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# MINUTES OF MONETARY POLICY COMMITTEE MEETING 6 and 7 December 2000

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These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 December 2000.

They are also available on the Internet  
(<http://www.bankofengland.co.uk/mpc/mpc0012.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 10 and 11 January will be published on 24 January 2001.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 DECEMBER 2000**

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

### **The world economy**

2 The news over the month suggested a rather more pronounced slowdown in the world economy, particularly in the United States, than in the central projection in the November *Inflation Report*. The issues were how fast this deceleration would be, to what extent any faster-than-expected slowdown would be offset by adjustments in monetary policy, and the implications of slower world growth for inflation prospects in the United Kingdom.

3 Although the slowdown in the United States now seemed rather greater than had earlier been expected, some moderation in US growth was necessary (and indeed welcome) if demand were not to outstrip productive capacity and put upwards pressure on prices. The extent of the slowdown required to bring the economy into balance would depend on the sustainable rate of growth in the United States, and in particular on how far the recent increase in productivity growth was a result of structural improvements, rather than cyclical factors. If the use of information technology outside the IT sector delivered further productivity gains, growth in potential supply might remain relatively rapid for some time to come. Estimates of the sustainable rate of growth were inevitably uncertain. But the greater the productive capacity of the economy, the less demand would need to slow to restrain inflationary pressures.

4 Recent US data pointed to a moderation in the pace of growth. Estimates of GDP growth in Q3 had been revised down slightly to 0.6%. Manufacturing output and retail sales were up only a little in October; more recently chainstore sales had been weak. The latest survey from the National Association of Purchasing Managers showed another small fall in the index, which was at its lowest level for two years, while growth in non-farm payrolls continued to slow. Share prices had been volatile, but had fallen over the month, with consumer confidence declining and some evidence of a

further tightening in credit conditions over the past quarter in the Federal Reserve Senior Officer Loan Survey.

5 Since early June, credit spreads for lower-rated borrowers had widened sharply in the United States. Staff analysis suggested that this might reflect firm-specific or sectoral factors rather than broader influences; sharp increases in spreads had been more prevalent in the communications and technology, and electronic, sectors. A differentiated pattern of this sort was typical of a period of rapid structural change, in which some firms were 'winners' and others lost out, resulting in spreads increasing on average. But spreads would also widen in a general economic downturn, with the risk of default increasing for financially weaker companies. If confidence fell sharply while spreads were increasing, the 'soft landing' might prove rather bumpy.

6 Computers, communications equipment and semiconductors continued to account for most of the increase in US manufacturing output. Orders data, however, suggested a deceleration in demand might be in prospect, raising the possibility of future overcapacity in these sectors. Equity prices for such companies had also moved sharply. While the NASDAQ index was still higher than it had been for most of 1999, it had fallen 45% since mid-March 2000. This might have implications for other parts of the US economy, both via confidence and wealth effects. That said, expectations of growth in earnings per share remained quite strong, at around 8% for the next year according to the recent Merrill Lynch survey of fund managers.

7 While movements in the NASDAQ index would not of themselves generate significant wealth effects, this was not the case for equity markets taken as a whole. Indeed, the previous rise in equity prices might well explain part of the fall in the US saving ratio. Now that wealth was no longer rising as a result of increasing equity prices, this might lead (once the lags had worked through) to a greater propensity to save out of current income. And if market participants revised down their estimates of trend productivity growth, equity prices might fall still further. It was recognised that consensus expectations of corporate earnings growth, although currently remaining strong, sometimes failed to signal a prospective downturn. If so, GDP growth could fall sharply, especially if inventories were cut back. In such circumstances, however, the Federal Reserve would have scope to adjust monetary policy accordingly, provided inflationary pressures were subdued.

8 The Committee agreed that while the downside risks to growth in the United States, acknowledged in its November projections, had increased over the past month, the most likely prospect was still for moderate growth rather than recession.

9 Within the euro area, GDP growth was likely to be lower in Q3 than in the previous quarter. The purchasing managers' indices in Germany and France had continued to fall, although these remained above the neutral 50 level. At the same time, consumer price inflation remained well above 2%, and the core inflation measure had risen to 1.5%. The recent fall in oil prices, if sustained, might reduce inflationary pressures in the euro area while helping to support domestic demand. If the euro exchange rate recovered against the dollar in response to slower growth in the United States, this would also help to contain inflation, although it would adversely affect the contribution to growth from net trade, which was likely to be influenced in any case by the slowdown in the world economy.

10 In Japan, GDP growth remained anaemic, at 0.2% in Q3, with the figure for Q2 having been revised down from 1.0% to 0.2%, following changes to the methodology used to produce the national accounts. Equity prices and bond yields had fallen, perhaps suggesting some faltering in expectations of a recovery in domestic demand. The export sector was vulnerable to any sharp slowdown in world demand, or a significant depreciation of the dollar against the yen.

11 There had been signs of fragility in Argentina and Turkey over the past month, but these appeared to reflect the particular circumstances in these countries; so far markets seemed to be differentiating between the emerging market economies more than in 1997 and 1998. Nevertheless, there was a risk that if growth in the United States, and in world trade more generally, slowed by more than expected, the emerging market economies as a whole might be more significantly affected. Within this group, equity prices in Asia had fallen steeply, and the (very rapid) growth rates in industrial production there had begun to moderate; this area was heavily dependent on exports of electronic goods to the United States. Nevertheless, Consensus GDP growth forecasts for these countries in 2001 had been revised down only a little, and their external liquidity positions were in most cases more firmly based than they had been in 1997.

12 The spot price for oil had fallen by around 10% over the past month, but it remained volatile and longer-dated futures prices had declined by less. While there were various short-term factors at

work, the more fundamental influence was probably the deceleration in world activity, and the expectation that the demand for oil would slow, at least in the near term. If sustained, the fallback in oil prices would reduce the upside risks to inflation, and moderate the decline in the prospects for world economic growth.

13 The Committee noted the significant fall in money market and government bond yields in the major industrial economies over the past month. The movements in short yields could be explained by cyclical factors, and the falls in longer yields did not seem to result from changes in inflation expectations; they might instead reflect a widespread downgrading of longer-term growth prospects.

14 If the world economy slowed by more than projected in the November *Inflation Report*, there would be a negative impact on UK growth, and hence on inflation. If the slowdown led to downward pressure on the prices of commodities and other imports, this would restrain inflation further. But if a sharper-than-expected slowdown in the United States led to a fall in the dollar against the euro, the overall impact on the United Kingdom would depend on how sterling reacted to such a move. If, for instance, it rose against the dollar, but fell back against the euro, then the much greater importance of the euro area for UK trade might mean that sterling's effective exchange rate would fall. This would tend to offset, at least in part, the dampening effect on UK prices and activity that would otherwise result from slower growth in world demand.

### **Money, credit and asset prices**

15 Growth in M4 remained strong, although the twelve-month rate had fallen back to 6.6% if deposits by other financial corporations (OFCs) were excluded. Similarly, growth in M4 lending remained robust at 13.2%, but excluding OFCs had fallen back to 11.6%. Lending to private non-financial corporations (PNFCs) had risen by almost 16½% over the past year.

16 M4 lending to households continued to grow at close to 10% a year, with unsecured lending still growing much faster than this. Annual growth in secured lending was little changed, at almost 8%. While on a year-on-year basis the rate of increase in house prices continued to fall on most measures, over a shorter horizon some of these measures showed a pick-up in growth over the past few months. Provisional data from the Royal Institution of Chartered Surveyors' (RICS) survey for November suggested an increase in the balance of estate agents reporting rises in house prices over the past

three months, particularly in the south. Housing market activity appeared to be broadly flat, but the value of loans approved continued to grow strongly, reflecting remortgaging activity. Meanwhile mortgage equity withdrawal had fallen from £3.3 billion in Q2 to a preliminary estimate of £2.4 billion in Q3. This was still high by the standards of the past eight years, and was not unexpected given the recent increase in net housing equity, and stronger competition in the mortgage market.

17 The Committee discussed the implications of these figures for consumption, which had been higher than expected in 2000 Q3, and was 4% up on a year ago (compared with 4.3% in the year to 1999 Q3). House prices had risen sharply during 1999; as a result, whether or not house price inflation was increasing now, homeowners already had considerable collateral against which to borrow, as evidenced by the figures for mortgage equity withdrawal. So far as the remortgaging data were concerned, it was unclear whether borrowers were simply switching between lenders in response to the increasingly competitive terms being offered, or whether at the same time they were increasing their mortgages. More fundamentally, the borrowing figures suggested that consumers still remained confident about their employment and earnings prospects.

18 Since the previous MPC meeting, interest rate expectations, as implied by short sterling futures contracts, had fallen sharply: by 40 basis points or more by the second half of 2001. Taken by itself this represented an easing of monetary conditions. In addition, the sterling effective exchange rate index had fallen by around 1½%, and was now 2% below the path assumed in the November *Inflation Report*. This depreciation could not be explained by movements in interest rate differentials.

19 Sterling had moved less than the euro, which had appreciated by over 3% against the dollar since the Committee's previous meeting, after falling in the first half of the month. This recovery in the euro appeared consistent with a downgrading of growth prospects in the United States, and perhaps also with some moderation in global mergers and acquisitions activity.

### **Demand and output**

20 GDP was estimated to have increased by 0.7% in Q3, unrevised from the preliminary release, and close to its average growth rate over the past year. More recently the Department of the

Environment, Transport and the Regions had released new figures for construction output in Q3 which, taken by themselves, implied that output growth might be revised down to 0.6%. At this stage indicators for Q4 were for growth at much the same rate.

21 The Committee noted that a substantial decrease in the rate of growth of private spending had been incorporated in the central projection of the November *Inflation Report*. Since then, the uncertainties had probably increased. The news in the National Accounts data for Q3 related mainly to the composition of demand. Consumption growth was stronger than expected, and as yet showed little signs of slowing as forecast in the November *Inflation Report*. But investment and government consumption had not grown as rapidly as projected, and so final domestic demand had grown a little slower than in Q2, at 0.8%.

22 The Committee discussed the implications of these figures for the path of output over the next few quarters. Some members placed more weight on the continuing buoyancy of consumption; others emphasised the relative weakness in the growth of other components of final domestic demand, in particular investment, and in addition the risk that stockbuilding might fall back.

23 To date, consumption had continued to grow at around 4% a year. When taken together with the household borrowing figures, high (and rising) house prices and a tight labour market this suggested continuing momentum in the economy. Consumption was by far the largest component of domestic demand and perhaps also one of the less erratic elements. Growth in real incomes and employment had recently begun to slow, and lower share prices had reduced financial wealth a little. These influences would tend to restrain consumption. The question was whether the deceleration would be as marked as in the central projection in the November *Inflation Report*.

24 Retail sales volumes had been flat in October, but private car registrations had grown quite strongly in October and November; sales of new cars to the personal sector were included in consumption but not in retail sales. Surveys were mixed. The CBI Distributive Trades survey for November had shown a surprisingly weak picture for the motor trades, but a sharp recovery in retail volumes, as well as in distribution and wholesaling; all three of these were close to their September levels, having fallen sharply in October. The three-month average measure of retail volumes had declined from the high levels recorded at the turn of the millennium, although the latest three-month period included the (possibly erratically low) October figure. The GfK consumer confidence survey,

conducted early in November, showed a small fall (perhaps related to uncertainty concerning possible fuel protests) while the MORI index had recovered quite sharply. But reports from the Bank's regional Agents suggested that there was as yet little sign of a slowdown in consumption.

25 Investment had again grown more slowly than expected. In Q3 the level of investment was unchanged, once net acquisitions of valuables were excluded. This raised some doubts as to whether investment would grow as rapidly as projected in the November *Report*. The Bank's regional Agents were now reporting some caution among their contacts about investment plans, not just in manufacturing but also in services, reflecting overcapacity in sectors such as leisure. Profit warnings were up on a year ago, particularly in the IT sector; some companies were faced with less favourable financing conditions now that their equity prices had fallen and credit spreads had widened. Once the oil sector was excluded, both gross and net rates of return for PNFCs had declined since 1998 Q1. But the level of investment as a share of GDP remained high by historical standards, at least on the basis of constant price measures.

26 Government consumption had grown by 0.6% in Q3, well down on its growth rate in the previous quarter, suggesting that unless there were to be a marked acceleration in spending in the next two quarters, departments would spend less than had been planned for this financial year. If public spending were to continue to grow more slowly than forecast, there would be more time for private spending to slow without the overall growth in demand placing excessive strains on the productive capacity of the economy.

27 In recent quarters stockbuilding had risen quite sharply; in the year to 2000 Q3 changes in stockbuilding had accounted for 1.1 percentage points of the 2.9% increase in GDP. If this rise was predicated on expected increases in final demand, stockbuilding could fall sharply if these expectations were not fulfilled. In that sense the inventory cycle represented a downside risk to activity.

28 Surveys by the Chartered Institute of Purchasing and Supply (CIPS) showed stronger output growth in manufacturing, while in services the CIPS index remained at 57, well above the neutral 50 level. However, the CBI Deloitte and Touche Services Survey suggested that while volumes continued to rise, particularly in consumer services, optimism had fallen, with the decline most marked in business and professional services.

29 Leading indicators for the United Kingdom pointed to a slowdown in growth continuing into 2001. Since these indicators were built up from information which was already available to the Committee, such as equity prices, confidence measures and new car sales, some members were not inclined to put much weight on them: to do so ran the risk of double counting. For others, leading indicators could be used to improve the projections of most UK macroeconomic models, and had done so over a long period. Such indicators therefore provided a useful cross-check to the forecast.

### **The labour market**

30 The latest quantities data suggested that the labour market remained tight, but might be turning. Growth in employment, as measured by the Labour Force Survey (LFS), had slowed steadily from 126,000 in the three months to May to under 70,000 in Q3. The underlying deceleration might be even greater: new population estimates had been used to gross up the latest data, and the effect was to increase measured employment in Q3 relative to earlier quarters. Claimant count unemployment had risen slightly in October, and while LFS unemployment had fallen by 36,000 in Q3 compared with Q2, it had risen compared with the three months to August. Overall labour input, as measured by total hours worked per week, was up only 0.1% on a year ago. Survey data, however, did not point to a major change in the demand for staff from employers.

31 There was little new information on pay settlements, and the Average Earnings Index continued to grow at not much above 4%, with regular pay (ie, excluding bonuses) growing at a similar rate. If anything, the rate of growth of regular pay appeared to have eased a little since May.

32 The Committee agreed that it would be important to monitor settlements in the new year closely to see how far, if at all, they began to reflect pressures on recruitment and retention and higher RPI (rather than RPIX) inflation. While a survey by Industrial Relations Services (IRS) suggested no sharp escalation in pay deals was likely over the next year, another by Incomes Data Services pointed to more upward pressure on settlements than for some time. The Bank's own survey, carried out by its regional Agents, suggested that 28% of employers expected settlements to be higher in 2001 than 2000, with 10% expecting them to be lower; the majority of respondents expected no change or had no company-wide settlement. The IRS survey pointed to a similar increase in the proportion of employers expecting higher settlements, but the average settlement was expected to

increase only from 3.1% to 3.4%. In the Bank's survey, 47% of employers expected pay per head to rise by more in 2001 than 2000, with 14% expecting a lower increase than in the previous year.

## **Prices**

33 RPIX inflation had fallen back to 2.0% in October, although the provisional estimate for November, which was available to the Committee at its meeting, was for some recovery. Despite the recent strength of oil prices, RPIX inflation remained subdued. The CBI Distributive Trades Survey, however, suggested diminishing downward pressure on average retail selling prices in Q4.

34 In October the services component of RPIX inflation had fallen to 3.1%, its lowest level since March 1998. But survey data on services prices were mixed. The CIPS prices charged measure stood at 55 in November, a little below October but well above its average level. The British Chambers of Commerce measure showed little change over the past year. The CBI Deloitte and Touche Services Survey suggested widespread price increases in consumer services since the previous survey, but with this moderating over the next three months. In the same survey, more respondents now expected prices to fall rather than rise in business and professional services.

35 The GDP deflator had risen by 1.9% over the past year. Most other measures of domestically generated inflation, such as unit labour costs (using either trend or actual productivity) and RPIX inflation excluding import prices, were at 2½% or less. Import price deflators remained weak, falling 0.3% in Q3 and rising only 0.8% over the past year. It was unclear how far this reflected a compression of overseas exporters' margins.

## **Tactical considerations**

36 The Committee noted that this month there was a very strong market expectation that the repo rate would be left unchanged, as evidenced (for instance) by the most recent Reuters poll of City economists. Any change in rates at this meeting – in either direction – would therefore be unexpected, and might be seen as a very strong signal by the market. The Committee agreed that these expectations did not act as a constraint on its actions; it merely underlined the need to provide a clear explanation for a decision to change rates. Nor could the Committee identify any other tactical factors which were relevant to its decision this month.

### **The immediate policy decision**

37 The Committee agreed that the world economy was probably slowing rather faster than expected, but that news on the UK economy was more mixed, with household consumption still buoyant but investment and government consumption growing more slowly. The Committee discussed the implications of these developments for its immediate policy decision.

38 On one view, the repo rate should be maintained at 6% this month. The slowdown in the world economy, after a period of robust growth, would tend to restrain net trade, and hence UK activity. This might reduce inflationary pressures from overseas, particularly if coupled with falling oil prices. However, the overall impact would depend on how sterling's effective exchange rate reacted to the new pattern of relative growth rates between the United States, the euro area and the United Kingdom; sterling was already 2% below the path assumed in the November *Inflation Report* central projection. Domestically, there was little sign of a slowdown in consumption, which continued to grow at 4% a year. Household borrowing continued apace, supported by high levels of house prices; indeed there were signs that house price inflation might again be picking up. Survey data were mixed, but did not point to a sharp slowdown in spending, and downward pressures on retail prices might be diminishing. For some members, the consumption-related indicators suggested not only that GDP growth would remain more unbalanced than was desirable, but also that inflationary pressures might strengthen. This represented an upside risk to the November forecast, and supported a case for not ruling out the need for some upward adjustment in the repo rate, particularly as recent movements in the exchange rate and market interest rates had already resulted in some easing of monetary conditions. But with weaker world activity, RPIX inflation still below target and steady earnings growth there were still reasons to wait and see. On balance, the repo rate should therefore remain at 6% this month. Other members, while agreeing that the repo rate should remain unchanged, saw the risks as more evenly balanced. While consumption remained buoyant, employment growth was moderating, with unemployment marginally higher, and real income growth might be slowing; pay settlements in the new year would be an important indicator of how far tightness in the labour market would translate into higher nominal pay awards. Growth in investment was sluggish (though its level remained high), there was uncertainty about how fast public spending would increase, and there was a risk that inventories could fall back as the economy slowed. For some of these members the uncertainties surrounding the outlook had increased further

since the time of the November *Inflation Report*. Taking all of these factors together, no change in the repo rate was needed this month.

39 On a second view, the repo rate should be reduced by 25 basis points. The major news this month had been the sharper-than-expected slowing in world demand. Its effect would be to lower activity in the United Kingdom, and reduce RPIX inflation below what had been seen as most likely in November (which for these members was lower than the central projection in the *Inflation Report* because they were more optimistic about the supply-side performance of the UK economy). Taken by itself, mechanically, this month's fall in the exchange rate would tend to raise inflation, but that effect would be offset by weaker oil prices, the lower import price deflator (if sustained) and the weakness of global equities. Moreover, the downside risk to international activity was probably greater than had been allowed for in the November *Inflation Report*. Domestically, consumption continued to grow quite quickly, with house prices perhaps picking up. But investment growth was weaker than in the central projection, government consumption might be lower than planned and the inventory cycle was a downside risk. Leading indicators and market interest rates both suggested that the peak in growth had passed, and that growth might slow more sharply than in the central projection. The labour market could be at a turning point, although it was too soon to be sure; growth in regular pay also seemed to be moderating. Even if house price inflation remained at its recent monthly rates, and the current level of petrol prices was sustained, the annual rate of RPIX inflation would tend to fall, other things being equal, as earlier high increases dropped out of the calculation. This effect would tend to be amplified by the likely fall in oil prices and also by the possible decline in fuel duties that would result if the measures set out for consultation in the Pre-Budget Report were enacted. RPIX inflation had now been below 2½% for more than 18 months; without an early policy response it might well continue to be so for the next two years. While current monetary conditions had loosened slightly over the month as a result of the fall in the exchange rate and in market interest rates, a Dynamic Monetary Conditions Index, which took account of the effects of lags, continued to tighten slightly. At present, on most estimates for neutral interest rate levels, monetary policy was slightly contractionary; this no longer appeared appropriate. To cut rates would be a pre-emptive move which would help sustain business and consumer confidence in the event of spillover effects from a deteriorating international environment. A reduction in the repo rate to 5.75% was therefore warranted this month.

40 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. Seven members of the Committee (the Governor, Mervyn King, David Clementi, Christopher Allsopp, Charles Bean, Stephen Nickell and Ian Plenderleith) voted for the proposition. DeAnne Julius and Sushil Wadhvani voted against, preferring a reduction in the repo rate of 25 basis points.

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  
Christopher Allsopp  
Charles Bean  
DeAnne Julius  
Stephen Nickell  
Ian Plenderleith  
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 December in advance of its meeting on 6-7 December 2000. 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 US GDP growth in Q3 had been revised down from 0.7% to 0.6%. The contribution of net trade had been weaker than in the advance release, but investment had been revised up somewhat. Manufacturing output had risen by 0.1% in October, but excluding high-technology components, which rose by 3.2%, it had fallen by 0.5%. New orders for capital goods corrected for erratic components (ie, defence, aircraft and aircraft parts) had fallen by 0.5% in October and there had been a reduction in the level of unfilled orders. Consumer confidence had fallen in October, possibly influenced by further falls in equity prices, especially in the telecommunications and technology sectors. Retail sales had weakened, with an increase of 0.1% in October. The unemployment rate had remained at 3.9%, although there had been an increase in weekly new claims over the past two months, and growth in non-farm payrolls had continued to slow.

A3 There had been some easing in spreads in investment-grade corporate bond markets. Within the high-yield corporate bond market spreads had continued to widen. But there was some evidence to suggest that the recent tightening in credit conditions had been largely due to sector or firm-specific factors. There had been further indications of tightening credit conditions from the Federal Reserve Senior Loan Officer Survey, which also pointed to a slowdown in loan demand. Commercial and industrial lending by commercial banks had declined by 0.1% in October.

A4 In the euro area, quarterly GDP growth in Q3 had been 0.6% in Germany, 0.7% in France and 0.5% in Italy, suggesting that euro-area GDP growth might slow relative to Q2, when it had been 0.8%. Euro-area business confidence had fallen in November, but consumer confidence had been unchanged from the previous two months, following the sharp fall in September. While the IFO index for western Germany had fallen for the fifth consecutive month, there had been a small improvement in expected economic conditions. Consumption had been weak in Germany, France

and Italy and there had been high contributions from stockbuilding in Germany for the second quarter in a row, suggesting that future demand might be met at least partially from stocks. The unemployment rate for the euro area had declined to 8.9% in October.

A5 In Japan, GDP had risen by 0.2% in Q3, and GDP growth in Q2 had been revised from 1% to 0.2%. Private capital expenditure, which for the first time included computer software, had risen by 7.8%. Although investment indicators had weakened in October, machinery orders had been strong, due to orders for high-technology machinery. Consumption had increased by only 0.1% during the quarter, reflecting a fall in household expenditure in Q3.

A6 The spot price for Brent crude oil had fallen by about \$3 since the previous meeting to around \$28 per barrel, and futures prices had fallen slightly. There had been a moderate increase in other commodity prices.

A7 In the United States, the headline measure of producer price inflation had increased to 3.6% in October, but the core measure had been 1.0%. In the euro area, producer price inflation had reached 6.0% in September with signs of a pick-up in non-energy components. Consumer price inflation in the United States had remained at 3.5% in October, but the core measure had fallen to 2.5%. In contrast, in the euro area, while headline inflation had eased to 2.7% in October, core inflation had risen to 1.5%. Preliminary data for Germany had shown an increase in headline inflation in November, making a fall in the headline measure for the euro area in that month unlikely.

A8 Market expectations of official interest rates in the United States and the euro area had eased over the past month. Expectations were now for a larger reduction of rates in the United States. In the euro area, expectations were now for no change in official rates over the next year.

A9 In the emerging market economies, industrial production growth had slowed and there had been indications of specific risks from the economies of Argentina and Turkey.

## **II Monetary and financial conditions**

A10 Both the twelve-month and three-month growth rates of notes and coin had remained strong in November. The provisional twelve-month rate had fallen to 7.2% in November from 8.0% in

October before the base effects of the rapid rise in banknotes ahead of the millennium date change had been taken into account, which were estimated to have depressed the twelve-month growth rate. The three-month annualised growth rate of notes and coin rose to 10.5% in November from 9.8% in the previous month. Some of this strength had been due to a temporary increase in cash holdings relating to government winter allowance payments.

A11 The twelve-month growth rate of M4 had remained strong, although it had fallen from 9.1% in September to 8.7% in October. However, the fall in the twelve-month growth rate of M4 excluding other financial corporations (OFCs) had been more pronounced, from 7.5% to 6.6%. The twelve-month growth of M4 lending excluding securitisations had remained unchanged at 13.2%, while the growth of M4 lending excluding OFCs had fallen slightly to 11.6%.

A12 The twelve-month growth rate of households' M4 lending excluding securitisations had fallen slightly to 9.8% in October. On a preliminary estimate, the level of mortgage equity withdrawal had fallen from £3.3 billion in Q2 to £2.4 billion in Q3. Unsecured lending to individuals had risen by £1.5 billion in October. There had been a small net outflow of households' deposits, with the twelve-month growth of households' M4 having fallen from 6.1% to 5.4%. This may have partly been explained by the unwinding of the effect on households' M4 of Scottish Widows windfall payments.

A13 The number of loan approvals for new mortgages and particulars delivered had risen during October, but only very moderately, suggesting that housing market activity had been broadly flat. However, the value of loan approvals had risen quite sharply, partly due to increased remortgaging activity.

A14 The twelve-month growth rate of private non-financial corporations' (PNFCs) M4 lending excluding securitisations had fallen slightly to 16.4% in October, while the growth rate of PNFCs' M4 fell to 11.5%. Net recourse by corporates to the banking sector had picked up in Q3. This was associated with a pick-up in the stock-output ratio in Q3. Both OFCs' M4 and M4 lending had been strong, though much of this had represented short-term distortions.

A15 Short-term nominal interest rates had fallen significantly since the Committee's previous meeting, continuing a downward trend in near-term expectations that had begun after the last repo

rate rise in February. Real and nominal zero-coupon rates had also been lower across the curve. Survey-based inflation expectations had changed little on the month.

A16 Accompanying the decline in gilt yields, there had been substantial falls in ten-year swap rates and A-rated corporate bond yields. A broadly similar picture had emerged at other maturities, and for other credit ratings. Non-gilt sterling bond issuance, particularly of long-maturity bonds and floating-rate notes, had continued to be strong. A significant proportion of new sterling issuance had been by supnationals and other non-UK corporations.

A17 Falls in short-maturity swap rates had been closely tracked by two-year fixed-rate mortgage rates. In contrast, two-year discounted floating mortgage rates had been rising over the year. But these changes in relative quoted mortgage rates had not boosted the share of fixed-rate mortgages in new business.

A18 Since the previous MPC meeting, the FTSE All-Share index had fallen by 3.2%. Falls had occurred in most sectors with the IT sector declining most. Since April the FTSE had outperformed other broad-based international equity markets. One possible explanation for this was that the IT and telecoms sectors had a lower weight in the FTSE compared with other indices such as the S&P 500. Excluding these two sectors, the FTSE All-Share and S&P 500 indices had increased by 3.0% and 1.1% respectively since April.

A19 Over recent months, there had been a greater number of profit warnings compared with the same period in 1999, and so far these were more heavily concentrated in the IT sector in Q4 than in Q3. The Merrill Lynch survey of UK fund managers had also shown a decline in expected earnings per share for 2001.

A20 Since the previous MPC meeting, the sterling exchange rate index (ERI) had fallen slightly by 1.5% to 105.4, as sterling depreciated against the euro but appreciated against the US dollar and the yen.

### III Demand and output

A21 Quarterly GDP had risen by 0.7% in Q3, unrevised from the preliminary GDP release. Manufacturing output growth had been 0.6% in Q3, up from 0.4% in Q2, while service sector growth had slowed to 0.7% from 0.9%. Construction output had grown by 0.4% in Q3. Within the service sector, the growth in business services had slowed to 0.8% in Q3 from 1.3% in Q2. Growth in distribution, hotels and catering had been revised upwards to 1.2% in Q3 from the preliminary estimate of 0.7%.

A22 On the expenditure side, household consumption growth had been 1.0% in Q3, compared with 0.8% in Q2. The Office for National Statistics (ONS) had indicated that the strength in consumption had been partly accounted for by higher spending on household durables, clothing and footwear, and transport and communications. Real government spending had increased by 0.6% in Q3. Net trade had contributed -0.6 percentage points to GDP growth in Q3. Total exports of goods and services had grown by 1.7% and imports by 3.0%. Inventories had contributed 0.4% to GDP growth.

A23 Total investment had grown by 0.5% in Q3, but investment excluding valuables had been flat. Business investment had grown by 0.7%. Within this, service sector investment growth had fallen to 1.7% in Q3 from 2.2% in Q2. Manufacturing investment had grown by 0.3%. The gross operating surplus of UK corporates had increased by 1.7% in Q3.

A24 Turning to indicators of Q4 activity, retail sales volumes had been flat in October, suggesting little adverse effect from the recent flooding. The CBI Distributive Trades Survey reported that the retail sales balance had increased to +13 in November from zero in October. The British Retail Consortium had reported slightly stronger sales in November. Total car registrations had increased by 2.6% in October on a year earlier, while private car registrations had increased by 14.1% over the same period. The GfK aggregate consumer confidence balance had fallen slightly to -2 in November from zero in October. But the survey had been conducted in early November and confidence might have been adversely affected by uncertainty concerning possible fuel protests.

A25 There had been signs that house price inflation had picked up after falls earlier in the year. The Nationwide index had increased by 0.9% in November following a similar increase in October.

The Halifax index had increased by 2.4% in the three months to November compared with the previous three months. And provisional data from the Royal Institution of Chartered Surveyors' (RICS) survey balance for house price inflation for November had suggested a pick-up from October's figure of +7. In terms of housing market activity, particulars delivered had risen slightly to 113,000 in October from 112,000 in September, but had remained below the average of 127,000 in the first half of the year. The House Builders' Federation net reservations balance had risen to -13 in October from -20 in September.

A26 Total industrial production had fallen by 0.2% in October. Within this, manufacturing sector output had fallen by 0.1%, mining and quarrying sector output had fallen by 4.1%, and utilities sector output had grown by 2.8%. The CBI Monthly Industrial Trends output balance and total order book balance surveys had been little changed in November compared with the previous month, at +1 and -17 respectively. The CIPS business activity index for services had been 57.0 in November, unchanged from October. In manufacturing, the CIPS purchasing managers index had been 51.3 in November, close to its average since the survey began in 1991, and up from 49.8 in the previous month. And the CIPS construction activity index had fallen slightly in November, to 54.3 from 55.7 in October.

#### **IV Labour market**

A27 Labour Force Survey (LFS) data for 2000 Q3 had used updated population estimates to weight individual responses, but historical LFS data had not yet been revised to be consistent with the new population figures. As a result, the levels and growth rates of the main LFS variables in Q3 had been increased relative to those for earlier quarters. Figures expressed in terms of rates or ratios (such as the unemployment rate) had been largely unaffected by the change. The largest impact had been on the levels of (and changes in) employment and inactivity.

A28 According to the published figures, LFS employment growth had eased to 0.2% in Q3, down 0.2 percentage points from the previous quarter. However, adjusting for the impact of the new population estimates, employment growth had weakened by rather more. The working-age employment rate had increased by 0.1 percentage points to 74.7%. Increased employment had been more than accounted for by higher part-time employment. As a proportion of total employment, part-time employment had risen to 25.2% in Q3, up 0.3% compared with the previous quarter. But

the quarterly fall in full-time employment had been the largest (on a consistent basis) since 1996 Q1. Average weekly hours per worker had fallen by 0.3%, compared with Q2.

A29 Contrary to weaker LFS employment growth, survey-based evidence had not indicated any significant change in employers' demand for staff. The latest CIPS surveys of the construction and service sectors had suggested that employment growth in November had continued at a similar rate to the previous two months, while the CIPS survey of manufacturing had suggested that employment was falling less rapidly. The Recruitment and Employment Confederation (REC) survey had reported that shortages of agency staff had widened further in November.

A30 LFS unemployment had fallen by 36,000 in Q3, a smaller decline than had been seen in recent monthly data releases. The LFS unemployment rate over this period had been 5.4%, which was down 0.1 percentage points compared with Q2, but was 0.1 percentage points higher than the rate for the period June to August. The slower decline in unemployment had been mainly accounted for by a much smaller fall in short-term unemployment. The claimant count had fallen by 48,700 in Q3, but had increased by 3,500 in October.

A31 The working-age inactivity rate had been 21.0% in Q3, unchanged from the previous quarter.

A32 Overall, there had been little change in the pattern of earnings growth. Whole-economy headline (three-month average) earnings growth had risen by 0.1 percentage points to 4.1% in Q3. Private-sector headline earnings growth had risen by 0.2 percentage points to 4.3%, while headline growth in the public sector had fallen by the same amount to 3.3%. In the manufacturing sector, headline earnings growth had remained unchanged at 4.3%. Earnings in the private service sector had also grown at a headline rate of 4.3%, up 0.4 percentage points from the previous month.

A33 Annual earnings growth in the year to September had been 4.3%, up slightly from the previous month. Historical AEI data had been revised to reflect updated seasonal adjustment factors, revised employment weights and other minor technical adjustments. The overall effect of these changes had been small, although the revisions had given regular pay growth a flatter profile since the beginning of the year than had previously been reported. The contributions of regular pay growth and bonus payments to overall earnings growth in September had been broadly unchanged

from the previous month. Bonuses had continued to make a negative contribution to earnings growth.

A34 There had been little new information on pay settlements. The Bank's AEI-weighted twelve-month mean settlement had remained unchanged at 3.0% in September. The three-month measure had increased slightly from the previous month.

## **V Prices**

A35 The Bank's oil-inclusive commodity price index had fallen by 1.6% in October, the first fall since July. This had taken the annual inflation rate down from 20.7% in September to 20.0% in October. The monthly fall had mainly reflected falls in the prices of metals and fuels. The fuels component of the index had fallen by 2.5% in October, largely accounted for by the fall of just over 4% in the average sterling oil price in the same month. The Bank's oil-exclusive commodity price index had fallen by 0.8% in October, but due to base effects the annual inflation rate had increased to 8.1% in October from 7.4% in September.

A36 Manufacturing input prices had fallen by 0.9% in October, taking the annual inflation rate down from 13.6% in September to 12.1% in October. The monthly fall had largely reflected the fall in the sterling oil price in October. Input prices excluding food, beverages, petroleum and tobacco industries had risen by 0.1% in October, but the annual inflation rate had remained broadly unchanged at 4.1%. The CIPS manufacturing survey input price index had been unchanged at 55.6 in October. Output prices excluding excise duties (PPIY) had risen by 0.1% in October, taking the annual inflation rate from 1.8% in September to 1.9% in October.

A37 The GDP deflator (at market prices) had risen by 0.9% in Q3, following a rise of 0.1% in Q2. The annual inflation rate of the GDP deflator had risen marginally to 1.9% in Q3. The annual inflation rate of the investment deflator had fallen to 2.4% in Q3 from 2.8% in Q2, while the annual inflation rate of the household consumption deflator had fallen from 1.3% to 1.0% in Q3. The import price deflator had fallen by 0.3% in Q3, following a rise of 0.7% in Q2.

A38 RPIX inflation had fallen by 0.2 percentage points to 2.0% in October. This decline largely reflected a fall in the contributions from petrol, seasonal food, household services and vehicle tax

and insurance prices. Annual services price inflation had fallen from 3.4% to 3.1% in October, the lowest annual rate since March 1998. RPI inflation had fallen from 3.3% to 3.1% in October. RPIY inflation had fallen to 1.6% in October, while HICP inflation had been unchanged at 1.0%. The difference between RPIX and HICP inflation had narrowed to 1.0%.

## **VI Reports by the Bank's Agents**

A39 The Bank's regional Agents reported that overall construction growth had remained broadly stable recently, although while commercial construction activity had continued at a high level, the pace of growth had probably now peaked. Offsetting this, public construction activity was expected to strengthen during 2001, but the timing was uncertain. Housing construction, which had slowed in recent months, had probably now stabilised at a lower level.

A40 Manufacturing output growth had picked up slightly further recently. The recovery had continued to be mostly driven by improvements in export demand. Agents' contacts had mentioned increased efforts to obtain expanded market share in 'dollar markets', such as the United States and the Middle East. While export volumes to the euro area had continued to grow, most firms had suggested that this had been at the expense of margins. On the whole, it was suggested that growth in imports continued to exceed that of exports.

A41 Reflecting continued concerns over profitability in many traditional manufacturing industries, investment intentions in the sector remained depressed in most regions, although some firms had invested heavily in research and development. Investment intentions in the services sector had remained strong and stable. But some contacts had noted caution about future investment plans due to concerns about overcapacity in some areas (eg, leisure).

A42 The Agents had suggested that there had been little change in underlying retail sales growth recently. However, the picture had become more difficult to read in recent months, due to the impact of the fuel dispute, flooding and rail disruptions. But, on the whole, most retailers had suggested that there had been little easing in consumer confidence recently. There had been some signs that, following a sustained period of year-on-year declines, sales of new vehicles had now stabilised. But there had been some caution regarding the extent of pent-up demand in this market.

A43 The pace of input price inflation had stabilised recently according to the Agents. Contacts had continued to cite price increases for oil-related products and regulatory costs as the greatest concerns. There had continued to be reports of higher import prices from dollar-denominated markets as a result of the depreciation of sterling. Cost increases had remained difficult to pass through to output prices. However, many contacts had suggested that there had been increasing resistance to further price cuts in recent months. Many UK exporters' margins had benefited from the relatively strong dollar, although domestic prices had remained under downward pressure as a result of import competition.

A44 Skill shortages had remained a major issue for many firms, although they had not intensified any further recently. Firms had increasingly mentioned the importance of staff retention, including the use of measures such as training and non-pay benefits.

A45 The Agents had conducted a survey of around 170 UK firms regarding pay prospects for 2001. The results had shown that around three-quarters of firms surveyed reported that pay settlements for next year were likely to be the same as, or higher than, a year ago. This was slightly higher than in a similar survey for 2000. There had been relatively little difference between results across sectors. Expectations about total pay growth per employee were slightly stronger than for settlements, with 47% of respondents expecting an increase, up from 38% in last year's survey. Problems recruiting and retaining staff were the most frequently cited factors affecting increased pay pressure.

## **VII Market intelligence**

A46 Short-term interest rate expectations implied by market rates and derived from surveys had fallen sharply over the month. Rates implied by short sterling futures contracts, for example, had fallen by 30-45 basis points for contracts maturing in 2001-02. More than half of those City economists polled by Reuters on 30 November expected the next move in the Bank's repo rate to be down. But they attached an average probability of 84% to the MPC leaving the Bank's repo rate unchanged in December – the highest level of confidence attached to such an outcome since the poll began in July 1998.

A47 The main factors leading to this downward revision in future rate expectations included the weaker-than-expected RPI and PPI price data, and the first rise in unemployment in two years. Implied rate expectations had also fallen following declines in international equity indices, and after the release of the November MPC minutes, which were interpreted as placing more weight on the downside risks to economic activity. As implied rates fell, the skewness derived from options on short sterling futures contracts had returned to a neutral position, having implied a greater downside risk during October and early November.

A48 Bond yields at all maturities had fallen over the month in all major markets. The 10-year gilt yield, for example, had fallen by more than 30 basis points. Spreads between sterling corporate bonds and gilts had widened slightly, but these changes were small relative to the large falls in yields within both markets. The downward movement in yields had been influenced primarily by considerations related to weakness and volatility in global equity markets and increased expectations of a slowdown in world growth.

A49 The sterling ERI had been relatively stable over the month, but had ended the period 1.5% lower at 105.4. During the first half of the month, the dollar had appreciated against sterling, but later it had weakened significantly, and had ended the period 0.8% lower against sterling at 1.4365. Though varying reports of each candidate's ascendancy in the US Presidential election had had little immediate impact on the dollar exchange rate, political uncertainty as well as prospects for lower US GDP growth had affected market sentiment. In contrast the euro had risen by 2.4% against sterling to 0.6160. The value of global cross-border M&A deals had continued to slow in November to its lowest level since September 1999, which suggested that one source of downward pressure on the euro might have begun to ease.