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MINUTES OF MONETARY POLICY COMMITTEE MEETING

6 and 7 August 1997

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 August 1997.

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

The Chancellor of the Exchequer announced on 6 May that the Government was giving 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 no later than 6 weeks after each meeting. Accordingly, the minutes of the Committee meeting held on 10 and 11 September will be published on 15 October.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 6-7 AUGUST 1997

1 Section I of this minute summarises the analysis presented to the Monetary Policy Committee by Bank staff, and also incorporates information that became available to the Committee after the presentation but before the decision-taking meeting. Section II summarises the Monetary Policy Committee's discussion of the policy implications of the analysis.

I Monetary conditions

2 Notes and coin, having increased by 0.8% in June, appeared to have decelerated in July to an increase of around 0.2%. That would reduce the twelve-month growth rate to 5.6% from 6.1% in June.

3 Broad money growth remained strong in June. M4 increased by 0.9%, and the three, seven and twelve-month growth rates were all in the range 11.6-11.7% (the seven-month growth rate was calculated because the six-month rate was distorted by the effect of the temporary contraction of the gilt repo market at the end of 1996). Retail M4 grew particularly strongly in June (1.2%) whereas the rise in wholesale M4 was unusually low (0.4%). That pattern may have reflected sales of Halifax shares by individuals to financial institutions following demutualisation.

4 The twelve-month growth rates of real money balances (deflated by RPIX) in June were 3.5% for M0 and 8.8% for M4.

5 The sectoral analysis of monetary growth in Q2 showed that individuals' M4 holdings increased by 1.8%, and their four-quarter growth rate went up from 7% to 7.3%. During the first half of the year they increased by around 4%, compared with 3% in the second half of 1996. The four-quarter growth rate of ICCs' M4 holdings in 1997 Q2 was 7.9%, down from the peak of 11.4% reached in 1996 Q3. ICCs' M4 holdings increased by 3.8% in the first half of 1997, much the same as in the second half of 1996.

6 However by far the fastest-growing component of M4 had been OFIs' holdings. These had grown much faster than individuals' or ICCs' holdings during the last 2-3 years, and accounted for about one half of the five percentage point rise in the four-quarter growth rate of total M4 since 1995 Q2. They increased by 4.7% in Q2 and their four-quarter growth rate had risen to 26.6%. The OFI sector contains a wide variety of types of financial intermediary, the money holdings of which might be affected by different factors. Overall, the growth of OFI's money had been dominated by life assurance and pension funds and, to a lesser extent, securities dealers.

7 Divisia money aims to identify balances held for transactions purposes. The four-quarter growth rate of aggregate Divisia money was 10.2% in 1997 Q2; that of personal Divisia money was 7.8% (up from 7.4% in Q1) and that of ICCs' Divisia money was 7.3% (down from 8.6% in Q1), and that of OFIs' Divisia money was 29.4% (up from 23.6% in Q1).

8 M4 lending (adjusted to exclude the effect of loan securitisations) rose by 0.7% in June, and its twelve-month growth rate was unchanged at 9.5%. The quarterly sectoral data showed that the four-quarter growth rate of lending was 7.2% for both persons and ICCs, and 20.2% for OFIs. Within personal lending, unsecured lending continued to accelerate: the twelve-month increase in June was 18.3%. The credit card component of unsecured lending (about 20% of the total) had been growing at around 20% for the last year or so. The residual component of unsecured lending (about 80% of the total) had grown by 17.8% in the twelve months to June, and its twelve-month growth rate had been rising in recent months. Although gross mortgage lending by banks and building societies had increased quite sharply over the last couple of years, the recent acceleration in net mortgage lending (to a twelve-month increase of 6.2% in June) was more modest.

9 M4 lending to ICCs bounced back in Q2 when it rose by 2.0%, after an unusually small increase of 0.3% in Q1. Its four-quarter growth rate continued to edge down to 7.2% compared with the recent peak of 15.2% reached in 1996 Q2. M4 lending to OFIs had risen sharply, by 5.3%, in 1997 Q2.

10 Real forward interest rates derived from index-linked gilt yields suggested that real yields at maturities of two years or so had risen slightly in recent months, as did Bank estimates based on surveys of inflation expectations.

II Demand and output

11 Retail sales volumes increased further (by 0.6%) in June after May's strong rise, and their twelve-month growth rate was 5.4%. The annualised growth rate since the start of the year was 8.2%. Though the twelve-month increase in volumes had continued to rise this year, the twelve-month increase in the value of retail sales had levelled out late in 1996 at a little below 6%.

12 Spending on durables had been growing faster than spending on non-durable goods and services, and in June purchases from household goods stores rose by 7.5%, or £140 million. Industry contacts expected that car sales would be very strong in August, and demand for holidays abroad was also reported to be strong. A standard consumption function used by Bank staff did not suggest that up to Q1 there had been any unusual strength in consumer spending (given wealth, income, interest rates and employment), of the kind that might have been caused by anticipation of windfall gains - though the standard error of the equation (around 0.6%) was large enough to absorb any such effects. Nor had the share of durables in total consumer spending been unusual up to Q1. It seemed likely that consumer spending in Q2 had been supported to some degree by windfall gains (some of which might have been anticipated). A survey by the British Retail Consortium of 1200 recipients of windfalls reported that of the 32% who planned to sell some or all of their shares, 33% were spending money on holidays; 26% were spending on new kitchens, bathrooms or other home improvements; 17% were spending the proceeds in the high street, particularly on goods for the home (eg carpets, furniture); and 11% were buying cars.

13 It seemed likely that consumer demand had also been supported by rising financial wealth. Gross financial wealth rose by 10% (£208 billion) in the year to 1997 Q1; 90% of the increase was the consequence of rising asset prices.

14 The Nationwide house price index for July showed its largest monthly increase for three years (1.8%), (and its twelve month growth rate had gone up to 12.2% from 11.0% in June). The Halifax index, however, rose by only 0.1% in that month, taking the twelve-month growth rate down to 6.4% from 7.1% in June. The recent divergence between the Nationwide and Halifax estimates of house price

inflation was puzzling (the indices are mix-adjusted, so as to exclude the influence of the types and locations of the houses which the two institutions were financing). The ratio of house prices to average earnings continued to be lower than in the early to mid 1980s, on either measure. The data on housing market activity were generally flat. An exception was mortgage loan approvals, which had been rising, but that could reflect remortgaging activity as well as net lending.

15 Investment intentions, as indicated by surveys and by reports from the Bank's regional Agencies, remained strong in both manufacturing and services, even though recorded manufacturing investment (which accounted for about 12% of total investment) was lower in 1997Q1 than a year earlier.

16 The monthly external trade figures continued to be surprisingly strong in the face of the appreciation of sterling. Import volumes from non-EU countries had risen by 7.2% in the second quarter (export volumes had risen by 5.2%); and there had been a very strong rise in imports of consumer goods, including cars. This was consistent with the recent and prospective pattern of consumer spending. Imports of services might be boosted by spending of windfall gains on holidays abroad.

17 Recent surveys (CBI, BCC, CIPS) suggested that orders for manufactured exports had fallen sharply, and Bank research based on analysis of the relationship between responses to the CBI survey and recorded exports suggested that the four-quarter growth rate of manufactured exports might have fallen in Q2, while remaining positive; there was a possibility that it might be negative in Q3. There also appeared from the BCC surveys to have been a slowdown in services exports.

18 The initial estimate of GDP growth in 1997Q2 was 0.9% (non-oil 1.0%), and the estimated four-quarter growth rate had risen to 3.4% (non-oil 3.6%). Manufacturing output had fallen by 0.1% in Q2, having risen by 0.5% in Q1. Its four-quarter growth rate was 1.6%, notwithstanding weakening export demand, and surveys suggested that growth was likely to continue. Construction activity appeared to be rising erratically. Services output was estimated by the ONS to have risen by 1.3% in Q2 and by 4.6% over the year to Q2; the BCC survey for Q2 suggested some moderation in the annual rate of growth.

III Labour market

19 Demand for labour continued to rise. The Labour Force Survey (LFS) reported a rise of 91,000 in employment between winter and spring, of which just under two thirds represented full-time jobs. Total hours worked rose by 1%, and were up by 1.7% on a year earlier. According to surveys and the Agencies' reports, recruitment intentions were exceptionally strong in service industries but had moderated in manufacturing.

20 The LFS showed a fall of 74,000 in unemployment between winter and spring to 7.2% (on the ILO definition). Short-term unemployment had fallen below its low point of spring 1989. On the claimant count measure, unemployment fell by 36,500 in June to a rate of 5.7%.

21 Analysis of the latest LFS suggested that the labour market had tightened slightly less since autumn 1996 than had previously been thought, and that the Jobseekers' Allowance had had a slightly more powerful effect than previously thought on claims from those not searching for a job. The underlying rate of tightening was now thought to be the equivalent of a monthly fall of 25,000-30,000 in the claimant count.

22 The number of unfilled vacancies reported to job centres rose by 8,000 in June to a new record level of 282,000, but the rise reflected a fall in placings (of 22,000) which exceeded the fall in new notifications (14,000).

23 The recorded twelve-month growth rate of underlying average earnings fell to 4_% in May: this was the first month since November in which the figure had not been affected by bonuses. Calculations by Bank staff based on analysis of sectoral earnings trends and statistical smoothing techniques suggested that the underlying growth rate of earnings including bonuses was just under 4_%.

24 Since the previous MPC meeting the local authority workers settlement, covering 1.4 million people, for a 2.5% basic increase plus the introduction of a minimum wage of £4 per hour, had been agreed. The total cost of the settlement was likely to amount to 2.8% of the pay bill. The twelve-month employment-weighted mean of settlements was just over 3%, with the private sector at 3.4% and the

public sector at 2.7%. Within the private sector, the service sector was at 3.6% and the production sector at 3.2%. A proposed settlement covering 600,000 construction workers could lead to a jump in the three-month employment-weighted mean of settlements in June.

25 The Bank's regional Agencies had conducted a survey of labour demand in 136 companies in July. 40% of those surveyed reported that staff numbers had risen over the previous 6 months, while 24% reported that they had fallen. 47% expected staff numbers to rise during the next 6 months, and 16% expected them to fall. Recruitment intentions were particularly strong in service industries, where 66% of respondents expected staff numbers to rise and 7% expected them to fall; in manufacturing 29% of respondents expected staff numbers to rise and 25% expected them to fall. Staff reductions during the previous six months had been mainly in large companies (ie companies with more than 500 employees).

26 Of those surveyed, 34% reported that staff turnover had increased in the past six months and nearly all of the others reported no change. 26% of all respondents (34% in services) reported a shortage of skilled workers and 24% quoted skill shortages as a reason for adjusting wages. 48% said that skill shortages had intensified in the past 6 months (57% in London and the South East). 23% reported a deterioration in the quality of applicants for jobs, while 8% reported an improvement: 32% said that skill shortages were inhibiting their ability to meet demand.

27 On pay, 40% of companies surveyed thought that their settlement would be higher than in 1996, while 10% thought it would be lower. For those expecting higher settlements, the main causes were staff turnover and recruitment problems. 53% of respondents (and 61% in the service sector) said that they would pay premium rates to key groups of skilled workers.

28 A summary of the recent OECD Employment Outlook evidence on job insecurity was presented to the Committee. The OECD drew heavily on surveys conducted by International Survey Research (ISR), which suggested that perceived job insecurity had increased internationally over the past five years, and that it was relatively high in the United Kingdom. The causes of job insecurity might be structural as well as cyclical: ISR surveys suggested that insecurity had increased in each year since 1987 in the United Kingdom. Greater job insecurity might lead to lower wage pressure and to higher

precautionary savings.

29 Evidence assembled by the OECD showed little change in job instability - for example average job tenure had changed little on balance between 1985 and 1995. Rates of staff retention had not changed much in most countries, and had actually risen a little in the United Kingdom between the late 1980s and early 1990s. Layoff rates in the United Kingdom had been similar in the 1990s recession to those in the 1980s recession, and were now lower than elsewhere in the European Union. The OECD had found little evidence of a statistically significant link between rates of temporary employment (eg on fixed-term contracts) or changes in statutory employment protection and perceptions of job insecurity across countries.

30 The British Household Panel survey corroborated a rise in job insecurity in the United Kingdom in the early 1990s. The British Social Attitudes Survey, however, suggested no trend in the fear of redundancy in recent years. But it also suggested that in the early to mid 1990s a relatively low percentage of respondents had thought it would take them less than three months to find an acceptable job, though the percentage had risen in 1995.

31 The OECD concluded that there had been a sharp rise in perceived job insecurity across many countries, mainly because the consequences of job loss had worsened: benefits paid to those out of work had become less generous and eligibility had been tightened, and entry wages into new jobs had fallen relative to average earnings. Institutional factors affecting the degree of centralised bargaining might also play a role. According to ISR data, though job insecurity in the United Kingdom appeared to have been increasing steadily during the current economic recovery, the United States showed a recent recovery in job security, presumably in response to the continued strength of the labour market.

IV Prices

32 The Bank's commodity price index fell by 1.6% (provisional figure) in June, having risen by 1.1% (revised figure) in May. These variations were partly explained by volatility in oil prices.

33 Non-oil import prices fell by a further 0.2% in May, and prices of non-oil imports from non-EU countries rose by 0.1% in June. Producer input prices fell by 0.8% in June and by a further 0.4% in July, when they were 9.0% lower than a year earlier. Producer output prices did not change in June or July, and in July they were 0.6% higher than a year earlier. The index excluding excise duties (PPIY) rose by 0.1% in June but did not change in July, when it was 0.4% higher than a year earlier. The CBI industrial trends survey did not suggest that producer output prices were likely to accelerate significantly. Non-oil export prices fell by a further 0.2% in May, though prices of non-oil exports to non-EU countries rose by 0.1% in June.

34 Twelve-month RPIX inflation rose from 2.5% in May to 2.7% in June, with the increase largely accounted for by seasonal food prices. RPI inflation rose from 2.6% in May to 2.9% in June, partly because of rises in mortgage rates. The EU Harmonised Consumer Price Index in June was 1.7% higher than a year earlier.

35 Food price inflation had been falling during the last twelve months and accounted for half of the fall in RPIX inflation from 3.3% to 2.5% between November 1996 and May 1997. This reflected both favourable supply conditions in 1996 and sterling's appreciation, which had had a much greater effect on food prices than on most other goods prices. Looking ahead, supply conditions in 1997 were likely to be less favourable and the effect of sterling's appreciation on the rate of food price inflation would at some point begin to wear off.

V Information from financial markets

36 The sterling ERI stood at 103.9 (1990 average = 100) at the close of business on 6 August. It had fallen by around 1/4% since 9 July but had risen by nearly 24% since 2 August 1996. Since 9 July, sterling was up by 1.1% against the Deutsche Mark and down by 5% against the dollar. It had fallen by

over 1.5% on the ERI on 6 August itself.

37 The main feature of foreign exchange markets during the last month had been the global strength of the dollar, reflecting optimistic assessments of the US economy and the perceived increased likelihood of EMU going ahead on schedule following the French budget package. Sterling fell slightly after the 1/4 percentage point rise in interest rates had been announced on 10 July, which suggested that some in the market had seen a larger rise in interest rates at that time as a possibility. Thereafter, for much of July sterling had moved up in parallel with the dollar, but it had weakened after the Bundesbank had announced fixed rate repos for the coming two weeks rather than the expected four, which had encouraged market expectations of higher interest rates in Germany. Analysis of options prices gave no reason to think that the market attached an unusually high probability to the prospect of a fall in sterling, though uncertainty had increased as sterling had appreciated. Likewise, chart analysis suggested no reason to think that sterling had peaked.

38 In the domestic money market, the announcement of a rise in interest rates on 10 July had very little effect, except for a slight fall in one-month rates, which suggested (like the small fall in sterling) that a larger rise had been seen as possible. Three-month LIBOR on 6 August was 7.13%; the levels implied by futures markets for September 1997, December 1997 and December 1998 were 7.28%, 7.45% and 7.33% respectively. The rates implied for December 1998 had fallen by 21 basis points during the month, and rates were now expected to peak in the spring. This appeared to reflect a perception that a slowdown in economic growth next year was possible, influenced in particular by the strength of sterling, by the fiscal tightening in the Budget, and by the vote not to demutualise the Nationwide Building Society. Analysis of option prices suggested that the fall in the level of short-term interest rates implied for March 1998 was accompanied by a fall in the probability attached to the prospect of sharply higher rates, while the probability attached to sharply lower rates was little changed.

39 Short-term interest rates implied by gilt prices for periods further in the future had also fallen since the last meeting: the implied profile was gently falling for periods up to 10 years, at which point the implied short-term interest rate was around 7.0%. This rate was broadly similar to comparable rates implied for the United States and Germany. Short-term market uncertainty about long-term interest rates (as measured from short term options on the long gilt future and interest rate swaps) had decreased

during the last month.

40 Future short-term interest rates implied for the average of large overseas industrial countries had risen for periods up to two years since 9 July, but had fallen for longer periods. There was no clear relationship between relative yield curve movements and changes in sterling's exchange rate during the month.

41 Analysis of money-market rates suggested that the market saw a material likelihood of a further increase in interest rates in August, and of a further rise later this year. Expectations of a rise in August rather than September had been growing in the last few days. It appeared that the market had not regarded substantial movements in sterling as a constraint on interest rate changes in the immediate future, though they perhaps had affected the market view of the longer-term outlook for interest rates.

42 In equity markets, the FT-SE 100 index had risen by 5.5% to 5026 since 9 July, and the FT-SE 250 index by 2.8% to 4517, but the FT-SE Small Capitalisation index had fallen by 0.9% to 2189. These indices account for around 75%, 20% and 5% of total market capitalisation respectively. During the last three months, during which the FT-SE 100 index had risen from 4436 to 5026, the probabilities attached by the market to high absolute levels of the FT-SE 100 share index in the future had increased, while the probabilities attached to low absolute levels were little changed. In conjunction with this, the probability attached to a large fall from current levels had increased.

II Policy implications

43 This section of the minutes summarises the Monetary Policy Committee's analysis of the data and its policy implications, which it assessed together with the inflation forecast and analysis to be published the following week in the Bank's *August Inflation Report*.

44 The Committee reviewed the current position of the economy. Non-oil GDP was growing at an annual rate of around 4%, well above any plausible estimate of capacity growth. Most commentators now estimated that the output gap was close to zero. If that were so, it followed that, unless output growth fell back fairly rapidly towards trend, a period of below - trend output growth would eventually

prove inevitable if the consequent upward pressures on inflation were to be relieved. It was however very difficult to judge the size of the output gap, and important to examine direct evidence about the extent of unused resources.

45 Important evidence was to be found in the labour market. The rate of short-term unemployment, at 4.5% according to the LFS, was lower than at any point since the early 1980s, and was close to the rate in the United States, while earnings growth was surprisingly low. It was possible that the natural rate of unemployment - the rate of unemployment consistent with a stable rate of inflation - had fallen, perhaps reflecting the cumulative effects of almost two decades of labour market reforms. The labour market had continued to tighten as the current upswing progressed, with gathering concerns throughout the economy about skill shortages, as reported by the Bank's Agencies and others. The Committee recalled its discussion at the previous month's meeting about earnings growth. Having been around 3 3/4% in spring 1996, earnings growth had recently been in a range of 4 1/4-4 1/2%, broadly consistent with the inflation target. It remained surprising that earnings had not accelerated more. The Committee agreed that the possibility of faster earnings growth should be treated as an upside risk to the Bank's central projection of inflation.

46 The Committee turned to other key elements of the quarter's data bearing on the outlook for inflation.

47 July's narrow money growth had been weak compared with the past year. Put together with the low May figure, it was possible that a lasting deceleration was occurring. It was, however, difficult to interpret the significance of such a change. On the one hand, it might reflect the flatter growth in retail sales values during 1997: lower retail price inflation had partly offset robust growth in retail sales volumes. On the other hand, if the earlier rapid growth had been caused by adjustment to a low-inflation environment in which individuals wanted to hold higher levels of cash in relation to income or wealth, some deceleration might be expected. Once the adjustment to low inflation was completed, velocity could begin to rise again, and the growth rate of narrow money could decline, given the continuing incentive to economise on cash holdings. It was not possible to conclude from just a few months' data that this was now happening. Narrow money data were therefore difficult to interpret, at least for the

moment.

48 Broad money and credit growth also posed important and difficult questions about the outlook for inflation. Much of the recent growth related to the OFI sector of the economy. There had also been a long-term trend decline in broad money velocity. Allowing for these factors, could current broad money growth in real terms of 8 1/2% be reconciled with the widely-shared expectations of a slowdown in consumption and activity growth over the next year or so? Put another way, did nominal M4 growth of between 11% and 12%, an increase from the second half of 1996, indicate a rise in inflation two years or so ahead once potentially temporary downward pressures on inflation, including sterling's appreciation, had abated or unwound?

49 The Committee noted that the rates of growth of the various sectoral components of M4 were different, although all were high. In addition, Divisia money - a measure of transaction balances, largely accounted for by personal sector money holdings - had grown by 10.2% in the year to second quarter, a modest increase in the growth rate during the last year. The growth of personal sector and company sector money could put upward pressure on inflation via effects on consumption and investment. The Committee concluded that both represented upside risks to the inflation outlook given the lack of supportive evidence for a permanent velocity shift.

50 The Committee discussed the possible implications for future demand and output of the recent rapid growth of OFIs' money, which accounted for about half of the increase in M4 in 1997 Q2. One possibility was that the sector was temporarily holding a high level of balances compared with long-run demand, perhaps partly as a result of the strength of cash-financed merger and acquisition activity and corporate share repurchases during 1995 and 1996. Intermediaries might have deliberately built up money holdings on a view that the rise in financial asset prices would not be sustained. If so, that money could eventually find its way back into asset markets if intermediaries eventually concluded that financial market valuations were robust after all, and so reinvested part of their money holdings. Some of the money would then pass to the company sector (for example via share issues) or to the personal sector (for example as demutualisation shares were sold). In either case, demand for consumption goods and services could be fuelled and a stimulus provided to investment if the cost of capital were reduced by further rises in financial asset prices. Alternatively, OFIs' demand for money might have increased

because portfolios had been adjusted to achieve desired asset allocations following the sharp rise in equity prices. In that case, intermediaries would not seek to reduce their money holdings unless financial asset prices fell, changing the value of their portfolios and relative prices. The Committee's view was that because so much of the recent acceleration in M4 was attributable to OFIs' holdings, it was perhaps less alarming than if the acceleration had been concentrated in either the personal or company sectors, but it represented an upside risk to the inflation outlook nevertheless.

51 The Committee discussed the outlook for consumption and the effect of windfall gains to the personal sector via demutualisation, reviewing its analysis at earlier meetings. On the basis of half-yearly growth rates, consumption had been growing at over 4% per annum for more than a year. A number of factors could plausibly explain this. Household wealth had increased rapidly, via the asset price appreciation discussed in the context of money demand. Consumer confidence remained at almost record levels. Short-maturity real interest rates had, during 1996 and early 1997, been relatively low for that point in the cycle. Strong consumption was not therefore a surprise even in the absence of the windfalls.

52 The effect of the windfalls on consumption depended upon the circumstances of households and the pattern of spending. The Committee's assessment was based on a view that households which were not constrained in their access to credit would treat the windfalls as providing an annuity income. Nevertheless, in the short run spending on durable goods - for example cars, furniture, major household appliances - might be boosted. This was a form of investment since durable goods were not instantly consumed, but were paid for upfront, increasing measured consumption expenditure. A minority of households were, however, judged likely to be credit-constrained. They would be more likely to increase consumption by more than the annuity value when windfall share allocations were sold for cash or used as newly available collateral for loans. Once these initial effects had worked their way through, growth in consumption should revert to a rate unaltered by windfalls, though the level of consumption would be higher because of the annuity effect. The emerging evidence was broadly consistent with this story. Retail sales had been strong again in June after a very strong May. The less timely data on sales of durable goods did not show a marked pick-up, but there was a lot of anecdotal evidence suggesting strength. Though the Bank's analysis seemed consistent with developments so far and with survey evidence, substantial uncertainties remained and the Committee agreed that Bank staff should encourage

further surveys designed to find out how people had in fact used the windfalls once they had been received.

53 The Committee noted that developments in consumer borrowing might also be linked to the windfalls. Unsecured consumer borrowing had been very strong and continued to accelerate. These loans might have been taken out in anticipation of the prospective increase in realisable wealth, with growth in unsecured borrowing accelerating as equity prices - and so the value of windfalls - rose. It would therefore be important to monitor future patterns of consumer credit.

54 The Committee agreed that the windfalls were most likely to have their largest effect on consumption during 1997, and that this should be reflected in the central projection incorporated in the Inflation Report. There was in addition an upside risk from the possibility that there are more credit-constrained households than the Bank had assumed and, separately, from the possibility that behaviour would be affected by expectations of further demutualisations in the future; this risk remained even after the vote of members of the Nationwide Building Society against demutualisation. A more important upside risk to the longer-run inflation outlook stemmed from the rise in wealth brought about by the rise in financial asset prices.

55 The Committee reviewed their July discussion of the effect of the fiscal position. Fiscal contraction had been in place for some time as a result of Budgets in 1993 and later years, including the most recent Budget in July. The general government deficit was expected by the Government to fall from 4% of GDP in 1996/97, to 1 1/2% in 1997/98, and to virtual balance the next financial year. It was likely to restrain demand, although the incidence of some of the recent measures was delayed. The precise effect, including its timing, was also uncertain. The assumption made in the Bank's inflation forecast would be that the nominal spending control total was met.

56 The Committee reviewed the recent behaviour of sterling. At the close of business on 6 August it had appreciated by about 5% in effective terms since the May *Inflation Report*, and so by around nearly 24% during the previous twelve months. There had been, in comparison, relatively little change since the Committee's last meeting, though the Committee noted that sterling had been volatile in the immediate run-up to the meeting on account of speculation about what it would decide. Looking at the

period since May, the Committee observed that around half of the appreciation was consistent with changes in UK and overseas yield curves (assuming no change in any exchange rate risk premium and in the long run no change in the real exchange rate) and so did not reflect any extra tightening of monetary conditions beyond what was already implied by the yield curves themselves. This element of the pound's appreciation could be expected to unwind gradually on the assumption of uncovered interest parity. Explanations of the remainder of the appreciation since May were difficult to identify and assess. It was widely suggested by commentators that it partly reflected portfolio shifts associated with uncertainty about EMU, possibly reducing any risk premium on sterling relative to some other European currencies. Some corroboration for this explanation was offered by the weakness of the Deutsche Mark against other currencies, including notably the US dollar. It was possible that the EMU outlook would become clearer during the coming months, in which case some of the upward pressure on sterling might be alleviated. However, this could not be counted on. If EMU did not lie behind much of sterling's appreciation, it was even less obvious what kind of news would affect its level. The Committee agreed that the central projection in the *Inflation Report* should be based on the assumption that sterling would depreciate by slightly more than would be implied by uncovered interest parity (based on the assumption of constant UK interest rates), reflecting a gradual and partial unwinding of that element of the appreciation over the last year that was not associated with changes in relative yield curves.

57 The Committee noted that surveys of business opinion were now showing consistently that export orders were suffering significantly from sterling's rise. The trade performance so far this year had been a puzzle, but the Committee thought it likely that the effects of the appreciation would soon be evident in the data. It was agreed that the forecast should incorporate a significant impact from net trade on output during the coming year, and that this should feed primarily into the central projection rather than just as a downside risk to inflation. On the other hand, the possibility of a rapid unwinding of sterling's appreciation represented an upside risk for inflation.

58 The Committee expressed considerable concern about sterling's level and its unbalancing effects on the economy. While members viewed estimates of equilibrium real exchange rates as highly uncertain, it seemed likely that sterling was overvalued.

59 This was at the heart of the dilemma discussed at the Committee's previous two meetings and really had two aspects. First, sterling's appreciation was leading to unbalanced activity, with business judgements about how to react made very difficult by the uncertainty over how long the appreciation would persist. Secondly, it posed a dilemma for monetary policy. As discussed in previous *Inflation Reports*, the appreciation would have a 'one-off' effect on the price level via import prices and the impact on external demand, and so only a temporary effect on inflation, assuming that sterling stopped rising and gradually declined. But meanwhile there were powerful forces fuelling underlying nominal demand which, if left unchecked, would eventually emerge in higher inflation and inflation expectations.

60 Some action to alleviate underlying inflationary pressures had already been taken in the form of the 75 basis points increase in official interest rates since May. The Committee reviewed whether it needed to make any further changes now in the light of the inflation forecast. Without a further tightening in monetary conditions, the Committee agreed that the most likely outcome was that inflation would be above the Government's inflation target of 2 1/2% at the Bank's forecast horizon of two years. In addition, the risks to inflation were skewed on the upside, and inflation was likely to be on an upward trend at the end of the period covered by the forecast. A 25 basis points increase in rates would reduce the central projection to broadly in line with the target but leave the risks skewed on the upside.

61 The Committee agreed that a further tightening of monetary conditions was, on current evidence, needed to put the economy on a course consistent with the inflation target. Before reaching its immediate decision, however, the Committee felt that the policy dilemma was sufficiently acute that it should consider whether there were, as is sometimes suggested, alternative policy instruments that might help to resolve the dilemma without introducing unacceptable distortions. Apart from quantitative credit controls, these were of three main types: (i) variable reserve requirements on the banking system; (ii) changes to debt management; (iii) foreign exchange market intervention.

62 Under the first heading, Bank staff had examined the circumstances in which a call for special deposits from the banking system, which would need to be unremunerated and so act as a tax, would be passed on as an increase in loan rates, while limiting upward pressure on the exchange rate. Borrowers who did not have alternative sources of credit - notably individuals and small businesses - would then be likely to choose to borrow less, and that could restrain spending. But the staff analysis pointed out that

in the current financial environment measures of this kind were most unlikely to be effective. If temporary, the cost might well be absorbed by banks rather than passed on to their customers. Alternatively, if the cost of credit was increased, credit flows were likely to be diverted heavily into unaffected channels given the financial liberalisations of the past twenty years. In addition, any expectation of future use of the instrument would create market uncertainty and have serious disincentive and inefficiency effects. The Committee agreed with the analysis and rejected this course.

63 Nor did the Committee see much attraction in recommending to the Government a change in government debt management policy objectives towards restraining broad monetary growth, either by selling more debt than needed to finance the Government's deficit, ie overfunding, or by skewing the pattern of issuance to stocks likely to appeal to domestic institutional investors, so possibly absorbing OFI liquidity. The Committee was not confident that such a change would contribute usefully to addressing the current policy dilemma.

64 The Committee discussed the possible merits of intervention in the foreign exchange markets. There was a consensus that intervention was worth contemplating but only if it was accompanied by credible actions to put the economy on a course consistent with the inflation target. In those circumstances, it could help to bring about an adjustment in the exchange rate, which might otherwise be more protracted.

65 Having concluded that monetary policy would need to be tightened again, the Committee considered whether to raise interest rates immediately. Arguments for not doing so were the advantages of waiting to gather more information and of avoiding the risk of putting further upward pressure on the exchange rate. The main argument for moving immediately was the need to hit the inflation target. There was also the potential impact on expectations of publishing an *Inflation Report* that, on unchanged rates, would combine a view that the most likely outturn at the two year forecast horizon was that RPIX inflation would be above the 2 1/2% target with the risks to inflation clearly skewed on the upside. That would create a clear risk of damaging credibility and so increasing inflationary expectations, and of putting further upward pressure on the exchange rate by causing the market to revise upwards their expected path of interest rates. By tightening by an extra 1/4 percentage point immediately and so publishing an *Inflation Report* showing a central projection around 2 1/2% at the 2

year horizon, the Bank might be able to reduce inflation pressures and so affect market expectations that some of the upward pressure on sterling would be alleviated. This was the tactical judgement. The Committee agreed that, on balance, it was the better course and that the press notice announcing the move should reflect the nature of the judgement.

66 The Committee then voted unanimously in favour of a 1/4 percentage point rise in the Bank's repo rate, to be announced immediately.

67 The following members of the Committee were present:

Eddie George (Governor)

Willem Buiter

Charles Goodhart

Mervyn King

Ian Plenderleith

68 Sir Alan Budd was also present as the Treasury's representative.