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MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
3 and 4 October 2001

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 October 2001

They are also available on the Internet (http://www.bankofengland.co.uk/mpc/mpc0110.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 7 and 8 November will be published on 21 November 2001.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 OCTOBER 2001

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

The world economy

2 In advance of the Committee's last scheduled meeting on 5-6 September, there had been some indications that the downturn in the US economy might be coming to an end. However, data released soon after that meeting suggested that recent economic performance and the near-term outlook were weaker than had been thought. Non-farm payrolls had fallen by 113,000 in August; the National Association of Purchasing Managers' (NAPM) survey index for August for non-manufacturing was down from 48.9 to 45.5 and was consistent with declining output; and the Michigan index of consumer confidence was also sharply lower. The Wilshire index of equity prices had fallen by 3½% between 5 and 10 September. However, the data for consumption in August, which were released at the beginning of October, still suggested resilience, with consumption 3.1% higher than a year before.

3 The extent to which the terrorist attacks in the United States on 11 September would affect the economy was unclear. Early indications suggested a significant fall in retail sales in the week of the attacks, and there was evidence of only a partial recovery. Survey evidence suggested setbacks to both activity and confidence: the final Michigan index of consumer confidence for September was even lower than the preliminary figure released before the attacks. Some sectors, such as air travel and tourism, had been hit especially hard. Overall, while the direction of the immediate impact was clear, it was too early to assess the magnitude or the duration of the effects.

4 Looking further forward, while demand would, to some extent, switch into other sectors, there would inevitably be a period of dislocation as capacity was reduced rapidly in the worst-affected sectors but took time to respond in the sectors where demand was increasing. There might also be more persistent effects on productivity and costs, as the perceived need for security precautions increased and insurance costs rose. A general increase in uncertainty could lead to a greater reluctance to make commitments and an increase in risk premia in financial markets. Despite a recent recovery

equity prices had fallen since 10 September, which would reduce households' wealth and would tend to dampen consumption. So there were elements of an adverse shock both to demand and supply. The setback to demand would tend to reduce inflationary pressure, while the effects of the supply shocks would tend to raise it.

5 The fall in the price of oil, to below $22 per barrel, from about $26.50 at the time of the Committee's 5-6 September meeting and a high of close to $30 just after the attacks, would reduce inflationary pressure if it were sustained. While political uncertainty in the Middle East might otherwise have raised the oil price, the weaker outlook for world activity had so far constituted a stronger deflationary influence. Oil futures and options prices suggested that the market's central expectation was for the price to remain around the current level.

6 In the euro area, the extent of the continuing weakness in activity and confidence was a puzzle. Earlier in the year, real disposable incomes had been adversely affected by the rise in oil prices and the weakness of the euro, but both these factors had unwound to some extent. The euro area had shared in the global shock to the information and communications technology (ICT) sector, and the downturn in the United States had reduced demand for euro area exports. Nevertheless, it was surprising that the French and German stock market indices had both fallen by around 12% since the Committee's scheduled September meeting, significantly more than the corresponding fall in the Wilshire or the FTSE All-Share index. The latest evidence, from surveys taken after 11 September, suggested further economic weakness. The euro-area manufacturing PMI had fallen from 47.5 in August to 46.0 in September. The services sector PMI had fallen from 51.7 in August to 49.0 in September, suggesting that activity in services was now also contracting.

7 In Japan, industrial production, exports and confidence were all declining. It was not clear what factors would revive growth. The Asian emerging economies had been severely affected by the global ICT shock and the associated fall in US imports, as well as by the weakness of Japan. The impact of the terrorist attacks on the US economy could well delay their recovery.

8 Monetary policy had responded to the weaker outlook in all the major economies, but there was uncertainty as to how quickly and to what extent activity would respond. In the United States, the Fed funds target rate had already been reduced by 4 percentage points since the beginning of the year, and the present target level of 2½% left rather less scope for further reductions. The typical lags in the

monetary transmission mechanism meant that the full impact of this decisive policy action would not be evident for some time. Meanwhile, output growth had continued to slow, and there was a risk that confidence might be adversely affected if the economy appeared not to be responding.

9 It was also relevant that fiscal policy might become more expansionary, both in the United States, with further tax cuts and increased military expenditure likely, and in the euro area, where it now seemed that automatic stabilisers would be allowed to operate.

Demand and output

10 The revisions to UK National Accounts data, published in the annual Blue Book on 26 September, showed that domestic demand and output had been stronger in the first half of this year, and the imbalances within the economy more pronounced, than previously thought. The upward revisions to consumption, investment and stockbuilding would by themselves have suggested stronger prospects for output growth than in the August *Inflation Report* projections. The new estimate for consumption growth in the second quarter was 1.3%, so there was now little evidence of a slowdown so far this year. This was also consistent with the more recent data for retail sales and household borrowing. Investment growth in the second quarter had been revised up from 0.2% to 2.2%, consistent with the bounce-back which the Committee had expected after the exceptional fall in the first quarter. Although the contribution from stockbuilding (including the alignment adjustment) had been revised down in the second quarter, data revisions further back implied that the stock/output ratio, which had previously been trending downwards since 1998, now appeared to have been broadly stable since 1994. However, these upward revisions to demand and output did not necessarily imply greater inflationary pressure going forward. The revisions to the level of output were largest for 1998 but there had been no systematic revisions to the level of the GDP deflator. The capital stock had also been revised upwards, which helped to explain why the higher level of output had been consistent with a broadly unchanged estimate of the GDP deflator.

11 Data for exports and imports had also been revised. It was surprising that imports were estimated to have fallen by 2% in the second quarter, given that consumption and investment were now believed to have been strong. Imports of ICT goods, in particular, had been weak. But there was a growing inconsistency between European Union countries' estimates of their exports to the United Kingdom and the ONS measure of UK imports from them. It was possible that the net trade

contribution to GDP in the first half of the year could eventually be revised downwards, although this would not necessarily affect estimates of GDP growth because it could be offset by a compensating revision to the alignment adjustment.

12 Recent survey evidence, which needed to be treated with particular caution given the likely immediate (but perhaps short-lived) effect on it of the terrorist attacks, was mixed but tended to suggest weaker activity going forward. The Chartered Institute of Purchasing and Supply (CIPS) services index fell to 48.1 in September from 50.9 in August. Given the past relationship between the survey data and services output, this was consistent with service sector output growth being above trend in the third quarter but continuing to slow. The CIPS manufacturing PMI had been much the same in September as in August, though incoming orders had fallen further. The CBI Distributive Trades Survey showed a rise in retailing activity in September. The GfK survey for September had shown a fall in consumer confidence, and the MORI poll, which referred only to consumers' judgments about the overall economy rather than their own personal circumstances and was taken later in the month, showed a much larger fall. Moreover, the prospects for consumption had been adversely affected by the recent fall in equity prices and hence in personal financial wealth.

13 The Committee noted that the fiscal implications of a military response to the terrorist attacks were probably limited, in the light of experience from the Gulf War and action in the Balkans. The more substantial effects were likely to be on business confidence, and reports from the Bank's regional Agents already suggested an adverse effect. Labour hiring and discretionary spending decisions were likely to be deferred for a while, to allow time for the situation to clarify, and investment could be reduced as businesses added a risk premium to the rate of return they required and planned for slower growth in revenues.

Money, credit and asset prices

14 Money and credit data were consistent with other evidence suggesting that the divergence between the household and corporate sectors had widened further: the rate of growth of households' deposits and borrowing had increased in August, while the growth of corporates' deposits and borrowing had declined. Housing loan approvals had risen rapidly in the three months to August. The evidence on house prices in September was mixed: the Nationwide index showed a 2.7% rise on the month, but the Halifax index was unchanged, and the RICS balance of price expectations for the next

three months showed a sharp fall.

15 The reaction of the foreign exchange markets to the terrorist attacks had been relatively muted, suggesting that the market had seen the attacks as implying a broadly similar effect for all the major economies. The dollar had fallen by less than 2½% against the euro since 10 September. Sterling's exchange rate index (ERI) fell by about ½% over the same period and by about 1% on the month.

16 UK equity prices had fallen: the FTSE All-Share index was 9½% lower on the month but, after a recent rally, only 4½% lower since 10 September. The latest fall could reflect lower central expectations for company profits in the wake of the attacks, but the equity risk premium might also have risen. It was possible that the equity market had recently taken encouragement from the resilience of equity prices in the United States.

17 There had been a striking change in the shape of the gilt yield curve. Short-term interest rates had fallen, but longer-term nominal forward interest rates had risen somewhat on the month. The rise was accounted for by a rise in the real forward rates derived from yields on long-term index-linked bonds, and there was no evidence of a rise in inflation expectations. Long real spot rates had not risen in other markets. The Committee noted several alternative explanations for the change in the shape of the forward rate curve: the inflation risk premium might have risen; the market might have raised its expectation for the amount of government bond issuance; and the Financial Services Authority had recently relaxed its resilience tests for insurance companies, which might otherwise have been induced to move out of equities into gilts. The last possibility would represent unwinding of a previous distortion in the gilt market.

The labour market

18 Labour market data had been broadly in line with expectations. The rate of unemployment by the LFS measure was unchanged in the three months to July, at 5%, although the claimant count measure had continued to fall in August. The growth in LFS employment had slowed in the three months to July, and temporary employment, in particular, had fallen. It was probable that, at the beginning of a downturn in employment, temporary employees would be affected first, but these data were volatile.

19 The headline figure for annual earnings growth had eased in July to 4.6% from 4.7% in June and over 5% earlier in the year. The effect of bonus payments continued to be strongly negative: regular pay growth in the private sector was stable at around 5%. Public sector regular pay was increasing more rapidly, at around 6%, which was considerably above settlements in this sector. Threshold and arrears payments associated with the introduction of new pay arrangements for experienced teachers accounted for some of this figure, but the gap between settlements and earnings growth had also increased in health and public administration. It was possible that this reflected the tightness of the labour market.

Prices and costs

20 Pressure on costs remained subdued. The recent fall in oil prices was an important influence, but other commodity prices had been falling in recent months so that the annual increase in the Bank's non-oil index had fallen from over 20% at the start of the year to about 12% in August. The CIPS manufacturing survey for September suggested that the rate of growth of input costs was at its lowest since 1999, despite the rise in insurance costs and before the benefit of the fall in oil prices over the previous three weeks had come through.

21 Nevertheless the 12-month increase in RPIX, at 2.6% in August, was 0.8 percentage points higher than in January even though many excise duties had not been indexed in the Budget; and RPIY had increased by 1.6 percentage points since January. At least part of the 0.8 percentage point rise in RPIX could be accounted for by factors which were arguably temporary: food prices, which had been affected by poor winter weather and then the foot-and-mouth epidemic; and utility and used car prices, where in both cases prices had been exceptionally low in 2000.

22 With strong growth in consumption and subdued producer price inflation, there was some evidence that retailers' margins were beginning to recover. The rate of deflation in the household goods sector had slowed in the last two years, as the effects of the exchange rate appreciation beginning in 1996 had worn off.

Possible tactical considerations

23 The Committee noted that there was a widespread expectation in financial markets that the repo rate would be reduced by 0.25% at this meeting: the 0.25% reduction agreed at the special meeting on 18 September had generated expectations of a further reduction. The Committee recognised that confidence considerations were of particular importance in current circumstances.

The immediate policy decision

24 The economic news on the month suggested that, prior to the terrorist attacks, the outlook for the world economy had weakened by more than expected, particularly in the euro area. In the United Kingdom, the revisions to National Accounts data suggested that imbalances in the economy were more pronounced than previously thought. The level of final domestic demand, notably of consumption, had been revised up since 1998, in particular for the first half of 2001. But the recent decline in business confidence suggested that the prospective slowdown might be more rapid than previously envisaged. The terrorist attacks had had an immediate adverse impact on confidence at home and abroad, but consumer spending in the United Kingdom appeared relatively unaffected so far. There had also been a mixed response in financial markets. The foreign exchange market had reacted less than might have been expected; yield curves had steepened; associated with an increase in uncertainty, there was some evidence of a rise in risk premia which could dampen activity, for example by reducing equity prices; and the fall in the oil price would ease inflation pressures in the near-term. The medium-term implications were unclear and might not entail a lasting effect on growth or inflation. Finally, monetary policy abroad had been eased. Against this background, the key issues were whether interest rates were now at a level which would maintain domestic demand growth at a rate sufficient to keep inflation on track to meet the target in the medium-term; and whether there was in addition a case for reducing rates further to sustain confidence, until the likely economic consequences of the terrorist attacks became clearer.

25 Given the 0.25% repo rate reduction which had already been made at the special meeting on 18 September, some arguments were identified against a further reduction. The revisions to the National Accounts data suggested that domestic demand had been stronger than previously thought in the first half of the year. A further repo rate reduction might worsen the current imbalances in the economy, to the extent that it could further stimulate the housing market and the growth of consumer

borrowing. RPIX had risen above its target level, although this reflected temporary factors and input price developments suggested inflation pressures were subdued. The economic consequences of the terrorist attacks, and of the military response, were uncertain and the Committee could make a fuller quantitative assessment in the November *Inflation Report* projections.

26 All members of the Committee, however, thought that a repo rate reduction was warranted. The weakness of the global economy had become increasingly apparent and widespread: the euro area, Japan, and the emerging markets, as well as the United States, were all weaker than previously thought. There were some signs in the United Kingdom that the labour market was around a turning point. The prospect of higher unemployment coupled with lower equity prices would depress consumer spending going forward. While there were both demand and supply elements to the shock from the terrorist attacks, the demand effects, which would dampen inflation, were likely to predominate. The attacks were likely to reinforce and prolong the weakness of the global economy. Several sectors, such as airlines and insurance, had been particularly adversely affected. While early indications were that the immediate impact on UK consumption had been temporary, business confidence was likely to be more seriously affected. More generally, reports from the Bank's Agents suggested that some investment decisions were likely to be deferred.

27 Most members concluded that a 25 basis point reduction in the repo rate was warranted now. The two main arguments for this reduction were the weakness in the world economy prior to 11 September that was now evident in the data, and to counter the impact of weakening confidence on business activity. For some members, a reduction of 50 basis points at this stage might well damage rather than sustain business confidence. It should be clear that the Committee stood ready to act in either direction going forward: further weakness in the world economy might require additional reductions in interest rates, but, if the world economy recovered, it might well be necessary to raise rates to contain domestic demand, and past experience suggested that such action might need to be taken quickly.

28 On another view, there was a case for a larger reduction in rates. On this view, the August *Inflation Report* projection for inflation had, at the time, been too high because the forecasts for the global economy were even then over-optimistic. The weak data on the global economy that had emerged since had confirmed this view. The reports from the Bank's Agents of a recent steep deterioration in business confidence were particularly important. The National Accounts revisions

suggested an upward revision to potential output as well as past output and demand, so that the pressure of current demand on inflation might not be much higher. The CIPS services survey suggested that this sector was weakening. While global equity prices had recovered much of the ground lost since the terrorist attacks, the full extent of the fall since the August *Inflation Report* was very significant. Overall, the balance of the economic impact from the attacks was much more negative for demand than supply, which implied downward pressure on inflation. There was a possibility that the political and military situation could turn out worse than currently envisaged, which would raise risk premia and so weaken equity prices and activity further. Moreover, the money market curve could imply a rate as low as 4% by December, and the recent recovery in equity prices was predicated on this market expectation of significantly lower interest rates. A repo reduction of 50 basis points would help to buttress business confidence and was appropriate now.

29 The Governor invited members to vote on the proposition that the Bank's repo rate should be reduced by 25 basis points to 4.50%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Christopher Allsopp, Kate Barker, Charles Bean, Stephen Nickell and Ian Plenderleith) voted in favour. Sushil Wadhwani voted against, preferring a reduction in the repo rate of 50 basis points.

30 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 Wadhwani

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 27 September, in advance of its meeting on 3-4 October 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 Prior to the terrorist attacks in the United States, growth forecasts for 2001 from the Consensus Economics survey had been revised down for the United States (by 0.1 percentage points, to 1.6%) and for the euro area (also by 0.1 percentage points, to 1.9%). They had been revised up for Japan (by 0.1 percentage points, to -0.1%). Following the attacks, there had been downward revisions to growth in the United States (by 0.5 percentage points in 2001, to 1.1% and by 1.2 percentage points in 2002, to 1.5%) and Japan (by 0.4 percentage points in 2001, to -0.5%, and by 1.0 percentage points in 2002, to -0.5%). There had been no new survey for the euro area, but projections for the larger euro-area countries had been revised down (for example, Germany by 0.2 percentage points in 2001, to 0.9%, and by 0.6 percentage points in 2002, to 1.5%).

A3 Since the Committee's previous meeting, the spot price for Brent crude oil had fallen by around $6 to $20.74 per barrel, the Economist industrial commodity index had fallen by 8.1% and the Economist food commodity index by 4.2%.

A4 Euro-area GDP had risen by 0.1% in Q2, following a rise of 0.5% in Q1. French GDP had risen by 0.3% in Q2 compared with growth of 0.5% in Q1. The western German IFO business confidence indicator had fallen to 89.5 in August, from 89.8 in July. For the sample taken prior to the terrorist attacks in the United States, the German Centre for European Economic Research's (ZEW) economic sentiment index had risen to 20.8; the index for the sample taken after the attacks had fallen to 8.0. This compares with 11.4 in August. The European Commission Business and Consumer Survey for September, which had largely been taken prior to 11 September, had shown a fall in industrial confidence to -11, from -10 in August. Consumer confidence had fallen to -9 in September, from -8 in August. The euro-area manufacturing Purchasing Managers' Index (PMI), which had been surveyed after the terrorist attacks in the United States, had fallen to 46.0 in September, from 47.5 in August.

The service sector Purchasing Managers' Index (PMI) had fallen to 49.0 in September, from 51.7 in August.

A5 Euro-area producer price inflation had fallen to 2.3% in the year to July, from 3.3% in the year to June. German producer price inflation had fallen to 2.7% in the year to August, from 3.1% in the year to July. Annual headline euro-area inflation, as measured by the harmonised index of consumer prices (HICP), had fallen to 2.7% in August, compared with 2.8% in the year to July. According to the preliminary estimate, headline consumer price inflation in Germany had been 2.1% in September, compared with 2.6% in August. Euro-area M3 growth had risen to 6.7% in the year to August, from 6.4% in the year to July.

A6 US GDP growth had been revised to 0.1% in Q1; it had been unchanged in the preliminary release. The level of manufacturing output in the United States had fallen by 1.0% in August, whereas it had been unchanged in July. Non-farm payrolls had fallen by 113,000 in August, following an increase of 13,000 in July. The unemployment rate had risen to 4.9%, from 4.5% in July. Consumption had risen by 0.2% in August; in July it had risen by 0.3%. The Bank of Tokyo Mitsubishi-UBS Warburg (BTM-UBSW) Chain Store Sales index had fallen by 1.4% on the month in the week of the attacks and had fallen 0.8% on the month in the week thereafter. The Lynch, Jones & Ryan (LJR) Redbook Report of retail sales had fallen by 3.2% on the month in the week of the attacks. It had fallen by 2.2% on the month in the week after the attacks. The Conference Board measure of consumer confidence had fallen to 97.6 in September, from 114.3 in August. In its second and final release for September, the University of Michigan survey of consumer confidence had fallen to 81.8; it had been 91.5 in August. In the first release, which had been based on surveys taken before 11 September, consumer confidence had fallen to 83.6. The National Association of Purchasing Managers' (NAPM) index had fallen to 47.0 in September, from 47.9 in August.

A7 Producer price inflation in the United States had been 2.1% in the year to August. But annual core producer price inflation, which excludes food and energy, had fallen to 1.3% in August, from 1.6% in July. Annual headline and core consumer price inflation had both remained at 2.7% in August.

A8 In Japan, GDP had fallen by 0.8% in Q2; it had risen by 0.1% in Q1. Industrial production had risen by 0.8% in August, following a 3.0% fall in July. Nominal retail sales had fallen by 3.5% in the year to August. The consumer price index had fallen by 0.9% in the year to August, the same decline as in July. The Tankan all-industry diffusion index – a measure of business confidence – had fallen to -36 in September from -27 in June. The Bank of Japan had reported that about 70% of the survey responses had been received after the attacks in the United States.

A9 Following the terrorist attacks in the United States, official interest rates had been lowered by central banks around the world. On 17 September, the Federal Open Market Committee had lowered the federal funds target rate by 50 basis points, to 3.0%. On the same day, the ECB had lowered the minimum bid rate on its main refinancing operations by 50 basis points, to 3.75%. On 18 September, the Bank of Japan had reduced the official discount rate by 15 basis points, to 0.1%. On 2 October, the Federal Open Market Committee had reduced the federal funds target rate by a further 50 basis points, to 2.5%. Expectations of the path of future official interest rates in the United States and the euro area had also fallen.

A10 Equity prices had fallen worldwide since 5 September. Over the month, Standard and Poor's S&P 500 index for the United States had fallen by 5%, the Japanese Nikkei 225 index by 6%, and the Dow Jones Euro Stoxx index by 12%. However, since 17 September, the S&P 500 index had risen by 3%, the Nikkei 225 by 4%, and the Euro Stoxx index by 1%. As percentages of GDP, the values represented by the falls in equity markets since 2000 had been more marked than the falls in the early 1970s, 1987 and 1990.

A11 Measures of equity price volatility implied by option contracts on the S&P 500 index for the United States had spiked up following the terrorist attacks in the United States, though they had partly reversed by 3 October as equity prices stabilised. While high, these measures of volatility had not been unusual compared to earlier peaks such as the Long-Term Capital Management (LTCM) crisis in 1998. Indices of corporate bond spreads had risen sharply, particularly in sectors such as air transport, but only to levels comparable with late 2000. There had also been falls in the IBES (Institutional Brokers' Estimate System) forecasts of US corporate earnings per share made in late August, suggesting some of the falls in equity prices over the previous few months had related to a re-rating of future profitability.

II Monetary and financial conditions

A12 The twelve-month growth rate of notes and coin had fallen slightly to 6.7% in September. Part of the fall was due to a base effect from last September's fuel crisis. Adjusting for this, the twelve-month growth rate had been at 7.2%. The three-month annualised growth rate had risen to 8.8%.

A13 M4 had increased by 1% in August, but the twelve-month growth rate of M4 had fallen to 7.1% as the large flows seen in August 2000 had dropped out of the calculation. The twelve-month growth rate of M4 excluding other financial corporations (OFCs) had fallen to 7.2% in August. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) including OFCs had fallen in August to 10.2% and the growth rate excluding OFCs to 9.7%.

A14 The twelve-month growth rate of households' M4 had continued to rise in August, to 9.0% – its highest rate since August 1991. The twelve-month growth rate of household M4 lending (excluding the effects of securitisations) had risen to 10.3%. Within total lending to individuals, the annual growth rate of secured lending had increased in August for the fifth consecutive month, to 9.2%. The growth rate of unsecured borrowing had risen to 12.4%. The number of loan approvals for house purchases had remained unchanged at 112,000 in August, but the three-month on three-month growth rate had remained consistent with a strong short-term outlook for housing market activity. The ratio of households' interest payments to disposable income had remained largely unchanged in Q2, while households' capital gearing (the ratio of total household debt to household wealth) had risen in Q2 and was likely to have risen further during Q3 as a result of falling equity wealth.

A15 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 had fallen to 0.3% in August. This had partly reflected the effect of large flows into PNFCs' M4 in August 2000 dropping out of the annual calculation, but the one-month flow was also exceptionally weak. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had fallen to 8.2% in August. The monthly average of total external corporate finance had fallen to £4.8 billion (estimated on two months' data) for 2001 Q3. PNFCs' capital gearing in terms of market value and replacement cost had continued to increase in 2001 Q2 and had been expected to increase further in 2001 Q3.

A16 The twelve-month growth rate of OFCs' M4 had fallen in August to 7.0%. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had fallen to 11.5%. These declines had occurred despite strong monthly flows in August, as even stronger flows a year ago had dropped out of the annual calculation.

A17 Since the Committee's previous scheduled meeting, short-term forward nominal rates, as inferred from prices of conventional gilts and general collateral repo contracts, had fallen around 60 basis points for maturities around the year end. These rates had fallen before and after the terrorist attacks in the United States. Forward rates had fallen for maturities of less than 5 years, but had risen by 30 basis points at 20 years. The rise had occurred before the Committee's special meeting on 18 September.

A18 Real interest rates had risen slightly at medium to long maturities since the Committee's previous scheduled meeting. Inflation expectations derived from a comparison of conventional and index-linked gilt yields had fallen since the Committee's previous scheduled meeting though there had been little change at the longest maturities.

A19 Survey-based measures of the inflation expectations of professional economists had been little changed in September. Inflation expectations of participants in HMT's survey for 2002 Q4 had risen marginally to 2.5%.

A20 Most variable retail rates had fallen in September, reflecting the August reduction in the Bank's repo rate. The standard variable mortgage rate (SVR) had fallen by 24 basis points since August and had been expected to fall following the mid-September reduction in the Bank's repo rate. The two-year discounted variable mortgage rate had decreased by 23 basis points while the two-year fixed mortgage rate (without lock-in) had decreased by 38 basis points in September. Saving rates had fallen broadly in line with cuts in the repo rate, but quoted unsecured loan rates had remained largely unchanged.

A21 UK equity market prices had fallen broadly in line with international markets since 5 September – at the sectoral level as well as for the aggregate indices. Over the month, the FTSE All-Share had fallen by 9.5%, but by only 1% since 17 September. The volatility of the FTSE 100 implied by options contracts had spiked up following the attacks in the United States, and showed a pattern similar to the United States, with a partial reversal later in the month. Indices of UK corporate spreads had also risen sharply, but had not been unusually high by historical standards. The IBES 3-5 year ahead forecasts of earnings per share for the UK made in late August had fallen by a similar amount to those in the United States. The number of profit warnings in September had been above the total for September 2000.

A22 Since 5 September, the sterling exchange rate index (ERI) had fallen by 0.8%, to 106.4 on 3 October. This depreciation of the ERI had reflected a 1.9% depreciation of sterling against the euro and a 1.7% appreciation of sterling against the US dollar.

III Demand and output

A23 The quarterly national accounts data and the annual Blue Book had contained significant revisions to the level of GDP and its components. The revisions had affected growth of GDP from 1998 onwards. The level of real GDP in 2001 Q2 had been revised up by 1%. Some of this reflected methodological changes (for example, the inclusion of estimates of smuggling of alcohol and tobacco), but better information about previously measured activity had also been incorporated. Quarterly growth of GDP had been estimated at 0.4% in Q2, up from the previous estimate of 0.3%. Annual growth in Q2 had been revised up to 2.3%, from 2.1%.

A24 In terms of the components of output, the most significant revisions had been to service sector activity. Quarterly output growth of services had been revised up from 0.9% and 0.8% to 1.1% and 0.9% in 2001 Q1 and Q2 respectively. Consequently, service sector output growth was still estimated to have slowed in 2001, but from a higher level than previously thought. Manufacturing output had contracted by 2.0% in Q2, in line with the previous estimate.

A25 The expenditure breakdown of GDP in 2001 Q2 showed that final domestic demand had grown by 1.4%, up from the previous estimate of 0.9%. This upward revision to final domestic demand had been largely offset by a more negative contribution from inventories growth (-1.0 percentage points rather than -0.7 percentage points). Net trade had again made no contribution to quarterly GDP growth.

A26 The level of household consumption had been revised up by 1.7% in 2001 Q2. A significant proportion of the revisions had been to data prior to 1998. Consumption had grown by 1.3% in 2001 Q2, up from 1.2% in the previous release. The level of whole economy investment in 2001 Q2 had been about 3.4% higher than estimated previously. Quarterly growth had been revised up in 2001 Q2 to 2.2% from 0.2%. Within total investment, business investment had also been revised up. The level of business investment in 2001 Q2 was estimated to be 5.2% higher than previously thought and growth in that quarter had been revised up to 2.5% from the previous estimate of 0.8%. The level of nominal government consumption in 2001 Q2 had been 0.9% higher than previously estimated. But a rise in the government consumption deflator had lowered real government consumption growth in Q2 to 0.7% from 0.8%. The level of inventories had been revised up by £7.4 billion in 2001 Q2, largely because of a substantial upward revision in 1999 to stocks of materials held by 'other industries'. This revision had meant that the ratio of inventories to output was no longer estimated to have declined in recent years.

A27 Both exports and imports of goods and services had been revised up by around 5% in 2001 Q2. These revisions had reflected the inclusion of estimates for smuggling of tobacco and alcohol, other methodological changes, and late data returns. Effects on the pattern of trade growth and the net trade contribution to GDP growth had been small.

A28 Turning to the breakdown of GDP by income, the level of households' nominal post-tax income had been revised up by 2.2% in 2001 Q1 and had been estimated to have grown by 1.1% in 2001 Q2. Income had been revised up by more than consumption, so the household saving ratio had been revised up through much of 2000 and 2001. In Q2, the saving ratio had been 4.9%. These revisions had reduced households' financial deficit. There had also been upward revisions to corporates' gross operating surplus in 1999 and 2000. But profits had fallen by 4.6% on the quarter in 2001 Q2. Revisions to investment expenditure had led to the corporate sector financial deficit being revised up. The revisions to the household and corporate sector financial balances were broadly offsetting, such that overall the private sector financial deficit had been little changed. The UK current account deficit had been revised up by an average of £1.1 billion in each quarter since 1987, with the most significant changes in the second half of the 1990s. A large proportion of the revisions reflected methodological changes.

A29 Indicators of activity in 2001 Q3 showed retail sales increasing by 0.5% in August, to a level 6.0% higher than a year earlier in the three months to August. Weekly retail sales data collected by the British Retail Consortium had shown a decline in retail sales after 11 September and some bounce-back in the following week. Other weekly retail data had indicated a broadly similar picture, suggesting little immediate effect on consumer spending. The overall GfK consumer confidence measure had weakened to -1 in September, from 0 in the previous month. The fall in confidence had been more marked in the week following the attacks in the United States.

A30 On balance, the housing market had continued to be robust. Although the Halifax house price index had been unchanged in September, the Nationwide house price index had risen by 2.7% in September, the largest monthly increase since June 1993, taking the annual growth rate to 14.6%. Particulars delivered had risen to 124,000 in August and loan approvals in the three months to August had been around 25% higher than in the same period a year earlier.

A31 Manufacturing output had contracted by 0.9% in July and by 2.1% on a three-monthly basis. These falls continued to be predominantly accounted for by lower activity in the electrical and optical engineering sectors. Looking ahead, however, orders for these sectors had suggested a possible easing in the rate of decline. The Chartered Institute of Purchasing and Supply (CIPS) Purchasing Managers' Index had shown the first contraction of business activity since February 1999.

IV The labour market

A32 According to the Labour Force Survey (LFS), employment had increased by 13,000 in the three months to July compared to the previous three months. This had been the lowest rise in employment since 2000 Q4. The slowdown in employment growth had reflected falls in temporary employees (down by 58,000) and the self-employed (down by 16,000). The 16+ employment rate had remained flat at 60.1% in the three months to July, while the working-age employment rate had declined by 0.2 percentage points to 74.6%. Total hours worked, however, had risen by 0.5% in the three months to July compared to the previous three months, reflecting a 0.4% increase in average hours.

A33 The number of Workforce Jobs had risen by 56,000 in Q2 following an upwardly revised increase of 8,000 in Q1. The main rises had been in financial and business services, and public administration. The number of manufacturing jobs continued to fall.

A34 The CIPS employment index for the manufacturing sector had risen slightly in September, suggesting an easing in the rate of employment decline in manufacturing. Employment growth in construction had moderated a little but remained strong. The overall index had edged down slightly but remained close to balance.

A35 The ONS had suspended the publication of the job centre vacancy statistics from May 2001 because of apparent distortions in the data arising from the introduction of a new notification process. The Recruitment and Employment Confederation index of job vacancies advertised in the national press had edged up slightly in August.

A36 The LFS measure of unemployment had risen by 13,000 in the three months to July, compared with the previous three months, leaving the rate unchanged at 5.0%. Over the same period, claimant-count unemployment had fallen by 28,400. It had declined by a further 6,000 in August. Inflows into the claimant count had increased by 2,400 in August, while outflows had fallen by 4,400.

A37 Inactivity amongst those of working age had increased by 72,000 in the three months to July, raising the rate by 0.2 percentage points to 21.3%. As in recent months, there had been an increase in the number of inactive people saying that they did not want a job (up by 98,000).

A38 Headline (three-monthly basis) whole-economy annual earnings growth, as measured by the Average Earnings Index (AEI), had been 4.6% in the year to July, down 0.1 percentage points from June. Headline earnings growth in the private sector had fallen by 0.3 percentage points to 4.3% but this had been partly offset by a 0.1 percentage point increase in the public sector to 5.6%. Actual whole-economy earnings growth had fallen from 4.8% in the year to June to 4.4% in July.

A39 Whole-economy regular pay growth (not seasonally adjusted) had remained stable at 5.2% in the year to July. Private sector regular pay growth had declined 0.2 percentage points to 4.9%, while regular pay growth in the public sector had increased to 6.7%, from 5.7% in June. Within the public sector, regular pay growth had picked up in public administration, and education, health and social work. In July, the bonus contribution to earnings growth in the private sector had been -1.2 percentage points (not seasonally adjusted). This had helped to explain the decline in the growth of the private sector AEI measure.

A40 According to the Bank's settlements database, the twelve-month AEI-weighted mean settlement had remained unchanged at 3.4% in August. There had been little additional news during the month.

A41 Annual growth in productivity, based on the Bank's LFS employment-based measure, had fallen from 1.7% in Q1 to 1.3% in Q2. At the same time, annual growth on the official National Statistics measure, based on Workforce Jobs, had declined by 0.5 percentage points to 1.6%. Annual growth in wages and salaries per head picked up to 5.1% in Q2, from 4.7% in Q1. As a result, annual growth in unit wage costs had risen by 1.0 percentage points to 3.5%.

V Prices

A42 The Bank's sterling commodity price index had risen by 0.1% in August. The small monthly rise had masked offsetting movements in domestic food prices and the prices of fuels. Domestic food prices had fallen by 1.1% in August, while fuel prices had risen by 0.9% over the same period. Due to base effects, the annual inflation rate of the Bank sterling commodity price index had fallen from 6.5% in July to 4.6% in August. This had been the lowest annual inflation rate since July 1999.

A43 In September, average sterling oil prices had been 2% above their average level in August. But, more recently, sterling oil prices had fallen sharply and had been around 15% below their level at the time of the MPC meeting on 5 September.

A44 Manufacturing input prices had fallen by 0.4% in August. The monthly fall had mainly reflected falls in the prices of domestic food and imported materials. Annual input price inflation had fallen for the fourth consecutive month, to -2.3% in August from -1.1% in September. Looking ahead, the CIPS manufacturing survey had continued to point to falling input prices. The input price balance had fallen to 41.8 in September from 44.5 in August.

A45 Manufacturing output prices excluding duties (PPIY) had been unchanged between July and August. Due to base effects, annual output price inflation had risen slightly to 0.7% in August, from

0.5% in July. Survey data had continued to point to weak output price inflation going forward. The Confederation of British Industry Monthly Trends Enquiry expected output price balance had been unchanged in September at -16.

A46 The latest national accounts data had contained revisions to previous estimates of the GDP deflator and to the deflators for the expenditure components of GDP. The annual inflation rate of the GDP deflator at market prices in 2001 Q2 had been revised up to 2.2% from 2.0%. Data for the GDP deflator at factor cost had also been available in the latest release. This deflator had risen by 2.7% in the year to 2001 Q2.

A47 There had been substantial revisions to the investment and government consumption deflators. The annual inflation rate of the investment deflator in 2001 Q2 had been revised down to 0.7% from 2.2% in the previous estimate. The level of the investment deflator in 2001 Q2 had been 2.6% lower than had previously been estimated. In contrast, the level of the government consumption deflator in 2001 Q2 had been revised up by 2.0% from the previous estimate. This had raised the annual inflation rate of the government consumption deflator to 4.9% in 2001 Q2, compared with the previous estimate of 3.9%.

A48 Annual RPIX inflation had risen by 0.4 percentage points in August to 2.6%. Annual goods price inflation had risen by 0.5 percentage points to 0.8%, while annual services price inflation had risen by 0.2% to 4.2%. On the RPI measure, annual inflation had risen by 0.5 percentage points, to 2.1%. Annual RPIY inflation had risen to 3.1% in August from 2.6% in July, while annual HICP inflation had risen to 1.8%, from 1.4% in July.

VI Report by the Bank’s Agents

A49 The Bank’s regional Agents had reported that the events of 11 September had resulted in increased nervousness, and deferral or cancellation of investment projects. However, prior to the attacks in the United States, the pace of decline in manufacturing orders had probably slowed. Export markets, particularly those in Europe, had continued to be weak for most sectors. The main exceptions had been the medical, pharmaceutical, oil and gas, aerospace, and consumer goods sectors, where manufacturers had seen increased demand from the United States, China and the Middle East. There had been some stabilisation in information, communications and technology (ICT) output, but orders had continued to be weak and there had been reports that components manufacture was increasingly being moved from the United Kingdom to Eastern Europe.

A50 Construction output had remained strong, particularly in the south of the United Kingdom, and order books had been boosted by public sector contracts. The housing market had continued to be buoyant, although demand at the top of the market had eased, and some purchases of new properties had been cancelled after the attacks in the United States. Commercial property appeared to have peaked and some projects had been deferred.

A51 Growth in services had continued to slow. Following the downturn in manufacturing and in ICT markets, service sector contacts had already been cutting back on non-essential expenditures such as consultancy, advertising, training, conferences, travel and corporate hospitality. The attacks in the United States had led to a substantial further decline in demand, particularly for hotels and car hire. The picture for consumer services had been more mixed, with evidence of the beginnings of a recovery in domestic tourism after the foot-and-mouth disease outbreak, and the beginnings of a slowdown for pubs and restaurants.

A52 Growth in retail sales had continued to be strong until 11 September. Immediately afterwards, sales had been sharply down, but had subsequently recovered (with the exception of high value goods, which continued to record weaker sales).

A53 Costs of materials had generally been falling and the greatest cost concern for most companies had continued to be increases in insurance premia and in regulation. Wage awards had been moving up slightly in some regions and there had been reports that unions had negotiated non-pay benefits in addition to the settlement figure. Sales staff, managers, accountants and solicitors had continued to be awarded annual pay increases of between 5 and 15%. The forthcoming change in company car tax had resulted in an increasing number of companies substituting cash payments in place of providing a car.

A54 The Bank's Agents had conducted a survey of around 180 firms in the service sector regarding their expectations for growth in turnover, levels of employment and investment in their companies over the next 12 months compared with the previous 12 months. Responses to the survey were collected in the week following 11 September but respondents had mostly been able to reply only with pre-attack judgements. Comments on the forms had suggested that the outlook post-attacks was considerably more uncertain.

A55 Overall, nearly half of respondents expected growth in turnover to be either slightly or significantly higher over the next 12 months. Companies with a consumer or public sector customer base (rather than a corporate sector base) had been most likely to expect higher growth in turnover. ICT and wholesale and retail companies were most optimistic about future turnover, while road haulage companies were least optimistic. In the case of ICT, it had been noted that work had been outsourced from the public sector and corporate businesses to ICT companies. 30% of all respondents expected employment in their companies to increase over the next 12 months, and 40% expected investment to be higher over the next 12 months. In both cases, the majority had indicated a slight, rather than a significant, increase.

VII Market intelligence

A56 Expectations of official interest rates implied by short sterling futures contracts expiring in 2001 and 2002 had fallen sharply since the Committee's 5-6 September meeting, decreasing by 50 to 80 basis points. The decline had largely occurred in the first half of the period. Between 5 and 10 September, near-term interest rate expectations had fallen by around 20 basis points, following weaker-than-expected UK industrial production and US labour market data. Then, between 10 and 12 September, near-term rate expectations had fallen by a further 30 basis points in response to the 11 September attacks in the United States. Interest rate expectations then fell further following the weaker-than-expected MORI consumer confidence and CIPS services surveys. These developments were partly offset by the stronger-than-expected RPIX inflation data, the larger-than-expected fall in unemployment, a better-than-expected Chicago PMI figure and the markets' reactions to the Prime Minister's comments about the possible timetable for a referendum on the United Kingdom's full membership of EMU.

A57 Interest rate uncertainty had risen following the attacks in the United States to levels last seen in autumn 1998. Nevertheless, the rate implied by the short sterling futures contract expiring in December 2001 had remained largely unmoved following the 25 basis point reduction in the official repo rate on 18 September, as the events of 11 September had led most market participants to expect a cut by October or November. However, very short-dated sterling cash rates had fallen following the rate reductions by the Federal Reserve and the ECB on 17 September, in anticipation that the Committee might also announce a rate reduction at that time. On 3 October, sterling money market instruments had implied a strong expectation that the MPC would reduce the official repo rate by a further 25 basis points at the meeting on 3-4 October. By contrast, economists polled by Reuters on 26 September attached only a 55% probability to a 25 basis point reduction in the official repo rate. Sterling money market instruments indicated an expected trough of 4.25% or less for the Bank's official repo rate.

A58 Since 5 September, movements in exchange rates had generally been limited compared with movements in other financial market prices. Sterling had fallen by 0.8% in effective terms. The dollar had depreciated at the start of the period, following the release of weaker-than-expected US economic data, and had fallen further after 11 September before recovering a little towards the end of the period. The Japanese authorities had intervened on a number of occasions to contain the appreciation of the yen. The euro had strengthened over the period, appreciating by 2.3% in effective terms and reaching 7-month highs against the dollar on 20 September. The Swiss franc had appreciated strongly in the aftermath of the events of 11 September, in particular by 6.1% against the dollar at its peak. Some market participants had attributed this to a rise in risk aversion and an associated flight to so-called 'safe haven' currencies.