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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 July 2001

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 July 2001

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0107.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 1 and 2 August will be published on 15 August 2001.



MINUTES OF MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 JULY 2001

1 Before turning to its immediate policy decision, the Committee discussed demand and output; money and credit; the world economy; the labour market; and prices and costs.

Demand and output

2 The Committee began by considering the most recent National Accounts data, and the strength of many of the indicators relating to consumption.

3 The National Accounts estimates for 2001 Q1 showed quarterly real GDP growth at 0.5%, up from 0.4% in the earlier release, and slightly higher than in 2000 Q4. By contrast, estimates of growth in final domestic demand had been revised down to zero, from 0.5% previously. These data were difficult to interpret. All of the 0.8% increase in domestic demand in Q1 was now attributed to stockbuilding (which included a positive alignment adjustment, an adjustment made to inventories to help balance the National Accounts). The other major revision was to whole-economy investment, which was estimated to have fallen by 3.2% in Q1, rather than rising by 0.7% as in the previous release. Within this total, business investment, and more particularly services sector investment, had fallen sharply. As expected, given the slowdown in the world economy, net trade had made a negative contribution to GDP growth in Q1, but government consumption in real terms had grown rather faster than previously thought.

4 It was puzzling that household consumption growth had not shown more of a rebound; at 0.6%, it was estimated to have grown no faster in Q1 than in the previous quarter, when it had been affected by bad weather and transport-related disruptions. Other indicators suggested a more buoyant picture for consumer spending, which had continued into the second quarter. Retail sales volumes had been growing very rapidly, at around 1½% at a quarterly rate since the turn of the year, and by 6.4% in the year to May. Such growth was much more rapid than the equivalent figures for household consumption of retail goods in the Q1 National Accounts. The latter figures might be revised (perhaps with a corresponding reduction in the alignment adjustment), although it was noted that even if the estimate for consumption growth were doubled to 1.2%, final domestic demand growth in Q1 would be only half the rate assumed in the *May Inflation Report*. Even if the figures

were not revised, such a disparity in growth rates was unlikely to persist for long. The strength in retail sales appeared to be consistent with rising consumer confidence (with the GfK measure in June at its highest since January 2000) and with the money, credit and housing market data. However, some of the strength might have reflected a shift in spending out of sectors such as leisure services, which had been affected by the foot and mouth outbreak. New private car registrations had risen by over 12% in the year to May, though this represented a slower rate of growth than earlier in the year.

5 The housing market appeared distinctly strong. The Nationwide and Halifax house price indices were both increasing by around 9½% on a year earlier, which seemed consistent with the data from the Royal Institution of Chartered Surveyors on the balance of estate agents reporting rises in house prices. If anything, house prices had accelerated recently, and mortgage approvals had risen further. The strength of house prices was both a symptom and a cause of robust consumer confidence. It would partly offset the fall in financial wealth resulting from movements in equity prices, which had declined by just over 5% since the Committee's June meeting.

6 Survey evidence was mixed. The index of business activity in services produced by the Chartered Institute of Purchasing and Supply (CIPS) had increased only slightly in June, and was still well below its average level for the preceding two years, despite an easing of the effects from the foot and mouth outbreak. The index for manufacturing, however, had risen a little (while remaining below the 'no change' 50 level) and that for construction had strengthened further. The Engineering Employers' Federation survey showed a significant weakening of output and new orders in the sector.

7 Would consumption growth soon start to slow, as had been forecast in the *May Inflation Report*, in part because of a deceleration in financial wealth? In one sense it already had: in the National Accounts for the past two quarters it had been steady at only 0.6% a quarter. But many of the consumption-related indicators remained strong, and it was not clear what would cause this underlying strength to diminish. Household debt-income ratios were at record levels, but the costs of servicing the debt in nominal terms, as measured by income gearing levels, were not unusually high. Consumer confidence might fall back if unemployment began to rise, but to date unemployment had continued to decline. The strength of house prices provided ample collateral against which consumers could borrow, often at very competitive rates. Increases in wealth had helped in the past

to support consumption, which over the past four years had tended to grow faster than real incomes, with the saving ratio falling to just over 4% in Q1.

8 Over and above the temporary effects associated with the foot and mouth outbreak, there were underlying imbalances within the economy and these could not continue to widen indefinitely. Over the past five years, private final domestic demand had grown by around 4½% a year. Such growth could not continue in the long run, at least on the basis of present estimates of likely growth in productive potential. To date, the counterpart had been a steady deterioration in the net trade position, although the worsening in trade volumes had to some extent been masked by changes in the terms of trade.

9 In general, the strongest areas of the economy were those least affected by competition from overseas, while the weakest were those exposed to the downturn in the world economy, and to the weakness of the euro against sterling. The Index of Production data for May, available to the Committee at its meeting, showed manufacturing again declining by more than had been expected. The electrical and optical equipment sector showed another sharp fall, reflecting the global downturn in the information and communications technology (ICT) sector, although this did not account for all of the reduction in manufacturing output.

10 Profitability data illustrated this dichotomy well. In 2001 Q1, the net rate of return on capital in services had been close to 15%, while that in manufacturing had fallen below 4%, from almost 11% in 1998. More generally, the drag on GDP growth from net trade helped to explain why the indicators relating to the corporate sector tended to be weaker than those relating to consumption. This divergence seemed particularly marked at present. It was possible that the strength of consumption might in the future feed through more fully into domestic production. Alternatively, pressures on businesses might lead to cutbacks in employment, which would then act as a brake on consumption growth, not least through the effects on consumer confidence.

11 The trade deficit on goods and services might be sustainable at current levels, at around 2% of GDP. But were the deficit to go on increasing, a fall in the exchange rate would become more likely. Moreover, the exchange rate might fall for other reasons, for instance a recovery in the euro. The implications of a fall in the exchange rate for the economy and for policy would depend on the reasons for that fall, and on the context.

Money and credit

12 Annual growth in broad money and credit had eased in May, reflecting slower growth in both measures for private non-financial corporations. Growth in notes and coin remained high by the standards of the past decade, but had not risen any further despite an acceleration in retail sales values.

13 Lending to households remained buoyant, growing by 9.7% in the year to May, and household M4 growth had picked up to 8.4%, its highest rate for nearly ten years. In part this reflected the weakness of retail unit trust sales and other inflows into equities, with some of these funds being held on deposit instead. Nevertheless, the increase in household money growth was consistent with continued robust retail spending growth. Loan approvals for house purchases had risen to their highest level since 1997 (when there had been a break in the statistical series) and growth in secured borrowing had also increased recently. All of this helped to buttress the present strength of the housing market, and of consumption more generally.

14 Interest rate expectations implied by short sterling futures had risen by up to 50 basis points since the Committee's previous meeting. This increase seemed to have been triggered by the unexpectedly strong RPIX data for May, even though much of that rise had resulted from increases in the prices of seasonal food and petrol, both of which might prove to be temporary.

15 While the RPIX data might have been the catalyst for this movement, particularly at short maturities, the increase in market rates had subsequently been underpinned by the strength of retail sales, and by the consumer confidence and housing market data. It was also possible that the dip in sterling early in the month had made the market more aware of the downside risks attached to the currency, even though the fall, which seemed to have been associated with speculation about early UK entry into economic and monetary union, had proved temporary.

16 While the move up in futures rates may have been exaggerated, there now seemed much less expectation in the market of a reduction in the repo rate to 5% or below. A poll of economists by Reuters on 28-29 June had put the probability of no change in the repo rate at the Committee's July meeting at nearly 80%, with divided views about the path of interest rates thereafter. The rise in

market rates was also beginning to feed through into the rest of the economy, with some lenders increasing their two-year fixed mortgage rates during the past month.

17 The Committee agreed that while market rates were not necessarily a good predictor of the future path of official interest rates, there had clearly been a shift in the market's perception of UK economic prospects over the past month. To the extent that this persisted, and falls in the Bank's repo rate were no longer discounted in market prices, it represented a de facto tightening in monetary conditions relative to the position a month earlier.

The world economy

18 Prospects in the United States seemed if anything a little brighter than a month ago. GDP growth in the first half of 2001 seemed to be running at around 1% at an annual rate, and the most likely outcome was for growth to pick up moderately over the remainder of this year and into 2002, though some members thought that growth in the first half of 2001 might be weaker. The Committee agreed that there were still significant risks, not least if there were to be a major downward revision to views of the sustainable medium-term growth rate of US productivity.

19 Consumer spending in the United States had so far proved resilient, with real consumption increasing by 0.3% both in April and May, while retail sales were little changed in May, after strong growth in April. Spending on autos had remained fairly robust, as had the housing market. The Conference Board measure of consumer confidence had also risen a little in June. But the overall business sector stock-to-sales ratio was increasing, despite falls in inventories, and the ICT investment overhang persisted, with sharp falls in capacity utilisation in that sector. Nevertheless, there were some signs that the falls in manufacturing output might soon begin to moderate. In particular, the National Association of Purchasing Managers' index had risen by 2½ points in June to 44.7, its highest level since November, although it remained well below the neutral 50 level. In addition, the 275 basis point reduction in US interest rates had yet to feed through fully into spending, and nor had the tax rebate, which would be distributed in Q3. But while non-defence capital goods orders had risen slightly in May, there had been a sharp fall in the imports of capital goods in April, which served to underline the global effects on this sector of the US downturn.

20 The outlook for the Japanese economy continued to be gloomy, although the deterioration in business prospects as measured by the Tankan survey had been a little less than expected by the market. GDP in Q1 had fallen, with private investment and exports especially weak. Since then, industrial production had declined by 1.2% in May, and by over 5% over the past year.

21 In the euro area, annual HICP inflation in May had risen to 3.4%, with the core measure edging up to over 2%. Meanwhile domestic demand in Q1 had been weak, with industrial and consumer confidence measures falling steadily during Q2. This slowdown would tend to result in higher fiscal deficits than otherwise, provided the automatic stabilisers were allowed to operate to cushion the effects on demand.

22 In Germany, industrial orders, particularly for capital goods, were sharply lower in April, and the IFO index of business confidence had fallen in May to its lowest level for two years. Consumption too was weak, with little sign of any boost from the tax cuts earlier in the year. Weak domestic demand in Germany had been a feature for some time, but there were also now signs of a weakening in domestic demand growth in France, which until recently had been relatively strong. All in all, near-term prospects in the euro area seemed weaker than previously.

23 It was clear that the slowdown in the euro area was not merely a reflection of a weaker world economy: net trade in Q1 had been a major contributor to GDP growth there, although this was due to a sharp fall in import volumes. The weakness of the euro was a complicating factor: it would tend to boost net trade volumes, while reducing the growth in real disposable incomes, and thus perhaps consumption growth. While an upturn in the United States would of itself help to sustain activity in the euro area, both directly and via confidence effects, there were also domestic factors behind the slowdown, particularly in Germany. Moreover, were the euro area to slow while growth recovered in the United States, this would tend to exacerbate the international imbalance.

The UK labour market

24 The Committee discussed whether the labour market had reached a turning point, or was instead continuing to tighten, and how far the present tightness was feeding through into pressures on pay.

25 Employment growth, as measured by the Labour Force Survey (LFS), had slowed in the three months to April compared with the previous three months, and was now broadly in line with the increase in the population of working age. This had followed a period of more rapid employment growth, after the disruptions of the previous autumn. Average hours worked had also fallen, but this decline might be erratic. The corresponding figures for LFS unemployment showed a decline of 65,000, similar in size to the increase in those not active in the labour market. The claimant-count unemployment measure had continued to fall in May.

26 Looking forward, the CIPS employment index had fallen to only a little above the 'no change' level of 50 in Q2, and the Recruitment and Employment Confederation survey suggested that the availability of staff had improved for the first time in two years. But while reports from the Bank's regional Agents suggested that the labour market, though tight, was no longer tightening any further, the number of vacancies reported to job centres in May had reached its highest level since the series was first published in 1980. It was therefore not at all clear that the labour market had yet reached a turning point.

27 Growth in the headline Average Earnings Index (AEI) had risen from 5.0% in March to 5.2% in April. The annual growth rate of regular pay (ie, earnings less bonuses but including overtime) had risen sharply, from 4.8% in March to 5.3% in April. Much of this reflected increases in the public sector, notably the backdating of threshold payments to teachers joining a new salary structure. In the private sector, regular pay had risen by 5.2% in the year to April, little different from its average over the past three years. More generally, the AEI had been volatile in recent months, partly because of 'echo effects' as payments related to the millennium date change dropped out of the annual comparison.

28 Settlements continued to average between 3% and 3½%, although if RPI inflation moderated more slowly than had earlier seemed likely this could reduce the downwards pressure on pay in the future. While the Agents had reported some easing in skill shortages, their contacts had also noted a few signs of increasing earnings pressure. Such an increase would be consistent with other signs that underlying regular pay growth had recently edged up.

Prices and costs

29 RPIX inflation had risen from 2.0% in April to 2.4% in May. This increase largely reflected sharp rises in the prices of seasonal foods and petrol. But some of the increase in inflation since January was more broadly based, although much was explained by increases in food prices. Some of the other price measures had also increased sharply, with RPIY and HICP inflation both up by 0.6 percentage points in May, to 2.8% and 1.7% respectively. It was noted that a 'persistence-weighted' measure of RPIX inflation had also risen, although it was still at a relatively low level (1.7%).

30 Part of this increase in inflation appeared to be temporary. Oil prices had fallen from around \$29 per barrel to under \$26 over the past month, and world gasoline prices had fallen relative to oil prices. The earlier strength of oil prices had been surprising; the recent reduction seemed more consistent with the much slower pace of world economic activity during 2001. While seasonal food prices might remain high for some months to come, these were likely to return to more normal levels by next year. There was also little sign that the increase in inflation had fed through into expectations of inflation further forward.

31 The Committee agreed that it would be wrong to read too much into one month's figures, and that RPIX inflation was likely to continue to fluctuate in the months ahead. There was in any case little the Committee could or should do to affect inflation over the very short term.

32 Surveys of retail prices had risen, consistent with the recent increase in RPIX inflation. But earlier in the supply chain, manufacturing input and output price inflation had fallen, as had the equivalent CIPS indices. Similarly, in the services sector the CIPS surveys of average prices charged and average input prices had both continued to fall, to their lowest levels since 1999.

The immediate policy decision

33 Members agreed that while there had been a considerable amount of news during the month, on balance it had not greatly altered their views on the appropriate setting of policy, although for some the news made it rather less likely that the next movement in interest rates would be down.

34 The Committee agreed that the prospects for the world economy were mixed. There had been some more promising news from the United States, in the sense that activity seemed to be holding up rather better than might have been feared. But the economic outlook for Japan and the euro area seemed worse than a month ago. With sterling remaining rather stronger than projected in the May *Inflation Report*, and given the importance of the euro area to UK exporters, the prospects for net trade had deteriorated. Partly for this reason, manufacturing production had weakened in recent months; the CIPS services survey was also not as strong as might have been expected. The National Accounts data showed a sharp rise in stockbuilding in Q1, with investment declining steeply, although both might prove to be erratic. But many of the other domestic indicators were robust: retail sales (although not the Q1 consumption figures), household credit, the housing market and consumer confidence. There was also little sign that the labour market was yet on the turn, although some forward-looking indicators continued to suggest that it might be soon. There were few indications of any marked increase in settlements, although regular pay growth had edged up over the past month. Much of the recent increase in RPIX inflation reflected temporary factors, such as seasonal food prices, and oil prices had begun to fall back. There were, however, some signs of a more broadly based increase in inflation since the start of the year, although forward-looking surveys suggested that this might not persist.

35 Against this background, most members of the Committee felt that the repo rate should not be changed this month. While it was important not to overinterpret some of the rather erratic recent data, on balance the information appeared to point to robust growth in consumption, combined with continuing pressure on the internationally exposed sectors, a buoyant labour market, and rather higher inflation in the short term than had earlier seemed likely. The strength of consumption seemed broadly based, with little sign of any faltering. While interest rates in the United Kingdom were higher in real terms than in some other countries, this probably reflected differences in national savings and investment patterns; there was no compelling evidence that the present level of interest rates was inappropriate. The dichotomy between the internationally exposed and more sheltered sectors continued, but while this heightened the risks at some point of an adjustment downwards in the exchange rate, differing views were expressed about the implications of this for policy. For some, the risk that the exchange rate was more likely to fall than to rise further in itself affected the inflation outlook, and so should enter the considerations for the setting of interest rates. Others questioned how far policy should seek to anticipate a fall in the exchange rate.

36 In any case, the news on the month suggested that there was no need to move rates. Instead the Committee should monitor the situation, being prepared to adjust rates in either direction in the light of new information. To the extent that market rates no longer discounted a further reduction in the repo rate, there had been a slight tightening in monetary conditions, which to some members was not unwelcome. For these reasons, the repo rate should remain at 5¼% this month.

37 On another view, it would have been right to reduce the repo rate to 5% at the Committee's previous meeting, and nothing had changed since then to alter this view. The news had been mixed, both on the world economy (where the US outlook remained unclear and where prospects elsewhere had weakened) and domestically. Equity prices had fallen back, suggesting some weakening in confidence about the outlook. The Q1 National Accounts data suggested that destocking represented a significant risk to the near-term outlook, and investment was weakening. Final domestic demand in Q1 was well below the central projection in the *May Inflation Report*, and it was likely that GDP growth in Q2 would be no higher than 0.5% for the third quarter in a row. While the housing market and retail sales remained strong, there were few signs of increasing pressures, either in the labour market or on prices, from forward-looking data. RPIX inflation had been higher than expected in May, but this reflected temporary effects which were unlikely to persist into next year, and it was notable that the global energy and food price shocks had been sufficient only to bring inflation back up to target, with UK inflation well below headline inflation in many other countries. The recent fall in the prices of oil and metals, and global competitive pressures, reflecting excess capacity in the world economy, would restrain UK inflation. Turning to the issue of imbalances and any associated exchange rate risk, if the short-term interest rate was held higher now because of an expected depreciation of the exchange rate, this might lead sterling to be stronger than it might otherwise be. Domestically, output recently had been growing below trend, reducing the pressure on productive potential. For these reasons, a reduction of 25 basis points in the repo rate to 5% was needed to meet the inflation target.

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

39 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

Gus O'Donnell was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 29 June in advance of its meeting on 4-5 July 2001. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is recorded in this Annex.

I The international environment

A2 According to the Bank's latest estimate, world GDP growth had slowed to 2.2% in the year to 2001 Q1, from 3.4% in 2000 Q4. World industrial production growth had slowed to 0.1% in the year to April, from 1.1% in March. Growth forecasts for 2001 from the Consensus Economics survey had been revised down by 0.3 percentage points for Japan, to 0.6%, with smaller downward revisions for the United States and the euro area.

A3 The spot price for Brent crude oil had fallen by around \$3.50 per barrel since the Committee's previous meeting, to around \$25.50. Other commodity prices were also lower: the Economist industrial commodity index had declined by 4.7% over the past month and the Economist food index had fallen by 1.2%.

A4 In the United States, manufacturing output had fallen by 0.7% in May. The decline had been particularly pronounced in the information and communications technology (ICT) sector, where output had fallen by 1.2% in May. The National Association of Purchasing Managers' index had risen to 44.7 in June from 42.1 in May, its highest level since November. Real consumption had risen by 0.3% in May following growth of 0.3% in April, although retail sales growth had slowed to 0.1% in May, compared with growth of 1.4% in April. The Conference Board measure of consumer confidence for June had risen to 117.9, from 116.1 in May; the increase mainly reflected a rise in the expectations component of the index.

A5 Industrial capacity utilisation had fallen to an 18-year low of 77.4% in May. The measure had fallen most sharply in the ICT sector, to 70.3% in May from 72.2% in April. Imports of capital goods had declined by 9.1% in April, although orders of non-defence capital goods had increased by 0.9% in May. Trade volume growth had continued to slow; import volumes had fallen by 2.7% and

exports by 3.2% in April. Producer prices had risen by 0.1% in May, to a level 3.8% higher than a year earlier. Core annual consumer price inflation – ie, excluding energy prices and food – had fallen to 2.5% in May from 2.6% in April. However, the headline annual rate of consumer price inflation had increased to 3.6% in May from 3.3%, which reflected a 6.0% rise in gasoline prices.

A6 In the euro area, GDP had grown by 0.5% in 2001 Q1, compared with growth of 0.6% in 2000 Q4. Growth had been boosted by a positive net trade contribution, arising from a sharp fall in imports. The increase in net trade had been offset by a negative contribution from investment, which had fallen by 0.9% in 2001 Q1.

A7 Euro-area industrial and consumer confidence had both continued to weaken in June; the European Commission industrial confidence indicator had fallen from -5 in May to -7, while the consumer confidence indicator had declined from -4 to -5. The west German IFO business confidence index had also fallen, from 92.5 in April to 90.9 in May, its lowest level for two years. German industrial orders had fallen by 1.1% in April, the fourth consecutive monthly decline. The sharpest fall had been in orders of capital goods, which had declined by 5.3%.

A8 Unemployment in Germany had risen by 18,000 in May, the fifth consecutive monthly increase, and by 28,000 in France, the first increase since August 2000. French consumer spending on manufactured goods had fallen by 0.5% in May, the second successive monthly fall, and spending on durable goods had fallen by 1.3%. French annual producer price inflation had fallen to 2.8% in May from 2.9% in April. In Germany, annual producer price inflation had fallen to 4.6% from 5.0% a month earlier. However euro-area annual HICP inflation had risen to 3.4% in May, compared with 2.9% in April. Core HICP inflation in the euro area had risen to 2.1% in May from 1.9% in April.

A9 Japanese GDP had fallen by 0.2% in 2001 Q1. Private consumption had been flat on the quarter, despite an increase of 1.5% in employees' compensation, and private investment had declined by 1.8%. Net trade had also made a negative contribution to GDP growth, due to a decline of 3.6% in exports. Industrial production had fallen by 1.2% in May, to a level 5.2% lower than a year earlier. Export volumes had declined by 9.9% in the year to May. However, import growth had stabilised in May, with volumes 3.5% higher than a year earlier. The Tankan all-industry diffusion index – a measure of business conditions – had declined to -27 in June from -22 in March.

II Monetary and financial conditions

A10 The twelve-month growth rate of notes and coin had risen slightly to 7.2% in June, and the three-month annualised growth rate had risen to 4.5%.

A11 The twelve-month growth rate of M4 had fallen in May to 7.5%. The twelve-month growth rate of M4 excluding other financial corporations (OFCs) had risen to 7.3%. The twelve-month growth rate of aggregate M4 lending (excluding the effects of securitisations) including and excluding OFCs had fallen in May, to 10.1% and 8.9% respectively.

A12 The twelve-month growth rate of household M4 had risen in May to 8.4%, the highest annual growth rate since 1991 Q3, and household M4 lending (excluding the effects of securitisations) had risen to 9.7%. Within total lending to individuals, annual growth of net secured lending had risen slightly in May to 8.4%, while the growth rate of net unsecured borrowing had fallen slightly to 11.7%. The number of loan approvals for house purchase had risen to 107,000, the highest since at least October 1997, when there was a statistical break in the series. The estimate of mortgage equity withdrawal in 2001 Q1 had been revised down slightly, from £3.2 billion to £3.1 billion. The debt to income ratio for the household sector had risen to 106.5% in 2001 Q1. The household sector debt to net wealth ratio (capital gearing) had risen to 16.3%, and the ratio of interest payments to income (income gearing) for the household sector had risen slightly, to 8.8% in 2001 Q1. While the debt to income ratio was at a historical high, households' income and capital gearing were still substantially below their previous peaks.

A13 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 had fallen in May to 2.9%. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had also fallen in May, to 6.9%. Total external corporate finance had risen by £6.4 billion in May, however, as market issuance rebounded. A measure of the liquidity ratio of PNFCs had fallen slightly in 2001 Q1, to 64.4%. The PNFCs' net debt to profits ratio had risen to 159.5%, above its previous peak in 1991. The ratio of PNFCs' interest payments to profits had fallen slightly to 21.1%, and was still well below its 1991 Q1 peak of 31.5%. The ratio of PNFCs' net debt to the value of the PNFCs' capital stock (capital gearing) had risen to 28.7% on a replacement cost measure and to 21.3% on a market value measure. The distribution of quoted companies' capital gearing on a replacement cost measure had widened further in 2000 compared with 1999.

A14 The twelve-month growth rate of OFCs' M4 had fallen in May to 8.1%. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had fallen to 14.1%.

A15 Short-term nominal forward interest rates had risen since the Committee's previous meeting. Long-term forward rates, at maturities of more than ten years, had fallen over the past month, but were still above their trough in March. The skew of the distribution of future three-month interest rates derived from short sterling options data had been negative at the time of the Committee's previous meeting, but had since risen above zero. The implied volatility of short sterling futures had also risen over the month.

A16 Real forward interest rates derived from index-linked gilts had fallen at all horizons since the Committee's previous meeting. The largest fall had been at the long end, with real forward rates falling by 27 basis points at a maturity of 25 years. Inflation expectations derived from conventional and index-linked gilt yields had risen at all horizons over the month.

A17 Survey-based measures of the inflation expectations of professional economists and the general public had risen in 2001 Q2.

A18 The standard variable mortgage rate (SVR) had fallen by 25 basis points in June, and the cumulative fall in the SVR since January had exceeded the fall in the repo rate. Two-year fixed-rate mortgage rates had risen in June, in line with swap rates. Two-year discounted variable rates had risen by 5 basis points in June. Savings rates and personal loan rates had fallen, but credit card rates had remained unchanged.

A19 UK corporate spreads over gilts had risen slightly, in line with swap spreads, since the Committee's previous meeting. Spreads on European telecommunications companies had risen since the June meeting, but were well below their peak in March. Issuance of non-gilt sterling bonds had fallen in June.

A20 The FTSE All-Share and FTSE 100 indices had fallen by 5.5% and 5.4% respectively since the Committee's previous meeting. The FTSE 250 and Small Cap indices had fallen by 5.7% and 7.1% respectively over the same period. IT and cyclical consumer goods had been the weakest

sectors. The number of profit warnings had fallen slightly in June, but was still above the level in June 2000.

A21 Since the Committee's June meeting, the sterling exchange rate index (ERI) had appreciated by 0.2% to 107.9, with sterling little changed against both the euro and the dollar. Forecasts from the Consensus Economics survey in June for the ERI two years ahead had fallen by 0.4% relative to the May survey. Longer-run Consensus forecasts for sterling against the euro had risen in the June survey relative to the February survey, and were back at the levels of the October 2000 survey.

III Demand and output

A22 In the National Accounts, quarterly real GDP growth had been revised up to 0.5% in Q1 from 0.4% in the previous release. Annual growth had also been revised up slightly, to 2.7% from 2.6%. The revisions had had little effect on the level of GDP in 2000.

A23 On the output side of the accounts, the main revision had been to the growth of construction output, which had been revised up to 1.7% in Q1 from -0.5% in the previous release. Service sector growth had been revised up slightly, to 0.9% from 0.8%.

A24 On the expenditure side of the accounts, quarterly final domestic demand growth in Q1 had been revised down to zero, from an initial estimate of 0.5%. This had largely reflected a downward revision to whole-economy investment growth. Domestic demand growth in Q1 had been unrevised at 0.8%.

A25 Household consumption growth in Q1 had been unrevised at 0.6%. Growth in whole-economy investment had been revised down to a fall of 3.2% in Q1 from the previous estimate of a rise of 0.7%. Within whole-economy investment, business investment growth was estimated to have fallen by 5.0% in Q1, the largest decline since 1985. Within business investment, manufacturing investment had grown by 0.9% in Q1 and service sector investment had fallen by 6.2%. Investment in dwellings had grown by 1.4%. Government investment had grown by 2.3% in Q1, following an upwardly revised growth rate of 16.6% in Q4.

A26 Real government consumption growth in Q1 had been revised up to 0.8% from 0.1%. Nominal government consumption had grown by 1.1%. The growth of nominal consumption had been revised down in the first three quarters of the fiscal year 2000/2001 so, when the upward revisions in Q1 were included, total nominal government consumption over the fiscal year 2000/2001 had been slightly lower than the Budget forecast.

A27 The contribution to GDP growth from stockbuilding in 2001 Q1 had been revised up to 0.9 percentage points from the previous estimate of 0.3 percentage points. Within stockbuilding, the alignment adjustment had contributed 0.4 percentage points to GDP growth.

A28 Total exports of goods and services had risen by 1.4%, while imports had grown by 2.2%. The contribution of net trade to GDP growth had been revised from -0.5 to -0.4 percentage points.

A29 On the income side of the accounts, households' real post-tax labour income had fallen by 0.1% in Q1 and real post-tax total income had fallen by 0.8%. The saving ratio had fallen to 4.1% from 5.5% in Q1. The household financial deficit had increased slightly in Q1 to 1.3% of GDP.

A30 The gross operating surplus of public and private corporations had risen by 4.7% in Q1 compared with a fall of 1.4% in Q4. The corporate sector's financial deficit decreased in Q1. Taking corporates and households together, the overall private sector deficit had been 2.4% of GDP in Q1 and had remained well below the levels of the late 1980s.

A31 The current account deficit had narrowed in Q1 to £0.2 billion from £3.7 billion in Q4. The trade deficit had widened to £5.0 billion in Q1 from £4.7 billion in the previous quarter, but this had been offset by an increase in the surplus on investment and other income to £5.5 billion in Q1 from £2.2 billion in Q4.

A32 Turning to Q2, retail sales had risen by 0.8% in May, from 0.6% in April. The GfK measure of consumer confidence had risen in June, to +6 from +3 in May, the highest balance since January 2000. New private car registrations in May had risen by 12.7% on a year earlier.

A33 The Halifax and Nationwide house price indices had risen by 1.6% and 1.9% respectively in June. On a three-month basis, the Halifax index had grown by 4.4% and the Nationwide index by 2.6%. Particulars delivered had fallen by 3,000 to 110,000 in May.

A34 The May industrial production data had been made available to the Committee in time for its meeting. Manufacturing output had fallen by 0.9% in May. This had mainly reflected a sharp fall in the output of the electrical and optical equipment industries. The three-month growth rate of manufacturing output had been -1.6%, the largest three-month fall since June 1991. The CBI industrial trends survey had shown small rises in orders in June; the total orders balance had risen to -22 from -24 and the export orders balance had risen to -29 from -32. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing activity index for June had risen slightly to 47.3, reversing the fall in May.

IV The labour market

A35 According to the Labour Force Survey (LFS), employment had risen by 67,000 (0.2%) in the period from February to April compared with the previous three months. This slowdown in employment growth, which had been close to 0.4% per quarter in recent data releases, was likely to have been a result of the period of temporary disruption during the autumn dropping out of the three-month on three-month comparison. The working-age employment rate had risen by 0.1 percentage points to 74.8%. Total actual hours worked had fallen by 0.4% in the period from February to April compared with the previous three months, reflecting a decline in average actual hours worked.

A36 The number of Workforce Jobs had fallen by 12,000 in the three months to March. The main falls had been in the public sector, in the production industries and in agriculture. Any impact from foot and mouth disease was thought to have been limited, since these data were collected on 9 March, only a few weeks after the first outbreak.

A37 The CIPS employment index for the service sector had fallen close to the neutral 50 level in June, consistent with little or no employment growth. The manufacturing index had risen slightly, although employment in manufacturing had continued to fall. Employment growth in construction

had remained firm. Looking at Q2 as a whole, employment growth across the whole economy had slowed, with the CIPS index averaging 50.2 compared with 52.7 in Q1.

A38 The June Recruitment and Employment Confederation survey had shown a slight improvement in the availability of both permanent and temporary staff for the first time in more than two years. And the Bank's regional Agents had reported a slight easing of skill shortages in June, notably in the information technology sector. Nevertheless, the number of vacancies notified to job centres remained at an all-time high. There had been 246,200 vacancies notified in May, the highest monthly figure since data measured on a comparable basis were first collected in 1980.

A39 LFS unemployment had fallen by 65,000 in the period from February to April compared with the previous three months. The LFS unemployment rate had fallen by 0.2 percentage points to 5.0%. Over the same period, claimant-count unemployment had fallen by 39,000. It had fallen by a further 3,200 in May. It would have fallen further had it not been for the introduction of Joint Claims, which the ONS estimated had added around 4,300 to the stock of claimant-count unemployment during April and May.

A40 The number of inactive people aged over 16 had risen by 61,000 in the period from February to April. At the same time, the number of inactive people of working age had risen by 50,000. The number of inactive people of working age who said they did not want a job had risen by 70,000. During the past year, there had been a marked fall in participation rates among the younger age groups, and particularly among those aged 16 to 17.

A41 Whole-economy headline earnings growth, as measured by the Average Earnings Index (AEI), had risen by 0.2 percentage points to 5.2% in April. The whole-economy annual rate had risen by 0.4 percentage points to 4.7% in April. Private sector annual earnings growth had risen by 0.5 percentage points to 4.7%; public sector annual earnings growth had risen by 0.9 percentage points to 5.4%.

A42 Annual earnings growth can be split into the contribution from bonuses and the contribution from non-bonus, or regular, pay. In April, the whole-economy bonus contribution had been -0.7 percentage points (not seasonally adjusted). Unlike March, this negative contribution was not thought to have been the result of a change in the timing of payments.

A43 Whole-economy regular pay growth had risen by 0.5 percentage points to 5.3% in April (not seasonally adjusted). The sharpest increase had been in the public sector, where regular pay growth had risen by 1.3 percentage points to 6.0% (not seasonally adjusted). Education, health and social work accounted for almost all of this increase. Aside from the usual April pay round, it was probable that the backdating of threshold payments to experienced teachers who had successfully applied to join a new pay scale had contributed significantly to public sector regular pay growth in April. Regular pay growth had risen by 0.7 percentage points to 5.3% (not seasonally adjusted) in manufacturing, due partly to increased overtime hours. Regular pay growth in private services had remained at 5.0% (not seasonally adjusted).

A44 According to information from the Bank's settlements database, the twelve-month AEI-weighted mean settlement had risen by 0.1 percentage points to 3.4% in May.

A45 Annual growth in productivity on the Bank's LFS-based heads measure had been unchanged at 1.9% in Q1. At the same time annual growth on an alternative measure, based on Workforce Jobs data, had fallen by 0.1 percentage points to 2.2%. Annual growth in wages and salaries per head had picked up in Q1. As a result, annual growth in unit wage costs had risen by 0.4 percentage points to 2.1%.

V Prices

A46 The Bank's oil-inclusive commodity price index had risen by 2.2% in May. The annual inflation rate had fallen to 18.9% in May from 23.8% in April due to base effects. The rise on the month had mainly reflected a rise in the price of oil; the average sterling oil price in May had been more than 8% higher than the April average. Excluding fuels, the Bank's commodity index had risen by 1% in May, taking the annual inflation rate to 8.4% in May from 6.6% in April.

A47 Manufacturing input prices had risen by 1.4% in May, taking the annual inflation rate to 4.7% in May from 6.7% in April. This figure excluded the effects of the Climate Change Levy, which the ONS had estimated would have added around 0.8% to the level of the input price index in May. Looking ahead, the CIPS input price balance had fallen to 45.7 in June from 48.6 in May. Manufacturing output prices excluding excise duties (PPIY) had risen by 0.2% in May. The

CBI Monthly Trends output price index had fallen to -17 in June from -12 in May, and the CIPS manufacturing output price index had fallen sharply, to 47.7 in June.

A48 The annual inflation rate of the GDP deflator at market prices in 2001 Q1 had been revised up to 2.4% in the latest National Accounts release from 2.1% in the previous release. The annual inflation rate of the GDP deflator at factor cost was estimated to have risen to 3.1% in 2001 Q1 from 1.6% in 2000 Q4. The annual inflation rate of the domestic demand deflator in 2001 Q1 had been revised up to 1.9% from 1.6%. This had reflected revisions to the government consumption deflator in 2000 and to the government consumption and investment deflators in 2001 Q1.

A49 Annual RPIX inflation had risen by 0.4 percentage points to 2.4% in May. The monthly rise had mainly reflected sharp increases in the contributions of seasonal food and petrol prices to annual RPIX inflation. Since January, annual RPIX inflation had risen by 0.6 percentage points. This cumulative increase had mainly reflected increases in the contributions from food, petrol and utility prices, although these had been partially offset by the downward effects of duty changes.

A50 Annual RPIY inflation had increased by 0.6 percentage points to 2.8% in May, while annual HICP inflation had risen to 1.7% in May from 1.1% in April.

VI Reports by the Bank's Agents

A51 The Bank's regional Agents reported that manufacturing output growth had continued to weaken and that there had been a sustained deterioration in business confidence within manufacturing. The ICT sector had remained the main driver of the deterioration. Manufacturing export growth had slowed further, with more signs of weaker demand, particularly from Germany.

A52 Construction output growth had stabilised at a robust level, following earlier weather-related delays. There had been more reports of increasing public sector construction, and contacts suggested that the demand for residential construction had continued to strengthen.

A53 Business services output growth had remained moderate, following the earlier weakening that had been driven by slowing activity in the ICT and financial services sectors. There had been further evidence that growth in consumer services had stabilised. The negative impact of foot and mouth

disease had continued to ease, but demand for tourism-related services had remained lower than a year ago.

A54 Investment intentions had stabilised, following a weakening in previous months. But there had been continued deferment of non-essential investment plans, particularly in the high-tech sectors of manufacturing. Most Agents suggested that investment spending in the service sector had remained robust, but some IT investment had continued to be deferred due to lower confidence caused by the US slowdown.

A55 Retail sales volumes had remained strong, but the pace of growth had shown signs of stabilising. Some Agents had reported tentative signs of an easing in consumer spending. Strong growth in new and used car sales continued to be reported.

A56 There had been further evidence of slower service sector employment growth and declines in manufacturing employment. Skill shortages had continued to ease, although they remained a significant concern. Contacts had maintained that the overall impact of the National Minimum Wage on output prices would be small.

A57 The Agents had conducted a survey of UK firms regarding changes in their levels of deposits and borrowing. Overall, firms had reported a slight fall in the level of deposits and quite a strong rise in borrowing over the past six months. This general pattern had broadly held for firms in the manufacturing and construction sectors, with firms in the construction sector reporting a stronger fall in deposits. Firms in the retail sector had reported a slight increase in deposits and (on average) unchanged levels of borrowing. Firms in the service sector had reported little change in the level of deposits, but a strong rise in borrowing. Overall, firms had reported that changes in cash flow and profitability, as well as investment intentions, had been the main drivers behind changes in both deposits and borrowing. Improved inventory control, particularly in the retail sector, had helped to reduce borrowing and increase deposits. Firms reported increased use of non-bank financing such as leasing and factoring. There had been no evidence of distress borrowing by firms.

VII Market intelligence

A58 Expectations of official interest rates implied by short sterling futures had risen since the Committee's previous meeting, increasing by 35 to 50 basis points for contracts maturing between September 2001 and end-2003. The increase had been most marked on 12 June, when the RPIX inflation figure for May of 2.4% had been published. This announcement appeared to have led market participants to revise up their short-term inflation forecasts and increase the probability that they attached to the Committee deciding not to reduce the Bank's repo rate any further. Stronger-than-expected retail sales, housing market activity, GfK consumer confidence and CIPS manufacturing survey data had also contributed to the increase in short-term interest rate expectations. In contrast, while there had been some discussion by market participants about the prospect of the United Kingdom joining economic and monetary union, this consideration had not appeared to affect short-term interest rates significantly during the period.

A59 Most money-market traders had expected the Committee to leave the official repo rate unchanged at its July meeting. Similarly, economists polled by Reuters on 28-29 June had attached a 79% mean probability to no change in the Bank's repo rate on 5 July.

A60 The sterling exchange rate index had been largely unchanged from the level of 107.7 seen at the time of the Committee's June meeting. However, there had been some volatility around the time of the election, associated with speculation that the United Kingdom might enter the European single currency earlier than had previously been expected. Sterling had reached a 15-year low against the dollar before recovering to pre-election levels later in the month. Sterling one-month implied volatilities against both the dollar and the euro had moved sharply higher, but this also seemed to have been a temporary phenomenon.