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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 October 2000

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 October 2000.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0010.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 8 and 9 November will be published on 22 November 2000.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 OCTOBER 2000

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

Prices and costs

2 RPIX inflation had fallen to 1.9% in August, largely reflecting falls in the contribution of petrol prices but also a fall in seasonal food prices: by contrast with recent years, such prices had risen in July but fallen back in August. The near-term outlook for petrol prices and for petrol retailers' margins suggested a rather lower path for inflation over the next few months than had been expected at the time of the projections made for the *August Inflation Report*. Were margins to be restored, and the normal relationship between oil prices and petrol prices to apply, the recent fall in RPIX inflation might be reversed. But the timing of any such restoration of margins was unclear. The latest ONS advance estimate of RPIX inflation, which was again available for the Committee's meeting, suggested that August's fall had been reversed, although no information was yet available on what accounted for this.

3 The range of measures of domestically generated inflation available to the Committee were for the first time all at or below the inflation target of 2.5%: RPIX inflation excluding import prices stood at 2.5%; the GDP deflator excluding export prices at 1.9%; and the growth of unit labour costs, adjusted for trend and using actual labour productivity growth, stood at 2.2% and 1.7% respectively - though both reflected lower bonuses, which might not persist. Contrary to expectations at the time of the previous meeting, the GDP deflator had not been revised upwards.

4 There were some indications however that inflation expectations had increased, notably in the results of the most recent Basix surveys of the general public and of trades unions whose expectations of inflation had increased by 30-40 basis points since the second quarter. Looking twelve months ahead, inflation expectations of the general public (which had always remained well above the Government's target of 2.5%) now stood at 4.2% and those of trades unions at

2.9%. The extent to which this was a temporary effect, reflecting a reaction to the disruption of petrol supplies in the first half of September, was unclear. Other surveys of inflation expectations suggested little change. But it would be worrying, particularly in the context of the apparent tightness in the labour market, if this increase in inflation expectations were to persist as it could then affect wage bargaining in the coming settlement round.

The world economy

5 Oil prices had fallen \$3 since the Committee's previous meeting, with the Brent one month future now just above \$30 per barrel. Oil price futures were indicating a fall in prices to about \$25 per barrel by the end of 2002, substantially above the projection in the August *Inflation Report*. It was unclear whether the factors determining the long-run level of the oil price had changed significantly, but the futures curve did at least suggest that the market's view of the horizon over which the price would return to more normal levels had lengthened in recent months.

6 Against this background, the Committee first reviewed the evidence on the likely source of the shock which had resulted in the sharp increase in the price of oil since the end of 1998. Most members felt that the initial shock could largely be attributed to the unexpectedly strong growth of the world economy, in particular the rapid recovery of the Asian economies from the difficulties they had experienced in the second half of 1998. This had subsequently been reinforced by OPEC restraint on supply. Other commodity prices had been slower to respond, but were now beginning to do so. The OPEC countries had recently shown themselves willing to increase their supply of oil, which - together with the release of oil from the US strategic stockpile - had helped to stabilise the market but at a relatively high nominal price level.

7 Looking forward, the price path implied by the futures curve would reflect the market consensus on the outlook for demand, for non-OPEC supply and for the ability of the OPEC countries to sustain the cohesion which would be required to stabilise prices at around their chosen target range. It continued to represent a plausible central case. But it was recognised by the Committee that there were risks around this path. In particular, there was felt by some members to be an upside risk in the coming months as the Northern Hemisphere winter

approached and downside risks further out - associated either with the build-up of non-OPEC supply or with a more rapid slowdown in world demand than was currently foreseen.

8 Though the experience of previous oil supply shocks was unlikely to be repeated, it was possible that further sharp movements in the price of oil could lie ahead. On this view, it could be a year or more before the non-OPEC supply response would begin to have a marked effect in restoring oil prices to more normal levels. In the meantime, prices could fluctuate quite sharply and this volatility could dampen world activity by denting confidence.

9 The Committee noted that the UK was better placed than some other countries to allow monetary policy to accommodate the first round effects of any supply-related shock to oil prices, with the economy currently operating at close to capacity and with inflation somewhat below target. In addition, in contrast to most OECD countries, the UK's position as a net oil exporter meant that the balance of payments and fiscal effects of an oil price rise were likely to be positive.

10 The consensus of outside forecasters was that the increases in the price of oil since the spring would reduce world activity by about half a percent. This was a somewhat more muted effect than had followed similar price movements in the past, reflecting reductions in the intensity of oil use since earlier shocks and the fact that the real price of oil remained significantly below previous peaks. In any case, some slowing of the world economy had been expected, and indications that it was now occurring simply confirmed those expectations. In addition, it was possible now that the OPEC countries would spend more of the extra income generated by the higher oil prices, because of changes in their financial positions. This would provide a larger offsetting boost to world export growth than had previously been the case.

11 Some members of the Committee, however, assessed the recent news as pointing to a risk of a sharper slowdown in world growth than had seemed likely at the time of the previous meeting. Market expectations for interest rates in the G7 countries had fallen over the past month, and the OECD leading indicator had now been falling since January. Imbalances in the world economy persisted and might be increasing. The benign forecasts for the world outlook were predicated on a soft landing in the US together with stronger activity growth in Europe.

There were some indications that that outturn might not be realised, with signs of slowdown in both the euro area and the United States. Second quarter growth in the euro area had been 0.9%, rather lower than was projected at the time of the August *Inflation Report*. Retail sales data and confidence surveys suggested that growth in the euro area might have slowed significantly in the third quarter. In contrast, activity had been stronger in the United States. The risks to the world outlook might on balance therefore have increased. Higher oil prices might depress consumer and investment spending. The marked falls in equity prices over the month could be an early indication of further slowdown in prospect. The possibility of further sharp movements in oil prices suggested that confidence could weaken and could lead to delays in planned investment. These risks would need to be examined in the context of the forecast for the November *Inflation Report*.

Monetary and financial conditions

12 Monetary data continued to show strong growth. Annual growth in notes and coin had increased by 1.8 percentage points to 8.7% in September, though perhaps a third of this increase reflected banks' precautionary build-up of cash holdings at the time of the disruption to fuel supplies. M4 growth in August had increased to 8.8%, its highest rate for two years, affected in part by transactions related to 3G telecommunications licences and to Lloyds TSB's takeover of Scottish Widows. Aggregate Divisia money growth was rising steadily and now stood at just under 6%. Total credit growth, at 13%, was the strongest since 1991 and though household M4 growth had eased a little it remained at levels last seen a decade ago. Secured lending to households had returned to the level established in the middle of 1999, reversing the dip in July. Mortgage equity withdrawal had been positive for two quarters and was expected to continue to support consumption in the coming months. Recent rapid growth in the level of corporate borrowing seemed to be related principally to the financing of merger and acquisition activity and to the purchase of 3G telecommunications licences, so was not inconsistent with the rather weak outturns for business investment growth in recent quarters. The overall picture was therefore somewhat stronger than a month ago, but remained broadly consistent with expectations at the time of the August *Inflation Report*.

13 Equity prices had fallen by about 5% over the month, across a range of countries, but the reasons for this were not entirely clear. In the UK, it was possible that part of the fall was related to the increase in longer term interest rates. But that was not the case in other countries which had experienced a similar fall in equity prices. Profit warnings, especially in the high-technology sectors, had increased. To some, the common factor was the recognition by these markets of the possibility of a sharper slowdown in the world economy than had previously been expected. The interaction between the oil price and the equities market was important and the market could recover if the oil price remained stable. But any further rise in the price of oil could precipitate a loss of confidence and prompt a sharp fall in equity prices.

14 Sterling's effective exchange rate was nearly 2% above the level assumed at the time of the August *Inflation Report* and a little over 1% above its level at the time of the Committee's previous meeting. Against this background, the Committee discussed recent developments in the foreign exchange markets. One explanation of the strength of the US dollar was that it reflected the pressure of capital flows. These, it was argued, were taking place in response to beneficial supply side developments in the US economy and the profitable investment opportunities they had created. On this view, the strong dollar exchange rate and the US current account deficit were necessary counterparts of the capital inflows and could be sustained until those profitable opportunities were exhausted. There was as yet little evidence to suggest any slowing in this process of the reallocation of capital, which some on the Committee felt gave greater credence to the view that a sustained period of faster US growth could be expected. Others however suggested that even quite small changes in expected productivity growth could have large effects both on equity prices and on capital flows, so were less confident that the dollar would remain strong. While such effects might indeed account for the US dollar's strength against the euro, they were less convincing as an explanation of the weakness of the euro against sterling or the yen. It therefore remained difficult to find a satisfactory explanation of the current constellation of exchange rates.

Demand and output

15 The Committee had assumed in its projections in the August *Inflation Report* that consumer spending growth would begin to slow, as households began to rebuild their balance

sheets and savings returned to a more normal level in relation to income and wealth. This would be necessary if government expenditure was to increase in line with the plans outlined in the March Budget and the Chancellor's subsequent Spending Review, without putting undue pressure on the supply capacity of the economy. So the evolution of the balance between private sector demand and government spending was a key issue for the inflationary outlook.

16 The news over the month suggested that the domestic demand picture remained broadly in line with this projection. The National Accounts data for the second quarter confirmed earlier estimates of quarterly GDP growth at 0.9%, though the level of GDP in 1999 had been revised up by 0.1 percentage point. Government spending in the second quarter was rather stronger than previously estimated, but fiscal outturns were so far in line with the Government's budget projections. The net trade position was a little weaker. None of this represented a significant change to the overall picture.

17 More recent indicators were mixed. Equity prices in the UK had fallen by 5% on the month and there had been sharp falls in consumer confidence - probably associated with the disruption to petrol supplies. The MORI survey showed that consumer confidence had fallen by 10 points between August and September, which was consistent with the tick down shown by the most recent GfK survey. Retail sales volumes had grown 0.6% in August, somewhat faster than had been expected, but house prices had now been broadly flat for six months. Provisional results from the Royal Institution of Chartered Surveyors' survey of estate agents in September indicated that there would be no change in the balance reporting house price increases over the previous three months, though the balance for London had recovered sharply.

18 The survey evidence on activity was generally weaker: the CBI Distributive Trades survey showed further weakness in motor traders' reported sales in September (though wholesalers' sales were the highest since February 1998); surveys from the Chartered Institute of Purchasing and Supply showed weaker output growth in manufacturing and in services, but stronger in construction; and the CBI/PricewaterhouseCoopers survey of financial services suggested that activity in that sector was growing at its slowest rate since December 1997.

19 The disruption to petrol supplies had plainly affected the surveys and would also affect official statistics in both the third and fourth quarters. Its direct effects were, however, hard to gauge. Staff estimates suggested that output in the third quarter might be as much as 0.2 percentage points lower as a result of the disruption, but that the effect on the third and fourth quarters together was likely to be minimal. These estimates were essentially judgmental: there were as yet no hard data. Some of the demand effects - for example, journeys and leisure activities forgone - might represent a permanent loss of output in those sectors, but the expenditure might simply have been switched to other goods; and there would be offsets in stockbuilding. The Bank's regional Agents reported that the disruption had had little impact on their manufacturing contacts, but that some retailers and leisure businesses had experienced a significant loss of trade which was unlikely to be recovered.

20 Looking further ahead, the disruption might nevertheless have more persistent effects on both business and consumer confidence. It was possible for example that there might be permanent effects on stock-holding levels, if businesses were to review their delivery strategies in the light of the disruption that had occurred (or might have done, had the shortages of fuel continued). Firms might be less willing to rely on 'just in time' delivery arrangements, leading to increased stock holding throughout the supply chain, or might wish to maintain larger stocks of fuel. There was also anecdotal evidence pointing to hesitancy over investment plans. So while the data seemed a little weaker overall, it was difficult to separate the effects of the petrol supply disruption itself and its effects on confidence from the underlying trend.

21 The updated staff central estimate, ahead of the Committee's meeting, had been for output growth in the third quarter of around 0.6%, in line with the forecast in the *August Inflation Report*. The available information on expenditure suggested that the risks were on the downside. However, the Index of Production for August, which was available to the Committee, showed production growth of 0.6% in August and included upward revisions of 0.4 percentage points to the index for July. Manufacturing growth of 0.8% in August was also stronger than had been expected, with very strong growth in the output of electrical and optical equipment (which included output of mobile phones and related infrastructure goods). This stronger industrial production would by itself probably add 0.1 percentage points to the estimate for output growth in the third quarter, putting it somewhat above the *Inflation Report* projection,

though the effects of the disruption to petrol supplies could more than offset this.

The labour market

22 Particular uncertainties surrounded the current conjuncture in the labour market. The continuing steady growth in employment, together with lower levels of claimant unemployment than had been seen since the 1970s, suggested that the market remained tight. Earnings growth on the other hand had fallen back sharply from its peak early in the year. It was unclear how long this benign conjunction of strong quantities and modest earnings growth could continue.

23 Employment growth had slowed a little in the three months to July, with the Labour Force Survey (LFS) measure up 0.3% compared with 0.4% in the three months to April. Average hours worked had increased by 0.1% over the same period. But LFS unemployment was down sharply, and by more than the increase in employment, lowering the unemployment rate by 0.3 percentage points to 5.3%. Inactivity had increased somewhat in each of the last two LFS data releases. Reports from the Bank's regional Agents did not suggest that there had been any further tightening in the market, though shortages persisted and the recent fall in unemployment had drawn particularly on the pool of short-term unemployed. It was noted that the Workforce Jobs measure of employment suggested rather slower employment growth over the first half of the year than the LFS measure along with more rapid growth in inactivity.

24 While quantities remained tight, the rate of growth of pay continued to be slower than expected. The Average Earnings Index (AEI) again showed a fall in the annual growth of earnings on the three-month headline basis, from 4.1% to 3.9%, while annual growth was unchanged on the month at 3.8% in July. Earnings growth in each of the last three months had included a substantial negative contribution from bonuses. These AEI data contrasted to some extent with those on rates of pay for agency staff, with Recruitment and Employment Confederation data for September showing further sharp increases in permanent salaries and rates for temporary staff, though they were now consistent with the rate of pay growth as measured by the Reward index. The Bank's regional Agents reported little evidence of increasing pay pressures and suggested that signs earlier in the year of imminent difficulties in pay negotiations had not materialised. So the dichotomy between strong quantities and weak

prices persisted.

25 The Committee discussed how long this benign combination of steady and quite rapid employment growth with subdued earnings growth could continue. Some members felt that this welcome development could persist. Overall earnings growth as measured by the AEI had been slowing for five months, regular pay was growing at a steady rate and settlements were steady or falling over the past year taken as a whole. The recent negative contributions from bonuses were not surprising. In financial services, tougher performance targets were likely to have been set for this year than for 1999, when the outlook had seemed less promising; and recent bonus outturns were consistent with the weak performance of the retail sector. To the extent that millennium-related payments had contributed to the sharp movements in earnings growth at the start of this year, temporarily inflating the level of pay, earnings growth in the coming months would be correspondingly reduced. Labour productivity per head was growing at around trend rates, and productivity per hour comfortably above it. The rate of growth of unit labour costs was slower than for several years. It was noted that the projection in the *August Inflation Report* envisaged higher levels of earnings growth in the coming months, which now seemed less likely.

26 Other members were less sanguine, finding it harder to reconcile the earnings data with other information on the labour market which to them pointed to the possibility of intensifying pay pressures in the months ahead. It was suggested that the low pay settlements earlier in the year had reflected the very low outturns for the RPI in the months leading up to this year's main settlement round and that, since then, the average level of settlements had climbed steadily month by month. The short-term outlook for the RPI suggested that circumstances would be rather different for next year's main pay round. The slowing in the growth of unit labour costs was substantially driven by recent weak bonus outturns, which were unlikely to persist. It was important to remain alert for the first signs of emerging wage pressures and it was in this context that the recent uptick in inflation expectations would - if it was confirmed as more than a temporary reaction to the uncertainties surrounding fuel supplies - be a particular cause for concern.

The immediate policy decision

27 Once again, there had been little decisive news over the month to alter the Committee's view on the underlying path of the UK economy. The projections in the *August Inflation Report* remained broadly intact, though the pace of earnings growth continued to be surprisingly modest given the rate of growth of employment and the pace at which unemployment was falling. Oil prices had eased in the past month and sterling had strengthened somewhat, but both were higher than expected at the time of the August projections. Nonetheless, the news on the month was on balance a little weaker. Despite the slightly stronger monetary, retail sales and index of production data, as well as the sharp fall in unemployment and the tick up in inflation expectations, equity prices had fallen significantly, earnings growth remained subdued, the survey evidence (including evidence on confidence) was on balance weaker and the RPIX inflation outturn was lower than had been expected at the time of the previous meeting.

28 On one view, while there remained arguments for an increase in the repo rate at some point these were not decisive. GDP was if anything growing a little more strongly than had been expected, though there were some signs that the growth of private demand was beginning to ease. This was necessary if the announced plans to increase government consumption and investment were not to place undue pressure on the productive capacity of the economy. Exports were remarkably buoyant, reflecting the strength of the world economy. Measures of domestically generated inflation were easing, but the downward external influences on UK inflation were now almost exhausted. The external factors which had allowed real wages to grow rapidly at a time of moderate growth in nominal earnings could not continue indefinitely. The evidence on labour shortages was mixed, but the market remained tight and it was unclear how long the benign outturns on earnings growth could continue. While the Bank's regional Agents reported few signs of increasing pay pressure and previous indications that wage negotiations might be becoming more difficult had not materialised, wage settlements had picked up in recent months. Unemployment was falling sharply, particularly amongst the short-term unemployed, and this could not persist without putting upward pressure on wages. Signs that inflation expectations amongst the general public and wage negotiators had increased were worrying and reinforced the view that upward pressure on wages was a substantial risk to the inflation outlook. Labour market conditions would need to be monitored very carefully for early

signs of inflationary pressure. Nevertheless, the weaker indicators in the past month were perhaps more forward-looking than the stronger. It remained to be seen whether the weakness in the activity surveys and the tick up in inflation expectations simply reflected a temporary lowering of confidence associated with the disruption to petrol supplies, or were indicative of an underlying weakening in sentiment which would persist. Another month's data would help to resolve this issue, and would cast further light on the puzzling behaviour of the labour market. Further information on the Government's fiscal plans would also probably become available in the pre-Budget Report. On balance therefore, and given also that any change in the repo rate this month would surprise the markets and put further upward pressure on a sterling exchange rate already nearly 2% higher than in the August *Inflation Report* projection, it was right to wait for some of these uncertainties to be resolved.

29 On another view, there was felt to be no case for a rise in interest rates now. The labour market picture was more encouraging, even though the recent negative contribution from bonuses was not expected to persist. More significant was the rate of growth of regular pay, which was not on this view inconsistent with current levels of tightness and with continued steady growth of employment. Recent outturns in earnings growth had been well below the projection in the August *Inflation Report* and the surge in pay growth associated with the millennium would not be repeated. The labour market did of course represent a risk to the outlook, but it had been tight - without generating inflationary pressures - for sufficiently long that it was better to react when there was clear evidence that those risks were beginning to materialise than to act against them on the basis only of a forecast. More important, on this view, was whether the pace of productivity growth would remain above its historical trend. The fact that the various measures of domestically generated inflation were at or below the inflation target was also helpful as it suggested less risk of breaching the target if the exchange rate were to fall. In addition, the current stance of policy was already slightly contractionary on the basis of estimates of the neutral level of interest rates. Dynamic monetary conditions indices suggested also that the past and current levels of sterling and of interest rates would continue to provide tightening monetary conditions for up to two years. A more substantial uncertainty on this second view was the outlook for the oil market and for the world economy. The prospects for a soft landing in the US and for stronger growth in the euro area, the basis for the projected gentle slowdown in world growth, had reduced and were the main risks to the UK inflation

outlook. It seemed more likely that instability in the oil market could persist and could be associated with equity market weakness. The euro area remained vulnerable to a further oil shock, with more fragile demand and greater current inflationary pressures than were faced in the UK. Though the UK economy was well-placed to weather a further shock, confidence had already been shaken here too. So the downside risk was larger than it had been a month ago.

30 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. 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

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 29 September in advance of its meeting on 4-5 October 2000. At the start of the 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 Q2 GDP growth in the United States had been revised up slightly to 1.4% on the quarter (from 1.3%). Consensus forecasts for US growth in 2000 and 2001 had also been revised upwards (to 5.2% for 2000, and 3.7% for 2001). Industrial production had been 0.3% higher on the month in August, but the three-month growth rate had slowed from its peak in Q2. Quarterly US consumption growth in Q2 had been revised up to 0.8%. Monthly consumption data for July and August had ticked up slightly to give a growth rate of 0.9% in the three months to August, and this was consistent with the recent pick-up in the US consumer confidence survey. Investment had risen by 2.7% in Q2, making a strong contribution to GDP, and recent new orders data for the United States, while somewhat weaker, supported the view that this could continue into Q3. The National Association of Purchasing Managers index had risen marginally in September to 49.9. Export volumes had fallen sharply by 2.4% on the month in July, with import volumes up by 0.1%.

A3 Euro-area GDP had grown by 0.9% in Q2. Consumption had remained strong, contributing 0.6 percentage points to growth. Investment in Q2 had been flat, and net trade had made a negative contribution. As reported in the previous month, German GDP had grown strongly in Q2 at 1.1% on the quarter. But the German IFO index had fallen for a third consecutive month in August, albeit only moderately, and in contrast with continued positive German orders data. The French economy had grown at 0.7% on the quarter, and Italian growth in Q2 had been 0.3%. The euro-area unemployment rate had remained unchanged at 9.0% in August.

A4 Japanese GDP had grown by 1% in Q2, having benefited from a strong contribution from public expenditure of 0.9 percentage points. Private consumption had made a 0.6 percentage point contribution to GDP growth. In contrast, investment had made an equivalent negative contribution, though this was not in line with either the monthly indicators or strong corporate profit growth, both of which had been on an upward trend since mid-1999. The Tankan survey had shown business conditions improving for the seventh consecutive quarter. Industrial production had risen by 3.3% on the month in August and by 8.3% on a year earlier.

A5 In the emerging market economies, industrial production had been rising at an annual rate of about 8% since the start of the year. But equity indices in emerging markets had recently fallen back, particularly in Asia.

A6 Futures prices were indicating a fall in oil prices to about \$25 per barrel in two years' time. OPEC production was now back at levels seen in 1998, though world demand had risen since then. Bank analysis of options price data had suggested that one outcome of the US government's announced release of part of its strategic oil reserves was to have reduced noticeably the probability the market attached to a rise in the oil price above \$40 per barrel in the coming months.

A7 US import price inflation was below the rate at the start of 2000. US consumer prices had fallen by 0.1% on the month in August, probably reflecting a temporary dip in the oil price and associated effects on petrol prices. Core inflation had risen by 0.2% on the month, leaving the annual rate slightly higher at 2.5%. Nevertheless, inflation expectations for the United States remained steady. Unit labour costs had eased, falling by 0.5% on a year earlier in Q2.

A8 HICP inflation in the euro area had fallen slightly in August to 2.3%, while core inflation had remained at an annual rate of 1.3%. The September release of German annual CPI inflation at 2.4% (compared with 1.8% in August) implied that a pick-up would probably be evident in the September euro-area inflation rate.

A9 The path of interest rates implied by futures contracts had moderated for the euro area, and in the case of the United States had converged to the current level of the Federal funds target rate. The euro-area current account was in deficit so far this year, and consistent with this the scale of combined net direct and portfolio capital outflows had fallen over the course of this year.

II Monetary and financial conditions

A10 The twelve-month growth rate of notes and coin had risen strongly, from 6.9% in August to 8.7% in September. Around 0.5 percentage points of this pick-up could be attributed to the petrol supply disruption, which had led banks to build up precautionary cash holdings.

A11 M4 and M4 lending had both been stronger. August M4 had increased by £18.2 billion and the twelve-month growth rate of M4 had risen to 8.8%. Some of the strength of M4 had been due to other financial corporations' (OFCs) deposits. Three special factors had appeared to increase OFCs' M4: a large 3G licence-related transaction; financing transactions related to Lloyds TSB's takeover of Scottish Widows; and swings in the repo position of the OFC sector. Excluding OFCs, twelve-month M4 growth had been 7.5%. M4 lending excluding securitisations had remained strong in August and had increased by £19.4 billion. The twelve-month growth rate of M4 lending had risen to 13%. M4 lending excluding OFCs had increased by 11.5%, though OFCs had accounted for almost all of the pick-up in the growth of M4 on the month.

A12 Households' M4 had risen by £4.4 billion, raising the twelve-month growth rate to 5.6%. Households' M4 lending excluding securitisations had been £4.1 billion; the twelve-month growth rate had fallen to 10%. Within total lending to individuals, net secured lending had recovered to more than £3.5 billion, and unsecured lending had fallen sharply to around £0.6 billion.

A13 Compared with the windfalls in 1997, the Scottish Widows windfall had been relatively small, but with a much higher proportion in cash. It was not possible, however, to quantify precisely the impact on the monetary data, and in particular the extent to which households' M4

may have been boosted.

A14 Particulars delivered and the number of mortgage approvals had both recovered from weaker July figures, consistent with evidence that housing market activity had stabilised. Following the National Accounts release, the Bank estimate of mortgage equity withdrawal in Q2 had been revised to £3.3 billion, or 2.1% of disposable income.

A15 Private non-financial corporations' (PNFCs) M4 had picked up strongly in August (by £5.5 billion), raising the twelve-month growth rate to 15.3%. M4 lending to PNFCs (excluding securitisations) had also increased, by £3.4 billion, with the twelve-month growth rate at 16%. The flow of external corporate finance had also remained strong in July/August, whereas investment by PNFCs had been largely flat. Comparing the changes in the full range of PNFCs' sources and uses of funds over the previous two years suggested that much of their increased borrowing had been used for mergers and acquisitions and the acquisition of 3G licences.

A16 Since the September MPC meeting, short-term interest rate expectations, as measured by the two-week gilt repo forward curve, had fallen slightly with an expected peak in base rates of just above 6%. The yield curve had disinverted somewhat: yields at maturities beyond five years had increased, with yields around 25 years 14 basis points higher. However, long corporate yields had fallen slightly more than those of short corporate yields. Sterling corporate bond issuance had been strong in Q3 and was more evenly spread across maturities than in the first half of the year.

A17 Survey measures of inflation expectations had shown a dichotomy between economist and finance professionals relative to the Basix survey of the general public and trade union secretaries. The former group's expectations remained largely unchanged, whereas the latter had shown a pick-up in expectations of inflation a year ahead of 40-50 basis points since a month ago. The general public survey had been carried out around the time of the petrol supply disruption. Retail interest rates had been little changed since the September MPC meeting.

A18 UK equity market indices had fallen by between 5% and 6½% since the September MPC meeting, broadly in line with international markets. Profit warnings issued by UK firms in Q3 had been close to 1999 levels; earlier in the year, they had been substantially lower than twelve months before.

A19 Since the previous MPC meeting, the sterling exchange rate index (ERI) had increased by 1.2% to 108.0. Sterling had appreciated against all major currencies; changes in interest rate differentials could have contributed to these movements. The risk premium on sterling, calculated using Consensus Economics' measure of expected nominal rates, had risen against the dollar, fallen against the euro and had remained little changed for the ERI.

III Demand and output

A20 In the National Accounts, quarterly GDP growth had been unrevised at 0.9% in Q2. The level of GDP had been revised up slightly by 0.1%, with annual growth correspondingly revised up from 3.1% to 3.2%. Revisions had brought the output-based measure of Q2 growth into line with the expenditure and income-based measures. Quarterly final domestic demand growth had been unrevised at 0.9% in Q2. The contribution of stockbuilding had been revised up slightly, to 0.1 percentage points in Q2, compared with zero in the previous GDP release.

A21 Quarterly household consumption growth had been unrevised at 0.8% in Q2. Within that, non-durable goods consumption had grown by 1.1%. Durables consumption had fallen by 0.1% in Q2, partly depressed by continued weak vehicle expenditure, which had fallen by 1.1% in Q2. Spending on services had increased by 0.7% in Q2, compared with 0.3% in Q1.

A22 Government consumption growth in Q2 had been revised up to 2.1% from 1.9%. Whole-economy investment growth in Q2 had been revised up from 0.2% to 0.4%. Excluding net acquisition of valuables, total investment growth had been revised up from 0.2% to 0.9%. Business, general government and dwellings investment had all risen on the quarter. Business

investment in the service sector had grown by 2.2% in Q2 and by 3.0% compared with a year earlier.

A23 Export growth in Q2 had been revised down from 2.6% to 2.0% and import growth from 2.3% to 2.2%. Accordingly, the net trade contribution to quarterly GDP growth had been revised down from zero to -0.2 percentage points in Q2. The current account deficit had been broadly unchanged in Q2 at £3.3 billion. Direct and portfolio investment outflows in Q2 had been broadly offset by an inflow of other investments, mostly accounted for by changes in bank deposits and lending.

A24 Employees' compensation growth had been weak in Q2: the 0.1% increase on the quarter had been the smallest since 1967. The saving ratio had fallen to 3.0% in Q2, similar to its trough in 1988, though it had remained somewhat higher than its 1988 low on an inflation-adjusted basis. Private non-financial corporations' gross operating surplus had risen by 3.3% in Q2. But their financial deficit had been little changed at £3.6 billion, as increased dividend, interest and tax payments had offset the increase in profits and the moderate reduction in investment.

A25 Turning to Q3, analysis by Bank staff had estimated that the negative effect of the petrol supply disruption on GDP growth in Q3 would be relatively small, and would to a large extent unwind in Q4. On the output side, leisure services, distribution and government output were identified as the sectors likely to be most significantly affected. On the expenditure side, any negative impact on consumption could be partly offset by higher stockbuilding.

A26 Retail sales had grown by 0.6% in August following zero growth in July. The BRC weekly data had pointed to strong growth in early September but growth had subsequently been heavily affected by the petrol dispute. The CBI Distributive Trades survey had indicated that retail sales had been less buoyant than expected in September, with the net balance of respondents reporting an annual increase in sales falling to +14 from +18 in August. The aggregate GfK measure of consumer confidence had fallen to -5 in September, though this had also been negatively affected by the petrol supply disruption. The MORI measure of consumer confidence had weakened

similarly, from -7 to -17 in September. Total new car registrations had weakened further, with registrations in July and August 5.8% lower than a year earlier.

A27 House prices had been broadly flat over the previous six months. Despite a 0.4% rise in September, the annual growth of the Nationwide house price index had eased to 10.2% in September, from 11.2% in August. The Halifax index had risen by 1.6% in September, after a 0.5% rise in August, increasing the annual growth rate by 1.8 percentage points to 9.2% in September. Particulars delivered had risen slightly to 121,000 in August, slightly below the level a year earlier. The House Builders Federation (HBF) survey balances for the annual change in site visits and net reservations had remained strongly negative. But the Royal Institution of Chartered Surveyors (RICS) survey had reported an increase in the average number of sales per estate agent to 29 in August from 25 in July.

A28 'Other' central government current expenditure in July and August had averaged £16 billion, compared with a monthly average of £16.7 billion in Q2 (not seasonally adjusted).

A29 The volume of goods imported in the three months to July had risen by 3.5% compared with three months earlier and had increased by 2.3% in July alone. The volume of goods exported had grown more slowly: it had fallen by 1.1% in July, leaving three-month growth at 2.6%. But data for August showed a 7.9% increase in exports to the non-EU area. The CIPS manufacturing survey balance for export orders was 50.6 in September.

A30 Total industrial production had grown by 0.6% in August. Within this, manufacturing output had grown by 0.8%, reflecting particularly strong growth in the electrical and optical sector of engineering, which had grown by 4.1% on the month. Upward revisions to energy sector output in July had increased total industrial production growth in that month to +0.4% from -0.1%. The CIPS manufacturing survey activity balance had been 51.6 in September and had remained broadly stable since July, despite the impact of the disruption to petrol supply. In contrast, the CIPS services activity balance had fallen back to 55 in September after having risen slightly in August. The CIPS construction activity index had fallen to 58 in August but had picked up to 60 in

September. And construction new orders in the three months to August had risen by 22% on the previous three months (compared with quarterly growth of 11.2% in Q2). In the CBI Monthly Trends Survey, output expectations had picked up to +5 in September from +2 in August. The National Institute of Economic and Social Research's estimate of GDP growth in the three months to August had been 0.8%.

IV The labour market

A31 The Labour Force Survey (LFS) measure of employment had risen by 93,000 (0.3%) in the three months to July compared with the previous three months, slightly weaker growth than in the three months to April (0.4%) and in Q2 (0.4%). The rise in LFS employment had mainly reflected an increase in part-time employment (57,000), which had raised the part-time share slightly to 25.0%. Workforce Jobs (a more volatile series, which is sampled on a single day in each quarter) had increased by 59,000 in Q2, compared with a fall of 10,000 in Q1.

A32 Average hours worked had increased by 0.1% in the three months to July. Both full-time and part-time average hours had increased, but there had been a decline in hours devoted to second jobs. Total hours worked had increased by 0.4% in the three months to July.

A33 The CIPS construction and services employment growth balances had both suggested continued employment growth in September, though at a reduced rate for construction with a sharp drop in the index on the month, while the balance for manufacturing had suggested a continued decline in employment. The Recruitment and Employment Confederation (REC) had reported a fall in the availability of temporary staff in September. The CBI/Deloitte & Touche service sector survey had suggested slightly greater recruiting difficulties in the business and professional services category. By contrast, the Bank's regional Agents had reported that skill shortages had not deteriorated further.

A34 LFS unemployment had fallen by 104,000 in the three months to July compared with the previous three months, slightly greater than the fall of 91,000 in Q2. The LFS unemployment rate

had fallen by 0.3 percentage points to 5.3%. The claimant count had fallen by 48,300 over the same period, and by a further 18,000 in August. As in Q2, the fall in LFS unemployment had largely been accounted for by a decline in short-term unemployment.

A35 Inactivity had risen by 46,000 in the three months to July compared with the previous three months, reflecting a 87,000 rise in male inactivity. The inactivity rate had remained at 21% of the population of working age.

A36 The official National Statistics measure of productivity, based on Workforce Jobs, had increased by 2.5% in the year to Q2, compared with an increase of 2.1% in Q1. An alternative measure based on LFS employment had increased by 1.7%, unchanged from Q1. Productivity per hour had increased by 2.5% in the year to Q2, falling from 3.1% in Q1.

A37 Headline earnings growth, a three-month moving average of the annual growth rates, had fallen by 0.2 percentage points to 3.9% in July. Headline private sector earnings growth had fallen by 0.2 percentage points to 4.0%, while headline public sector earnings growth had fallen by 0.3 percentage points to 3.4%. Headline earnings growth in the manufacturing sector had remained unchanged at 4.7% for the third consecutive month. Headline earnings growth in private sector services had fallen by 0.4 percentage points to 3.5%.

A38 Actual earnings growth had been 3.8% in July, unchanged from June. Growth in regular pay, ie excluding bonuses, had also remained unchanged at 4.4% (not seasonally adjusted). Bonuses had reduced earnings growth by 0.8 percentage points (not seasonally adjusted), the third successive negative contribution to actual earnings growth. The Bank's estimate of growth in earnings per hour, based on a smoothed hours series, had fallen by 0.3 percentage points to 4.8% in July.

A39 The annual growth of wages and salaries per head, calculated from the National Accounts, had fallen from 4.8% in Q1 to 3.6% in Q2, broadly in line with movements in the AEI over this period. Annual growth of the real product wage had exceeded that of the real consumption wage in Q2 for the first time since 1999 Q1. Largely reflecting the fall in the growth of wages and salaries,

the annual growth rate of whole-economy unit labour costs had fallen to 1.1% in Q2 from 2.7% in Q1.

A40 As was usual for this time of year, there had been relatively little new information on settlements. The Bank's AEI-weighted twelve-month mean settlement had remained unchanged at 3.0% in August. Most of the settlement data in August had related to workers in the public sector. The whole-economy three-month mean settlement had fallen by 0.1 percentage points to 3.2%, reflecting a 0.5 percentage point fall in the public sector mean.

V Prices

A41 The Bank's oil-inclusive commodity price index had risen by 0.5% in August, which, due to base effects, had taken the annual inflation rate down to 15.3% from 16.8% in July. The small monthly increase had mainly reflected rises in the prices of the fuels and metals components of the index more than offsetting a fall in the price of domestic food. The rise of around 6% in the sterling oil price had largely accounted for the increase in fuels prices. The Bank's oil-exclusive commodity price index had fallen by 0.5% in August, mainly reflecting the fall in domestic food prices. This took the annual inflation rate down to 3.6% from 4.1% in the previous month.

A42 Manufacturing input prices had risen by 0.6% in August, but the annual inflation rate had eased slightly to 10.7% from 10.8% in July. The monthly rise had mainly reflected rises in the prices of oil, chemicals and metals. These were partially offset, however, by a fall in domestic food prices. Input prices excluding oil (not seasonally adjusted) had fallen by 0.1% in August, but were 3.8% higher than a year earlier. The CIPS manufacturing survey input price index was broadly unchanged at 56.5 in September. Output prices excluding excise duties had fallen by 0.2% in August, largely driven by a fall in petroleum product prices. This had taken the annual inflation rate down to 1.7% from 2.1% in July. The output price balance in the September CBI Industrial Trends survey had fallen to -20, from -15 in the previous month.

A43 Prices of imported goods had risen by 2.1% overall in the three months to July compared with the previous three months. Excluding oil and erratics, prices of imported goods had risen by 1.4% over the same period. On the same basis, prices of exported goods had risen by 2.5% overall, while those excluding oil and erratics had risen by 1.5%.

A44 Annual inflation in the GDP deflator at market prices in 2000 Q2 had been unrevised at 1.8%.

A45 Annual RPIX inflation had fallen by 0.3 percentage points to 1.9% in August. This fall had mainly reflected falls in the contributions of petrol and, to a lesser extent, seasonal food prices. RPI inflation had also fallen by 0.3 percentage points to 3.0% in August. RPIY inflation had fallen to 1.5% in August from 1.9% in the previous month, while HICP inflation had fallen to 0.6% from 1.0% in July.

VI Reports by the Bank's Agents

A46 The Agents suggested that the overall impact of the recent fuel supply disruption had been relatively small, but that a significant impact had been noted in certain sectors. Food sales during September had reportedly been unaffected, with panic buying in the week of the disruption offset by lower sales in the following week. But non-food sales had been heavily affected in some cases. While some of these lost sales were expected to be recovered in coming months, others were likely to represent a permanent loss of business. The effect on industrial production was reported to have been small and most losses were likely to have already been recovered. Oil refinery production had been unaffected. But the Agents had suggested that the level of precautionary stocks of fuel and other components held by firms may rise in the future. Within services, the most significant impact was reported for leisure sector activities, most of which was unlikely to be recovered. Most contacts had felt that if the disruption had lasted another 48 hours its effects would have been far more serious.

A47 More generally, the Agents had reported a continuing recovery in manufacturing output growth, though the majority of this remained export-led. Many regions continued to report little

improvement in domestic orders. While reports of manufacturing firms locating new capacity overseas continued, there had been announcements of substantial new investment plans in the energy sector, reflecting the higher oil price.

A48 Annual retail sales value growth had continued to ease slightly according to the Agents, though volume growth had been maintained. Contrary to the expectations of some contacts, there had been little improvement in motor vehicle sales during September.

A49 The Agents continued to report that the most significant input price increases had been for oil and gas. But most price rises continued to be mitigated to some extent by increased importing, efficiency gains and more effective purchasing strategies. Competitive pressures on manufacturers' output prices continued to be reported.

A50 The labour market picture had remained similar to recent months. Skill shortages remained an important concern, but most contacts suggested that they had been no worse than in recent months. Pay growth in manufacturing was reported to have remained broadly unchanged, despite earlier concerns of rising pressures. Upward pay pressure on service sector pay growth remained, although annual growth had been restrained by lower bonus payments than last year.

A51 The Agents had undertaken a survey of around 200 firms regarding their use of full-time labour, to try to explain the gradual decline in full-time average working hours seen since early 1998 in the official statistics. The majority of respondents suggested that the average working hours of their full-time staff had been broadly unchanged compared with a year earlier and there had been little evidence of any significant sectoral differences. Moreover, most companies had expected average hours to remain unchanged over the remainder of the year. With regard to the management of short-term fluctuations in labour requirements, widespread use of overtime had continued, particularly for small firms. Around a third of firms reported greater use of temporary and part-time labour, while around a quarter had made more use of flexible working hours. These trends were said to be particularly evident in the service sector, where labour market pressures had been relatively tight. Though only around 10% of firms reported an increase in the use of contracts

based on annualised hours, many contacts suggested that the introduction of these types of contract was planned for the future.

VII Market intelligence

A52 Short-term interest rate expectations had fallen further since the previous meeting of the Committee. Rates implied by short sterling futures contracts, for example, had decreased by 10-17 basis points for contracts maturing in 2000-02. The main factors leading to lower interest rate expectations during the period included September's announcement of an unchanged Bank repo rate, and data on average earnings, industrial production and the CBI Distributive Trades survey, which were all weaker than the market had expected. Most market participants expected the MPC to leave the repo rate unchanged in October; economists in a Reuters poll had attached a 70% probability, on average, to such an outcome. In reaching these views, market participants had referred to the more benign price and earnings data, the expected slowdown in domestic activity (partly arising from oil price increases) and lower equity prices. Others believed that the economy was still growing robustly and that the arguments were finely balanced.

A53 The sterling exchange rate index (ERI) had fallen in the first half of the period and then appreciated in the second half, to finish 1.2% higher at 108.0. The strength of the dollar against most other currencies in the first half of the month was a major factor in explaining sterling's initial depreciation. Sterling reached a 14-year low against the dollar, leading some market participants to question whether the recent strong correlation with the dollar had weakened, though neither short-term nor long-term implied correlations (derived from foreign exchange options contracts) had suggested this. The sterling ERI had more than reversed its fall in the second half of September, mainly reflecting an appreciation against the euro. This movement was related, at least in part, to actual and expected merger and acquisition activity. Coordinated G7 intervention on 22 September had supported the euro. Following the intervention, prices of euro call options had become more expensive relative to euro put options, suggesting that market participants had become more confident that the euro would appreciate rather than depreciate against the dollar.