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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 December 2002

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 December 2002

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0212.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 8 and 9 January will be published on 22 January 2003.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 DECEMBER 2002

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

The world economy

2 The month's information about the world economy contained few surprises. In the United States, GDP was now estimated to have increased by 1% in the third quarter, a little faster than in the advance estimate, and consumption had increased at the same rate. Business and consumer confidence had improved; the survey indicators from the Institute for Supply Management (ISM) had picked up, both in manufacturing and, more substantially, in non-manufacturing; production of information, communications and technology (ICT) goods had increased again in October, and was about 15% above its level a year earlier; and new orders for non-defence capital goods had picked up. Industrial production had, however, weakened again and the ISM manufacturing survey balance was below 50; investment was still weak; and the levels of manufacturing and consumer confidence, though higher, had not yet recovered to levels seen earlier in the year. The dollar yield curve was now quite steeply upward-sloping at shorter maturities, reflecting in part the change to a neutral bias in the Federal Open Market Committee's statement accompanying their November interest rate decision. Credit conditions generally were somewhat easier in wholesale markets and spreads had narrowed. The market was more receptive to debt issuance and there had been fewer credit rating downgrades, though the Federal Reserve Board survey of loan officers reported that conditions for smaller corporate borrowers had tightened modestly in the past quarter.

3 The Committee's central view remained that US output growth in the fourth quarter would be somewhat slower than in the third. Looking further ahead, the prospects for recovery were unchanged. Though investment had not yet started to increase, the relatively shorter lives of ICT capital goods suggested that the investment cycle might now be shorter than in the past. It would in any case not be surprising if investment were to follow, rather than lead, the upswing, and its return to growth would be a clear sign that recovery was firmly established.

4 The Committee noted that Consensus forecasts, which had previously been rather stronger than those underlying the *Inflation Report* projections, had weakened and were, in the November release, a little lower than the Committee's central view in the November *Report*. It was agreed that these differences might reflect the time at which the various forecasts had been made and, in particular, their timing relative to the autumn recovery in equity prices and the somewhat stronger US data released since October. Some may have been completed before the Committee's own most recent projection.

5 In the euro area, growth remained subdued. Growth in the second quarter had been revised down a little; the first estimate of growth in the third quarter was, at 0.3%, slightly weaker than the Committee's central expectation. Within that overall picture, the contribution of final domestic demand to third-quarter growth in the euro area as a whole was a little stronger than had been expected. This afforded some comfort that the pace of growth might start to pick up in the coming months. However, retail sales growth had eased in September and consumer confidence was falling. In Germany, the rate of unemployment had increased to 10% and the IFO index had fallen further in November; and France now seemed to be among the euro-area countries showing signs of weaker growth. Market expectations were that the ECB would reduce interest rates, most probably by 50 basis points, at its meeting on 5 December.

6 On the basis of new data, GDP growth in Japan had now been positive and increasing for the first three quarters of this year. These data were volatile and there was, in particular, considerable uncertainty about the consumption data. But the rapid growth in exports to other Asian countries this year suggested that there might nevertheless be substance in these new estimates and it was encouraging that signs of recovery in Japan were now starting to emerge.

7 International financial markets had been more stable during November. The main stock market indices were little changed on the month, and volatility had fallen: whereas, in October, the volatility implied by options prices had been higher in the near term than at six month maturities, the volatility profile was now flatter and reflected the generally calmer market conditions. Exchange rates had moved rather more during the month than over the month as a whole. Sterling had ended it a little stronger in effective rate terms.

Money, credit and asset prices

8 In the United Kingdom, household borrowing continued to grow strongly. The twelve-month growth rate of M4 lending to households had increased to just under 14% in October; the corresponding rate of growth of total secured lending to individuals had risen to just under 13% – the highest rate since 1990; and mortgage equity withdrawal in the third quarter was provisionally estimated to have been 6.9% of personal disposable income, up from 5.9% in the second quarter. This was consistent with the continued rise in consumers' confidence about their own financial situation and the generally robust consumption picture. Household deposits were also growing quite rapidly, at just over 8% in the year to October. This might in part reflect as yet unspent funds realised from equity withdrawn from the housing market.

9 Housing market developments had not changed substantially since the Committee's previous meeting. It was noted that the main upward pressure on house prices now seemed to be coming from the lower end of the market. The pressure had moved away from London and the South East to other regions. This might in part reflect a shift of buy-to-let demand from the London market, where returns were increasingly reported to be disappointing, to other areas of the country. But the evidence did not support any one explanation of recent house price movements, and there was substantial local variation in price pressures.

10 The Chancellor's Pre-Budget Report had projected higher levels of Government borrowing this year, and in both 2003 and 2004, than had been expected at the time of the main Budget statement earlier in the year. This was unsurprising, given the slower-than-expected pace of growth this year, and the Committee noted that the fiscal rules were still expected to be comfortably met. There did not, therefore, seem to be any immediate pressure on the Government to change its fiscal stance, which remained one which would, helpfully, support domestic demand over the next year or two.

11 Two longer-term issues were noted. First, a significant part of the unexpected weakness in government revenues was attributed to the current depressed level of profitability in the financial sector. This might well (as was implied by the Treasury's fiscal projections) be reversed, as output returned to trend. But it was also possible that profitability in that sector had been exceptionally high in the late 1990s, so that a part of the recent fall in tax revenues from this sector might persist. The assumptions underlying the Pre-Budget Report were more cautious than those in the Budget itself, as

they were based on the current lower level of equity prices. But some cuts in the cost base of financial sector firms were also implied, if profitability was to be restored to previous levels.

12 Second, the Treasury's projections incorporated new estimates of UK population growth, both in the past (reflecting the results of the 2001 Census) and looking forward (reflecting revised projections by the Government Actuary's Department). The downward revisions to past population data had led, mechanically, to somewhat faster measured trend productivity growth in the past. This was projected to continue in the years ahead. The Treasury had, as usual, adopted a more cautious assumption about trend output growth in its fiscal projections than the central assumption in its economic forecast.

Demand and output

13 The estimate of GDP growth in the third quarter was revised up, by 0.1 percentage points, to 0.8% in the November data release. The main news was in the components, with consumption growth, at 0.8%, much stronger than had been expected at the time of the November *Inflation Report*; and investment much weaker, falling for the seventh quarter in succession. This continued the recent pattern of stronger-than-expected consumption growth and weaker-than-expected investment.

14 Early indications of consumption in the fourth quarter were quite robust: retail sales volumes increased by 0.8% in October, and the CBI distributive trades survey suggested that they had remained strong in November. Household borrowing, consumer confidence and housing market information supported the view that consumption would continue to grow strongly in the fourth quarter.

15 It was difficult to know how to assess the weak business investment outturn. Investment growth could vary substantially, for relatively small changes in firms' desired capital stock; and, as a share of GDP, it was unclear whether the nominal share or the constant price share offered the better guide to the sustainable level of investment. The price of investment goods had been falling relative to that of output as a whole for many years, and it was therefore not surprising that the constant price share had been on a rising trend, although it had been falling since the start of the slowdown in 2001. The direction in which the nominal share would move in response to relative price changes depended, however, on the ease with which capital could be substituted for labour. The nominal share was currently below its long-run average. It was noted also that the fall in manufacturing investment was not surprising, given the weakness in output: the puzzle was that service sector investment was weak.

Corporate balance sheets seemed in general to have strengthened, leaving firms better placed to increase investment expenditure if expectations of future demand were to strengthen. The special survey of investment by the Bank's regional Agents suggested that weak external demand was a key factor.

The labour market

16 Employment, as measured by the Labour Force Survey (LFS), had fallen in the third quarter, and unemployment on the LFS measure had increased to 5.3% – in contrast to the slight fall embodied in the projections for the November *Inflation Report*. But claimant unemployment continued to fall slowly. It therefore seemed unlikely that the earlier-than-expected pick-up in the LFS measure of unemployment signalled more rapid increases further out, or that the increases in unemployment were yet sufficient to dampen the pace of consumption growth.

17 Earnings growth remained stable overall, at an annual rate of a little below 4%. But the pattern of growth in public sector pay, which had risen sharply to nearly 6% in the second quarter of 2001 and fallen to 3% a year later but was now back to around 4%, was puzzling: it did not obviously fit with Government strategy for recruiting and retaining public sector staff. Part of the explanation could be timing factors, including the threshold payments to teachers last year and the delay in this year's local authorities pay settlement. The latter would continue to affect the data well into next year. More rapid public sector earnings growth could have a direct effect on RPIX inflation through Council Tax, and indirect effects if it led to higher private sector settlements. But the labour market had eased, despite the continuing increase in public sector employment. So concerns about possible inflationary pressures from public sector earnings growth would be less acute.

Prices and costs

18 RPIX inflation was 2.3% in the year to October, as had been expected. It was likely to move above target in November, as last October's fall in petrol prices would drop out of the annual comparison and the continuing rapid pace of house price inflation would add to the contribution to the index from housing depreciation. Though spot oil prices were some 6% higher (in sterling terms) than at the Committee's previous meeting, they were lower on average in November than had been expected at the time of the Committee's November projections, and futures prices had changed very

little further out. The net effect would be to reduce inflation a little, relative to the *Inflation Report* profile, in the coming months, but to raise it further out.

Other considerations

19 The monthly poll of economists by Reuters showed that none of them expected a change in the repo rate this month. This was broadly consistent with what was implied by market forward rates. The short end of the sterling money market curve had moved up by about 25 basis points on the month. This might reflect in part the market view of the implications for UK interest rates of the November reduction in US interest rates and of the expected reduction this month in euro-area rates.

20 The Committee noted the lingering perception in some quarters that its decisions either were, or should be, directed at achieving greater house price stability. They unanimously reaffirmed their view that this would be inappropriate, given the Committee's remit: the price stability target set by the Chancellor was specified in terms of retail price inflation, as measured by RPIX, and not house prices (or indeed any other asset price). House price movements were, nonetheless, a potentially important influence on the prospect for inflation. The policy judgment would take them into account alongside other potential influences on inflation in deciding on the most appropriate setting of interest rates.

The immediate policy decision

21 The Committee agreed that the news on the month was limited and did not materially affect the projections for inflation and output growth included in the November *Inflation Report*. Though there were one or two weaker indicators from the United States, the month's data and survey information about the US economy had on balance been mildly encouraging. Economic news from the euro area was somewhat weaker, though comfort was taken by some members from the stronger-than-expected indicators of domestic demand. There was also an expectation of imminent monetary policy action to support recovery there. And there had been more positive indicators from Japan. Financial markets around the world seemed to have stabilised, at least for the present, and uncertainties from that source accordingly to have receded somewhat. In the United Kingdom, overall growth prospects were little changed, though consumption had been stronger and investment weaker than expected. There were some signs of easing in the labour market, which might moderate possible concerns about public sector pay pressures. While the Pre-Budget Report suggested some uncertainties about the public finances in

the longer term, government spending was helpfully supporting domestic demand and, on the Treasury's central view, the fiscal rules were comfortably met.

22 Against this background, which continued to suggest that UK inflation would be broadly around target over the next two years and growth close to trend, the immediate policy decision depended largely on judgments about the risks to this outlook.

23 A number of arguments were identified for leaving the repo rate unchanged. For most members, the central projection for inflation did not suggest that a reduction in the repo rate was necessary and the balance of risks for inflation was weighted modestly to the upside. The news on the world economy suggested that the downside risks, for example from possible retrenchment by US consumers, were no worse. While some of those arguing for no change in the repo rate felt that those risks were still present, others were more inclined to the view that they were somewhat less than they had seemed a month ago. Domestically, the persistent strength of consumption growth and the continued rapid pace of household borrowing and house price inflation suggested that there remained an upside risk to inflation from stronger-than-projected consumption growth. There were also the upside risks from next April's increases in employer and employee National Insurance Contributions, from public sector pay and from pay pressures more generally in the coming settlement round. Other arguments for no change in the repo rate were adduced, to which different weights were attached. There remained a concern that households' perceptions of their future sustainable levels of consumption might be unrealistic. This could be because they were assuming that the rapid growth of real incomes in recent years, in part the result of the terms of trade improvement, would continue; or because they looked only at the current low nominal rate of interest they paid on mortgage debt, rather than at the average rate they could expect to pay over the life of the loan; or because they had not fully appreciated the real burden of the debts they were accumulating in the current, low inflation, environment. The longer any such misperceptions persisted, the greater the imbalances in the economy and the consequent downside risks to demand further ahead would become. So, for some members, an interest rate reduction now would add to uncertainty about the future path of output and inflation, and about the ability of monetary policy action to keep inflation close to target. Others were of the view that there was too much uncertainty about the magnitude or timing of the downside risks to demand from high levels of house prices or household borrowing for them to influence their current interest rate decision to any great extent.

24 Some members, however, took a slightly different view of the most likely path of inflation over the next two years and assessed the risks somewhat differently, as had been the case a month ago. The outlook for the world economy and for domestic investment was in their view a little weaker than in the Committee's central projection, and domestic inflationary pressures appeared muted. There was, *prima facie*, a case for a small reduction in the repo rate, to keep inflation on target. That would support the corporate sector and help stimulate investment. For these members, the policy issue was whether or not the risks to the outlook were a reason to change that view. A number of arguments suggested that they were not. First, growing household indebtedness would if anything add to the downward pressures further out. Second, the recent rapid growth in consumption and the associated accumulation of debt by households were a rational response to their experience of strong income growth, a robust labour market and favourable rates of interest on borrowing secured on property. So there was no reason to suppose that any abrupt adjustment in debt accumulation and consumption was likely. Third, even if high levels of household debt were seen to be a problem in the longer term, a modest reduction in interest rates would probably induce only a very modest additional increase in debt levels. Fourth, the regional pattern of house price increases suggested to these members that the current house price cycle was moving into its later stages, and a small reduction in the repo rate was therefore more likely to moderate the end of that cycle than to put renewed upward pressure on house prices. Fifth, it was younger households which were most likely to be at risk from adverse developments in the housing market. Such households were less likely, given low inflation in recent years, to be basing their decisions on an assumption that inflation would rapidly erode the real burden of their debts. They would also be more likely to experience relatively rapid income growth. Finally, loan-to-value ratios were not high by historical standards and a larger proportion of households now included two wage-earners. Both factors would moderate the impact of any adverse shock to employment; and the implications for consumption of higher debt servicing costs could if necessary be addressed by policy easing.

25 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4.0%. Seven members of the Committee (the Governor, Mervyn King, Andrew Large, Kate Barker, Charles Bean, Marian Bell and Paul Tucker) voted in favour. Christopher Allsopp and Stephen Nickell voted against, preferring a reduction in the repo rate of 25 basis points.

26 The following members of the Committee were present:

Eddie George, Governor

Mervyn King, Deputy Governor responsible for monetary policy

Andrew Large, Deputy Governor responsible for financial stability

Christopher Allsopp

Kate Barker

Charles Bean

Marian Bell

Stephen Nickell

Paul Tucker

Gus O'Donnell was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 29 November 2002, in advance of its meeting on 4-5 December. At the start of the Committee meeting itself, members were made aware of the information that had subsequently become available, and that information is included in this annex.

I The international environment

A2 Consensus Economics forecasts of US GDP growth for 2002 and 2003 had been revised down in November, to 2.3% and 2.7% respectively, from 2.4% and 3.0% in October. The forecast of euro-area GDP growth for 2002 had been unchanged at 0.8%, but the 2003 projection had been revised down to 1.7%, from 1.9% in October. The forecast of Japanese GDP growth for 2002 had been unchanged at -0.9%, but the projection for 2003 had been revised down to 0.8%, from 0.9% in October.

A3 According to the preliminary estimate, US GDP had increased by 1.0% on the quarter in 2002 Q3 (revised up from the advance estimate of 0.8%), to a level 3.2% higher than a year earlier. Consumption had grown by 1.0% on the quarter, unchanged from the advance estimate. Investment had been unchanged on the quarter, compared with the advance estimate of a 0.1% increase. Government spending had grown by 0.8% on the quarter, compared with the advance estimate of 0.5%. Net trade had made no contribution to quarterly GDP growth, unchanged from the advance estimate; inventories had contributed 0.1 percentage points. Pre-tax corporate profits (including an adjustment for inventory valuation and capital consumption) had fallen by 1.8% in 2002 Q3, following a 1.6% fall in 2002 Q2. US non-farm business sector labour productivity had increased by 1.2% on the quarter in 2002 Q3, following a rise of 0.4% in 2002 Q2. Unit labour costs in the United States were unchanged on the quarter, after an increase of 0.5% in 2002 Q2.

A4 Manufacturing output in the United States had fallen by 0.7% between September and October, but had been 1.3% higher than a year earlier. This had reflected a 5.2% decline in auto production on the month. Production in the information, communications and technology (ICT) sector had increased by 0.5% in October, and had been 14.7% higher than a year earlier. New orders for non-defence capital goods had increased by 4.5% in October. The Institute for Supply Management (ISM) manufacturing index had increased to 49.2 in November, from 48.5 in October. The non-manufacturing ISM index had risen to 57.4 in November, from 53.1 in October. The Conference

Board measure of consumer confidence had risen to 84.1 in November, from an upwardly-revised 79.6 in October. The University of Michigan headline index of consumer confidence had increased to 84.2 in November, from 80.6 in the previous month.

A5 US real consumption had risen by 0.2% on the month in October, following a decrease of 0.6% in September. US real personal income had been unchanged in October, following an increase of 0.3% in September. The US saving rate had fallen to 4.2% in October, from 4.4% in September. US retail sales had been unchanged on the month in October, following a fall of 1.3% in September. Excluding sales of automobiles, retail sales had risen by 0.7% in October, following a fall of 0.1% in September.

A6 The US headline consumer price index had risen by 0.3% in October, and by 2.0% on a year earlier, from 0.2% on the month and 1.5% on the year in September. The annual core rate of inflation (that is, excluding food and energy prices) had been 2.2% in October, unchanged from a 2.2% annual increase in September. US producer prices had risen by 0.6% in the year to October, after a fall of 1.9% in the year to September. Core US producer prices had risen by 0.5% in the year to October, after having fallen by 0.4% in the year to September.

A7 Euro-area GDP had grown by 0.3% in Q3, the same quarterly rate of increase as had been recorded in Q2. Private consumption had increased by 0.5% and government consumption by 0.3%. Investment had been flat over the quarter, while changes in stocks had reduced the quarterly GDP growth rate by 0.1 percentage points. Net trade had made no contribution to quarterly GDP growth. German GDP had grown by 0.3% in 2002 Q3, following downwardly-revised growth of 0.2% in Q2. Private consumption had grown by 0.5% and government consumption by 0.1%. Total investment had fallen by 0.5% on the quarter. Net trade had made a 0.1 percentage point contribution to quarterly GDP growth. French GDP had increased by 0.2% in 2002 Q3, following an increase of 0.4% in Q2. Private consumption growth had increased to 0.7%, but total investment had fallen by 0.9%. The change in inventories had reduced quarterly growth by 0.3 percentage points, while net trade had increased it by 0.3 percentage points. Italian GDP had grown by 0.3% in 2002 Q3, following an increase of 0.2% in Q2.

A8 Industrial production in the euro area had fallen by 0.2% on the month in September, following an increase of 0.2% in August. The business confidence indicator in the European Commission survey

had increased by one point in November, to -10; and the consumer confidence indicator had fallen by two points, to -14. The euro-area purchasing managers' index (PMI) for manufacturing had increased to 49.5 in November, from 49.1 in October. The services PMI had risen to 50.8 in November, from 50.1 in October. The west German IFO index had fallen to 87.3 in November, from 87.7 in October. German manufacturing orders had fallen by 2.5% in September, following an increase of 1.4% in August. Euro-area retail sales had fallen by 2.1% in September, after rising by 1.0% in August. French consumer spending on manufactured goods had increased by 1.0% in October.

A9 Producer prices in the euro area had increased by 0.2% in October and by 0.9% on a year earlier. Annual inflation in the euro-area harmonised index of consumer prices (HICP) had increased to 2.3% in October, from 2.1% in September. Annual HICP core inflation (excluding energy, food, alcohol and tobacco) had been 2.3% in October, unchanged from September. According to Eurostat's flash estimate, annual HICP inflation had remained unchanged at 2.2% in November.

A10 According to the preliminary estimate, Japanese GDP had increased by 0.7% in 2002 Q3, to a level 1.5% higher than a year earlier. The estimate of quarterly GDP growth in 2002 Q2 had been revised up, to 1.0%, from the previous estimate of 0.6%. Private consumption in Japan had increased by 0.8% in 2002 Q3, while total private investment had fallen by 0.8%. Inventories had contributed 0.5 percentage points to quarterly growth, while net trade had reduced it by 0.1 percentage points.

A11 Japanese export volumes had increased by 12.5% on a year earlier in October, up from 9.2% in September. Within that total, Japanese exports to the rest of Asia had increased by 29.2% on a year earlier; export values to China alone had risen by 47.3% over the period. Export volumes to the US had been 2.1% higher, while export volumes to the EU had fallen by 1.9%. Import volumes had grown by 1.6%.

A12 Industrial production in Japan had fallen by 0.3% in October. Nominal retail sales in Japan had fallen by 2.0% in October, to a level 2.8% lower than a year earlier. This had been the 19th consecutive month of decline on an annual basis. The Japanese index of tertiary activity had fallen by 0.1% in September, following an increase of 0.1% in August. The Japanese all-activity index (a weighted average of industrial production, the tertiary index and construction) had been unchanged in September. Japanese total domestic private machinery orders (excluding volatile orders of ships and

electric power) had fallen by 2.6% on a year earlier in September, following a fall of 20.6% on a year earlier in August.

A13 Japanese consumer prices (CPI) had fallen by 0.9% in the year to October, as had the core CPI measure. Seasonally adjusted unemployment in Japan had increased to 5.5% in October, from 5.4% in September. Japanese workers' household expenditure had fallen by 0.7% in real terms in the year to October, following an increase of 4.1% in the year to September.

A14 Between 6 November and 4 December, the spot price of Brent crude oil had increased by \$1.70 per barrel to around \$25, while *The Economist* dollar non-oil commodity price index had been unchanged. Most major international equity indices had fallen over this period. In local currency terms, the Wilshire 5000 had fallen by 0.4%, the FTSE All-Share by 1.2% and the Topix had fallen by 1.0%. The Dow Jones EuroStoxx had risen by 1.0%.

II Monetary and financial conditions

A15 The twelve-month growth rate of notes and coin had fallen to 6.9% in November, from 8.3% in October. The twelve-month growth rate of M4 had been 5.4% in October, unchanged from September. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had risen slightly, to 9.8%, in October, up from 9.7% in September. Excluding other financial corporations (OFCs), the annual growth rates of both M4 and M4 lending had increased in October.

A16 The twelve-month growth rate of households' M4 had risen slightly, to 8.2%, in October, from 8.0% in September. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had continued to rise, to 13.9% in October from 13.5% in September. Within total net lending to individuals, the annual growth rate of secured lending had risen further, to 12.8% in October, the highest rate since 1990 Q4; and the annual growth rate of unsecured lending had remained unchanged at 15.9% in October. Within unsecured lending, the annual growth in credit card lending had eased slightly.

A17 Particulars delivered had been 131,000 in October, little changed from September. The number of loan approvals for house purchase, after adjusting for the number of working days, had also risen, to 121,000 in October from 117,000 in September.

A18 The twelve-month growth rate of private non-financial corporations' (PNFCs) M4 deposits had risen to 6.8% in October, from 5.5% in September. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had increased to 4.5% in October, from 3.8% in September. Data from the major British banking groups (MBBG) had shown slight increases in the growth of borrowing by most categories within the corporate sector in October. PNFCs had raised £6.0 billion in total external finance in October, compared with a monthly average flow of £5.1 billion in 2002 Q3.

A19 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had fallen further, to -2.8% in October from -1.6% in September. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had fallen, to 4.7% in October from 5.5% in September.

A20 Between 6 November and 4 December, the FTSE All-Share index had fallen by 1.2%, the FTSE 100 had fallen by 1.3% and the FTSE Small-Cap had risen by 2.8%. Within the FTSE All-Share index, the strongest-performing sector over the month had been non-cyclical services, which had risen by about 9%, while the weakest-performing sector had been basic industries, which had fallen by about 5%. Uncertainty about the FTSE 100, as measured by the volatility implied by option prices, had fallen over the month, though it had remained above the levels seen in May. There had also been an increase in the downside skew to the market over the month. Profit warnings in November had been below the average of the previous year.

A21 Between 6 November and 4 December, nominal forward rates had risen at all maturities below about two years. At longer maturities, nominal forward rates derived from gilts had fallen – by 11 basis points at ten years. The skew on three-month short sterling interest rates now suggested that the risks to the market's central expectation were seen as fairly evenly balanced, and the standard deviation implied by option prices, a measure of uncertainty, had fallen slightly over the month. Real forward rates derived from index-linked gilts had risen by 4 basis points at ten years.

A22 Since the Committee's previous meeting, implied inflation expectations had fallen slightly, by 15 basis points at around ten years. Mean inflation expectations in HM Treasury's survey for 2002 Q4

had risen to 2.3% in November, from 2.2% in October. Consensus Economics forecasts of average inflation for 2002 and 2003 had been unchanged at 2.2% and 2.3% respectively.

A23 The Merrill Lynch index of investment-grade sterling corporate bond spreads had fallen slightly between 6 November and 4 December, by 7 basis points. Yields had fallen by 4 basis points.

A24 Quoted interest rates on household borrowing had remained broadly unchanged since the Committee's previous meeting. According to the most recent Council of Mortgage Lenders' release, the estimated proportion of fixed rate mortgages in gross lending had increased to 28% in October, from 24% in September.

A25 The sterling effective exchange rate index (ERI) had risen by 0.7%, to 106.2, between 6 November and 4 December. Over the month, sterling had appreciated against both the dollar and the euro. The movements in sterling over the month had been greater than could be accounted for by movements in interest rates in the United Kingdom relative to those in other major economies.

III Demand and output

A26 Quarterly growth of GDP at market prices in 2002 Q3 had been revised up by 0.1 percentage points, to 0.8%; annual growth in 2002 Q3 had been correspondingly revised up 0.1 percentage points, to 1.8%. Growth of GDP at basic prices had also been 0.8% in the third quarter.

A27 Service sector output growth had been revised up by 0.1 percentage points, to 0.9%, in 2002 Q3. Within the service sector, output of the transport and communication sector had risen by 1.5%, output of the business services and finance sector by 1.2% and output of the distribution, hotels and catering sector by 0.7%.

A28 Manufacturing output had risen by 1.1% on the quarter. This was the first quarter since 2000 Q4 that growth in this sector had exceeded growth in service sector output. But much of this had been accounted for by the effect of the Jubilee holidays, which had reduced the level of manufacturing output in 2002 Q2.

A29 Final domestic demand had risen by 0.6% in 2002 Q3. Domestic demand had risen by 1.0% on the quarter, with the change in stockbuilding contributing 0.5 percentage points to GDP growth.

A30 Private consumption had grown by 0.8% on the quarter and real government consumption by 1.3%. Whole-economy investment had fallen by 1.1% on the quarter, but within this net acquisition of valuables had added one percentage point to quarterly investment growth; business investment had fallen by 2.8%. Net trade had reduced GDP growth by 0.3 percentage points. Exports had fallen by 1.7%, and imports by 0.7%.

A31 The Bank's regional Agents had conducted a special survey on firms' investment plans. Around 190 firms had been included in the survey. Respondents had been asked to compare their level of investment spending over the last twelve months with what they had planned to spend a year ago, and to compare planned investment over the next year with actual investment over the past twelve months. Firms had also been asked what factors would cause them to increase their spending on investment. The results of the survey were weighted by turnover.

A32 On balance, firms had spent less than they had planned over the last year, particularly in the manufacturing sector. In contrast, the majority of construction firms had spent more than they had planned a year ago. This sectoral split had also been reflected in spending plans for the next year: manufacturers planned to cut investment spending while construction and distribution firms were planning to increase spending. On balance, UK-owned firms planned to increase investment while foreign-owned firms planned to reduce it. Similarly, firms with mainly domestic sales on balance planned to increase investment while those with overseas sales planned to reduce it. Firms had reported that increased demand would be the factor most likely to boost their investment spending.

A33 Turning to indicators of activity for the fourth quarter, retail sales volumes had risen by 0.8% in October. Abstracting from monthly volatility, it seemed that retail sales growth had not moderated significantly so far in 2002. The Confederation of British Industry (CBI) Distributive Trades survey suggested continued strength of retail sales in 2002 Q4: the reported sales balance had fallen slightly, to +21 in November from +25 in October. Private car registrations had fallen by 5% in the year to October. The GfK consumer confidence balance had risen to +2 in November. House prices had increased by 2% on the Nationwide index in November, taking the annual growth rate to 25.5%, while on the Halifax index they had risen by 1.4%, taking the annual growth rate to 29.2%.

A34 Disregarding months affected by Jubilee-related volatility, the level of manufacturing output had been broadly flat since the start of the year. The CBI Monthly Trends Enquiry expected output volume balance stood at +2 in November, down from +8 the previous month. The CIPS manufacturing survey had shown a fall in the output index to 50.9 in November from 53.0 in October. The CIPS services activity and incoming new business indices had been little changed on the month in November, and stood at +55 and +54 respectively. The CBI/Grant Thornton Service Sector Survey for November had shown a rise in business volumes in business and professional services, with the survey balance rising to +17, from +1 in August, but only a marginal increase in consumer services business volumes, with the balance rising to +2, from -8 in the previous survey.

IV Labour market

A35 Labour Force Survey (LFS) data had been revised by the Office for National Statistics to reflect the interim population estimates, incorporating information from the 2001 Census. According to the latest figures, employment had fallen by 36,000 in the three months to September, compared with a 132,000 rise in the previous non-overlapping quarter. The fall in employment had been more than accounted for by full-time workers (down 72,000). The working-age employment rate had fallen by 0.2 percentage points, to 74.3%, but was unchanged on a year earlier. Total hours worked and average hours worked had risen by 0.4% and 0.5% respectively in the three months to September, but both were lower than a year earlier.

A36 The overall CIPS employment index had fallen slightly in November and had remained below the no-change level of 50: a fall in the services sub-index had more than offset increases in manufacturing and construction. The Recruitment and Employment Confederation survey for November had suggested that improvements in the availability of agency staff had become less widespread.

A37 LFS unemployment had risen by 45,000 in the three months to September and had been 61,000 higher than a year earlier. The unemployment rate had risen by 0.2 percentage points, to 5.3%, in the three months to September. Claimant count unemployment had, however, fallen by 4,800 in the third quarter, and by a further 4,500 in October. Working-age inactivity had increased by 40,000 in the three months to September, and the rate had risen by 0.1 percentage points to 21.5%.

A38 Headline (three-month average) whole-economy annual average earnings growth had been 3.8% in September, unchanged from the previous month. Headline earnings growth in the private sector had slowed by 0.1 percentage points, to 3.8%. In the public sector, headline earnings growth had increased by 0.2 percentage points, to 3.6%. Actual whole-economy earnings growth had been 3.7% in the year to September, up 0.1 percentage points from the August figure. Whole-economy regular pay growth (not seasonally adjusted) had increased from 3.4% in August to 3.6% in September. For the third consecutive month, bonuses had made no contribution to overall average earnings growth.

A39 The Bank's twelve-month average earnings index (AEI)-weighted, whole-economy mean measure of pay settlements had fallen by 0.1 percentage points in October, to 2.9%.

V Prices

A40 Sterling oil prices had risen by around 6% since the Committee's November meeting, but had been lower on average in November than in October.

A41 Manufacturing input prices had risen by 1.0% in October. This and base effects had increased the annual inflation rate to 2.0% in October, from -1.3% in September. But the CIPS manufacturing survey had continued to point to falling input prices going forward: the input price balance had fallen for the fourth consecutive month, to 46.4 in November from 49.5 in October.

A42 Manufacturing output prices excluding duties (PPIY) had risen by 0.1% in October, while the annual inflation rate had risen to 0.6%, from 0.5% in September. Looking ahead, survey data had continued to point to downward pressure on output prices. The expected output price balance from the CBI Monthly Trends survey had fallen to -14 in November, from -8 in October.

A43 The ONS experimental Corporate Services Price Index (CSPI) had suggested that annual corporate services price inflation had fallen further in Q3. Annual CSPI inflation had fallen for the sixth consecutive quarter, to 2.2% in 2002 Q3 from 2.5% in 2002 Q2.

A44 Annual RPIX inflation had risen by 0.2 percentage points, to 2.3% in October. Within this, annual goods price inflation had risen to -0.7%, from -0.9% in September, and annual services price

inflation had been unchanged, at 4.8% in October. Annual RPI and RPIY inflation had risen by 0.4 percentage points in October, to 2.1% and 2.4% respectively. Annual HICP inflation had risen to 1.4% in October, from 1.0% in September.

VI Reports by the Bank's Agents

A45 The Bank's regional Agents reported that house price inflation had been higher for mid-market and lower-market properties, and had been higher in regions outside London and the South-East. Price increases had been more modest in Northern Ireland and Scotland. At the extremes, properties in London valued at more than £1 million had fallen in price by around 10% from their peak in the summer, whereas prices of low-priced and medium-priced houses in hotspots in the north of England had increased by 40% to 50% year-on-year, with little evidence of any slowdown in recent months. Overall, Agents reported that contacts believed that the rate of price increase was slowing and that the strong Halifax index data in October had reflected prices agreed in August.

A46 There had been little sign of any general slowing in retail sales growth. Expectations for Christmas had been good, although there had been more uncertainty about prospects for 2003. Agents reported that there had been a change in car manufacturers' behaviour, which may have masked a larger fall in car sales than shown by the official SMMT registration statistics. A significant element in new car sales since September had been pre-registrations: cars for which there was no known purchaser, but which the dealer registered before selling subsequently as 'nearly new'. This had increased dealers' stocks of cars and was likely to put downward pressure on car prices when the pre-registered cars were sold.

A47 Manufacturers' margins had remained under pressure, although recent movements in the value of sterling had not led to any significant change in Agents' assessments of margins on domestic and export orders. Raw materials costs had been mostly flat overall, but there were increases in indirect costs, especially insurance. A doubling of premiums for employers' and public liability insurance had not been uncommon, and 2003 renewal notices had shown further substantial increases. Agency contacts had also reported increasing costs of regulation and taxation. Manufacturers had little scope to increase output prices, except on specialist products. Customers had expected continuing price cuts in sectors where there was foreign competition and weak demand. Manufacturers had responded to

lower margins in a number of ways: by sourcing more materials and components from overseas, by moving production overseas, by using internet auctions and by reducing labour and waste.

VII Market intelligence

A48 On 4 December, interest rates implied by short sterling futures contracts had been higher than on 6 November. The rate implied by the June 2003 contract had been 30 basis points higher at 4.21%, and that implied by the June 2004 contract had been 17 basis points higher at 4.88%. Implied rates for contracts maturing in 2002 and 2003 had increased steadily for much of the period, but had risen relatively sharply following the November MPC decision and the publication of the November *Inflation Report*, as well as in response to stronger-than-expected retail sales and RPIX data. Implied interest rates had also risen following some stronger-than-expected US data released on the afternoon of the Chancellor's Pre-Budget Report.

A49 Market participants had generally expected the Committee not to change the Bank's official repo rate at its December meeting. Economists polled by Reuters on 26 and 27 November had attached a mean probability of 86% to no change in the Bank's repo rate at the December meeting, and a mean probability of only 12% to a decrease of 25 basis points. All these economists had forecast that the Bank's repo rate would be unchanged at end-2002. Forecasts for end-2003 were little changed from the previous poll, with a mean expectation for the repo rate of 4.42%.

A50 Between 6 November and 4 December, sterling had risen by 0.7% on an effective basis, appreciating by 0.5% and 0.8% against the euro and the dollar respectively. There had, however, been some intra-month volatility. Market participants had ascribed these movements to several factors, including widening short-term interest rate differentials between sterling and the dollar early in the period and flows associated with cross-border corporate mergers.