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MINUTES OF MONETARY POLICY COMMITTEE MEETING
5 and 6 September 2001

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 September 2001

They are also available on the Internet (http://www.bankofengland.co.uk/mpc/mpc0109.pdf).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 3 and 4 October will be published on 17 October 2001.

BANK OF ENGLAND

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 SEPTEMBER 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; and prices and costs.

The world economy

2 Recent large revisions to past US data, and the news on the month, made it seem more likely that the downturn in the US economy might be coming to an end. A gradual recovery during the second half of this year and into the next, as was embodied in the projections made for the August *Inflation Report*, remained a reasonable central case. GDP growth in 2000 had been revised down from 5% to 4.1%, and average productivity growth over the past five years from 2.8% to 2.5%. Most of this downward revision was associated with lower investment, especially in software, and weaker profits. The associated stronger growth in labour income meant that the household saving ratio had been stable (and positive) since 1999, rather than - as had previously been thought - continuing to fall. Growth in the second quarter had also been revised down, from 0.2% to zero, and with a significant change in the mix of demand with weaker contributions from stocks, investment and net trade but stronger consumption growth. Taken together, these data suggested that the inventory cycle might be closer to completion than previously thought and that activity might accordingly strengthen in the second half of this year.

3 The National Association of Purchasing Managers' (NAPM) survey index in August for manufacturing suggested that - despite the continuing falls in output in the information and communications technology (ICT) sector - some recovery might now be in prospect, at least in the 'old economy' sectors. Though consumer confidence had edged lower, consumption was 0.2% higher in July and real personal disposable incomes 1.8% higher, as tax rebates and lower energy prices fed through. The rate of decline of non-farm payrolls had slowed in July, though the market was attaching importance to the August data (to be published the next day).

4 There were, nonetheless, some continuing concerns about the outlook. The revisions to measured productivity growth, for example, suggested that the sustainable rate of growth achievable by the US economy might be rather lower than had come to be widely accepted during the recent period of rapid growth. On the one hand, market forecasts of very strong corporate earnings growth

next year and beyond implied an implausibly rapid recovery in GDP growth and profit margins. Past over-investment implied that some adjustment in the corporate sector was still to take place, and that overcapacity was likely to continue to put downward pressure on margins. In addition, some of the activity indicators which had been stronger in the first half of the year - such as construction - now showed signs of weakness. A significant market correction seemed likely if those earnings expectations were revised: at current prices, the market was still well above historic price/earnings ratios. On the other hand, market views on the likely sustainable growth rate of the US economy had probably already been lowered. The recent falls in equity prices could imply that market assessments were now based on more modest expectations than were reflected in the published corporate earnings forecasts. It would be surprising if the market were still substantially overvalued, given that the slowdown was now well-established. In addition, the downward revisions to past investment data could mean that over-investment had been less extensive than was previously thought, even if the sustainable growth rate was indeed now somewhat lower.

5 In the euro area, recent data outturns for second quarter growth in Germany and Italy had been weaker than expected. The latest surveys had however been mildly encouraging, with the German IFO index a little higher in July and the euro-area manufacturing Purchasing Managers' Index also a little stronger in August (although the corresponding services index had fallen slightly). Both consumer and business confidence had edged lower, but consumer confidence remained on balance positive relative to historical norms. The recent cut in interest rates by the European Central Bank would help to support demand, and the evidence of weaker inflationary pressures suggested that concerns about inflation in the euro area might now be less of a constraint on further policy action if it were felt to be needed.

6 The outlook in Japan was bleak and it remained unclear whether the conditions were in place for renewed growth there.

Demand and output

7 The second release of GDP data for the second quarter showed growth in the United Kingdom unchanged from the first release, at 0.3%. But the data which were now available on the composition of expenditure in the quarter differed from those expected at the time of the August *Inflation Report*, with consumption growing more strongly and investment again weaker than expected. The strength in consumption in the second quarter was mainly accounted for by a stronger-than-expected contribution

from retail goods. This robustness was also evident in early indications of consumption in the third quarter, for example in retail sales in July and in survey data for August. It was consistent with the monetary data and with the continued strength of the housing market. The most recent surveys did suggest some weakening in consumer confidence, with the GfK survey reporting that consumer perceptions of the general economic prospect were sharply lower, but respondents still regarded their own financial situation as being very strong. The subsequent MORI survey had also registered a sharp fall in consumer confidence.

8 By contrast, investment had grown less strongly in the second quarter than had been projected and the level of investment in the quarter was well below expectations. It was not clear how this outturn should be interpreted, given the recent large swings in quarterly rates of investment growth and the fact that investment data were particularly susceptible to revision. While it appeared likely that business investment was weak, it was difficult, from these data, to be confident about the underlying trend. It nevertheless seemed that, taking these data and those on consumption together, the imbalances in the economy were if anything becoming worse.

9 More recent indicators of output growth were also weaker than expected: industrial production was 0.5% lower in July than in June, and manufacturing output almost 1% lower. But services output growth, on which revised and fuller second quarter data were now available, was rather stronger than previously estimated, at 0.8%. The Chartered Institute of Purchasing and Supply (CIPS) services survey balance was up a little in August, though the new business component had fallen below the 'no change' level. The CBI/Deloitte and Touche survey of consumer and business services suggested that consumer services had recovered only modestly from the fall-off associated in part with the foot-and-mouth epidemic, while there was a pronounced weakening in business and professional services. Reports from the Bank's regional Agents also suggested weaker growth in business services, but alongside some strengthening in consumer services and domestic tourism. The CBI survey of distributive trades had picked up further in August.

10 Looking ahead, output growth in the third quarter now seemed likely to be rather lower than projected in the August *Inflation Report* and it was noted that, the distributive trades survey apart, the forward-looking elements of recent surveys were consistently weak: business confidence had fallen, reported new orders and incoming business were weaker, there was weakness now in surveys of service sector investment intentions and the Bank's Agents also reported that business confidence was falling. Against this, however, it was pointed out that the fall in overall consumer confidence was not

yet at all marked, at least on the GfK measure, and that current consumer spending - arguably the key indicator of sentiment - remained strong.

11 It would be important to see if these indications of a weaker outlook were confirmed by next month's surveys. Planned growth in government spending, and the feed-through to the economy of interest rate cuts made earlier in the year, would continue to support output growth in the coming quarters; and there was also some prospect of external demand picking up by the end of this year.

Money, credit and asset prices

12 Money and credit data broadly confirmed the picture of the economy given by the output and expenditure data. Household money indicators remained strong: household M4 growth continued to rise, and - at nearly 9% in July - was higher than a year earlier and the strongest growth since 1991. Growth in Divisia money was also strong. Among the credit indicators, secured lending to individuals was also growing more strongly than at any time since 1991 and mortgage equity withdrawal continued apace. While it was possible that the faster growth in household deposits could partly reflect portfolio shifts by households in response to movements in relative returns, the overall picture was consistent with continued near-term strength in consumption growth.

13 Corporate deposit growth, however, was slowing and (once due allowance was made for known distortions) was on a steady downward trend. While lending to firms remained robust in aggregate, there was a clear divergence between manufacturing, to which lending was falling, and the construction and services sectors. These data were consistent with steady retrenchment and subdued investment growth in manufacturing, rather than with distress borrowing. The buoyancy of lending to real estate companies was the most notable feature of the strong growth in lending to the service sector.

14 Housing market indicators remained strong. The Nationwide index of house prices had risen more slowly in August than in July, but the reverse was true of the Halifax index and both showed house prices growing by over 10% at an annual rate. The Bank's regional Agents reported some signs that both activity and the pace of price increases were peaking, but loan approvals were up some 20% on a year ago and these were a good leading indicator of housing market activity. So it seemed likely that housing market activity would remain buoyant, at least in the near term.

15 In the foreign exchange markets, sterling's effective exchange rate had weakened by about 2% as the euro strengthened against the dollar, but this had been reversed in the days leading up to the Committee's meeting.

16 Though the market still priced in a further small cut in domestic interest rates over the coming months, the market expectation was that it would not be made at this month's meeting.

The labour market

17 Though employment as measured by the Labour Force Survey (LFS) was a little lower in the second quarter than in the three months to May, the more reliable comparison was with the first quarter and on that basis employment had continued to grow steadily. The CIPS surveys' overall employment index (covering the private sector) had been flat at around its no change level for several months and the Recruitment and Employment Confederation data suggested a decline in the demand for permanent staff from agencies, so there were some indications that the market might now be close to a turning point. But this was still not evident in the official data: unemployment continued to fall and it was notable that both inflows to and outflows from the claimant count were still falling steadily. Inflows into unemployment tended to be counter-cyclical, so the absence of any marked pick-up in inflows - despite the many announcements of layoffs and redundancies - was notable. This might, however, be explained partly by delays between announcement of job cuts and their implementation. It was also somewhat puzzling, given the divergent employment trends in the manufacturing and services sectors (which would tend to increase market turnover), that outflows were falling too.

18 It was curious that employment should still be growing despite several quarters of below-trend output growth. Productivity was as a result plainly growing more slowly than its trend. To some extent this too might be a reflection of the imbalances in the economy, with an increasing proportion of output now accounted for by the services sector in which measured productivity tended to grow more slowly than in manufacturing. But this could not wholly explain the puzzle, as manufacturing productivity growth was itself slowing.

19 Annual earnings growth in the second quarter had been a little stronger than had been projected in the August *Inflation Report*, with regular pay now growing at over 5% in the private sector and nearly 6% in the public sector. The continued strength of public sector earnings growth suggested that its recent sharp increase did not simply reflect the transitory effects of the introduction of new pay

scales for experienced teachers, and the associated payment of arrears, but might be more persistent. It was however suggested that the implication of this for inflation would be modest, given that government spending was set in nominal terms and that spill-over from public to private sector pay had in the past typically been limited. More generally, the high level of regular pay growth was mitigated to some extent by the recent negative contributions from bonuses. It was possible that it might therefore reflect in part a consolidation of bonuses into regular pay, rather than being an indication of stronger underlying pay pressures. Pay settlements, however, remained at the higher average level established in the first quarter of this year. They had not, as some had expected, eased in response to the falls in RPI inflation, perhaps because the labour market had continued to tighten.

Prices and costs

20 Input price inflation had eased further, with input prices falling 0.5% in the year to July - in part reflecting oil price falls. Producer output prices had increased by only 0.1%, down from nearly 3% at the end of last year. This sharp slowdown in producer price inflation raised the important question of whether it would feed through to weaker retail goods price inflation. The two had in the past been quite closely linked, but a substantial gap had opened up in 1999 between their respective inflation rates, with output prices growing faster than retail.

21 There was no conclusive evidence of a structural break in this relationship. On one view, the implied compression of margins over the past two years could be permanent and there was therefore no reason to expect faster relative increases in retail prices. But it could also reflect temporary factors, the effects of which would now unwind, leading retail price inflation to move above output price inflation for a while as the relative levels of output and retail prices returned to a more normal relationship. There were some indications that that might be at least part of the story: used car prices, for example, had been unexpectedly strong in recent months and it was possible also to identify some factors which had temporarily depressed clothing and footwear prices.

22 RPIX inflation had fallen to 2.2% in July, a little lower than expected. But this was more than explained by a faster-than-expected unwinding of the recent spike in seasonal food prices and the forecast for RPIX inflation in the third quarter therefore remained unchanged.

The immediate policy decision

23 There was general agreement in the Committee that the news on the month was limited and that the arguments for deciding on the appropriate level of interest rates were much as they had been at the time of its August meeting. The world outlook - at least in the near term - was much as was projected in the August *Inflation Report*: the US economy seemed to be near a low point, with the most likely prospect one of gradual recovery into 2002; the data on the euro area had been somewhat weaker than expected but there were tentative signs there too of some recovery ahead; and the outlook in Japan remained disappointing, with recovery elusive. The pattern of exchange rates had reverted towards the end of the month to a familiar one of euro weakness and related sterling strength. The imbalances in the UK economy seemed if anything to have worsened, with continuing strength in consumption but weaker-than-expected investment, partly reflected in the strength of services alongside very weak manufacturing. There were, however, some indications of weaker consumer confidence, and that business worries were spreading to parts of the services sector. But there were few signs yet in the data that labour market conditions were starting to ease or the housing market to weaken. Slower consumption growth did not seem to be an immediate prospect.

24 Against this background, most members of the Committee felt that the repo rate should not be changed this month. For some, there was in fact little to justify changing the view they had taken last month, that a repo rate of 5.25% was appropriate: while the downside risks remained real, there was no sign that consumption growth was slowing, nor of the long-awaited turning point in the labour market; the imbalances in the economy had worsened over the month; the full effects of past policy easing had yet to come through; and the prospect remained for the US economy to recover in due course from its recent slowdown. Indeed, some of the reasons cited last month for reducing rates would, if anything, now carry less weight: new orders data in the United States had picked up; confidence within the euro area had not faltered; emerging market spreads had narrowed, not widened; the service sector had grown faster than expected in the second quarter, and the evidence of more recent weakness there was not yet fully convincing. It also seemed possible that the squeeze in retail margins, which had allowed output prices to rise faster than retail prices over the past eighteen months, might now be beginning to unwind. But an immediate reversal of last month’s reduction would surprise the markets, and the data over the month did not justify it. It would imply an unrealistic degree of fine-tuning and such a change could in any case have a greater impact than would be warranted by the small difference in the level of interest rates. The strength of sterling in recent days was unhelpful, as it would tend to worsen the external imbalance. If it were to persist, the case

for a reduction in interest rates from their current level might become stronger, although it was not clear what effect that would have on the exchange rate.

25 Most of those members sharing the view that the repo rate should remain unchanged this month were, however, more comfortable with the current level of interest rates. For them too, the outlook for growth and inflation was not materially different from their assessment of it a month ago; there was little that was unexpected in the data and so a further reduction in interest rates now was not justified. The main surprise on the month had been the apparent weakening of business sentiment domestically and the gloomier tone of the reports from the Bank's regional Agents. That was, to these members, rather more worrying than the continuing strength of consumption. While the latter was uncomfortable, it was to some extent an inevitable consequence of the policy action taken earlier in the year to sustain domestic demand in the face of the adverse external shock. Consumer confidence - and with it, consumer spending - could falter quite quickly, but there remained scope to provide a further stimulus to consumption, should that be necessary. If, however, the world economy did indeed begin to recover, any further policy action now (which would in any case take time to have its effects) could entail a sharper increase in interest rates in due course to ensure that demand growth remained consistent with keeping inflation close to target in the medium term. The continuing strength of the labour market was a source of uncertainty about whether the domestic economy was evolving as had been projected. Output growth had now been below trend for several quarters and it was therefore surprising to some of these members that employment growth had not yet started to ease. Data confirming that it was doing so would for them be important in future interest rate decisions. Others were less surprised by these lags and placed greater weight on the signs from surveys that the labour market, and consumer confidence, were already starting to ease. Indeed for one member, the overall picture already suggested that another reduction in interest rates would soon be needed.

26 On another view, a further reduction of 25 basis points in the repo rate was already justified. The second quarter outturns for the United States, the euro area and Japan had all been below the August *Inflation Report* projection, and global equities markets had fallen by between 6% and 9% on the month. These data alone suggested that the world prospect was weaker than had been projected. The euro area surveys and the most recent NAPM survey had been more positive, and it was possible in the United States that the 'old economy' inventory cycle was ending and that the forecast for growth in the second half of this year might now be realised. But the outlook beyond that was rather less strong, and did not on this view support current corporate earnings projections. Probable equity market weakness was likely to undermine the prospects of a recovery. Domestically, the most

significant development was the worsening position of the manufacturing sector and the further signs of weakness in the services sector. Though consumption growth in the second quarter had been stronger than expected, investment was weaker and the outturn for the level of final domestic demand was well below what had been projected in the August *Inflation Report.* If latest expectations for growth in the third quarter were realised, it would represent the fourth successive quarter of below trend growth. Last month, a reduction of 50 basis points in the repo rate could have been justified, in part because the most likely path for inflation over the next two years was significantly below target. But to have made one of that size last month would have been a shock to the markets. This month, another modest reduction would be much less surprising. Domestic imbalances were indeed a source of concern, but it was not at all clear whether or in which direction they should influence this month's decision. Inflationary pressures remained weak. So a further reduction, of 25 basis points, was warranted now.

27 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 5.0%. 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 25 basis points.

28 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 31 August in advance of the meeting on 5-6 September 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 According to the Bank's latest estimate, world industrial production had fallen by 2.5% in the year to June, compared with a fall of 1.2% in the year to May. Growth forecasts for 2001 from the Consensus Economics survey had been revised down for Japan (by 0.1 percentage points, to -0.2%), and for the euro area (by 0.1 percentage points, to 2.0%). They had been revised up for the United States (by 0.1 percentage points, to 1.7%).

A3 Since the Committee's previous meeting, the spot price for Brent crude oil had risen by around $1.80, to around $26.60 per barrel; the *Economist* industrial commodity index had fallen by 0.9%; and the *Economist* food commodity index had fallen by 1.6%.

A4 In the euro area, Italian GDP had fallen by 0.1% in Q2. It had risen by 0.8% in Q1. German GDP had been unchanged in Q2, compared with growth of 0.4% in Q1. The expenditure components of German GDP in Q1 had been revised, so that consumption was estimated to have risen by 1.0%, compared with 0.1% in the previous release. In Q2, German consumption had risen by 0.9%. Construction sector investment in Q1 had been revised up, but still showed that the sector had been in recession. The West German IFO business confidence indicator had risen to 89.8 in July, from 89.5 in June. The euro-area Purchasing Managers' Index (PMI) had risen to 47.6 in August, from 47.3 in July. That had been the first increase in the index since April 2000. The volume of euro-area retail trade had increased by 0.6% in June.

A5 The euro-area unemployment rate had been unchanged at 8.3% in July. The German unemployment rate had been unchanged at 9.3% in August. Euro-area producer price inflation had fallen to 3.3% in the year to June, from 3.7% in the year to May. German producer price inflation had fallen to 3.1% in the year to July, from 4.3% in the year to June. Annual headline euro-area inflation, as measured by the harmonised index of consumer prices (HICP), had fallen to 2.8% in July, compared with 3.0% in the year to June. According to the preliminary estimate, headline consumer price inflation in Germany had been 2.6% in August, unchanged from July.

A6 The ECB had lowered the minimum bid rate on its main refinancing operations by 25 basis points, to 4.25%, on 30 August. Expectations of the path of official interest rates in the euro area had softened slightly.

A7 Revised data showed that US GDP had been broadly unchanged in Q2. That compared with the advance estimate of 0.2% growth. The contribution of net trade had been weaker than in the advance release. Investment had been revised down, but consumption had been revised up slightly. Growth in non-farm business labour productivity had been weaker than previously thought. There had also been revisions to earlier data, most notably for 2000, for which GDP growth had been revised down to 4.2% (from 5.0%). These revisions had lowered the level of GDP in 2001 Q1 by 0.9% compared with the previous release. Labour productivity growth in 2000 had been revised down by 1.3 percentage points, to 3.0%. These revisions had reduced average annual productivity growth during the period 1996 to 2000 from 2.8% to 2.5%, but the pick-up in the late 1990s had still been marked in comparison with the previous 25 years.

A8 The level of manufacturing output in the United States had been unchanged in July compared with a month earlier. It had fallen in each of the previous nine months. The National Association of Purchasing Managers' (NAPM) index had risen to 47.9 in August from 43.6 in July. All components of the index had risen. The production and new orders components had both been above the neutral '50' level for the first time this year. Output in the service sector had risen by 0.6% in Q2.

A9 US real personal disposable income growth had risen to 1.7% in July from 0.1% in June. Growth had been boosted by tax rebates. The saving rate had increased to 2.5% in July, from 1.0% in June. Real consumption had risen by 0.2% in July, similar to the growth rate in recent months. Weekly data for retail sales had suggested a similar rate of growth of consumption in August. The Conference Board measure of consumer confidence had fallen to 114.3 in August, mainly due to a downward revision to the 'present situation' component, but the preliminary release of the Michigan survey had shown a slight rise in confidence, reflecting a stronger assessment of current conditions. The 'expectations' component had changed little in either survey. Annual headline producer price inflation had fallen to 1.6% in July, from 2.5% in June, mainly due to a fall in gasoline prices. Annual core producer price inflation, which excludes food and energy, had been unchanged at 1.6% in July.

The fall in energy prices had also led to a decline in the annual rate of headline consumer price inflation, to 2.7% in July, from 3.3% in June.

A10 In Japan, GDP growth in Q1 had been revised up to 0.1%. The previous release had shown a fall of 0.2%. Early indicators had pointed to a weak figure for Q2. The all-industry activity index had declined by 1.9% in the quarter, and household expenditure had declined by 2.3%. Industrial production had fallen by 2.8% in July, the fifth consecutive monthly fall. Export volumes had declined by 12.4% in the year to July.

II Monetary and financial conditions

A11 The twelve-month growth rate of notes and coin had risen slightly to 7.5% in August. The three-month annualised growth rate had risen, also to 7.5%.

A12 The twelve-month growth rate of M4 had risen slightly, to 7.6% in July. The annual growth rate of M4 excluding other financial corporations (OFCs) had remained at 8.0%. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 10.9%; excluding OFCs, the annual growth rate had remained at 9.8%.

A13 The twelve-month growth rate of households' M4 deposits had risen to 8.7% in July. The strength in households' M4 deposit growth over the previous twelve months had coincided with a narrowing of the spread between time deposit rates and the repo rate. Some of the strength in money growth might therefore have reflected portfolio reallocation on the part of households. But retail sales growth had been strong, so there might also have been an increase in money holdings for transactions motives.

A14 The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen to 10.0% in July. The twelve-month growth rate of total unsecured net lending to individuals had risen to 12.2%. The number of approvals for house purchase in July had been 111,000, the highest figure since the series was redefined in 1997. The stock of outstanding mortgage approvals had also continued to rise. These figures had suggested robust housing market activity, at least in the short term. The annual growth rate of net secured lending to individuals had increased to 8.9%.

A15 Provisional estimates had suggested that mortgage equity withdrawal in Q2 had been strong.

A16 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 had fallen to 5.3% in July. The twelve-month growth rate of PNFCs' M4 lending had also fallen, to 9.1%. Total external finance had fallen to £3.5 billion in July, around £2.4 billion below the average monthly flow in 2001 Q2 which had been boosted by substantial equity issues by two telecommunications companies.

A17 The industrial breakdown of sterling bank lending to PNFCs in Q2 had shown a clear divergence between the twelve-month growth rate of lending to the manufacturing sector (at -4.6%) and to the service sector (at 16.7%). Much of the strength in the latter had been attributable to strong lending to real estate companies. Annual growth in lending to the service sector other than real estate companies had been 8.9%.

A18 Since the Committee's August meeting, risk-free short-term nominal interest rates had fallen by 19 basis points one year ahead, and by more at shorter maturities. Forward rates at twenty years had been little changed over the period. The real forward curve had shifted down at the short end, and by somewhat more than the nominal forward curve. Inflation expectations derived from index-linked and nominal yields had risen across the curve. Monthly survey-based measures of inflation expectations of professional economists had been unchanged in August.

A19 Deposit rates had been little changed in August, but - on the basis of announcements - falls were expected in September. Unsecured loan rates had risen in August as previous cuts had been unwound. The two-year discounted mortgage rate had fallen by 24 basis points in August. The latest base rate cut had not yet been passed through to the standard variable mortgage rate (SVR), which had fallen by only 1 basis point, but - on the basis of announcements - the SVR had been expected to fall by a further 23 basis points in September.

A20 UK corporate spreads and swap spreads had been largely unchanged in August. Non-gilt sterling bond issuance had been relatively modest in August.

A21 The FTSE All-Share and FTSE 100 indices had fallen by 3.8% and 4.2% respectively since the Committee's August meeting. The fall in the FTSE All-Share had been smaller than the falls in other major international indices. Information technology and non-cyclical services had been the weakest sectors in the FTSE All-Share index. They had fallen by 15.6% and 8.4% respectively. The recent falls in the FTSE 100 had coincided with a less negative skew in the distribution of expected returns over the next three months, suggesting that investors had attached a smaller probability to a further fall in the index. In contrast, the S&P 500 skew had become more negative over the period. Profit warnings in August had been lower than in June or July, but higher than one year previously.

A22 Since the August meeting, the sterling exchange rate index (ERI) had risen by 0.5% to 107.3. This appreciation had reflected a 1.4% appreciation in the value of sterling against the dollar, and a 0.4% appreciation in the value of sterling against the euro. The sterling exchange rate had been 0.7% above the August *Inflation Report* projection. The fall in sterling following the Committee's August decision had been broadly commensurate with the fall in domestic short-term interest rates, but over the month as a whole sterling exchange rate movements had been associated with other factors.

III Demand and output

A23 Quarterly GDP growth in 2001 Q2 had been unrevised at 0.3%, leaving the annual growth rate unrevised at 2.1%. Service sector growth in Q2 had been revised up to 0.8% from 0.6% in the preliminary release, while manufacturing output had fallen by 2.1% on the quarter. Construction output had risen by 0.6%. GDP growth had been boosted by a sharp rise in mining output of 5.8%. GDP excluding the primary sectors (agriculture, mining and utilities) had risen by an estimated 0.2% on the quarter.

A24 According to the expenditure breakdown of GDP, final domestic demand had grown by 0.9% in Q2. Domestic demand had grown by 0.3%, with changes in inventories reducing quarterly GDP growth by 0.7 percentage points. The sectoral data had indicated that there had been a run-down of stocks in the manufacturing sector.

A25 Private sector consumption (including that of non-profit institutions serving households) had grown by 1.2% in Q2, and real government consumption had risen by 0.8%. Total investment (including net acquisitions of valuables) had increased by 0.2% in Q2. Business investment had increased by 0.8%. The sectoral breakdown of business investment had indicated that private manufacturing investment had fallen by 4.0% in Q2, while private service sector investment had risen by 1.0% on the quarter. Net trade had made no contribution to quarterly GDP growth in 2001 Q2. Total exports of goods and services had fallen by 2.9%, while imports had fallen by 2.5%.

A26 Turning to indicators of activity in the third quarter, retail sales volumes had risen by 0.6% in July and by 1.5% in the three months to July compared with the previous three months. The Confederation of British Industry (CBI) survey of distributive trades had suggested that retail sales would continue to be strong over coming months: the reported sales balance had risen to +49 in August from +44 in July, and the expected sales balance for September had been strong at +42. But measures of consumer confidence had weakened: the GfK index had fallen to zero in August, from +4 in July, while the MORI measure had fallen to -31 in August, from -15 in July.

A27 The Halifax house price index had risen by 1.5% in August, taking its annual growth rate to 11.0%. The Nationwide house price index had increased by 0.4% in August, taking its annual growth rate to 11.9%. The Royal Institution of Chartered Surveyors' (RICS) balance of estate agents reporting increased prices over the previous three months had risen slightly to +54 in July, from +47 in June. The House Builders' Federation monthly survey had shown a net balance of housebuilders reporting an increase in house prices of +48 in July, broadly unchanged from June. Particulars delivered had fallen by 3,000 in July, to 118,000. But in the three months to July, particulars delivered had been 4.0% higher than in the previous three months.

A28 Total industrial production had fallen by 0.5% in July. Within the total, manufacturing output had fallen by 0.9%. The manufacturing output expectations balance in the CBI Monthly Trends survey had fallen to -13 in August, from +3 in July. The total orders balance had also fallen slightly, to -29 in August from -26 in July. The headline index of the Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey had been 46.4 in August. The new orders index had fallen to 46.1 in August from 47.4 in July. The August CBI/Deloitte & Touche service sector survey had reported falls in the business volumes balances both for 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 services index had risen to 50.9 in August, from 50.3 in July. The CIPS construction index had fallen to 56.3 in August, from 59.9 in July.

IV Labour market

A29 Employment, as measured by the Labour Force Survey (LFS), had increased by 75,000 in 2001 Q2. Nevertheless, it had been a little lower than in the previous monthly data release, which covered the three months to May. The increase in the second quarter had been more than accounted for by increased full-time employment.

A30 The working-age employment rate had been unchanged on the quarter, but it had been a little lower than in the three months to May. Manufacturing employment had continued to decline, and at a rather faster rate in May and June than previously. The August CBI/Deloitte & Touche service sector survey had suggested that employment growth in business and professional services was slowing. Recent CIPS surveys had shown a weaker employment picture than had the LFS data, and the overall CIPS index had been close to balance for several months. The Recruitment and Employment Confederation (REC) survey for August had indicated a more rapid decline in the demand for permanent staff. However, there had again been a moderate increase in the demand for temporary staff.

A31 New vacancies notified to Jobcentres had increased by 10,200 in July to reach another all-time high. But the National Press Recruitment index had declined further in July, to the lowest level since September 1996.

A32 LFS unemployment had fallen by 14,000 in 2001 Q2, but it had been higher than in the three months to May. The claimant count had fallen by 23,400 in the second quarter and by a further 12,800 in July. Both inflows to, and outflows from, regional claimant counts had continued to fall steadily throughout the United Kingdom.

A33 The CBI/Deloitte & Touche service sector survey had reported reduced shortages of skilled labour in business and professional services, and the August REC survey had suggested that improvements in the availability of agency staff had become more widespread.

A34 Working-age inactivity, as measured by the LFS, had increased by 16,000 in 2001 Q2, with the number of those not wanting a job up by 70,000. The inactivity rate had been unchanged.

A35 Bank estimates of labour productivity growth during the year to 2001 Q2, based on LFS employment data, had been below average whether measured on an hours or on a numbers-employed basis. The corresponding estimate of growth in whole-economy unit wage costs had risen by 0.3 percentage points, to 3.6%. According to official data, annual growth in manufacturing labour productivity had risen by 0.6 percentage points to 3.0% in June. That growth rate had, nevertheless, been below growth rates seen during the previous year. Annual growth in manufacturing unit wage costs had fallen to 2.0% in June, from 2.2% in May.

A36 Whole-economy headline earnings growth, as measured by the Average Earnings Index (AEI), had risen by 0.2 percentage points to 4.8% in June. There had been similar increases in both private sector and public sector earnings growth. Within the private sector figure, headline growth in services earnings had also risen, but headline growth in manufacturing earnings had eased. Annual growth in whole-economy earnings excluding bonuses (not seasonally adjusted) had remained above 5% in June, and growth in both the manufacturing and the public sectors had remained strong. Bonuses had reduced annual earnings growth in June (not seasonally adjusted) by 0.5 percentage points. According to the August REC survey, increases in permanent salaries and temporary rates for agency placements had again become less widespread.

A37 The Bank had received information on 83 wage settlements that had become effective in July. These had covered 282,000 employees, all of whom had been in the private sector. The AEI-weighted twelve-month whole-economy mean had been unchanged in July at 3.4%, while the private sector mean had risen by 0.1 percentage points.

V Prices

A38 The sterling oil price had risen by around 1% in August. But this had followed a reduction of 10% in July, and so the price had remained below its level of a year earlier.

A39 Producer input prices had fallen by 1.8% in July, driven mainly by the reduction in the sterling price of oil. This monthly fall meant that producer input prices had fallen by 0.3% in the year to July, having risen by 1.9% in the year to June. Between June and July, the contribution of imported materials prices to annual input price inflation had fallen by 0.9 percentage points. Looking ahead, the CIPS manufacturing survey input price index had remained broadly stable, but below the no-change balance, indicating a further easing of input price inflation.

A40 The official input price index had not yet incorporated the effects of the Climate Change Levy, but the ONS had estimated that the levy would add around 0.9% to the input price index in July.

A41 Annual output price inflation excluding duties (PPIY) had been 0.5% in July compared with 0.6% in June. Looking forward, the CBI Monthly Trends survey output price balance had been unchanged at -16 in August. The CIPS manufacturing survey output price balance had fallen to 46.1 in August from 47.4 in July.

A42 The annual rate of increase of the market-price GDP deflator had fallen to 2.0% in Q2, from 2.4% in Q1. The annual rate of increase of the domestic demand deflator had risen to 2.3% in Q2, from 1.9% in Q1. Within this, the annual rate of increase of the investment deflator had risen to 2.2% in Q2, from 1.6% in Q1.

A43 Annual RPIX inflation had fallen by 0.2 percentage points to 2.2% in July. Annual services price inflation had been unchanged at 4.0%. Annual goods price inflation had fallen to 0.3% in July, from 0.7% in June. This fall had mainly reflected a 9.8% fall in seasonal food prices between June and July. Annual RPIY inflation had fallen to 2.6% in July from 2.8% in June. Annual HICP inflation had also fallen, to 1.4% in July from 1.7% in June.

VI Reports by the Bank's Agents

A44 The Bank's regional Agents had reported a sharp weakening in business confidence during recent weeks. This weakening had occurred across most sectors and across all regions of the United Kingdom. It had resulted from the weaker international economy.

A45 Overall, manufacturing output and orders had continued to weaken. Weak demand from the United States and euro-area economies, as well as from the domestic ICT sector, had continued to be the main drivers of this slowdown. And de-stocking had further reduced output. Engineering and ICT had deteriorated further. But many Agencies had reported continued strength in output of oil and gas equipment, consumer goods and construction-related products. Some contacts had suggested that the downturn in manufacturing might be flattening out.

A46 Growth in services had slowed. Investment banks in London had been hardest hit, particularly by the decline in merger and acquisition activity. They had cut expenditure on other services, for example IT systems and advertising. Weaker demand from Japan and from the United States had contributed to lower corporate hotel and travel bookings. Growth in consumer services had continued, but there had been fewer tourists, particularly from the United States. There had been some recovery in domestic tourism.

A47 Agencies had reported that construction output growth had remained strong, boosted by public sector contracts. However, forward order books had been weaker. New housing starts had been expected to be lower in 2002 than in 2001, and house prices had been reported to have peaked in several regions. Growth in retail sales volumes had again been strong, and private new car sales had remained buoyant.

A48 A continued fall in manufacturing employment, combined with slower growth in services employment, had led to an easing of skill shortages.

VII Market intelligence

A49 Near-term expectations of official interest rates implied by short sterling futures had fallen since the Committee's previous meeting, by between 11 and 34 basis points for contracts maturing in 2001 and in 2002. Short sterling rates had declined sharply on 2 August, following the Committee's decision to reduce the official repo rate by 25 basis points, a decision that had not been anticipated by market participants. Weak CIPS services data in July and the release of the Federal Reserve's *Beige Book* containing a weak outlook for the US economy, also contributed to a fall in short-term interest rate expectations. The fall in short-term rate expectations had been partly reversed following the release of stronger-than-expected retail sales data and NAPM data in the US, and following the publication of UK labour market data and the minutes of the Committee's August meeting. Most market participants had expected the Committee to leave the Bank's repo rate unchanged at its September meeting. Similarly, economists polled by Reuters on 29 August had attached a mean probability of 79% to no change in the official repo rate on 6 September.

A50 The sterling exchange rate index had risen to 107.3 from 106.8 at the time of the Committee's August meeting. It had fallen during the early part of this period, at a time when UK short-term interest rates were declining, both in absolute terms and relative to international interest rates. Sterling one-month implied volatilities against the dollar had risen. Sterling one-month implied volatilities against the euro had been little changed, despite having fallen earlier in the month to their lowest level since May. The euro had risen by 1.1% against the dollar since the Committee's August meeting. Earlier in the month, it had been up to 5.1% higher, apparently reflecting a change in sentiment towards the dollar, together with concerns about the timing of recovery in the United States, and about the sustainability of the current account deficit. But most of these gains had been reversed following the release of the US NAPM data.