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MINUTES OF MONETARY POLICY COMMITTEE MEETING 3 and 4 July 2002

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 July 2002

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0207.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 31 July and 1 August will be published on 14 August 2002.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 JULY 2002

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

The world economy

2 The US economy had continued to recover broadly as envisaged in the May *Inflation Report* projections. Output growth had been revised up to 1.5% in the first quarter but, as in the earlier releases, this had in large part reflected a turnround in the stock cycle. There were now several indications that growth had slowed, as had been expected, in the second quarter. Industrial production had grown less quickly, and retail sales had fallen, in May, and consumer confidence had declined on both the Michigan and Conference Board measures in June. The Institute for Supply Management indices of business confidence for June had shown a rise in manufacturing and a fall in non-manufacturing, but both movements were small.

3 Looking forward, the most likely outlook was still for steady growth. The latest labour market data had shown a fall in unemployment in May, and demand would be further supported by the recent tax reductions and the falls in market interest rates in the past month. Corporate profitability had improved in the first quarter, which could help sustain business activity. It was possible, however, that the downside risks to this outlook had increased. First, the recent sharp falls in equity prices might adversely affect both consumption and investment, although it was too early to identify evidence of such effects as yet. Moreover corporate accounts were being closely scrutinised, and there was a risk that confidence could be further damaged if more cases of misreporting emerged. Second, there had apparently been an increase in the past month in risk aversion and measures of financial market uncertainty; for example, there had been substantial increases in the spreads on corporate bonds, especially lower-rated bonds, over US Treasuries, and expected equity index volatility implied by options had risen. Third, growth in broad money had slowed sharply in 2002. Fourth, the persistent

imbalances in the US economy gave rise to risks; in particular, household debt and income gearing remained at high levels, suggesting a downside risk to consumption going forward.

4 In the euro area, economic activity continued to pick up gradually. However, net external demand, which had in turn been supported by the US recovery, had been largely responsible for this and there were still signs of weakness in domestic activity in some large euro-area economies. For the euro area as a whole, the European Commission measures of industrial and consumer confidence, and the purchasing managers' indices for manufacturing and services, taken together, were little changed in June. The rates of unemployment in France and Germany had risen so far this year, and consumption had fallen in Germany in 2001 Q4 and 2002 Q1. The rise in the euro against the dollar would make it more difficult for the euro area to rely on net exports as a continuing source of demand stimulus going forward. But any fall in the contribution of exports to growth would to some extent be offset as the associated improvement in the terms of trade raised households' real income. Furthermore, the disinflationary impulse from a higher exchange rate would permit lower interest rates than would otherwise have been the case. Core inflation in the euro-area had been surprisingly persistent, although the flash estimate of the area-wide Harmonised Index of Consumer Prices, on the headline measure, had unexpectedly fallen somewhat, from 2.0% in May to 1.7% in June.

5 The first estimate for Japanese GDP in 2002 Q1 had shown a strong increase, although this was likely to be subject to revision. Exports and machinery orders were higher, stimulated by a more general recovery in Asia which had been led by the information and communications technology (ICT) sector and supported by the US recovery so far this year. These positive developments for global activity might be partially offset by increasing concerns about some Latin American economies. Spreads on Brazilian debt had increased, while Argentina continued to face severe economic difficulties.

6 Several of the major international equity markets had fallen by broadly similar amounts, around 9-12%, in local currency terms since the Committee's June meeting. The dollar had declined by around 4% against the yen, some 4½% against the euro and nearly 5% against sterling over the same period, so the falls in the S&P 500 and the Wilshire indices were greater than those in equity indices for other major countries when expressed in a common currency. Much of the weakness in equities in the past month had been triggered by the news that WorldCom's profits had been overstated, and might therefore reflect a rise in the equity risk premium, possibly resulting from market concerns about

the reliability of corporate accounts, rather than a more generalised decline in expectations of corporate earnings in the United States and elsewhere. There was as yet no evidence of material damage to US business confidence from the most recent weakness in equity prices, but there might nevertheless be some negative influence on demand, arising from an increase in the real cost of capital and the adverse impact on household wealth and consumer confidence. The level of equity prices might still be vulnerable, as it was possible that it continued to reflect a rate of growth of expected earnings that was relatively high by historical standards.

7 The Committee considered four possible explanations offered by market commentators for the further decline in the dollar during June. First, the shock to equity prices had, in common currency terms, been more pronounced in the United States than elsewhere, consequently damaging international investors' confidence in dollar assets. However, the relationship between equity prices and the dollar was not completely clear-cut: on the one hand, the dollar might be vulnerable to further weakness in US equities; on the other hand, if the dollar were to fall far enough, foreign investors might then find US equities cheap in common currency terms and drive their prices up. Second, more generally, there were increasing market concerns as to whether the capital inflows to the United States which were the counterpart of its current account deficit could be sustained at the current level of the dollar. It was possible that these doubts partly reflected less buoyant expectations for corporate earnings and hence for prospective returns to equity. Third, some of the economic data released in the United States had been weaker than expected by market commentators. But it was not clear that recent US data releases had been weaker relative to the Committee's expectations than data for other major economies. Fourth, US market interest rates had fallen relative to those in other major industrial countries, perhaps because a setback to the recent mood of confidence meant that some commentators now thought rises in the Federal funds target rate were more distant than had been thought a month ago. However, the recent fall in the dollar appeared larger than would have been warranted solely by changes in market interest rates.

8 The previous sustained strength of the dollar had been a puzzle. While this implied a risk that the dollar would fall at some stage, the timing of the recent depreciation was difficult to explain. There was no immediate reason to expect the dollar to depreciate further, but risks remained. Past experience suggested significant current account imbalances could take several years to adjust, and the associated swings in exchange rates could be similarly prolonged. Furthermore, it was not clear what would constitute an equilibrium level for the US current account: the United States had experienced a

current account deficit for most of the past thirty years. Moreover, while the decline in the dollar to date could contribute to a reduction of international current account imbalances, it would redistribute demand towards US goods and services and away from output produced by the rest of the world. The implications of this for global demand and inflation would depend on monetary and fiscal policy responses in the United States and elsewhere.

Money, credit and asset prices

9 Growth in notes and coin in circulation was increasing and stood at over 9% in the year to June, although M4 growth remained steady, at 6% in the year to May.

10 The growth in household borrowing from banks and building societies was particularly strong at 12.4% in the year to May, the highest rate since the fourth quarter of 1990. Mortgage equity withdrawal (MEW) had risen to around 4½% of personal disposable income in the first quarter, and seemed likely to rise still further in the second quarter. Total lending for consumption had increased to over 7% of personal disposable income in the first quarter, which was the highest proportion since 1988. While household deposits were also growing rapidly, at 8.7% in the year to May, the net balance of flows of household deposits less borrowing was nevertheless heavily negative.

11 Sterling's effective exchange rate index had risen by around 1% since the Committee's June meeting. Although it was still around 2% below its level at the time of the May meeting, it had moved back inside the broad range within which it had traded for most of the past two years. Forward rates implied sterling depreciation against both the euro and the dollar, although options prices suggested that the perceived balance of risks around these paths were not symmetrical. Relative to these implied paths, expectations for sterling-euro were skewed towards sterling depreciation, although perhaps slightly less so than last month, while sterling-dollar expectations were skewed towards sterling appreciation.

12 UK interest rates had fallen at all maturities since the June meeting, by some 20 basis points at ten years. Market interest rates in other major economies had also fallen. The fall in rates appeared to be associated in part with the weakness of equity prices.

13 The FTSE All-Share index had fallen by about 12% since the Committee's previous meeting, and expected volatility implied by options on the FTSE 100 index had risen. There had also been increases in UK corporate bond spreads over gilt yields in this period, of around 15 basis points for the Merrill Lynch aggregate index. The largest increases in spread had occurred for lower-rated bonds.

Demand and output

14 The latest National Accounts data release had revised the estimates for GDP growth at market prices in both 2001 Q4 and 2002 Q1 slightly upwards, to 0.1% in both quarters. The level of GDP at market prices in 2002 Q1 had been revised up by only 0.1%, but within that the revisions to individual expenditure components had been more significant.

15 The estimate of consumption growth in 2002 Q1 had been revised to 0.5% in Q1, down by 0.2 percentage points from the original release. However, upward revisions for 1999 and 2000 meant that the estimated level of consumption in the first quarter of 2002 stood 1.3% higher than previously estimated. There had been even larger upward revisions to the estimated level of household income, such that the estimated saving ratio had also been revised up. These upward revisions to household income could help explain the previously puzzling strength of consumption over the past two years. Although it was probable that household real income growth would slow going forward, and that this would restrain consumption growth, there was now less risk of an additional downward adjustment to consumption as households' balance sheets appeared less stretched than previously thought. However, although both the households' debt-to-income ratio and households' income gearing had been revised downwards, the debt-to-income ratio had nevertheless risen in 2001 Q4 and 2002 Q1.

16 The volume of investment had fallen by 1.4% in the first quarter, with a fall of over 3% in business investment partially offset by an increase of over 9% in government investment. There had been significant downward revisions to the estimated level of investment back to 1999, and the estimate of business investment in the first quarter of 2002 had been revised down by over 7%. The new data implied a much lower ratio of investment to GDP than previously believed in both constant and current price terms. Manufacturing investment had been particularly weak, but it was surprising that investment in services had fallen by almost 11% in the year to 2002 Q1. Overall, the profile of the aggregate investment-to-GDP ratio now appeared perhaps more plausible than before, given the recent slowdown in activity, but the Committee would need to assess whether a bounceback in services

investment was likely as output growth recovered or whether by contrast the strength in services investment in the 1990s had been to some extent a one-off development, particularly in the telecom sector.

17 The revised data continued to imply a surprisingly large improvement in the terms of trade, of some 7% taking 2001 Q4 and 2002 Q1 together. Recent increases in the deflator for government consumption had also remained surprisingly high, which could reflect the difficulties in measuring public sector output and productivity. But even if this deflator were mismeasured, that would not necessarily have material implications for the outlook for inflation in the marketed sector of the economy, and hence for RPIX.

18 The latest surveys and data releases continued to suggest a robust recovery of economic activity in the second quarter, although the normal pattern of activity might be distorted by the Queen's Golden Jubilee and the World Cup, which complicated the assessment. Retail sales had risen strongly in April, although they had eased somewhat in May, and the CBI Distributive Trades survey pointed to a further slowdown in annual growth in June. Manufacturing output had also increased strongly in April. Although the most recent business surveys suggested that this rate of expansion might ease in May and June, manufacturing output looked set to grow relatively robustly in the second quarter compared with the first.

19 The Halifax and Nationwide house price indices had risen by 2.3% and 3.3% respectively in June. The annual rates of increase on both measures were close to 20%. That implied a further stimulus to the outlook for demand above what had been implied in the May *Inflation Report* projections, chiefly through homeowners' ability to use the greater equity in their homes as collateral to borrow in the form of MEW to finance expenditure. However, this effect would be broadly offset over the forecast period by the recent fall in equity prices.

20 The current rate of increase in house prices was clearly unsustainable, but the Committee considered various arguments suggesting that the equilibrium level of house prices to earnings might have risen. First, a higher level might be characteristic of an economy in which the inflation rate and nominal interest rates were lower and more stable than hitherto. Without the 'front-end loading' of mortgage repayments previously implied by high nominal interest rates and a higher average rate of inflation, households could service larger initial mortgage debts, and there was some evidence that

lenders were now willing to lend a higher multiple of earnings. This transition might well help explain the strong increases in house prices up to 2000, and the subsequent easing in house price increases might have reflected the fact that interest rates had increased around then. There was, however, a concern based on this line of argument that the latest surge in house prices might reflect a belief by some borrowers that the reduction in interest rates from 6% to 4% over the past year would be permanent. In that case house prices would be vulnerable when interest rates eventually rose. Second, it was possible that, as nominal returns on bonds and savings deposits had declined and investors' confidence in the equity market had weakened, households had chosen to hold more of their long-term savings in the form of housing. Third, increased competition among lenders might have led to some easing of lending criteria, although there was as yet no evidence of materially higher mortgage arrears and defaults. Fourth, the slowdown in housebuilding, set against an increasing number of households, meant that the balance of supply and demand was placing upward pressure on prices. If it were the case that the equilibrium level of house prices to earnings had risen in recent years, that could be consistent with rapid increases in prices during the transition to the new equilibrium. But it was not clear where the new equilibrium level was, nor whether the rate of increase would level off as the new equilibrium approached or whether house prices would overshoot. Moreover, there could be a longer-term drag on consumption as households were faced with a continuing higher real level of outstanding debt, although this might not have a material effect within the time horizon relevant to the policy decision.

The labour market

21 Employment continued to grow steadily, by 88,000 in the latest three months compared with the previous three, and unemployment on the LFS measure had been stable at 5.1-5.2% for the past ten months. Survey evidence suggested little change to this picture, although inflows to the claimant count had risen for three consecutive months. This stable picture was broadly consistent with the *May Inflation Report* projections, although the level of unemployment now looked significantly lower than might have been expected at the beginning of the year.

22 Growth in regular pay had eased from around 4½% at the end of 2001 to 4% in April, while the negative contribution to average earnings growth from lower bonuses had fallen. Private sector settlements had averaged 2.7% in the three months to May. On a matched sample, settlements were around ½ percentage point lower than the previous year. However, it could be argued that in real

terms this represented an increase in pay pressures: for example, the Tax and Prices index had fallen by 0.1% in the year to March 2002, whereas it had risen by 2.1% in the previous year. Given the slow pace of economic activity in 2001 Q4 and 2002 Q1, a bigger fall in settlements might have been expected.

23 Whole economy productivity per job had increased by 0.4% in the year to the first quarter, and the annual growth rate had now stood below the long-term trend rate of about 2% for over a year. It was possible that the figures were affected by difficulties in measuring output in the service sector, but productivity in manufacturing had been particularly weak, falling by 2% in the year to the first quarter. It was noted that the path of manufacturing productivity looked similar to that in previous economic cycles if the electrical and optical sector, which included the ICT category in which fluctuations in productivity had been unusually pronounced in the present cycle, was excluded. Against the background of weak productivity growth and a high level of employment, the Committee considered whether there would be a shortage of spare capacity in the event that economic activity picked up. It was likely, though by no means certain, that there had been some labour hoarding during the recent slowdown in activity; average hours had fallen late last year. However, there was continuing anecdotal evidence of labour shortages across a range of different skills.

Prices and costs

24 RPIX inflation had fallen by ½ percentage point in May, to 1.8%. A fall to about 2% had been expected, largely reflecting base effects associated with the sharp increases in seasonal food and petrol prices in May 2001. However, although the fall in inflation had been somewhat greater than expected, the factors giving rise to it were likely to be temporary. So the low May outturn was unlikely to have implications for inflation prospects beyond the very short term. The Committee noted that the differential between goods and services inflation, at 5.4%, was at its highest for almost 20 years.

25 The sterling price of oil was about 6% higher than at the time of the Committee's June meeting, though still around 3% lower than expected in the May *Inflation Report* projections. However, oil futures prices suggested that the sterling price of oil would converge on the *Inflation Report* profile next year. The picture from commodity price indices was mixed: the Bank's own, more comprehensive, index showed a fall in sterling commodity prices excluding oil of nearly 7% in May, but the Economist index showed a rise of 1% in sterling terms in June, again excluding oil, and this

was supported by a rise in the CIPS manufacturing survey of input prices. The recent rise in sterling against the dollar would tend to mitigate any impact on UK prices of rises in the prices of commodities traded and denominated in dollars.

Other considerations

26 The latest Reuters poll of economists' expectations attached a 78% probability to a no change decision this month, and market interest rates were also consistent with the view that no change was expected.

27 The Committee considered whether the recent developments in financial markets should affect the interest rate decision. There was some evidence of a decrease in financial confidence worldwide: the expected volatility of equity prices and exchange rates implied by options prices had risen, as had corporate bond spreads. It was possible that an unexpected increase in interest rates against a background of increased nervousness could have an unintentionally strong impact on both market and business confidence. That in turn could depress output and demand and push inflation below the target.

The immediate policy decision

28 The key decision facing the Committee remained for how long monetary policy could be set so as to encourage strong growth of consumption, to compensate for weak external demand and investment growth, given the likelihood that inflation would be rising above target towards the two-year horizon. Recent international data had not greatly changed the central outlook for the world economy. But the downside risks might have increased somewhat, and the international recovery still appeared dependent on the United States. The Committee had to assess three new developments: first, the implications of the latest revisions to the National Accounts; second, how much weight should be given to the recent developments in equity markets; and third, the continuing unexpectedly rapid increases in house prices. The estimate for Q1 GDP growth had been revised up, as expected; second quarter growth looked likely to be strong; and the data helped to explain some of the previous puzzles affecting consumption and investment, which might reduce the uncertainty around the Committee's projections going forward. The increase in house prices, allowing households to increase their borrowing for consumption using housing equity as collateral, could be expected broadly to offset the

effect of the decline in equity prices on consumption and investment.

29 The Committee identified a number of arguments for leaving the repo rate unchanged this month. These arguments were qualitatively similar to those identified in the previous month, although their quantitative importance had been affected by recent developments. First, the strength of the world economic recovery was uncertain. This remained the case, and the downside risks might now be greater as a consequence of increased financial market nervousness set alongside the existing longer-term economic imbalances in the United States. Second, the pace of UK economic recovery was also uncertain. Third, there had been doubt at the previous meeting as to whether the fall in sterling would be maintained or continue further. This was still not clear. The sterling effective exchange rate index had risen by about 1% in the past month, though it remained below the profile assumed in the *May Inflation Report* projections. Fourth, equity prices had been falling, and had fallen substantially further in the latest month. The likely effects of this on consumption and investment needed to be taken into account. Finally, labour market pressures remained benign, although there were a few signs of prospective upward pressure on input costs. RPIX inflation was likely to continue below target for some time, before rising to around the target rate next year and only moving above target thereafter. So a delay in raising rates was consistent with the Committee aiming to achieve the target at all times.

30 The arguments identified by the Committee last month for raising rates immediately or in the near future also remained relevant. First, the sterling effective exchange rate index was still sufficiently below the path assumed in the *May Inflation Report* to imply a material upward effect on inflation. Second, the repo rate of 4% remained well below any likely long-run neutral rate, and therefore implied a continuing stimulus to activity and inflation, while the economic outlook had clearly strengthened since the repo rate had been reduced to its present level. The strength of growth in the money and credit aggregates confirmed that monetary policy was currently stimulatory. Third, at the current level of interest rates, inflation was expected to be rising quite steeply above target in the medium term. The passage of time itself strengthened the case for an increase in rates, as the time available for the increase to take effect before the projected pick-up in inflation diminished. Fourth, the prospects for demand, and in particular consumption, looked buoyant going forward, and some slowdown would be necessary. Finally, by the time the world economic recovery was clearly established, it might be too late to restrain the consequences for UK inflation.

31 The Committee agreed that the arguments remained finely balanced. Most members concluded that the news on the latest month had left the most likely outlook for inflation little changed, although perhaps implying a greater downside risk than before. It was not yet necessary to raise interest rates, and there was a possibility that an increase in interest rates at this point could have an unusually sharp impact on business and consumer confidence. Some of these members believed that the arguments for not raising rates were stronger this month than at the Committee's previous meeting. One member argued that a modest increase in interest rates would be appropriate now. The arguments advanced last month both for raising rates and for waiting still held. The direct effects of the recent fragility in equity markets should be taken into account, but it would be wrong to give undue weight to this, just as the Committee had not done so for the recent strong rises in house prices. An increase would not represent a contractionary policy stance so much as a reduction in the degree of monetary stimulus that was currently being injected.

32 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4.0%. Eight members of the Committee (The Governor, David Clementi, Christopher Allsopp, Kate Barker, Charles Bean, Marian Bell, Stephen Nickell and Paul Tucker) voted in favour. Mervyn King voted against, preferring a rise in the repo rate of 25 basis points.

33 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

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 28 June, in advance of its meeting on 3 and 4 July. 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 US industrial production had risen by 0.1% in May on the previous month. This had represented a fall of 1.6% on a year earlier. Industrial production growth in April had been revised down to an increase of 0.3% on the previous month, from 0.4%. The US trade deficit had widened in April to \$35.9 billion from \$32.5 billion in March. The Institute for Supply Management (ISM) manufacturing headline index had increased in June, to 56.2 from 55.7 in May. The ISM non-manufacturing headline index had fallen, to 57.2 in June from 60.1 in May.

A3 The University of Michigan headline index of consumer confidence had fallen to 92.4 in June (revised up from 90.8) from 96.9 in May (revised up from 96.0). The Conference Board measure of consumer confidence had also fallen, to 106.4 in June, from an upwardly revised 110.3 in May (previously 109.8). US retail sales values in May had fallen by 0.9% on the previous month, following a rise of 1.2% in April. Real consumption had remained unchanged in May on the month (it had risen 3.0% on a year earlier) following a rise of 0.1% in April. Real personal disposable income in the United States had risen by 0.4% on the month in May following a fall of 0.1% in April. The US household saving rate had risen to 3.1% from 2.8% in April.

A4 Italian GDP in 2002 Q1 had grown by 0.2% on the quarter, compared with a fall of 0.2% in 2001 Q4. Private consumption in Italy had remained unchanged and total investment had fallen by 2.4% in 2002 Q1 compared with the previous quarter. Exports had fallen by 2.1% and imports had

fallen by 0.4%, implying that net trade had contributed –0.5 percentage points to Italian GDP in 2002 Q1. There had been a positive contribution from stocks of 1.2 percentage points.

A5 Industrial production in the euro area had fallen by 0.5% on the previous month in April, compared with a rise of 0.5% in March. Euro-area industrial production in April had fallen by 1.2% compared with a year earlier. The euro-area unemployment rate had remained unchanged at 8.3% in May compared with a month earlier. The euro-area purchasing managers' index (PMI) for manufacturing had risen to 51.8 in June from 51.5 in May. The euro-area PMI for services had risen to 52.9 in June from 52.1 in May. The confidence indicator in the European Commission business survey had fallen, to –10 in June from –9 in May. The confidence indicator in the consumer survey had also fallen, to –9 in June from –8 in May. The west German Ifo index had fallen in June, to 91.3 from 91.6 in May. German manufacturing orders had risen by 2.3% in April on the previous month, the first monthly increase since December 2001. German retail sales had fallen by 0.8% in May compared with the previous month. French consumer spending on manufactured goods had fallen by 1.3% in May compared with the previous month.

A6 Japanese real GDP in 2002 Q1 had grown by 1.4% on the quarter, compared with a fall of 1.2% in 2001 Q4. Private consumption in Japan had risen by 1.6% in 2002 Q1 and total private investment had fallen by 3.0%. Exports had risen by 6.4% and imports had remained unchanged, so net trade had contributed 0.7 percentage points to Japanese GDP growth in 2002 Q1. Public investment had increased 4.1% in 2002 Q1 on the previous quarter, and government consumption had risen by 1.2%. Industrial production in Japan had risen 3.9% in May compared with a month earlier, the fourth consecutive monthly increase and the largest monthly increase since 1992. The index of all-industry activity for Japan had fallen by 1.3% on the month in April. Japanese total domestic private machinery orders (excluding orders of ships and electric power) had increased by 8.4% in April, following a fall of 6.2% in March. The June Tankan survey had shown a rise in business confidence since March.

A7 Japanese export volumes in May had risen by 14.8% on the previous year. Japanese export volumes to Asia had shown the strongest increase, growing by 21.4%, while export volumes to the United States had risen by 7.2%. Japanese import volumes in May had fallen by 2.5% on the previous year, following a rise of 2.2% on the same basis in April.

A8 US headline CPI inflation had fallen to 1.2% in the year to May, from 1.6% in the year to April. Core CPI inflation (excluding food and energy) had been 2.5% in the year to May, unchanged from April. US producer prices had fallen by 2.7% in the year to May, compared with a fall of 2.0% in the year to April. Inflation in the Harmonised Index of Consumer Prices (HICP) in the euro area had fallen to 2.0% in the year to May, from 2.4% in April. The flash estimate of annual HICP inflation had been 1.7% in June. Euro-area core inflation (HICP excluding energy, food, alcohol and tobacco) had risen to 2.6% in May from 2.4% in April. Japanese consumer price inflation had been -0.9% in the year to May 2002.

A9 Since the Committee's previous meeting, the spot price of Brent crude had risen from around \$23 per barrel to around \$26, and there had been a small rise in the price of oil futures. *The Economist* non-oil commodity dollar price index had risen by 2.3%. The major international equity indices had fallen since the Committee's previous meeting. The Wilshire 5000 had fallen by 9.4%, the FTSE All Share by 12.0%, the Dow Jones Euro Stoxx index by 10.4% and the Topix index had fallen by 6.5%. Indices of corporate bond spreads had risen. Sovereign bond spreads in many emerging market economies had on average widened during the month and spreads had widened particularly sharply in Brazil.

II Monetary and financial conditions

A10 The twelve-month growth rate of notes and coin in circulation had risen to 9.5% in June, from 9.3% in May. The twelve-month growth rate of M4 had remained at 6.0% in May. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had risen to 8.9% in May, from 8.4% in April. Excluding other financial corporations (OFCs), the annual growth of M4 deposits and M4 lending had both increased in May.

A11 The twelve-month growth rate of households' M4 had risen to 8.7% in May, from 8.2% in April. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen further, to 12.4% in May. Within total net lending to individuals, the annual growth rate of secured lending had risen to 11.3% in May, the highest rate since 1991 Q1. The annual growth rate of unsecured lending had declined slightly, to 15.1%, as growth in credit card lending had

slowed. The number of loan approvals for house purchase had remained at a high level of 125,000 in May.

A12 Mortgage equity withdrawal (MEW) in 2002 Q1 had been £8.1 billion. The estimated households' debt-to-income ratio had risen in 2002 Q1, and the estimated households' capital gearing ratio had risen slightly. The estimated ratio of households' interest payments to disposable income had declined slightly in 2002 Q1.

A13 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 7.4% in May, from 7.0% in April. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had increased to 6.0% in May, from 4.5% in April. PNFCs had raised an average of £4.4 billion in total external finance in May and April, compared with an average monthly flow of £3.6 billion in 2002 Q1.

A14 The corporate debt-to-profits ratio was estimated to have increased in 2002 Q1. Corporate capital gearing at market value was also estimated to have increased somewhat in 2002 Q1, while estimated corporate income gearing had decreased further.

A15 The twelve-month growth rate of OFCs' M4 deposits had declined to -2.0% in May, from -0.5% in April. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had also declined, to 2.9% in May from 3.4% in April.

A16 Short-term nominal interest rates had declined since the Committee's previous meeting. The general collateral repo two-week forward rate had declined out to two years. Longer-term nominal forward rates had also declined beyond five years by around 20-30 basis points since the Committee's previous meeting. Forward real rates derived from index-linked gilts had fallen slightly beyond the five-year horizon by around 5 basis points.

A17 Implied forward inflation rates derived from conventional and index-linked gilts had fallen since the Committee's previous meeting by around 10 basis points at the shorter end and 15-25 basis points beyond five years. But survey-based inflation expectations had remained broadly unchanged for 2002. The monthly Consensus Economics forecast for average inflation in 2002 and 2003 had

increased slightly to 2.3% and 2.4%, respectively.

A18 Quoted interest rates had shown little change in June. The standard variable rate (SVR) for mortgages had remained unchanged in June. The two-year fixed mortgage rate had been unchanged, and the spread over two-year swaps had widened slightly.

A19 The Merrill Lynch aggregate index of investment-grade sterling corporate bond yields had fallen by 7 basis points since the Committee's previous meeting. Aggregate spreads had ticked up only slightly on the month, but the spread for the telecoms sub-index had increased further.

A20 The FTSE All-Share index had fallen by 12.0% since the Committee's previous meeting. The decline on the month had been broadly in line with other international markets, in local currency terms. The financial sector as well as the information technology (IT) sector had shown significant weakness. The number of profit warnings issued in June had fallen since May.

A21 Between 5 June and 3 July, the sterling exchange rate index (£ERI) had appreciated by 1.1% to 104.3. That had reflected a 4.9% appreciation of sterling against the US dollar, and a 0.3% appreciation against the euro. Movements in sterling against the euro had been broadly consistent with movements in relative shorter-term interest rates. The Consensus short-run expected £ERI profile had moved down by around 2% at all horizons. This had reflected a significant weakening in the exchange rate expected for sterling against the euro over the next two years.

III Demand and output

A22 The Q1 National Accounts, published on the 28 June, had shown slight upward revisions to GDP growth over the previous six months. Quarterly GDP growth at constant market prices had been revised to 0.1%, from 0.0%, in both 2001 Q4 and 2002 Q1. Household consumption growth in 2002 Q1 had been revised down to 0.5%, from 0.7%. In contrast, government consumption growth had been revised upwards, to 2.0%, from 1.2%. Growth in both exports and imports had been revised downwards. The contribution of stockbuilding (including the alignment adjustment) to GDP growth in 2002 Q1 had been unrevised, at 0.4 percentage points.

A23 The level of GDP in 2002 Q1 had been revised up by 0.1%. But within that, there had been more significant revisions to the individual components of GDP. The level of whole economy investment was estimated to be 5.4% lower in 2002 Q1 than in the previous Output, Income and Expenditure release. That revision had been offset by upward revisions to the level of household consumption and government consumption, which had been revised by 1.3% and 0.5% respectively. The revisions to the expenditure components were such that the level of final domestic demand in 2002 Q1 had not been revised compared with the Output, Income and Expenditure release.

A24 On the income side of the accounts, households' real post-tax income (deflated by the household expenditure deflator) had risen by 0.3% in 2002 Q1. The revisions to the back data meant that the level of households' real post-tax income was 2.1% higher in 2001 Q4 than had been previously estimated. That revision was larger than the revisions to the level of households' consumption, resulting in an upward revision to the level of the households' saving ratio. In 2002 Q1, the households' saving ratio had been 5.6%.

A25 On the output side of the accounts, the upward revision to GDP growth in 2002 Q1 had reflected an upward revision to the growth of both construction output to 3.0% from 1.0%, and manufacturing output, to -1.1%, from -1.5%.

A26 Looking forward, the Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey for June had shown the output index falling back to 53.6, from 56.0 in May. The new orders index had also fallen back, to 51.3, from 55.8 in May. The CIPS Report on Services for June had also shown a slight slowdown in the rate of activity growth, with the business activity index falling back to 54.9, from 56.7.

A27 Turning to consumption indicators in Q2, retail sales volumes had fallen by 0.6% in May, after rising sharply in April. New private car registration figures from the Society of Motor Manufacturers and Traders (SMMT) had shown annual growth slowing to 13.4% in May, from 24.5% in April. House prices had continued to rise strongly. The Nationwide measure had risen by 3.3% in June, while the Halifax index had risen by 2.3% in June. The GfK consumer confidence aggregate indicator had fallen back slightly, to +5.6, from +6.5 in May.

IV The labour market

A28 According to the Labour Force Survey (LFS), employment had risen by 88,000 in the three months to April 2002, compared with 35,000 in the previous three months. The working-age employment rate was 74.6%, up 0.1 percentage points on the previous three months. Average hours had increased by 0.1% in the three months to April; total hours had increased by 0.4%.

A29 The number of Workforce Jobs had risen by 32,000 in 2002 Q1. Within the total the number of service sector jobs had increased by 81,000, while the number of jobs in the manufacturing sector had fallen by 42,000.

A30 The CIPS manufacturing employment index for June had risen while the index for services had fallen, although both had remained below the no change level of 50. The construction index had fallen slightly but remained above the no change level. The Andersen/REC survey for June had reported more widespread increases in demand for temporary and permanent staff.

A31 LFS unemployment had risen by 19,000 in the three months to April, and had been 57,000 higher than a year earlier. The LFS unemployment rate had been unchanged at 5.2%. Claimant count unemployment had fallen by 7,000 in May, following increases of 4,000 in April and 2,000 in March: outflows had picked up sharply, and perhaps erratically, in May. The claimant count rate had been 3.1% in May. Inflows to the claimant count had now risen for three consecutive months. Inactivity amongst those aged 16 and older had fallen by 41,000 in the three months to April. The working age inactivity rate had fallen by 0.1 percentage points to 21.2%.

A32 The official ONS measure of annual growth in productivity per job had fallen 0.5 percentage points to 0.4% in 2002 Q1. Annual growth in productivity per hour had fallen by 0.8 percentage points to 0.5% over the same period. Annual growth in the official ONS measure of unit wage costs had fallen by 0.4 percentage points to 3.0%.

A33 Headline (three-month average) whole-economy average earnings growth had been 3.3% in the year to April, up 0.4 percentage points on the previous month. Headline earnings growth in the private sector had increased by 0.5 percentage points to 3.1%. In the public sector, headline earnings growth

had fallen by 0.4 percentage points to 4.1%. Annual earnings growth had been 4.0% in the year to April, up 0.5 percentage points from the March figure.

A34 The increase in earnings growth (not seasonally adjusted) had reflected a significantly less negative contribution from bonuses. Bonuses had reduced whole-economy earnings growth by only 0.1 percentage points in the year to April, following a negative contribution of 1.0 percentage points in March. Regular pay growth had slowed by 0.3 percentage points, to 4.0% (not seasonally adjusted) in the year to April.

A35 The Bank's twelve-month, Average Earnings Index (AEI)-weighted, whole economy mean settlement had been 3.1% in May, unchanged from the April figure which had been revised down 0.2 percentage points reflecting the receipt of new information on recent settlements. The three-month, AEI-weighted mean settlement had risen 0.1 percentage points to 2.9%. The three-month mean had been 0.4 percentage points lower than the corresponding period a year earlier.

V Prices

A36 Sterling oil prices had risen by around 5% since the June MPC meeting, but on average were somewhat lower in June than had been expected at the time of the *May Inflation Report*.

A37 Manufacturing input prices had fallen by 0.7% in May. The fall had mainly reflected falls in the price of crude oil. Annual input price inflation had fallen in May to -6.1% from -4.5% in April. But the CIPS manufacturing survey had suggested that input price pressures might not be so subdued going forward. The input price balance had risen to 53.0 in June from 49.0 in May.

A38 Manufacturing output prices excluding duties (PPIY) had been unchanged in May, while the annual inflation rate had fallen by 0.1 percentage points to 0.2%. Survey data had continued to point to subdued output price inflation going forward. The CBI Monthly Trends survey expected output price balance had been broadly unchanged at -10 in June.

A39 The annual inflation rate of the GDP deflator at market prices had risen to 3.4% in 2002 Q1 from 2.3% in 2001 Q4. This compared with the previous estimate in the Output, Income and

Expenditure release of 3.5% for Q1. Within the aggregate, the annual inflation rate of the consumption deflator had been revised down sharply to 1.0% in Q1, from 1.9% in the initial release. In contrast, the annual inflation rate of the government deflator had been revised up significantly in Q1 to 6.5% from 4.8% in the initial release. The annual inflation rates of the imports and exports deflators had been –3.6% and 0.3% respectively in Q1.

A40 Annual RPIX inflation had fallen by 0.5 percentage points to 1.8% in May. Within the aggregate, annual goods price inflation had fallen sharply to –0.9% from 0.1% in April and annual services price inflation had been unchanged at 4.5% in May. This meant that the differential between goods and services price inflation had widened to its highest level for almost 20 years. Annual RPIY inflation had fallen by 0.7 percentage points, to be equal to RPIX inflation at 1.8% in May. Annual RPI inflation had fallen 0.4 percentage points to 1.1% in May, while annual HICP inflation had fallen to 0.8%, down from 1.3% in the previous month.

VI Report by the Bank's Agents

A41 The Bank's regional Agents reported that a gradual but uneven recovery had been underway in some parts of the manufacturing and services sectors.

A42 Most contacts had reported that it was too early to assess the effects of the depreciation of sterling against the Euro and the appreciation against the dollar. Most exporters who priced in euros had left euro prices unchanged for the time being. And competitive pressures had been expected to deter UK importers from raising prices fully in line with the depreciation of sterling against the euro.

A43 In the domestic market, non-food retailers had reported flat trade over the early-June Bank Holiday period. During the World Cup, demand had been strong for alcohol, convenience foods, wide-screen televisions and football-related products. Pubs had benefited from extra trade during the key games. New car sales had remained strong but some other retailers had reported lower footfall. Overall retail sales had slowed during the month, but other forms of consumer spending had strengthened.

A44 In the housing market, property prices had generally continued to rise, but there had been some signs that potential buyers were considering the possibility of higher interest rates. Some contacts had expected a correction in prices, though not a very sharp one. There had been some reports of relaxation in lending criteria in southern districts; generally this had been on loan-to-income multiples rather than loan-to-house value rates. Mortgage arrears had been at historically low rates relative to total loan books.

A45 The Bank's regional Agents had conducted a special survey of recent developments in exports. 148 firms with total turnover of around £21bn responded. Overall the survey described a slight increase in export sales values in 2002 Q2. The weighted (by turnover) balance of firms in the manufacturing sector expected an increase in export sales in 2002 Q2 relative to Q1, following a slight negative balance in Q1. Respondents reported weaker export growth expectations in consumer and particularly semi-finished goods in Q2, but capital goods sales were expected to increase. The increase in manufacturing export sales in Q1 to countries outside the EU had been outweighed by a weakening of sales to EU countries. This was expected to reverse in Q2, in part because of the expected completion of restocking in the United States and in Far Eastern economies. A majority of respondents in the manufacturing sector said they had not raised sterling export prices over the six months to June. This was in contrast to the rise in the ONS export price index since January 2002.

VII Market intelligence

A46 Between 5 June and 3 July, interest rates implied by short sterling futures contracts had fallen. Rates implied by the contract for September 2002 had fallen by 38 basis points and those implied by the contract for September 2003 had fallen by 24 basis points. During the period, rates had fallen following lower-than-expected RPIX and US retail sales data, and also following the June MPC decision, but they had risen following stronger-than-expected UK industrial production data. Movements in short-term interest rate expectations had been highly correlated with changes in the FTSE 100.

A47 Market participants had generally expected the Committee not to change the Bank's official repo rate at its July meeting. 25 economists polled by Reuters on 27 June had attached a mean probability of 78% to no change in the Bank's repo rate at the July meeting, and a probability of 22%

to an increase of 25 basis points. All 25 economists had thought that rates were most likely to remain unchanged.

A48 The dollar had depreciated by 4.4% against the euro since the Committee's previous meeting. Dollar depreciation against all major currencies had occurred against the background of falling US equity markets and, following a record US current account deficit in 2002 Q1, concerns over the sustainability of capital inflows into the United States. A possible shift in sentiment about the dollar may have been reflected in reduced inflows to the United States and increased purchases of euro-denominated assets over the period, as evidenced in some investment banks' proprietary flow data. Sterling ended the month 0.3% higher against the euro having again been influenced during the month by fluctuating perceptions about the likelihood of EMU entry. The one-year implied correlation between sterling and the euro versus the dollar reached a new high of 0.84 over the period. On an effective basis, sterling rose 1.1%.