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MINUTES OF MONETARY POLICY COMMITTEE MEETING 10 and 11 September 1997

These are the minutes of the Monetary Policy Committee meeting held on 10 and 11 September 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 8 and 9 October will be published on 12 November.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 10-11 SEPTEMBER 1997

1 The meeting took place against the background of an earlier presentation by Bank staff of the most recent data on monetary and economic conditions. The presentation is summarised in the Annex, updated for the data which subsequently became available before the Monetary Policy Committee meeting.

2 The Committee began its meeting by recalling the statement in the August *Inflation Report* that: "... the MPC 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." An overview of the subsequent data suggested a mixed picture. Domestic demand continued to grow strongly and, whilst the exchange rate had fallen back from its peak, it remained some 20% above the level in August 1996. The latest revision of the manufacturing output data had eliminated the slowdown signalled earlier; but survey evidence still warned of a slowing in activity ahead. The financial market price movements following the August announcement of the 25bp rate rise showed a fall and subsequent partial reversal in short-term interest rate expectations, but a more sustained fall in sterling.

3 The Committee went on to examine this overview under three headings: demand and output, including the impact of asset price developments; monetary aggregates; and the labour market.

Demand and output

4 The Committee discussed the implications of the new Mori survey on demutualisation windfalls. The survey results broadly confirmed the assumptions used in the August *Inflation Report*. However, the survey suggested that the time profile would show a more concentrated impact in mid-1997 when the payments were made, arising from the immediate impact on those freed from their liquidity constraint; and a smaller impact next year and the year after.

5 The latest BRC survey indicated a slowdown in retail sales in August. This was consistent with suggestions that the immediate effect of the windfalls had begun to tail off, although it was also noted that much of the windfall expenditure, for example on cars and foreign holidays, would not be captured by the retail sales measure. It was also pointed out that other survey and anecdotal

evidence, and the data from some retail groups, pointed to a weaker August than July; and that this would be consistent with the M0 data.

6 Overall the Committee thought that the Mori survey results, taken on their own, suggested that windfalls posed a smaller upside risk to the central projection in the Inflation Report than had earlier been thought. The Mori survey had not confirmed some of the more extreme estimates which had been suggested.

7 Moving on to fixed investment, Committee members discussed the preliminary aggregate data which showed investment barely rising. By contrast some sectoral data showed investment rising robustly in the second quarter, and it seemed unlikely that those sectors for which data were not yet available - private residential and public sector investment - would have fallen sufficiently sharply to validate the aggregate data. The Committee therefore thought that the aggregate figure might be revised upwards.

8 As for external trade, the Committee noted the suggestions by Bank staff that import prices for the EU might have been overestimated and import volumes commensurately underestimated. If this proved true, it would imply that the domestic value added component of UK inflation would have been correspondingly higher, since there was no evidence of distortions to the RPI, and a higher level of domestically generated inflation would be a cause for concern.

9 The Committee reviewed the puzzling relationship between the rising exchange rate and robust trade volumes. It was agreed that modelling trade was problematic, in other countries as in the UK, with income and relative price effects rarely providing a complete explanation of the data. Time trends to capture other influences were frequently used but were not informative. One possible view was that there had been a fundamental improvement in the UK's underlying trade performance which had led to, and to some extent offset, sterling appreciation. Another view was that the lags in transmitting exchange rate movements were longer than expected. Firms would try to maintain export market share in the face of uncertainty about how long sterling's appreciation would be sustained. For at least some firms, the strength of domestic margins would have helped them absorb the squeeze on export margins. On this view the impact of the appreciation would eventually come through, although sterling's recent retreat might moderate its scale.

10 Committee members noted that the survey evidence continued to point to a deteriorating export outlook. Whilst the most recent data for continental economies suggested that economic growth was picking up, much of this was export rather than domestic demand led. The recent

financial crises in Asia would tend to reduce external demand but, unless the problems became more widespread, probably not by a significant amount or for very long. Overall the Committee saw no reason to change the central projection of the August *Inflation Report*, that the appreciation of sterling since August would cause net exports to make a significant negative contribution to GDP over the next two years.

11 The Committee noted the evidence, including the latest CIPS survey, that service sector output, whilst still growing strongly, had decelerated a bit in Q3, following strong recorded growth in Q2. Meanwhile the latest industrial production data contained significant back revisions, suggesting that Q2 GDP growth might be revised upwards slightly. Manufacturing output looked less weak in recent months than had previously been the case.

Asset prices

12 The Committee turned its attention to asset prices, particularly equities and the housing market, noting that recent rises had been dominated by particular sectors (in the equity market) and particular regions (in the housing market). Even at the aggregate level not all asset prices had been growing strongly. For example, although Tobin's Q, which is the ratio of the market valuation of ICCs to the replacement cost of their capital stock, is estimated to have been exceptionally strong in the 1990s, the prices of industrial, retail and office property had been growing this year by only 3 to 4% per annum, after falling by between 5 and 10% during 1995.

13 As regards house prices, it was hard to interpret the latest data, given the increasing divergence between the Halifax index, with its longer track record and bigger sample, and the Nationwide index, which was showing faster growth in line with DoE data. Part of the rapid rise in house prices may have represented a bounceback from the low levels associated with debt deflation in the late 1980s and early 1990s. On this view, house price inflation should moderate as debt:income ratios fall back to more normal levels. This could explain the recent moderation in the Halifax index. However the Nationwide and DoE indices were less reassuring. The Committee noted that rising house prices would have contributed to the rise in consumer confidence reported by surveys. These surveys were regarded as corroborative, rather than independent, evidence of strong consumer demand.

14 High and rising stock market prices were a concern both because of their immediate contribution to the rapid growth of consumption and because, if they proved unsustainable and fell

abruptly, they might create a shock to the real economy. Some comfort on the latter point could be taken from the relatively small percentages of loans collateralised against stocks and shares.

15 The Committee considered the proposition that the impact of equity price movements could have been increased by wider share ownership. The number of individuals holding shares had been increased both by the recent demutualisations and by the earlier privatisations, but the aggregate value of direct holdings remained small. The value of equity held indirectly through pensions had significantly increased during the past decade. If equity prices fell sharply, future pensions paid out of defined-contribution schemes might be lower, and companies with defined-benefit pension schemes might have to make larger contributions, so that their shareholders might suffer. The Committee concluded that there was no simple relationship between asset prices and future inflation but it was essential to continue to review asset price developments.

Money

16 The Committee discussed how to interpret the divergent money data: narrow money had decelerated but broad money, whether measured by M4 or Divisia money, had accelerated. The rise in narrow money velocity might be explained by the period of adjustment to a low inflation environment coming to an end, but it might also reflect a slowdown in consumer spending.

17 The Committee noted the divergence between the bank and building society components of retail M4. If the strong inflows into building societies had been encouraged by speculation about future demutualisations, then the resulting balances could perhaps be regarded as temporary investment rather than transaction balances. Bank staff were continuing to analyse the significance within M4 of OFIs' holdings but no new information had come to hand.

Labour market

18 Discussion turned to the state of the labour market. The falls in unemployment continued to indicate tightening, although the pace had been exaggerated by the impact of the Jobseeker's Allowance (JSA) on the claimant count figures. This distinction did not directly affect unemployment as measured by the Labour Force Survey. Measured in this way, short-term unemployment was now lower than at any time since the Survey was first published in the early 1980s. Business surveys and the Bank Agents' contacts continued to indicate tightening and skill shortages .

19 This evidence, together with stable earnings growth, could be taken to imply that the rate of unemployment consistent with a stable rate of inflation was lower than previously thought. Job insecurity might have been a stronger factor; or inflation expectations might have been more subdued. But it was also possible that the growth in average earnings could suddenly increase as in the late 1980s after a long period of stability. This remained an upside risk to the central projection for inflation.

20 The Committee considered the alternative proposition that a significant degree of slack remained in the labour market. Hours worked per week, although rising over the last few years, remained below the peak of the late 1980s; employment as a percentage of the working population showed a similar picture; and the inactivity rate had changed little since the recovery began. Such indicators might suggest that there was still potential to increase employment without reducing unemployment, in which case upward pressure on wages would be deferred.

21 The Committee concluded that uncertainties remained about how much further tightening of the labour market could be tolerated without generating upward pressure on wages. It would be unwise in the current state of knowledge to take a strong view about the level of the natural rate of unemployment; but it remained essential to monitor closely wage settlements and average earnings.

Financial markets

22 The Committee discussed the main market movements since the August meeting. The exchange rate had fallen, particularly against the DM, but the fall in the UK yield curve relative to that abroad immediately following the August meeting had since been reversed, so that changes in relative monetary conditions did not appear to have contributed significantly to the fall in sterling. The Committee discussed whether sterling's fall could be explained by changed views about the prospect for EMU. The chances of countries meeting the fiscal convergence criteria were perceived by the market to have increased, as continental economies recovered. Bond market data showed no evidence of a prospective high-inflation euro, but nor had they for some time. A more confident market view towards the euro may have lessened the attraction of sterling as a safe haven currency.

Summary and policy conclusion

23 The Committee agreed that the evidence over the last month did not point conclusively in either direction, nor resolve the main uncertainties. The upward revisions to industrial production suggested that GDP might have been a little higher in Q2 than earlier thought. The survey evidence on windfalls provided some reassurance that one of the upside risks to the Bank's central projection

for inflation might prove less serious than earlier thought. There were uncertainties about the trend in house prices; whilst equity prices remained an upside risk although no more so than last month. There was no new evidence on the pace and impact of fiscal consolidation. The trade data continued to be stronger than expected, and their future deterioration remained uncertain. M4 remained a clear upside risk. The possibility that labour costs might suddenly accelerate sharply, as in the 1980s, could not be excluded but equally some remaining degree of slack in the labour market could not be ruled out.

24 In the light of the conclusion of the *August Inflation Report*, and the fact that the subsequent evidence did not point conclusively in either direction, the Committee voted unanimously to leave interest rates unchanged.

25 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

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

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

1 This Annex summarises the data and analysis presented by Bank staff to the Monetary Policy Committee ahead of its meeting. At the start of the Committee meeting itself, members were made aware of subsequent information that had become available, and this is reflected in this Annex.

I Monetary conditions

2 Notes and coin grew by 0.4% in August so that the twelve-month growth rate continued to fall, to 5.1% from 5.5% in June and 7.6% a year ago. Some of this deceleration might have been associated with a decline over this period of tourist spending in the UK, as the strength of sterling and demutualisation windfalls encouraged people to take holidays abroad. But some was probably also explained by structural influences: narrow money growth had in recent years exceeded that of retail spending, as individuals had adjusted their portfolios to accommodate higher transactions balances to a low inflation environment, but this adjustment could be coming to an end.

3 However broad money grew strongly again in July. M4 increased by 1%, raising the three-month annualised growth rate to 13.7% and the twelve-month rate to 12%, higher than the broadly 10% rate observed for much of last year.

4 Retail M4 grew by 0.6% in July, down from the exceptionally strong rise of 1.1% in June. In part this reflected the drawdown of Halifax deposits as the proceeds of sales of Halifax shares, which had been placed temporarily on deposit in June, were subsequently withdrawn. Retail bank deposits were unchanged in July whereas building society deposits grew exceptionally strongly, at 1.8%, and it seemed plausible that at least part of the funds withdrawn from Halifax were transferred to building societies, perhaps in the hope of gaining from subsequent demutualisation windfalls. Reflecting this, the growth of individuals' underlying M4 holdings had continued to rise, with the three-month annualised rate at 10.5%, causing the twelve-month rate to rise to 7.8%.

5 Wholesale M4, which had grown only slowly in June, accelerated in July, though its monthly growth of 1.7% was not out of line with the average this year.

6 There had been no new data on the sectoral composition of M4 growth. OFIs' deposits were thus still estimated to have contributed almost half of the growth in M4 over the past year. Rising

asset prices and values would, under well-established portfolio theory, have been expected to lead OFIs to hold higher money balances. But there may also have been causality in the other direction; money balances in excess of some equilibrium might have been spent and helped to drive up asset prices. Tentative analysis by Bank staff of life assurance and pension funds' M4 holdings, which had accounted for some 40% of the rise in OFIs' M4 since 1995, appeared to indicate that LAPFs' M4 balances may currently exceed equilibrium levels, with the risk that they could be run down, contributing to higher asset prices in the process. But this analysis was obviously sensitive to the measurement of equilibrium money holdings, which would in practice depend crucially on expected returns from equities and other assets, and these were inevitably hard to model.

7 M4 lending grew by 0.5% in July, rather slower than the average monthly rate during 1997, possibly because of a share redemption by a single company without which M4 lending might have grown by up to 0.7%.

8 Although M4 growth had now reached 12%, M4 lending growth had not kept pace but rather remained steady, at around 9%. The flows of M4 and M4 lending had been broadly comparable in money value, as the contribution from other M4 counterparts had been roughly offsetting. In particular, banks' capital had risen with increased profitability, while banks' net external outflows had risen with increased sterling lending overseas. But the relative sizes of the outstanding stocks of M4 lending and M4 meant that M4 growth had exceeded M4 lending when expressed in percentage terms.

9 Within the (rather slower) growth in M4 lending in July, net secured borrowing by persons continued its gradual pick-up but gross borrowing rose more, reflecting remortgage activity and/or a greater rate of repayments. Persons' net unsecured borrowing was much more subdued in July than in recent months, with a very sharp rise of around £1 bn in repayments of consumer credit almost certainly as a result of windfall receipts. But unsecured consumer credit continued to grow strongly, at around 17% pa, and whilst some part of this may have been due to borrowing in anticipation of receiving windfalls, this effect could well have been largely unwound in July. The underlying strength of consumer borrowing reflected both higher personal wealth and reduced interest costs, as credit card and unsecured personal loan spreads over market rates had fallen; it could therefore persist.

10 As for asset prices, changes in monetary conditions at home and abroad over the past month did not seem to have contributed to sterling's depreciation, measured on an effective-rate basis; but

changed market perceptions about prospects for monetary policy in Germany did, by contrast, seem to have played a role in sterling's depreciation against the DM.

11 Bank staff also noted that an analysis of recent movements in the interest rates applicable to standard variable mortgages and to typical low-balance instant access deposit accounts showed that recent increases in official rates had already been more than fully passed on into mortgage rates, an unusually rapid response in relation to historical experience. Experience of deposit rates, however, differed significantly. Whilst bank deposit rates had fully adjusted, building society rates had not kept pace, not surprisingly given the scale of speculative inflows to this sector, whereas institutions converting into banks had more than matched increases in official rates perhaps to try to stem outflows following conversion.

II Demand and output

12 The first full, but provisional, estimates of GDP and its expenditure components in Q2 confirmed overall growth at 0.9% with non North Sea GDP revised down slightly also to this rate. But, revisions to the level of manufacturing output had led to upward revisions of 0.2pp to the level of industrial production. That was likely to lead to a small upward revision to GDP in Q2, assuming no other offsetting revisions. Domestic demand growth was very strong (1.2%), although not quite as strong as had been expected, with private consumption showing the most rapid growth (1.5%), broadly in line with Bank staff's expectation. Net trade exerted a negative contribution (-0.4%), but this was less than had been expected and was in any event more than accounted for by oil and erratic items. Fixed investment growth was surprisingly low, at 0.1%, which taken together with other available data would imply weak government and private housing sectors.

13 Retail sales volumes grew by 0.3% in July, more slowly than the 0.7% monthly average in the first half of the year, but this was nevertheless sufficient in combination with the strong growth in May and June to keep the three-month (on previous three months) growth rate on a rising trend. Compared with a year ago, retail sales volumes were 6.5% higher in July and 5.8% up in the latest three months as a whole. Within retail sales, household goods were much less robust than in the previous two months, but nevertheless the ONS estimated that some £100 mn of retail sales in household goods stores in July were exceptional and indicative of windfall-related spending; and Bank staff calculated an equivalent figure of some £300-£400 mn using a deviation from trend method, over the three months to July, a figure much lower than some other estimates but consistent with the Mori survey (see below).

14 In contrast to the official retail sales data, which were consistent with continuing strong consumer confidence data, the CBI distributive trades survey suggested slowing retail sales growth. The survey nevertheless interestingly showed a sharp increase in retail import penetration to the highest level since May 1990.

15 There were record car registrations in August, up 10% from last August, with business and fleet sales rather surprisingly stronger than private. Some 68% of sales were imported, up from 63% last August, helping to explain why domestic car output was significantly less buoyant.

16 An assessment of developments in the housing market continued to be clouded by the divergent Halifax and Nationwide house price data: the Halifax index was decelerating, to 6.4% in the year to August, whereas the Nationwide index had continued to accelerate, to just over 12% in August. Analysis of their regional components showed that most of the difference lies in parts of the Midlands, North of England and Northern Ireland; both indices confirmed the strength of the market in London and the South East. Overall housing market indicators gave a mixed picture of both house price inflation and activity.

17 Finally in the personal sector, Bank staff focused on the results, published on 5 September, of the Mori survey of the response of consumers to the windfall receipts from the demutualisations in the building society and insurance sectors, and provided a preliminary assessment of their implications. The survey was conducted in late August, with telephone interviews of 764 individuals all of whom had received at least one of the four largest windfalls (which accounted for just under £31 bn of total windfalls of nearly £36 bn).

18 The main findings were that:

- by value, some 35% of free shares had already been sold, implying additional sales beyond those who had pre-registered to sell;
- of which some 47% of the proceeds had been spent and the same proportion saved, with 6% used to repay debt;
- home improvements had been the biggest expenditure category, with holidays, cars and household goods receiving rather smaller proportions;

- nearly 40% of the reported spending would have occurred anyway, financed in other ways, giving additional spending on household goods around the time of the flotations, for example, of around £450 mn, not inconsistent with an ONS estimate of some £300 mn in June and July together;
- only a small amount of the windfall receipts were used to bring forward consumption in anticipation; and
- the proceeds were used to repay some £800 mn of borrowing, suggesting this as a major explanation for the July consumer credit data.

19 Taking the survey results at face value, total spending from windfalls were estimated at around £10 bn, of which around £6 bn was additional (see below).

MORI survey on consumer windfalls: amount of windfalls identified as spent		
	<u>% of estimated total 1997 windfalls</u>	<u>Value (£ billions)</u>
Spending undertaken	20	7.5
of which:		
Pre-windfall spending	4	1.6
Spending out of share proceeds	16	5.9
<u>Planned spending in next 12 months</u>	6	2.2
of which, financed by:		
Proceeds from share sales placed on short term deposit	3	1.2
Future share sales	2	0.7
Borrowing (dissaving) against share collateral	1	0.4
Total spending	26	9.7
Of which: Additional spending	16	6.0

20 However, the relaxation of financing constraints on consumers could give rise to further spending which was more difficult to quantify, so the survey alone was likely to provide a lower bound for estimated additional spending. It was questionable whether the survey had captured accurately the incremental spending by individuals who were not liquidity constrained. Theory suggested that these individuals would smooth their additional consumption, spending the annuity value in each year: for example, the annuity value of a windfall of £2,000 spread over 30 years with a real interest rate of 4% was a little over £100. It was not clear that these individuals would identify a relatively small increase in spending as a “windfall effect”: in responding to the survey, a large proportion may well have answered that their spending had not increased - ie *as if* they had saved their windfall. If an adjustment was added to the survey results for such an annuity effect, the total

impact on domestic demand over 1997 to 1998 would be close to the estimate embodied in the August *Inflation Report* forecast, although the survey suggested a more concentrated impact than previously thought.

21 The preliminary Q2 figure for aggregate investment, which barely showed an increase, was hard to square with the available partial sectoral data. Manufacturing investment continued to recover from the sharp falls in 1996 whilst investment in the services sector continued to grow strongly; and overall the trends in investment were unchanged despite a weak aggregate figure. To assist an assessment of the prospects for investment, the Bank's Agents had undertaken in mid-to-late-August a survey of 113 diverse UK companies in manufacturing and services. The survey had confirmed the rather greater readiness to invest of the service sector - driven in particular by capacity shortages - than manufacturing - where cost and efficiency considerations were judged more influential. The survey suggested that overall there may be a slowdown next year, reflecting to some extent uncertainties about demand. The strength of sterling did not appear to be a significant deterrent for most companies (although a more important factor than two years ago), perhaps because of the proportion of capital goods imported. Companies with overseas investment programmes on balance expected to increase the proportion spent overseas.

22 Stockbuilding was estimated to have contributed positively to GDP in Q2 but the data were particularly subject to revision.

23 The latest public sector data, for July, were encouraging, with rather greater tax revenues than expected contributing to a reduced PSBR, but much of this may simply have reflected the timing of payments.

24 The external trade volume data remained surprisingly strong in the face of sterling's appreciation. More than all of the estimated negative (0.4%) contribution of net trade to GDP growth in Q2 could be explained by oil and erratics. Robust growth in overseas markets, especially in the US in Q2, may have had a stronger than expected offsetting effect. Disaggregated data suggested that there might be a positive correlation between those sectors most exposed externally, as measured by the contribution of exports and degree of import penetration, and a weakening in output growth. It was possible that sterling's appreciation may have had a greater impact on trade volumes than the aggregate data indicated, and this could also help to explain a growing puzzle in trying to equate the supply of and demand for manufactured goods. A large gap had opened up between the strong growth in retail sales and much weaker manufactured consumer goods output, which could be at least partly explained by a more rapid growth than so far identified in manufactured import

volumes. Upward revisions to the level of manufacturing output, published with the July data, still left a significant gap.

25 Industrial production had risen by 0.6% in July; and manufacturing production by 0.4%. Large upward revisions to the level of manufacturing output in the first six months of 1997 were also published. These had had the effect of raising the level of the June index by 0.7pp from that previously estimated.

26 The latest survey evidence for manufacturing, from CIPS and other surveys, showed further weakening in export orders; and there were suggestions in a number of recent surveys (BCC, CIPS and CBI financial services) that sterling's appreciation might have been beginning also to affect services.

III Labour market

27 There was little news in the labour market data this month. Claimant count unemployment fell by 50,000 in July to 1.55 mn, the lowest level for 17 years, representing 5.5% of the workforce. Some 20,000 of the fall was explained by rather fewer students than normal registering, possibly deterred by the tighter JSA rules.

28 The number of notified vacancies increased by 1,500, less than the recent monthly average of around 3,500. Whilst the inflow of notified vacancies was declining, placings were declining even faster, perhaps reflecting skill shortages.

29 Underlying average earnings growth was estimated to have remained unchanged at 4¼% in June, with services unchanged at 4½% and manufacturing unchanged at 4¼%. As a result, average earnings growth in Q2 was lower than in Q1 when bonuses inflated the data: after smoothing for bonuses, average earnings were currently estimated by Bank staff to be growing at a little under 4½%.

30 There was no significant change in wage settlements in the twelve months to July, with whole economy settlements continuing to grow at 3.1%, with private and public sector components at 3.5% and 2.7% respectively. Within the private sector, services - at 3.6% - were running ahead of the production industries - at 3.2%. The Bank's Agents continued to corroborate reports of quite widespread skill shortages in specific sectors and evidence of pay premia to retain key staff. The 5% construction workers' settlement would affect the August data, significantly raising the three-month rate then.

IV Prices

31 The Bank's index of sterling commodity prices (weighted by UK usage) showed a further small fall in July, to 7.3% below a year ago. By contrast the Economist index showed a small rise in dollar commodity prices in recent months, particularly because of the rather bigger weight attached to metals prices. Oil prices had risen in early August on uncertainties over Iraqi supplies, but had since fallen back to their July level.

32 Although producer input prices fell again in July, under the influence of sterling appreciation and favourable supply conditions, they rather unexpectedly increased in August, by 0.6% to stand 7.8 % below a year ago, under the impact particularly of higher oil and zinc prices. Producer output prices showed a modest rise in July, accounted for by higher excise duties, and again in August, when there were small increases spread across a range of industries. Output prices were now 1.4% above a year ago. Difficulties in raising prices of goods for domestic consumption in the face of competition from imports were widely reported.

33 Export prices had been slow to react to sterling's appreciation but there was evidence of an increasing impact: in Q2, excluding oil and erratics, sterling export prices were 1.7% lower than in Q1, on a non-annualised basis, with prices to the non-EU falling faster than to the EU.

34 Import prices continued to fall steadily, to a level in June some 6% lower than last August when sterling began to appreciate, but nevertheless the pace of the pass-through had been slow. The partial non-EU data indicated a further fall in July. Bank staff pointed out that the ONS did not collect import prices for distinct EU and non-EU goods, but used trade value weights to derive different price indices. This could explain why import volumes appeared, oddly, to have been growing much faster from non-EU countries. It is conceivable that, within the growing value data, import prices from the EU might have been overestimated and volumes commensurately underestimated. Moreover the method for estimating total import prices left open the possibility that they may have been overstated (particularly for finished manufactures); and even quite a small measurement error could have had significant effects, through import volumes, on the GDP expenditure estimates (and hence on the reconciliation with GDP on an output basis).

35 Manufacturers' domestic margins were estimated to be widening only slowly despite falling input prices, and export margins were narrowing as export prices fell. By contrast estimates of retailers' margins showed a marked further rise in Q2, as retail prices continued to rise in the face of

strong retail sales volumes whilst weighted costs decelerated and began to fall, with falling fuel costs recently and bought-in goods prices, notably foods, over the last year.

36 RPIX inflation fell back a little in August, to 2.8% from 3% in July, following the unwinding of recent increases in seasonal food prices. RPIY inflation moderated slightly, to 2.1% in August. By contrast, headline RPI inflation increased to 3.5%, from 3.3% in July and 2.9% in June, under the influence of mortgage interest rate changes this year and last.

37 On an international comparison, UK inflation clearly stood above many other major countries: within Europe on the harmonised CPI measure, where the UK stood in July at 2%, only Denmark and Greece had higher inflation (on the latest comprehensive data for June).

38 Looking ahead, with cost pressures remaining weak and as sterling's appreciation continued to have an impact, RPIX inflation was expected to moderate, although the risks remained on the upside.

V Information from financial markets

39 The sterling ERI stood at 99.9 (1990 average = 100) at the close of business on 10 September, 4% lower than the level (103.9) on 6 August, the eve of the final part of the August Committee. Over this period sterling had fallen by 5% against the Deutschemark, although by only 1% against the dollar. Since its peak on 23 July, sterling had fallen back by 6.8% on its ERI, and by 7.5% and 5.9% against the DM and dollar respectively.

40 The foreign exchange markets had been volatile in August, even more so than normal. The DM had recovered some of its recent losses, particularly against the US dollar and sterling, on a belief that the strengthening German economy could lead the Bundesbank to begin raising interest rates later this year, earlier than previously thought. But the yen had weakened, as the large depreciations in many SE Asian currencies encouraged the view that the Japanese authorities would be less hostile to a lower value for the yen in order to alleviate some of the competitive losses which Japan would otherwise suffer.

41 Sterling had fallen sharply, against the dollar, DM and on the ERI, in the aftermath of the Committee announcement accompanying the $\frac{1}{4}$ % rise in interest rates on 7 August. It had fallen further on 13 August, as the *Inflation Report* had confirmed the message that the central projection for inflation two years ahead was in line with the inflation target, although with the risks skewed on the upside, and as the Bundesbank had published its monthly report which had led to speculation

about a possible rise in German interest rates. Sterling might also have been affected by market rumours, subsequently denied by HM Treasury, that the Government would take the UK into the single currency.

42 In the middle of August sterling had briefly rallied as the dollar had begun to move up, but towards end-August and in early September it had subsequently softened again. It was noteworthy that in this latest period sterling had not generally moved up on those occasions when the dollar had rallied, so that the sterling:dollar rate had fallen back below 1.60 and indeed below technical support levels, which had encouraged further selling. Some part of this may have been due to renewed market discussion of a possible postponement of EMU, which some believe would increase the possibility of sterling's inclusion.

43 Not surprisingly, sterling's sharp downward adjustment against the DM, but also to a lesser extent against the dollar, had increased market uncertainty about particularly the immediate future prospect for sterling. Options prices revealed that since the last Committee meeting the market had come to attach a higher probability to sterling falling further, particularly against the DM. Whereas on 6 August the probability of the £:DM rate being at or below 2.80 one month ahead had been calculated at under 5%, this probability had increased to nearly 25% by 4 September (when the one month forward rate stood at DM 2.87).

44 In the domestic markets, interest rate expectations were immediately moderated by the Committee announcement on 7 August, falling by as much as 12 basis points in 1998. But expectations had subsequently firmed through much of August, both on the perceived greater prospect of higher international interest rates and on the release of strong UK economic data, particularly for retail sales and M4; although they had eased back again most recently. Overall market expectations of interest rate prospects over the next eighteen months were a little lower than on the first day of the last Committee meeting, by up to 15bp 18 months ahead. The markets expected rates to peak early in 1998, $\frac{1}{4}$ % higher than current levels. Following the last Committee statement, there was virtually no market expectation of any rise in official rate in September. It was noteworthy from options prices that implied volatility of short-term interest rates had fallen sharply in the wake of the August Committee announcement, as expectations had hardened around the central view; but subsequent data releases later in August had led to renewed uncertainty.

45 The gilt market had been relatively thin and quiet in August, and overall less volatile than other international bond markets. In the early part of the month, the nominal yield curve, which had previously been virtually flat around 7%, had appeared to tilt upwards, with short yields falling and

long yields rising. But by early September the yield curve had again become effectively flat, close to 7%.

46 Equity markets had been dominated by the sharp falls in the SE Asian markets but Western markets had remained relatively insulated. There had nevertheless been increased volatility, particularly in the US and UK, as doubts continued about whether the recent strength in equity prices could be sustained. The FTSE 100 had fallen back since the August Committee meeting, under the influence particularly of financial stocks, but the FTSE 250 and FTSE small cap indices were higher. Closer analysis indicated that the five largest stocks (by capitalisation) had accounted for a disproportionate share of recent large daily movements in the FTSE 100 index and, given the international orientation of these companies, it was hard to read into them any message about prospects for the UK economy.