve-month growth rate of PNFs' M4 lending had remained strong at 12.7%.

A11 The flow of external corporate finance had been £17.5 billion in 2000 Q2, up from £15.6 billion in 2000 Q1. The proportion of external corporate finance in the form of sterling bank borrowing had also risen in 2000 Q2. The quarterly industrial breakdown of bank lending showed that the majority of sterling bank borrowing by corporates in 2000 Q2 had been undertaken by service sector firms, continuing the trend seen since 1999 Q3.

A12 Holdings of M4 by other financial corporations (OFCs) had increased by £3.4 billion (1.8%) in June. The twelve-month growth rate was 9.0%, having risen by more than 14 percentage points between 1999 Q3 and 2000 Q2. Since 1999 Q3, the majority of this growth had been due to the increased money holdings of other financial institutions and financial auxiliaries (OFIFAs) rather than insurance companies and pension funds (ICPFs). OFCs' M4 lending had grown by £1.4 billion (0.6%) in June - the twelve-month growth rate had been 13.7%.

A13 Since the July MPC meeting, interest rate expectations, as measured by the two-week gilt repo curve, had risen by up to around 15 basis points. Longer-term nominal interest rates had risen by around 10 basis points since the July MPC meeting.

A14 The term structure of corporate bond yields had remained fairly flat since the July MPC meeting. Data on corporate bond issuance in July had shown that there had been a reduction in the proportion of corporate bonds issued at longer maturities. The spread of corporate bond yields over gilts had been increasing steadily since the beginning of the year. But the spread of corporate bond yields over swap rates had been broadly flat, suggesting that factors affecting the gilt market were at least partly responsible.

A15 Retail interest rates had been little changed since the July MPC meeting. It was noted that the structure of the mortgage market had been changing over recent years. For example, the average two-year discount offered on standard variable-rate mortgages had risen to around 170 basis points in July from an average of around 130 basis points in 1997-99.

A16 Survey measures of inflation expectations had changed very little since the July MPC meeting.

A17 The FTSE-100, the FTSE All-Share and the FTSE Small Cap indices had all remained broadly unchanged since the July MPC meeting. The UK IT sector, as measured by the FTSE techMARK index had risen by 4.1% over the month.

A18 Since the previous MPC meeting, the sterling ERI had appreciated by 2.3%, reflecting a 3.4% appreciation against the euro. Interest rate differentials could explain almost all of sterling's appreciation against the euro on the month, but could not explain sterling's 3.2% depreciation against the dollar since the July MPC meeting. Over a longer period, interest rate differentials could not explain sterling's depreciation since the May *Inflation Report*.

III Demand and output

A19 The preliminary National Statistics estimate of GDP growth in 2000 Q2 had shown growth picking up to 0.9% from 0.5% in Q1. Service sector output had grown by 1% in Q2, to 3.6% higher than a year earlier. Within services, the distribution, hotels and catering sector had grown by 0.3%. Industrial production had grown by 0.9% in the three months to May, and manufacturing output had grown by 0.3% over the same period.

A20 The total deficit on trade in goods and services had narrowed very slightly in May to £1.6 billion. Total export volumes had grown by 3.6%, and total import volumes by 2.7%, in the three months to May. Excluding oil and erratics, total export volumes had grown by 2.6% over the same period, and total import volumes had grown by 1.6%. Non-EU export volumes had risen by 5.6% in Q2, and non-EU import volumes had risen by 4.4%.

A21 Retail sales had grown by 0.7% in June and by 0.3% in Q2. Total new car registrations in the three months to June had risen by 0.1% on a year earlier, while private new car registrations had fallen by 7.5% over the same period. The retail indicator of the CBI survey of distributive trades had increased to +24 in July from +15 in June. The quarterly Consumers' Association survey of consumer confidence had increased to +37 in July from +33 in April. Against this, the GFK consumer confidence index had fallen to -2.0 in July, from +0.1 in June. The MORI index had increased to -10 in July, from -14 in June.

A22 The Nationwide house price index had fallen by 0.2% in July, but remained 13.9% higher than a year earlier. The Royal Institute of Chartered Surveyors (RICS) house price had survey balance had fallen to +5 in June, from +25 in May. The survey had suggested that prices had continued to rise outside London and the South East, although the rate of increase had slowed in several regions. The House Builders' Federation (HBF) house price survey had been virtually unchanged in June at +21. HBF net reservations had fallen to -17 in June, from -11 in May. Particulars delivered had fallen by 1.6% in June, but remained 3.6% higher than a year earlier.

A23 Public sector net borrowing in June had been £2.7 billion, compared with £2.6 billion in June 1999. Net borrowing had been £4.2 billion in 2000 Q2, marginally higher than in the same period last year. The Spending Review had included modest upward revisions to total managed expenditure reflecting a partial carry-forward of the underspend in the fiscal year 1999-00.

A24 Survey data on manufacturing investment intentions had been mixed. The British Chambers of Commerce (BCC) Quarterly Economic Survey had reported that the balance of investment intentions in manufacturing had increased to 12 in Q2 from 9 in Q1. On the other hand, the Confederation of British Industry (CBI) quarterly survey had reported a virtually unchanged balance of -21. BCC survey data for the service sector had showed that the balance of investment intentions had increased slightly, to 21 from 18 in Q1.

A25 Survey evidence on trends in stocks had been mixed. The July CBI industrial trends survey had indicated falling stocks balances. The CBI distributive trades survey for the same month had suggested that stocks had remained steady in Q2.

A26 The CBI and BCC surveys had shown a fall in orders to the manufacturing sector in Q2. However, there had been a rise in the headline index of the CIPS purchasing managers' survey of manufacturing to 51.8 in July from 50.4 in June. Other surveys, such as those by Dun & Bradstreet and Euler Trade Indemnity, had suggested slowing manufacturing activity in Q3. The Dun and Bradstreet and BCC surveys had also suggested weaker expected profitability in manufacturing. Survey data on services output had remained buoyant. The CIPS services activity index had risen slightly in July, while the BCC survey had reported an increase in orders to the service sector.

IV Labour market

A27 Employment growth had strengthened. LFS employment had increased by 126,000 (0.5%) in the three months to May compared with the previous three months. This was double the increase in the previous non-overlapping period, and also slightly higher than the growth in the three months to April. Most of the increased employment had been in full-time work, which had risen by 107,000 (0.5%); part-time employment had risen by 19,000 (0.3%). Higher employment had contributed to an increase of 0.3% in total hours worked in the three months to May, although average hours worked had fallen by 0.1%. During the past year, there had been a widening gap between employment growth and the growth in hours worked.

A28 Survey evidence had suggested that employment growth would remain strong. The CIPS employment survey had indicated that employment growth in the service and construction sectors increased in July, and that the decline in manufacturing employment had slowed. In addition, responses to the questions on employment intentions in the BCC and CBI surveys both suggested that growth would remain strong in the next few months.

A29 Survey evidence had also indicated that staff shortages and recruitment difficulties persisted. The CBI Industrial Trends Survey had reported that shortages of both skilled and unskilled staff increased in Q2, although the degree of the measured disparity between workers' skills and the skill levels demanded by firms was similar to historical averages. The BCC survey had shown that recruitment difficulties also remained high in Q2. The Recruitment and Employment Confederation survey had suggested that the shortage of agency staff continued to worsen in July.

A30 The number of new vacancies notified to Job Centres had increased in June (along with the number of placements). This had reversed part of the fall in May.

A31 LFS unemployment had fallen by 47,000, with the unemployment rate falling by 0.2 percentage points to 5.6% in the three months to May compared with the previous three months. The fall in LFS unemployment had been fairly evenly split between the less-one-year unemployed (down by 20,000) and the long-term unemployed (down by 28,000). Claimant count unemployment had fallen by 11,900 in June, with the rate unchanged at 3.8%.

A32 The LFS measure of inactivity had fallen by 42,000 in the three months to May compared with the previous three months. Amongst people of working age, inactivity had fallen by 65,000, the largest fall since one winter of 1998-99. The largest decline had been among people who did not want a job.

A33 Whole-economy headline earnings growth had fallen by 0.5 percentage points to 4.6% in the year to May. Headline earnings growth had fallen in both the private sector (down by 0.6 percentage points to 4.8%) and the public sector (down by 0.4 percentage points to 3.8%). Within the private sector, headline earnings growth in service sector firms had fallen by 0.8 percentage points to 4.9%, but had increased in the manufacturing sector by 0.1 percentage points to 4.6%. Actual earnings growth in the year to May had been 4.0%, down by 0.6 percentage points from the previous month. This decline was more than accounted for by weaker bonus growth. There had been significant revisions to earnings growth data for April, particularly in the manufacturing and public sectors.

A34 There had been little new information on settlements. The Bank's AEI-weighted twelve-month mean settlement had fallen by 0.1 percentage points to 3.0% in June, but the three-month mean was unchanged. Most of the settlement data in June had related to workers in the construction industry.

V Prices

A35 The Bank's oil-inclusive commodity price index had risen by 3.8% in June, taking the annual inflation rate from 17.1% up to 22.3%. Higher fuel and domestic food prices had largely accounted for the rise in the annual rate. Excluding oil, commodity prices had risen by 5.2% in the twelve months to June, up from 2.6% in the previous month.

A36 Seasonally adjusted manufacturing input prices had risen by 1.4% in June, taking the annual inflation rate from 12.9% to 14.1%. The rise reflected higher prices of oil and other raw materials including chemicals and domestic food. The annual rate of change of seasonally adjusted total output prices excluding excise duties (PPIY) had increased strongly, to 2.4% from 1.8% in May, largely on account of higher petroleum price inflation. Looking ahead, the latest CBI expected output price balance had strengthened to -15 in July from -18. This contrasted with

the data from the BCC survey on manufacturing. The BCC price expectation balance for services had fallen to 21 in Q2 from 26 in Q1.

A37 Prices of total imported goods had risen by 2.5% in May. Excluding oil and erratics, prices of imported goods had also risen by 1.6%.

A38 RPIX had increased by 2.2% in the year to June, up from 2.0% in May, largely owing to higher petrol price and seasonal food price inflation.

VI Reports by the Bank's Agents

A39 The Agents suggested that manufacturing output growth had continued to slow in recent months. Against this, there had been clear signs of an improvement in export markets in some regions in recent weeks.

A40 Most areas of business services had continued to record strong growth, although transport services (particularly road haulage) had appeared to slow recently. Demand for IT services, which had seen a dip since late-1999 was reported to have picked up in recent weeks. There had been a noticeable downturn in domestic tourism.

A41 There had been further evidence of a slowing in residential construction activity - particularly noticeable in the southern regions of the United Kingdom. This was reported to have been the result of both supply-side constraints and a slowing in demand – evidenced by fewer site visits and increased cancellations. In contrast, growth in commercial construction was said to have been maintained in most regions.

A42 Agents reported that there had been a further rise in input price inflation, as earlier rises in the oil price had fed through to stronger increases in the price of related products. In addition, there had been some indication of a recent increase in output price pressures.

A43 House price growth appeared to have slowed further in most regions. In the southern regions, where inflation had slowed markedly recently, there had been reports of some small price falls.

A44 The labour market picture had remained similar to recent months. Although little change to recent settlements had been reported, there had been an increase in the number of contacts indicating that negotiations had become more difficult to resolve recently. In some cases employees had reportedly reacted to higher petrol prices and tax increases. Pressures on the total pay bill had continued to increase in the construction and service sectors.

A45 The Agents had conducted a survey of UK firms regarding the pace of consumer spending in recent months. The results had shown that more than half of those firms surveyed in the retail goods, service and motor vehicle sectors reported that recent sales value growth had been lower than expected. Motor vehicle sales had been the weakest relative to expectations. Reasons for the lower-than-expected outturn had included some temporary factors (such as poor weather), but had also indicated some weakness in consumer demand. For motor vehicles, the key factor had been the impact uncertainty surrounding the review of UK car prices. Firms had also been asked about their expectations for annual sales value growth over the next three months. On balance, the results of the Agents' survey had suggested very little change to the current pace of growth. Car dealers were expecting competition issues to be resolved in the near future.

A46 Firms had also been asked about recent price discounting relative to a year ago. Over half of the respondents reported that the extent of summer 'sales' this year was slightly greater or significantly greater than last year. This was particularly evident for motor vehicles, but also for retail goods.

VII Market intelligence

A47 Market participants' expectations of official UK interest rates had risen slightly since the July MPC meeting. Two-week forward rates derived from the gilt market had risen by up to around 15 basis points at the 1-2 year maturity. The majority of those polled in the latest Reuters poll of City economists thought that the MPC would not raise rates in August, but the poll had shown a mean expectation that rates would be at or above 6¼% by year end.