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MINUTES OF MONETARY POLICY COMMITTEE MEETING

5 and 6 November 1997

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 November 1997.

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

The Chancellor of the Exchequer announced on 6 May 1997 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 3 and 4 December will be published on 14 January 1998.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 5-6 NOVEMBER 1997

1 The meeting was preceded by a presentation by Bank staff of the most recent data on monetary and economic conditions, and also by discussions on the November inflation forecast and analysis. The staff presentation is summarised in the Annex to these minutes; it has been updated to incorporate data that subsequently became available to the Monetary Policy Committee before its meeting. The November Inflation Report was published on Wednesday, 12 November.

2 The Committee began by discussing issues raised by recent economic developments - monetary growth, the balance of demand and supply in the goods and labour markets, including the latest retail sales data and retail margins, and the impact of the exchange rate on net trade. It then reviewed the possible implications of developments in the Asian economies and recent financial market volatility.

Monetary growth

3 M4 lending had slowed slightly over the quarter, driven by a fall in the growth of company borrowing. But otherwise the picture was much the same as in August. In particular, Divisia money had grown more than expected and the broad money balances of Other Financial Institutions (OFIs) had continued to grow at a very fast rate. Analysis by Bank staff using models of sectoral demand for money suggested that there probably remained a liquidity overhang in the OFI sector, and in particular amongst Life Assurance companies and Pension Funds (LAPFs). Staff work also suggested that the level of M4 velocity was below trend, supporting the picture from sectoral analysis that there was probably an aggregate money overhang. It seemed possible though that much of the decline in M4 velocity in recent years could be explained by the rise in the wealth/income ratio.

4 There were various possible interpretations of the implications of the monetary situation for future demand and inflationary pressures. There was an argument that the large cumulative growth in broad money over recent years did not represent a clear inflationary threat, given the possibility that much of it could be explained by the increase in the wealth/income ratio. However, it was not clear

that this increase represented a sustained change; it might alternatively be transitory, caused by asset price appreciation in a loose monetary environment. And even if it were sustained, it still left a material overhang in the OFI sector.

5 Another possible view was that it was important to look at both aggregate and sectoral money developments. Real broad money balances had been growing at a fast rate, pointing to strong real demand and inflationary pressures. Rapid growth in total OFI money balances could lead increases in wealth, as had been the case in the late 1980s when it was a clear symptom of inflationary conditions. Furthermore, there were identified ways in which OFI money growth could enter the transmission mechanism. It could feed through to asset prices or directly into spending if it was passed to the personal or company sectors and not used to repay bank loans. A variant of this was that, within OFIs, the focus should be on LAPF money growth, on the view that growth in OFI balances reflecting increased intermediation via repo markets should not be a concern.

6 Another interpretation was that the focus should not be on aggregate M4, but more on Divisia, as an indicator of transactions money, and on total financial wealth. This would be on the grounds that the non-transactions element of broad money could not be distinguished conceptually from other wealth holdings. This approach did, however, lead to much the same concern about the outlook for demand and inflation on account of higher than expected Divisia growth and the rapid growth of financial wealth.

7 It was agreed that the monetary data continued to create upside risks to the inflation outlook.

Demand and output

8 There was an extensive debate on capacity and labour market pressures. The key issues were (i) the rate at which pressures on productive capacity were building up; (ii) whether there was any slack left and in particular at what point pressures of demand relative to supply would feed into inflation; and (iii) how quickly demand pressures would abate given the policy tightening already implemented.

9 At 1%, GDP growth had been faster in Q3 than expected at the time of the August Inflation Report, and was well above trend. The labour market had continued to tighten on most measures; for example, claimant count unemployment (excluding Jobs Seekers Allowance effects) had been falling by around 25-30,000 per month, taking short term unemployment to levels not seen since the period of unsustainable growth in the late 1980s. There was clear agreement that, with growth in Q3 continuing well above any plausible estimate of trend, the degree of slack was lower than anticipated in August. But there could be no certainty about where output was in relation to trend.

10 There was some evidence that pressures on capacity might not be immediately threatening and might in fact be declining. The Q3 British Chamber of Commerce (BCC) survey suggested that the number of manufacturing firms operating at full capacity was, at 30%, around the long run average; and recruitment intentions, while still positive, had fallen since Q2. The number of service sector firms at full capacity remained above the long run average but had declined from the 1996 peak. It was suggested that pressures in the service sector were easing as extra capacity came on stream; the BCC survey balance of service sector firms investing in plant and machinery was higher than at any point since the survey began in 1989. Firms were also reporting increased levels of training.

11 But there was also opposing evidence. The BCC survey recorded a balance of nearly 70% of manufacturing firms experiencing recruitment difficulties, compared with a long run average balance of around 50%; and a balance of over 60% of service sector firms in that position, compared with a long run average of around 45%. In the October CBI Industrial Trends survey, which gave a more recent reading than the Q3 BCC survey, the balance of manufacturing firms not working below capacity had recently risen sharply, to above 50%. Skilled labour shortages were reported as increasing in the manufacturing sector. The Bank's regional Agents supported this picture for the economy more widely and were warning of increased wage pressures in 1998. But it was suggested that the absence of any recent increases in economy wide earnings growth might point to sectoral variations in labour market tightening; any premium having to be paid in especially tight sectors might be being offset by lower earnings growth in other sectors.

12 There was agreement that the important question was at which point the pressure of demand on supply would feed into higher inflation and inflation expectations. In an arithmetic sense, earnings

growth of around 4 1/4-4 1/2% could be regarded as either the maximum or the minimum consistent with the 2 1/2% inflation target given trend productivity growth of around 2% a year. It could be argued that, at the current juncture falling unemployment and rising employment should be viewed as a clear warning sign; earnings growth was much more likely to rise and feed into higher retail price increases. Alternatively the last step of this argument might not be axiomatic. Some US commentators were saying that even if wages accelerated, prices need not follow in line, but instead profit margins could fall for a time. That might also happen in the UK.

13 The assessment turned on whether there had been a material reduction in the natural rate of unemployment - the rate consistent with stable inflation. It was possible that the natural rate had fallen not only during the 1980s but also again, materially, during the 1990s on account of continuing labour market reforms, such as the introduction of the Job Seekers Allowance. On the other hand, it was possible that the natural rate had fallen but that unemployment was nevertheless now close to or at the natural rate. There was agreement that there was enormous uncertainty about the natural rate and also, as discussed at the October meeting, that there could be “speed limit” pressures on inflation as any remaining gap closed.

14 In summary, all agreed that output growth was still well above trend, that the labour market continued to tighten, and that, if any slack remained, it was being “used up” quickly.

Retail sales and retail margins

15 The Committee discussed what weight it should give to retail sales having fallen by 1.9% in September. This had widely been attributed to the funeral of Diana, Princess of Wales and also to unusually warm weather depressing sales of clothing and footwear. It had followed eight consecutive monthly rises, the longest such sequence since 1987, suggesting considerable underlying strength. The most recent consumer confidence surveys from MORI and GFK were both strong, and there was an expectation that spending of the windfalls from the summer’s building society and insurance company demutualisations would continue in Q4, especially around Christmas. The Committee agreed that the September retail sales figure was not, taken on its own, evidence of a slowdown.

16 The outlook for retail margins was highly uncertain. They had widened during Q3, reflecting the modest pass through of sterling's appreciation into retail prices. On one view, the rise in margins was not surprising and might not unwind, given the strength of current and prospective consumption. Cyclically, this was a time to rebuild margins. Moreover, if sterling's appreciation was causing valuation losses on overseas earnings, there was a strong incentive to protect overall profitability by not cutting domestic margins.

17 On another view, it would be surprising if retail profit margins fell back from current levels, given the lack of clear statistical evidence of any past cyclical component in their behaviour.

18 A third view would be that there were structural reasons to expect a fall. Competition in the retail sector remained intense. The main force behind the recent rise in retail margins had been weak input prices rather than increases in retail prices. As demand and output slowed and firms' growth forecasts were revised down, margins should fall.

19 It was agreed that the assumption in the Inflation Report forecast should be that it was most likely that part of the recent rise in retail margins would unwind, but with the balance of risks for the next year weighted towards their being stronger than in the central case.

Net trade

20 The Committee regarded the outlook for net trade as a very important area of uncertainty. So far the impact of sterling's appreciation had been much less than expected; for example, preliminary data suggested that, excluding oil and erratics, the three month on previous 3 month growth rate of export volumes had risen to 4 1/2% in August from 3.7% in July. The key issue was whether the lags were simply longer than had been thought or whether there would be less of an effect.

21 One possible explanation was the strength of external demand. OECD data suggested that in the first half of 1997 the UK's export markets for goods had grown strongly, which may have helped to sustain export volumes in spite of the appreciation. There had also been a striking growth in exports outside Europe. It was possible that UK exporters had responded by increasing their efforts

to penetrate new markets, against which sterling's appreciation had been smaller than against continental Europe.

22 A second contributory factor might be that exporters had initially cut margins in order to maintain market share, in which case they might eventually have to cut costs to rebuild profitability. There was some support for this from anecdotal evidence that managements were taking further measures to cut costs.

23 It was possible that the real exchange rate had appreciated because of supply side improvements, or quality enhancements. It was noted that a recent CBI study suggested that a large proportion of UK manufacturing firms fell short of "best practice" in terms of productivity, so that there was scope for such improvements. This was consistent with the assumption about the path of the exchange rate in the central projection of the November Inflation Report; some of the portfolio or erratic factors contributing to sterling's appreciation had unwound faster than assumed in August, and it was now assumed that the most likely course was that there would be no further unwind of these factors, leading to a slower rate of depreciation in the central case than in August. The possibility of a further unwind was instead reflected in a skewed balance of risks around the central projection.

24 A further possibility was that, against a history of relatively high exchange rate volatility, firms had originally thought the appreciation would be temporary, and had thus accepted what they regarded as temporary falls in export margins. If true, as the appreciation persisted, firms would increasingly regard sterling's higher level as permanent, and the volume effects on net trade would bite. However, it could be argued that, if this were so, surveys of expected export volumes should be showing a continuing deterioration, whereas the latest CIPS monthly survey had shown renewed growth and the CBI survey had shown a slightly less negative balance. Against this, the slightly less up to date quarterly BCC survey reported manufactured export sales at a five year low.

25 The Committee agreed that the picture on net trade was difficult to assess. Notwithstanding the limited impact so far, the most likely effect of a 20% appreciation over a year was that net exports would make a marked negative contribution to GDP growth next year, so that the impact was delayed. But as time passed without concrete evidence of this, the possibility of a smaller effect increased. To the extent that a reduced sensitivity of exports to worsening competitiveness reflected

supply-side improvements (such as higher productivity and efficiency), a smaller than expected effect from sterling's appreciation on exports need not signal increased inflationary pressure.

Developments in Asia and financial market volatility

26 In a discussion of the Asian situation, it was noted that circumstances had moved on since the summer when the IMF view had been relatively optimistic. More countries were now affected, creating a risk of weaker net exports to and profits from the region. However, Asia accounted for a small part of UK trade directly, and there had been an offsetting improvement in short run growth prospects in Continental Europe. The more important question, therefore, was the potential for knock-on effects in other regions, for example Latin America, or for the emergence of other financial fragility concerns.

27 The Committee thought that, as yet, there were no obviously new fragility issues. The fall in the UK equity markets was modest set against the rise over the past year, so there was little impact on wealth. Other European and North American markets had also so far fared better than emerging markets. The Committee concluded that the recent financial market volatility did not of itself require an easing of policy or inhibit a tightening of policy. But the situation should be monitored carefully, and policy would need to be reassessed if any future financial market developments were to threaten a sharp deterioration in the economic outlook.

Policy conclusions

28 The Committee discussed the implications of the inflation forecast prepared for the November Inflation Report. On the basis of unchanged interest rates at 7%, output growth was initially expected to decline, reflecting past policy tightening, the weakening of the windfall effect, and also a delayed effect on net trade from sterling's appreciation. It then rose again as the net trade effect on the twelve month growth rate passed. The range of uncertainty was large. At the two year horizon, the central projection for inflation was above the target of 2 1/2% and gently rising, with the risks clearly weighted towards the upside. The issue therefore was whether an interest rate increase was needed. A 25bp rise would take the central projection to more or less where it had been in August, around 2 1/2% two years hence, and move the mass of the probability distribution

downwards. The risks would remain skewed on the upside. The probability of inflation falling below the target in the short run would be lower than in August, reflecting a higher starting point for inflation.

29 The Committee discussed three possible interpretations of the evidence. One was that, tactical considerations aside, there was a case for not changing interest rates this month. There had been both good and bad news about the inflation outlook since the Committee's October meeting. There were signs that service sector growth had peaked; survey evidence suggested the net trade effect of sterling's appreciation would still come through; and monetary and fiscal policy had both already been tightened, with inevitably lagged effects, so patience was needed. While domestic demand remained strong, it was likely that output growth was now peaking and there were clear downside risks to output next year. Also robust growth would bring with it capacity increases and could raise activity and employment amongst groups of workers that had become detached from the labour force. This would contribute to offsetting inflationary pressures. On this view there was a case for waiting to see how the slowdown developed before increasing rates again.

30 A second placed greater emphasis on the continuing strength of demand notwithstanding the existing policy tightening and sterling's appreciation. The majority of evidence since the August Inflation Report pointed to continuing inflationary pressures. The risks of net trade not slowing, and so relieving pressure on capacity, increased as time passed with no concrete evidence that it was happening. The updated central projection on unchanged rates did not itself require an immediate increase but, given the upside balance of risks, it was important to act now to meet the target.

31 A third was that a 1/4% step was needed now, and indeed that some further increases might be necessary. Growth remained unsustainably strong and the labour market continued to tighten. Since the Committee's August decision to pause to observe accumulating evidence on the balance of risks, most of the data had been stronger than expected, and sterling had fallen back by more than was expected. Though a slowdown was already likely next year, this was too uncertain and risked being too late to prevent inflation and inflation expectations rising. The money numbers underlined this. It was argued that the balance of risks between raising and not raising rates was asymmetric. There was a high probability that, as well as growing at an above trend rate, the level of output was now higher than potential. A policy tightening would bring output back to its trend level more quickly, and if

necessary interest rates could be cut if new evidence emerged that the economy was weaker than expected. If, on the other hand, policy was not tightened, there was a risk that inflation expectations would rise as strong demand pressures persisted. The Committee might then find itself having to tighten sharply, increasing the risk of a recession, to bring things back on course. The predominance of upside risks to inflation therefore required an early move.

32 Turning to tactical considerations, the Committee noted that, although a rise would probably come as a surprise to some, any initial impact on financial markets might be reassessed once the Inflation Report was published. The Committee considered whether the recent disturbed conditions in financial markets should inhibit it from raising rates. It judged that conditions in the domestic UK markets were not sufficiently fragile for a delay to be necessary and a tightening was unlikely to have a significant effect on worldwide financial markets. There were attractions in moving before the publication of some of the data due out in the next month, given the possibility of a rebound in retail sales growth from the September dip and a likely strong RPIX outturn for October. The Committee might then find itself increasing rates in an environment where it was wrongly perceived as reacting to specific bad data.

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

34 The following members of the Committee were present:

Eddie George (Governor)

David Clementi (Deputy Governor)

Willem Buiters

Charles Goodhart

DeAnne Julius

Mervyn King

Ian Plenderleith

35 Sir Terence Burns was also present as the Treasury's representative.

ANNEX: SUMMARY OF DATA PRESENTED TO THE MONETARY POLICY COMMITTEE BY BANK STAFF

A1 This annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 31 October 1997, in advance of its meeting. 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 Monetary conditions

A2 The growth of notes and coin was still being affected by the introduction of the new 50p coin. The new coins had been introduced, but the banks had not yet been able to surrender all of the old ones. This effect added 0.1pp on October's monthly growth rate in notes and coin of 0.8% and 0.5pp to the 12-month growth rate of 6.5%.

A3 The 1-month and 12-month growth rates of M4 increased by 0.2pp in September to 1.0% and 11.8% respectively. Retail M4 growth had been modest, reflecting a small increase in bank deposits. But there was continued strong growth in building society deposits - probably in expectation of future de-mutualisations; the three-month annualised rate of growth in building society deposits had reached 20.8% in September. These substantial increases in deposits had enabled building societies to reduce their deposit account rates relative to rates paid by banks. By contrast, the demutualised former societies had in recent months raised their rates relative to other banks, perhaps in order to keep their deposit-customers or attract new ones. Wholesale M4 continued to grow strongly in September, increasing by 2.1% on the previous month and 21.9% on a year earlier. Overall real broad money balances grew by just under 9% in the year to September.

A4 Sectoral money numbers for Q3 were now available. Four-quarter growth of personal sector money holdings had slowed slightly from 7.8% to 7.5%, but ICCs' deposits had grown by 11.2%, up from 7.7% in 1997 Q2. The reduced flow into personal sector M4 and the increased flow into ICCs' deposits were roughly equal. OFIs' deposits were 25.7% higher than a year earlier. Within OFIs, figures for Q2 (the latest available) suggested that deposits from life assurance and pension funds (LAPFs) had again grown strongly. According to Bank research, the LAPFs continued to hold excess money balances. ICCs' money holdings were also estimated to be above long run

equilibrium. Estimates of aggregate trend velocity suggested that the actual level was slightly below long run equilibrium confirming the sectoral picture of a liquidity overhang.

A5 Divisia growth had been over 10%. Sectoral Divisia numbers showed similar trends to the sectoral M4 numbers.

A6 On the other side of banks' balance sheets, the monthly numbers again suggested that M4 lending growth might be slowing. However, as with deposits, there was a sharp divergence between building societies and banks, with the former lending at a much faster rate. This could also have been caused by expectations of future windfalls; or alternatively lower deposit rates feeding through to lower mortgage rates, attracting custom to building societies.

A7 There had been a slight fall in the growth of lending to persons in Q3. This was due to slower growth in unsecured lending, possibly as a result of repayments financed out of windfalls in July. Within mortgage lending there had been a shift of new business towards fixed rate business as medium term maturity yields had fallen.

A8 The slowdown in aggregate M4 lending between Q2 and Q3 was driven by lower corporate borrowing. Company borrowing from capital markets had also weakened slightly, suggesting their demand for external funds had fallen.

A9 Lending to OFIs had continued to grow at a rapid rate of 20% in the year to Q3. Borrowing by financial leasing companies seemed likely to have remained a relatively significant factor.

A10 A slowdown in M4 lending would typically lead to slower growth of M4 deposits. But examination of M4 counterparts showed strong bank lending overseas (not part of M4 lending), which could provide a continuing impetus to M4 deposits in the future if it continued and if, when the money flowed back to the UK, the non-bank private sector chose to hold it in M4 assets.

A11 Turning to the price element of monetary conditions, estimates of short term real rates, derived from index-linked gilts, had risen over the last month and were now again above longer maturity real rates derived from the same source. Inflation expectations, calculated by comparing conventional and index-linked gilts yield curves and making no allowance for risk premia, suggested the market expected inflation to be above 2.5% throughout the next 20 years; but the gap from the

inflation target was around 1% or below, within estimates of the inflation risk premium.

A12 The sterling effective exchange rate index had initially depreciated rather more quickly than the August Inflation Report forecast had anticipated. But since the MPC's October meeting, sterling had increased by 2.1% (on an effective basis) and was now broadly in line with the August forecast.

A13 The UIP decomposition of exchange rate movements suggested that around 1.50pp of the depreciation since August could be explained by changes in the market expectations of future monetary policy in the UK and overseas. In particular financial markets now anticipated tighter monetary policy in the main continental European economies.

II Demand and Output

A14 October saw the first release of GDP output for Q3, but there were no new national accounts expenditure numbers published. Consumers' confidence remained high according to both GFK and MORI, even though the latter measure had fallen back slightly from record highs earlier in the year. Retail sales volumes fell by 1.9% in September. But it was a volatile series; and unusually volumes had grown continuously for eight months in a row. On past behaviour, a fall at some point would have been expected despite any underlying strength. There was likely to have been a big negative effect on sales associated with the funeral of Diana, Princess of Wales. A further factor was the unusually warm weather in September which had depressed sales of autumn clothing and footwear.

A15 The 12-month rate of house price inflation on the Nationwide and Halifax measures both fell in October, but the divergence between the two series continued to widen. In Q2 the differences had mainly been accounted for by sections of the Midlands and the North, the numbers in Q3 had been consistently dissimilar across the whole country. Nevertheless, on both series house price inflation was still fastest in Greater London.

A16 The PSBR undershoot of the Budget forecast continued to grow. The undershoot was expected largely to unwind before the end of the financial year, although lower unemployment would create an end-year shortfall on social security expenditure. October would be an important month, as it was one of four months during the year in which ACT was paid.

A17 Net trade continued to be robust. Export volume growth was stronger than expected, although there may have been some early signs of weakness from September's non-EU data.

A18 The ONS's preliminary estimate of GDP for 1997 Q3 showed a 1.0% increase on the previous quarter. This was a little lower than the Bank's expectation. Nevertheless 1.0% was still strong. Within the total, manufacturing output had grown by 0.6% compared to an average of 0.4% since the beginning of the recovery. The latest monthly survey from the Chartered Institute of Purchasing and Supply (CIPS) had shown a pick up in manufacturing output and export orders. But recent quarterly survey results from the CBI and British Chambers of Commerce had shown a less robust picture. Industrial production growth overall in the UK was lower than in other European countries and was not as strong as it might be given the UK's GDP growth rate - perhaps evidence of an appreciation effect.

A19 However, there were many factors supporting manufacturing exports and output in the face of the appreciation. World trade growth was strong. And the UK was managing to maintain its share of world trade partly by diverting exports to markets where the effect of the appreciation had been less severe. Even in Europe where economies were enjoying export-led growth, UK exporters appeared to have been able to sell capital and intermediate goods. Manufacturing productivity in the UK had begun to rise as firms had reacted to the appreciation by cutting costs.

A20 Despite the overall resilience of manufacturing, some sectors had experienced problems. Clothing and footwear output had fallen, with strong retail demand being met by imports.

A21 The quarterly growth rate of services appeared to be weakening slightly, having peaked in 1996 Q4. Slower service sector exports could be a cause.

A22 More general indicators of the service sector's position were presented to the Committee. Service sector inflation had picked up in early 1996 from 2% to over 3%, despite regulatory restraint on utilities' prices. But it appeared that service sector inflation might have peaked as more capacity had come on stream, following strong past investment. Activity had been strong throughout the private service sector, but especially so in transport, finance and communications.

A23 The Bank's regional agencies had conducted a survey of 132 of their contacts to examine developments in the service sector. On balance, respondents had said that growth had been higher in Q3 than in the first half of the year. Further, more expected growth to increase in the fourth quarter and 1998 Q1 than expected it to fall, although financial services and hotels expected some moderation. One consequence of strong output growth was that labour supply problems were affecting a third of the contacts surveyed, in terms of both quality and quantity of potential recruits.

A24 The potential effects on the real economy of events in Asia were considered. Asian countries account for just over 8 1/2% of UK exports, but close to 20% of US exports. Thus part of the risk to the UK may come via the US and other industrial countries. Asia is also the source of 10% of UK imports, where the initial effect will be downward price pressure on import-competing firms and lower input costs for import-using firms. The OECD had undertaken some simulations on the effects of developments in Asia on the world economy. These indicated lower GDP growth of 0.1pp this year and 0.2pp next year in the EU together with 0.2pp lower inflation in 1998. These simulations had been undertaken at the end of September before the most recent stock market turbulence and therefore might be considered a lower bound to the likely effects.

III Labour Market

A25 The results of the ONS Labour Force Survey for summer 1997 had been published in October. These showed an 86,000 rise in employment during the summer months (0.3%) and a 440,000 increase on a year earlier (1.7%), which was broadly in line with the ONS's Workforce in Employment numbers - available last month. The rise in employees in employment was even stronger, as the numbers of self employed fell. Unlike the earlier stages of the recovery, most net new jobs were now full time. A wider measure of labour demand was hours worked, and this had grown more quickly than the head count during the summer, by 0.6%. But over the year it had grown by 1.7%, the same rate as employment.

A26 Looking ahead, the Q3 British Chambers of Commerce (BCC) Survey showed a further rise in employment intentions for the service sector, from an already buoyant level. The picture for manufacturing was more mixed. The BCC survey showed employers still expecting to recruit more staff on balance, but at a lower rate - a view supported by the Bank's Agents; while the CBI survey showed employers expecting a fall in employment during the final quarter of 1997. Indeed, ONS

data for manufacturing employees in employment had already shown a decline in July and August of 12,000 a month, although the series was volatile.

A27 There had been a marked increase in skill shortages, according to the October CBI Industrial Trends Survey for manufacturing, although it was still well below its late 1980s peak. The Bank's Agents had also noted this trend and that it was leading to substantial pay rises for particular groups of workers, such as IT, bricklayers and HGV drivers.

A28 The claimant count unemployment numbers had fallen by 28,000 in September, so that the unemployment rate stood at 5.2%. There had also been a further rise in notified vacancies at job centres of almost 9,000 to a reported level of just over 300,000. But this stock level was probably overstated, perhaps by some 40,000.

A29 The LFS measure of unemployment had fallen from 7.2% to 7.1% over the summer. There had been different movements in short-term and long-term unemployment as measured by the LFS. Short-term unemployment had risen slightly and was no longer below the trough of the late 1980s.

A30 The fall in total LFS unemployment between the spring and the summer was 40,000, much less than the claimant count drop of some 115,000 over the same period. Moreover there was now a record gap between the two measures of just over 500,000. The LFS measure, the Bank's preferred one, recorded people who were actively searching for work. It thus differed from the claimant count because non-claimants, who were ineligible for benefit, searched for work and because some claimants were not actively seeking employment. Three months ago the Bank had expected the number of claimant searchers to fall by 75,000-90,000 over the summer (an average of 25,000-30,000 each month). The Bank had also expected the number of claimant non-searchers to be little changed, as it was thought that the deterrent effect of the Job Seekers Allowance (JSA) should have come to end. The number of searching non-claimants had been expected to remain the same, or perhaps increase slightly in line with the trend of the previous year (an encouraged worker effect).

A31 In the event, Bank estimates suggested that the number of claimant searchers fell broadly in line with expectations. But the number of claimants not searching continued to fall. This possibly reflected further deterrent effects of the JSA, as students may have been discouraged from signing on for benefit during the vacation - an effect on the claimant count which could unwind in the autumn when fewer students than normal leave the register. Also the number of non-claimant

searchers rose more strongly, as more women entered the job market, but were unable to find jobs immediately.

A32 Over the autumn, a further fall in claimant searchers of 75,000-90,000 is expected. The student effect may lead to a slight rise in the claimants who are not searching, but equally there may be some further JSA effects pushing this number down as checks on continued eligibility for the allowance are carried out after six, twelve and twenty-four months. It was also possible that there may be a further small rise in searching non-claimants as more people are encouraged back into the labour market.

A33 This raised the question as to whether the possibility of more people joining the labour market increased the level of potential labour market slack. Inactivity rates (ie those who were neither employed nor looking for work as a percentage of the population of working age) were still well above the trough in the late 1980s. However, since the 1980s there had been significant increases in the numbers of students and long-term sick and disabled. These were two categories that were relatively unlikely to be drawn back into the labour force by strong demand. The inactivity rate excluding these two groups was below its previous trough in the late 1980s.

A34 There was little news on earnings this month. There had been no change in the headline underlying earnings growth in August, which remained at 4 1/2 per cent. Although the actual growth rate of earnings had increased from 4.3 per cent to 4.6 per cent, this had been due to arrears, the timing of settlements and back-pay. After smoothing bonus payments over the whole year, the trend in average earnings growth remained at just below 4 1/2 per cent in the whole economy.

A35 There had been few wage settlements in September; the autumn was a very fallow period on this front - only 8% of employees covered by the Bank's settlements database had settled between September and December 1996. January was the next key month. The Committee was warned that the Bank's Agents expected increased wage pressure in 1998. This was partly due to the tightness in the labour market; another factor was that the first stage of the phasing out of profit related pay would probably put upward pressure on basic settlements.

IV Prices

A36 There was no sign of upward pressure on non-oil commodity prices currently: the Bank index had fallen in September, according to latest estimates, although it might be revised upwards modestly when hard data on food prices have been incorporated. Oil prices had risen in October, to around \$20 per barrel. They were expected to stabilise at or just below this level into next year as supply kept pace with demand.

A37 Input prices rose in the two months to September, but they were still 7.8% lower than a year earlier. Moreover, the most recent CIPS survey had suggested that there was still a downward impetus.

A38 Output prices were showing some signs of an upturn, however. Producer prices (excluding duties) had risen by 0.2% in September; and there had been no monthly fall since March. The CBI Survey balance had increased slightly and the Bank's Agents reported expectations of higher price rises in 1998 than this year. Also margins on domestic sales seemed to have risen.

A39 Export prices appeared to have bottomed out although margins did appear to have fallen further. Import prices had also risen in August. RPIX inflation had been 2.7% in September, compared with 2.8% in August.

A40 The wedge between RPIX goods and RPIX service inflation had narrowed, but this was largely due to tax effects: higher taxes on petrol and reduced VAT on domestic energy bills. Rent and utility prices had been affected by special factors; excluding these components would have given underlying service sector inflation of around 4 1/2%. Goods price inflation had continued to moderate, but by less than expected given sterling's appreciation.

A41 A gap had opened up between the UK and the main EU economies on local measures of consumer price inflation, with the former above the latter. But the UK was close to the EU average on a harmonised basis. Lower "harmonised" inflation in the UK was largely due to the exclusion of housing from the index and its construction as a geometric rather than an arithmetic mean.

A42 The effect of the appreciation on RPIX inflation had been less than might have been expected. Some sectors had felt the effect of the exchange rate more than others: the appreciation had held

down prices of leisure goods and to some extent household goods, but there was no sign of any effect on clothing and footwear prices. Retailers' margins appeared to have been significantly boosted by the appreciation: it had reversed much of the narrowing which margins had experienced from 1992 to 1995.

V Financial Markets

A43 It had been a turbulent month in the financial markets. The main developments had been in the equity markets, and they had had an important influence on the foreign exchanges. There had been an increase in volatility for the major currencies rather than any major shifts in the levels over the month as a whole. The dollar was little changed in October; the Deutsche Mark strengthened at the beginning of the month following the unexpected size of the rise in the Bundesbank repo rate, but ended the month slightly down. The Yen strengthened temporarily in mid-October on rumours of a package to stimulate the economy. Sterling moved within a narrow channel in the first half of the month, until news that the UK would not join EMU in 1999 pushed the pound up. Sterling had appreciated by 2.0% since the October MPC, but had depreciated by 2.6% since the August Inflation Report was finalised. However, the depreciation was small compared to the appreciation which had preceded it. (Details of changes in the value of sterling between MPC meetings are given in the table below.) There were increasing signs of convergence among the ERM currencies and expected future short-term interest rates, reflecting confidence that EMU would go ahead.

Sterling Exchange Rates

| | 8 October 1997 | 5 November 1997 |
|-------|----------------|-----------------|
| £ ERI | 100.39 | 102.41 |
| £/\$ | 1.62 | 1.68 |
| £/DM | 2.85 | 2.89 |

A44 As a general rule the correlations of the £/DM and \$/DM rates was fairly strong. But there had been a break in this relationship during October: sterling had not depreciated against the Deutsche Mark at a time when the dollar had. It seemed possible that expectations of a rate rise in the USA before the year end had ebbed, more so than in the UK.

A45 Even so, in domestic financial markets, short-term interest rate expectations had fallen slightly between 8 and 28 October at maturities out as far as September 1998. But there had been an increase in expected rates for the period from next September outwards.

A46 Longer-term UK real yields had declined since mid-September in contrast to the US, where they had remained flat. This could have been due to several factors. Pension and investment fund managers had moved into the UK market; in the case of pension funds, because of new regulations causing them to favour holding more UK index-linked gilts. Low PSBR numbers may have caused the market to expect a reduced supply of index-linked gilts. The flight from volatile equities had been a modest support to index linked gilts as well as conventionals in late October. This was in contrast to the US where the “flight to quality” had been predominantly towards non-index-linked government stock. There may also have been a fall in UK inflation expectations.

A47 There was some talk in the market of the possibility of an interest rate rise this month but no general expectation, in contrast with a month ago when a rise in November had been expected. But the expectation of a possible rate rise in December remained. The market’s assessment that a rise was not likely in November seemed to rest on labour market data which were more modest than expected; the unanimity of the September MPC decision for no change; stronger sterling after EMU reversals; possible concern for systemic stability after the equity market volatility; and the need to see data on retail sales which were unaffected by the death of Princess Diana. Some market participants had commented on the positive gap between RPI and RPIX, which they thought might make further interest rate rises counter-productive by fuelling higher wage demands. Those who expected an increase in the near term pointed to strong economic data; and the suggestion of a possible lower inflation target in the Chancellor’s recent EMU speech.

A48 Equity markets had fallen worldwide. The biggest falls had been in the perceived riskier developing markets like Brazil and in those markets that had risen most rapidly, eg Germany. There was little clear correlation between movements in G7 stock market indices and trade exposure to Asia.

A49 One reason for the fall in UK and US equity prices recently may have been an increase in the equity risk premium. Equity prices reflect discounted future earnings. The rate at which expected profits are discounted includes a risk premium, because equities are riskier than other assets such as government bonds. A rise in the risk premium would cause a rise in the rate of discount and hence a

fall in equity prices. Staff research suggested that risk premia in the UK and US were not unusually low prior to the downturn. Price-earnings ratios had also been high by historic standards before the equity price falls.

A50 Inspection of implied volatilities derived from options prices suggested that the market uncertainty about future equity prices was most evident in the short term; it declined over the next twelve months. Nevertheless, there appeared to be a much more pronounced negative skew in the implied probability distributions than there had been before the recent turbulence, suggesting that the markets believed a large fall over the coming months was more likely.