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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 December 2001

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 December 2001

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0112.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 9 and 10 January will be published on 23 January 2002.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 DECEMBER 2001

1 Before turning to its immediate policy decision, the Committee discussed the world economy; demand and output, including the implications of the Chancellor's Pre-Budget Report; money, credit and asset prices; the labour market; and prices and costs.

The world economy

2 The news on the world economy was mixed. In the United States, revised data for third quarter GDP showed a fall of 0.3% compared with the initial estimate of a fall of 0.1%, but this was in line with the assumptions embodied in the central projection for the November *Inflation Report*. Consumption, on the other hand, had been more buoyant than expected and recent survey results from the National Association of Purchasing Managers had been surprisingly strong. Labour productivity had apparently improved in the third quarter, reflecting the substantial recent reductions in employment. This should help corporate profitability, and illustrated the underlying flexibility of the US economy. The overall picture, however, was little changed: the United States remained in recession and there was little sign yet that the prospective recovery had begun. So the questions about the outlook were much as they had been at the Committee's previous meeting.

3 The latest Consensus survey of projections for growth in the United States (and indeed in the other major economies) in both 2001 and 2002 were weaker than those the Committee had included in its central projection in November. This weakness was accounted for largely by differences between the projections for the final quarter of this year and the first quarter of next: indeed, the subsequent recovery in the Consensus forecasts was rather steeper than the Committee's own projection. The possibility of differences in the near term was becoming apparent at the time that projection had been agreed, and a weaker outlook was represented in the downside risks which had been attached to it. The implications for inflation in the United Kingdom, if the Consensus projections were treated as the most likely outcome and the downside risk removed, were thought by some members unlikely to be large. These differences in alternative forecasts, along with other news on the international economy, would be considered again in the context of the next forecast round.

4 In contrast to this mixed economic news, equity prices had strengthened, bond yields had risen and implied interest rate expectations had firmed in the past month. Some analysts were putting

weight on estimates of the typical length of post-war recessions and on that basis concluding that the US equity markets had now reached a low point. Military developments in Afghanistan could also have affected market sentiment. But the recovery seemed to be too broadly-based to be explicable simply in these terms. It was surprising, particularly given the recent downward revisions to Consensus forecasts, and seemed to indicate a fair degree of market optimism that the US economy would recover strongly in the second half of next year. However, a number of technical factors might have contributed to the rise in bond yields, including stop-loss selling, possibly exacerbated by year-end effects. There was a risk of over-interpreting these short-term market movements at a time of increased market volatility. The path of dollar interest rates previously implied by the shape of the yield curve – of a further reduction and then an increase as early as March – had given way to a path which now implied no increase until next June.

5 Recent data and surveys on the euro-area economies were perhaps a little weaker than had been expected, with GDP increasing less than in the Committee's projection. Most surveys of activity and sentiment (of businesses and consumers) were somewhat weaker too. The outlook in Japan remained bleak, with further evidence of fragility in the insurance and banking sectors. There were some signs of improvement elsewhere in Asia. It was encouraging that there had so far been little contagion from the most recent crisis in Argentina.

Demand and output

6 The latest estimate of third quarter growth in UK GDP at market prices had been revised down slightly from the initial estimate of 0.6%, to 0.5%, but with stronger consumption growth and weaker investment than expected. GDP at basic prices had grown by 0.4%. The Index of Production for October, which was available to the Committee at its meeting, showed a small fall on the month in manufacturing output and a fall of 1.1% in total production (accounted for in significant part by weak energy output, reflecting the warmest weather on record for the month). Comparing the three months to October with the previous three months, both production and manufacturing had fallen more slowly, but by more than expected.

7 The continued strength of consumption, despite the falls in equity prices and the weaker labour market, was notable: its growth over the past six months had been stronger than at any time since 1988. Retail sales had eased in October, but the warm weather was probably a factor and household spending seemed likely to be quite strong again in November. A special survey by the Bank's regional

Agents suggested that retailers expected consumption to remain resilient into the first half of next year, though it might perhaps grow at a somewhat slower pace than in recent quarters. It was underpinned by continued strong growth in real post-tax incomes, strong household borrowing and a resilient housing market, and had shown little response to the recent dip in consumer confidence.

8 Three possible explanations were suggested for the unexpected strength in consumption in recent quarters: first, that it might represent over-optimism on the part of consumers and so could end abruptly – triggered, perhaps, by a change in labour market conditions; second, that it might reflect financial market liberalisation and the associated improvements in access to credit, which had allowed consumers to sustain for a while a higher rate of consumption growth relative to income growth; and third, that monetary policy might now be having a more powerful effect on consumers, or might be taking effect more quickly, than in the past.

9 In discussing these possibilities, members noted that households' income gearing was still quite low, relative to the peak reached in the late 1980s, so the risk of an abrupt fall in consumption on that account was probably quite low. In addition, the comparative tightness of the labour market might foster expectations that it would be relatively easy to find a new job even if redundancies increased. So it would probably require a serious threat to job prospects for consumption growth to slow sharply. In the absence of such a trigger, it seemed to some members unlikely that there would be an abrupt slowing in consumption growth. Household borrowing had continued apace, and conditions in the housing market too indicated that recent international events had had little lasting impact on UK consumer behaviour. Indeed, it was remarkable how resilient consumers had been to recent shocks.

10 The investment data had been characteristically erratic and were prone to substantial revision. There was, nevertheless, evidence in the data of a pattern consistent with an investment-led slowdown over the past year, with weaker investment leading first to a build-up of stocks and then to weaker output and imports of capital goods as their producers adjusted to the lower level of investment demand. It was perhaps also relevant that the slowdown in investment had particularly affected investment in plant and machinery (notably information and telecommunications equipment). Although data were not directly available on the import content of such investment, it was plausible that it was higher than average and therefore that the effect on GDP of this investment weakness was more limited than it would have been if the weakness had been more broadly based.

11 The ratio of investment to output had now returned to the levels of two or three years ago, though this was still well above those of the early 1990s. The question was, how much further would it fall? None of the latest data reflected to any significant extent the effects of the additional uncertainty engendered by the terrorist attacks in the United States or their aftermath. Recent survey indicators pointed to further weakness in the coming months, and the special surveys a month ago by both the CBI and the Bank's regional Agents suggested that investment decisions had in many cases been deferred until the early part of next year. It would be some time before it would be possible to determine the level at which investment would stabilise, though some members remained of the view that recent outturns were consistent with a substantial capital overhang as a result of previous over-investment.

12 The fiscal plans contained in the Chancellor's Pre-Budget Report were felt to have few consequences for the inflation outlook. The differences between the Treasury's projections for output and inflation and those in the November *Inflation Report* were small. Government spending so far this year was somewhat below target, and would need to pick up rapidly if the target for the year was to be met; so an underspend was possible for the fiscal year as a whole. However, tax revenues (particularly from the financial services industry and from the associated City bonus payments to staff) were also coming in below the levels projected in this year's Budget. The net effect on activity should therefore be small. Looking further ahead, there was uncertainty surrounding the extent to which the increase in tax revenues relative to GDP in recent years was in fact structural rather than cyclical. On one view, this might suggest that some of the tax assumptions built in to the Committee's projections, as well as assumptions about the extent of underspending, should be reviewed. But neither of these factors was likely to have large effects.

Money, credit and asset prices

13 Household borrowing growth picked up further in October, to its highest annual rate since February 1991; the pace of growth of secured lending to individuals had increased, growth of unsecured lending remained strong and the estimated level of mortgage equity withdrawal in the third quarter was both high and had increased from its level in the second quarter. All these data were consistent with the continuing strength of consumption growth and suggested that it was likely to remain robust for a while yet. Similarly, the money and credit indicators for the corporate sector continued to reflect its weakness: the growth in total external corporate finance had eased a little in October and the growth of sterling lending to corporates (by the major British banking groups) had

continued to slow. The only clear exception to this trend was in their lending to the real estate sector, which remained strong.

14 In the financial markets, sterling's effective exchange rate was about 2% lower than at the time of the Committee's previous meeting and around 0.9% lower than the rate included in the November *Inflation Report* projections. This was mainly a reflection of sterling's fall against the US dollar. Interest rate uncertainty, as measured by short sterling implied volatilities, remained high beyond the very short term. Government bond yields had also risen in the past month, and so too – though by somewhat less – had corporate bond yields. The pass-through of the policy easing this year to corporates' bank borrowing rates had not been complete. To that extent, corporates might therefore have benefited less from this easing than had households. That too was consistent with the demand and activity indicators.

15 Market indicators of interest rate expectations had risen sharply from their low point on 12 November and now implied that official rates would reach a low point in the first quarter of next year, at only a little below their current level. The latest Reuters' survey of economists indicated that a substantial majority expected no change in the Bank's repo rate this month.

The labour market

16 Recent data confirmed that the labour market had probably passed a turning point and was easing gradually. On the Labour Force Survey measures, employment was falling and unemployment had edged a little higher in the third quarter. In October, claimant unemployment had ticked up slightly and gross inflows to the claimant count had now increased for three months in succession. The latest surveys of employment were also weaker, and there were reports from the Bank's regional Agents that some firms had already prepared plans for redundancies which could be implemented quickly if the economic outlook were to deteriorate in the early part of next year.

17 But inactivity was also rising, and this was associated with further falls in female part-time employment. It was for this reason that the recent falls in employment had not been reflected to the same extent in increasing levels of unemployment. This increase in inactivity suggested that there might be a greater degree of slack in the market than would be indicated by looking at unemployment alone. This could help to explain the absence of upward pressure on earnings growth in recent months. Overall earnings growth, the growth in regular pay and the average level of pay settlements over the

past year were all little changed. With few signs of upward pay pressures, the prospect was for settlements in the Spring pay round to be much the same as, or somewhat below, those agreed this year.

Prices and costs

18 Price pressures remained muted. Oil prices had been surprisingly weak in the wake of the terrorist attacks in September, when it might have been reasonable on the basis of previous episodes of international tension to have expected the reverse, and had fallen further in the past month. Futures prices now suggested a gentle pick-up in oil prices over the forecast horizon. Though inflation would therefore necessarily be lower in the short run, this effect would not persist and so was of limited relevance in setting policy to meet the inflation target over the medium term.

19 Some members attached weight to the sharp fall in the import deflator in the third quarter, which had been much lower than expected. For them, this was consistent both with global excess capacity and with relatively weak producer price outturns. Others, however, noted that this deflator might not be a good indication of import prices as it was not based on direct measurement of prices. It also incorporated compositional effects. In addition, it was associated with stronger-than-expected deflators for government expenditure and for investment. This was difficult to rationalise. However, some members noted that industrial countries' export prices, which were better measured, had generally been coming in below expectations.

The immediate policy decision

20 Members agreed that the data over the past month had been mixed and in some respects contradictory, but taken as a whole contained little that was unexpected or which had material implications for the prospects for UK inflation. The US economy was clearly weak, but no more so than had been expected at the previous meeting, and there were some more positive signs. The euro area, however, appeared to be a little weaker. The Committee's central projection for world activity growth might, if the forecast were to be reassessed now, be a little lower in the next few quarters than it had been at the time of the November *Inflation Report*. But at the same time, the downside risks to that projection might be rather smaller than previously thought.

21 In the United Kingdom, consumption growth in the third quarter had been stronger than expected and looked set to remain robust into the first half of next year, whereas investment outturns and prospects were weaker. So the domestic imbalance between the household and corporate sectors was continuing to widen, and it remained unclear what would bring them back into balance. The labour market was gradually easing. This might gather pace, but there was as yet no clear evidence that it was doing so. Price pressures remained weak.

22 For most members, the underlying issue for policy remained much as it had been in recent months. On the one hand, there were the risks of doing too little to support domestic demand, and so allowing output growth to dip further below trend and inflation to move further below target. On the other hand, there were the risks of doing too much and, in doing so, creating difficulties in meeting the inflation target further out by allowing households to build up excessive levels of debt, which might in turn lead to a sharp correction in consumer spending. The balance between these risks was in their view best struck this month by maintaining the Bank's repo rate at 4.0%. A number of factors were identified in reaching this conclusion. First, confidence seemed, for the present at least, to have stabilised and perhaps even to have improved: financial markets in particular indicated greater optimism about economic prospects. Having reduced interest rates by 50 basis points at the previous meeting, a further cut was not therefore needed now to bolster confidence. Consumption was proving to be surprisingly robust and continued to grow rapidly. With household borrowing also growing strongly and the housing market stable, there was no reason to believe that households needed a further stimulus at this point. Nor did household finances seem to be especially vulnerable by historical standards. Second, investment was weak and forward-looking indicators suggested that it would remain so in the coming months. But it remained unclear whether this weakness would persist beyond the early part of next year, when decisions postponed in the wake of the terrorist attacks in the United States would be taken. The implications for the outlook were equally unclear. If these outturns simply represented the correction of an investment overhang, that should in time correct itself (though it would remain a drag on growth until it had done so). If it were indicative of a change in perceptions about the longer-term prospects for growth, however, it could be a more serious concern – especially as recent reductions in short-term interest rates did not seem to be assisting companies as much as households, because of changes in the slope of the yield curve. Third, price pressures remained weak and surveys of price expectations suggested that they would remain so. RPIX inflation outturns in the next few months were likely to be temporarily lower, as the effects of lower oil prices fed through to the economy. But policy should accommodate this short-term effect and focus instead on the prospects for inflation further out. Fourth, the effects of recent policy action needed to be given time

to work through fully to the economy. It was unreasonable to expect the effects to be immediately apparent, except perhaps in indicators of confidence and in financial markets.

23 For some members, however, the subdued outlook for inflation warranted a further 25 basis point reduction in interest rates now. These members took some comfort from recent data that the downside risks to prospects for the world economy had lessened. Oil prices remained low, and higher equity prices could in the short term, at least, boost confidence and so be self-reinforcing (even though they might still be overvalued in relation to longer-term prospects, and so vulnerable to another downward correction); the inventory cycle might be starting to unwind; and there were signs that the Asian economies were beginning to regain momentum. The central projection agreed for the November *Inflation Report* nevertheless remained, in their view, too high. The weakening US labour market, the synchronous nature of the global slowdown and the failure of euro-area surveys to recover in November remained worrying. The indicators of weaker price pressures were consistent with global disinflation and with general excess capacity: the prices of finished goods, and not just of oil, were weaker, and that was material to the medium-term outlook for inflation. In addition, even if the global economy were to recover in line with the projection, these members felt that domestic price and wage pressures were weaker than was reflected in the Committee's central projection. An immediate reduction in the repo rate might also help to unwind the unwelcome rise in intermediate-term yields that had occurred since the previous meeting. A further reduction in interest rates would buttress business confidence ahead of the decisions which would be taken in the coming months both on investment plans and on employment, and was needed in order to meet the inflation target in the medium term.

24 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4%. Seven members (the Governor, Mervyn King, David Clementi, Kate Barker, Charles Bean, Stephen Nickell and Ian Plenderleith) voted in favour. Christopher Allsopp and Sushil Wadhvani voted against, preferring a reduction in the repo rate of 25 basis points.

25 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

Kate Barker

Charles Bean

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 30 November, in advance of its meeting on 4-5 December 2001. 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 had been revised to -0.3% in Q3, from -0.1% in the advance release. Manufacturing output in the United States had fallen by 1.2% in October compared with a month earlier. Production of information-processing equipment had fallen by 0.7% on the month, following a fall of 1.7% in September. The National Association of Purchasing Managers' (NAPM) index had risen to 44.5 in November, from 39.8 in October. Quarterly non-farm labour productivity growth had increased to 0.7% in Q3, compared with 0.5% in Q2. This had reflected a sharp fall in hours worked, more than offsetting the decline in output. New non-defence capital goods orders had risen by 7.4% in October compared with a month earlier, partly reversing the 13.1% fall in orders in September. Retail sales had risen sharply in October, up 7.1% on the month. This had reflected a surge in sales of motor vehicles, associated with 0% financing deals on new vehicles, which had risen by 26.4% compared with a month earlier. Given that production of motor vehicles had fallen in October, this implied that inventories of motor vehicles had fallen sharply. Real consumption had risen by 2.2% in October compared with a month earlier, following a fall of 1.1% in September. Measures of consumer confidence in the United States had moved in different directions in November: the Conference Board index had fallen to 82.3 from 85.3 in October, but the University of Michigan measure had risen to 83.9 from 82.7. The four-week moving average of initial unemployment insurance claims had fallen during November.

A3 In the euro area, GDP had increased by 0.1% in Q3 according to the first estimate, compared with the previous quarter. GDP had fallen by 0.1% in Germany, but had risen by 0.5% in France. In Germany, net trade had made a substantial positive contribution to growth, but this had been more than offset by negative contributions from final domestic demand and inventories. In France, household consumption had risen by 1.2% in Q3 compared with the previous quarter, and investment had risen by 0.1%. Inventories had made a negative contribution to growth. The German IFO index had fallen to 84.7 in October, from 85.0 in September, and the French INSEE industrial confidence index had fallen

to 89 in November, from 93 in October. Annual growth in French consumption of manufactured goods had fallen to 3.0% in October, compared with 4.3% in September. The euro-area Purchasing Managers' Index (PMI) for manufacturing had risen to 43.6 in November, from 42.9 in October. The service sector PMI had risen to 46.9 in November, from 46.7 in October. The European Commission Business and Consumer Survey for November had shown a fall in industrial confidence to -18, from -16 in October. Consumer confidence had fallen to -12 in November, from -10 in October.

A4 In Japan, the all-industry activity index had fallen by 1.7% in Q3 compared with the previous quarter, following a fall of 1.9% in Q2. The fall in GDP in Q2 had been revised down to 0.7% on the quarter, from 0.8% in the preliminary release. Machinery orders had fallen by 5.7% in Q3 compared with the previous quarter. Industrial production had fallen by 0.3% on the month in October. The slowdown in industrial production in recent months had in part reflected an inventory correction: producers' inventories had fallen by 4.1% from their peak in May. Japanese export volumes had been 9.6% lower in October than a year earlier, and import volumes had been 5.9% lower. The unemployment rate had risen to 5.4% in October, from 5.3% in September. The Japanese government had agreed a supplementary budget for the financial year 2001 that provided additional net expenditure of around one trillion yen.

A5 The spot price for Brent crude oil had fallen to around \$17 per barrel in mid-November but had subsequently risen to around \$19 per barrel, little changed from the price at the time of the Committee's previous meeting. The *Economist* industrial metals index had risen by 12% over the same period, and the *Economist* non-food agricultural commodities index had risen by 1%; the aggregate index had risen by 7%.

A6 In the United States, producer prices had fallen by 1.6% in October compared with a month earlier, reflecting a 7.7% fall in energy prices and a 4.7% fall in the price of passenger cars. Annual producer price inflation had been -0.4% in October compared with 1.6% in September. Annual consumer price inflation had fallen to 2.1% in October, compared with 2.6% in September, reflecting the fall in energy prices. Core consumer price inflation, which excluded energy and food prices, had remained unchanged at 2.6%. In the euro area, the harmonised index of consumer prices (HICP) had increased by 2.4% in the year to October, compared with a rise of 2.5% in the year to September. Producer prices had fallen by 0.7% in the year to September, reflecting falling energy prices. In Japan, annual consumer price inflation had been -0.8% in October, unchanged from the rate in September.

A7 The interest rates implied by futures contracts and government bond yields had risen in the United States and euro area since the Committee's previous meeting. Equity indices had increased in the United States (the Wilshire 5000 had risen by 3.1%) and the euro area (the Dow Jones Euro Stoxx index had risen by 1.6%) since the Committee's previous meeting. High-technology indices within these countries had risen by more than the broad indices. In Japan, the Topix had fallen by 1.0%. In the United States, the November Senior Loan Officer survey showed an increased net balance of banks reporting tighter credit conditions for loans to commercial and industrial companies compared with three months earlier, and weaker demand for loans from both the corporate and household sectors. US dollar-denominated sovereign bond spreads in most emerging markets had narrowed during the month, but spreads in Argentina had widened sharply.

II Monetary and financial conditions

A8 The twelve-month growth rate of notes and coin had risen to 8.1% in November, compared with 7.3% in October. The twelve-month growth rate of M4 had risen slightly in October, to 8.1%. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had risen to 10.1% in October.

A9 The twelve-month growth rate of households' M4 deposits had risen to 9.0% in October. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had also risen, to 10.6%, the highest rate since February 1991. Flows into retail unit trusts had been weaker this year than in 2000, perhaps linked to the fall in equity prices and an increase in equity market uncertainty. The lower retail unit trust sales might have been associated with stronger households' M4 deposits.

A10 Within total lending to individuals, the annual growth rate of secured lending had risen to 9.8% in October. The number of loan approvals for house purchase had risen in October, after falling in September. Unsecured lending had remained strong in October, with the annual growth rate unchanged at 12.9%.

A11 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 3.5% in October. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had risen to 8.1%. The flow of total external corporate finance had been £3.9 billion in October, a little weaker than the monthly average for 2001 Q3. Growth of sterling lending by the

major British banking groups to corporates had continued to slow in October, although growth of lending to the real estate sector had remained strong.

A12 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had fallen to 8.8% in October. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had slowed, to 10.6%.

A13 Short-term nominal interest rates had risen at all but the very shortest maturities since the Committee's previous meeting. The general collateral repo two-week forward rate had risen by around 30 basis points around six months ahead. Uncertainty about interest rates six and twelve months ahead, as measured by the volatility implied by options on short sterling futures, had remained broadly unchanged on the month, close to the levels seen immediately after 11 September. At three-month maturities, uncertainty had fallen on the month and had declined by more than uncertainty at longer maturities since 11 September. The measure of skewness in short sterling futures three months ahead, which had been negative in October, had increased and was now a little above zero, suggesting a market perception that there was now a more even balance of risks around the expected central path of short-term interest rates. Long-term nominal forward rates had also risen over the month – by around 15 basis points at the ten-year horizon. This rise had almost entirely been associated with a rise in real yields. However, the rise in the two and ten-year real yields had only partly reversed the falls in October.

A14 Inflation expectations derived from gilts at maturities of up to ten years had changed very little since the Committee's previous meeting. Inflation expectations of participants in HMT's survey for 2002 Q4 and the Consensus Economics year average forecast for 2002 had both fallen slightly to 2.3% in November. The Bank of England's quarterly survey of general public inflation expectations for the year ahead had also fallen, to 2.0%.

A15 Unsecured lending rates had changed very little this month. Saving rates had fallen in line with the October repo rate reduction. The standard variable rate (SVR) for mortgages had fallen by 23 basis points in response to the October rate cut. Pre-announcements in November had suggested that the November rate cut would largely be passed through in December. The effective two-year fixed mortgage rate had also fallen by 23 basis points, but the spread over two-year swaps had widened.

A16 The Merrill Lynch aggregate index of investment grade corporate bond spreads had fallen since the Committee's previous meeting, but remained slightly above levels seen before 11 September. Spreads across all the main sectors had narrowed.

A17 Most UK equity indices had strengthened since the Committee's previous meeting: the FTSE All-Share had risen by 0.9% on the month and the FTSE 250 had risen by 5.8%, although the FTSE 100 had been little changed. The implied volatility of the FTSE 100 had fallen since the Committee's previous meeting, and the skew had become slightly less negative. The increase in the FTSE All-Share had been strongest for the information technology, basic industries, and cyclical services sectors. The divergence in the FTSE All-Share and FTSE SmallCap following the 11 September attacks in the United States had largely unwound since the Committee's previous meeting. The number of profit warnings issued in November had fallen compared with the previous month, but had been around the average monthly number seen this year.

A18 Since 7 November, the sterling exchange rate index (ERI) had fallen by 2.1% to 105.0. This reflected a 2.9% depreciation of sterling against the US dollar, a 2.0% depreciation of sterling against the euro, and a 0.4% depreciation of sterling against the yen. The depreciation of sterling on the month had been consistent with relative movements in nominal yields at shorter maturities. The November Consensus Economics forecast of the short-term ERI profile had been similar to most of the profiles observed in the past few months.

III Demand and output

A19 Quarterly GDP growth in 2001 Q3 had been revised down to 0.5%, from 0.6% in the preliminary release. The annual growth rate had been revised down to 2.1%, the lowest rate since 1999 Q2. Service sector growth in 2001 Q3 had been revised down to 0.6%, from 0.8% in the preliminary release, while manufacturing output had fallen by 0.8%, compared with the preliminary estimate of a fall of 0.4%. Within services, finance and business services growth had eased to 0.4% in Q3, from 1.2% in the previous quarter. Construction output had risen by 1.5%. GDP excluding the primary sectors (agriculture, mining and utilities) had risen by an estimated 0.5% on the quarter.

A20 According to the expenditure breakdown of GDP, final domestic demand had risen by 0.5%. Domestic demand had also increased by 0.5%, with changes in inventories making no contribution to

quarterly GDP growth.

A21 Private sector consumption (including that of non-profit institutions serving households) had increased by 1.3% in Q3, and real government consumption had risen by 0.7%. Total investment (including net acquisitions of valuables) had fallen by 2.6% in Q3. Business investment had decreased by 4.1%. The sectoral breakdown of business investment had indicated that private manufacturing investment had fallen by 13.9% in Q3, the largest fall since records began, while private service sector investment had decreased by 3.9% on the quarter. Net trade had reduced quarterly GDP growth by 0.1% in Q3. Total exports of goods and services had fallen by 3.6%, while imports had fallen by 2.8%.

A22 Turning to indicators of activity for the fourth quarter, retail sales volumes had fallen by 0.1% in October, and growth had eased in the three months to October to 1.3%, from 1.5% in the three months to September. The Confederation of British Industry (CBI) survey of distributive trades had suggested that growth in retail sales volumes would increase in the coming months: the reported sales balance had risen to +29 in November from +19 in October, and the expected sales balance for December had increased to +30. The British Retail Consortium had reported stronger sales in November. Measures of consumer confidence had risen: the GfK index had increased to -3 in November from -5 in October, while the MORI measure had risen to -29 in November, from -43 in October.

A23 The Halifax house price index had risen by 2% in November, taking its annual growth rate to 11.5%. The Nationwide house price index had increased by 0.7% in November, taking its annual growth rate to 12.8%. The Royal Institution of Chartered Surveyors' (RICS) balance of estate agents reporting increased prices over the previous three months had fallen to +24 in October from +39 in September. Preliminary figures for the RICS balance in November had suggested a further fall in house price inflation. The House Builders' Federation monthly survey had shown a net balance of housebuilders reporting an increase in house prices of +28 in October, compared with +40 in September. Particulars delivered had fallen by 1,000 in October, to 122,000. But in the three months to October, particulars delivered had been 1.7% higher than in the previous three months and 7.3% higher than a year earlier.

A24 The overall activity index in the Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey had been 48.2 in November, compared with 48.0 in October. The new orders index had fallen slightly to 45.5 in November, from 45.9 in October. The November CBI/Deloitte &

Touche service sector survey had reported falls in the business volumes balances for both business and professional services, and for consumer services. Respondents in both sectors had expected output to fall further in the next three months. The headline CIPS service sector index had risen slightly in November but remained below the no-change level. The CIPS construction index had fallen to 50.9 in November from 52.2 in October.

A25 The Chancellor's Pre-Budget Report (PBR) had been published on 27 November. Compared with the Budget published in March 2001, the PBR anticipated weaker receipts for 2001-02 and 2002-03. Borrowing was therefore expected to increase by 1% of GDP in 2002-03. But receipts were expected to recover towards previously announced levels by 2003-04.

IV Labour market

A26 According to the Labour Force Survey (LFS), employment had fallen by 24,000 in the third quarter, compared with the previous quarter. The fall in employment had been more than accounted for by a fall in female employment (down 53,000), while male employment had risen (up 29,000). Part-time and temporary employment had continued to decline (down 57,000 and 116,000 respectively). The working-age employment rate had fallen by 0.3 percentage points in the third quarter and had been 0.1 percentage points lower than the same quarter a year ago.

A27 Total hours worked had fallen by 0.2% in the third quarter but had increased by 1.0% on the same quarter in the previous year. Average hours worked had fallen by 0.2% in the third quarter but had been 0.4% higher than a year earlier.

A28 The CIPS employment index had fallen again in November, to the lowest level since the series began in 1996. The index for construction had fallen to the no-change level. The index for services had continued to indicate falling employment, and the index for manufacturing had fallen again – to a three-year low. The CBI/Deloitte & Touche service sector survey showed that the consumer services sector had increased its employment levels in the third quarter, while there had been a decline in employment in the business and professional services sectors. Furthermore, employment intentions had declined in both consumer services and business and professional services. The Recruitment and Employment Confederation (REC) survey for November had indicated a further decline in demand for permanent and temporary staff. The REC's index of job vacancies advertised in national newspapers

had fallen further in October. ONS data on Jobcentre vacancies remained suspended.

A29 The LFS measure of unemployment had risen by 28,000 in the third quarter, compared with the previous quarter, and the unemployment rate had risen to 5.1%. Over the same period, claimant-count unemployment had fallen by 24,500, but there had been a 4,300 rise in the claimant count in October.

A30 Working-age inactivity had increased by 84,000 in the third quarter compared with the previous quarter, raising the rate by 0.2 percentage points to 21.4%. The rise in working-age inactivity had been more than accounted for by women (up 97,000).

A31 Bank estimates of labour productivity growth during the year to 2001 Q3, based on LFS employment data, had been below the historical average whether measured on an hours or numbers-employed basis. The corresponding estimate of annual growth in whole-economy unit wage costs, based on the Average Earnings Index (AEI) measure of wages, had fallen by 0.2 percentage points on the previous quarter, to 3.1%.

A32 Headline whole-economy annual earnings growth, as measured by the AEI, had been 4.4% in September, down 0.1 percentage points from August. Headline earnings growth in the public sector had risen by 0.1 percentage points to 5.8%, but this had been more than offset by a 0.2 percentage point fall in the private sector to 4.1%. Actual whole-economy earnings growth had risen from 4.3% in August to 4.4% in September. Whole-economy regular pay growth (not seasonally adjusted) had fallen by 0.2 percentage points to 5.0% in September. The contribution of bonuses reduced annual whole-economy earnings growth by 0.6 percentage points (not seasonally adjusted) in September.

V Prices

A33 The Bank's sterling commodity price index had fallen by 4.1% in October. Fuels and metals prices, which had fallen by 7.2% and 2% respectively on the month, had outweighed a rise of 0.4% in domestic food prices. The annual inflation rate of the index had fallen for the fifth consecutive month in October, to -6.8% – its lowest rate since January 1999.

A34 There had been further falls in oil prices in November. Average sterling oil prices had been 9.6% lower than in October, and around 40% lower than a year earlier.

A35 Manufacturing input prices had fallen by 2.6% in October. This had mainly reflected further falls in the prices of crude petroleum products and of several imported components. Annual input price inflation had fallen for the sixth consecutive month, to -9.0% in October from -6.6% in September, the lowest annual rate since December 1998. Looking ahead, the CIPS manufacturing survey had continued to point to falling input prices: the input prices balance had fallen to 40.7 in November from 41.6 in October.

A36 Manufacturing output prices excluding duties (PPIY) had fallen by 0.1% in October, leaving the level unchanged on a year ago. The annual inflation rate of total output prices fell to -0.6% in October, the lowest since records began in 1958. Survey data had continued to point to weak output price inflation going forward. The CBI Monthly Trends survey expected output prices balance had fallen sharply, to -30 in November from -21 in October.

A37 The CIPS services survey and the ONS's experimental corporate services price index (CSPI) had both suggested that service sector inflation had declined since the beginning of the year. The CIPS average prices charged index had fallen to 49.2 in November from 49.8 in October, and the CSPI annual inflation rate had fallen to 4.4% in Q3 from 5.0% in the previous quarter.

A38 The annual inflation rate of the GDP deflator had risen to 2.4% in Q3 from 2.2% in Q2. Within this, the annual inflation rates of the household consumption and government deflators had fallen to 1.4% and 4.3% respectively in Q3. The annual inflation rate of the import price deflator had fallen sharply, from 2.0% in Q2 to -0.7% in Q3.

A39 Annual RPIX inflation had been unchanged in October at 2.3%. A rise of 0.1 percentage points in annual services price inflation to 4.0% had been offset by a fall of 0.1 percentage points in annual goods price inflation, to 0.4%. On the RPI measure, annual inflation had fallen by 0.1 percentage points, to 1.6%. Annual RPIY inflation had been unchanged in October at 2.8%, while annual HICP inflation had fallen to 1.2%, down from 1.3% in the previous month.

VI Reports by the Bank's Agents

A40 The Bank's regional Agents had reported that the general level of weakness in confidence reported the previous month had continued.

A41 Manufacturing output had remained weak, particularly for export markets. In the domestic market, demand for capital goods had weakened, and import penetration by European companies trying to offset weak home markets had increased. Some manufacturing companies had been taking on work at cost to maintain output, but this would not be sustainable in the long term. Output in the aerospace sector had begun to decline, with further, sharper falls expected in 2002 Q1 when destocking of components and a fall in orders were expected.

A42 Growth in business services output had continued to moderate, particularly in areas such as advertising, corporate entertaining and corporate finance. Consumer services had remained strong, except for international tourism. Domestic tourism had continued to recover from the outbreak of foot-and-mouth disease and domestic operators hoped to benefit from a switch away from holidays abroad.

A43 There were signs that agricultural output had stopped declining and greater price stability had helped to restore confidence in the sector. But agricultural activity remained at a low level.

A44 Construction output had remained strong but future prospects for privately-funded projects had weakened. However, orders for public sector projects were starting to feed through. The housing market was still strong although new starts remained below government targets and there was some evidence of an easing in demand for higher-priced houses.

A45 Consumer demand had remained strong and retailers were positive about the outlook for Christmas. The previously-reported slowing in demand for big-ticket items appeared to have been temporary, as sales of white and brown electrical goods had been strong recently. New car sales had remained buoyant over the past month or so but sales were expected to slow in 2002. Investment intentions had remained uncertain, with many decisions on hold until the new year.

A46 There had been little cost pressure from pay or materials but indirect costs, mainly regulation, pensions, and insurance had continued to rise. Output prices had remained relatively stable. The labour market had eased slightly making recruitment easier, although skill shortages remained in some areas, for example construction and transport. A number of high-profile companies had announced redundancies but many of these would not take effect until 2002 Q1.

A47 The Bank's Agents had conducted a special survey of more than 150 firms in the service sector regarding their expectations for sales to consumers. Respondents had been asked to what extent their forecasts for sales had changed following the events of 11 September, and what their expectations were with regard to volumes and prices.

A48 Overall, 85% of respondents expected no significant change in sales values in 2002 H1 compared with 2001 H1. 51% of respondents expected sales values to be higher in 2002 H1, but most of these respondents expected sales to be only slightly higher, rather than significantly so. Of those asked, retailers had been the sector most likely to expect sales values to increase. 45% of respondents had made no revision to their expectations of sales as a result of the events of 11 September; one third of respondents had revised their expectations down slightly. 53% of respondents from the housing sector had revised their expectations of sales up slightly, presumably as a result of lower interest rates. 98% of respondents in the service sector had expected no change or only slight changes in prices in 2002 H1 compared with 2001 H1. Expected price changes had not fully explained expected changes in sales values, but 83% of respondents expected no, or only slight, changes in volume growth.

VII Market intelligence

A49 Near-term expectations of official interest rates implied by short sterling futures had risen since the Committee's previous meeting, by up to 40 basis points for contracts maturing in 2001 and 2002. Short-term interest rate expectations had risen particularly strongly in the two weeks following 12 November, following better-than-expected economic data releases, including US retail sales and jobless claims figures, and military developments in Afghanistan. The reference to upside inflation risk in the Bank's *Inflation Report* had supported the upward movement in rates. But technical factors in the market might have exaggerated the rise. The rise in short-term rate expectations had been partly reversed, following weaker-than-expected CIPS manufacturing data, a weak CBI Deloitte & Touche services report, and weaker-than-expected Chicago PMI data. Interest rate uncertainty at the three, six, and twelve-month horizon had risen in the middle of November, partly in response to stronger-than-expected economic data releases and global events, but had then fallen back somewhat.

A50 Most market participants expected the Committee to leave the Bank's repo rate unchanged at its 5 December meeting. Similarly, economists polled by Reuters on 27 and 28 November attached a mean probability of 68% to no change in the official repo rate.

A51 Since the Committee's previous meeting, the US dollar had appreciated by 1.1% in effective terms. The dollar had risen for most of November, due to a perceived improvement in the outlook for the US economy, but had then fallen back a little at the end of the month. Sterling had fallen by 2.1% in effective terms, and had depreciated by 2.9% against the dollar and by 2.0% against the euro. Implied sterling one-month volatilities had been broadly unchanged and remained below the levels seen prior to the terrorist attacks in the United States.