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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 September 2002

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

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0209.pdf>).

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



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 SEPTEMBER 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 main global economic news at the Committee's previous meeting had been the substantial falls in equity prices around the world, despite some recovery in the week before the meeting. During August, equity markets had stabilised above the low points reached in July. In the days before the Committee's current meeting, however, there had been further sharp falls, which had taken prices lower on the month, but markets remained volatile and little significance could be attached to short-term movements. The falls in the United States on 3 September had been associated with the release of weak business survey data. And whereas the earlier falls had been broadly uniform across countries in local currency terms, the latest falls had been differentiated: the main US and UK indices had fallen back to levels which were at or only a little below those used as the starting point for the projections in the August *Inflation Report*, while the Topix was 10% and the Eurostoxx 5% lower than when those projections were made. US and UK price/earnings ratios remained high by long-term historical standards, and market expectations (as reflected in options prices) were still skewed to the downside.

3 In reviewing the possible explanations for these events, it was noted that the latest falls were unlikely to reflect renewed concerns about accounting standards or corporate governance. The 14 August deadline set by the Securities and Exchange Commission for CEOs and CFOs of large public companies to attest personally to the veracity of their company's accounts had passed successfully; and there had been no significant accounting or governance news since that date. That pointed to conventional concerns about longer-run profitability as a more likely cause. Nervousness about the possibility of military action in Iraq might also be a factor. But that possibility had been a

concern for some weeks and the economic implications of such action were unclear. If concerns about profitability were the explanation, it was puzzling that the largest falls in prices had been in Japanese and euro-area equity markets.

4 Turning to the news on world activity, recent data from the United States were broadly consistent with the Committee's August projections (which, perhaps because they had already incorporated the July news on equity prices, had been below those of many outside commentators). Growth in the rest of this year had always been expected to be weaker than growth in the first quarter, which had been driven by the turnaround in the inventory cycle. Business surveys and confidence were softer in July, though non-defence new orders were up and broad money growth was no longer falling rapidly. Despite the higher level of unemployment, consumption too was holding up, supported by strong auto sales. The zero interest finance deals now available might suggest that auto consumption was simply being brought forward. If so, the 0.2% monthly growth of retail sales excluding autos might be a better measure of the underlying strength of consumer demand. But the sharp increase in mortgage refinancing, at current lower long-term rates of interest, could help sustain consumption growth. It was also mildly encouraging that the latest survey of senior loan officers suggested that credit conditions were tightening less rapidly than in recent months.

5 Outside commentators were beginning to revise down their forecasts for US growth, bringing them more into line with the Committee's own projection. There was nonetheless a question about what the fall in long bond yields implied for the outlook. Dollar bond yields were now around 50 basis points lower than had been incorporated in the *Inflation Report* projection, and implied a lower path for US short-term interest rates. This fall in yields would provide some stimulus to demand and so might, in the absence of other shocks, be consistent with a rather stronger prospect for growth than the Committee had judged likely in August, particularly as long rates seemed to play an important role in the US monetary policy transmission mechanism.

6 Economic news from the euro area continued to be weaker than expected. Consumption growth remained subdued and was weaker than could easily be explained by its determinants. It could be that households in the euro area tended to have less recourse to borrowing to smooth consumption than was usual in the United States or the United Kingdom. It was possible also that consumer resistance to recent price increases for some items, which some associated with the introduction of euro notes and coin, was a factor. Business surveys and confidence had weakened, consistent with the recent

weakness of investment growth, and sustained domestically generated growth remained elusive. Policy could however respond, and some easing in monetary stance was already implied by the lower level of euro market interest rates.

7 Japanese economic developments were very difficult to interpret, as a new approach to the measurement of activity had resulted in a sharper-than-expected downward revision to what had previously been estimated as strong growth in the first quarter. Despite the preliminary estimate of 0.5% growth in the second quarter, it was still unclear whether sustained recovery there was under way. More encouragingly, however, the rest of Asia seemed to be growing quite strongly. There were grounds for thinking that this growth, particularly in China, Korea and India, was to a significant extent domestically generated. So the recovery in this region might be less dependent on the strength of the US economy than might have been thought.

8 A number of Latin American countries continued to face severe economic problems, though the news on the month had if anything been positive, with support for the IMF package agreed for Brazil and lower spreads on Brazilian bonds, and some signs of stabilisation in Argentina.

Money, credit and asset prices

9 The other key financial development over the month was the downward shift in yield curves around the world. The movement at short maturities was not surprising: the perceived monetary policy consequence of recent events had been that official rates would, for a while, be lower than they would otherwise have been. More puzzling was the movement in long-term forward rates, which had fallen by about 45 basis points in the United Kingdom (and on a similar scale in other major economies), reversing increases earlier in the year. This fall seemed largely to represent lower real rates. It was possible that it reflected market doubts about the speed of recovery, or that the volatility in equity markets had increased the attractiveness of government bonds. But it was not obviously related to any particular economic news. While long forward rates had tended in the past to move by more than could be explained simply by movements in short rates, the scale of the movement in long real rates had recently been unusually large. In the short term, at least, a change in attitudes towards risk might account for such movements.

10 In aggregate, the UK monetary data showed some signs of slowing: broad money growth, at 5.7% in the year to July, continued the gradual slowing evident since late last year and the annualised three-month growth rate of notes and coin had fallen to 6.6% in August (though this was affected by the Jubilee holidays). The annual growth in total bank credit, which had been 11% a year ago, had slowed further, from 8.2% to 7.9%, over the past month. But it was the corporate sector, including financial companies, which accounted for this easing. Household borrowing, by contrast, was 12.8% higher than a year ago and mortgage equity withdrawal was estimated to have been £10.5 billion, equivalent to 5.7% of personal disposable income, in the second quarter. That was close to the rate seen in the late 1980s. Recent data suggested that it could again be high in the third quarter.

11 Sterling's effective exchange rate had fallen by about 1% since the Committee's previous meeting. That brought it back close to the rate in the *August Inflation Report* projections.

Demand and output

12 Consumption was estimated by ONS to have increased by 1.2% in the second quarter. While the monetary and some of the housing market indicators suggested that it still had considerable momentum, retail sales growth had eased, to 0.3% in July, and the latest CBI Distributive Trades survey indicated further slowing in sales growth in August. It was possible too that further notifications to households of shortfalls in endowment policy returns might dampen consumption looking forward. Some slowing in consumption growth was anticipated for later in the year, in the projections made in the *August Inflation Report*.

13 In reviewing the contrasting evidence on current and prospective consumption growth, it was noted that real personal disposable incomes might well have grown less rapidly in the second quarter and that households might have responded by increasing their borrowing. Equally, retail sales represented only part of consumption. Apart from vehicle sales, no information was yet available for the third quarter on its other components. In addition, the CBI survey measure had not been a consistently good predictor of retail sales; and business surveys tended to be less reliable in the main holiday period than at other times. Forward-looking information from the housing market did not suggest any unexpectedly abrupt slowing: indeed, the preview of the Royal Institution of Chartered Surveyors' survey showed a pick-up in expectations of house price increases, reversing its recent trend. Again, however, seasonal factors were significant at this time of year. The survey did,

nevertheless, still imply the prospect of slower house price inflation than had been seen in the past few months.

14 The data on output were also difficult to interpret, because of the effects of the Jubilee-related switch of a Bank Holiday from May to June and the additional Bank Holiday in June itself. Manufacturing output had fallen by 5.3% in June, and so had fallen for six consecutive quarters – the longest decline in the post-war period. This had converted an expected 0.7% growth of production in the second quarter into a fall of the same amount; and the ONS estimate of GDP growth had been revised down to 0.6%, from the 0.9% estimate in the preliminary release. Staff estimates of the likely July outturn for manufacturing output, based on the assumption that May and June together had been little affected by the Jubilee, had suggested that it would increase by about 4½% in July. The data, which became available to the Committee during its meeting, showed growth of 4.9%. So the stronger-than-expected May and weak June outturns did indeed seem to be consistent with Jubilee-related holiday effects. The official data for the past few months, taken as a whole, together with surveys of activity, investment intentions and orders, still pointed to a gentle recovery in underlying manufacturing output.

The labour market

15 The Labour Force Survey data for the second quarter showed the largest quarterly increase in numbers employed, but also the largest fall in average hours worked, for over two years. The employment increase had, however, been predominantly in part-time workers; and average hours were affected by the Jubilee holidays. Taken together, and allowing for the temporary Jubilee effects, it seemed that labour demand might be a little weaker than expected. The Chartered Institute of Purchasing and Supply surveys of employment (which did not include the public sector) were weaker in August, as was the Recruitment and Employment Confederation survey of placements by agencies. Public sector spending, however, was in line with plans which embodied increases in public sector employment, on which no second quarter data were yet available.

16 Earnings developments also seemed benign, with annual earnings growth apparently stable at around 4% and its level no longer affected by temporarily weak bonuses. Pay settlements too were little changed. The indications of somewhat weaker-than-expected private sector labour demand reduced the risk that next year's pre-announced increases in National Insurance contributions would be

reflected in higher pay settlements, though the Bank's regional Agents reported that firms were at least as concerned about the growing cost of pension provision.

17 Public sector pay, as measured by the ONS data, was increasing less strongly than might have been expected on the basis of the pay review body awards and the government's declared intention to increase public sector employment. The delay in this year's Local Authorities' pay settlement might, however, be distorting the data.

Prices and costs

18 RPIX inflation had picked up sharply in July from the 1.5% June outturn, and at 2.0% was stronger than expected – mainly because of a larger-than-expected contribution from goods prices. June and July together, however, were in line with earlier expectations. The near-term outlook was now for inflation to move back to target by the end of this year, with a growing contribution from housing depreciation and with price falls last year dropping out of the annual comparison, but to ease thereafter. So while the immediate prospect was for inflation to be a little higher than had been reflected in the Committee's August *Inflation Report* projection, it was not clear that the latest data had any implications for inflation further out.

19 Oil prices had strengthened in recent months. While input prices were lower on the annual comparison, they were now falling less rapidly and should soon stabilise. Together, these factors suggested rising pressures at the start of the pricing chain and that output price inflation might therefore start to increase in the coming months. However, the August CBI Distributive Trades survey suggested that retailers' price expectations had fallen quite sharply since May.

Other considerations

20 None of the economists polled by Reuters expected a change in the repo rate this month. There was some expectation now, reflected in the pattern of market rates, that the next change would be a reduction in rates at some point over the next few months, though not at this month's meeting.

The immediate policy decision

21 The world economy was on balance a little weaker than it had appeared to be a month ago. That weakness was, in the case of the United States, evident less in the macroeconomic data than in the fresh turbulence in equity markets. But equity prices there had so far not fallen below the levels embodied in the Committee's August projections, and the fall in market interest rates would tend to counteract the economic effects of these equity price falls. In the euro area, the weakness of domestic demand was more pronounced than previously expected. The prospects for Japan remained subdued. Other Asian economies, however, seemed stronger.

22 In the United Kingdom, the key issue was how much weight should be put on the tentative signs that consumption growth and house price inflation might be starting to slow. The Committee shared the view that the recent pace of house price inflation could not safely be sustained for long; and had for some time wanted to see a gradual slowing in consumption growth, to accommodate expected stronger government and external demand. Such slowing would however be unwelcome if it were to be too abrupt or too early, particularly if the recovery in world activity were to be less strong.

23 The Committee explored the case for reducing the repo rate this month. The world outlook remained fragile. Though the prospects for world activity did not seem to be substantially different from those embodied in the Committee's latest projections, outside commentators were now lowering their own expectations and – despite the falls in market interest rates – the risks were on the downside. In addition, it seemed possible that consumption growth in the United Kingdom was already starting to slow and the pace of house price inflation to ease. Against the background of a possibly weaker world outlook, pre-emptive action to delay the slowing in consumption growth might now be warranted.

24 The Committee nevertheless agreed that it was premature to conclude that further stimulus was necessary. Developments over the past month were not inconsistent with the forecasts in the *August Inflation Report*. Once due allowance had been made for the effects of the Jubilee holidays on the pattern of output in May, June and July, there was little evidence that the UK recovery was faltering. The evidence of consumption growth slowing prematurely was not clear-cut. To reduce interest rates at this stage could give undue encouragement to households to accumulate yet more debt, and renew the upward pressure on house prices.

25 Finally, the Committee noted that a decision to maintain the repo rate at 4% did not represent a lack of response to the slower-than-expected recovery in world activity and the marked falls in equity prices. For much of this year, the prospect had been that inflation would be moving sharply above target at the two-year horizon. As a result, it had been widely expected that official interest rates would by now need to be on an upward path. That the repo rate had still not been increased in itself represented a policy response to the changed prospect for inflation. This was reflected in lower market interest rates, maintaining monetary conditions which continued to support the growth of domestic demand. The Committee remained ready to take further action, by reducing rates, if and when any additional stimulus to demand were judged to be necessary to meet the inflation target.

26 The Governor invited members to vote on the proposition that the repo rate should be maintained at 4.0%. The Committee voted unanimously in favour of the proposition.

27 The following members of the Committee were present:

Eddie George, Governor
Mervyn King, Deputy Governor responsible for monetary policy
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 30 August 2002, in advance of its meeting on 4-5 September. 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 Consensus Economics forecasts of US GDP growth for 2002 and 2003 had been revised down to 2.3% and 3.1% respectively in August, from 2.8% and 3.6% in July. Forecasts of euro-area GDP growth for 2002 and 2003 had been revised down to 1.1% and 2.5 % respectively in August, from 1.3% and 2.7% in July. Forecasts of Japanese GDP growth for 2002 and 2003 had remained unchanged, at -0.4% and 1.1% respectively.

A3 According to the preliminary estimate, US GDP had increased by 0.3% on the quarter in 2002 Q2 (the same as in the advance estimate), to a level 2.1% higher than a year earlier. Investment had fallen by 0.3% on the quarter, compared with the advance estimate of a 0.1% increase. The net trade contribution to quarterly GDP growth had been revised to -0.3 percentage points from -0.4 percentage points. Pre-tax corporate profits (including an adjustment for inventory valuation and capital consumption) had fallen by 1.7% in 2002 Q2, following a fall of the same amount in 2002 Q1.

A4 Manufacturing output in the United States had risen by 0.1% in July compared with June, and had been unchanged on a year earlier. This had included a 4.2% rise in auto production on the month. Production of ICT goods had increased by 0.1% in July on a month earlier, and by 11.0% on a year earlier. The Institute for Supply Management (ISM) manufacturing index had remained unchanged in August, at 50.5. The non-manufacturing ISM index had fallen to 53.1 in July, from 57.2 in June. New orders for non-defence capital goods had increased by 13.5% in July on a month earlier, more than reversing the fall of 9.6% in June. The Conference Board measure of consumer confidence had fallen to 93.5 in August, from an upwardly-revised 97.4 in July. The University of Michigan headline index of consumer confidence had fallen to 87.6 in August, from 88.1 in the previous month. US real consumption had risen by 0.8% in July on a month earlier, following an increase of 0.4% in June.

A5 Annual headline consumer price inflation in the United States had increased to 1.5% in July from 1.1% in June. But core annual consumer price inflation (that is, excluding food and energy prices) had fallen to 2.2% in July, from 2.3% in June. US producer prices had fallen by 1.1% in July on the previous year, compared with a fall of 2.0% in the year to June. Core US producer prices had fallen by 0.2% in the year to July, after rising by 0.3% in the year to June.

A6 German GDP had grown by 0.3% on the quarter in 2002 Q2, following an increase of 0.3% in Q1. Private consumption had grown by 0.2%, the first quarterly increase since 2001 Q2. Total investment had fallen by 2.5% on the quarter. Inventory adjustment had contributed 0.8 percentage points to growth in the second quarter, due to a smaller decline in the level of stocks than in the previous quarter, while net trade had contributed a fall of 0.1 percentage points. French GDP had increased by 0.5% on the quarter in 2002 Q2, following an increase of 0.5% in the first quarter. Private consumption had increased by 0.5% on the quarter and investment had grown by 0.1%. The change in inventories had reduced growth in the second quarter by 0.3 percentage points. Net trade had contributed an increase of 0.3 percentage points. Italian GDP had grown by 0.2% on the quarter in 2002 Q2, following an increase of 0.1% in Q1.

A7 Industrial production in the euro area had increased by 0.5% in June compared with a month earlier, and had been 1.2% lower than a year earlier. The business confidence indicator for the euro area in the European Commission survey had remained unchanged in July compared with the previous month, but the consumer confidence indicator had fallen slightly. The euro-area purchasing managers index (PMI) for manufacturing had fallen to 50.8 in August, from 51.6 in July. The euro-area PMI for services had fallen to 50.8 in August, from 52.3 in July. Euro-area retail sales volumes had fallen by 0.5% in June compared with the previous month, and by 0.9% on a year earlier. German manufacturing orders had fallen by 3.3% in June on the previous month, reversing the increase of 3.3% in May. In June, German domestic orders had increased by 0.6%, but foreign orders had fallen by 7.4% compared with the previous month.

A8 According to Eurostat's flash estimate, annual inflation in the euro-area harmonised index of consumer prices (HICP) had increased to 2.1% in August, from 1.9% in July. Producer prices in the euro area had fallen by 1.1% in the year to June.

A9 According to the preliminary estimate, Japanese GDP had increased by 0.5% in 2002 Q2, to a level 0.8% lower than a year earlier. The estimate of GDP growth in 2002 Q1 had been revised down

to zero, from the previous estimate of 1.4%. Private consumption in Japan had increased by 0.3% in 2002 Q2, while total private investment had fallen by 0.6%. Inventories had made no contribution to GDP growth in 2002 Q2, while net trade had contributed 0.3 percentage points.

A10 Industrial production in Japan had fallen by 0.4% in July on a month earlier, to a level 0.6% higher than a year earlier. Japanese export volumes had increased by 14.6% on a year earlier in July, up from 10.4% in June. Within that total, Japanese exports to the rest of Asia had increased by 27.9% on a year earlier in July; and exports to China alone had risen by 45.5% over the same period. Japanese import volumes had grown by 7.9% in July on a year earlier - the largest increase since January 2001. Nominal retail sales in Japan had fallen by 2.2% in July on a month earlier, to a level 5.3% lower than a year earlier. The headline seasonally adjusted unemployment rate had remained unchanged at 5.6% in July. The Japanese consumer price index had fallen by 0.8% in July on a year earlier.

A11 Since the Committee's previous meeting, the spot price of Brent crude oil had increased by \$1 per barrel to around \$27, and *The Economist* dollar non-oil commodity price index had increased by 2.4%. The major international equity indices had generally fallen over the same period. In local currency terms, the Wilshire 5000 had fallen by 1.8%, the FTSE All-Share by 4.6%, the Dow Jones EuroStoxx by 5.2% and the Topix by 8.1%. Sovereign spreads in many emerging market economies, including Brazil, had on average narrowed during the month.

II Monetary and financial conditions

A12 The twelve-month growth rate of notes and coin had been 8.6% in August, the same as in July. The three-month annualised growth rate had fallen to 6.6% in August, from 9.0% in July, although it had continued to be distorted by the effects of the Jubilee Bank Holiday. The twelve-month growth rate of M4 had fallen to 5.7% in July, from 6.1% in June. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 7.9% in July, from 8.2% in June.

A13 The twelve-month growth rate of households' M4 had increased to 8.6% in July, compared with 8.3% in June. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen to 12.8% in July, compared with 12.6% in June. Within total lending to individuals, the annual growth rate of secured lending had risen to 11.8% in July, compared with 11.4% in June, and the annual growth rate of unsecured lending had been unchanged from June at

15.0%. The number of loan approvals for house purchase had increased to 120,000 in July, compared with 107,000 in June. When adjusted for the unusual pattern of working days in June and July, the number of approvals had fallen in July, although it had remained higher than earlier in the year.

A14 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 4.7% in July, from 3.9% in June. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had fallen further, to 2.8%, in July, from 3.2% in June. PNFCs had raised £4.7bn in total external finance in July, compared with an average monthly flow of £3.3bn in the first half of 2002. The strong flow of total external finance in July had largely reflected market issuance rather than bank borrowing.

A15 Other financial corporations' (OFCs') M4 deposits had fallen by 1.3% on a year earlier in July, after increasing 1.6% on a year earlier in June. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had fallen to 0.3% in July, from 2.2% in June.

A16 Short-term nominal rates had fallen at all but the very shortest maturities. The gilt forward rate had fallen by around 40 basis points three years ahead. The skew (at the three-month horizon) on short sterling interest rates had fallen since the Committee's previous meeting, and had become slightly negative, and remained lower than in the spring. Long-term nominal forward interest rates had also fallen, by 47 basis points at 20 years. Movements in real yields had been qualitatively similar to those in the nominal curve, and had fallen by nearly 15 basis points at 20 years.

A17 Inflation expectations derived from gilts yields had generally fallen slightly since the Committee's previous meeting, by over 30 basis points at 20 years. Inflation expectations in HM Treasury's survey for 2002 Q4 and Consensus Economics' year-average forecast for 2002 had both fallen to 2.1% in August. Inflation expectations for 2003 from both surveys had remained steady, slightly below the 2½% target for RPIX and in line with the projections in the August 2002 *Inflation Report*.

A18 Credit card interest rates had remained unchanged since the Committee's previous meeting. The quoted standard variable mortgage rate had also remained unchanged in August compared with July. The two-year discounted rate had fallen slightly on the month. The two-year fixed mortgage rate had fallen by 49 basis points since the Committee's previous meeting, the largest one-month change since

January 1999. The spread of fixed mortgage rates over swap rates, lagged a month, had also fallen in August.

A19 Sterling investment-grade bond yields had fallen by about 40 to 50 basis points, depending on credit rating, since the previous meeting, largely reflecting the falls in risk-free rates. Corporate bond issuance had been very weak in August.

A20 Since the Committee's previous meeting, UK equity indices had fallen, and they had been very volatile during the period. The FTSE All-Share and FTSE 100 indices had fallen by 4.6% and 5.3% respectively since the Committee's previous meeting. The FTSE 250 index had fallen by 1.0% over the same period. Most sectors had shared in the general decline, although the information technology and financial sectors had been particularly weak. The volatility of FTSE 100 returns had increased in August, but had remained below the high levels experienced in July. The number of profit warnings issued in August had fallen on the month, and had been less than in August 2001.

A21 The sterling exchange rate index (ERI) had fallen by 0.9%, to 105.9, between 31 July and 4 September. This had reflected a 1.2% depreciation of sterling against the euro, and a 0.2% appreciation of sterling against the dollar. The depreciation of sterling had not been consistent with relative movements in short-term interest rates. The expected ERI profile implied by the latest Consensus Economics survey had shown little change in exchange rate expectations on the month.

III Demand and output

A22 Estimated quarterly real GDP growth at market prices in 2002 Q2 had been revised down to 0.6%, from 0.9% in the preliminary release. Annual growth had also been revised down, to 1.2%, from 1.5%. GDP at basic prices had grown by 0.6% in 2002 Q2 and had increased by 0.8% on an annual basis.

A23 Service sector output had grown by 0.6% in 2002 Q2, unrevised from the preliminary estimate. Within the service sector, output of the distribution, hotels and catering sector had risen by 1.2% and output of the business services and finance sector by 1.0%. But output of the transport and communications sector had fallen by 0.3%. Manufacturing output had fallen by 0.7% on the quarter.

A24 The Committee had received the industrial production data for July 2002 during its meeting. Manufacturing output had grown by 4.9% on the month in July, following a downwardly revised fall of 5.5% in June.

A25 On the expenditure side of the accounts, final domestic demand had risen by 0.5% in the second quarter. Domestic demand had increased by 0.2%, with changes in inventories having reduced GDP growth by 0.3 percentage points.

A26 Private sector consumption (including that of non-profit institutions serving households) had increased by 1.2%, and real government consumption had fallen by 0.9%, in the second quarter. Whole-economy investment (including the net acquisition of valuables) had fallen by 0.6%. Business investment had risen by 0.3% on the quarter, within which private sector manufacturing investment had fallen and private services investment had increased slightly. Net trade had contributed 0.4 percentage points to quarterly GDP growth. Total exports of goods and services had risen by 3.0%, and total imports had increased by 1.5%.

A27 Turning to indicators of activity for the third quarter, retail sales volumes had grown by 0.3% in July. In the year to July, sales had increased by 4.5%, which had been the lowest annual growth rate since January 2001. The Confederation of British Industry (CBI) Distributive Trades survey in August had suggested that annual growth in retail sales volumes would continue to ease. The reported sales balance had fallen to +5 in August, from +16 in July. The GfK index of consumer confidence had been unchanged at +2 in August. Annual growth in private car registrations had remained robust in July.

A28 The Nationwide house price index had risen by 2.5% in August, taking its annual rate of increase to 22.7%. The Halifax house price index had increased by 0.2% in August, taking its annual rate of increase to 18.8%. Particulars delivered were 132,000 in July, unchanged from June.

A29 The output and orders indices in the Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey both picked up in August, having weakened for the previous three months. The output balance rose to 55.0 in August, from 50.2 in July, and the orders balance rose to 51.0, from 49.5. The CBI Monthly Trends manufacturing survey had also shown an improvement in the expected output balance, which had risen to +16 in August from +9 in July.

A30 The CIPS service sector survey had suggested an improvement in service sector activity in August: the activity index had risen to 55.1, from 54.7 in July. The CBI/Grant Thornton service sector survey had pointed towards continuing weak activity in business and professional services in 2002 Q3, but to an improvement in consumer services.

IV Labour market

A31 According to the Labour Force Survey (LFS), employment had risen by 132,000 (0.5%) in the three months to June 2002, compared with the previous three months. This increase had been predominantly in part-time employment, which had risen by 110,000 (1.6%) over the same period. The working-age employment rate had increased by 0.2 percentage points, to 74.8%. However, average hours worked had decreased by 1.1% in the three months to June, and total hours worked had fallen by 0.6% over the same period. The fall in average hours worked would in part have reflected the Jubilee Bank Holidays in June.

A32 The Recruitment and Employment Confederation survey for August had suggested that the demand for temporary agency staff had been increasing less rapidly, while the demand for permanent staff had started to ease again. The survey had also indicated that increased availability of agency workers had continued to become more widespread.

A33 LFS unemployment had increased by 6,000 in the three months to June, and the LFS working-age unemployment rate had been unchanged at 5.2%. Claimant count unemployment had fallen by 3,000 in July and the claimant count rate had fallen, from 3.2% to 3.1%. Working-age inactivity had fallen by 72,000 (0.9%) in the three months to June, and the working-age inactivity rate had fallen by 0.2 percentage points, to 21.1%. The decline in inactivity had been predominantly accounted for by lower female inactivity.

A34 Headline (three-month average) whole-economy average earnings growth had been 3.9% in the year to June, up 0.1 percentage points on the previous month. Headline earnings growth had increased by 0.2 percentage points in the private sector, to 4.0%, but had fallen 0.2 percentage points in the public sector, to 3.6%. Actual average earnings growth in June had been 3.8% (seasonally adjusted), down 0.2 percentage points on May.

A35 Regular pay growth had been 4.1% (not seasonally adjusted) in the year to June, up 0.2 percentage points on May. The pick-up in whole-economy regular pay growth in June reflected an increase in regular pay growth in both the public sector and private sector services. Bonuses had reduced whole-economy earnings growth by 0.4 percentage points in the year to June, reflecting a change in the timing of bonus payments in a small number of financial sector firms.

A36 The Bank's twelve-month average earnings index (AEI)-weighted, whole-economy mean measure of pay settlements had been 3.1% in July, unchanged from the June figure. However, the three-month AEI-weighted mean settlement had fallen 0.4 percentage points to 2.5%. The decline in the three-month measure had reflected the weakness in settlements in private services, down 0.6 percentage points to 2.0%.

V Prices

A37 In August, sterling oil prices had been on average around 4% higher than in July. Manufacturing input prices had risen by 0.6% in July, mainly reflecting increases in the prices of crude oil and imported chemicals. Annual input price inflation had risen in July to -3.6%, from -6.8% in June, mainly due to base effects. The CIPS manufacturing input price balance had fallen to 56.5 in August, from 56.9 in July. This had suggested that input prices would rise going forward, although at a slightly slower rate.

A38 Manufacturing output prices excluding duties (PPIY) had increased by 0.1% in July, while the annual inflation rate had increased by 0.3 percentage points, to 0.4%. Survey data had continued to point to subdued output price inflation going forward. The CBI monthly trends survey expected output price balance had remained unchanged at -10 in August.

A39 The ONS' experimental corporate services price index (CSPI) had suggested that corporate service sector inflation had eased in 2002 Q2. The CSPI annual inflation rate had fallen to 2.5% in 2002 Q2, from 2.8% in the previous quarter. But the CIPS services survey had suggested a small pick-up more recently: the average prices charged balance had risen to 52.0 in August, from 51.9 in July, compared with an average of 51.6 in 2002 Q2.

A40 The annual inflation rate of the GDP market prices deflator had fallen to 2.5% in 2002 Q2, from 3.4% in 2002 Q1. Within this, the annual inflation rate of the consumption deflator had fallen to 0.4%

in 2002 Q2, from 1.0% in 2002 Q1. The annual inflation rate of the imports deflator had risen slightly, to -3.4% in 2002 Q2, from -3.6% in 2002 Q1.

A41 Annual RPIX inflation had increased by 0.5 percentage points, to 2.0%, in July. Within this, annual goods price inflation had risen sharply to -0.9% in July, from a low point of -1.6% in June. Annual services price inflation had remained unchanged on the month, at 4.5%. Annual RPI and RPIY inflation had also both risen by 0.5 percentage points in July, to 1.5% and 1.9% respectively. Annual HICP inflation had risen to 1.1% in July, up from 0.6% in the previous month.

VI Reports by the Bank's Agents

A42 The Bank's regional Agents had reported that demand and output growth had slowed slightly in July and August relative to June. Agents had asked their manufacturing contacts about closure arrangements at the time of the Jubilee. Most had observed the two Bank Holidays and a sizeable minority had closed for the whole Jubilee week. However, some of these would normally have closed for Whitsun week and others had required workers to use holiday entitlements. The main effects of the Jubilee, therefore, had been a switching of production from June to May or August, and some lost production due to the extra Bank Holiday. Abstracting from these effects, Agents had concluded that manufacturing output had continued to recover gradually in July and August, but that the flow of new orders from both domestic and overseas customers had slowed.

A43 Agents' contacts had reported three main effects of recent weak equity prices. First, lower equity prices had helped to dampen activity in some areas of financial services, and this had led the companies affected to consider further cuts in employment. Second, continuing lower equity prices, combined with other factors such as the loss of dividend tax credits, had led many firms to expect that substantial increases in the level of pension contributions would be required. Finally, lower equity prices had eroded business confidence and lowered planned investment. However, most contacts had not found difficulty in raising equity finance to be a barrier to investment: factors such as uncertainty about future demand and increased competition from producers in lower-wage countries had appeared to be more important.

A44 Agents' retail contacts had become cautious about purchases of stock, following slower growth in sales and, in some cases, extended summer clearance periods due to weak demand. Growth in sales of new cars had eased for volume-market models, but had remained buoyant for prestige models.

Prospects for car sales in September, when the new registration plate would be introduced, had been seen as similarly mixed. In the housing market, there had been reports from areas of rapid price inflation that high prices were choking off demand for expensive properties. Buy-to-let demand had also eased in London and other major cities as rents softened. But across much of the country, housing demand had yet to show any appreciable weakening.

VII Market intelligence

A45 On 4 September, interest rates implied by short sterling futures contracts were lower than they had been on 31 July. Rates implied by the contract for December 2002 were 22 basis points lower and those implied by the contract for December 2003 were 54 basis points lower. Given the continued correlations between UK, US and euro-area short-term interest rates, it appeared that global factors had again been the major influence on UK short-term interest rate expectations, but the correlation with equity prices had been slightly weaker than before. Short-term interest rate expectations had fallen in the early part of the period when major equity markets had been weakening, but had risen after the Federal Open Market Committee meeting on 13 August and the passing of the Securities and Exchange Commission deadline on 14 August. More recently, short-term interest rate expectations had fallen again, partly due to the further fall in equity prices.

A46 Market participants had generally expected the Committee not to change the Bank's official repo rate at its September meeting. 31 economists polled by Reuters between 27 and 29 August had attached a mean probability of 85% to no change in the Bank's repo rate at the September meeting, a probability of 4% to an increase of 25 basis points and a probability of 10% to a decrease of 25 basis points. All 31 economists had thought that rates were most likely to remain unchanged. The proportion expecting the Bank's repo rate to be unchanged at end-2002 had increased from around 28% to 74%.

A47 Since the Committee's previous meeting, the sterling ERI had fallen by 0.9%, to 105.9, with most of the fall taking place between 2 and 12 August. This had largely reversed the increase in the sterling ERI during the second half of July. By 4 September, compared with 31 July, sterling was 0.2% higher against the dollar, 1.2% lower against the euro and 1.3% lower against the yen. The depreciation of sterling in early August coincided with some weaker economic data, such as industrial production and manufacturing output for June, but this was not reflected in changes in interest rate differentials at the time.