

Publication date: 14 October 1998

MINUTES OF MONETARY POLICY COMMITTEE MEETING 9 and 10 September 1998

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 September 1998.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9809.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 no later than 6 weeks after each meeting. Accordingly, the minutes of the Committee meeting held on 7 and 8 October will be published on 21 October 1998.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 9-10 SEPTEMBER 1998

1. The Committee began by discussing recent world developments, particularly the problems in emerging market economies and the increasing weakness in Japan. On the domestic economy, the Committee contrasted the official output data with the picture presented by business surveys, and discussed the possible news in the latest data for earnings and monetary growth. Taking the external and domestic news together, the Committee considered the implications for its own inflation and output projections before turning to the immediate policy decision.

The world economy

2. The main developments in the world economy since the previous meeting had been the financial and political crisis in Russia and the continued deterioration of the outlook for growth in Japan. The Committee considered the direct trade linkages with Russia, the implications of changes in capital flows, the reaction in world equity, bond and money markets, the likely impact of weak commodity prices – especially for oil – and the outlook for world growth.

3. Looking at the direct effects on trade it was clear that Russia on its own would have a relatively small impact via trade linkages, accounting for just 0.7% of UK exports compared with 1.2% going to Latin America and 7.8% to Asia (excluding Japan). Following the unilateral restructuring of Russian debt there had been a sharp reaction in world financial markets. In particular there had been a global widening of spreads on corporate debt over risk-free assets, including for industrialised world companies exposed to the emerging market economies, which had raised the cost of capital. There had also been a large increase in bond yields for emerging-market sovereign debt. This would make it more difficult for those countries to finance external deficits and to refinance maturing debt. To ward off the threat of contagion, the policy response in a number of these countries had been to tighten monetary and fiscal policy, with deflationary implications for the world economy.

4. Capital flows to the emerging market economies were thought to have largely come to a halt. In the short-run the Committee thought that this could put pressure on the exchange rate pegs of a number of countries, causing further financial instability. Assuming that the change in capital flows persisted, there would have to be a corresponding re-balancing of trade flows, with smaller deficits/larger surpluses in emerging market economies and bigger deficits/smaller surpluses in the industrialised world. This in turn would require a higher real exchange rate relative to the currencies of the emerging market economies.

5. The Committee noted that, unfortunately, the industrialised countries were not well placed to expand demand appropriately. Ideally the largest increases in demand would come in Japan and then continental Europe, with less change in the United States and the United Kingdom which were already experiencing strong domestic demand and increasing trade deficits. In Japan – which had cut interest rates on the first day of the meeting (9 September), guiding call money rates down by 25 basis points to just 0.25% – little progress had as yet been made in restructuring the financial system and achieving sustained growth in domestic demand. In continental Europe, attention was focussed on the introduction of the single currency. National fiscal policy would be constrained by the Stability and Growth Pact, which might make any immediate expansionary policy response problematic.

6. In consequence, the Committee thought it was likely that the US and UK trade deficits would have to bear a large share of the burden, and that this could have exchange rate consequences. If the US and UK trade deficits continued to get larger, then the dollar and sterling effective rates could come under pressure, despite appreciating against the currencies of emerging market economies. The dollar had already weakened significantly. The sterling effective exchange rate had appreciated sharply immediately following the Russian crisis, to reach a peak of 106.9, but had fallen back to 103.5 by the start of the Committee's meeting.

7. The financial market reaction had included a fall in the major world equity markets of 5%-10%, and the FT-SE 100 index had fallen by around 10%. Committee members suggested that, in the aftermath of such events, it could be difficult for markets to establish new equilibrium prices, either for equities or for currencies. Consistent with this, there had been a marked increase in the volatility of asset prices. The Committee also considered that there might yet be further adjustment downwards in world equity markets, especially since price-to-earnings ratios remained high.

8. Market interest rates in the industrialised countries had fallen, consistent with a fall in expected future rates. This might indicate a degree of monetary easing. The expected starting level of official rates in the Euro-area, implied by future rates, had fallen from around 3¾% to 3.3% (the current level of official rates in France and Germany). In the United Kingdom, actual money market rates had fallen by one eighth of a percentage point for one-month London inter-bank rates, by one quarter of a percentage point on three-month rates and by half of one percentage point on twelve-month rates. Bond yields over one year had also fallen by up to half a percentage point.

9. One particular consequence of recent events was that world commodity prices were likely to remain weak, especially for oil. This in turn would put financial pressure on oil-producing countries at a time when OPEC was already struggling to agree reduced production levels. A reduction in oil and other commodity prices would constitute a change in the terms of trade, redistributing demand to the importers. It would also have favourable supply-side effects on employment and capital

formation. In the medium-run this would be beneficial to world growth. However, based on what had happened when oil prices fell in 1986, the initial effect could be to weaken world growth if, as then, demand fell faster in the oil exporting countries than it rose in the importing countries.

10. The Committee considered the impact of all these developments on the outlook for world output and prices. Within the last month forecasts for Japanese output growth in 1998 and 1999 had been revised down substantially and forecasts for other G7 economies were also being revised down for 1999. The Committee agreed that weaker world demand growth would result in excess capacity. These conditions of excess supply should result in lower world inflation.

The policy implication of external developments

11. The Committee discussed its reaction to an internationally co-ordinated monetary policy response, should such a proposal emerge. The Committee would consider changing interest rates if that were consistent with pursuit of the domestic inflation target.

12. It was not clear, however, that a co-ordinated monetary easing was the appropriate policy response in current circumstances. On one possible view, the current crises in emerging market economies reflected problems originating within those economies and were not caused by excessively tight monetary policies in the industrialised economies. Although faster demand growth in, say, the OECD countries might help alleviate some of the symptoms, it would not solve the fundamental problems in Russia. And any plausible changes in policy rates would be small relative to the rise in spreads engendered by the crisis. Another possible view held that the magnitude of the spreads might not be independent of the level of interest rates in the main industrial countries. A monetary relaxation could then be rather more effective.

13. The Committee noted that the different cyclical and structural situations in Japan, continental Europe, the United States and the United Kingdom would make a differentiated response more appropriate. For some countries an appropriate monetary easing might be to increase rates by less than previously thought likely, whereas for others it might be more appropriate to cut.

Domestic output and business surveys

14. The official GDP data for the second quarter and industrial production data for July were broadly in line with the central projection for output growth in the *August Inflation Report*. But the Committee noted that business surveys, particularly of manufacturing, had been weak for the second month running. Staff analysis of the surveys – matching the balances to actual growth rates – gave a mixed picture. Some survey data – such as expectations reported in the British Chambers of Commerce survey carried out in Q2 – had been broadly consistent with continuing flat

manufacturing output growth in Q3 and with services growth declining from strong rates, but still positive. In contrast some survey data – notably the CBI industrial trends survey and the CIPS (Chartered Institute of Purchasing and Supply) survey of manufacturing – clearly indicated negative manufacturing growth in the third quarter. In this context the July figures for manufacturing output – showing growth of 0.1% on the month – supported a somewhat firmer picture.

15. The Committee felt that the evidence was consistent with its central expectation of a further modest slowdown in output growth in the third quarter, with growth overall likely to remain positive. However, the Committee noted the weaker CBI evidence and also recalled the experience of 1990 when the official data released up to the Autumn gave little indication of the imminent sharp fall in output. The balance of risks to the short-run outlook for output remained on the downside.

16. The weaker surveys and the official data could be reconciled if it were the case that there was an unplanned build-up in stocks, delaying the reduction in actual output. The Committee noted that stockbuilding had made a third successive positive contribution to growth in the second quarter. The Committee decided to ask the Agents to investigate further what was happening to stock levels.

17. The Committee considered the growing evidence that the projected slowdown in demand growth was also materialising. The Q2 data suggested that domestic demand was slightly stronger than projected in the August *Inflation Report*, but this was entirely accounted for by stockbuilding. For Q3 the main indicators of demand were for retail sales, cars, consumer confidence and the housing market.

18. The British Retail Consortium data for August had indicated a continuing slowdown in annual retail sales growth, although quarterly changes in retail sales might be erratically strong after a weak second quarter. The CBI Distributive Trades survey for August was consistent with a slowing growth rate in retail sales. Some members of the Committee thought that the survey was not quite as weak as it might have been, given the weak expectations for August recorded in the July survey. Car registrations had been erratically weak in Q2 and the staff had indicated that there was likely to be some rebound in growth in Q3, but the CBI Distributive Trades survey indicated a weak August for the motor trades.

19. Consumer confidence had been weakening. The Committee noted that the deterioration was in large part due to sentiment about the general economic situation rather than respondents' own financial positions. The housing market was also giving mixed signals but house prices were no longer accelerating and had fallen in August according to both the Nationwide and Halifax indices. Surprisingly, the net mortgage lending data had risen strongly in July but no firm conclusions could be drawn from one month's numbers.

20. Taking all the demand indicators together, the Committee concluded that there was evidence of continuing underlying slowdown in the third quarter.

Earnings growth

21. The labour market data for June had been somewhat surprising for both quantities and prices. Despite the slowdown in output growth, unemployment was continuing to fall on both the Labour Force Survey (LFS) and claimant count measures and the decline in LFS unemployment had been greater in the second quarter than the first. According to the LFS, employment was rising less quickly than unemployment was falling. The difference was explained by an increasing number of people becoming inactive. The latest Federation of Recruitment and Employment Services survey indicated that the labour market was continuing to tighten, albeit at a slower pace than earlier in the year. This picture was supported by the reports of the Bank's regional Agents.

22. In the context of an otherwise tightening labour market, a significant slowing in the annual growth rate of earnings had been surprising. The twelve-month rate had fallen to 4.5% in June from 5.3% in May. Within the total the growth of the 'irregular' pay component had been expected to fall back, and had done so, but the regular pay component had also fallen from 4.7% in May to 4.4% in June. Furthermore, the fall had occurred equally in both manufacturing and services. On the other hand, public sector pay growth had risen to 3.8%, sharply reducing the difference between private and public sector growth rates. And data on settlements continued to show an upwards trend.

23. There was no evidence that the earnings figures were being distorted by special factors but the Committee could not place too much weight on one month's figures. If further data confirmed a slowdown in earnings growth, that would be good news in terms of lower domestically generated inflationary pressure.

Monetary growth

24. The growth of broad money had been slowing during 1998, giving some support to the projection of a slowdown in nominal demand growth. But aggregate M4 growth had risen to 10.3% in the twelve-months to July from 9.3% in June. It was possible that these two months had been affected by seasonal distortions, but even taken together, the picture of a slowdown was weakened.

25. Narrow money growth had also picked up, with M0 growth rising from 5.8% in the twelve months to July to 6.2% in August. Although Notes and Coin growth rose by just 0.1 to 6.0%, both figures gave less support for an underlying slowdown in nominal demand growth.

26. As with the earnings data, the Committee could not place much weight on one month's figures. In this case, if further data confirmed strong rates of money growth, that would be bad news in terms of inflationary pressures (in the absence of a decline in velocity).

Retail Prices

27. The Committee briefly reviewed the evidence on retail prices. Having peaked at 3.2% in May, affected by tax effects and other erratic factors, it was comforting that RPIX inflation had fallen back to 2.6% by July, only just above the target of 2.5%. Staff estimates of the short-run influences on RPIX components suggested that inflation might be slightly lower over the next few months than projected in the August *Inflation Report*.

Consequences for the Committee's inflation and output projections

28. The Committee concluded that there had been relatively little in the data on the domestic economy that would change its projections. Demand and output growth seemed to be slowing in line with the August central projection although the risk of a faster slowdown had increased. The data on earnings would be good news for inflation prospects if sustained in the coming months, while continuing strong money supply data would be adverse.

29. In its evaluation of external developments it was clear to the Committee that there had been an increase in the downside risks to world activity, principally arising from the recent and possible future contagion of financial market crises in emerging market economies. Taking external and domestic factors together the balance of risks to inflation, which had been on the upside at the time of the August *Inflation Report*, had shifted towards the downside.

30. The Committee also concluded that the degree of uncertainty surrounding future world prospects had risen and this had been seen in increased market volatility.

31. The Committee further agreed that its expectations for world growth and inflation were now lower than at the time of the August *Inflation Report*. However, there was a range of views over whether developments so far should lead to any substantial change as yet in the central projection for UK inflation.

32. On one view, world events so far should cause only a small change to the central projection for UK inflation. Although it was possible to imagine any number of downside scenarios for the world economy, the Committee should not assume that the most extreme outcome was the central case. The most important economies for world activity and for UK exports remained the United States, continental Europe and Japan. Growth remained robust in the United States and domestic demand

had been strengthening in the major EU economies, although the pace of expansion had been variable. Japan had weakened further. The Russian crisis and the widespread fall in equity prices were evidence that some of the downside risks identified earlier were now coming to pass but most of the concern over emerging market economies was in relation to possible future events rather than actual outcomes. And sterling had weakened since the August MPC meeting. Hence the central projection had shifted by less than the balance of risks.

33. On another view there had been a significant increase in excess world supply, which would lead to a prolonged deflationary effect on the world economy. The major world equity markets still had high price-to-earnings ratios and more price adjustment was likely. It was also possible that domestic activity was weakening faster than projected in August, under the influence of high interest rates and a strong exchange rate. On this view, recent external developments reinforced earlier concerns that inflation might undershoot the target and the central projection should be revised down by more.

The immediate policy decision

34. The Committee agreed that there had been a marked shift in its position since the August meeting. The balance of risks for its projection of UK inflation had been on the upside in the August *Inflation Report* and that balance had since shifted towards the downside, largely reflecting international developments. One consequence of these developments had been some correction in equity prices, but these still seemed high and a more significant adjustment might yet occur.

35. The out-turns for domestic data had been much as the Committee had expected, although there was common concern over the weaker signals from business surveys and a welcoming of the weaker data on earnings growth. There was broad agreement that the risks had at least shifted sufficiently to remove the balance on the upside of the August central projection of inflation. The discussion concentrated on whether there was a sufficient case yet for rates to be cut immediately, taking into account all the relevant external and domestic considerations.

36. On one view, the factors determining the central projection had not yet shifted sufficiently to justify a change in rates. If the forecast were to be revised, the balance of risks would clearly have shifted towards the downside and the 'hump' shape in the inflation projection for 1999 might be less marked, but any change in the central projection for inflation in the medium-term would be small. And the balance of risks might alter if rates were cut at the wrong moment. In particular, an early cut, which the markets might well take as indicating a change in the direction of rates, could lead to a sharp fall in sterling, which might more than offset the increased downside pressures on inflation from weaker world output and inflation. All Committee members nevertheless acknowledged the increased downside risks to the world economy and the possibility that domestic growth could be

slowing more quickly than projected and indicated a willingness to move quickly should either possibility prove to be the case.

37. On a second view, although the outturns for official data on domestic activity were broadly as expected, business surveys were very weak for the second consecutive month, the equity market had come off the top and the correction might still have a long way to go. The change in the world outlook was also significant news. Taking these factors together there was sufficient evidence already to shift the central projection for UK inflation from above the target to below. On this basis, rates should now be cut by 25 basis points.

38. On a third view, there had already been a danger of undershooting the inflation target and the previous case for a cut in rates was reinforced. The full extent and timing of the reduction would be a matter of tactics but it should start immediately. Even after interest rates started to fall, sterling would be subject to upwards as well as downwards pressure, given the relative strength of the UK economy and investors seeking a safe haven from world events.

39. The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be maintained at 7.50% this month. Seven members of the Committee (the Governor, Mervyn King, David Clementi, Alan Budd, Charles Goodhart, Ian Plenderleith and John Vickers) voted for the proposition, and two (Willem Buiter and DeAnne Julius) voted against, preferring an immediate cut in interest rates.

40. After reaching its decision, the Committee decided to make a statement to reflect the shared view that, despite no change in interest rates, the balance of risks had nevertheless shifted since the August meeting.

41. 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 Buiter

Charles Goodhart

DeAnne Julius

Ian Plenderleith

John Vickers

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

SUMMARY OF ANALYSIS PRESENTED TO THE MONETARY POLICY COMMITTEE BY BANK STAFF ON 4 SEPTEMBER 1998

A1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 4 September 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 International financial crisis

(i) World financial markets

A2 The spread of US\$ denominated Brady bonds over US treasuries had risen from some 6 percentage points in July to around 15 percentage points by the end of August – similar to the level during the ‘Mexican crisis’ in 1995. Russian equity prices had fallen by two-thirds in dollar terms since the middle of July when its IMF loan was approved. That fall was much larger than in other emerging market economies, though Latin American equity prices had also experienced substantial falls during the month (30%-40%), and eastern Europe (20%-30%). Hong Kong equity prices were virtually unchanged since July. Emerging market exchange rate movements against the US dollar were generally small, except for the Russian rouble, which had depreciated by more than 50% since end-July.

A3 One explanation for this turmoil was the weakness in commodity prices. Many of the affected countries relied on primary commodities as their main exports (for example, three-quarters of all Venezuela’s exports were oil, and half of Russia’s exports were primary commodities). Another possible explanation was a rise in the risk premia associated with emerging market debt default: spreads on foreign currency-denominated debt had risen significantly since Russia announced a package of economic measures on 17 August including a devaluation of the rouble, a freezing of its domestic debt market, and a 90-day moratorium on foreign commercial debts. Emerging market asset prices moved more closely together than usual during times of financial stress, which reduced the possibility of diversification. These problems may have been exacerbated by institutional and/or liquidity effects, with capital flowing out of emerging market economies to allow banks or investment houses to meet margin calls. There was evidence of this happening at the time of the Asia crisis in 1997.

A4 The German banking system had a large direct exposure to Russia, though a good deal of this was backed by German government guarantees. The US banking system had a large exposure to Latin America. In the United Kingdom, banks' largest exposures in emerging market economies were to Asia (\$55 billion out of around \$100 billion to emerging market economies in total at end-1997), most of which was with Hong Kong.

A5 The yen had touched an eight-year low against the US dollar on 11 August of ¥147.6, but then started to appreciate as the likelihood of intervention was perceived to increase. More recently the yen had strengthened to around ¥135 at the beginning of September. Japanese firms appeared to be buying back yen to offset losses caused by weakness in Japanese asset markets ahead of the half-year-end reporting. And hedge funds, which had gone short of yen earlier in the year, were also said to have liquidated profitable positions to offset losses on emerging market economies. Despite Japan being a major commodity importer, the yen and commodity prices had fallen together during 1998; both seemed to reflect weakness in Asian demand.

A6 The exchange rates of commodity exporters had continued to fall. For example, the Canadian dollar and Norwegian krone both fell sharply in August despite rises in official short term interest rates in both countries. Some European currencies also experienced weakness. But the pressure did not move the prospective euro members' forward exchange rates for 1 January 1999 much from their central parities.

A7 The Deutsche Mark had appeared to soften initially following the Russian turmoil, perhaps reflecting concerns about the impact on the German banking system. But as these fears abated the US dollar had depreciated quickly against both the DM and other currencies as US equity prices fell sharply. This may have reflected views that the US economy was more sensitive to changes in equity wealth than other countries, as well as its greater vulnerability to events in Latin America.

A8 Sterling initially rose following the Russian turmoil – with the UK effective exchange rate index increasing around 2½% to 106.7 – as the United Kingdom was perceived to be relatively insulated from the emerging market problems. But as the market realised that concerns over the DM had been overdone sterling fell back, reaching DM2.87 on 9 September, slightly below the

rate at the time of the previous MPC meeting. But sterling was around 2 cents higher against the dollar at \$1.66.

A9 Turning to domestic financial markets, these too had been influenced by the international turmoil as government bond markets in industrialised countries received a flight of capital from emerging market economies. This had dominated the effect of domestic data releases in the United Kingdom, though the earnings data were lower than the market had expected. Looking at the expected path for UK short-term interest rates, the main movement followed the fall in equities at the end of August and increased Russian turmoil. The market now seemed to expect an earlier and steeper fall in UK rates than previously. At the same time, expectations of rising rates in the US and Germany had receded.

A10 Ten-year spot yields on government bonds had fallen in all of the G7 except for Canada (which had raised short-term interest rates); the fall in UK yields was in line with most others' experience. In recent months the German and US yield curve had flattened and the UK curve had become more steeply downward sloping.

A11 The recent falls in equity prices globally had been, in general, larger than the falls experienced during October last year when the Asian turmoil arose. The steep falls in US and UK equity prices at the end of August coincided with announcement of details of the Russian debt rescheduling on 26 August. Small UK firms' share prices had fallen earlier and more sharply than those on the FT-SE 100 index.

A12 Using a simple dividend discount model, it was possible to illustrate possible combinations of dividend yield, risk premia and implied real dividend growth which share price movements during the past month might imply. This suggested that the recent rise in dividend yield was consistent with only a relatively small rise in the risk premium and a small fall in implied real dividend growth. Direct survey evidence showed analysts expectations of corporate earnings growth had fallen slightly in August for 1998/99 but not for 1999/2000.

A13 Implied volatility of the equity market had risen significantly since the August MPC. The implied risk neutral distribution for equity returns had become wider and the probability attached to very large negative returns had increased.

A14 A selection of corporate credit spreads over government bonds in both sterling and US dollars had widened during the past month, and in some cases more so than they had following the start of Asian turmoil last year. Swap spreads (which partly reflect bank credit risk relative to government risk) had also increased considerably towards the end of August.

(ii) The international real economy

A15 The US economy remained relatively robust. In the United States, consumption growth was slowing but remained strong, with nominal retail sales having grown 4.4% on a year earlier in July. The recent fall in consumer confidence, which was largely due to a deterioration in expectations of future economic conditions, suggested a further slowing in US consumption in the near future. There was some evidence of a split between manufacturing and services activity. Service sector activity and employment was growing more strongly than manufacturing, even after adjusting for the effects of the GM strike. This pattern had also been apparent in labour cost data and the National Association of Purchasing Managers' surveys.

A16 Although French GDP rose by 0.7% during 1998 Q2, growth in the prospective euro-currency area as a whole was likely to have been a little weaker. That largely reflected weak German growth as the increase in consumption in Q1, caused by the impending VAT increase, unwound. Industrial production in the euro-area was also slowing. But industrial confidence remained strong with declines in Italy and Germany offset by improvements elsewhere. Retail sales continued to grow strongly and this was mirrored in continued improvements in consumer confidence.

A17 The Japanese economy continued to weaken. Industrial production fell 9.3% in July on a year earlier, and with inventory levels still high, further cuts in production were likely. The Economic Planning Agency had indicated that GDP could fall in both the second and third quarters of 1998. Private consumption remained depressed. Real household spending fell 3.4% in July on a year earlier. There was little sign that the earlier economic packages were having much effect on activity. The ability of local governments to shoulder their burden of public works spending had been hampered by their fiscal deficits. Construction and housing starts continued to fall. However, Japanese exporters had managed to offset some of the fall in demand from Asia by switching to US and European markets.

A18 The Russian economy had very limited trade links to Europe, accounting for 0.7% of UK exports and 1.1% of EU exports. The main risk for G7 economies from Russian instability therefore probably lay in financial market contagion. A world financial crisis would affect UK GDP and RPIX in three main ways. UK net trade could be adversely affected by lower external demand and a possible safe-haven effect on sterling. Domestic demand could be affected by changes in wealth and confidence. Last, import prices could fall due to weaker commodity prices.

II Monetary conditions

A19 Aggregate M4 growth had risen sharply in July. The one-month growth rate was 1.4% and the twelve-month rate had risen to 10.3%, from an upwardly revised 9.3% in June. This strong outturn was partly accounted for by increased repo-market activity. Wholesale deposits had risen by 2.2% in July, and the twelve-month growth rate had risen by 1.2 percentage points to 18.3%. Retail deposits were also strong at 1.1% in July, following a weak outturn in June. However, the unusual pattern of retail inflows in June and July during the previous two years may have distorted the seasonal adjustment factors applied to unadjusted data in July 1998. The average one-month growth rate over June and July 1998 was 0.6%.

A20 Sectoral data indicated that persons' deposits had risen by 1.1% in July and 6.7% on a year earlier, in line with the behaviour of retail deposits. Looking at the institutional split of persons M4, twelve-month growth in building society deposits at 12% had continued to exceed bank deposits growth at 6.7%.

A21 ICCs' deposits had grown by 0.9% in July and the annual rate of growth in 1998 Q2 had been revised up by 0.5 percentage points to 5.8%. Robust growth in OFIs' deposits of 2.8% in July had in part been accounted for strong repo activity. It had also been consistent with a recent Merrill Lynch-Gallup survey of major UK pension fund managers' asset allocation intentions which suggested the share of cash in LAPFs' portfolios had risen.

A22 M4 lending had risen sharply in July following a weak June outturn. The one-month growth rate had risen to 1.1% from 0.4% in June and the twelve-month growth rate had risen by 0.7 percentage points to 8.5%. The sectoral breakdown indicated strong lending to individuals. In particular, total net secured lending had risen by 0.6% in July, the highest monthly rate since

the series began in April 1993. Figures from the Council of Mortgage Lenders and estimates by Bank staff suggested that remortgaging activity remained robust. There was also evidence of a rising share of new business and remortgaging being undertaken at fixed rates. Unsecured lending had continued to rise strongly, with the twelve-month rate at 16.3% in July; the twelve-month growth in credit card lending had remained high at 25.7%.

A23 M4 lending to ICCs had been flat in July, following a fall of 0.2% in June. But despite weak sterling bank lending, ICCs' total external finance had remained robust due to strong sterling capital issues and foreign currency borrowing. OFIs' borrowing had risen sharply by 3.3% in July on a month earlier, largely accounted for by strong reverse repo activity. The twelve-month growth rate remained generally weaker than in 1997.

A24 Turning to the price component of monetary developments, most banks and building societies had now passed through the most recent rise in official interest rates and there had been little change on the month in retail rates. But fixed rate mortgages had risen for a second successive month despite a fall in swap rates.

A25 The short-term RPIX expectations of outside forecasters with respect to a fixed end-point, as surveyed by Consensus Economics, HM Treasury and Merrill Lynch-Gallup, had nudged down in August. This had offset similar rises in July and had been in line with recent movements in current RPIX inflation. Forecasters' expectations for RPIX inflation at the end of 1999 remained fairly close to the inflation target.

A26 In wholesale markets, expected three-month inter-bank rates implied by sterling futures contracts had moved down across all maturities since the previous MPC meeting. A profile of falling rates remained priced into short sterling futures, with the December 1999 contract implying nominal rates of close to 6%. Expectations of inflation in ten years time and real forward rates, as derived from index-linked gilts, had changed little over the month. But three-year real forward rates and inflation expectations, derived from index-linked gilts had fallen by around 30 basis points and 20 basis points respectively. There was also evidence that corporate bond and swap spreads over gilt yields had widened quite substantially during the month. If this were the case, the cost of capital for persons and corporates might be little changed overall.

A27 Sterling had been volatile over the month but by 9 September the nominal effective exchange rate was just 0.6% lower than at the previous MPC meeting; the broad ERI, incorporating 49 currencies, had fallen by 0.1%. The forward path of the ERI implied by nominal interest rate differentials suggested a similar depreciation path to that incorporated in the August *Inflation Report*. UK and overseas forward interest rates had moved broadly together during August suggesting little net monetary news during the month. Evidence from the Consensus Economics survey of exchange rates had suggested that the sterling risk premium had been rising in recent months. But the most recent survey on August 10 indicated a fall, perhaps consistent with a change in foreign currency risk premia in favour of sterling given concerns about financial fragility overseas.

III Demand and output

A28 GDP at factor cost had grown by 0.5% in 1998 Q2, unrevised from the preliminary estimate. The expenditure breakdown had revealed a sharp slowdown in domestic demand growth, from 1.3% in 1998Q1 to 0.6% in 1998 Q2. Prior to that, the slowdown in GDP growth had been driven by a deterioration in net trade. Net trade had deteriorated further in 1998 Q2, reducing overall GDP growth by 0.1 percentage point compared with 0.7 percentage points in 1998 Q1.

A29 Within domestic demand: quarterly consumption growth had slowed to 0.7% in Q2, compared with 0.9% in Q1 - annual growth had fallen to 3.8% from 4.9% in Q1; government consumption had grown strongly in 1998 Q2, by 1.1%; and investment had fallen by 1.9% in Q2. Overall, final domestic demand (domestic demand excluding stockbuilding) had increased by 0.3% in 1998 Q2. Stockbuilding had increased by £1.3 billion, contributing 0.3 percentage points to GDP growth - the third consecutive positive contribution. Typically a temporary build-up of stocks followed a slowdown in final demand. But at this stage, Bank staff felt the data might include a large quarterly alignment adjustment, so it was not clear by how much actual stockbuilding had risen.

A30 Investment had fallen in 1998 Q2, following the large contribution from erratic components in Q1 (an oil rig, tube trains). Business investment had fallen sharply, by 5.5%. Excluding the less cyclical sectors (public corporations, oil and utilities) annual growth in business investment had fallen from 11.3% in 1997 Q4 to 1.1% in 1998 Q2. Service sector

investment had fallen for the second consecutive quarter, though annual growth in service sector investment remained positive at 2.2% in 1998 Q2 and British Chambers of Commerce (BCC) survey investment intentions balances had remained relatively strong. Manufacturing investment had risen by 6.7% in 1998 Q2, though it had fallen by 1.9% on an annual basis. But investment data were volatile and prone to revision so it was too early to determine the pace of the slowdown in investment

A31 Following June's 1.5% fall, retail sales had grown by 0.9% in July, largely due to a 6% rise in clothing and footwear sales. Despite the volatile monthly pattern, a slowdown in demand remained evident: annual growth in retail spending had fallen to 3.2% in July (latest three months) compared with 3.6% in June. British Retail Consortium data showed that total sales values growth had slowed to 4.3% in the year to August but remained unchanged from July on a like-for-like basis at 1.5%. The growth rate of the official ONS series normally lay between these two figures. The August CBI Distributive Trades survey showed a further fall in expected sales balances, to +10 from +27 in July, below its average level since 1992 (+25). Car registrations had totalled 505,312 in August, a fall of 3.8% on the previous year. Private registrations had fallen by 7.2% on their level a year earlier.

A32 There had been a rise in housing turnover during the summer: particulars delivered had increased in June and July though they remained 2% lower over the latest three-month period compared with the previous three months; and 6.7% lower compared with the same three months a year ago. A large rise in net mortgage lending in July had also pointed to higher turnover over the coming few months. But the House Builders' Federation survey had reported falling balances for site visits and reservations in July. And housing starts had fallen by 10.7% in the second quarter. House prices had fallen in August according to both the Halifax and Nationwide indices. Annual rates of increase had moderated to 9.2% and 5.3% respectively, with three-month annualised rates of 6.0% and 5.4%.

A33 Monthly trade data had shown a narrower goods deficit in June reflecting trade with non-EU countries, as the deficit with EU countries had widened. Both exports and import goods volumes (excluding oil and erratics) had increased in 1998 Q2, by 0.2% and 1.0% respectively. But exports to non-EU countries had fallen in July, as had imports. The puzzle regarding the continued growth of exports to EU countries following sterling's appreciation could be explained, in part, by the growth in EU markets over the period. The UK share of EU markets

had been falling since 1997 H1 after rising for much of the period since the late 1980s. There had been a longer term decline in the share of non-EU markets which had recently intensified following the Asian crisis.

A34 There had been little change in the output data since the preliminary GDP release. Services output had risen by 0.6% in 1998 Q2. New data on the more disaggregated components of output suggested that growth in the transport & communications and finance & business services sectors had remained strong at 0.9% and 1.0% respectively. But this had been offset by growth of 0.1% in the distribution and hotels & catering sector. Construction output had fallen in 1998 Q2 by 2.6%, leaving output 0.6% higher than a year earlier. Manufacturing output had increased by 0.1%, following two quarterly falls. Total industrial production had grown by 1.1%, boosted by large increases in energy (oil & gas) and utilities output following falls in the first quarter. GDP excluding primary sectors had grown by 0.2% in 1998 Q2 compared to 0.5% for total GDP. Manufacturing output had increased by 0.1% in July though level of output was little changed on a year earlier. Total industrial production had risen by 0.4%, reflecting higher gas and electricity output due to cooler than normal weather in July.

A35 The continued contrast between the manufacturing and service sectors had remained evident in the latest business surveys. The August CBI Industrial Trends survey had recorded a further fall in the expected output balance: to -15 compared with -8 in July and -3 in June; and the Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey had recorded another fall in its output index. The CIPS services survey showed continued growth in service sector activity in August though at a slower pace. Work undertaken in the Bank using a regression technique to generate growth rates based on the past relationship between survey responses and ONS data had suggested that recent BCC service sector responses were consistent with continued strong growth in service sector output in 1998 Q3. For manufacturing, the BCC survey was consistent with flat output in Q3. But the CBI and CIPS surveys were more indicative of a fall in manufacturing output in 1998 Q3.

IV Labour market

A36 LFS employment had grown by 21,000 in the three months to June compared with the previous three months. That was slower than the average rate of growth over the past year. The CIPS survey for August reported continued employment growth in services but at a slowing

rate, and falling employment in manufacturing, a picture which had been broadly corroborated by the Bank's regional Agents. The total number of hours worked had flattened off according to the LFS, implying a fall in the number of hours worked per person. That was consistent with data showing that employment gains over the past three months had been in part-time employment at the expense of full-time jobs. Further evidence of increasing demand for employees was shown by the Federation of Recruitment and Employment Services survey for August, though the rate of growth of jobs showed further signs of slowing.

A37 The stock of Jobcentre vacancies increased by 1,900 in July, although the number of new notifications fell. The National Press Recruitment Advertising index also rose to a new record in July according to NTC.

A38 Turning to unemployment, both of the main measures had reported falls in the latest month. LFS unemployment was 62,000 lower in the three months to June than in the previous three months. The rate fell to 6.2%. That fall was mainly accounted for by falls in short-term unemployment (under twelve months), in contrast to falls over the past year which had been mainly in long-term unemployment. Claimant unemployment fell by 26,000 in July following a revised fall of 5,800 in June. July's data were probably affected by inappropriate seasonal adjustment. Before the Job Seeker's Allowance (JSA) was introduced, there had tended to be a rise in the unadjusted claimant count every July as students signed on over the summer, followed by a fall as they signed off in October. Since the introduction of the JSA the size of these flows had fallen. But the ONS seasonal adjustment package was still trying to adjust the data based on pre-JSA behaviour. Taking this into account, it was likely that unemployment was falling at an underlying rate of around 5,000 per month.

A39 According to the LFS, there had also been a sharp rise in inactivity in the three months to June, which was entirely accounted for by people who said they did not want a job.

A40 One feature of the recovery in the 1990s had been a sharp rise in temporary employment from around 5.5% of employees in 1992 to 7.5% in 1997. There was a possibility that the higher numbers of temporary employees may lead to a faster response of employment to changes in output. In a downturn this would imply a faster rise in unemployment and a faster abatement of inflationary pressure.

A41 Turning to earnings, there had been a sharp fall in headline earnings growth (a centred three month moving average) from 5.4% in April to 5.0% in May. The monthly earnings index was 4.5% higher in June than a year earlier. As expected the ONS's measured contribution of irregular bonuses and PRP had fallen to 0.3% in June, similar to June 1997. The surprise had been in the outturn for estimated regular earnings. But earnings data were volatile, and more than one month's data would be necessary to infer a change in the trend.

A42 The Bank's estimate of bonus-smoothed earnings — using the technique described in the August 1998 *Inflation Report* — fell from 5.2% in May to 5.0% in June assuming a continuation of current bonus growth, and from 4.9% to 4.7% assuming bonus growth slows to 10%. Over the coming months, the size of the irregular bonus contributions was expected to be relatively small: few firms pay bonuses between August and October. Headline earnings estimates may thus fall below the smoothed estimates for a time, reversing the pattern during the bonus payment period.

A43 There had been a fall in private sector headline earnings growth from 6.2% in April to 5.7% in May, while the public sector increased from 2.8% to 3.2%. Headline earnings growth had fallen in both the manufacturing and the services sectors to 5.1% and 5.3% respectively.

A44 Twelve-month wage settlements continued to creep upwards in July, although the Bank's mean settlement remained at 3.8% to one decimal place. There had been small increases in both private and public settlements.

V Prices

A45 Commodity prices had continued to fall. The Bank's UK-demand weighted index had fallen by 1.4% in July (1.0% excluding oil) and by 13.7% in the year to July (16.2% excluding oil). Input price deflation had also continued. Manufacturers' input prices fell 8.9% over the year to July, and the CIPS survey indicator remained close to 40 (well below the neutral 50 level), as it had done for the past two years. Manufacturers' output prices had remained at around the same level since early 1996.

A46 According to Bank estimates, goods retailers were able to widen their margins in the year to 1998 Q2, despite a rise in unit labour costs.

A47 All three headline measures of retail price inflation in the year to July were broadly in line with the August *Inflation Report* central projection. Annual RPI and RPIX inflation had both fallen 0.2 percentage points, from 3.7% to 3.5% and 2.8% to 2.6% respectively, as last year's increase in petrol price duty dropped out of the annual comparison. RPIY inflation, which excludes the effects of indirect tax changes, had risen from 2.0% to 2.1%.

A48 Some indicators of RPI inflation during August had suggested that inflation might be lower than previously expected during the autumn. In particular, there had been evidence of downward pressures on food price inflation and second-hand car prices, both of which could be sustained in the short-term.

VI Reports by the Bank's Agents

A49 The Bank's Agents had undertaken a survey of their contacts to give some insights into the pace of the slowdown in activity during July and August and the outlook for output during the rest of the year. The industrial composition of their sample was similar to the whole of the private sector.

A50 In the service sector, 44% of companies reported no change in output during July and August compared with 1998 Q2. The proportion of firms reporting positive growth was balanced by those reporting falling output. The outlook for the rest of the year was slightly more sanguine, with the distribution of responses marginally skewed towards those expecting positive growth. However, responses from different parts of the sector varied considerably.

A51 Output was weaker in manufacturing: 43% of those surveyed reported that output had fallen in July and August, while 50% expected lower output during the rest of the year. Net trade was highlighted by a majority of respondents across all sectors as the most important factor restraining output.

A52 The Agents also reported on the results of more general discussions with their contacts. Business confidence was still being affected by events in Asia, though comfort was being taken by the strength in the European economy. Recent events in Russia and their impact on world financial markets had yet to have a significant effect on sentiment. Contacts had argued that

there was a danger of talking the economy into a recession. Though the value of sterling was being talked about less as a negative factor, there were increasing instances of transferring some production offshore. The Agents were also being told that markets lost on sterling's strength, would not be easily won back if sterling fell in value.

A53 Retailers noted that sales growth was falling. The used car market was weak as new cars were becoming increasingly competitive, but even that market was slowing. There were many non-price special offers, such as zero per cent finance, on retail goods as well as price-related deals, such as multiple purchase discounts. Contacts were concerned that these were not being captured by the RPI index. The housing market was weakening. The construction sector's output was flattening but not going into reverse.

A54 Skill shortages persisted in IT, electrical engineering and construction. There were also reports of shortages of able unskilled staff in the service sector. Even so, many service sector contacts expected recruitment to slow and some could see a downturn in employment ahead.