

Publication date: 12 November 1997

MINUTES OF MONETARY POLICY COMMITTEE MEETING

8 and 9 October 1997

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 October 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 5 and 6 November will be published on 10 December.



**MINUTES OF THE MONETARY POLICY COMMITTEE
MEETING ON 8-9 OCTOBER 1997**

1 The meeting was preceded by a presentation by Bank staff of the most recent data on monetary and economic conditions. The presentation is summarised in the Annex to these minutes; it has been updated to incorporate data that subsequently became available before the Monetary Policy Committee meeting.

2 The Committee began by discussing the issues raised by recent economic developments - demand and output (and in particular, the effect of the exchange rate appreciation on net exports and output) the labour market, prices, monetary growth and financial market developments.

Demand and output

3 The Committee reviewed recent developments in demand and output. The appreciation of the exchange rate had had much less effect on the reported data on external trade in goods up to August (non-EU) and July (EU), and in services (up to Q2) than had been expected. Business surveys and reports from the Bank's Agencies had suggested that there would be a large effect (and most were continuing to do so), but some surveys, eg the September CIPS survey, were now suggesting that the export outlook had become less gloomy. Meanwhile, the indications available to date were that output growth in Q3 had been considerably stronger than the central projection in the August *Inflation Report*.

4 There was relatively little news on domestic demand. Consumer spending had been growing fairly fast. It was not accelerating, but the CBI distributive trades survey - which might have been depressed as a consequence of public reaction to the death of Diana, Princess of Wales - had shown greater optimism among retailers. Though the GFK index of consumer confidence had been rising steadily, the MORI index had fallen back sharply, partly reversing a large rise that had probably been the result of demutualisation windfalls. In the housing market, the divergence between the Nationwide and Halifax price indices had widened further, but the other indicators of housing demand did not suggest rapidly growing demand, and therefore seemed more easily reconciled with the Halifax view of more moderate growth. There was no evidence that domestic demand had been

substantially stronger than expected in Q3, so it seemed likely that the unexpected strength of output reflected net exports.

5 The Committee discussed the significance of stronger than expected output, and four points were made. First, the manufacturing output figures combined with the newly released Workforce In Employment survey implied, if taken at face value, that manufacturing productivity had been static in the last two years, during which the economy had been in a cyclical upswing. Some members thought that the manufacturing output figures would be revised upwards. To the extent that higher output reflected higher productivity and higher capacity output this would not necessarily imply that there was more pressure on productive capacity than currently thought.

6 Second, the depreciation of the exchange rate since its peak in late July would have relieved part of the pressure on exporters' margins. Moreover, it might have encouraged exporters to believe that the earlier appreciation was partly transitory, and thus to persist in selling at unattractive margins to maintain their presence in overseas markets. The Committee considered whether recent reports that the United Kingdom was more likely to join EMU would have encouraged exporters further, by reducing uncertainty about future exchange rates.

7 Third, it was possible that the effects of sterling appreciation on net exports had simply been delayed. It was notoriously difficult to predict the timing of peaks in economic growth rates, and the peak might come a little later than had been projected in the August *Inflation Report*. There were signs in business surveys that growth might now be slowing and important questions for policy were whether the labour market was at the point at which earnings would begin to accelerate and whether the policy tightening that had taken place already would be enough to bring GDP growth back towards trend. If the peak in growth were to be later than in the *Inflation Report* projection, but the profile of growth after the peak were to be the same as in the projection, the level of output after the peak would be higher than in the projection by a constant amount. Inflation would be higher than in the projection, unless potential output was also higher than assumed.

8 Fourth, it was possible that there had been a supply-side improvement in the non-price competitiveness of internationally tradeable goods and services produced in the United Kingdom, or that the relevant price elasticities were smaller than had been thought, so that the long-run effect of the appreciation on net exports would be smaller than had been projected.

9 Taken as a whole, the evidence suggested that net exports could remain stronger than had been projected in August, and the net effect of this on total demand and hence on domestic costs would need to be carefully watched.

Labour market

10 The tightening of the labour market had continued, and the fall in claimant unemployment of 49,000 in August had been higher than the staff estimate of the trend fall of 25,000-30,000 a month. According to the most recent Labour Force Survey, short-term unemployment was at its lowest since the early 1980s. The inactivity rate, however, was not unusually low: the counterpart of rising employment during this recovery had been falling unemployment rather than a falling inactivity rate, and total employment was still well below its late-1980s levels. The higher inactivity rate, and its persistence, might be a one-off consequence of the expansion of tertiary education. Indications of skill shortages were becoming more widespread. More information on the extent of labour market tightening would be provided in the quarterly Labour Force Survey, which would be available before the Committee's next meeting.

11 Notwithstanding the tightening of the labour market, earnings growth had remained lower than projected in the August *Inflation Report*. The staff analysis had showed that the reported increase in underlying average earnings growth in July had been the result of bonus payments. Spreading these payments over the full year put underlying average earnings growth in the range 4 ¼ - 4 ½%; these calculations did not show any acceleration in earnings during the last few months.

12 Members discussed the recent three-year pay settlement in the construction industry. It appeared that the first-year award included the consolidation of a number of special payments and in aggregate terms was equivalent to around 3 ½%. But the larger increases in later years appeared to reflect both shortages of skilled labour and an expectation of rising inflation.

13 Members discussed the current combination of rapid tightening and surprisingly low earnings growth, and made a number of points. First, the level of the natural rate of unemployment was uncertain, but it was plausible that it was lower than in the 1980s, because of the structural changes that had taken place since then. Second, even if the natural rate of unemployment were below the current level, there might be a 'speed limit effect' - ie the faster unemployment fell towards the natural rate, the higher the rate of inflation. Third, some of the payments that were recorded as bonuses represented profit-sharing payments to staff, which would automatically decrease if profits fell. Such payments were akin in some respects to equity returns.

Prices

14 The Committee discussed recent price data. RPIX inflation was stronger than had been projected in the August *Inflation Report*, and the staff analysis suggested that import prices had

fallen by less than was expected given the rise in the exchange rate, and that retail prices had risen by more than was expected. In other words, the pass-through from exchange rate appreciation had been unexpectedly weak.

15 The Committee emphasised that policy decisions had to be based on forecast inflation, rather than on current inflation, because of the lag between an interest rate change and its effect on output and prices. The unexpectedly small fall in RPIX inflation during the last few months had been accompanied by a widening of retailers' margins, which members thought reflected the strength of domestic demand. Members discussed whether the depreciation of sterling since August would have an upward effect on the domestic price level, but concluded that since the pass-through from the earlier much larger appreciation seemed to be incomplete, there was a good chance that the recent depreciation would have little effect.

16 The dip in the twelve-month rate of inflation that had been expected in the *August Inflation Report* now seemed likely to be shallower, so that RPIX inflation might prove to be below 2 ½% for a shorter period than expected. Members noted that recent experience had been of above-trend growth accompanied by flat or declining inflation, but it was suggested that had it not been for the appreciation of sterling, the inflation profile would have been considerably less reassuring.

Monetary growth

17 There was little new information. The Committee noted that, on the latest month's data, monetary growth, both narrow and broad, and M4 lending now seemed a little slower. It was acknowledged that the policy implications of recent monetary growth depended on the comparison with the earlier expectation of a gradual deceleration in the monetary aggregates as demand slowed.

Financial market developments

18 The Committee discussed the impact of the perceived increased likelihood of the United Kingdom joining EMU on the yield curve. Implied future short-term interest rates were slightly higher at the March 1998 maturity but much lower at 1999 and 2000 maturities.

19 The Committee noted that *ex ante* real interest rates at the two-year maturity appeared to have fallen sharply in the last month. Moreover, equity prices had risen and bond yields had fallen, and the exchange rate had depreciated after the *Financial Times* story suggesting that the United Kingdom was likely to join EMU had appeared on 26 September. While acknowledging that markets were currently more than usually volatile, the Committee felt that the changes that had taken place during the month were likely to have a positive effect on aggregate demand.

Summary and policy conclusion

20 Though the monetary data now looked a little more encouraging than in previous months and earnings growth had not accelerated, a number of the developments that the Committee had surveyed pointed to somewhat faster output growth than had been expected. It remained probable that economic growth was about to slow down, although one or two quarters later than expected.

21 Members discussed how recent developments affected the inflation outlook. Output and demand were stronger in Q3 than had been expected, and it was possible that net exports would remain stronger than projected. Taken together with the effects of changes in asset prices and the exchange rate, this suggested that the level of output might be higher than expected in relation to the productive capacity of the economy, so that inflation might be higher than the August projection. The absence of much reduction in RPIX inflation in the past few months suggested that the expected dip in the twelve-month rate of inflation might be shallower than previously thought, and that when inflation began to increase it would do so from a higher starting rate.

22 Members discussed how policy should react to this situation, bearing in mind the statement in the *August Inflation Report* that ‘... the Monetary Policy Committee concluded that monetary policy has now reached a position at which it should be possible to pause in order to assess the direction in which the risks are likely to materialise’.

23 Members considered whether a rise in interest rates was needed in order to meet the inflation target. The prospects for weaker net trade - supported by survey evidence of lower exports in the near term - suggested that output growth was likely to fall. Two possible interpretations of this outlook were discussed. The first was that the impact on domestic demand of the monetary and fiscal tightening earlier this year would be sufficient to slow down the economy, and so the need for a further rise in interest rates was not yet clear. One argument in support of that proposition was the failure of earnings growth, adjusting for the timing of bonuses, to rise this year. The second interpretation was that the early indications of strong growth in the third quarter meant that the slowdown had at least been deferred, and so the risks to the inflation outlook were clearly on the upside. On that interpretation, there would need to be a further significant rise in interest rates in order to meet the inflation target. The Committee agreed that it did not, as yet, have sufficient information to feel confident in choosing between these two interpretations.

24 The Committee considered whether, if a rise in interest rates were needed, it would be better to implement it immediately, or to make no change this month but with the expectation of an increase in November. The arguments for an immediate move were that any delay would carry the risk that

the eventual increase might need to be larger than would otherwise have been the case. Moreover, if there was an inhibition about moving other than in steps of $\frac{1}{4}\%$, and the necessary increase was more than $\frac{1}{4}\%$, then it would be better to start the process of increasing rates immediately. The arguments for waiting a month before raising interest rates were as follows. First, in practice it was unlikely that a delay of a month would make a significant difference to the economic impact of a rise in interest rates, should a rise prove necessary. Second, there was no reason why interest rates should not move in steps of more than $\frac{1}{4}\%$, or indeed less, if circumstances warranted it. Third, a large amount of quarterly information would become available before the next meeting - the CBI quarterly survey, the preliminary estimate of GDP in Q3, the Labour Force Survey, the money figures for Q3, including sectoral money holdings and estimates of Divisia money. Moreover, work on the November *Inflation Report*, which would take place before the next meeting, would enable the Committee to make a new inflation forecast. Members preferred to wait another month to see how the evidence on the balance of risks accumulated.

25 In the light of the discussion, the Committee voted unanimously to leave interest rates unchanged this month.

26 The following members of the Committee were present:

Eddie George (Governor)

David Clementi (Deputy Governor)

Willem Buiter

Charles Goodhart

DeAnne Julius

Mervyn King

Ian Plenderleith

27 The Treasury representative, Sir Alan Budd, was also present.

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 3 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 the Annex.

I Monetary conditions

A2 Notes and coin had decelerated during the summer and their twelve-month growth rate had fallen from 6.1% in June to 5.1% in August. There had been bounce-back in September, when notes and coin had risen by 1.0% and the twelve-month growth rate had gone back up to 5.9%. It seemed likely, however, that the September outturn had been affected by the introduction of the new 50p coin on 1 September. The amount issued during the month was equivalent to 0.4% of notes and coin. The banks were not yet able to surrender all of their old 50p coins, but would be able to do so during the remainder of this financial year. It therefore seemed likely that the introduction of the new coin had inflated both the month-to-month and the twelve-month growth rate of notes and coin by about 0.4% in September, and that the effect on the level of notes and coin would unwind by the end of the financial year, though the statistical effect on the twelve-month growth rate would last longer. Abstracting from the 50p coin effect, it was not clear whether the deceleration in notes and coin during recent months reflected the re-establishment of a rising trend in velocity, or whether it indicated a slowing-down in demand.

A3 The estimated increase in M4 in July had been revised downwards from 1.0% to 0.9%, and the estimated August increase was 0.8%. In August, the annualised three and six-month growth rates (10.4% and 11.0% respectively) were lower than the twelve-month rate (11.6%). Real M4 (ie M4 deflated by RPIX) grew by around 8½% in the twelve months to August, but its annualised growth rate in the latest three months was around 6½%. Since the trough of the recession in 1992 Q1, M4 had risen by 44%; two thirds of this increase had occurred since 1995 Q1. It was not easy to explain the fall in the velocity of M4 since 1995 Q1 by reference to structural changes of the kind that had led to falling velocity throughout the 1980s.

A4 Retail M4 went up by 0.4% in August, and its twelve-month growth rate fell to 7.0%. There were strong indications of speculative flows into the remaining building societies: in July and August retail flows into societies had been unusually large, while there had been only a very small rise in retail bank deposits, even though the rates offered by building societies were generally materially lower than deposit rates offered by banks.

A5 Wholesale M4 had risen by 1.4% in August. There had been a strong public sector contribution, including a gilt redemption, but no gilt auction.

A6 The signs of a slowdown since the spring were clearer in M4 lending than in M4. The annualised three, six and twelve-month growth rates were 6.5%, 8.0% and 8.7% respectively. In August, steady growth in net secured lending to individuals continued (up 6.4% on a year earlier). Net unsecured lending to individuals by banks and building societies had been unusually low in July, probably because people had made extra repayments out of windfalls from demutualisations, but it had rebounded in August and its twelve-month growth rate was 17.6%. Its continued growth might reflect the narrowing of interest rate spreads since the end of 1995.

A7 The preliminary estimate of lending to OFIs was unusually low in August (only £0.2 billion); the slowdown was entirely accounted for by a fall in reverse repos included in M4 lending. But lending to leasing companies (which represented about one third of the stock of bank lending to OFIs) had grown. Though it appeared to have picked up somewhat in August, lending to ICCs had slowed down over a longer period. Its twelve-month growth rate had fallen from 13.1% at the end of 1996 to 7.2% at the end of 1997 Q2.

A8 Estimates of *ex ante* real interest rates at the two-year maturity can be derived either from the short end of the index-linked zero-coupon gilt yield curve or from the nominal yield curve and a survey-based estimate of inflationary expectations. Both techniques indicated a rise in *ex ante* real interest rates between early June and early September: the indexed yield curve showed a rise from 3.7% to 4.2% and the survey-based method from 4.1% to 4.4%. At the same time, the ten-year forward real yield (ie the short-term real yield implicit in the yield curve for a date ten years in the future), which might give some indication of equilibrium, had fallen from 3.7% to 3.5%. In other words, monetary conditions on this measure had become tighter. Between early September and 1 October, however, index-linked yields in the United Kingdom had fallen sharply, and the estimated two-year zero coupon real yield had fallen from 4.2% to 3.3%, while the ten-year forward real yield had fallen more modestly, from 3.5% to 3.3%. These latest moves in both short and long-term real interest rates seemed likely to have a positive effect on aggregate demand.

II Demand and output

A9 The full national accounts for Q2 incorporated a downward revision of estimated GDP growth in Q1 from 0.9% to 0.8%, compensated by an upward revision of estimated growth in Q2 from 0.9% to 1.0%. The estimated fall in net exports in Q2 was revised from 0.4% to 0.5% of GDP, and estimated growth in investment was revised upwards from 0.1% to 2.0%. The estimated increase in consumption of 1.5% was unchanged.

A10 The estimated savings ratio increased to 11.7% in Q2. This might partly have reflected unusually large corporate dividend payments ahead of the Budget.

A11 Retail sales volumes increased by a further 0.4% in August, when they were up by 5-6% on a year earlier. The picture of accelerating retail sales in the ONS data was not consistent with the survey data from the CBI and the BRC, which was more subdued. The survey data fitted more closely with the ONS retail sales values data, which had accelerated by less than the volume data as goods price inflation had slowed. Moreover, the surveys were mainly of large retailers, which had been gaining market share particularly fast in 1995/96. This had affected the relationship between the surveys and the comprehensive ONS data. Large retailers were now gaining share at a somewhat slower rate than in 1995/96; this could help explain the apparent relative strength of the ONS data. The BRC survey showed 'like-for-like' percentage increases in sales, but these figures did not allow for the effect of increasing floorspace, and typically showed lower growth in retail sales values than the ONS data.

A12 How much of recent spending had been windfall-related? The ONS, using a simple technique based on comparison of outturns with an extrapolated trend, estimated that windfall-related spending on household and other goods had been around £500 million between May and August. On this basis, retail sales volumes excluding windfall effects had been growing at around 5% during the last year, but were not accelerating rapidly.

A13 Spending on consumer durables had been unusually strong in Q2 - up by 6.8% on the quarter. Although spending on durables was normally volatile, the Q2 increase was consistent with other evidence of spending of windfalls from demutualisations. Car registrations in August were the highest for 16 years, and there was no solid evidence that pre-registrations had been higher than in August 1996; registrations in September had been the highest since 1989.

A14 The divergence between the Nationwide and Halifax estimates of house price inflation had widened further: their estimates for the year to September were 12.9% and 6.9% respectively. Housing market turnover, as measured by particulars delivered, fell in August, but there had been an increase in housing starts.

A15 Manufacturing investment had grown strongly in Q2, and the ONS data were now more consistent with indications from business surveys. Investment in service industries as recorded in the national accounts had fallen: the ONS had adjusted the results of the capital expenditure survey (which had shown a large increase) in order to achieve consistency with other parts of the national accounts. The adjustments in Q1 and Q2 had been large and in opposite directions. Surveys continued to indicate quite strong investment intentions in service industries.

A16 Stockbuilding had made a small positive contribution to GDP growth in Q2.

A17 The external current account had recorded its third consecutive quarterly surplus in Q2. Though net exports of goods and services had fallen in Q2 by the equivalent of 0.5% of GDP, the fall was entirely accounted for by oil and erratic items, and net exports of goods other than oil and erratic items had increased. The CIPS survey showed only a small decrease in orders for manufactured exports in September. There were reports from the Agencies that demand in Europe was recovering and that there had been some switching of exports to markets where demand was stronger.

A18 Notwithstanding recent ONS data revisions, output was growing much faster in services (up by 1.2% in Q2) than in manufacturing (up by 0.3% in Q2). But recent CIPS surveys were indicating a slowdown in services output and perhaps some acceleration in manufacturing, and ONS data suggested that manufacturing output has strengthened in July and August. Moreover, CBI surveys suggested consistently that manufacturing output was stronger than the ONS data indicated, and there was a wide gap between the growth rate of retail sales of manufactured goods and output of manufactured consumer goods, which was much lower.

A19 Bank research showed that the construction industry was very sensitive to interest rates. Construction output had increased by 1.0% in Q2 and had been up by 3.5% on 1996 Q2. Indicators of capacity utilisation from BEC surveys had risen during the last year or so. The recent building industry wage settlement increased basic pay by 5.5% from August this year, with larger increases agreed for 1998 and 1999. Tender price inflation had increased. There had been an upward trend in orders.

A20 The unexpectedly low PSBR in the first five months of the financial year (April-August) appeared to be mainly the result of unexpectedly low outlays. The shortfall in outlays was larger than could be accounted for by the fact that unemployment was lower than had been assumed in making the projection.

A21 The Bank's regional agencies had conducted a survey of 144 contacts on the recent behaviour of imports. Of those surveyed, 90 were manufacturers, 25 retailers and 15 service providers. 39 were large (turnover of £100 million), 42 were medium-sized (turnover £25-100 million) and 63 were small. Most respondents (55%, including 72% of retailers) thought that the market share of imports of goods and services had increased during the last twelve months, and 57% expected it to increase during the next twelve months. The impact of imports had been greatest in homogenous products; niche markets were easier to defend but even there, profitability had been affected. Long-standing partnership arrangements between suppliers and customers had helped to delay the effect of the exchange rate appreciation on sourcing. There was some limited evidence of a reduction in foreign visitors to the United Kingdom and a rise in holidays abroad.

A22 The fall in the cost of imports was much smaller than the appreciation of the exchange rate. 17% of respondents said that the cost of imports to them had not fallen at all during the past twelve months; 45% said it had fallen by less than 5%, and only 38% said it had fallen by more than 5%. Only 13% of respondents said they had cut their own prices by more than 5% because of cheaper imported imports in relation to a year ago; 27% said they had cut prices by less than 5%; and 60% said they had not cut prices.

A23 There had been somewhat more price-cutting to maintain market share against cheaper imports. 23% of respondents (including 29% of manufacturers) had cut prices by more than 5% for that reason, 34% had cut prices by less than 5%, and 42% had not cut at all. Some respondents said that foreign cars were gaining market share: their prices had not been cut, but more extras were being offered.

A24 51% of respondents said the appreciation of sterling had damaged their profitability - chiefly on account of exports, but also partly because of competition from imports. 28% reported no change in profitability, and 20% (notably retailers) reported an improvement resulting from lower input costs.

A25 Asked whether the exchange rate appreciation had led to a transfer of production overseas, 55% of respondents (notably small companies) said 'no'. 13% said 'yes' and a further 14% said that it was likely to do so in the future.

III Labour market

A26 Claimant unemployment fell by 49,000 in August to a rate of 5.3%, the lowest since August 1980. This was a larger fall than Bank staff had expected and followed a large fall in July (now

revised up to 55,000), which was thought to reflect a lower-than-usual flow of students into the claimant count. There were three possible explanations for the surprising August figure - continuing adjustment to the Jobseekers' Allowance, month-to-month volatility, and a faster rate of labour market tightening than previously thought. The next Labour Force Survey should help distinguish among these explanations. The stock of vacancies rose by 7,000 in August.

A27 The Workforce In Employment survey showed a rise in employment of 64,000 in 1997 Q2; the number of employees had risen by 95,000. There had been a strong rise in employment in 'other industries' - largely construction (45,000 in Q2), but overall the number of employees had risen by a little less than earlier surveys of employment intentions had suggested.

A28 The annual benchmarking survey led to large upward revisions to earlier estimates of the workforce in employment. The estimated total in September 1996 had been revised upwards by some 200,000, or 0.8%. The revisions brought the changes in employment during the last year estimated by the Workforce in Employment and the Labour Force Surveys closer together. The revision implied a downward revision to whole-economy productivity growth, which was estimated at 1.6% in the year to Q2; unit wage costs rose by 2.7% in the same period.

A29 The Manpower survey conducted in September indicated the highest recruitment intentions for the next three months since 1988. The Bank's Agencies reported continuing strength in employment in manufacturing and services, and the CIPS surveys reported that employment in manufacturing and services had increased modestly in September.

A30 Reported underlying average earnings growth increased from 4 ¼% in June to 4 ½% in July. The figures for manufacturing and services had been unchanged at 4 ¼% and 4 ½% respectively, but the unrounded rate had fallen slightly in manufacturing and risen slightly in services. Moreover, there had been a significant increase in construction earnings.

A31 The underlying average earnings growth figure for July had been affected by large bonus payments in the transport and communication sector, where earnings growth rose from 4% in June to 9% in July. After adjustment to smooth out bonus payments using the technique described in the *August Inflation Report*, average earnings growth appeared either unchanged or even slightly lower in July than in June.

A32 The twelve month employment-weighted mean of pay settlements rose from 3.1% in July to 3.3% in August. The private sector component rose from 3.4% to 3.7%, while the public sector component was unchanged at 2.8%. The major influence was the construction workers' settlement, covering 600,000 people. It provides for a pay increase of 5.5% this year; craft workers receive a further 13.9% next year and 10% in 1999; labourers receive 5.7% next year and 7.6% in 1999.

A33 Reports from the Bank's Agencies and business surveys indicate growing skill shortages, particularly of IT staff but also of engineering and construction workers, lawyers and accountants. A recent survey by Reed personnel suggested that 76% of firms were experiencing shortages of skilled applicants for jobs - 8% up from six months earlier. Perhaps surprisingly, the shortages were most acute in manufacturing. The CBI reported that 13% of manufacturers were citing a shortage of skilled labour as a constraint on future output, compared with 10% at the beginning of this year. The BCC reported that 60-70% of firms in both manufacturing and services were experiencing recruitment difficulties. The BEC reported a rise in the number of construction firms reporting difficulties in recruiting specialised skills. And though the data are suspect, the stock of unskilled vacancies at Jobcentres has continued to increase.

A34 The CBI indicator - the percentage of manufacturing firms citing shortage of skilled labour as a constraint on future output - has risen since 1992, but at 13% remains well below its late-1980s peak of more than 25%. If skills were portable across industrial sectors, this could indicate that skill shortages across the whole economy remained much less serious than in the late 1980s. But other indicators suggested a different conclusion - the BCC indicators of recruitment difficulties were back to their late-1980s levels, and the ratio of vacancies reported to Jobcentres (corrected as far as possible to remove known errors) to short-term unemployment was if anything higher than in the late 1980s.

IV Prices

A35 The Bank's commodity price index (weighted by UK usage) rose by 1.7% (provisional) in August, to a level 6.0% lower than in August 1996. The index excluding oil rose by 0.5% in August, mainly reflecting higher prices of zinc and rubber. The price of oil, which had risen in August, fell back modestly in September.

A36 Producer input prices rose by 0.6% in August to a level 7.9% lower than in August 1996. The CIPS survey suggested that input prices were continuing to fall sharply. Producer output prices had risen very slightly since April. The Bank's Agencies reported that manufacturers might try to secure price increases next January, but such attempts had generally not succeeded in recent years.

A37 Consistent with the Agencies' survey reported in paragraph A22 above, ONS data continued to show that import prices had fallen by much less than the exchange rate had appreciated: in July they were down by 6.9% compared with a year earlier; the corresponding fall for export prices was 5.9%. Prices of exports of services were little changed in the year to Q2, whilst imports of services had fallen a little more in price than imports of goods.

A38 RPIX inflation fell from 2.8% in August to 2.7% in September. The fall, which could be entirely accounted for by the reduction in VAT on fuel, was smaller than might have been expected, reflecting wider domestic profit margins. For example, margins on petrol had been widened after the Budget tax increase, and there had been less pass-through from lower import prices to clothing, footwear and durables than might have been expected.

A39 Consumer price inflation in Germany rose to 2.1% in August, an increase of more than 0.5% in four months, though there were signs of a possible fall in inflation in September. Most of the recent increase appeared to reflect external or temporary factors - higher import prices (including oil) and administered prices (in some cases a consequence of fiscal consolidation). Measures of domestically-generated inflation were lower - for example, the increase in the GDP deflator in the year to Q2 was 0.8% - and with wage settlements remaining low and broad money growth having fallen back to within the target range, the scope for second-round inflationary effects from higher import and administered prices seemed limited.

A40 The IMF forecast of an acceleration of world output growth - and of a convergence of growth rates - suggested that there might be a risk of a rise in commodity prices. And the El Nino weather system might put upward pressure on food prices. The IMF themselves expected prices to remain weak on account of good supply conditions, but commodity prices were inherently volatile and any changes could be sharp, though the effect on retail prices would be heavily damped.

V Financial markets

A41 The sterling ERI stood at 100.4 (1990 average = 100) at the close of business on 8 October, 0.5% higher than on 10 September, on the eve of the final part of the September meeting. Since its peak on 23 July, sterling had fallen by 5.8% on the ERI, and by 7.4% and 3.5% against the DM and the dollar respectively.

A42 During the course of the month, sterling had strengthened after the release of strong retail sales and labour market data on 17 September, but it had fallen sharply on 26 September, when a *Financial Times* article suggested that the Government was planning to join European Monetary Union. Although the spot £/DM rate had fallen after this article had appeared, the five-year forward rate had risen slightly, reflecting the fall in the UK yield curve. Chart analysis suggested no near-term trend in sterling, but it was vulnerable to further EMU-related developments.

A43 The implied one and twelve-month volatility in £/DM options prices had fallen sharply in the month since the previous MPC meeting, and the implied one and twelve-month correlations between £/\$ and \$/DM spot rates had increased. Part of the change took place in mid-September, and part

after the publication of the *Financial Times* article on 26 September. These changes were consistent with a higher probability being attached by the market to the prospect of the United Kingdom joining EMU.

A44 In the domestic money markets, with the Bank's repo rate at 7%, on 8 October three-month LIBOR had been 7.28%, compared with 7.22% on 10 September; the three-month LIBOR for December 1997, March 1998 and March 1999 implied by futures prices were 7.46%, 7.50% and 7.07% respectively, compared with 7.37%, 7.38% and 7.15% on 10 September. Implied volatility in option contracts on three-month sterling interest rates in the next nine months had not changed much during the last month.

A45 A number of factors had influenced the market in a turbulent month: some UK data (notably on the labour market and retail sales) had been stronger than expected, but US data (the CPI, the NAPM survey and the labour market figures) had been generally reassuring about inflation; the PSBR figures and market comments on them had led to expectations of a reduced supply of gilts; and the perceived probability of UK entry into EMU had increased.

A46 Market rates suggested that during the last month, there had been a slight increase in interest rate expectations for early 1998, but a large fall in expectations for 1999 and 2000. Three-month rates were now expected to peak early in 1998 at about 7½% and to fall by more than 1% in the following two years.

A47 On 16 September, the release of the smaller-than-expected PSBR for August and the unexpectedly low US CPI figure had led to falls of 10-15 basis points in futures rates, with larger falls in longer-dated futures. On 17 September, the strong UK labour market and retail sales data caused futures rates to rise modestly.

A48 The *Financial Times* article on 26 September led to heavy falls in futures rates for 1999 and 2000, though there was little change in the March 1998 rate. These developments were likely to have reflected an increased probability attached to the prospect of UK and German interest rates converging.

A49 The implied two-week repo rate for two weeks forward was very close to where it had been a month ago, and there was no real market expectation that the Bank's repo rate would be increased in October. This reflected the market reaction to the pause in monetary policy mentioned in the August *Inflation Report*, and the belief that US and German interest rates were 'on hold'. Rates implied for November were about 1/8% above their current level: a substantial probability was attached to a rise in November, reflecting strong recent UK data, the upside risks mentioned in the August *Inflation*

Report, and the belief that a new *Inflation Report* could provide an opportunity to raise interest rates.

A50 In the gilt market, yields had fallen at all maturities during the last month, particularly in the five-ten year area. The main change had come after the *Financial Times* article. It was curious that though implied future nominal short-term interest rates had generally fallen, at long maturities of 20 years or so they had risen, this pattern was also seen in implied inflationary expectations. A possible technical explanation was that yield curve movements had been temporarily distorted by the need of the gilt-edged market-makers to adjust the positions they had taken in the auction held earlier that week, after the appearance of the *Financial Times* article. If this had been the case, the surprising pattern of forward yields might prove temporary. There had indeed been some adjustment the following week, but it could also have reflected official denials of the *Financial Times* story, as well as domestic and foreign data releases favourable to long gilts.

A51 The implied volatility of gilts rose during the past month, in contrast to that of Bunds, which continued to fall. One possible explanation was that greater uncertainty over UK membership of EMU had led to greater uncertainty about future UK interest rates.

A52 Equity prices rose since the September MPC meeting: the FT-SE 100 index rose from 4,905 on 10 September to 5,262 on 8 October, the FT-SE 250 index from 4,665 to 4,882 and the FT-SE Small Cap from 2,281 to 2,380.