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MINUTES OF MONETARY POLICY COMMITTEE MEETING

6 and 7 October 1999

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 October 1999.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9910.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 3 and 4 November will be published on 17 November 1999.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 6-7 OCTOBER 1999

1 Before turning to its immediate policy decision, the Committee discussed the world economy; money and credit; demand and output; the labour market; and prices and costs.

The world economy

2 In the United States final domestic demand was still growing strongly, although GDP growth in Q2 had slowed to below ½%, reflecting negative contributions from net trade and stockbuilding. Headline consumer price inflation was increasing, reflecting higher oil prices.

3 There had been little market reaction to the tightening of US monetary policy in August, although equity prices had fallen slightly in recent weeks. While this could be consistent with a soft landing for the US economy, it need not be so, particularly if the current account deficit continued to grow as a result of strong domestic demand, or if forward-looking indicators of price pressures continued to rise. The prospects for sustainable growth would be improved if supply-side changes, such as a rise in productivity, continued to underpin the increase in output in the US, and led to inflows of capital from the rest of the world. Nevertheless risks remained of a sharp move in the dollar and/or in equity prices if these supply-side factors should tail off. At its October meeting the FOMC had left rates unchanged, but with a bias towards a possible firming of policy going forward. The Committee agreed that although there were still risks to the outlook for the US economy, it was not clear that these were any greater than they had been a month earlier.

4 In Japan output had been stronger in Q2 than expected, although it was too soon to say whether this upturn would be sustained. A fiscal package now looked likely, and statements by the Bank of Japan had indicated that monetary policy would remain accommodative. But over the past month there had been a strong appreciation in the yen which, if sustained, could weaken future growth prospects.

5 In the euro area, business confidence was now back to its long-term average, with Q2 GDP growth positive in most countries other than Germany. Orders data also pointed to a recovery. Broad money growth was above its reference value, although doubts remained

about the quality of these data, subject as they were to revision. The recovery was still in its early stages, and had yet to become firmly established.

6 Prospects in the emerging market economies were on balance little changed from a month earlier. If anything, forecasts were now a little less negative for Russia and Brazil, although not for the rest of Latin America. In many Asian countries growth was strong, if much as expected.

7 While the uncertainties about the prospects for the world economy had diminished over the past few months, and recent data suggested a stronger recovery in world trade, the Committee concluded that there had been little change in the outlook since its previous meeting.

Money and credit

8 Recent data for the monetary aggregates had been volatile, and it was unclear whether the latest figures contained much in the way of significant information. In September M0 was virtually unchanged from a month earlier, and as a result the annual growth rate had fallen to 7.0% from 7.8% in August. In August M4 had grown in underlying terms for the first time since April, with the annual growth rate a little higher at 4.3%. The growth in August primarily reflected movements in the deposits of Other Financial Corporations; deposits by Private Non-Financial Corporations had fallen.

9 Household credit growth in the year to August, and estimates of mortgage equity withdrawal in real terms in Q2, were both at their highest levels since 1991 Q4, although the latter had been revised down slightly. While it was too soon to draw conclusions from the various house price indices, there was now some suggestion that the hype surrounding the housing market had moderated.

10 Nominal interest rates implied by futures contracts for the next nine months were some 40 basis points higher than a month earlier, with rates higher across most of the yield curve, although at around two years the implied rates were little changed. Towards the end of September these rates had been lower than at the time of the Committee's previous meeting, but there was little sign yet that by moving in September the Committee had achieved any

lasting reduction in interest rate expectations further along the yield curve. On a longer-term basis, two-year real interest rates, calculated using survey-based measures of inflation expectations, had risen by 60-90 basis points over the past quarter. Swap rates for maturities of three years or more were generally 20-30 basis points higher over the month as a whole, with gilt yields up by rather more. Equity indices had fallen by around 4% over the month, and the sterling effective exchange rate had appreciated by 2%. The magnitude of the rise in medium-term interest rates and the exchange rate over the month as a whole was higher than might normally be expected from a rise in the repo rate of 25 basis points. This might have reflected market perceptions of a turning point in interest rates, and it was possible that there had also been other influences, for example higher European interest rates and M&A-related activity in the exchange markets. Whatever the cause, these movements over the past month would tend to restrain demand.

Demand and output

11 Real quarterly GDP growth was now stronger than earlier estimated, at 0.2% in Q1 and 0.6% in Q2, and on a year-on-year basis had picked up from its low point of 1.3% in Q1. Manufacturing output had increased by 0.4% both in July and August, and the National Institute for Economic and Social Research now projected GDP growth of 0.8% in Q3.

12 During the past month, household expenditure had been revised up in Q1, in part due to new estimates for expenditure on cars. But with the level of household expenditure little changed in Q2, the quarterly growth rate had been revised down to 1.1%. Business investment had been revised up to 0.8% in Q2, though government investment had fallen by 5%. Final domestic demand therefore continued to grow strongly, although by less than in the previous quarter. Domestic demand itself was much less buoyant, reflecting a sharp fall in inventories, especially in manufacturing. The difference between growth in final domestic demand in Q2 (at 4.5% on a year earlier) and GDP (at 1.4%) had been the highest since the first quarter of 1988.

13 Although the current account deficit had widened in Q2, in volume terms the net trade contribution to quarterly GDP growth had been positive. While these were volatile numbers, the most recent trade data suggested that the stronger export performance in Q2 might have

continued into the third quarter, on account of stronger world trade. Manufacturing export orders, as measured by the Chartered Institute of Purchasing and Supply (CIPS), had also risen in Q3 and many of the contacts of the Bank's regional Agents had reported some recovery in overseas orders. A strengthening in exports relative to domestic demand would lead to a better-balanced recovery.

14 Indications for domestic demand in Q3 remained strong, judging by the retail sales data, the CBI Distributive Trades Survey, and reports from the Bank's regional Agents, but the GfK consumer confidence measure had fallen back in September and the CIPS services survey, while remaining well above 50, was also slightly lower. Measures of industrial confidence about profitability had strengthened, although the effects of the recent appreciation of sterling were unlikely to have fed through to survey data yet. Car registration data and evidence from the Bank's regional Agents suggested that activity in this sector may have slowed in Q3, although the data were still hard to interpret given the changes in the registration cycle for new vehicles and survey evidence was mixed. Tax revenues appeared to be buoyant, perhaps largely reflecting cyclical factors.

15 Taken together, the evidence suggested slightly stronger output growth than had been expected the previous month, and perhaps a rather stronger export performance. Some Committee members saw a few signs that domestic demand growth could perhaps be moderating, as it would need to do at some point if growth were to prove sustainable, although a period of above-trend growth was to be expected in the recovery phase of the cycle.

Labour market

16 Employment growth was no longer slowing, with an increase of more than 50,000 on the latest three month Labour Force Survey (LFS) measure, and around 100,000 in Q2 on the more volatile Workforce jobs measure. The LFS unemployment rate continued to fall, reaching 5.9% in the three months to July, and the claimant count rate was down to 4.2%. Measures of labour market inactivity had meanwhile risen.

17 The Federation of Recruitment and Employment Services reported that shortages of temporary and permanent staff persisted in September, and the Bank's regional Agents spoke

of a similar picture in most parts of the UK. So far as skill shortages were concerned, it was important to distinguish between cyclical effects and structural issues relating to education and training. It was also possible that skill shortages might now lead to less generalised pressure on earnings than in the past, given the increasing importance of individually-tailored contracts. But some of the Agents' contacts reported labour shortages even for unskilled jobs.

18 These skill shortages did not yet appear to be influencing pay settlements, which continued to fall. The recently announced electricians' settlement was a possible exception, but it appeared to have consolidated certain existing supplementary payments so that the net settlement might have been rather less than had been reported. Earnings growth, as measured by the Average Earnings Index, had meanwhile fallen to 4.4% in the year to July, from 5.2% in the previous month. The headline rate, a less volatile measure calculated as a three-month moving average, had risen slightly to 4.6%.

19 Real earnings growth had increased, and might suggest that pressures in the labour market were greater than implied by the path of nominal earnings. But it might be that employers and employees had expected rather higher inflation when settlements were agreed, and to that extent had been surprised by the subsequent growth in real earnings. How that would influence next spring's pay bargaining round remained to be seen.

Prices and costs

20 Input prices for manufacturing were rising, as a result of higher oil prices, and were 3.8% up on a year earlier. However, output prices (excluding excise duties) were little changed. Despite higher oil prices, RPIX inflation in the year to August had been a little lower than expected, at 2.1%, in part due to lower food prices. Within this total, goods price inflation was very low, and had turned negative on some measures, such as the retail sales deflator, while the prices of services continued to increase. The implied deflator for GDP at market prices had been revised, with the annual rate of change at 1.8% in Q2. Most measures of domestically generated inflation were falling, with the RPIX-based measure down to 3.6% in Q2 on a year earlier, compared with almost 5% only six months earlier.

21 It was possible that increasing competition in the retail sector, for instance in food and clothing, might reduce RPIX inflation further below target, at least in the short term. But it was difficult to be sure how large any such effect might be. Some types of price cut (such as ‘2 for 1’ offers) were not captured by the RPIX. Others might be offset by increases in prices elsewhere, although the scope to do so would be limited if competition was indeed more intense, or if low and stable inflation made it easier for consumers to identify and react to relative price changes. A survey by the Bank’s regional Agents had shown widespread discounting driven by new and existing competition, and consumer resistance to price rises. Regulatory decisions (for example on utilities pricing) and rulings by competition authorities might add to the downwards pressure on inflation, although not all these factors were new: deregulation and competition had been important influences on pricing for many years, although more sectors currently might perhaps be affected than in recent years.

22 Even if competition were important in restraining price increases in the near term, what would be the effect on inflation further out? To the extent that lower prices fed through into inflation expectations and wage bargaining negotiations next spring, the effects might persist beyond the short run. But to the extent that some of the reductions in prices were time-limited (and perhaps analogous to advertising) there could be a bounceback in inflation further ahead as they unwound. A further factor which might prolong downward pressure on prices was e-commerce. Both the short-run and longer-run effects of these various factors would need to be considered carefully in the context of the forthcoming *Inflation Report* forecast.

23 The Committee discussed the recent doubling in oil prices. In the short term, these increases would push up inflation, albeit from a position below target. The Committee had to set policy so that prospective inflation further ahead was on target, so it would be important not to accommodate the longer-run effects from higher oil prices.

The immediate policy decision

24 The Committee discussed various arguments for leaving the repo rate unchanged at 5.25%.

25 Final domestic demand was still growing rapidly, and was beginning to be reflected in stronger output growth; growth in Q3 might be clearly above trend for the first time in two years, and output had been revised up for both Q1 and Q2. There were signs – not least in survey data – that world trade in general, and UK exports in particular, might be recovering. With stronger input prices and a tight labour market, there were upside risks to inflation in the medium term, although if the economy had fallen below potential after a period of below-trend growth, a period of above-trend growth would be consistent with the inflation target. More immediately, there was a possibility that increased competition would result in greater downwards pressure on margins and prices, at least in the short term.

26 Until recently, falling import prices had helped to restrain inflation, while output had been held back by a negative contribution from net trade. Both of these influences might now be coming to an end, although much would depend on the future path of the exchange rate. If domestic demand growth and domestically generated inflation fell back as net trade and import prices picked up, the economy should be better balanced going forward. If not, pressure on resources – and inflationary pressures more generally – would increase.

27 The increase in the Bank's repo rate at the Committee's previous meeting had surprised the markets. Compared with a month earlier, market interest rates were higher at most maturities, as were rates on fixed-rate mortgages, while sterling was stronger and equity prices lower. While these developments might in part reflect influences other than the increase in official rates, if maintained they would help to restrain demand growth and inflation in the medium term.

28 There remained a number of puzzles, with most output and demand figures continuing to be stronger than expected, while inflation was if anything lower. Similarly, in the labour market, despite a continuing fall in unemployment and reports of growing labour shortages there was as yet little sign of an acceleration in nominal earnings, although unit labour cost estimates were increasing quite rapidly. The increase in real earnings growth might signal labour market pressures, but it could instead reflect lower than expected inflation. It was unclear how long this combination of stronger growth with lower inflation would last; it might reflect domestic developments, such as structural changes in product and labour markets, or alternatively external influences, which could prove temporary. The change in market rates since the Committee's previous meeting in September meant there was no need

to move official rates now, although the Committee would remain alert to any signs that robust growth was feeding through into pressure on prices.

29 Some members of the Committee emphasised the likelihood that inflation, particularly in the short run, would fall further below target, in part reflecting the competitive pressures in retailing and regulatory developments in the utilities sector. Nearly all inflation measures were at present falling; RPIX had been below target for five months, and excluding petrol prices was running at only 1.7%. Given the structural changes that may have occurred in the labour and product markets, it made sense to see whether higher growth would translate into as much of a rise in inflation as was suggested by historical relationships. The rise in the repo rate had contributed to a significant tightening across the yield curve, and the impact of a stronger exchange rate had yet to be seen, even in survey data.

30 The Governor invited the Committee to vote on the proposition that the Bank's repo rate be maintained at 5.25%. The Committee voted unanimously in favour of the proposition.

31 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

Willem Buiter

Charles Goodhart

DeAnne Julius

Ian Plenderleith

John Vickers

Sushil Wadhvani

Gus O'Donnell was 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 1 October, in advance of its meeting on 6-7 October 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in this Annex.

I The international environment

A2 The US economy had remained strong, and leading indicators for the euro area continued to indicate the prospect of faster growth. Q2 GDP growth in Japan had been stronger than expected.

A3 In the US economy strong personal consumption had accompanied further increases in household wealth. New orders had been strong, especially in durable goods and manufacturing, in all Federal Reserve districts. In the short run, some reversal of recent declines in inventories might support GDP growth. According to standard measures, labour cost pressures had not yet emerged, but more refined measures including the effect of stock options suggested some rise over the past few months. Headline CPI inflation had increased to 2.3% in August due to higher crude oil prices, but core consumer price inflation (which excludes energy and food prices) had continued to slow.

A4 GDP in the euro area was provisionally estimated to have risen by 0.3% in Q2. GDP in Germany had been flat on the quarter, but had risen by 0.4% in Italy. Euro area HICP inflation had increased from 1.1% to 1.2% in August but, net of energy prices, had fallen again. Confidence measures had shown further improvement in economic conditions reported by both consumers and producers, particularly in Germany and France.

A5 In Japan, GDP had risen by 0.2% in the second quarter. Industrial production had remained strong. The September Tankan survey had shown an improvement in business confidence. There had also been a pick-up in trade flows, in particular to South East Asia, where growth had been strong. Prices of goods and services covered in the headline CPI had risen by

0.3% from July to August, a reversal in the recent trend. This may have been accounted for by volatile food prices.

A6 World commodity prices had increased, to a large extent accounted for by an increase in the price of crude oil, which seemed to have occurred because of a high degree of compliance with the agreement among OPEC members to limit supply. The price per barrel had reached \$24 at the end of September, up from \$10 in December 1998. The strength in oil prices had contributed to a rise in producer prices in the euro area and the US. However, despite the strength in oil prices, producer prices in Japan had fallen further. Food prices, by contrast, had moved to their lowest level since October 1992. According to the Economist all-items index, non-oil commodities had declined by 5% in dollar terms over the year.

A7 There had been a further appreciation of the Japanese yen in foreign exchange markets. The extent of the yen's appreciation against the euro and the dollar had been similar, and the bilateral euro-dollar rate had been broadly unaltered. Equity markets around the world had fallen somewhat over the month. One development had been the increase in buying intentions of US fund managers for euro-denominated equities as reported by Merrill Lynch's Fund Manager Survey.

II Monetary and financial conditions

A8 Narrow money growth had slowed sharply in September. The twelve-month growth rate of notes and coin, after adjusting for the introduction of the new 50 pence and £2 coins, had fallen to 7.0% in September compared with 7.8% in August. The one-month growth rate, at 0.0%, had been unusually low by recent historical standards. The sharp reduction in the rate of monthly growth was unlikely to have been solely 'noise', and might indicate that the underlying growth rate was less than had been previously thought.

A9 M4 had risen by £4.6 billion (0.6%) in August, with the annual growth rate rising to 4.3%. After adjusting for an unusual transaction that had affected the flows in May and June, this had been the first rise in M4 since April. M4 lending (excluding the effects of

securitisations) had been very strong in August, rising by £10.0 billion (1.1%), but recent flows had been erratic.

A10 Households' M4 lending had been strong in August, rising by £4.1 billion (0.7%), and the annual growth rate, at 8.3%, had been the highest since 1991 Q4. The three and six-month rates, at 9.4% and 9.2%, were above the twelve-month rate. Total lending to individuals, including banks, building societies and other lenders had fallen slightly on the previous month to £3.2 billion, but it remained strong compared with an average of £2.8 billion for the first half of 1998. The value of new loans approved for house purchase in August was £10.3 billion, little changed from the July figure of £10.2 billion. It appeared that outflows from the stock of approvals had been mostly due to flows into gross lending; cancellations remained flat. Total unsecured lending had been strong in August, with the three, six and twelve-month annualised growth rates at 14.9%, 14.1% and 14.1% respectively. Recent data had led to the provisional estimate of mortgage equity withdrawal in Q2 being revised down from £1.9 billion to £1.6 billion. But mortgage equity withdrawal in Q2 was still estimated to have been stronger in real terms than at any point since 1991 Q4. Households' M4 deposits had been weak in August, rising by £0.9 billion (0.2%). The twelve-month growth rate was 6.2%.

A11 Private non-financial corporations (PNFCs) had repaid bank borrowing in each of the last four months and the twelve-month growth rate had fallen by 0.7 percentage points to 3.5% in August. But a wider measure of PNFCs' borrowing (which also includes bond and equity issues) had been strong between January and August, averaging £4.4 billion, compared with an average of £2.9 billion in 1998. The August figure had been down by £0.3 billion to £2.4 billion. PNFCs' M4 deposits had fallen by £1.2 billion (1.0%) in August. The twelve-month growth rate had fallen by 2.2 percentage points to 3.9%.

A12 Other financial corporations' (OFCs') M4 deposits had risen by £5.0 billion (2.9%) in August, only the second monthly increase in 1999. OFCs' M4 lending had also risen sharply, by £6.1 billion (3.0%). Repo and reverse repo transactions had been £1.1 billion and £1.4 billion (nsa) compared with -£2.7 billion and -£3.1 billion in August 1998.

A13 Interest rate expectations out to June 2000 implied by short-dated sterling futures contracts had increased by 25 basis points or more, after the 25 basis point increase in the official repo rate on 8 September. Over the month, nominal forward rates implied by gilts had also risen at short to medium maturities. Swap rates had risen by around 30 basis points, slightly less than the 40 basis point rise in gilts, resulting in a narrowing of swap spreads, except at the two-year maturity. Yields on corporate bonds had risen by between 30 and 35 basis points at maturities of between five and ten years. There had been less than complete pass-through of the official repo rate increase to an average of standard variable mortgage rates offered by banks and building societies, but many institutions had not yet announced how they intended to respond. The spread of five-year fixed-rate mortgages over swap rates of corresponding maturities had narrowed.

A14 Real interest rates derived from the index-linked gilt market had been little affected by the official rate rise, so implied inflation expectations moved in line with gilt yields. In contrast, short-term survey-based measures of inflation expectations had been little changed. And survey-based real interest rates had increased by between 60 and 90 basis points between the Q2 and Q3 surveys of inflation expectations.

A15 The sterling effective exchange rate index (ERI) had appreciated by 2.1% over the month. Within this, sterling had appreciated by 2.0% against the euro, 3.1% against the dollar, and had been virtually unchanged against the yen. Monetary news had appeared to account for a significant amount of the appreciation in sterling's ERI. The FT-SE All-Share index had fallen by 4.1% over the month. This fall had been broadly spread across the sectoral components of the index.

III Demand and output

A16 Quarterly GDP growth at constant market prices had been revised up by 0.1 percentage point in both the first and second quarters, to 0.2% in Q1 and 0.6% in Q2. The growth rate in the year to the second quarter had been revised up to 1.4% from 1.3%. Domestic demand growth in the second quarter had been revised down on a quarterly basis to 0.2%, but up on an annual basis, reflecting upward revisions to the level in both the first and second quarters. But the lower growth had been outweighed by the contribution to quarterly GDP growth made by net trade,

which had been revised up to 0.5 percentage points, largely due to stronger export growth and an upwardly revised trade deficit in Q1.

A17 Quarterly growth of household expenditure had been revised down to 1.1% in Q2, though the level in the second quarter had been essentially unchanged from the previous estimate. Spending on durables had been the main driving force of consumption growth in the first half of 1999. Roughly half the revision to the Q1 number had come from expenditure on cars (which had been significantly distorted by the introduction of the new registration month in March). Expenditure on services had been weak in the second quarter, particularly spending on financial services, which had fallen by 5.1%. Expenditure on investment (excluding net acquisitions of valuables) had been revised up slightly in the second quarter, but the composition of growth had changed more markedly. Business investment had been revised up significantly, but government investment had fallen by 5%. Government consumption expenditure had not been revised.

A18 Final domestic demand growth had been much stronger than domestic demand growth, as the change in inventories had contributed -0.8 percentage points to quarterly GDP growth. The change in inventories had been revised up in both of the first two quarters by the equivalent of 0.3% of GDP. The rate of manufacturing destocking had been revised up in the second quarter, but the level of retailers' stocks had increased again by £405 million. The sharp fall in the level of inventories in the second quarter had been slightly larger when excluding the quarterly alignment adjustment. The sum of the alignment adjustments on the expenditure measure in the first two quarters had been close to £400 million. The alignment adjustment has to sum to zero in any calendar year, which implied that either there would be downward revisions to the first two quarters in subsequent releases, or it would be negative in the second half of the year.

A19 The current account deficit had widened in Q2, and had been at its largest since 1990. But the trade deficit had narrowed as export volumes had grown by 2.1%. Growth in import volumes had been revised up to 0.5%. The revision had made the data more plausible as the previous estimate of a fall in imports had been difficult to reconcile with the strength of domestic demand, especially durables spending.

A20 The revision to the income data within the National Accounts had shown growth of post-tax income of 3.1%, greater than spending growth in Q2. The strength had been partly due to very strong growth of dividend income following a fall in Q1. The gross operating surplus of corporations had remained weak in the revisions.

A21 On the output measure of GDP, services growth had been revised up in the second quarter to 0.6%. Within services, communications growth had been strong and finance and business output growth had picked up after slow growth in the previous two quarters. Construction growth had been revised up in both the first and second quarters, to 0.5% and 0.6% respectively.

A22 Retail sales volume growth had remained stronger than values growth in August. Volume growth in the year to August had been 3.6% compared with values growth of 3.2%. The official data had been consistent with information from the Bank's regional Agents. The CBI distributive trades survey had suggested that growth would continue to strengthen, despite a small fall in the level of consumer confidence, as measured by the GfK survey.

A23 The Nationwide measure of house price inflation had risen to 11.0% in September, compared with a figure of 9.8% in August. However, the Halifax measure had fallen from an annual growth rate of 9.4% in August to 8.8% for September. The strong growth of house prices generally over the past year had not brought the level far from the long-run trend and, compared with incomes, the average house price had remained well below the recent peak in 1990. Loan approvals growth had remained strong, as had survey evidence of housing strength.

A24 Data on economic activity in the third quarter had remained strong in general. Export volumes (excluding oil and erratics) had increased by 2.6% in the three months to July, with widespread growth on a geographical basis. Imports had also been strong, rising by 3% over the same period. Construction orders had fallen by 1.7% in the three months to July and by 5.9% compared with July 1998. But the Chartered Institute of Purchasing and Supply (CIPS) construction index had been 59.6 in September, indicating continued growth, though lower than in the summer. Both the CIPS and CBI surveys had continued to show strengthening manufacturing output in September. The CIPS services survey had remained well above 50,

though it had fallen slightly for the second successive month. The National Institute of Economic and Social Research's estimate of GDP growth in the three months to September had been 0.8%, and had been produced after the publication of the August industrial production data.

IV The labour market

A25 LFS employment had increased by 54,000 (0.2%) in the three months to July, compared with the previous three months, broadly the same as growth in the three months to April. Workforce jobs had increased by 104,000 in Q2, though the series had been volatile and the average growth for H1 had been in line with LFS growth for the same period. The rise in LFS employment had been split mainly between self-employment and employees, with employment growth broadly the same in both head-count and in full-time equivalent terms. By industry, the recent rise in Workforce jobs had been concentrated in the services sector; employment had continued to fall in the manufacturing sector, though at a slightly slower pace. The total number of hours worked had risen by 0.7% in the three months to July, and so average hours worked per person had increased by 0.5%.

A26 The CIPS manufacturing survey for September had suggested a slowdown in the rate of decline of manufacturing employment. In the construction sector, employment had expanded at a less rapid rate than in August, while services employment had grown at a slightly faster rate. The Federation of Recruitment and Employment Services (FRES) survey had suggested that shortages of permanent and temporary staff had persisted in September. The latest reports by the Bank's regional Agents had suggested that skill shortages were a major concern in some areas. The stock of job centre vacancies (adjusted for recent data problems) and notifications of new vacancies had been broadly unchanged in August. The National Press Recruitment Advertising index (produced by FRES) had stabilised.

A27 Both measures of unemployment had fallen in the latest data release. LFS unemployment had decreased by 86,000 in the three months to July compared with three months earlier, and the rate had fallen by 0.3 percentage points to 5.9%. Claimant count unemployment had declined by 22,300 in August; the rate had fallen by 0.1 percentage points to 4.2%, its

lowest rate since March 1980. The latest fall in LFS unemployment had been mainly among the short-term unemployed, but long-term unemployment had also been lower.

A28 Labour market inactivity had risen by 71,000 in the three months to July compared with the previous three months, with much of this increase accounted for by the number of people classified as not wanting a job. The inactivity rate had increased by 0.1 percentage points to 21.2% in the three months to July.

A29 Whole-economy headline earnings growth, a three-month moving average of the monthly annual rate, had increased from 4.4% to 4.6% in July, driven by a pick-up in private sector earnings. Service sector headline earnings growth had mirrored the increase in private sector earnings growth, rising to 5.0%, while manufacturing headline earnings growth had fallen back slightly to 3.4%. The twelve-month growth rate of earnings had fallen back sharply from 5.2% in June to 4.4% in July. The fall in the annual rate of earnings growth in July had been affected by bonus payments; some firms in the telecommunications sector had paid bonuses in June, not in July as they had done in previous years. A smoothed measure of earnings growth, generated using a statistical filter, had been 4.6% in July, though this measure was sensitive to new data. The Committee were briefed about developments regarding the new Average Earnings Index sample.

A30 Other earnings data had been mixed. The Reward index had fallen from 3.4% in July to 3.3% in August. The September FRES survey had indicated a further rise in earnings growth of temporary staff supplied by job agencies, though growth rates for permanent staff had eased slightly. The measure of wages and salaries per head from the National Accounts had grown at an annual rate of 5.3% in Q2, which had been higher than the annual growth rate of the Average Earnings Index.

A31 The Bank's measures of wage settlements in August had been broadly unchanged from July. The twelve-month whole-economy mean had fallen since the end of 1998 but had been unchanged at 3.4% in August. The three-month whole-economy measure had been relatively stable, at around 3.1%. Other published settlements measures had been subdued in recent months. A range of measures had shown that the real value of settlements had been rising.

A32 The ONS measure of annual productivity growth had fallen to 0.9% in Q2. Productivity surveys for July and August which had been produced by NTC Research and the Institute of Management Services had suggested a sharp pick-up in productivity growth in Q3. Growth in unit wage costs had risen again in Q2, as wages and salaries had grown faster than productivity.

V Prices

A33 The Bank's oil-inclusive commodity price index had risen by 1.3% in August, mainly as a result of continued strengthening in crude oil prices. Excluding oil, commodity prices had fallen slightly over the month, taking the annual inflation rate to -1.3%. This had been mainly accounted for by falling UK food prices.

A34 Manufacturing input prices had risen by only 0.1% in August and were now 3.8% higher compared with a year earlier. The latest CIPS survey input price index had risen to 54.6 in September, above the neutral 50 mark for the second consecutive month. Output prices had also picked up. The index excluding excise duties (PPIY) had recorded its first annual increase in two years. But producer price inflation, excluding food, tobacco, beverages and petroleum, had remained subdued.

A35 Both export and import prices had risen by 0.6% in July. However, after stripping out the oil component, export prices had fallen by more than import prices over the last 12 months.

A36 The annual rate of change of the GDP and household expenditure deflator had been revised up to 1.8% and 1.5% respectively in Q2. The weakness in the latter had been mainly accounted for by the steep fall in durable goods price inflation.

A37 Retail price inflation in August had been below expectations. RPIX inflation had fallen to 2.1% mainly because of the weakness in food prices and by a less-than-expected seasonal bounceback in some other goods prices.

VI Reports by the Bank's Agents

A38 The Bank's regional Agents reported that overall there had been a continued pick-up in the pace of activity, driven by domestic demand. But the regional divergences had widened. The pick-up in growth had been most pronounced in the South, boosted by growth in services. Manufacturing activity overall had increased at a moderate pace, but output in more specialist sectors such as pharmaceuticals and high-technology products had risen more quickly. Construction activity had remained relatively robust across the regions. Service sector growth had strengthened in a number of regions, with particularly strong demand for financial services. Consumer demand had accelerated at different rates across the regions. The retail picture had remained mixed, with discount stores continuing to record stronger growth than department stores. The renewed appreciation of sterling had affected manufacturers' margins further and contacts had reported that business was being lost to inward competition. The agricultural sector had remained weak.

A39 There had been evidence of further tightening in the labour market. Most regions had reported skill shortages. These had been more evident in services than in manufacturing and were quite acute in some sectors. A significant number of contacts had reported that labour shortages had been spreading and affecting a wider range of skilled and unskilled jobs (particularly in the retail sector and financial services). However, there had so far been little evidence of skill shortages affecting pay rates. Firms reported that pay increases had been directed at performance-related pay rather than 'across-the-board' increases. Many big manufacturers had contained overall increases in the pay bill, targeting increases at groups of staff and cutting staff costs elsewhere.

A40 Commodity prices had begun to pick up for fuels, metals, paper and packaging. However, firms had continued to find it difficult to pass on increased costs. Contacts had reported that increases in fuel prices had not been passed through to output prices. The Agents had conducted a survey of contacts in September to find out whether discounting in the retail and other service sectors had become more marked than in the past. Increased discounting had been notable in the food, mixed retailing, cars, and clothing and footwear sectors. There had been little evidence of increases in discounting for services. In those areas where discounting had

increased, a number of explanations had been given for the pattern. Existing and new competition were frequently cited for increasing the pressure on firms to discount prices. Furthermore, a number of firms thought that consumers had become more sensitive to price differences within each sector, and had begun to bargain over price to an increasing extent.

A41 Rising house price inflation had been most pronounced in the southern regions. In the most recent month, reports of an acceleration in house prices had been more widespread, though some regions had not seen any pick-up in housing market activity.

VII Market intelligence

A42 In addition to the market view of short-term prospects, Bank staff looked at two key issues. First, what factors had contributed to changes in the peak that interest rates implied by the short sterling futures curve were expected to reach; and second, what had contributed to the rise in sterling over the month?

A43 Looking at very short-term rates, mid-October two-week repo rates were expected to be higher than at present, suggesting a modest expectation of a rise in rates. The Reuters' poll of economists had shown a one in three chance of a 25 basis point rise in rates at the October meeting and a two in three chance of a 25 basis point rise before the end of the year.

A44 Looking further out, implied short-term rates in the two-year area (where the short sterling curve had peaked earlier) had fallen over much of the month, but subsequently had returned to a level close to that prevailing before the September Monetary Policy Committee announcement. Individual UK and international economic data releases had not appeared to explain all of this movement. Bank staff considered whether equity prices had been an influence. Falls in equity prices had appeared to reduce interest rate expectations, but more so in the United States than in the United Kingdom. Bank staff had also considered that, at times, movements in sterling may have been a factor. Finally, some market contacts had suggested that the fall in the two-year peak had been a continuation of the gradual adjustment to this summer's earlier 'overshoot'.

A45 The sterling ERI had appreciated by 2.1% since the previous MPC meeting. Risk reversals had suggested little change in risk-hedging behaviour since the beginning of the year. Weak US equities could have been a factor: sterling had strengthened against the dollar during the period of global equity falls. But it had been hard to say whether the dollar had fallen because US equities had weakened more than elsewhere, or whether it had been feared that they had further to go, or whether equities had been of greater significance in the US economy than elsewhere; and the decline in US interest rate expectations which had accompanied weakening equity prices was one of the components of the monetary news. Market contacts had argued that, with hedge funds now less leveraged, 'real money' flows, including those from merger and acquisition activity, carried more weight in market movements. This could mean that such flows had a more persistent, though still temporary, effect on the exchange rate.