

Publication date: 15 August 2001

MINUTES OF MONETARY POLICY COMMITTEE MEETING 1 and 2 August 2001

These are the minutes of the Monetary Policy Committee meeting held on 1 and 2 August 2001

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0108.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 5 and 6 September will be published on 19 September 2001.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 1-2 AUGUST 2001

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed the world economy; demand and output; money, credit and asset prices; the labour market; prices and costs; and some possible tactical considerations.

The world economy

2 The outlook for the world economy had deteriorated since the Committee's May *Inflation Report* projections. World industrial production had been falling, and the slowdown was clearly set to be more prolonged than in 1998-99. In the most recent month, there had been more news about continental Europe than about Japan or the US.

3 Nevertheless, the forward-looking prospect depended heavily on the US. Perhaps reflecting very strong growth in investment over recent years, capacity utilisation was now low and corporate profitability weak. Some parts of the corporate sector were under financial pressure. Investment had already fallen and seemed set to remain weak. Meanwhile, the household sector had so far been more resilient than many commentators had expected, with consumption growth remaining robust. GDP was estimated to have grown by 0.2% in Q2, down from 0.3% in Q1. There had also been material revisions to data for earlier periods, particularly 2000. GDP growth in 2000 had been revised down significantly, as had consumption growth, investment in the information and communications technology (ICT) sector, and corporate profits. In consequence, it now seemed that past productivity growth – especially for 2000 – was likely to be revised down somewhat. Household income had, however, been revised up, so the household saving ratio was now estimated to be higher than previously thought; it was now positive rather than negative and while it had declined steadily in the late 1990s, it was now estimated to have stabilised early last year.

4 Against that background, the Committee discussed various risks to the US outlook. On the one hand, downside risks arose from the imbalances in the economy and potentially stretched corporate and household sector balance sheets, reflecting substantial debt accumulation in recent years. It was possible that the evident pressures on the corporate sector would, via rising unemployment and reduced real income growth, feed through to the household sector and so to consumption growth in due course; in the view of some members, forward-looking survey indicators (for example the

National Association of Purchasing Managers index) did not suggest an imminent recovery in the corporate sector, which therefore carried the associated risk of a spillover into weaker consumption, and yet Consensus forecasts assumed that consumption growth would rise. Although down around 10% since the beginning of the year, on some assumptions equity market valuations remained elevated, and were GDP growth to be more sluggish than implied by the consensus, there would be a risk of further falls in equity prices. Also, estimates of trend productivity might be revised down in the light of the revised GDP data, to a greater or lesser extent depending on how much weight had been given to the earlier, unrevised data for 2000; some commentators were already doing so. If productivity growth were lower, the corporate sector might also be weaker than expected.

5 On the other hand, there were some upside risks. Taken together, the easing of monetary policy and of fiscal policy was large by historical standards and might provide more stimulus than was reflected in the central projections. In addition, the recent data revisions might imply less need for households to increase their saving in order to rebuild balance sheets, so consumption might be stronger than expected.

6 Overall, while the outlook was still highly uncertain, US prospects were judged by most members to remain broadly in line with the assumptions made by the Committee in its May projections, with the risks still skewed to the downside; other members preferred a lower central projection for US growth.

7 The outlook in Japan was weak. It seemed to be heading for recession; and the difficult conjunctural and structural policy issues remained. There had not been much news over the past month.

8 By contrast, there had been quite a lot of news about the euro area, where the outlook was now weaker than previously assumed. There were distinct, but interacting, domestic and external influences at work. In part, the slowdown in domestic demand in recent months might have reflected a supply shock. In particular, spikes in energy prices and food prices, combined with the fall in the euro's exchange rate earlier in the year, had taken consumer price inflation higher than had been expected. That might have reduced growth in real personal disposable incomes and so weakened consumption. The effect of the shock on domestic demand should in principle be temporary, although it might persist for a while, for example if the consequent slowdown in GDP growth prompted the corporate sector to lay off workers. While investment intentions had been stable in recent months according to the latest European Commission survey, surveys of new orders were still weakening, and

business and consumer confidence had fallen further. As well as the domestic influences, weaker confidence might reflect the impact on euro area multinational companies of the world economic slowdown, as well as the effect on the business sector generally of the global fall in demand for ICT. While ICT industries represented a materially smaller share of output in the euro area than in the US, their contribution to GDP growth had risen over the past few years. There were other contrasts with the US. On the one hand, imbalances were less pronounced and, in particular, corporate and household sector balance sheets were less obviously vulnerable. On the other hand, there was perhaps less prospect of a pronounced policy easing given the euro area's fiscal guidelines and inflation having been above the zone defined by the European Central Bank (ECB) as consistent with price stability. Overall, while the euro area was less vulnerable to a sharp deterioration than the US, growth could remain sluggish for some time, although some of the factors slowing growth were temporary. This was reflected in a downward adjustment to the Committee's latest projections compared with May.

9 The considerable uncertainties about US and euro area growth prospects were associated with similar uncertainties about exchange rates. Some members of the Committee placed little weight on the possibility of the euro recovering against the dollar in the near term, given the deterioration in the euro area outlook and continuing market uncertainties about ECB policy. Others thought it possible that a reappraisal of US prospects could affect exchange rates, even if there were no change to the euro area outlook.

Demand and output

10 GDP growth had eased to 0.3% in Q2 from 0.5% in Q1. Excluding utilities, mining and quarrying, and agriculture – typically, the more volatile components of GDP – output had been up only about 0.1% on the quarter. It was noted that this was the third successive quarter in which growth had been below trend; and that survey-based measures suggested that growth in Q3 might be below trend too. Some members noted, however, that in recent quarters growth had been temporarily depressed by adverse weather, travel disruptions and foot-and-mouth disease.

11 The Committee discussed the possible implications for policy of the imbalances in the UK economy against the background of divergent pictures of household consumption and corporate spending.

12 The Committee had for some time been expecting a slowdown in consumption growth that had so far failed to materialise. There had been – and continued to be – good reasons to expect deceleration. Given weaker equity prices, there had been a fall in household financial wealth; and the growth of both employment and real incomes was expected to slow. But it remained unclear how quickly consumption growth would weaken. While the National Accounts data for Q1 had recorded softer-than-expected consumption growth, those data sat uneasily with strong growth in retail sales and private vehicle registrations in Q1 and Q2, and with the narrow and Divisia monetary data. Forward-looking indicators were also strong. Household borrowing and house prices were both rising at an annual rate of about 10%. The July CBI Distributive Sales survey had pointed to continuing robust retail sales. The GfK measure of consumer confidence remained above its average levels and had softened only slightly in the latest month, although the MORI index was weaker.

13 By contrast, investment spending had weakened. Business investment was estimated to have fallen sharply, by roughly 5%, in Q1; and while this would to some extent reflect quarter-to-quarter volatility, taking Q4 and Q1 together showed a distinct softening since earlier last year. Looking ahead, both surveys and reports from the Bank's regional Agents pointed to a somewhat weaker outlook.

14 These contrasting pictures were mirrored in divergent output data for sectors relatively exposed to the external environment and for those which were relatively sheltered. For 2001 H1, the annualised rates of growth in services, construction and manufacturing were estimated to be 3%, 5% and minus 3% respectively.

15 Manufacturing – much, but not all, of which was internationally tradeable – was overall in recession. The pressure on the sector was not just an ICT story. While there had been particularly pronounced falls in the previously strong electrical and optical equipment sector, growth in the remainder of manufacturing had been flat for a number of years and reflected structural change rather than cyclical weakness together with the high exchange rate. Survey indicators all pointed to continuing weakness in the sector as a whole, although some had improved slightly in the latest month and the picture was not uniform across the sector.

16 Taken as a whole, services sector growth and profitability had so far remained far stronger than manufacturing. The first estimate of 2001 Q2 service sector output growth had, though, been 0.6%, slower than in previous quarters. There had been an expectation of some temporary weakness on

account of the effects of the foot-and-mouth epidemic on services such as tourism, hotels and catering. But the slowdown might be greater than such temporary factors could account for. The CIPS services survey had fallen in July; at 50.3, the balance of respondents reporting growth in business activity was at its lowest level since February 1999. It was, therefore, possible that, in addition to temporary domestic factors, some parts of the business services sector were now being adversely affected by the global slowdown and by the pressures on domestic manufacturing.

17 The factors behind this contrasting picture were reasonably clear. The externally exposed parts of the economy were under pressure from the weakening external environment and the persistent strength of sterling's exchange rate, which was 1% higher than had been projected in May on account of the euro's further depreciation. In order to offset to some degree the prospective negative contribution to output growth from net trade, the Committee had eased monetary policy by a cumulative 75 basis points during the first half of the year, buttressing consumption growth. Since then, the external outlook had deteriorated further, as had business investment in the United Kingdom. There were also signs of excess stock holdings.

18 In the face of weakening external demand, the Committee had reduced interest rates in order to maintain aggregate demand in line with the economy's supply capacity, despite the increasing imbalances in the economy. The Committee debated whether or not there were risks to the policy of continuing to stimulate domestic demand to offset a weaker-than-expected world economy. Several points were noted. First, if consumption were to be stimulated by successive further policy easings, it might build up momentum which could prove difficult to arrest when the world economy eventually recovered, requiring a sharper-than-usual policy tightening in due course. Against that, however, it was noted that if buoyant consumption were accompanied by a substantial further accumulation of debt in the household sector, its exposure to interest rate changes would be greater, so that a smaller-than-usual tightening might be needed to slow consumption. Any risk of debt deflation would, on this view, work in the direction of dampening household spending. Also, not reducing interest rates in the face of a weakening global economy could hurt investment and thereby depress the UK economy's future productive capacity. Second, it was possible that a persistent current account deficit and the consequent accumulation of external debt could lead to sterling's exchange rate depreciating materially. That might also be prompted if persistent weakness in the US economy were eventually to lead to a fall in the dollar against the euro. If that happened, there could be strong upward pressures on UK inflation. Against that, it was noted that an abrupt sterling depreciation would cause a one-off rise in the price level, the direct effects of which policy could accommodate; and that the medium-term

effect of a depreciation would be to support net trade, which would be helpful given the assumed scenario of persistent world economic weakness. On that view, depending on the relative size of exchange rate depreciation and global economic weakness, interest rates might even have to be reduced. It was also suggested, however, that the path of the exchange rate might be volatile, but with a gradual and cumulatively substantial depreciation. That might present a greater challenge to policy, as it would be less easy to judge at any particular point the extent of the eventual one-off effect on the price level which should be accommodated.

19 The Committee noted that a persistently weak external environment was only one possible scenario, the probability of which was very difficult to judge. Moreover, while the imbalances in the UK economy were uncomfortable, there remained good reasons to expect consumption to weaken as output and income growth slowed, but with uncertainty about how soon it would do so. Some members were, in consequence, more concerned about the immediate and more tangible pressures on the corporate sector.

Money, credit and asset prices

20 The disparity between conditions in the household sector and the corporate sector was apparent in the money and credit data. Annual growth in non-financial corporate sector money holdings had fallen from around 10% last autumn to 6% or less in the most recent months. Bank lending had decelerated too, but there was a marked divergence between the manufacturing and service sectors. In the year to Q2, the manufacturing sector had made net repayments of bank debt, whereas services sector borrowing from banks had risen over 16%.

21 For households, the growth rate of both money and borrowing had increased. Household M4 had risen by nearly 9% in the year to June, the strongest rate since September 1991. Divisia money growth was about 9½%, the strongest since 1990 Q3. Total borrowing continued to grow at around 10%.

22 The annual rate of increase in house prices was around 10% on both the Halifax and Nationwide measures. Mortgage loan approvals were well up on a year ago; and particulars delivered, while still slightly lower than a year ago, had risen sharply in June. The FTSE All Share equity index was just over 1% lower than at the time of the Committee's July meeting, but well below the level projected in May.

23 Sterling's exchange rate index was about 1% lower on the month, having fallen against the euro and risen against the dollar.

The labour market

24 In the three months to May, employment had risen by about 90,000, and at a faster rate than the population of working age. Unemployment had fallen to 4.9% on the Labour Force Survey measure. Inactivity had again increased. Settlements had continued to edge up slightly, to 3.4%. The headline measure of earnings growth was 4.5%, easing back from around 5% earlier in the year, which had reflected unusually high bonus payments.

25 Taken together with a continuing high number of vacancies, these data suggested that the labour market remained tight. Given the persistent tightness of labour market conditions over the past year or so, it remained surprising that pay and earnings had not risen more. More recently, as pressure on the tradeables sector had intensified, it had been a puzzle that the employment rate had continued to rise. There was anecdotal evidence that, over the past year or so, companies with unsatisfied demand for labour had not bid up wages to recruit, on the grounds that product market conditions would not have allowed them to pass increased costs into prices, but that they were now picking up workers shed by firms in difficulty. It was conceivable that that explained why the pressure on the externally exposed sectors had not yet led to falling employment or rising unemployment. If so, there might be an unsatisfied latent demand for labour which was not showing up in the quantity or price data. It was also possible that firms might be holding on to under-utilised labour if they believed that the slowdown would be temporary and wished to avoid the costs of first laying off labour but subsequently having to re-recruit staff with the desired skills.

26 There was, though, some evidence suggesting some easing of labour market conditions. Survey-based measures of recruitment intentions had fallen, and reports of skill shortages had eased somewhat.

Prices and costs

27 After a sharp rise in May, RPIX inflation had remained at 2.4% in June. Short-term factors – changes in food prices, utility prices, tax duty changes – were likely to make the path of RPIX volatile for a period, while not having material implications overall for the medium-term outlook.

28 Further back in the ‘pipeline’, commodity prices had decelerated. The rate of increase of producer input prices had fallen. Producer output price inflation had also edged down, but was broadly unchanged if the effects of falling tax duties were excluded. Forward-looking surveys suggested weak price pressures. But the magnitude of the impact on RPIX was unclear, as the relationship between producer output prices and retail prices had been less close since the mid-1990s. In the current conjuncture, an important influence on retail prices would be the strength of consumption. According to surveys, retailers were expecting buoyant sales, so it was possible that there would be some cyclical rise in their margins in the near term, but the projected weakening of consumption built in to the forecast might reasonably be expected to be associated eventually with some moderation of the price pressures from this source.

The August GDP growth and inflation projections

29 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 8 August.

30 On the assumption of an official repo rate of 5.25% over the next two years, the central projection would have been for RPIX inflation to be below the 2½% target throughout the forecast period.

31 On the alternative assumption of an official repo rate of 5.0% over the next two years, the central projection was for GDP growth to be a little below trend – slightly weaker than in May. The central projection for RPIX inflation edged downwards to around 2% over the next half year or so, before rising back towards the target towards the end of the two-year forecast period. The path was likely to be volatile given the range of special factors which would affect the twelve-month measure.

32 Some members preferred different assumptions for the central projection for inflation. Some thought that it could be a little higher. Others thought that it could be up to ½ percentage point lower, reflecting views that the world economy would be weaker, that the world slowdown would have a greater effect on UK inflation, and that there was more spare capacity in the economy than assumed in the published fan chart central projections; these more substantial differences were reflected in the calibrations recorded in Table 6.B of the *Inflation Report*.

33 On the best collective judgment of the Committee, the balance of risks to growth was on the downside throughout the forecast period, reflecting in particular the possibilities of a weaker world economic outlook and of a sharper slowdown in private sector final demand in the United Kingdom; and for RPIX inflation, it was slightly on the downside in the second year of the projections. There was, though, a range of views on the balance of risks, with some members placing greater weight on the probability of a significant depreciation in sterling's exchange rate.

Possible tactical considerations

34 The Committee noted that there was a clear expectation, amongst commentators and in financial markets, that the repo rate would be maintained at 5.25% this month, although some expectation had developed in the days leading up to the meeting of further easing in the next few months. An immediate change would, therefore, come as a substantial surprise. It was difficult to know how a cut might affect financial markets, but it would be unwelcome if sterling rose or if longer-term interest rates increased.

The immediate policy decision

35 For most members, the outlook for inflation, and the balance of risks, were broadly as published in the *Inflation Report* fan charts. Given the weaker external environment, and sterling's further appreciation against the euro since the *May Report*, net trade was set to continue to be a drag on output growth. Faced with softening external demand, widespread weakness in ICT-related sectors, heightened uncertainty about the global outlook, and pressure on the profitability and financial position of parts of the corporate sector, UK business investment spending was likely to be subdued for a while. The outlook for household consumption was less clear. On the one hand, it was likely to be restrained by past falls in equity prices, and by prospective lower labour income growth as the economy slowed. On the other hand, growth in retail sales and in household sector money and borrowing all remained robust, consumer confidence was firm, and the housing market was strong. For these members, the imbalances in the economy presented a dilemma for policy and the immediate choice was finely balanced between maintaining the Bank's repo rate at 5.25% and a reduction of 25 basis points.

36 Various arguments – given different weights by different members – were advanced for maintaining rates at 5.25%. First, against the Committee's previous expectations, there were still few if any signs of consumption growth weakening. The labour market remained tight, and the pressures

on the corporate sector had yet to feed through to employment and unemployment, which if and when it happened would dampen household confidence and spending. Given that an immediate repo rate cut would not do much to alleviate the pressures on the corporate sector from abroad, there was advantage in waiting a month or two to see whether labour market conditions were easing and consumption was indeed starting to slow. Second, an immediate cut would exacerbate the imbalances in the economy, by further stimulating consumption in circumstances where the housing market was already buoyant and household confidence was robust. A cut in mortgage rates would tend to fuel this. There was, therefore, a risk of increasing the size of the adjustment that would ultimately be necessary, possibly leading to larger deviations of inflation from the target and undesirable volatility in output. Third and associated with the imbalances, there was a perceptible risk that sterling could fall, triggered for example by deteriorating world conditions, by a reappraisal of the sustainability of persistent trade deficits or by domestic adjustment as UK households tried to strengthen their balance sheets. The timing of any such fall was, of course, highly uncertain. But it would tend to increase inflation. As well as any one-off effect on the price level and the consequences for net trade, a depreciation might well also – given current conditions in the labour market – put upward pressure on nominal earnings as the consequent rise in the sterling price of imports would reduce the purchasing power of households' real incomes. Fourth, the full impact of the earlier easing of monetary policy was still to come through, and the planned rapid rise in government spending was now well underway. Both would help to underpin domestic demand over the next year or so, and so a further boost from another repo rate cut was not necessary now. Fifth, although the prospects for the world economy had weakened, the course of events in the US economy, which was the most important influence on global activity, was not inconsistent with some recovery in growth towards the end of the year and into the early part of 2002. Sixth, the data on the month did not make a sufficient case for surprising financial markets. There was a risk that financial markets would overreact to a surprise cut, with a generalised fall in money market rates and so a greater-than-planned easing in monetary conditions. It might also conceivably lead, perversely, to a strengthening of the exchange rate if the markets concluded that the Committee was more committed to sustaining output growth than previously thought, particularly given market uncertainties about the policies of other central banks. Seventh, if rates were maintained at 5.25%, the central projection for inflation in the *Inflation Report* would be below the 2½% target for the forecast period, which would imply the likelihood of an interest rate reduction later in the year. That would itself probably lead to lower short-term money market rates and so to easier monetary conditions, without the Committee so actively bolstering consumption.

37 Various arguments – again given different weights by different members – were advanced for an immediate reduction of 25 basis points. First, the central projection for inflation, based on an assumption of unchanged interest rates of 5.25%, was below target for the whole of the two-year forecast period. That being so, and since there was not much prospect of significant news about consumption or the labour market in the next month or two, there was little advantage to waiting before easing policy. Second, the risks to output – and, in the view of most members, to inflation – were on the downside, given the direct and indirect effects on net trade of the inhospitable international environment, which recent surveys suggested might now be spreading to the services sector. That would put further downward pressures on inflation. An immediate reduction in the repo rate would, therefore, provide a degree of insurance against a further deterioration in the outlook. Third, the pressures on the corporate sector represented a greater risk to the outlook than the apparently buoyant conditions in the household sector. In both manufacturing and services, some firms were capable of switching production from external to domestic markets. But domestic demand needed to be sustained to support these sectors. Otherwise, output growth might be weaker than in the central projection, with inflation undershooting the target. Fourth, while some of the indicators of consumption currently remained strong, the most likely outlook remained for consumption growth to slow. Given weak net trade and investment, it was therefore appropriate to provide some further support for consumption by cutting interest rates, in order to maintain aggregate demand in line with the economy's supply capacity. Fifth, even if consumption did not slow, the risks to household sector balance sheets would not be material in the near term. While household debt had risen relative to income over the past few years, neither income gearing nor debt relative to household wealth appeared exceptional by historical standards. While the housing market was strong, it was nowhere near as strong as in the boom conditions of the mid-1970s or the late-1980s. The possibility of consumption growth not falling back soon would not, therefore, create unacceptable risks. Sixth, if – against expectations – domestic demand were to remain strong or the international economy were to recover more quickly than anticipated, policy could be re-tightened. That would be easier to justify after the event than not easing now but having to do so later in the face of weakening in demand and output accompanied by an undershoot of the inflation target. Seventh, if sterling were to fall on account of accumulating economic imbalances, policy would probably be easier rather than harder to operate in the medium-term, so concerns about the imbalances on that score should not stand in the way of a further cut in interest rates now.

38 For some other members, in addition to the reasons set out the previous paragraph, the news on the month had been sufficiently on the downside, both internationally and domestically, to raise the

question of whether an interest rate cut of more than 25 basis points was merited. In the US, the National Association of Purchasing Managers survey – especially for new orders – had fallen back; and the revised GDP data implied somewhat weaker trend growth. In continental Europe, the deterioration in confidence and in indicators of new orders was worrying. Japan and several other Asian countries were being badly hit by the global ICT sector problems. Emerging market bond yield spreads had widened and global equity prices were lower. The international outlook was therefore gloomy. Domestically, the CIPS services survey had been surprisingly weak. It seemed that services sector output might be even weaker in Q3 than in Q2. Weakness in the corporate sector was likely to feed through to the household sector. The outlook for inflation was materially weaker than presented in the published fan chart. As reflected in Table 6.B of the *Inflation Report*, different preferred assumptions could reduce the central projection for inflation two years ahead by about 0.5 percentage points, to a little below 2%. The balance of risks was also on the downside. That being so, the immediate policy choice was between a cut of 25 or of 50 basis points. Pre-emption pointed towards a 50 basis point cut immediately. It was unlikely that sterling would perversely strengthen if interest rates were cut. However, a large cut would be especially surprising and would entail an unnecessary risk of further stimulating the housing market. In any case, at a time of increased uncertainty, a gradualist strategy might be preferable. On balance, the better immediate course was a 25 basis point cut.

39 The Governor invited the Committee to vote on the proposition that the Bank's repo rate should be reduced by 25 basis points to 5.0%. Six members of the Committee (the Governor, Christopher Allsopp, Kate Barker, Charles Bean, Stephen Nickell and Sushil Wadhvani) voted for the proposition. Mervyn King, David Clementi and Ian Plenderleith voted against, preferring to maintain the repo rate at 5.25%.

40 The following members of the Committee were present:

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

Andrew Turnbull was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 27 July in advance of its meeting on 1-2 August 2001. 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 this Annex.

I The international environment

A2 According to the Bank's latest estimate, world GDP growth had slowed to 2.1% in the year to 2001 Q1, from 3.4% in 2000. World industrial production had fallen by 1.3% in the year to May from unchanged in the year to April.

A3 The price of Brent crude oil had stabilised at around \$25 per barrel, after a fall early in the month, slightly below its level at the time of the Committee's previous meeting. The price had fallen early in the month, but had risen again following the announcement by OPEC members of a cut in supply in view of lower world demand. The Economist industrial commodity index had fallen by 3.0% on the month, but the Economist food index had risen by 4.0%.

A4 In the euro area, orders for German manufactured goods had risen by 4.4% in May, the first monthly rise since the beginning of the year. German industrial production had continued to follow the downward trend of 2001 Q1, although the fall in construction sector output had been smaller than in previous months. The West German IFO business confidence indicator had fallen further in June, to 89.5 from 90.8 in May, reaching a seven-year low. Results of a European Commission survey of expectations of investment growth conducted in spring 2001 had shown no change in investment intentions for this year since autumn 2000 with an expectation of investment growth for 2001 of 3%. After falls in April and May, French consumption of manufactured goods had risen in June by 1.5%.

A5 Euro-area producer price inflation had fallen to 3.6% in the year to May. German producer price inflation had fallen further, to 4.3% in the year to June. Annual HICP inflation had fallen to 3% in June, mainly accounted for by a fall in energy prices. Preliminary German data had suggested a further fall in July. Annual euro-area unadjusted M3 growth had increased to 6.1% in June.

A6 Headline US GDP growth had slowed to 0.2% in 2000 Q2, from 0.3% in Q1. Consumption growth had remained strong, though easing to 0.5% in Q2 from 0.7% in Q1, while private investment had fallen 2.2% in Q2 after a rise of 0.5% in Q1 – the first quarterly fall in six years. The contributions from both stocks and net trade were zero, with destocking in Q2 continuing at the same rate as in Q1 and both exports and imports falling in Q2. Substantial revisions to back data had lowered GDP growth in 2000 by 0.8 percentage points, to 4.2%. Corporate profits had also been revised down, but household income had been revised up, increasing the household saving rate.

A7 Manufacturing output in the United States had fallen by 0.8% between May and June, which had brought the cumulative fall since last September to 5%. Production of information and communications technology (ICT) goods had fallen for the sixth consecutive month. The National Association of Purchasing Managers' (NAPM) index had fallen to 43.6 in July from 44.7 in June, reflecting falls in the new orders and inventories components. Retail sales in the United States had risen by 0.2% in June, bringing the growth rate in 2001 Q2 to 1.5%. The Conference Board measure of consumer confidence had fallen to 116.5 in July from 118.9 in June, mainly due to a downward revision to the 'present situation' component. Non-farm payrolls had fallen by 14,000 in June following an increase of 8,000 in May. This reflected a further fall in manufacturing employment: service sector employment had remained little changed.

A8 Headline producer price inflation in the United States had fallen to 2.5% in June from 3.7% in May, mainly because of a sharp drop in energy prices. Core producer price index (PPI) inflation had remained unchanged at 1.6%. Weaker energy prices had also contributed to a decline in headline consumer price index (CPI) inflation to 3.2% in June, from 3.6% in May. Employment cost growth had slowed in Q2, mainly due to lower benefit costs.

A9 US imports had declined in May, mainly because of a fall in capital goods imports; the sharpest decline had been registered in imports from Asia, although imports from the United Kingdom and, to a lesser extent, the euro area, had also fallen.

A10 Exports from Japan and a number of other East Asian economies had continued to fall, as had industrial production. Japanese inventories had picked up, and had risen by 6% in the year to May.

A11 There had been little evidence of contagion from Argentina and Turkey to the spreads on bonds of other emerging market economies.

II Monetary and financial conditions

A12 The twelve-month growth rate of notes and coin had risen slightly, to 7.4% in July, and the three-month annualised growth rate had risen to 5.3%.

A13 The twelve-month growth rate of M4 had also risen slightly, to 7.6% in June. The twelve-month growth rate of M4 excluding other financial corporations (OFCs) had risen to 8.3% in June, the highest growth rate since August 1997. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) including and excluding OFCs had risen to 11.4% and 9.8% respectively.

A14 The twelve-month growth rate of households' M4 had continued to rise in June, to 8.8% - its highest level since September 1991. Household M4 lending (excluding the effects of securitisations) had remained strong, at 9.7%. Within total lending to individuals, the annual growth rate of secured lending had remained strong in June, at 8.5%, and the growth rate of unsecured borrowing had risen slightly, to 11.9%. Total household sector M4 debt had increased to 92% of total household income in 2001 Q1. Within this total, consumer credit as a percentage of total disposable income had risen to 15% in 2001 Q1. The number of loan approvals for house purchases had fallen slightly, to 106,000 in June, but the three-month on three-month growth rate of loan approvals had remained consistent with a strong outlook for housing market activity.

A15 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 had risen to 6.0% in June. This had partly reflected temporary factors, and the underlying trend in the growth rate was likely still to be downward. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had risen to 10% in June. Total external corporate finance (in terms of average monthly flows) had risen to around £6.5 billion in 2001 Q2.

A16 The twelve-month growth rate of OFCs' M4 had fallen to 5.6% in June. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had risen to 16.9%.

A17 Short-term nominal forward rates had fallen since the Committee's July meeting: by 23 basis points for the December 2001 short sterling contract and by 20 - 35 basis points for 2002 contracts. Long-term forward rates had also fallen since that meeting. Real interest rates had fallen slightly at shorter maturities and had risen slightly at longer maturities over this period. Inflation

expectations derived from conventional and index-linked gilt yields had fallen for all maturities, partly reversing a rise in June.

A18 Survey-based measures of the inflation expectations of professional economists had risen in July. Given that the surveys had been carried out at around the time of the Committee's July meeting, they had reflected the higher-than-expected May RPI data published in June and had been consistent with the increase observed during June in inflation expectations derived from conventional and index-linked gilt yields.

A19 The quoted average standard variable mortgage rate had remained virtually unchanged at 6.42% in July. The two-year discounted variable mortgage rate had increased by 15 basis points while the two-year fixed mortgage rate (without lock-in) had increased by 27 basis points in July. Interest rates on savings had remained virtually unchanged, while unsecured loan rates had fallen by 42 basis points.

A20 UK corporate spreads over gilts had remained virtually unchanged since the Committee's previous meeting. Issuance of non-gilt sterling bonds so far in July had been at levels similar to those observed in June.

A21 The FTSE All-Share and FTSE 100 indices had fallen by 1.2% and 1.0% respectively since the Committee's July meeting. The FTSE Small Cap and the FTSE 250 indices had fallen by 5.5% and 2.0% respectively over the same period. Information technology (IT) had been the weakest sector. The number of profit warnings over the previous three months had remained higher than in the same three-month period of the previous year.

A22 Since the July meeting, the sterling exchange rate index (ERI) had fallen by 1.0%. This depreciation of the ERI had reflected a 2.0% depreciation of sterling against the euro and an appreciation of sterling of 1.8% against the US dollar and 1.9% against the Japanese yen.

III Demand and output

A23 The preliminary estimate of GDP growth in 2001 Q2 had shown growth slowing to 0.3%, from 0.5% in Q1. Service sector growth had been 0.6% in Q2, down from 0.9% in Q1. Within services, the distribution, hotels and catering sector had grown by 0.9% in Q2.

A24 Retail sales volumes had been flat in June, but had grown by 1.6% in Q2 as a whole. Annual growth of retail sales had risen to 6.1% in Q2, its highest rate since 1988. Private vehicle registrations had been 18% higher in Q2 than a year earlier. In July, the retail sales balance in the CBI survey of Distributive Trades had increased to +44 from +30 in June. Consumer confidence had weakened on the GfK index to +4.9 in July from +6.2 in June, while on the MORI index it had fallen to -15.0 in July from -4.0 in June.

A25 The Nationwide house price index had risen by 1.1% in July, while the Halifax index had risen by 0.7%. Annual growth on the Nationwide index had been 10.9% in July, while on the Halifax index had been 9.6%. House price inflation in Greater London had bounced back in Q2. Particulars delivered had increased by 10,000 in June to 121,000, the highest level for twelve months.

A26 Central government other current expenditure had been 14% higher in Q2 than a year earlier. Public sector net investment in 2001 Q2 had increased by £1.1 billion compared with 2000 Q2. The CBI's Industrial Trends survey had shown that stocks had fallen in Q2. Total goods export volumes had fallen by 2.8% and total goods import volumes by 1.9% in the three months to May compared with the three months to February. In Q2, exports of goods to non-EU countries had fallen by 4% on the previous quarter, while imports of goods had fallen by 2%.

A27 Surveys conducted in 2001 Q2 had pointed towards some divergence between service sector and manufacturing sector confidence. The BCC and CIPS surveys had reported broadly unchanged service sector confidence. In contrast, the BCC survey had reported a fall in manufacturers' confidence about both profitability and turnover in the second quarter of 2001. In addition, the CBI July Industrial Trends survey and the Institute of Directors' June Business Opinion survey both indicated that manufacturers' optimism had remained below average.

A28 Forward-looking survey data on services output had weakened. The BCC service sector home orders balance had fallen to +19 in Q2 from +26 in Q1, and the CIPS services incoming new business balance had averaged 52.1 in the three months to July, down from 54.9 in the three months to April.

A29 Manufacturing orders had also fallen. The CBI Quarterly Industrial Trends survey total new orders balance had weakened in July to -6, down from -1 in April. The BCC manufacturing sector home orders balance had fallen to -5 in Q2, from +8 in Q1. In addition, the CIPS manufacturing

orders balance had averaged 47.6 in the three months to July, down from 51.0 in the three months to April.

IV The labour market

A30 According to the Labour Force Survey (LFS), employment had increased by 92,000 (0.3%) in the period from March to May compared with the previous three months. The quarterly increase had been more than accounted for by an increase in full-time employment of 109,000 (0.5%). The rate of LFS employment growth had returned to the level seen before the slowdown last autumn.

A31 Total hours had increased by 0.2% in the three months to May and had increased by 1.4% on the previous year. Average hours had fallen slightly (-0.1%) in the three months to May but had been 0.4% higher than a year earlier. Average full-time hours had fallen by 0.3% on the three months, while part-time hours had increased by 0.6%. Overtime hours calculated from LFS data had been little changed over the year and had been relatively stable since autumn 1998.

A32 According to LFS longitudinal data, the number of people entering employment had increased over the past six months, partly offset by increasing numbers leaving employment. These data also showed that flows to inactivity from employment had continued to rise while those from unemployment had fallen.

A33 The CIPS employment index for manufacturing had fallen slightly in July and survey evidence suggested that employment intentions for Q3 had weakened, particularly in the manufacturing sector. Employment intentions as recorded by the CBI manufacturing survey had fallen to -28, reflecting the prevalence of manufacturers reducing their staffing demands. The BCC and Manpower surveys of manufacturers' employment intentions had also fallen again, and both were now below their respective averages. These two surveys had also shown declining service sector employment intentions, although these intentions were still above the average for the series.

A34 Survey evidence had also pointed to some easing of labour shortages. The BCC measure of recruitment difficulties in manufacturing had declined sharply in Q2, although the services measure had fallen only slightly. And the CBI survey for Q2 had shown that shortages of skilled labour in manufacturing had declined further.

A35 The LFS measure of unemployment had fallen by 82,000 in the period from March to May, compared with the previous three months, pushing the rate 0.3 percentage points lower to 4.9%. The claimant count had fallen by 21,000 over the same period and by a further 12,000 in June. Recent movements in LFS unemployment had contrasted with more moderate declines in the claimant count.

A36 Working-age inactivity had risen by 45,000 in the three months to May, raising the rate by 0.1 percentage points to 21.2%. There had been an increase of 93,000 in the number of inactive people saying they did not want a job.

A37 Headline annual earnings growth, a three-month average of the actual rate, had been 4.5% in May, down 0.7 percentage points from April. Headline earnings growth in the public sector had increased sharply to 5.3%, an increase of 1.0 percentage points, while the private sector had fallen by an equal amount to 4.4%. Actual whole-economy earnings growth in the year to January had fallen less sharply, from 4.8% in April to 4.5% in May. Whole-economy regular pay growth (not seasonally adjusted) fell by 0.2 percentage points to 5.1% in May. Bonus contributions had continued to reduce aggregate pay growth in May. The effect of lower bonuses in the private sector had been to lower compensation growth by 1.0 percentage points, with private services showing a larger reduction of -1.2 percentage points.

A38 The Bank's twelve-month AEI-weighted mean pay settlement had increased by 0.1 percentage points to 3.4% in June (after a -0.1 percentage point revision to May), while the three-month measure had fallen by 0.1 percentage points to 3.4%. The most important factor on the month had been a 5.5% settlement for construction workers, the second year of a three-year deal.

A39 Manufacturing productivity had grown by 2.6% in the year to May – the slowest growth rate since June 1999. This had contributed to a 0.7 percentage point increase in the growth of manufacturing unit wage costs, to an annual rate of 2.1%.

V Prices

A40 The Bank's commodity price index had fallen by 1.5% in June. This had mainly reflected falls in the prices of natural gas and oil. Domestic food prices rose for the fourth consecutive month. As last June's sharp rise in oil prices had dropped out of the annual comparison, the annual inflation rate of the Bank's commodity price index had fallen sharply to 12.8% in June, from 20.2% in May.

Looking ahead, the monthly average sterling oil price had fallen by 9.4% in July, taking sterling oil prices to their lowest level since April.

A41 Producer input prices had risen by 0.1% in June, but due to base effects the annual inflation rate had fallen to 2.6% in June, from 4.5% in May. Annual input price inflation excluding oil had eased from 5.0% in January to 2.4% in June. Over the period, increases in domestic food input costs had been more than offset by a slowdown in the annual inflation rate of the sterling prices of imported materials. Looking ahead, the CIPS input price balance was broadly unchanged in July, but had been below the no-change level of 50 for four consecutive months.

A42 Producer output prices excluding excise duties (PPIY) had risen by 0.1% in June, but due to base effects, the annual inflation rate had eased to 0.7% in June, from 1.1% in May. Looking ahead, the CBI Industrial Trends expected output price balance had fallen to -16 in June, from -13 in April, and the CIPS manufacturing survey output price balance had fallen to 47.4 in July, from 47.7 in June.

A43 Annual RPIX inflation had been unchanged at 2.4% in June. Annual services price inflation had been unchanged at 4.0% and annual goods price inflation had remained unchanged at 0.7% in June.

A44 On a quarterly basis, annual RPIX inflation had risen to 2.3% in Q2, from 1.9% in Q1. Between Q1 and Q2, the contribution of food and utilities prices to annual RPIX inflation had risen by 0.6 percentage points. This had been partly offset by a fall in Q2 of 0.4 percentage points in the contribution of duties to annual RPIX inflation. Annual RPIY inflation had risen by 1 percentage point in Q2, to 2.6%, while annual RPI inflation had fallen to 1.9% in Q2, from 2.6% in Q1.

VI Reports by the Bank's Agents

A45 The Bank's regional Agents reported that growth in the service sector had eased slightly. Business services growth had slowed, driven largely by the ICT sector. There had been tentative signs of a modest recovery from the declines in demand for leisure services which had resulted from foot-and-mouth disease, which had led to an improvement in consumer services growth.

A46 Both activity and business confidence within the manufacturing sector had weakened further. The ICT sector had continued to be the main driver of the slowdown, but there had also been some

evidence of weakening in other parts of manufacturing. Manufacturing export activity had deteriorated further, with signs of weaker exports to Europe, particularly Germany.

A47 Construction output growth had eased slightly, following the surge earlier this year when firms had cleared backlogs caused by earlier weather-related delays. However, construction activity had remained robust, with further reports of increased public sector demand and continued strong growth in residential construction.

A48 Agencies reported that investment intentions had weakened overall, driven by sustained uncertainty about the world slowdown. Manufacturers' investment intentions had declined further, with the most significant downward revisions concentrated in the high-tech sectors of manufacturing. Investment spending plans in the service sector had remained strong, but growth had eased, driven by further deferrals of ICT expenditure.

A49 There had been continued strong growth in retail sales volumes, and the start to the mid-season sales had been robust.

A50 Manufacturing employment had declined at a more rapid pace than in the previous month, due to lower activity in the sector. Employment growth within the service sector had slowed and there had been continued reports of an easing in ICT recruitment. Skill shortages had continued to ease and pay growth had been broadly unchanged.

A51 The Agents had conducted a survey of around 170 firms on their exports over the past year and revisions to export prospects for 2001 as a whole. Contacts had been asked about revisions in export prospects to the EU and about the factors causing them. About three-quarters of respondents had reported that exports to the EU in 2001 Q2 had been lower than or the same as a year earlier, while the proportion for total exports had been about 60%. A net balance of around two-fifth of firms had reported that they had revised down their expectations for the growth of exports to the EU since the beginning of the year, while the net balance for overall export growth had been about a third of firms. This net downward revision had mainly reflected weaker prospects for exporters of capital goods and services. Respondents had cited the level of sterling and demand conditions abroad as the most important factors behind the downward revisions. For some contacts, foot-and-mouth disease had dented prospect for exports of food products and had adversely affected prospects for inward tourism.

VII Market intelligence

A52 Expectations of official interest rates implied by short sterling futures had fallen since the Committee's previous meeting, decreasing by 20 to 55 basis points for contracts maturing between September 2001 and end-2003. A large reduction in short sterling rates had occurred on 6 July, following the release of the industrial production data for the United Kingdom and the non-farm payrolls data for the United States. Both of these data releases were weaker than market participants had been expecting. Other considerations that had contributed to the decline in rate expectations over the month were the decline in equity prices and the weaker-than-expected GfK consumer confidence survey data for the United Kingdom. Fears of much weaker-than-expected UK GDP data towards the end of the month had also been cited by market participants as having led to a fall in short-term interest rate expectations. Although the market expectations of much weaker GDP growth had proved unfounded, interest rate expectations remained lower after publication of the data.

A53 Most money market traders had expected the Committee to leave the official repo rate unchanged at its August meeting. Similarly, economists polled by Reuters on 26 July had attached an 81% mean probability to no change in the Bank's repo rate on 1 August.

A54 The sterling exchange rate index had fallen to 106.8 from 107.9 at the time of the Committee's July meeting, reflecting both international developments and UK-specific factors. Within the month, there had at times been signs of EMU convergence effects leading to a decline in sterling's exchange rate.