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MINUTES OF MONETARY POLICY COMMITTEE MEETING

9 and 10 October 2002

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 October 2002

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0210.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 6 and 7 November will be published on 20 November 2002.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 OCTOBER 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 some other considerations.

The world economy

2 The main development since the Committee's September meeting had, once again, been a substantial fall in most leading equity market indices. The FTSE All-Share index had fallen by some 8%, the S&P 500 index by 13%, and the Dax by some 25% over the period. Implied volatility in equity markets was close to the levels reached in the second half of 1998. The falls in equity prices since 2000 had been initiated by the weakness of the information and communications technology (ICT) sector, but this year equity prices had fallen across a wide range of sectors in all the major markets.

3 There were various possible explanations for the most recent falls. In the euro area, medium-term expectations for earnings per share reported by the Institutional Brokers Estimate System (IBES) had been falling since April, which was consistent with changes in market expectations of growth there. In the United States, however, the falls in equity prices this year could not fully be accounted for by lower expectations of medium-term earnings and changes in real interest rates, which might indicate that there had been a rise in the equity risk premium.

4 The Committee considered whether equity prices were moving closer to a sustainable long-term equilibrium. On some measures this appeared to be the case: for example, based on the ratio of the equity price to the average of earnings over the previous five years, the S&P 500 and FTSE-100 indices were now close to average values over the past seventy years. However, such backward-looking calculations were sensitive to the choice of sample periods and to the number of years' earnings included. Moreover, history suggested that equity prices could undershoot their longer-run

equilibrium level.

5 There were several mechanisms by which the falls in equity prices could adversely affect world demand. First, the reduction in personal wealth could be expected to reduce consumption. Second, the fall in equity prices might imply a higher cost of capital; and this, combined with greater uncertainty about economic prospects, could reduce investment. Third, the effect of lower equity values on the net asset positions of financial intermediaries in some countries could reduce their ability and willingness to provide credit to the private sector.

6 The overall impact of weaker equity prices on the global economy would be mitigated by the associated falls in interest rates. For example, in the United States and the euro area, the expected policy interest rates implied for spring 2003 had fallen over the past month by some 25 basis points. Nominal and real rates had also fallen there in the three-to-five year maturity range, following larger falls in interest rates at all maturities during August. But lower medium-term and longer-term interest rates had not been reflected fully in the cost of capital to business because of a rise in corporate spreads in the major markets.

7 These financial market developments did not appear wholly consistent with the latest economic indicators and with surveys of business and consumer confidence in the major economies. The US economy still seemed to be evolving broadly as envisaged in the August *Inflation Report* projections, although the latest indicators were mixed. It was possible that third quarter GDP would be stronger than projected, although this rate of growth might not be sustained. There were signs that investment might be turning up: non-defence capital goods orders had risen by 5.8% in August, and ICT sector output had picked up during the course of the year. Recent labour market indicators had suggested that the economy had passed its trough: unemployment had fallen to 5.6% in September. Manufacturing output had, however, fallen by 0.1% in August. The manufacturing purchasing managers' index (PMI) had fallen in September, but the non-manufacturing PMI had risen. Consumption had been robust, but this had partly reflected strong car purchases encouraged by generous financing deals. House prices had increased by 6.5% in the year to 2002 Q2 on the Office of Federal Housing Enterprise Oversight measure, which had helped to offset the impact of lower equity prices on consumption. But this rate of increase might not be sustained. Consumer confidence had weakened sharply since the spring. Downside risks to activity remained from the continuing imbalance between domestic and external

demand, as well as from the possible future impact of the recent equity price falls.

8 Economic news from the euro area had been a little weaker than the Committee had expected. Industrial production had fallen by 0.9% in July after rising by 1% in June, and both manufacturing and service sector PMIs had fallen below 50 in September. Industrial confidence had remained unchanged, but consumer confidence had risen very slightly in September. The flash estimate of the harmonised index of consumer prices (HICP) for September had been 2.2%, which was above the range the ECB regarded as consistent with price stability. The deadline by which member countries were to reduce their budget deficits to close to balance under the Stability and Growth Pact had recently been extended to 2006. In Germany, business and housing investment and consumption had all been weak in the third quarter, but retail sales and manufacturing output had risen in August, consumer confidence had picked up in September, and the latest IFO survey had not been as weak as expected. Inflation was lower in Germany than elsewhere, implying that ex post measures of real interest rates were higher there, while equities had fallen by more than in other euro-area countries, perhaps reflecting greater downward revisions to expected earnings. German banks appeared to be tightening their lending conditions, which might have a particularly adverse effect on small- and medium-sized companies.

9 There had been some better news from Japan: Japanese industrial production had risen by 1.6% in August, and the Tankan survey had risen in Q3, although it remained negative. Exports to the rest of Asia were growing robustly, and there had been some signs of political intent to begin resolving the problems in the banking system. In several other countries in Asia, domestic demand was now growing robustly and with perhaps somewhat less dependence on the US economy. The non-Japanese Asian economies accounted for around a fifth of world trade, and so their recovery might make a material contribution to world growth, though their share of UK trade was much smaller.

10 For the world economy as a whole, the latest indicators and the falls in equity prices, if sustained, suggested that prospects for activity might be a little weaker than envisaged at the time of the Bank's August *Inflation Report*, which had already assumed slower growth than the IMF and Consensus forecasts published at around the same time. The downside risks had increased. The weaker outlook for world activity need not, however, necessarily result in lower UK inflation in the short run, because the recent rise in food and oil prices might result in higher world export prices.

Money, credit and asset prices

11 Growth in the UK broad money aggregates had slowed in August: the twelve-month increase in M4 was 5.6% while the corresponding increase in M4 lending was 7.7%. Within the M4 lending total, banks' lending to corporates had picked up, although manufacturers continued to repay bank debt. There had been a reduction in corporates' foreign currency borrowing, which might reflect a reduction in the supply of credit by foreign banks as credit conditions in their home countries tightened. Foreign currency facilities to corporates had fallen by more than their foreign currency borrowing in the first half of 2002. Nevertheless, total external finance in August was higher than the recent average. Household borrowing growth had increased still further, to an annual rate of over 13%. The recent strength of house price inflation had permitted a rapid increase in mortgage equity withdrawal (MEW), to nearly 6% of personal disposable income in 2002 Q2; if the past relationship between MEW and loan approvals were to be maintained, this figure might rise further in the third quarter, which was likely to imply total lending for consumption of over 10% of personal disposable income, close to the peak reached in 1989. Although the repo rate had been unchanged for nearly a year, some interest rates facing the personal sector had fallen recently: the quoted rate on personal loans had fallen by an average of almost one percentage point in the past month, while two-year and five-year fixed rate mortgage rates had fallen materially in the past two months in line with the general fall in wholesale market interest rates.

12 UK equity prices had fallen by less than in most other major markets over the past month. The exchange rate for sterling had risen and now stood some 1½% above the level assumed for the end of the third quarter at the time of the *August Inflation Report*. The fall in both short-term and long-term government bond rates since the *Inflation Report* had been less than in the United States and the euro area, while investment grade sterling corporate bond spreads had risen by less than spreads on dollar and euro bonds over the same period. All these market indicators were consistent with a relative improvement in UK growth prospects. Since June, the Consensus forecast for growth in 2003 had been revised down less for the United Kingdom than for the United States or the euro area, while IBES expectations for growth of earnings per share in the medium term had been little changed in the United Kingdom, despite markdowns in the euro area.

13 In recent years, some traders and market commentators had associated currency appreciation with relatively strong growth performance, and it was possible that the relative resilience of UK

economic indicators was one factor contributing to the strength of sterling over the past two months. Such a relationship could reflect a view that short- and medium-term interest rates would rise more, or fall less, in a faster-growing economy. International political uncertainty or other short-term influences could also have contributed to the recent strength of sterling. However, there was no evidence that recent movements in sterling had been associated with movements in the price of oil. The Committee concluded that it remained difficult to explain short-term movements in sterling.

14 House prices had continued to rise sharply. Both the Halifax and the Nationwide indices showed increases of around 4½% over the past two months. There were some tentative indications that activity in the housing market might be slowing. For example, the House Builders' Federation monthly survey showed that the percentage balance of respondents reporting an increase in net reservations over the same month in the previous year was +9 in August, after allowing for seasonal factors, whereas the corresponding figure for April had been around +40; loan approvals in the three months to August were some 3% higher than a year earlier (after taking account of variations in the number of working days in each month), whereas the corresponding figure in April had been around 20%; and there were also signs of easing in the number of particulars delivered and the number of sales per instruction at estate agents. But the level of housing activity was still high and the signs of cooling were inconclusive. It was not clear how quickly the rate of house price increases would fall back to around the rate of increase in earnings, nor where the level of house prices stood relative to its equilibrium, given that in recent years a variety of economic and demographic influences might have raised the equilibrium relative to its historical average. The main significance for monetary policy of the rapid increase in house prices was that the increase in housing equity permitted home owners to borrow, in the form of mortgage equity withdrawal, more cheaply and readily than they could otherwise have done, so supporting consumption. If house price inflation were to fall more sharply than projected, there would be a risk to the outlook for consumption.

Demand and output

15 New information relating to 2002 Q2 and Q3 had helped the assessment of the underlying trends in the economy, although the effects of the Golden Jubilee holidays continued to make interpretation difficult.

16 On the demand side, consumption had increased by 1.3% in the second quarter, which was slightly faster than envisaged in the August *Inflation Report* forecast. Growth was expected to be much slower in the third quarter. This partly reflected the effects of the timing of Easter and the Jubilee holidays on the pattern of retail sales. There had also been a very sharp decline in car sales; this slowdown might have reflected a smaller stimulus from new registration plates than the previous year. Some other indicators suggested continuing strength: retail sales had risen by 0.6% in August, and stood 5% higher than a year earlier; consumer confidence surveys suggested continuing optimism, and in particular the latest GfK survey had shown households' confidence in their own economic position over the next twelve months to be at a record high. Although the household saving ratio had fallen to 4.5% in the second quarter, the household sector had still been broadly in financial balance in that quarter. The greater-than-expected rise in house prices would tend to offset the influence of the fall in equity prices on consumption, and might lead to a stronger near-term prospect for consumption than envisaged in the August *Inflation Report*. However, average quarterly growth in consumption in the first three quarters of 2002 taken together was likely to be lower than for any comparable period in the previous few years. Moreover, it was possible that the effect of the fall in equity prices on consumption could increase over time, if more households were to find that their savings were inadequate to repay their endowment mortgages or to provide for their pensions. This last concern, however, might not be material within the period relevant to the Committee's policy decision.

17 Business investment was estimated to have been broadly unchanged in 2002 Q2, although a further fall had been expected. But the latest revisions to the National Accounts data showed that business investment had fallen more sharply in 2001 Q4 and 2002 Q1 than previously estimated, so that the level of business investment in Q2 was broadly in line with the August *Inflation Report*. It was possible that the increase in uncertainty following the terrorist attacks on 11 September had had a greater impact than previously believed. However, this did not necessarily imply that any subsequent recovery would now be stronger. Uncertainty concerning both economic prospects and the international situation was still high. The latest report on manufacturing by the Chartered Institute of Purchasing and Supply (CIPS) had shown new orders of investment goods much lower in August than in April and May. The Bank's regional Agents had reported that the level of investment in the service sector was expected to fall in the next twelve months relative to the past year. Corporates' gross operating surplus had fallen in 2002 Q2, while profit warnings in September had risen to their highest level in 2002. And the cost of capital had risen in the second quarter, with the fall in equity prices not fully offset by lower long-term interest rates, while there was evidence that some foreign financial

intermediaries might have reduced the supply of bank credit to UK corporates.

18 Government consumption had fallen by 2.7% in real terms in the second quarter. However, this had probably reflected the effects of the Jubilee, and a sharp recovery was likely in the third quarter. Tax receipts, in particular from corporation tax, were running somewhat lower than had been forecast at the time of the Budget, so, with spending broadly on track, the public sector was helpfully continuing to support domestic demand.

19 Net trade had made a contribution of 0.9 percentage points to GDP growth in 2002 Q2. This partly reflected temporary factors associated with the Jubilee. Nevertheless, underlying import and export volumes had recently been broadly flat, while the terms of trade improvement at the beginning of the year had been maintained in the second quarter. Overall, this represented a surprisingly strong trade performance given the relative weakness of demand in the United Kingdom's main trading partners. The Committee identified three possible explanations for this. First, it was possible that any improvement was erratic, or the product of measurement errors. Second, domestic demand had recently been relatively weak in the most import-intensive sectors, such as investment goods and exports. Third, it was conceivable that there had been an underlying improvement in UK non-price competitiveness.

20 On the output side, manufacturing output and industrial production in August had been weaker than expected. As expected, there had been a very strong increase in vehicle production, but this had been offset by relatively weak outturns in most other manufacturing subsectors. Overall the trend in manufacturing output since February appeared to have been broadly flat. The latest CIPS manufacturing PMI had shown a fall in September, but the figures for output and new orders had increased, suggesting a very gentle recovery. The picture in the service sector continued to be more buoyant. The CIPS services survey had shown an increase in September; the index of service sector output had suggested that growth in services was running at about $\frac{3}{4}\%$ per quarter; and the Bank's Agents had reported that contacts expected a pick-up in both corporate and consumer services. Looking at output as a whole, it was striking that while the United Kingdom had had the weakest growth of industrial production among the major seven economies in the middle of 2002, it had had the strongest GDP growth, although growth in the second and third quarters taken together looked likely to have been slightly weaker than envisaged in the August *Inflation Report* projections.

The labour market

21 LFS employment had risen broadly in line with population growth in the three months to July, though this had been more than accounted for by increased part-time employment and the Workforce Jobs survey had suggested a smaller increase in employment. The latest CIPS surveys showed employment falling in both manufacturing and services and rising in construction. But these surveys did not cover the public sector, which had increased employment in the past year by an average of over 30,000 per quarter. Overall, inflows to unemployment had not picked up significantly and were still broadly matched by outflows. Unemployment showed a rise of 7,000 on the ILO basis in July, but its rate was unchanged at 5.2%, while the claimant count had fallen by 6,400 in August. The September REC survey had suggested that the availability of agency staff had increased, and the Bank's Agents had reported some easing of shortages of staff with particular skills, although anecdote still suggested some difficulties in recruitment, for example of HGV drivers. In summary, the indicators were consistent with a very modest easing in the labour market.

22 The Committee noted the first results of the 2001 Census, which had suggested that the UK population was about one million smaller than previously thought. The ONS had concluded that male emigration, particularly those of prime working age, had been underestimated since the 1981 Census. However, this would be of little significance for the Committee's forecast unless the additional emigration had been concentrated in the most recent years: a persistently lower rate of growth of the population simply implied a small offsetting increase in the estimated rate of growth of productivity over that period.

23 The underlying rate of growth in average earnings had been difficult to assess in recent months because of volatility in the pattern of bonus payments, but this influence was now disappearing. Average earnings in the private sector had increased by 4.2% in the year to July. Public sector earnings had increased by 3.9% in the same period, but would increase faster once the delayed settlement for local authority workers, covering a million employees and offering between 7.7% and 10.9% over two years, took effect. There was little sign of any overall change in pay pressures, and private sector settlements were lower than at the same time last year.

Prices and costs

24 The spot price of oil had risen by more than a dollar per barrel since the Committee's September meeting, but this appeared to reflect temporary factors, since the futures price two years ahead was little changed. However, the Committee noted that the futures price had not in the past been a good predictor of the evolution of the spot price. Food commodity prices had risen by 3% on the month, and by 19% since May, but the impact of this was likely to be offset by falls in the prices of metals and non-food agricultural products.

25 RPIX inflation had been 1.9% in the year to August, slightly weaker than expected. This inflation rate was expected to rise towards, and possibly above, the target rate of 2.5% by the end of the year, reflecting three influences. First, the period in late 2001 in which inflation had been reduced by a fall in petrol prices would soon drop out of the calculation, and this would raise measured inflation in the latest twelve months. Second, oil prices had risen more recently. Third, there had been a strong and rising contribution from the housing depreciation component.

26 Within RPIX, goods prices had fallen by 1.1% in the year to August while service sector prices had risen by 4.6%. Although some difference in inflation between these sectors was to be expected, because of the higher rate of growth of productivity in goods output, the current divergence was exceptional and was greater than could be accounted for by the difference in productivity growth. However, the Committee recognised that the inflation target was set in terms of the aggregate RPIX index, notwithstanding divergent behaviour in any individual subsector.

Other considerations

27 Only one of the economists polled by Reuters expected a reduction in rates at the October MPC meeting, although the mean probability attached to a no-change decision was 74% compared with 85% for the September meeting. Short-term interest rates had fallen slightly on the month, and suggested that market participants believed that a reduction in the repo rate was possible over the next few months but was unlikely this month.

28 The Committee noted that economic data due to be released over the next month, including preliminary GDP data for Q3, could give a clearer picture of underlying trends in demand and activity

taking out the effects of the Jubilee, and that it would be possible to evaluate more fully the impact of the recent news from financial markets in the context of the forecast round.

The immediate policy decision

29 The news over the past month suggested that prospects for the world economy were slightly weaker than envisaged in the August *Inflation Report* projections, largely reflecting developments in the euro area. Moreover, the downside risks to the world economic outlook appeared greater. If sustained, the recent falls in equity prices posed a risk, both to the global and the domestic economy, although there had recently been a contrast, at home and abroad, between the weakness of equity prices and the general resilience of most confidence measures. In the United Kingdom, underlying consumption growth, supported by strong growth in household borrowing facilitated by a rapid increase in house prices, remained reasonably buoyant, although there were tentative signs that housing market activity was slowing. Government expenditure, net of taxes, was also supporting activity, although business spending remained weak. The profile for inflation in the next few months might be slightly higher than expected at the time of the August *Inflation Report* projections, but further out it could possibly be a little lower.

30 As for some time, the Committee agreed that the key issue was whether, in the face of continuing slow growth in external demand, monetary policy should now provide a further stimulus to domestic demand. On the one hand, there was a risk of failing to prevent too rapid a slowdown in domestic demand growth before the world economy picked up, which might imply that inflation would fall below target over the next two years or so. On the other hand, there was a risk that maintaining the momentum of the economy would add to the build-up of household debt and house price inflation, leading at some point to a sharp retrenchment in consumer spending and a fall in the rate of inflation further ahead.

31 The Committee identified a number of possible arguments for reducing the repo rate this month. First, the outlook for the global economy, in particular for the euro area, was a little weaker, and UK domestic demand (though not total demand) had been less strong over the second and third quarters than expected. Second, one reason for not reducing rates in August or September had been that the recent asset price movements (the fall in equity prices and the rise in sterling) might have been temporary. The fall in equity prices had in fact gone further, and the rise in sterling had persisted.

Third, the downside risks to the outlook had increased. Without a pre-emptive repo rate reduction now, domestic demand growth might fall faster than currently envisaged, leaving inflation below target for longer. If the lower profile of market interest rates were to be sustained, the Committee would eventually need to reduce rates in line with market expectations. Finally, the profile of inflation had already been expected to be below the target for most of the next two years at the time of the August *Inflation Report*, and an interest rate reduction had been under consideration for some time, so on this view the recent news would justify a reduction in rates without waiting for a further forecast.

32 The Committee also identified a number of possible arguments for leaving the repo rate unchanged. First, domestic demand was still quite resilient and the economy was growing at close to potential. An interest rate reduction seemed likely at present predominantly to affect house prices, household borrowing and consumption, which were already increasing strongly. A further reduction in the repo rate risked creating an unsustainable increase in debt which might subsequently unwind sharply. This would increase the risk of undershooting the inflation target in the medium term. Second, inflation had been projected in the August *Inflation Report* to be rising at the end of the forecast horizon. Third, it was difficult to quantify precisely the net effect on inflation of the changes to equity and house prices, the exchange rate and other news in the past two months. It was not clear either that the world outlook would be significantly softer than in the August *Inflation Report*. The November *Inflation Report* round would permit a fuller assessment of underlying trends in demand and output. Finally, one member, who in September had been particularly concerned about signs of an abrupt slowing of consumption, felt that the case for a reduction had diminished in the light of the more robust consumption indicators in the past month.

33 The Committee agreed that the decision remained finely balanced. Most members, weighing the arguments, preferred to leave the repo rate unchanged and to review all the recent information in the context of preparing the November *Inflation Report* forecast. Others regarded the news in the past month, together with other news since August, as sufficient to warrant an immediate repo rate reduction given that the decision had in their view been finely balanced for a while.

34 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4.0%. Six members of the Committee (the Governor, Mervyn King, Andrew Large, Charles Bean, Marian Bell and Paul Tucker) voted in favour. Christopher Allsopp, Kate Barker and

Stephen Nickell voted against, preferring a reduction in the repo rate of 25 basis points.

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 4 October 2002, in advance of its meeting on 9-10 October. 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 Manufacturing output in the United States had fallen by 0.1% in August compared with July, the first monthly decline since December 2001. Production of ICT goods had increased by 1.6% in August compared with a month earlier, and was 4.7% below the December 2000 peak. The Institute for Supply Management (ISM) manufacturing index had fallen to 49.5 in September, from 50.5 in August. The non-manufacturing ISM index had risen to 53.9 in September, from 50.9 in August. New orders for non-defence capital goods had increased by 5.8% in August compared with July.

A3 US real consumption had risen by 0.1% in August on a month earlier, following an increase of 0.9% in July. US motor vehicle sales had risen by 1.9% in August on a month earlier, following a rise of 4.0% in July. US real personal income had risen by 0.2% in August on a month earlier.

A4 Non-farm payrolls had fallen by 43,000 in September, following an upwardly revised increase of 107,000 in August. The unemployment rate had fallen to 5.6% in September, from 5.7% in August.

A5 The US headline consumer price index had risen by 0.3% in August on a month earlier.

A6 Euro-area GDP had increased by 0.3% on the quarter in 2002 Q2. Industrial production in the euro area had fallen by 0.9% in July on the previous month, compared with a rise of 1.0% in June. The confidence indicator in the European Commission business survey had been unchanged in September; and that in the consumer survey had risen to -9 in September, from -11 in August. The west German IFO index had fallen to 88.2 in September, from 88.8 in August. German manufacturing orders had risen by 1.7% in August on a month earlier, following a fall of 0.4% in July. Euro-area retail sales had increased by 0.6% in July on a month earlier, after falling by 0.4% in June. French consumer spending on manufactured goods had fallen by 0.1% in August compared with the previous month.

A7 Euro-area producer prices had increased by 0.1% in August on the previous month. This had represented a fall of 0.2% on a year earlier. Annual inflation in the euro-area harmonised index of consumer prices (HICP) had increased to 2.1% in August, from 1.9% in July. Eurostat's flash estimate of annual HICP inflation had increased to 2.2% in September.

A8 Industrial production in Japan had risen by 1.6% in August compared with a month earlier, with the increase concentrated in the electrical machinery sector. Japanese total domestic private machinery orders (excluding orders of ships and electrical power, which can be volatile month to month) had fallen by 13.6% in August on the previous month, following a rise of 1.9% in July. The Bank of Japan's Tankan large manufacturers' diffusion index had risen by 4 points to -14 in 2002 Q3, after a 20 point rise in 2002 Q2.

A9 Annual growth in Japanese export volumes had slowed to 11.9% in August, from 14.7% in July. Growth in the volume of Japanese exports to Asia had remained robust, at 25.9% on a year earlier, while export volumes to the United States had risen by 2.2% and to the European Union by 0.9%.

A10 Since the Committee's previous meeting, the spot price of Brent crude oil had risen from around \$27 per barrel to around \$28. *The Economist* dollar non-oil commodity price index had risen by 1% since the Committee's previous meeting, with food prices having risen by 2.7% to around 19% above the level in May. The major international equity indices had fallen since the Committee's previous meeting: the Wilshire 5000 by 13.3%, the Dow Jones Euro Stoxx index by 15.8% and the Topix index by 4.7%.

II Monetary and financial conditions

A11 In the United Kingdom, the twelve-month growth rate of notes and coin had fallen to 8.2% in September, from 8.6% in August. Despite recent volatility in the series caused by the Jubilee Bank Holidays in June, there now appeared to be some signs that there had been a slowdown in growth since late spring. The twelve-month growth rate of M4 had fallen slightly to 5.6% in August, from 5.7% in July. And the twelve-month growth rate of M4 lending (excluding the effects of securitisations) had continued to fall, to 7.7% in August, from 8.0% in July. But excluding other financial corporations

(OFCs), the annual growth rate of M4 deposits and M4 lending had remained broadly stable in August.

A12 The twelve-month growth rate of households' M4 had decreased to 8.4% in August, from 8.7% in July. The twelve-month growth rate of M4 lending to households (excluding the effects of securitisations) had risen to 13.2% in August, compared with 12.9% in July. Within total net lending to individuals, the annual growth rate of secured lending had continued to rise, to 12.0% in August, compared with 11.8% in July, and the annual growth rate of unsecured lending had also increased, to 15.5% in August, from 15.1% in July. Within unsecured lending, annual growth in credit card lending had increased further in August.

A13 The number of loan approvals for house purchase had fallen sharply to 108,000 in August, compared with 118,000 in July. The fall had been somewhat smaller if adjusted for the number of working days in the month.

A14 Mortgage equity withdrawal (MEW) had been £10.6bn in 2002 Q2.

A15 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 5.5% in August, from 5.2% in July. The twelve-month growth rate of M4 lending to PNFCs (excluding the effects of securitisations) had increased to 4.0% in August, from 3.2% in July. PNFCs had raised £4.6bn in total external finance in August, compared with an average monthly flow of £3.5bn in the first half of 2002.

A16 Corporate income gearing had been little changed in 2002 Q2. But capital gearing at market value had risen substantially in the quarter.

A17 The twelve-month growth rate of OFCs' M4 deposits had been unchanged at -1.8% in August. The twelve-month growth rate of M4 lending to OFCs (excluding the effects of securitisations) had fallen to -2.2% in August, from +0.5% in July.

A18 Short-term nominal forward rates had fallen at all maturities below six years since the Committee's previous meeting. The gilt forward rate had fallen by around 15 basis points two years ahead. The skew (at the three-month horizon) on short sterling interest rates had remained at a level similar to that in August, and lower than in the first half of the year. Long-term nominal forward

interest rates had risen, by around 15 basis points at 20 years. The real forward rate derived from index-linked gilts had risen at all maturities, but only marginally at the long end.

A19 Inflation expectations derived from gilt yields had fallen for maturities below nine years, and had risen by around 10 basis points at 15 years since the Committee's previous meeting. Inflation expectations in HM Treasury's survey for 2002 Q4 and Consensus Economics' year-average forecast for 2002 had both remained unchanged at 2.1% in September. Inflation expectations for 2003 from both surveys had remained slightly below the inflation target.

A20 Since the Committee's previous meeting, quoted unsecured personal loan rates had fallen. The two-year fixed mortgage rate had fallen by 25 basis points, following falls in swap rates. The spread of two-year fixed mortgage rates over two-year swap rates, lagged a month, had increased by 14 basis points in September.

A21 Sterling investment-grade bond yields had remained broadly unchanged since the Committee's previous meeting. Sterling corporate bond issuance had increased in September, although issuance had been very weak in August.

A22 Since the Committee's previous meeting, UK equity indices had fallen. The FTSE All-Share and FTSE 100 indices had fallen by 8.0% and 7.1% respectively. The FTSE 250 index had fallen by 12.8% over the same period. All sectors had shared in the general decline, although the information technology and general industrials sectors had been particularly weak. The number of profit warnings issued in September had risen on the month, reaching the highest monthly total since November 2001.

A23 The sterling effective exchange rate index (ERI) had risen by 0.4% to 106.3 between 4 September and 9 October. The appreciation of sterling had been broadly consistent with movements in short- and medium-term interest rates in the United Kingdom relative to other major economies. The expected ERI profile from the latest Consensus Economics survey had shown little change in exchange rate expectations on the month.

III Demand and output

A24 In the second quarter National Accounts release, published on 27 September, quarterly GDP growth at constant market prices in 2002 Q2 had been unrevised from the previous release, at 0.6%. However, annual growth had been revised up, to 1.3% from 1.2%. The latest releases had included revisions to GDP and its components from 2001 onwards. The net impact of these revisions had been to raise the level of GDP at market prices in 2002 Q2 by 0.1%.

A25 On the output measure, GDP growth at basic prices, at 0.6% in 2002 Q2, had not been revised from the previous release. Within the total, service sector and manufacturing output growth had both been unrevised, at +0.6% and -0.7% respectively.

A26 On the expenditure measure, quarterly final domestic demand growth in 2002 Q2 had been revised down to 0.3%, from 0.5% in the previous release. Household consumption growth (including non-profit institutions serving households) had been revised up to 1.3% in 2002 Q2, from 1.2% in the previous release. Consumption growth in Q2 (as well as in Q1 and Q3) had been affected by special factors, such as the timing of Easter this year and the Jubilee Bank Holidays. Whole-economy investment growth (including valuables) had been unrevised from the previous release, at -0.6% in 2002 Q2. But within this there had been a downward revision to growth in business investment, to -0.2% from +0.3%. Government consumption had been revised down, to -2.7% from -0.9%.

A27 The contribution from inventories to quarterly GDP growth in 2002 Q2 had been revised down to -0.6 percentage points, from -0.3 percentage points in the previous release. Within this, underlying stocks had reduced GDP growth by 0.4 percentage points, while the alignment adjustment had reduced it by a further 0.1 percentage points. Domestic demand growth had fallen by 0.3% in 2002 Q2, compared with an increase of 0.2% in the previous release.

A28 Export growth had been revised up to 3.5% in 2002 Q2 (from 3.0% in the previous release), while import growth had been revised down to 0.6% (from 1.5%). As a result, the net trade contribution to GDP growth had been revised up, to 0.9 percentage points, from the previous estimate of 0.4 percentage points.

A29 Households' real post-tax income had been unchanged in 2002 Q2, compared with growth of 0.5% in Q1. This had mainly reflected a sharp fall in dividends received by households. Households' real post-tax labour income, which excluded dividends and other non-labour income, had risen by 1.0%. The saving ratio had fallen to 4.5% in 2002 Q2, from 5.8% in Q1. Following five successive quarters of surplus, households' net financial balance had moved into deficit (equivalent to 0.8% of GDP) in 2002 Q2.

A30 The gross operating surplus of private corporations (excluding the alignment adjustment) fell by 1.3% in 2002 Q2, following a rise of 3.0% in Q1. Financial corporations' gross operating surplus had fallen by 41.5%, which had more than offset a 2.5% rise in the gross operating surplus of private non-financial corporations (excluding the alignment adjustment). Private corporations (excluding the alignment adjustment) had been close to financial balance in 2002 Q2. Together with the move into deficit of households' net financial balance, this had resulted in a slight increase in the private sector net financial deficit. In contrast, the general government net financial deficit had fallen slightly in Q2.

A31 The current account deficit had been little changed, at £4.0bn in 2002 Q2, following a deficit of £3.8bn in Q1.

A32 Turning to 2002 Q3 data, retail sales volumes had risen by 0.6% in August, following a rise of 0.5% in July. New private car registrations had been 11.4% lower in September than a year earlier, according to data from the Society of Motor Manufacturers and Traders (SMMT). House prices had continued to increase strongly: in September, the Nationwide and Halifax measures had increased by 2.1% and 4.3% respectively. The GfK consumer confidence aggregate indicator had remained around the high levels seen for most of the year.

A33 Manufacturing output had been unchanged in August. Within this, output of transport equipment had risen by 8.1%, while that of the electrical and optical sector had fallen by 3.6%.

A34 Goods export volumes had fallen by 3.7% in the three months to August, compared with the previous three months. Goods import volumes had also fallen, by 2.4%, over this period.

A35 The Bank's Agents had conducted a survey of around 230 firms in the service sector, covering business and consumer service firms with both public and private sector clients. Companies covered

by the survey had a total turnover of £99bn and nearly 687,000 employees. Responses had been weighted by turnover or employment, as appropriate. Respondents had been asked how they expected the next twelve months to compare with the previous twelve, in terms of growth in turnover and levels of employment and investment.

A36 The majority of companies surveyed had expected faster growth in turnover over the next twelve months than over the previous twelve months, albeit in many cases from a subdued rate. Only the wholesale and retail sector had expected a slower rate of growth in turnover than in the previous twelve months. On balance, respondents had expected to reduce both employment and investment over the next twelve months. Professional services companies had been the least pessimistic, and had expected to increase investment slightly. A net balance of around 30% of respondents serving the public sector had expected investment to be higher than in the previous twelve months, and a somewhat larger net balance of these respondents expected an increase in employment.

A37 There had been a contrast between expectations of faster growth in turnover over the next twelve months and lower expected levels of employment and investment. Various factors might have contributed to explaining this contrast. Current turnover had been low, giving rise to expectations of a pick-up. But there had been pressure on margins, which might bear on investment. There was thought to have been some labour hoarding recently, while there had been a longer-term trend towards outsourcing work.

IV The labour market

A38 According to the Labour Force Survey (LFS), employment had risen by 38,000 in the three months to July 2002, compared with 88,000 in the previous non-overlapping quarter. The working-age employment rate was 74.6%, unchanged on the previous non-overlapping quarter and on a year earlier. Average hours had fallen by 0.6% in the three months to July; total hours had fallen by 0.4%. Workforce Jobs had risen by 20,000 in 2002 Q2. Manufacturing jobs had fallen by 18,000, whereas jobs in distribution, hotels and restaurants had risen by 41,000 and in public administration, education and health by 33,000.

A39 The overall CIPS employment index for September had fallen slightly, and had remained below the no-change level of 50; the manufacturing and services sub-indices had fallen, though the

construction index had risen and remained above the no-change level. The September Deloitte & Touche/REC survey had reported rising availability of temporary and permanent staff.

A40 LFS unemployment had risen by 7,000 in the three months to July, and had been 52,000 higher than a year earlier. The LFS unemployment rate had remained unchanged at 5.2%. Claimant count unemployment had risen by 2,900 in the three months to July, but had fallen by 6,400 in August, with the rate remaining at 3.1%. Inactivity amongst people aged 16 and older had increased by 23,000 in the three months to July. The working-age inactivity rate had remained constant at 21.2%.

A41 The first results from the 2001 Census had been published. The UK population had been 58.8 million on 29 April 2001. This had been approximately 1.2 million lower than the Government Actuary's Department projection for mid-2001. The discrepancy had been attributed by the ONS to underestimation of emigration, particularly of working-age men, for a number of years. The implication had been that the annual rate of population growth had been 0.1 percentage points per year less than previously reported. The Census results would be reflected in revisions to population and Labour Force Survey data back to the early 1980s.

A42 Headline (three-month average) whole-economy average earnings growth had been 4.0% in the year to July, up 0.1 percentage points on the previous month. Headline earnings growth in the private sector had remained steady at 4.0%; in the public sector, headline earnings growth had risen by 0.1 percentage points to 3.7%. Actual whole-economy earnings growth had been 4.1% in the year to July, up 0.3 percentage points from the June figure; the corresponding figure for the private sector had been 4.2%, up 0.4 percentage points. Bonuses had made no contribution to average earnings growth in July, after 16 consecutive months of negative contributions.

A43 The Bank's three- and twelve-month measures of whole-economy pay settlements, weighted to match the average earnings index, had been unchanged at 2.9% and 3.1% respectively in August, though the number of recent settlements had been seasonally low.

A44 Output per job for the whole economy had risen by 0.9% in 2002 Q2 compared with the same quarter a year earlier, up 0.6 percentage points from the Q1 figure. Output per hour had risen by 1.7%. Unit wage costs for the whole economy had increased by 2.9% in 2002 Q2 compared with the same quarter a year earlier, down 0.3 percentage points from the Q1 figure.

V Prices

A45 Sterling oil prices had increased by around 5% since the September MPC meeting, and on average had been over 10% higher in September than had been projected at the time of the August *Inflation Report*.

A46 Manufacturing input prices had risen by 0.4% in August, mainly reflecting increases in the price of crude oil. Annual input price inflation had risen to -2.3% in August, from -3.5% in July. The CIPS manufacturing survey input price balance had fallen to 50.6 in September, from 53.9 in August.

A47 Manufacturing output prices excluding duties (PPIY) had been unchanged in August, and the annual inflation rate had remained at 0.4%. Survey data had continued to point to subdued output price inflation going forward. The expected output price balance in the CBI monthly trends survey had fallen slightly to -13 in September, from -10 in August.

A48 The annual inflation rate of the GDP deflator at market prices had fallen to 2.6% in 2002 Q2, from 3.2% in 2002 Q1. Within this, the annual inflation rate of the consumption deflator had fallen a little, to 0.7% in Q2 from 0.9% in Q1. The annual inflation rate of the government expenditure deflator had fallen sharply, to 4.0% in Q2 compared with 5.2% in Q1. The annual inflation rates of the import and export deflators had been -3.1% and +0.2% respectively in Q2.

A49 Annual RPIX inflation had fallen by 0.1 percentage points, to 1.9%, in August. Within this, annual goods price inflation had fallen to -1.1%, from -0.9% in July, and annual services price inflation had risen to 4.6% in August, from 4.5% in July. Annual RPI, RPIY and HICP inflation had also fallen by 0.1 percentage points, to 1.4%, 1.8% and 1.0% respectively, in August.

VI Reports by the Bank's Agents

A50 The Bank's regional Agents had reported that the picture received from contacts had on balance been slightly more gloomy and uncertain than before the summer holiday period. Business confidence had weakened as a result of falling equity prices, the threat of war with Iraq, and the perceived delay in

the expected world economic recovery. A high level of uncertainty about prospects had been reflected in weaker investment intentions.

A51 Manufacturing output had seen continuation of a weak and patchy recovery, with consumer and construction goods output relatively stronger than output of capital goods. Growth in business services turnover had slowed further over the past two months: private sector spending had been weak across a range of services, and this had not been fully offset by increased public sector demand. Construction output had remained relatively strong, although not quite as buoyant as a few months earlier. This could in part have been due to delays in starting large public sector projects. The outlook for commercial construction had been less buoyant, as high levels of vacant office space had caused speculative development to dry up.

A52 Underlying growth in consumer spending had appeared to have eased. Consumers had been reported as becoming more cautious, especially those older consumers who were likely to have been affected by falling equity prices. New car sales to consumers in September had been below the level for September 2001 in most regions. Sales of clothing and white goods had also weakened. But demand for consumer services had been more robust, and the housing market had remained strong in most regions.

VII Market intelligence

A53 On 9 October, interest rates implied by short sterling futures contracts had been lower than on 4 September. The rate implied by the December 2002 contract was 4 basis points lower at 3.8%, and that implied by the December 2003 contract had been 11 basis points lower at 4.35%. Implied rates had increased early in the period, but had subsequently fallen, in part reflecting falls in equity prices and some weaker-than-expected data, such as the Chicago PMI survey and UK industrial production. Implied rates had also fallen following the release of the September MPC minutes. Implied rates had continued to be closely correlated with equity prices over the period.

A54 Market participants had generally expected the Committee not to change the Bank's official repo rate at its October meeting. Economists polled by Reuters between 1 and 3 October had attached a mean probability of 74% to no change in the Bank's repo rate at the October meeting, a mean probability of 23% to a decrease of 25 basis points and most of the remainder to a decrease of 50 basis

points. The proportion expecting the Bank's repo rate to be unchanged at end-2002 had fallen to 65%, from 74%, and the proportion expecting that the rate at end-2002 would be below 4% had increased to 35%, from 16%.

A55 Since the Committee's previous meeting, sterling's effective exchange rate had risen by 0.4%. Sterling had appreciated by 0.3% against the euro and by 4.4% against the yen, and had depreciated by 0.4% against the dollar. Consensus Economics growth forecasts for the United Kingdom had recently been revised down by less than those for the euro area and the United States, which market participants had suggested had been supportive for sterling. Market contacts had reported that low volatility and a lack of willingness to take directional positions had encouraged 'carry-trades', benefiting high-yielding currencies such as the Norwegian krone, the Australian and New Zealand dollars and, to some extent, sterling.