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# MINUTES OF MONETARY POLICY COMMITTEE MEETING 31 July and 1 August 2002

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These are the minutes of the Monetary Policy Committee meeting held on 31 July and 1 August 2002

They are also available on the Internet  
(<http://www.bankofengland.co.uk/mpc/mpc0208.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 4 and 5 September will be published on 18 September 2002.



## MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 31 JULY AND 1 AUGUST 2002

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; money, credit and the exchange rate; demand and output; the labour market; prices and costs; and some other considerations.

### **The world economy**

2 Over the month since the July MPC meeting, there had been further substantial falls in equity prices around the world. In domestic currency terms, the Wilshire index had fallen 4%, the Dow Jones Eurostoxx index 8%, the Topix index 7½% and the FTSE All-Share index 4%. Major indices (apart from Japan's) were some 20% below the average levels used as a starting point in the May *Inflation Report*; and some of the 'high tech' indices were 30% or so lower. Indices had been more volatile, too, and uncertainty about future prices had risen, judging by the expected volatility implied by options prices.

3 According to the first estimate of US GDP in 2002 Q2, the quarterly growth rate was 0.3%, slightly lower than expected. The growth rate of private investment, at 0.1%, although modest, was the first positive figure in seven quarters, and suggested that the divergence between consumption and investment growth might be narrowing a little. Substantial revisions to past data meant that GDP growth was now estimated to have fallen in the first three quarters of 2001, not just in the third quarter, and the estimated level of GDP in 2002 Q1 had been revised down by 1.3%. As a result, the implied growth rate of productivity in 2001 was now significantly lower. Both consumption and investment were affected by the revisions, but the revision to the estimate of firms' spending on computers – a reduction of 16% – was particularly marked. Any 'capital overhang' from excessive investment in ICT was consequently likely to be less than previously thought, so the prospects for investment might to that extent have improved. Forward-looking indicators in July, however, suggested some deterioration in the economic outlook. For example, the Conference Board measure of consumer confidence had fallen to 97.1, from 106.3 in June, and the Michigan measure to 88.1, from 92.4 in the previous month – for both measures, the second monthly fall in a row. While these data pointed to a more gradual and subdued recovery, it was important to remember that some

slowing from the sharply higher rate of GDP growth in 2002 Q1, now estimated to have been 1.2%, had been expected, given the one-off boost in that quarter from the turnaround in the inventory cycle.

4 News from the euro area was not reassuring about the robustness of the recovery there. There had been signs that activity had been lower than previously suggested by surveys, and now those forward-looking indicators were weakening too. Based on April and May data, it seemed likely that euro-area industrial production had fallen slightly in 2002 Q2, after rising 0.6% in Q1. Both consumer and industrial confidence in the euro area had fallen in June (the latest month for which comprehensive data were available). German, French, Italian and Belgian industrial confidence had fallen in July. Moreover, the outlook for external demand was likely to have deteriorated because of the rise in the euro's effective exchange rate during the second quarter. One factor behind the particular weakness of output in Germany might have been relatively high costs and output prices; if that were the case, activity might continue to be relatively weak while the German price level fell relative to the levels in other countries, including those in the euro area, leading to a depreciation of Germany's real exchange rate. But German labour costs had always been relatively high, and that had not prevented net external demand making an important contribution to German growth.

5 Against this background, the Committee discussed the probable causes and implications of the falls in equity prices. The news about real economic activity since the *May Inflation Report* had perhaps suggested that the global recovery was marginally less robust than previously expected, but that did not seem to be sufficient to explain the size of the equity price adjustments. It was puzzling now that the falls had been relatively uniform across most industrial countries, just as it had been puzzling that equity prices outside the United States had increased as much as they had in the second half of the 1990s, given the relative rates of productivity growth. In the United States, the continuing debate about corporate governance, the reliability of corporate accounts and events such as WorldCom's filing for protection under Chapter 11 on 21 July might have led to a view that the outlook for corporate profitability was weaker than previously priced into the equity market. The increase in the implied volatility of share prices suggested that uncertainty about corporate earnings had increased, and that would have reinforced the impact on those prices of any adverse shock to the outlook for profits. It was difficult to identify comparable factors affecting profit expectations outside the United States, so the size of the equity price falls elsewhere was perhaps surprising. Conventional valuation methods suggested that, even allowing for factors that might have increased equilibrium price-earnings ratios, equity prices in the United States might still embody unduly

optimistic expectations of corporate earnings growth. Nevertheless, over the week before the MPC meeting, the US market had proved quite resilient to disappointing data releases (such as the Q2 US GDP numbers), and market movements had been less correlated with the dollar, perhaps suggesting that domestic and foreign investors might have become more confident about valuation levels recently. It was also notable that US markets had reacted favourably to the signing into law on 30 July of the Sarbanes-Oxley Act, designed to protect investors by improving the accuracy and reliability of corporate disclosures, and addressing many of the perceived corporate malpractices recently in the public eye.

6 Given the uncertainty about why equity markets had fallen, it was difficult to estimate the likely impact of these falls on economic activity. But in broad terms, they were likely to depress both investment, by increasing the cost of capital, and consumption, by reducing household wealth. The impact on consumption was likely to differ across households, depending on the level and composition of their financial wealth. Direct holders of equities were likely to see a clear and immediate change in their wealth. The impact on households whose exposures to equities were less direct, for example through pension funds and life insurance, was likely to be slower and less certain, to an extent that would depend on the nature of the saving products held. It could reinforce other factors, such as increasing life expectancy, that might encourage people to save more. But it was noted that long-standing projections of increased funding problems for state pension schemes in several countries, which might also have been expected to stimulate higher saving, appeared to have had little effect on consumers' behaviour.

7 The deterioration in the prospects for some Latin American countries' finances did not appear to have had a substantial effect on international financial markets over the past month. Argentina's problems had not been resolved, Brazilian sovereign debt spreads had increased sharply, and there had been pressure on the Uruguayan banking system from deposit withdrawals. But investors still did not seem to regard these difficulties as symptomatic of a broader problem; unlike in 1997-98, there was no sign yet that this might trigger a generalised reduction in appetite for emerging-market assets, or for risky assets generally. Recent developments in Latin America were unlikely to have a significant impact on the US recovery; and in contrast, the Canadian economy, which was more important for US trade, was performing better than expected.

8 The economic recovery in non-Japan Asia remained strong, although it was likely to be particularly dependent on future US developments. There was little reason to change the Committee's judgment that the short-term prospects for Japan remained subdued.

### **Money, credit and the exchange rate**

9 The UK monetary data over the past month were consistent with continuing robust economic growth. Household M4 borrowing had stayed strong, growing at an annual rate of 12.5% in June, but had not materially accelerated further. On the corporate side, the divergence between the borrowing behaviour of the manufacturing and the non-financial services sectors had widened over the past year, with the former, in aggregate, repaying sterling bank loans at a faster rate in recent quarters, while the latter continued to be net borrowers. Committee members thought it unlikely that this reflected any change in the relative willingness of banks to supply finance to manufacturing. The net repayment of loans might suggest that manufacturers still saw few opportunities for profitable investment; rates of return in manufacturing remained much lower on average than in services, and indeed new estimates of manufacturing profitability had revealed that it had been lower than previously thought. Another possibility was that some manufacturers might have been substituting funds borrowed on the capital markets (including in foreign currencies) for bank loans, for example, to help finance investment overseas.

10 Sterling had appreciated by 2½% in effective terms over the past month, and was now at a level similar to the 15 working-day average used as a starting point in the May *Inflation Report*. The appreciation had taken place at a time when bilateral rates between the dollar, euro and yen had been relatively stable (in contrast to May and June). In principle, it could have reflected an increase in the attractiveness of investing in the production of tradable services in the United Kingdom relative to elsewhere, but there was little evidence to corroborate that hypothesis at the moment. Anecdote in the foreign exchange market suggested that, to many market participants, the economic performance of the United Kingdom appeared relatively stronger, partly as a result of the strong preliminary estimate for the growth of GDP in 2002 Q2, and there was more confidence about the UK authorities' likely policy responses to economic shocks. However, if that were the case, it was puzzling that the performance of the UK stock market had not also been better.

## **Demand and output**

11 According to the ONS' first estimate, GDP in 2002 Q2 grew by 0.9% over the previous quarter. That broadly confirmed earlier signals from surveys of a pick-up in growth. But the special factors of the Jubilee long weekend, the World Cup, and the movement of a Bank Holiday from May to June made it difficult to assess the underlying pattern of demand and output; as well as the arithmetic impact of changes in the number of working days, there may have been temporary changes in firms' and households' behaviour. At a sectoral level, manufacturing output had been a little higher than expected in April and May; but the growth of services output had been a little lower than expected in Q2 as a whole. The most recent CIPS survey evidence, for July, suggested that new orders in manufacturing were falling and output was flat, but that services output and new business were continuing to grow. The Bank's regional Agents' contacts had reported a gradual, but patchy, recovery in manufacturing.

12 The Bank's Agents had reported that investment intentions had stalled recently but had not so far been significantly affected by the earlier falls in equity markets. Consumption growth appeared to have picked up in Q2. There were some signs from the June retail sales figures and the latest CBI distributive trades survey that it might have eased a little around the end of the quarter, but consumer confidence on the GfK measure was little changed in July after seasonal adjustment, and household borrowing growth had hardly slackened. The Agents' contacts suggested that consumption remained fairly firm, with some signs of a rebound in July from a weaker June. The recently announced details of the Government's public spending plans, in the Comprehensive Spending Review, did not materially change the fiscal outlook.

13 The drop in equity prices already experienced was likely to affect investment and consumption. Consumers might save more to attempt to restore their financial wealth, including the value of prospective pensions. In the case of corporate defined-benefit pension schemes, the wealth effect would be borne by the shareholders of the sponsoring firms rather than by the scheme members; but it might take some time for the implications of equity market developments to become clear to those shareholders. The implementation of accounting standard FRS17 in the United Kingdom was making any funding shortfalls more visible. The possibility of increased precautionary saving as a result of doubts about the permanence of existing pension scheme arrangements on the part of scheme members was a downside risk to consumption. In the United States, a similar proportion of

pension scheme assets was held in defined-contribution plans as in defined-benefit schemes, a much higher share than in the United Kingdom, where defined-benefit schemes still dominated the pension component of household financial wealth; in continental Europe, assets in private pension schemes of either sort tended to be much lower. That was one of the factors pointing to the likelihood of a bigger impact of the equity price falls on consumption in the short run in the United States than elsewhere. The financial wealth of consumers in the United Kingdom, compared with much of the rest of Europe, was probably more sensitive to the price falls, because of the greater exposure to equities through with-profits life insurance policies (including those embodied in endowment mortgages) and equity mutual funds. The Committee expected only a modest rise in the UK saving ratio, but acknowledged that recent asset price developments had increased the uncertainty about this projection.

14 One factor continuing to bolster consumption was the strength of the housing market. The latest house price data from both the Nationwide and Halifax showed an acceleration over the past three months; both now pointed to an annual rate of increase of over 20%. Looking forward, however, Royal Institution of Chartered Surveyors' data on new buyer enquiries and house price expectations and a special survey by the Bank's regional Agents suggested that more people were expecting the market to slow in the second half of the year. Demand in the buy-to-let market appeared to be weakening, although the summer holiday season could have been at least partly responsible, and some indicators of housing market activity, such as particulars delivered, had fallen. This was consistent with what would be expected if the demand for housing had started to decelerate. But mortgage approvals were still running at a high rate, after allowing for the number of working days in June, and this apparent slowdown in housing market activity could prove short-lived, as had some pauses in the past.

15 The Committee reviewed the question of whether or not the current level of house prices was unsustainable. There were several reasons why the ratio of house prices to earnings might now be higher in the long run. First, in an environment of lower inflation, the real value of initial mortgage payments for first-time buyers was lower for any given term and interest rate (less 'front loading' of mortgage payments), making housing more affordable for liquidity-constrained households. Second, the supply of houses had fallen relative to the number of households. And, third, continuing financial liberalisation and competition had relaxed quantitative limits on mortgage lending.

16 Overall, the prospect continued to be for a modest strengthening of aggregate demand. But the falls in equity markets around the world were likely to bring about lower growth in both investment and consumption than expected in May and constituted a source of significant uncertainty about the outlook.

### **The labour market**

17 There was little news on the month to suggest that labour market pressures had changed significantly. On the LFS measure, unemployment stood at 5.2% in May, and had been broadly flat for some time. Regular pay growth had been 3.9% in the year to May, much the same as in April. Looking forward, it was likely that the large wedge between the growth rates of the consumption wage – average earnings compared with the tax and price index (TPI) – and the product wage – employers' wage costs compared with the GDP deflator – would diminish. Import prices were expected to edge up a little faster and the planned National Insurance increases would lead to an increase in the tax element of the TPI. Indeed, TPI inflation, which had been negative for several months, had picked up and, since April, had been close to the rate of increase of the RPI. The expected slowdown in the growth of the consumption wage was consistent with the outlook for slower consumption growth. It might also increase upward pressure on nominal wages in the future to the extent that workers tried to maintain real wage growth; that was an upside risk to cost pressures.

18 Wage settlements had varied across sectors. Public sector settlements had exceeded those in the private sector since early 1999, but there were few signs of any spillovers. It seemed less likely that the public sector pay pressures would affect manufacturing than services, given the type of skills in demand in the public sector and the fact that, where the same type of skills were in demand, wages still tended to be higher in manufacturing than in private services.

### **Prices and costs**

19 Annual RPIX inflation was 1.5% in June. This was lower than had been expected at the time of the May inflation projection. The Committee discussed the reasons for the June outturn and the prospects for the annual inflation rate over the next few months. First, most of the weakness of annual RPIX inflation in June reflected the historically low contribution of two volatile components

of the RPI: seasonal food and petrol prices. That reflected a fall of around 15% in seasonal food prices from their flood-related high levels last year, together with a significant fall in oil prices, which in June were around 20% lower than a year earlier. The annual inflation rate of RPIX excluding seasonal food and petrol was 2.2% in June. Second, annual RPIX inflation had fallen by 1.1 percentage points since its recent peak in January. This fall was entirely accounted for by sharply lower annual goods price inflation, which had fallen by around 2 percentage points since January to -1.6% in June, the lowest rate since the start of the series in 1975. Around half of that fall reflected a significantly lower contribution from seasonal food prices due to movements in those prices twelve months earlier (so-called 'base effects') and the recent sharp price falls. These falls had been partially offset by a small rise in annual services price inflation.

20 The outturn in June still seemed likely to represent a low point for RPIX inflation, as had been expected at the turn of the year. Base effects over the coming months, mainly relating to seasonal food and petrol prices, would, other things equal, lead to increases in annual RPIX inflation over the remainder of this year. The two most significant of these would be in July and November. In July, last year's fall between June and July of almost 10% in seasonal food prices would no longer contribute to the annual comparison, and in November, last year's fall between October and November of over 5% in petrol prices would no longer reduce the inflation figure; each of these base effects would add 0.2 percentage points to annual RPIX inflation in the relevant months. Past rapid rises in UK house prices were also likely to put upward pressure on the twelve-month inflation rate via the element of the RPI capturing housing depreciation.

21 One feature of the current conjuncture was the size of the gap between annual goods and services price inflation – over six percentage points in June. That was much greater than was likely to be sustainable, given historical differences in productivity growth in goods and services production, which implied a long-run gap closer to 2%-2½%. Base effects were likely to narrow the gap over the rest of the year. But the low level of goods price inflation was a worldwide phenomenon, possibly reflecting the global slowdown last year. That might change as the global recovery proceeded. Oil prices had remained surprisingly stable.

## **Other considerations**

22 The Committee noted that all the economists polled by Reuters expected no change in the repo rate this month. Short-term market interest rates had fallen, suggesting that the likely date of an increase in the repo rate had receded in the view of financial market participants.

## **The August GDP growth and inflation projections**

23 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 7 August.

24 Based on the assumption of an unchanged official repo rate of 4% over the next two years, according to the central projection, the annual rate of GDP growth would rise over the next year or so to around its long-run trend, and remain close to that level thereafter; the twelve-month RPIX inflation rate would increase to 2%-2¼% by the end of this year and would then rise gently, reaching the 2½% target in around two years' time. Inflation would be increasing less rapidly at the end of the forecast period than envisaged in May. In the *Inflation Report* fan charts, the balance of risks to growth was symmetric in the first year and weighted marginally to the downside in the second year. The risks to inflation were also evenly balanced in the first year, but were weighted to the upside in the second year. There were some differences among the Committee about the overall balance of risks, but the spread of opinion was relatively small. The Committee noted that these projections were similar to the consensus of outside forecasts.

## **The immediate policy decision**

25 Committee members agreed that the latest economic data broadly confirmed that a gradual increase in the pace of global economic activity was under way. There had, however, been some signs of greater weakness than expected in the euro area. Also, estimates of US GDP had been revised downwards and growth in 2002 Q2 had been a little lower than expected. In the United Kingdom, growth was estimated to have picked up sharply in Q2, though it was unlikely to sustain that rate in the near term. Interpreting the latest UK activity data was difficult, however, because this June had been atypical on account of the Jubilee long weekend and other factors. The inflation outturn in June had been unexpectedly low, largely because of erratic factors that were

likely to unwind. The main news on the month had been in asset prices: the sharp falls in equity markets around the world and, to a lesser extent, the rise in sterling's effective exchange rate. These developments, if they persisted, would tend to reduce the growth of consumption and investment and reduce cost pressures; but they were also a source of considerable uncertainty about the outlook for output and inflation.

26 The Committee considered what level of interest rates was appropriate in the light of prospective RPIX inflation. At recent meetings, the Committee had discussed the case for an interest rate increase. The declines in equity prices had moderated the outlook for inflation and the case for a rise in rates was, at the very least, less urgent. Indeed, given recent developments, there were several factors now suggesting that a reduction in interest rates might be warranted. First, as the new inflation projection was below 2½% for most of the forecast period, a small reduction in rates might be appropriate, given the Committee's mandate to aim for 2½% inflation at all times. Second, the global recovery was fragile; domestic demand in the euro area remained weak, and imbalances in the US economy might still exert more of a drag on output than currently expected; the shortfall in Q2 GDP growth relative to expectations could point in that direction. In the United States, at least, equity valuations still looked high by historical standards on some calculations; and, judging by recent experience, any further falls there were likely to be reflected in UK equity prices, at least in the short run. Market participants might also have doubts about the capacity of policymakers in the United States and the euro area to respond to further falls, given the already low level of interest rates, the recent loosening of fiscal policy in the United States, and the constraints on fiscal policy in the euro area. Third, in the view of some members, there was also a risk, not reflected in the central projection, of continuing deflation of world goods prices, which had persistently turned out lower than expected.

27 There were, however, arguments against reducing the repo rate, and these were seen as more compelling. First, the analysis embodied in the new *Inflation Report* projection of inflation did not suggest that a reduction in the repo rate from its current level of 4% was needed in order to meet the target over the medium term. The decline in equity markets since the projections published in the May *Inflation Report* had moderated the outlook for inflation. At unchanged official interest rates, RPIX inflation was expected to return towards the 2½% target over the next two years, rising slightly above it at the forecast horizon. Second, over the previous week, equity markets had moved above the 15 working-day average for equity prices used as the starting point for the forecast. It was

sensible to wait and see whether markets settled in their current range before adjusting the repo rate. Third, house prices had continued to increase rapidly, and this would sustain the strong growth of consumption, at least for some time. Moreover, households could more easily than in the past increase their withdrawal of mortgage equity. In these circumstances, a reduction in interest rates now risked further stimulating the housing market, increasing the risk of a sharp correction later. Fourth, there were upside risks to inflation from the planned increases in National Insurance contributions and, in the view of some Committee members, from the sterling exchange rate. Finally, reducing the repo rate would risk denting confidence by implying that conditions were worse than the Committee believed them to be.

28 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4.0%. The Committee voted unanimously in favour of the proposition.

29 Finally, on the occasion of David Clementi's last Committee meeting, the Governor expressed his appreciation of the contribution he had made to the Committee. The Treasury representative added the Chancellor's thanks for the way in which Mr Clementi had fulfilled his responsibilities.

30 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  
Marian Bell  
Stephen Nickell  
Paul Tucker

Simon Brooks 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 26 July 2002, in advance of the meeting on 31 July-1 August. 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 advance estimate, US GDP in 2002 Q2 had grown by 0.3% on a quarter earlier, following a rise of 1.2% in Q1. The estimated level of GDP in 2002 Q1 had been revised down by 1.3%, mainly because of revisions to GDP growth in 2001. Manufacturing output had increased by 0.8% in June compared with May, and output in the information and communication technology (ICT) sector had increased by 1.7% in June. New orders for non-defence capital goods had fallen by 8.5% in June. The ISM manufacturing index had fallen from 56.2 in June to 50.9 in July.

A3 Retail sales values had risen by 1.1% in June compared with a month earlier. The University of Michigan consumer confidence index had fallen to 88.1 in July, from 92.4 in June.

A4 Non-farm payrolls had risen by 36,000 in June. The unemployment rate had risen slightly, to 5.9% in June from 5.8% in May, but initial claims for unemployment insurance had fallen during the month.

A5 Annual consumer price inflation in the United States had fallen to 1.1% in June, from 1.2% in May. Annual core consumer price inflation, excluding food and energy, had also fallen, to 2.3% in June from 2.5% in May. The overseas trade deficit had widened in May, with an increase in import values more than offsetting a rise in exports.

A6 Industrial production in the euro area had risen by 0.1% in May compared with a month earlier. It had fallen in Germany and France, but had risen in Italy. Germany manufacturing orders had increased by 3.1% compared with the previous month. Domestic orders had fallen by 2.3% but foreign orders had risen by 9.6%. Indicators of business confidence had continued to decline: the

Italian ISAE and the Belgian BNB industrial confidence indices had both fallen in July, as had the German IFO index, which had fallen to 89.9 in July from 91.3 in June. The euro-area manufacturing PMI had declined slightly in July, falling to 51.6 from 51.8 in June.

A7 The European Commission measure of consumer confidence for the euro area had fallen slightly in June; national indicators for Italy and the Netherlands recorded sharp falls in July. French consumer spending had increased by 1.0% in June, after falling by 1.3% in May. The overall indicator of French consumer confidence had, however, deteriorated further in July, falling to -17 from -13 in June. The euro-area harmonised index of consumer prices (HICP) had risen by 1.8% in the year to June, down from 2.0% in May. The preliminary estimate for euro-area HICP inflation had indicated a rate of 1.9% in the year to July. Core inflation had fallen to 2.5% in the year to June, down from 2.6% in May.

A8 Japanese industrial production had fallen by 0.7% in June compared with a month earlier, although in Q2 as a whole industrial production had increased by 3.6% compared with a quarter earlier. The index of tertiary activity had risen by 1.0% in May, bringing the annual rate of decline to 0.7%, the smallest since November 2001. Export volumes had increased by 12.4% in the year to June. Exports to other Asian countries had shown particular strength, increasing by 25.1% in the year to June.

A9 The Wilshire 5000 index had fallen by 4.2% since Wednesday 3 July, at the time of the previous Committee meeting. The FTSE All-Share, Topix and Dow Jones Eurostoxx indices had fallen by 4.2%, 7.6% and 7.9% respectively over the same period. Among equity indices with a higher concentration of information and communications technology (ICT) sector firms, the Nasdaq, the Japanese Telecom and the FTSE Techmark indices had fallen by 3.8%, 6.7% and 2.6% respectively, while the German Nemax 50 index had risen by 2.3% over the same period.

A10 The dollar spot price for Brent crude oil was little changed since 3 July, and the *Economist* all-items dollar price index had risen by 1.4%. The industrial metals sub-index and the non-food agricultural sub-index had fallen by 3.1% and 4.2% respectively over that period, while the food sub-index had risen by 5.1% over the same period.

## II Monetary and financial conditions

A11 On the basis of partial data, the twelve-month growth rate of notes and coin in circulation had fallen to 8.6% in July, from 9.4% in June, as the effects of the Jubilee Bank Holiday had unwound. The twelve-month growth rate of M4 had ticked up slightly to 6.4% in June, from 6.1% in May. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 8.2% in June, from 8.9% in May. Excluding other financial corporations (OFCs), the annual growth rate of both M4 deposits and M4 lending had fallen slightly in June.

A12 The twelve-month growth rate of households' M4 had fallen to 8.5% in June, from 8.7% in May. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen slightly, to 12.5% in June from 12.4% in May. Within total net lending to individuals, the annual growth rate of secured lending had remained buoyant at 11.4% in June. The annual growth rate of unsecured lending had continued to decline in June, falling to 14.7%. The growth of household Divisia, an aggregate of household money holdings, weighted by the liquidity of different types of holding, had increased in 2002 Q2. The estimated number of loan approvals for house purchase, adjusted for the number of working days, had fallen slightly in June, but remained historically high.

A13 The twelve-month growth rate of private non-financial corporations' (PNFCs) M4 deposits had fallen to 4.3% in June, from 7.3% in May. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had fallen to 3.3% in June, from 5.9% in April. A breakdown of bank lending by industry showed that the fall in the growth of M4 lending to PNFCs was broadly based. Total external finance fell to an average of £2.6 billion per month in 2002 Q2, compared with an average monthly flow of £3.5 billion in 2002 Q1.

A14 Corporate capital gearing at replacement cost had ticked up to 30.3% in 2002 Q1.

A15 The twelve-month growth rate of OFCs' M4 deposits had risen to 2.4% in June, from -1.3% in May. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had fallen to 2.2% in June, from 3.0% in May.

A16 Quoted retail deposit and mortgage rates were broadly unchanged in July.

A17 Between 3 and 31 July, the FTSE All-Share index had fallen by 4.2%. Equity market uncertainty, as measured by volatilities implied by options prices, had increased, but skews from equity options had become less negative since 3 July, suggesting some reduction in perceptions of downside risk. Prices in all sectors except non-cyclical services had fallen. There had been only a small downward movement in IBES earnings forecasts between June and July, and the number of profit warnings issued in July was higher than in June, but was lower than a year earlier. The Merrill Lynch index of investment-grade sterling corporate bond spreads had risen by 15 basis points since 3 July. The Merrill Lynch sterling high-yield index had risen by more, but investment-grade corporate yields had fallen by 5 basis points since 3 July. Telecom sector spreads had narrowed by 16 basis points on the month, but remained relatively high.

A18 Short-term nominal interest rates had declined substantially since 3 July. Uncertainty from options about future interest rates had increased slightly. Ten-year nominal forward rates had increased by 7 basis points. Forward real rates derived from index-linked gilts had increased by 18 basis points at three years, but had increased by less further along the curve. Implied inflation rates derived from conventional and index-linked gilts had fallen since 3 July by 31 basis points at three years, and six basis points at ten years, reversing some of the increases seen earlier in the year. Average inflation expectations, for both 2002 and 2003, as measured by Consensus Economics' monthly survey, had fallen by ten basis points in July, to 2.2% and 2.3% respectively.

A19 Between 3 and 31 July, the sterling effective exchange rate index had appreciated by 2.5% to 106.9, reflecting sterling's appreciation of 2.3% against the dollar and 2.4% against the euro. Relative movements in nominal UK and US interest rates were consistent with the movement of sterling against the dollar.

### **III Demand and output**

A20 The ONS' preliminary estimate of quarterly growth of GDP at constant market prices in 2002 Q2 had been 0.9%, following 0.1% growth in each of the previous two quarters. Annual GDP growth had picked up to 1.5%, from 1.1% in 2002 Q1. The Q2 quarterly rate had been the highest since the end of 1999.

A21 The preliminary estimate of services sector quarterly output growth had been 0.6% in 2002 Q2, following growth of 0.2% in 2002 Q1. Within this, output in the distribution, hotels and catering sector was estimated to have risen by 1.1%. Manufacturing output had grown by 0.7% in May compared with a month earlier, following growth of 1.1% in April.

A22 The ONS had indicated that the unusual pattern of Bank Holidays in 2002 had made seasonal adjustment of the index of production data in May and June problematic: because of the Jubilee, there had been one fewer Bank Holiday in May and two extra in June. The ONS had made no adjustment to the May data to reflect the change in timing of the late Spring Bank Holiday. This had created difficulties for the interpretation of monthly changes in output in these months.

A23 Retail sales had fallen by 0.7% in June. They had risen by 1.7% in 2002 Q2, up from 1.0% in 2002 Q1. The Confederation of British Industry (CBI) survey of distributive trades had suggested that annual retail sales growth was unchanged in July. Annual growth in new private car registrations had also risen in Q2, increasing by 10.4% compared with 5.2% in Q1. This had pointed to a further quarterly rise in the ONS' measure of household expenditure on vehicles in Q2.

A24 The CBI Quarterly Industrial Trends survey had suggested that the manufacturing sector had continued to run down their stocks in Q2, with the balance on reported stocks negative in all reporting sectors. The CBI survey in July had indicated that the level of stocks in the manufacturing sector had been close to its long-run average relative to demand.

A25 Volumes of goods exports had increased by 5.3% in the three months to May compared with the previous three months. Volumes of goods imports had also increased, but at a more moderate 2.2%. This had suggested that net trade was likely to make a positive contribution to GDP growth in 2002 Q2, following a 0.7pp negative contribution in Q1.

A26 The Nationwide house index had risen by a further 2.5% in July, increasing the annual rate of increase by 1.2 percentage points to 21.0%. The Halifax index had risen by a further 1.8% in July, increasing the annual rate of increase by 1.5 percentage points to 20.8%. Looking forward, the Royal Institution of Chartered Surveyors (RICS) survey in June had reported another fall in expected house price inflation over the next three months, with the seasonally unadjusted reported balance falling to +27 from +56 in May, a larger fall than seasonal factors could typically account for. The

RICS survey had also suggested a fall in June in the underlying numbers of enquiries from new buyers. Moreover, the Woolwich Mortgage Index, a monthly survey of UK households, had suggested a fall in expectations of house price inflation over the next twelve months.

A27 The GfK consumer confidence index had fallen to +2.2 in July from +5.6 in June. Business confidence as measured by the British Chambers of Commerce (BCC) 2002 Q2 surveys had picked up slightly for both service sector and manufacturing firms. The CBI Quarterly Industrial Trends Survey for 2002 Q2, conducted up to 10 July, had indicated some easing in business confidence in the manufacturing sector, with the balance falling to +4 in Q2 from +21 in Q1.

A28 The BCC survey balance for service sector investment intentions had remained broadly unchanged in Q2 at around its long-term average. In contrast, the BCC survey had reported a rise in manufacturing investment intentions in Q2, with the survey balance rising to +7, from -3 in 2002 Q1, but it had still been below its long-term average. The July CBI Quarterly Industrial Trends survey for 2002 Q2 had similarly shown a strong rise in investment intentions: the balance of manufacturing firms expecting to increase investment in plant and machinery had increased to -13, from -25 in the April survey. The CBI survey had suggested low capacity utilisation in the manufacturing sector, at odds with the BCC measure of capacity utilisation in the manufacturing sector, which had increased to +38 in Q2 from +33 in Q1, above its long-run average of +32.

A29 In Q2, the BCC survey balance for services sector domestic orders had eased to +19, from +20 in 2002Q1. The Chartered Institute of Purchasing and Supply (CIPS) services sector survey for June had shown the new orders balance increasing to +55.5 in Q2 from +52.9 in Q1.

A30 The BCC domestic new orders survey balance had eased to +9 in 2002 Q2, from +12 in Q1. The CBI Quarterly Industrial Trends survey had shown the expected output survey balance falling to +9 in Q2, from +14 in Q1 survey. The CIPS manufacturing survey for July had pointed to orders rising in Q2: the balance of reported new orders had increased to +55.2 from +51.4 in Q1, but this balance had fallen back in July to +48.8.

A31 The Bank's regional Agents had conducted a special survey of recent developments and near-term prospects in the housing and rental market. A total of 140 mortgage lenders, housebuilders and estate agents had responded. Respondents were asked three questions. Two concerned their

expectations about the prospects for house prices and residential rents over the next six months. The third asked for their views about the main factor responsible for the recent rapid increase in house prices. The responses had been weighted according to the respondents' typical number of transactions. Mortgage lenders overwhelmingly pointed to lower interest rates as the reason for the rapid increases in house prices. Estate agents concurred, but also placed more weight on investment demand as a key factor, while housebuilders emphasised lack of new supply. Looking at the regional picture, investment and low supply were more significant in London and the South East, while low interest rates and credit availability were more significant elsewhere. House prices were expected by most respondents to increase at a slower rate in the second half of this year than they had in the first; this was true of entry-level and other properties, and for all regions. House-price inflation was perceived to have slowed over the previous four to six weeks. On balance, residential rents were expected to fall slightly over the coming six months, with the falls expected to be a little less for entry-level properties.

#### **IV Labour market**

A32 According to the Labour Force Survey (LFS), employment had risen by 91,000 (0.3%) in the three months to May 2002, compared with 29,000 in the previous non-overlapping quarter. The working-age employment rate had increased by 0.1 percentage points to 74.7%. Average hours had increased by 0.3% in the three months to May, though they were still lower than in the first half of 2001.

A33 Surveys of employment intentions for Q3 had been little changed on the previous quarter, suggesting that employment would continue to grow broadly in line with recent outturns. Surveys of labour shortages had indicated a sharp increase in shortages reported in consumer services and a fall in clerical shortages reported in financial services. Shortages elsewhere were little changed, though lower than they had been in 2001. The Bank's Agents had reported an increase in shortages of some skills and that shortages of others had persisted.

A34 LFS unemployment had risen by 52,000 in the three months to May, compared with a fall of 15,000 in the previous non-overlapping quarter. The LFS unemployment rate had been unchanged, at 5.2%. Claimant count unemployment had risen by 1,300 in June but the claimant count rate had remained at 3.2%. Working-age inactivity had fallen by 66,000 in the three months to May, and the

rate had fallen by 0.2 percentage points to 21.1%. The fall in inactivity had been entirely accounted for by lower female inactivity.

A35 Headline (three-month average) whole-economy average earnings growth had been 3.8% in the year to May, up 0.5 percentage points on the previous month. Headline earnings growth in the private sector had increased by 0.7 percentage points, to 3.8%. In the public sector, headline earnings growth had fallen by 0.3 percentage points, to 3.8%. The pick-up in the whole-economy and private sector headline figures had largely reflected weak earnings data in February dropping out of the three-month average.

A36 Regular pay growth had been 3.9% (not seasonally adjusted) in the year to May, down 0.1 percentage points on April. The recent slowdown in regular pay growth had in part reflected falling average hours on a year earlier, especially overtime hours. Bonuses had reduced whole-economy earnings growth by 0.1 percentage points in the year to May.

A37 The Bank's twelve-month Average Earnings Index (AEI)-weighted, whole-economy mean measure of pay settlements had been 3.1% in June, unchanged from the May figure. The three-month AEI-weighted mean settlement had risen 0.1 percentage points to 2.9%. The small pick-up in the three-month measure had reflected two large deals in construction, one of which was the third year of a three-year deal.

## **V Prices**

A38 Sterling oil prices had fallen by around 2% since the July MPC meeting, but on average were somewhat higher in July than they had been in June.

A39 Manufacturing input prices had fallen by 0.9% in June. This fall had mainly reflected falls in the price of crude oil. Annual input price inflation had fallen in June to -7.2%, from -6.5% in May. But the CIPS manufacturing survey had continued to suggest that input price pressures might not be so subdued going forward. The input price balance had risen for the second consecutive month, to 56.9 in July from 53.1 in June.

A40 Manufacturing output prices excluding duties (PPIY) had been unchanged in June, while the annual inflation rate had fallen by 0.1 percentage points to 0.1%. Survey data had continued to point to subdued output price inflation going forward. The CBI Industrial Trends survey expected output price balance, at -10 in July, had been unchanged from the previous month.

A41 Annual RPIX inflation had fallen by 0.3 percentage points to 1.5% in June, the lowest annual inflation rate since the series began in January 1975. Compared with annual RPI inflation before 1975, June's outturn had been the lowest annual inflation rate since September 1967. Within this, annual goods price inflation had fallen sharply to -1.6%, from -0.9% in May. Annual services price inflation had remained unchanged at 4.5% in June. Annual RPIY inflation had fallen by 0.4 percentage points to 1.4% in June. Annual RPI inflation had fallen 0.1 percentage points to 1.0% in June, while annual HICP inflation had fallen to 0.6%, down from 0.8% in the previous month.

## **VI Reports by the Bank's Agents**

A42 The Bank's regional Agents reported that the underlying trend in manufacturing was of continued slow recovery in domestic and external markets, although there had been some weakness in June. Some vehicle manufacturing companies had closed plants for up to a week at the time of the early June Bank Holidays. Production had, however, caught up quickly thereafter. Aerospace had remained weak but growth was reported in food processing, pharmaceuticals and construction-related manufacturing. Although Agents' contacts had thought that output in the electrical and optical engineering sector had bottomed out, they expected the sector to act as a drag on the pace of recovery in manufacturing.

A43 The improvement in investment intentions in both services and manufacturing had stalled over the past month or two. Equity price falls appeared to have damaged confidence, leading to increased caution amongst companies with regard to investment. Manufacturing investment had continued to be primarily in overseas locations.

A44 Growth in retail sales had been easing slightly since the turn of the year. Sales in June had been particularly affected by the World Cup, the Jubilee weekend and by poor weather. But reports from the first two weeks of July had suggested that growth had picked up again. Retailers had appeared mostly to be expecting a slight moderation in growth in the second half of the year. Car

sales and some consumer services had also recovered quite strongly, following a lull at the time of the World Cup.

## **VII Market intelligence**

A45 Between 3 and 31 July, interest rates implied by short sterling futures contracts had fallen. Rates implied by the contract for September 2002 had fallen by 36 basis points and those implied by the contract for September 2003 had fallen by 60 basis points. Short-term interest rate expectations had moved down following falls in equity markets and weaker-than-expected RPIX data. Movements in short-term interest rate expectations had been highly correlated with changes in the FTSE 100 equity index.

A46 Market participants had generally expected the Committee not to change the Bank's official repo rate at its August meeting. Economists polled by Reuters on 23-25 July had attached a mean probability of 83% to no change in the Bank's repo rate at the August meeting, a probability of 7% to an increase of 25 basis points and a probability of 9% to a reduction of 25 basis points.

A47 The period since the Committee's previous meeting had been marked by sterling strength independent of moves in other exchange rates. Reports suggested that this was associated in part with the unwinding of EMU convergence trades, especially against the Swedish krona. Over the period, sterling had appreciated by 2.3% against the dollar and by 2.4% against the euro, and was 2.5% higher on an effective basis. The dollar had first depreciated against the euro, sterling and the yen, before recovering towards the end of the period. The correlation of the euro-dollar exchange rate with the level of US equity indices, which had been high for most of the year, had been lower during the fortnight before the Committee's meeting. Market contacts reported two-way repatriation flows by US and European asset managers during the period.