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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 November 1998

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 November 1998.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9811.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 9 and 10 December will be published on 23 December 1998.



MONETARY POLICY COMMITTEE MEETING 4-5 NOVEMBER 1998

1 In the context of completing its quarterly inflation and activity projections, the Committee discussed the indications from surveys and from the Bank's regional Agents of a sharp slowdown in economic growth; how to gauge labour market conditions given the problems with the Average Earnings Index; the world economic outlook; and monetary and financial market conditions, including whether a material tightening of credit conditions had occurred or was in prospect. Prior to the meeting, the Committee was briefed by Treasury officials on the Chancellor's latest projections for economic activity and the public finances.

Survey evidence, domestic demand, activity

2 The evidence of a sharp slowdown in domestic output growth was strongest in the surveys and in reports from the Bank's regional Agencies. Both business and consumer confidence had continued to deteriorate during October. Survey indicators of export orders had been very weak for some time, but the domestic activity indicators had fallen sharply in the latest month, and this had extended to services as well as manufacturing; the CIPS measure of incoming new business, for example, was below 50, although business expectations remained quite buoyant. There had not been such an abrupt change in sentiment in manufacturing - as measured by the CBI Industrial Trends Survey of business optimism - since the early 1980s. It was, however, difficult to make comparisons with the past as there were now many more surveys, mostly with relatively short histories.

3 The Bank's regional Agents had for some time been indicating that the economy was slowing, but their reports over the past two months indicated a sharper slowdown. The Committee noted that the Agents had identified evidence of the downturn in the early 1990s before it had become apparent in the official data.

4 This latest evidence suggested that the slowdown was more marked than predicted in the Committee's August central projection, although measured GDP growth in Q3 was slightly stronger than expected. In judging how much weight to place on survey data, the Committee discussed

possible causes and its consistency with recent data on demand and activity.

5 One source of accumulating stress had been the substantial appreciation in the real exchange rate from mid-1996. This had not immediately hit confidence, in marked contrast to some earlier episodes when sterling had risen sharply, for example in the 1970s and early 1980s. And its impact on net trade had in fact taken much longer to emerge than the Bank had originally expected. There were various possible explanations for this, each of which probably had some validity. Some firms had initially had in place financial market hedges against currency movements, but anecdotal evidence suggested probably not much beyond a year. Similarly some firms would have enjoyed a degree of stability until contracts with overseas trading partners matured and were renegotiated. There might also have been a delayed effect where plans and major investment and expansion projects were reviewed at infrequent intervals. And, more generally, businesses had had to judge how persistent sterling's appreciation would be. As discussed at previous meetings and in earlier *Inflation Reports*, these and other factors might have contributed to long lags in the impact of sterling's appreciation on export volumes. As the effects became evident, the implications for the economy generally of a slowdown in the trade of externally exposed businesses might have become more apparent to firms in relatively more sheltered sectors and to consumers. For example, just as a buoyant services sector and strong domestic demand growth had probably helped to sustain growth in manufacturing for a while, so services would not be insulated from a manufacturing slowdown.

6 In the absence of other factors, the slowdown brought about by sterling's appreciation and the tightening of monetary and fiscal policy could plausibly have been associated with a gradual decline in domestic sentiment rather than the sharp fall indicated by surveys. But the world economic outlook had been affected over the summer by a series of adverse shocks, which would further reduce external demand for UK exports and sharpen price competition from imports. Confidence in the financial services industry had been hit; optimism in the financial sector, as measured by the CBI Financial Services Survey, was lower in 1998 Q3 than for eight years. Well publicised job cuts in a range of sectors, whether or not directly affected by general economic conditions, had probably increased awareness of the changing outlook.

7 The preliminary official estimate suggested that Q3 GDP growth was unchanged at 0.5%, still close to trend. But the latest industrial production numbers showed that output had recently been

falling; in particular, manufacturing output fell by 1.1% between July and September, with falls in most parts of the production industries. These numbers were more consistent with what recent surveys had been indicating, and gave grounds for thinking that the Q3 GDP number might be revised down. Separately there were signs in recent surveys - for example in the monthly CBI Industrial Trends Survey and the CBI Distributive Trades Survey - that recent output growth might have been associated with greater than planned stockbuilding, with production not yet fully adjusted to weakening demand.

8 On the expenditure side, the Committee noted that the latest data showed falling retail sales growth, and lower turnover in the housing market compared with a year ago. Despite the recent sharp rebound, the equity market was 15% lower than its peak in July, which would tend to reduce consumption growth via its effect on households wealth, and reduce investment demand via a higher cost of capital.

9 There were, therefore, signs in the data that a slowdown, as indicated by surveys, was occurring. The direction of change was clear. But it was quite possible that the surveys were painting too bleak a picture. For example, the equity market had not fallen to a level that would reduce consumption to the extent suggested by surveys. And the surveys had historically been more volatile than recorded output and so could mislead. Moreover, the tone of some public comment had moved from predicting a slowdown through a downturn, to a recession and even a slump. That was extreme, and might be contributing to deteriorating confidence. It could, therefore, have some effect on spending.

10 In the light of all these considerations, the Committee judged that the forward-looking evidence from surveys and the Bank's regional Agents should be given increased weight in assessing the outlook for activity and inflation. The Committee thought that the economy should, however, be better placed to face adverse shocks than in the early 1990s, in large part because both corporate and personal sector balance sheets (especially in the housing market) and liquidity were stronger now than then, and inflation had already reached the target. Moreover, monetary growth remained robust. The most likely outcome was for continuing positive output growth in 1999, though at a lower rate than expected in August, and the downside risks had increased.

Implications of the world economic environment

11 The international environment remained fragile. There was still considerable uncertainty about the prospects for recovery in the Japanese economy. The recession there was deeper than had been assumed in the Committee's August forecast. Most forecasters had revised down their projections for continental European growth. According to the initial estimate, Q3 growth in the United States had been stronger than expected, although some of that strength might be the result of involuntary inventory accumulation. US broad monetary growth remained quite strong. The risks of further contagion and shocks to emerging market economies seemed to have reduced somewhat over the past month, and the extreme uncertainty in some markets had lessened, perhaps helped most recently by the G7 statement.

12 An important element of the Committee's analysis was the deteriorating outlook for world trade given the poor prospects in Japan and some emerging market economies. Between 1980 and 1993 world trade had grown at an average annual rate of 4%. This had risen to around 9% in 1994-97, but was projected by the international organisations to fall to 4-6% over 1998-2000. Part of the expected fall was attributable to (perhaps temporarily) reduced intra-Asian trade, which had accounted for much of the earlier increase. The Committee thought that the near term growth rate of the UK's export markets should fall by less than overall world trade. But on the other hand the strength of sterling, although less pronounced than in August, was likely to mean that UK exports would grow less quickly than UK export markets over the forecast period. The Committee agreed that it was most likely that net trade would contribute negatively to output growth over the next two years.

13 The weakening in the external environment had also had a material effect on world prices. Commodity prices were still falling, as were input prices more generally. Looking forward, the expected rate of world price inflation had fallen compared with a quarter ago, reducing expected imported inflation and thus the outlook for RPIX. This was an important factor in the Committee's inflation projection. In addition, domestic output price inflation was at its lowest level since 1975. Both CBI and BCC surveys indicated further falls.

The labour market

14 The Committee discussed a range of labour market indicators. LFS employment had risen quite strongly in the three months to August, as had total hours worked. On the other hand, LFS unemployment had increased slightly. The number of economically inactive people had fallen. Overall the latest quantity data suggested that conditions were still tight but might no longer be tightening.

15 Earnings growth was a key indicator of domestically generated inflation. While labour market pressures should abate and earnings growth ease as the economy slowed, the implications for inflation would also depend on the current rate of earnings growth. There was greater than normal uncertainty about this, given the problems with the Average Earnings Index (AEI). The Committee agreed to reflect this in its forecast variance.

Monetary and credit conditions

16 The future path of interest rates expected by the market was lower than a month ago, and much lower than at the time of the *August Inflation Report*. Taken together with the Committee's 25 basis point cut at its October meeting, this had delivered some easing in monetary conditions.

17 Sterling had fallen 4¼% from the 15-day average used in the projections published in the *August Inflation Report*. This would tend to reduce the restraining effect on inflation from sterling's earlier appreciation. The Committee judged that the balance of risks was still in the direction of sterling falling by more than assumed in its central projection, although the downside risk was not as large as in August.

18 The Committee noted that broad money and credit growth remained robust. High broad money growth remained an upside risk to the inflation outlook. Unsecured lending to the personal sector continued to grow rapidly, although the macroeconomic consequences were possibly not great as it accounted for only around 20% of the stock of lending to the personal sector.

19 Of more immediate interest was whether there were signs of a material tightening in credit conditions. The spread of corporate bond yields over government bond yields had increased significantly since the Russian and Long-Term Capital Management crises, corporate issuance was lower than usual, and actual and implied volatility were higher in a number of markets. But, perhaps in contrast to the United States, there was no evidence that the credit process had been significantly interrupted in the United Kingdom. Corporate bond and swap market spreads had eased slightly from the peaks, but were still high by previous standards. There had recently been some domestic corporate bond issuance in sterling, as well as a more marked return of issuance in international bond markets. Perhaps more significantly, UK banking markets seemed to have been less affected by the turbulence than capital markets. Conditions in wholesale money markets seemed reasonably calm. The syndicated credit markets had remained open; spreads had risen in this market too, but by rather less than in capital markets. The September M4 numbers did not suggest emergency drawing down of deposits, and showed continued robust growth in lending to the corporate sector. It was possible that that reflected reintermediation into the banking sector of some borrowing that would previously have been undertaken in the capital markets. This was widely believed to be occurring in the US, but dependence on capital market borrowing was much greater there. Evidence of this happening in the United Kingdom was less clear. The UK banking sector was, on the basis of currently available information, well capitalised by the standards of recent decades and so prospectively capable of reintermediating credit flows if that were to prove necessary.

20 The Committee agreed that so far there was no evidence of a 'credit crunch' in the sense of a material tightening of credit conditions for a given general level of interest rates and borrower credit risk. The environment had nevertheless changed somewhat. On the one hand, the general level of medium-longer maturity interest rates had fallen in recent months, so that the level of nominal yields (and probably real yields) on corporate bonds had fallen for at least the highest credit ratings, notwithstanding the widening of spreads. This would tend to be supportive of activity. On the other hand, as the economy slowed and as the shocks from the external environment affected the UK, the creditworthiness of some borrowers was deteriorating, which would affect the terms on which they could obtain credit. The corporate sector as a whole was, however, stronger financially than in the late 1980s-early 1990s, and thus should generally be better able to withstand a downturn.

21 The Committee agreed that world financial markets were calmer than a few weeks earlier. But the possibility of a tightening of credit conditions in the future needed to be kept under careful review.

The MPC's November forecast

22 The Committee reviewed its forecast, which was described fully in the *Inflation Report* published in the week following the meeting.

23 The general shape of the projections was as follows. Output growth was expected to fall for a year or so before recovering, principally via stronger domestic demand growth. In the second half of the forecast period and beyond, an important source of this increased demand was public sector consumption and investment, but there was some uncertainty about the timing of public investment spending. The balance of risks to activity were on the downside, largely on account of the external environment and risks to consumption. The central projection for inflation rose somewhat in the short run before falling. The balance of risks to the inflation outlook were modestly on the upside until mid-2000 and then modestly on the downside, but overall closer to neutral throughout the forecast period than in August when the balance of risks had clearly been on the upside.

24 There was a more important difference from the August forecast. For any given level of interest rates, the level of the projections for output growth and inflation were now both lower. If interest rates were left at 7.25%, the central projection for inflation would undershoot the target at the end of the forecast period.

25 The Committee discussed whether there were any major eventualities not captured in the forecast. It had increased the short-term uncertainty underlying the published projections to reflect the problems with the AEI numbers, but it was very difficult to judge the degree of extra uncertainty created. It was possible that further adverse news about the world economy could dent the outlook for output growth still further. And it was possible that weak world price inflation and the fall in domestic inflation expectations would have a bigger than assumed impact on RPIX. On the other hand, the recent recovery in the equity market meant that at the time of the meeting equity prices were 6% higher than the 15-day average used in the forecast. Overall the Committee felt that the important

factors were reflected in the forecast.

26 The Committee noted that the shape and level of the projections were different when made using market expectations of the likely path of interest rates (as derived from the short sterling futures contract adjusted for the typical premium between unsecured interbank deposit rates and gilt repo rates). Faster growth was implied, and a central projection for inflation which was above the target throughout 1999 and 2000. The *Inflation Report* would show the difference between projections based on constant interest rates and market rates (as at 4 November).

27 The Committee discussed the predictions of a sample of outside forecasters. The average forecast of GDP in the year to Q4 1999 was down by one percentage point since August. Most forecasters predicted recovery in 2000. Inflation profiles were generally lower than three months ago. The average of outside forecasts was similar to the Bank's central projection.

Tactical considerations

28 While reiterating its earlier expressed view that there could be no mechanical or precise link between the forecast and policy settings, the Committee agreed that its latest forecast clearly pointed to a further cut in official interest rates. Before turning to the immediate policy decision, members first discussed a number of tactical considerations.

29 Was there a case for delaying part of any desired rate cut on the grounds that some of the uncertainty about the earnings data should be resolved by the December or January meetings? The Committee agreed that this should not affect its immediate decision. It would need to take account of the new information about earnings as and when it became available, changing interest rates then if necessary.

30 What would be the impact of different sized cuts on confidence and expectations in the real economy and financial markets? A range of views was expressed on this. One possible view was that, taken in isolation, a cut of more than 25 basis points might create the misleading impression that the outlook was worse than implied by the Committee's central projection on the grounds that (i) financial markets thought the most likely outcome of the meeting was a cut of 25 basis points; and

(ii) the Committee had so far moved (in both directions) in steps of 25 basis points. But, against this, any move would in fact be followed by publication of the *Inflation Report* a week later. Whatever the Committee's decision, policy would then be seen in the light of its forecast for inflation.

31 A second possible view was that there would be positive merit in moving by more than 25 basis points in order to display that, as the Committee had said before, it was prepared to move in larger steps. The Committee agreed that while that might be a welcome by-product of a cut of more than 25 basis points, it could not be part of the reason for such a cut, which had to depend on its assessment of the inflation outlook. A similarly welcome by-product, but again not one that could affect the decision, was that a larger than expected cut would underline the symmetry of the Committee's remit, ie that a prospect of falling below the 2½% target was taken as seriously as exceeding the target.

32 A third possible view was that the Committee should err on the side of a larger cut in order to underpin business and consumer confidence in the economy. Against this it was felt that, whatever its size, the effect of a reduction in interest rates on confidence would depend on the justification for it. The Committee also needed to bear in mind that the larger the cut, the more likely it was that sterling would fall, which would tend to increase the price level and thus temporarily increase future expected inflation.

The immediate policy decision

33 By way of background, the Committee noted that over the past six years the economy had on average grown above trend, and until quite recently had still been growing at a rate that could not be sustained given the economy's productive capacity. That had been the justification for the past tightening of monetary policy. Relatively high short-term real rates of interest, fiscal policy tightening and the appreciation of the exchange rate had all helped to keep inflation in check, but it had still not fallen below 2½%, which was indicative of the strength of domestically generated inflationary pressures. Since August there had been a lot of news affecting the outlook for activity and inflation, including the fall in sterling, the shocks to the world economy, and the evidence from surveys and the Bank's regional Agents of a sharp fall in business and consumer confidence. The extent of the lags between these developments and their effect on growth and inflation was highly

uncertain, but they implied lower activity growth and inflation than expected in August.

34 Against this background, the Committee discussed the arguments for interest rate cuts of 25 basis points, 50 basis points, and of up to 75 basis points.

35 Possible arguments identified for a 25 basis point cut were that the unusually high uncertainty about the earnings data pointed to caution in any move; that the Committee should avoid surprising financial markets given the risk of sterling falling if it did so; and that the Committee should avoid taking actions that could be construed as trying to fine tune output growth in 1999. On the first of these points the Committee agreed that if the earnings data were substantially revised upwards the interest rate move might need to be reversed, but that was not per se an argument for moving in small steps now. On the second point, the Committee agreed that the risk of surprising the financial markets could not justify limiting the cut to a size that would leave the central projection for inflation materially below the target in the second year of the forecast. On the third point, the Committee agreed that monetary policy could not have a significant impact on output growth in 1999 given the lags in its effects. But this did not amount to an argument for a 25 basis point cut.

36 The arguments identified for a 50 basis point cut, supported in varying degrees by those members of the Committee who voted for this course of action, were as follows. First, on the central projection, with a 50 basis point cut inflation would rise slightly above the target before returning to around 2.5% at the two year horizon, with the risks initially on the upside and later on the downside, and with uncertainty greater at the longer horizons. By contrast, if rates were cut by 75 basis points, inflation would be above the target throughout the year 2000 on the central projection and up to the third quarter of 2000 even if the balance of downside risks assumed in the forecast materialised. Second, a larger cut might cause sterling to fall by more than was taken into account in the forecast. Third, notwithstanding the opportunity to explain any policy decision in the following week's *Inflation Report*, there could well be a prolonged effect on perceptions of the Committee's assessment of the outlook, with a risk that people, businesses and markets mistakenly concluded that the Committee knew something that it had not disclosed about the outlook.

37 Among those members favouring an immediate 50 basis point cut, there was a range of views on the likely future course of policy. On one view, it was more likely than not that further cuts would at

some point be needed, but the lags in the economy meant that it was not optimal to make those cuts now. It was argued that further cuts could over time be necessary because at 6.75% official rates would still most probably be above the “neutral” rate implied by an equilibrium real interest rate and the 2½% inflation target. It was also possible that the near-term downward pressures on UK domestic prices might be greater than reflected in the projection. On another view, the short run outlook for future policy was more evenly balanced, bearing in mind continued domestically generated inflationary pressures.

38 The arguments identified for a cut of up to 75 basis points were as follows. First, given that the balance of risks to inflation was on the downside at the end of the forecast period, inflation could be expected to undershoot the target in about two years’ time if rates were cut by only 50 basis points. The size of cut should take account of these risks. A cut of more than 50 basis points – possibly 75 basis points, possibly in between – could be viewed as taking out insurance against those risks, with the precise size depending on the weight given to the downside risks and the value placed on insurance. Second, a larger cut might fortify otherwise fragile business and consumer confidence, helping to guard against the effects of encircling gloom and thus worse outcomes than featured in the Committee’s forecast. Third, while a larger cut might well surprise the markets, it could be carefully explained in the *Inflation Report*, so that the cost of any surprise should be short-lived. Fourth, cutting by more than 50 basis points was preferable to cutting by 50 basis points with an expectation of making further cuts later.

39 The Governor invited members of the Committee to vote on the proposition that the Bank’s repo rate be cut by 50 basis points to 6.75%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Alan Budd, Charles Goodhart, DeAnne Julius, Ian Plenderleith and John Vickers) voted for the proposition. Willem Buiter voted against, preferring a cut of 75 basis points.

40 The following members of the Committee were present:

Eddie George, Governor

Mervyn King, Deputy Governor responsible for monetary policy

David Clementi, Deputy Governor responsible for financial stability

Alan Budd

Willem Buiters

Charles Goodhart

DeAnne Julius

Ian Plenderleith

John Vickers

41 Gus O'Donnell was also present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 30 October 1998, 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 Financial markets

Foreign exchange

A2 Between 6 October and 8 October, \$/yen had fallen from 132 to 112. DM/yen had fallen by almost as much. The trigger for these unusually large fall may have been the perception that progress was being made to resolve the banking problems in Japan. Poor liquidity had exacerbated the fall in the \$/yen exchange rate, as participants who had borrowed cheap yen to fund positions elsewhere had attempted to unwind their positions. After that, the yen had stabilised, perhaps reflecting a perception that a rate just below 120 was closer to its 'equilibrium' value. One-month implied volatility for \$/yen had remained at historically high levels, even though it had halved since 8 October. The dollar had also fallen against other major currencies in recent months, reflecting expectations of interest rate cuts (which had been borne out) and concerns about the impact on the US trade balance of a Latin American recession. However, on a broader measure of the effective exchange rate the dollar had only fallen by 4%.

A3 The correlation between movement in the dollar and sterling had remained strong, and had possibly strengthened. The 8 October MPC announcement cutting rates by 25 basis points and the 14 October downward revision to average earnings had coincided with significant moves in sterling, although the former came at the height of the \$/yen turmoil, which appeared to have exaggerated the upward move.

Government bond and money markets

A4 Implied interest rates had fallen at the short end of the yield curve following the MPC's 25 basis point cut in October, and again after the US cut. At longer maturities, the recovering equity market and sharp currency moves had been associated with higher yields. Most international bond markets had fallen following the sharp appreciation in the yen. At the same time, market participants in the United States and United Kingdom had begun to expect more aggressive monetary easing, and this had been reflected in less inverted bond yield curves. But the currency movements had also meant that some market participants had looked to close out their

positions and, coupled with poor liquidity, these technical factors had probably exacerbated the yield changes. Implied volatility in the long gilt future had fallen from a peak of around 13%, but had remained high, and futures turnover had fallen, suggesting that the markets remained less liquid than usual.

A5 In the futures market, implied interest rates had fallen by about 30 basis points since the previous MPC meeting, whereas longer contracts had been at roughly the same level, implying that the market had brought forward when it expected rates to be cut, but not the extent of the easing it expected. There had been a spread of 100 basis points between current three-month Libor and the short sterling March contract, implying that significant cuts in rates were expected before Easter. A few market participants had expected a 50 basis point cut in November, although most had anticipated 25 basis points.

A6 The spread between interbank and CD rates and gilt repo had been unusually high in late October. This could be argued to have understated the rise in credit risk premia demanded by the market, because some weaker credits might have withdrawn from the market. On the other hand, an increase in short term deposits at the major banks, subject to sterling stock liquidity requirements, would have tended to increase their demand for liquid assets including repo, and this could have worked to widen the interbank-repo spread.

Equity markets

A7 Equity indices had risen since the previous MPC meeting in most international markets. In the United Kingdom, the relative fall in banking sector share prices in September had been reversed, while indices for utilities, property and food retailers, which had been seen as ‘safe havens’ during market turbulence, had underperformed the market. Implied volatilities for the FTSE 100 and S&P 500 had declined from their September peak, but remained above their 1998 averages. Analysts’ forecasts for growth in earnings per share over the next year had declined further. But analysts’ longer-term outlook for growth in earnings per share had remained constant, as they had done for most of 1998. The number of profits warnings had been higher than a year earlier, with concerns about demand and problems in emerging markets frequently cited as reasons.

II Monetary and credit conditions

Monetary Quantities

A8 The (provisional) twelve-month growth rate of notes and coin (adjusted for 50p and £2 coin effects) had been 5.2% in October, compared with 5.7% in September. The three and six-month annualised growth rates had also fallen in October. Annual growth in broad money (M4) had been

9.0% in September, compared with 8.7% in August. M4 growth in the third quarter of 1998 had been slightly up on the second quarter (2.2% in Q3, compared with 2.1% in Q2).

A9 Households' M4 had grown by more in September (£1.6 billion) than in August (£1.1 billion), with the twelve-month rate at 6.1%. The twelve-month rate of growth of M4 of Other Financial Corporations (OFCs) had been 19.2% in September. According to the Merrill Lynch survey of fund managers, the ratio of cash to portfolio value of Insurance Companies and Pension Funds (ICPFs) had risen from 4.9% in September to 6.9% in October.

A10 The slight pick-up in annual growth in aggregate Divisia in the third quarter (7.8%, compared with 7.7% in the second quarter) had been broadly similar to the pattern in the M4 data. Within the aggregate, household Divisia growth had been unchanged in the third quarter at 6.6%; the annual growth in OFCs' Divisia had fallen back from 16.8% in the second quarter to 16.2% in the third; and the growth in Divisia of Private Non-Financial Corporations (PNFCs) had increased from 5.6% to 7.5% in the third quarter.

A11 Aggregate M4 lending had been £6.2 billion in September, similar to August (£6.6 billion). M4 lending to households had been increasing, with three and six-month annualised growth rates higher than the annual growth rate of 7.4%. Within lending, annual growth in total secured lending to individuals, at 5.9%, had picked up slightly in the third quarter. There had been a third consecutive monthly fall in the number of loan approvals for house purchase in September. The annual growth in unsecured lending to individuals had remained strong (19.0% in the third quarter) and net credit card borrowing had also increased in September (by £439 million compared with £406 million in August), with the twelve-month growth rate at 26.5%. There had been anecdotal evidence of a modest rise in arrears. The twelve-month growth rate in lending to OFCs had been weaker in September, with a flow of £1.7 billion compared with £2.1 billion in August, with the annual rate of growth at 16.6%.

Monetary prices

A12 The 8 October cut in the Bank's repo rate had not yet been passed on by banks and building societies into standard variable-rate mortgages; but many had announced that they would reduce standard variable rates from November. In the secured market, fixed rates on mortgages had continued to fall, reflecting falls in comparable swap rates.

A13 There was no direct measure of ex ante short-term real interest rates, but a measure could be constructed using the Merrill Lynch survey of fund managers' short-term inflation expectations for the end of 1999. This suggested that the real forward rate for 1999 had fallen from 4.3% in September to 4.1% in October.

Have UK corporate credit conditions tightened?

A14 Bank staff had examined whether the UK company sector had experienced a tightening in credit conditions. Spreads on corporate bond yields over gilts had fallen since the previous MPC meeting, although they had remained at high levels relative to the 1990s average. Similarly, US corporate bond indices had shown the credit spread on investment grade bonds to be at or near their highest levels in the 1990s. A similar picture had emerged when looking at spreads in the swaps markets, both in the United States and the United Kingdom.

A15 The syndicated loan market remained open, although spreads had widened by about 10 basis points for higher grades and more for lower-rated companies. Conversations with market participants had suggested that some loan demand had been deferred; others had borrowed before the recent turbulence hit the markets, and thought that it might be more difficult to borrow now.

A16 Bankers had reported there had been no material change in the terms applied to customers of a given risk. However, the creditworthiness of some firms had fallen with the worsening in the economic outlook. A survey of major clearing banks had revealed that the demand for finance from small firms had been steady in the past six months, and for large firms had, if anything, increased.

A17 Annual growth in PNFCs' M4 deposits had been 6.5% in the third quarter, compared with 5.9% in the second quarter. Growth in M4 lending to PNFCs had risen in the third quarter, to 6.0% compared with 5.1% in Q2. Neither had suggested a rationing of credit, nor an emergency drawdown of deposits. Total external finance had been steady at £3.2 billion in September.

A18 One question had been whether the banking system's capital could support a material reintermediation of credit if capital market borrowing remained low for a prolonged period. The capital positions of the large UK banks in 1998 H1 had shown risk-asset ratios above the Basle 8% minimum.

A19 Other evidence from the CBI Industrial Trends Survey in October 1998 had shown that 6% of firms thought that constraints on external finance might limit their ability to undertake investment. This had been the highest proportion since January 1993. But uncertainty about demand had been reported as a larger constraint on investment (56%, compared with 50% in September).

A20 As to the financial strength of the corporate sector if credit conditions were to tighten, PNFCs' capital gearing in 1998 Q2 (defined as the ratio of net debt outstanding to the market valuation of the capital stock), at 24.5%, was well below its previous peak (41.4% in 1990 Q3). However, this partly reflected the rise in equity prices in recent years. PNFCs' income gearing, at 20.9%, had been well below the peak of 39.0% in 1990 Q2, although it had risen from the low of

16.7% in 1996 Q2 to 20.9% in 1998 Q2. This had probably been related to repo rate rises over the period, and weakening profits. Unlike companies in the United States, PNFCs in the United Kingdom had modest non-equity capital market obligations, compared with their liquid assets.

III The international economy

A21 In the United States, a slowdown in the real economy had become more evident. Quarterly consumption growth in 1998 Q3 had slowed to 1.0% from 1.5% in both Q1 and Q2, and investment growth had fallen to 0.4% in Q3, from 4.7% in Q1 and 3.1% in Q2. Overall, US GDP had grown by 0.8%, to 3.4% higher than a year before.

A22 Industrial production in the United States had fallen by 0.3% in September, to 2.5% higher than a year earlier. Capacity utilisation had been 81.1% in September and, although distorted by the GM strike, had been trending lower since the end of 1997. The NAPM index had fallen to 48.3 in October, from 49.4 in September. The US trade balance had widened to \$16.8 billion in August from \$14.5 billion in July. This had been because of a larger goods deficit; the services surplus had remained little changed. Export volumes had fallen year-on-year for the second consecutive month, while the growth in import volumes had slowed. US consumer confidence had fallen by 9 points in October, its fourth consecutive monthly fall, to its lowest level since October 1997. Annual CPI inflation had fallen to 1.4% in September from 1.7% in August, and annual average earnings growth had fallen to 4% in the year to September, from 4.1% in August. The IMF had forecast US GDP growth to be 2.0% in 1999, down from 3.5% in 1998.

A23 In the prospective euro area (EU11), industrial confidence had fallen further in August and September in most member countries. Industrial production had rebounded in Germany, rising by 3.1% on Q2, but had fallen back in France (-0.1%) and Italy (-0.9%). Consumer confidence in the EU11 had fallen by 1 percentage point between July and September. Annual EU11 consumer price inflation on the harmonised measure had fallen to 1.0% in September down from 1.2% in August. Harmonised inflation had fallen in Germany (to 0.6%) and France (to 0.5%). Money supply across the EU11 had grown by 4.7% in the year to July, down from 5.7% in June.

A24 Japan's industrial production had fallen 8.4% in the year to September. Inventories had fallen by 1.8% over the year. Total employment had fallen by 1.1% over the year to September, with job losses concentrated in the construction and manufacturing sectors. Retail sales in Japan had fallen by 5.1% in September from a year ago. Imports had fallen by 9.3%, while exports had grown 3.9% over the year to September. Japan's trade surplus with the United States was ¥ 0.7 trillion in September, and ¥ 0.4 trillion with the European Union. Deflationary pressures had been continuing - wholesale prices in September had fallen by 1.5% on an annual basis, and annual consumer price inflation in September had fallen to -0.2%. The IMF had forecast a fall in GDP in 1998 of 2.5% and a rise of 0.5% in 1999.

IV Demand and output

A25 The preliminary estimate for GDP growth in 1998 Q3 had been 0.5%, the same rate as in Q2. The annual rate of growth had slowed from 3.0% in the year to Q2 to 2.5% in the year to Q3. Service sector output had grown by 0.6% in Q3, the same rate as in Q2. Manufacturing output had fallen by 0.6% in August and 0.4% in September. Survey evidence had suggested that the fall in manufacturing output would be the beginning of a sustained decline. Manufacturing output over the third quarter had fallen slightly, by 0.1%, in contrast to ONS indications in the GDP preliminary estimate for the third quarter of 'a small increase'. This had raised the possibility of a downward revision to GDP growth in 1998 Q3.

A26 The boost to GDP growth from utilities output in 1998 Q2 had not unwound in Q3 so the level remained relatively high. Monthly industrial production data had shown that electricity, gas and water supply had increased by 1.1% in 1998 Q3, though output had fallen by 1.6% in September. The ONS had also reported that construction and agricultural output had risen overall in Q3.

A27 On the expenditure side, retail sales had fallen by 0.4% in September, having increased in the previous two months. Annual growth over the latest three months had increased to 3.1% in September from 2.4% in August. This had partly reflected weak sales in September 1997. Nonetheless, ONS data had suggested that, although slowing, growth had remained above average, a stronger out-turn than indicated by either the CBI Distributive Trades Survey or data from the British Retail Consortium. Quarterly growth in retail sales volumes in Q3 had been 0.7%, compared with 0.2% in Q2 (though consumption of retail goods in the National Accounts had increased by 0.9% in Q2). Services consumption had fallen in Q2, because of lower catering and financial services spending. Output data so far available had suggested that another fall in the third quarter was unlikely. Overall, it was possible that household spending would increase by more in Q3 than in Q2 (0.4%).

A28 Analysis of surveys of consumer confidence supported a picture of an underlying slowdown in consumption growth. The GfK and MORI surveys had declined further in October. The MORI balance had fallen to -46 from -37 in September, as low as in October 1992 and September 1990. The aggregate GfK balance had fallen to -8.2, 18 points below its recent peak. In the past, the level of consumer confidence had been a timely, coincident indicator of household spending growth. The recent deterioration in the GfK survey had been because of deteriorating sentiment about the general economic situation. Perceptions about households' own situations had held up better. Analysis had shown that survey responses to general economy-wide questions had been, if anything, better correlated with spending growth in the past than household-specific questions. Analysis had also suggested that consumer confidence contained additional information about

spending over and above other determinants of consumption such as income, wealth etc; and that it had some predictive power for future spending as well as current spending.

A29 The Halifax and Nationwide prices indices had both recorded increases in October. But housing turnover had fallen in September, with particulars delivered 5.7% lower than a year ago, though 4.8% higher over the latest three months than the previous three months. Net lending secured on dwellings had fallen in September, leaving the twelve-month growth rate unchanged at 5.8%; and loan approvals had fallen to their lowest level in 1998. Survey data from RICS and HBF had also indicated activity moderating.

A30 Service sector investment intentions for plant and equipment had fallen from a balance of +27 to +14 in the latest British Chambers of Commerce (BCC) survey, though they had remained around their average level since 1989. Manufacturing investment intentions had fallen from a balance of +13 in Q2, to 0 in Q3. In the October CBI quarterly Industrial Trends Survey, the balance had fallen from -21 to -32 for plant and equipment, and from -26 to -36 for buildings. However, construction orders had remained relatively high, rising by 6% in the three months to August. The CIPS Report on Construction had indicated falling orders in October for the first time this year, although the optimism index had remained strong.

A31 There had been some evidence of rising stocks in the manufacturing and retail sectors in survey data. The CBI Industrial Trends Survey had reported a rise in the balance of firms reporting excessive stocks (+26 in October). The CBI Distributive Trades Survey had recorded a higher balance of retailers reporting high stocks relative to expected sales: +23 in October, compared with an average balance since 1992 of +19. Retailers were likely to unwind any excess inventories fairly quickly.

A32 The PSNCR had been £1.6 billion in September, and £2.7 billion over the first six months of the financial year 1998/9. Spending had been 2.7% higher over the first six months of 1998/9 compared with a year earlier. This had suggested continued growth in government consumption in 1998 Q3.

A33 Goods trade data had pointed to a negative contribution from net trade in 1998 Q3. There had been little change in the trade deficit in August: £1.2 billion compared with £1.4 billion in July (excluding oil and erratics). The deficit with EU countries had narrowed, while the deficit with non-EU countries had widened. And there had been a large increase in the deficit with non-EU countries in September. Import and export volumes had both increased in the three months to August, but imports by more. For 1998 Q3 as a whole, imports from non-EU countries had risen by 4.6%; exports had fallen by 0.7%.

A34 Surveys suggested that business sentiment had continued to weaken. The BCC survey had reported negative balances for home deliveries and home orders in the manufacturing sector of -12 and -16 respectively for Q3, compared with +3 and +2 respectively for Q2. And there had been further sharp falls in export orders and deliveries. This had brought the BCC survey more in to line with the CBI survey, both indicating further falls in manufacturing output. BCC services balances had remained positive, but had fallen. Home orders and deliveries balances had fallen for the third consecutive quarter, and by the largest degree between Q2 and Q3 since the previous recession, consistent with a slowdown in services output growth in Q4.

A35 There had also been a further decline in CBI Industrial Trends survey balances. The business optimism balance had fallen to its lowest level since July 1980. This might be a better indicator of output in the manufacturing sector rather than GDP given the nature of the downturn. Sentiment towards exports had stabilised, but at very low levels. In contrast, indicators of domestic activity had fallen sharply: the reported output balance from -4 to -30, expected output from -8 to -29. The CIPS Report on Manufacturing output index had fallen to 41.6 in October, a new low, and the largest monthly fall since the survey began in 1991. The CIPS Report on Services had shown the first fall in the incoming new business index since the survey began in mid 1996. And the outstanding business index had continued to fall, and by its largest amount in October (44.9).

V Labour market

A36 The Labour Force Survey (LFS) measure of employment had risen by 122,000 (0.5%) in the three months to August, compared with the previous three months. If anything, the rate of increase had appeared to be rising - the average quarterly increase over the past year had been 77,000. Thus the contrast between the strength in LFS employment and the weakness in recent Workforce Jobs figures had become even more marked, though more weight should be attached to the LFS figures (given their lower sampling variance and the possibility of special factors affecting the Workforce Jobs data). The increase in LFS employment in June to August had reflected a large 222,000 (0.9%) increase in employees, partly offset by a 94,000 (2.9%) fall in the numbers self-employed. And it had been more than accounted for by an increase in full-time employment (part-time employment fell slightly). Total hours worked had increased by 0.6% over the quarter, so hours per head were broadly unchanged.

A37 Turning to survey information, the CIPS October surveys had suggested that employment growth in services had been weakening but remained positive, construction employment had been unchanged, and the rate of job loss in manufacturing had been increasing. This sectoral picture was broadly consistent with reports from the Bank's regional Agents. The BCC survey for Q3 had shown a fall in employment intentions in services, though they had remained positive, while the balance of manufacturers expecting to recruit staff had fallen sharply to almost zero. The CBI

Industrial Trends Survey for Q3 had also shown a large deterioration in manufacturing employment intentions, the seasonally adjusted balance falling to its lowest level since 1993.

A38 New notifications of vacancies had risen by 4,000 in September, with the stock of vacancies broadly unchanged. National press advertising had risen to another high in August, reflecting sustained demand for staff at the top end of the labour market. The FRES report had showed that recruitment agency business had continued to increase in September, but the rate of growth had fallen back to its weakest this year. The BCC survey had shown some easing in recruitment difficulties in both manufacturing and services, though they still persisted. And the CBI Industrial Trends survey for Q3 had shown a further fall in the balance of manufacturers quoting skill shortages as a factor likely to limit output.

A39 LFS unemployment had increased by 9,000 in the three months to August, compared with the previous three months. The rise had partly reflected a 28,000 increase in unemployment among 16-17 year olds. Despite the rise, the rate of LFS unemployment remained unchanged to the nearest decimal point at 6.3%. The claimant count had continued to fall in September (by 12,000), with part of the fall likely to have reflected a New Deal effect.

A40 According to LFS figures, the number of economically inactive people of working age had fallen by 93,000 in the three months to August, which contrasted with the increases recorded in the previous three quarters.

A41 The ONS had announced a further set of revisions to the earnings data on 14 October following a rebasing exercise, which had resulted in significant revisions to the earnings data going back to 1991. The key factors behind the revisions had been: the use of new employment weights to aggregate earnings in different industries; the application of new grossing factors to firms in different size bands to make the sample more representative; and the use of a new public/private sector classification, which reflected legal as well as industrial status. However, there were a number of features of the revised data that had been difficult to understand and, partly for this reason, an external enquiry into the figures had been set up. The ONS subsequently issued a press release on 2 November suspending publication of the figures until it was satisfied about their quality.

A42 According to the revised figures, headline annual earnings growth had peaked in 1998 in June (at 5.2%), not in April as previously thought, and had dropped back to 4.6% in July. But more puzzling was that the revised series had suggested that aggregate earnings growth had fallen rather than risen in 1997, at a time when the quantities data had suggested that the labour market was tightening. This change in profile was more pronounced in the services data; the manufacturing profile was much more similar to the old data.

A43 Another puzzle in the revised data had been that they suggested that public sector earnings had accelerated from mid-1997, not grown at a broadly constant rate of around 2.5% to 3.0% as had previously been thought. On the new figures, headline public sector earnings grew by 4.6% in the year to July (up from 4.5% in June), which compared with private sector earnings growth of 4.7% (down from 5.4%).

A44 A further puzzle in the new data concerned bonuses. Previously it had been thought that irregular pay had constantly made a positive contribution to the annual growth of average earnings in 1997 and 1998. But according to the new figures, the contribution had been erratic, and the large positive contribution of bonuses and other irregular payments in March 1998, seen in the unrevised data, was no longer apparent.

A45 The revised figures had seemed difficult to reconcile with other measures of earnings, none of which had suggested weaker growth during 1997. The growth rate of the National Accounts measure of wages and salaries per head had increased during 1997-98, though these figures were partly derived from the Average Earnings Index and were therefore subject to be revised if the quality of the new series was confirmed. The Reward Index of earnings growth had also been stronger than the revised Average Earnings Index in 1997 and 1998, despite having dropped back recently (to 5.1% in September). And a comparison with figures from the annual New Earnings Survey also suggested that earnings growth in recent years had if anything been closer to the old average earnings series, than the revised one.

A46 The view that wage pressure had eased in 1997 was also not supported by evidence from wage settlements which had increased through 1997 and the early part of 1998. And there had been no evidence of a slowdown in wage settlements in recent months: the twelve-month employment weighted mean measure remained at 3.7% in September for the fifth consecutive month.

VI Prices

A47 Commodity prices had continued to fall in September. The Bank index excluding oil had fallen by 0.6% in September, mainly because of metals and food prices. The index had fallen by 18% since its peak in March 1996. But United Nations data had suggested that the recent weakness of commodity prices relative to consumer prices was in line with the trend change over the previous thirty years. Input price deflation had persisted: prices had fallen by 1.1% in September and by 9.8% since September 1997. The price of Brent crude oil had fallen to \$13.19 a barrel by 28 October.

A48 Annual output price inflation had fallen to its lowest rates for over twenty years in September: output price inflation excluding excise duties (PPIY) to -0.6% (its lowest rate since

1975) and total output price inflation to 0.3% (its lowest rate since 1960). The CBI and BCC surveys had continued to suggest that output price inflation might fall further. Their weakness relative to the official data might have been explained by the split between gross and net output price inflation. The gross index, which includes intermediate prices within the manufacturing sector, had been falling, while the net index had risen slightly, implying intermediate price deflation. It was possible the survey balances had reflected gross output price deflation better than the net numbers published in the headline producer price index. Trade prices had also continued to fall. Export prices to the European Union had fallen by 0.4% in August. Import prices had fallen further in 1998 from countries outside the European Union (-9.4% in the year to September), but had remained broadly unchanged from other EU countries (-5.9% in the year to September).

A49 RPIX inflation had remained at 2.5% in September, while RPIY and RPI inflation had both fallen by 0.1 percentage point, to 2.0% and 3.2% respectively. RPIX services prices had risen by 3.5% in the year to September, up from 3.2% in August. That had reflected the reduction of the VAT rate payable on domestic fuel in September 1997, which had fallen out of the annual inflation rate. Household services had risen sharply, partly owing to private school fees. The HICP inflation rate had risen by 0.2 percentage points in September to 1.5%, whereas the RPIX inflation rate had remained unchanged. But the difference had been almost entirely due to rounding. The retail sales deflator had been revised as part of the rebasing of the retail sales index, which had been published since the previous MPC meeting. But annual retail sales price inflation had remained close to its previous rates and stood at 0.6% in September.

VII Reports by the Bank's regional Agents

A50 The Bank's regional Agents had undertaken a survey of their contacts on domestic credit conditions. They had asked whether the demand for finance had changed over recent months. 40% of respondents reported unchanged usage of finance, 48% increased use and 12% reduced use. Of those who had increased their demand for loans, some had done so because of deteriorating trading conditions. They had also asked whether firms thought that the terms and conditions of finance offered by banks had worsened. Most contacts had said that they had not. 10% of contacts had reported that they had recently had a loan request turned down. The Agents had also contacted local clearing bank representatives. They had suggested that they had for some time been seeking to improve loan quality and exercising more due diligence, and that this had not been connected with the recent turbulence in financial markets. Some contacts had reported that the terms of syndicated loans had tightened.

A51 Looking ahead, the Agents reported that contacts had expected credit conditions to tighten in the future as the economy slowed. Some respondents had thought that small and medium-sized enterprises would have been most affected by this. The Agents had also asked about the exposure of their contacts to emerging markets, which had appeared to be limited. For example, although

60% of manufacturing firms had some sales exposure, only 20% of these had more than 10% of their sales in emerging markets.

A52 The Agents also reported on general discussions with their contacts. The outlook for activity reported by manufacturing firms had been more in line with the deterioration recorded in the survey data than the most recent ONS data. All Agents had reported further declines in orders, and there were particular concerns about the first half of 1999. Export orders had remained extremely weak and some firms had reported a loss of domestic market share to importers. Services growth had continued to slow, and had spread to sectors such as catering and leisure. Retail spending had slowed, with firms reporting falling sales of clothing and household goods in late September and October. In the labour market, regional divergence had increased: skill shortages had persisted in parts of the service sector in the south-east of England, but elsewhere prospects had deteriorated.