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MINUTES OF MONETARY POLICY COMMITTEE MEETING

8 and 9 October 2003

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 October 2003.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0310.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 5 and 6 November will be published on 19 November 2003.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 OCTOBER 2003

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

The world economy

2 Recent data tended to confirm the recent strong performance of the US economy and to suggest signs of a recovery in Japan. But growth in the euro area remained weak.

3 In the United States, growth was likely to remain robust in the second half of the year. The key question was whether this strength would be sustained into 2004. Real consumption had increased by 0.7% on the month in July and 0.5% in August, but it was not clear that rapid consumption growth would continue, and there were signs of weaker spending in September. Consumer confidence remained subdued, with both the Conference Board and University of Michigan measures falling slightly. Concerns about employment prospects may have been weighing on households: more people were reporting that jobs were hard to find, and non-farm payrolls were still more than a million below their level in November 2001. But consumers had benefited further in August from tax rebates, and some might still have scope to refinance their mortgages at lower interest rates, given the recent fall in market rates.

4 US industrial production had risen by 0.1% on the month in August, according to the latest available data release, while new orders for capital goods had fallen slightly. It was not yet clear whether the pick-up in investment would be sustained or whether it simply reflected the arrival of a postponed replacement cycle. Information, communications and technology production had risen by 2.3% on the month; it was possible that companies that had postponed IT investment were now beginning to replace old software and equipment. The Institute of Supply Management indices

together suggested that overall output growth might slow a little between Q3 and Q4: both the manufacturing and non-manufacturing indices had fallen slightly in September, although the latter remained close to its all-time high. The combination of fairly robust output growth with little increase in employment implied rapid productivity growth; annual US non-farm business sector labour productivity growth had been over 4% in 2003 Q2. Ultimately that would stimulate aggregate demand by raising expected real income growth, increasing the incentive to invest and improving the price competitiveness of US goods and services.

5 More generally, US aggregate demand would continue to be stimulated by the expansionary fiscal stance, reflecting the increase in defence spending and the administration's Jobs and Growth package. Monetary policy, too, was supportive and, judging by recent falls in the US yield curve, financial market participants were persuaded that the FOMC would remain very accommodative for some time. The 5% fall in the dollar's effective exchange rate over the past month should also help to sustain demand.

6 In the euro area, there continued to be a contrast between weak data outturns and more promising business survey indicators, in particular the forward-looking components. GDP had fallen by 0.1% in the second quarter, according to the latest data – below the earlier flash estimate. Investment and net trade had made the main contributions to the decrease. On the basis of available indicators, it looked likely that GDP would turn out to have been broadly flat in the year to Q3. Germany, Italy and the Netherlands had each had two consecutive quarters of economic contraction, and data for France had surprised on the downside. But recent business surveys were more encouraging. Euro-area industrial confidence had increased in both August and September, and the German IFO index had risen for the fifth consecutive month. The euro-area manufacturing Purchasing Managers' Index (PMI) had risen above 50 for the first time since February and the services PMI had reached its highest level since April 2002. However, the improvements were largely due to stronger expectations of future, not current, conditions, and such surveys had proved misleading last year. There were no obvious signs of a consumer-led recovery: German retail sales (excluding car-related sales) and French consumer spending on manufactured goods both fell in August, and euro-area consumer confidence was flat in September. Nevertheless, taking a longer perspective, euro-area final domestic demand growth had picked up somewhat, even though it was still below trend. But this had been counteracted by the increasingly negative contribution of net trade; how that evolved would depend on how the impact of the appreciation of the euro weighed against the growth of the euro area's external markets.

According to the September German manufacturing PMI survey, firms were more optimistic about exports. However, it was possible that this sentiment pre-dated the most recent rise in the effective exchange rate of the euro.

7 In Japan, the expenditure-based estimate of GDP growth in Q2 had been revised up, to 1% (quarter on quarter). The output-based all-activity index, however, suggested a much lower rate of around 0.1%. The real GDP estimates needed to be treated with caution: they were particularly prone to revision and the recent figures relied on an estimated decline of the GDP deflator that seemed surprisingly large given other price developments. However, there were some signs of possible economic recovery. The revision to business investment in Q2 was due to an upward revision in nominal spending, not a downward revision in the deflator. Real household spending had increased, and unemployment had fallen, in August, while the September Tankan survey reported improvements in corporate sentiment, particularly amongst large manufacturers (although it most probably took place before the recent appreciation of the yen).

8 The emerging markets of Asia continued to report rapid growth.

Financial markets, money and credit

9 Short-term interest rates around the world had fallen a little since the previous MPC meeting, although a partial reversal had been triggered by the most recent US non-farm payrolls data. The falls seemed to reflect the impact of a few weaker-than-expected international data releases on views about the strength of the global recovery. It was also likely that financial market participants had changed their view of the FOMC's policy stance. Sterling interest rates had fallen rather less than in the United States and the euro area. This could be because financial market participants had interpreted recent UK economic data (new and revised) as implying relatively robust growth; they might have taken that and the most recent MPC minutes to imply that UK short-term rates would rise relative to those of other countries. That view of relative prospects was also reflected in equity markets: in common currency terms, the FTSE All-Share index had performed relatively strongly.

10 The 9% appreciation of the euro relative to the dollar was difficult to explain in terms of news about relative euro-area and US growth prospects. Some of the appreciation could be accounted for by differential interest rate movements. Another factor may have been renewed concerns about the

sustainability of the US current account, possibly reinforced by market interpretations of the recent G7 communiqué. The sterling effective exchange rate had remained fairly stable, falling a little just before the Committee's meeting.

11 In the United Kingdom, the twelve-month rate of increase of unsecured lending to individuals fell back a little in August, but secured lending continued to expand rapidly. There were signs of a pick-up in housing market activity; approvals for house purchase (adjusted for working days in the month) had increased to a ten-year high in August, and the House Builders Federation series for net reservations of new houses also rose sharply. House-price inflation seemed to have stopped falling; monthly price increases had been averaging just over 1% recently, and house prices in the third quarter were likely to have been somewhat above the level expected at the time of the *August Inflation Report*.

12 What might explain the renewed buoyancy of the housing market? First, the equilibrium ratio of house prices to earnings might be higher than had previously been thought, so that house prices were less far above equilibrium – and therefore under less pressure to ease. But prices were now well above the Committee's previous best estimate of equilibrium, which had itself already been revised upwards last year. Second, the lenders' indices for house prices might have been exaggerating the underlying rate of increase, as they did not adjust fully for improvements in housing quality; and the RICS survey balances earlier this year had, for example, pointed to lower house price increases than had the lenders' indices. But this seemed an unconvincing explanation. Third, the recent rise in house prices might have been driven in part by speculative behaviour and/or over-optimistic views about the sustainable level of house prices.

Demand and output

13 New National Accounts data had become available in the past month. These incorporated some new information on nominal spending, including corrections for the effects of 'missing trader intra-community' fraud on recorded trade; methodological changes; and the usual annual Blue Book revisions. The data revealed a somewhat different pattern of growth over recent years than had previously been estimated, including an upward revision to growth in the first half of this year. This could have implications for the Committee's assessment of both aggregate demand and potential supply in the economy.

14 Growth was now estimated to have been stronger in 1999 and 2000 than previously reported, mainly because of revisions to the split of nominal quantities between price and volume, rather than to the nominal data themselves; estimated growth since 2001 was less affected. This meant that the level of GDP had been higher than previously thought for some time, and in 2003 Q2 had been around one percentage point higher. However, that did not necessarily imply that aggregate demand was higher relative to potential supply; or, even if that were the case, that inflationary pressure was higher than previously thought. First, revisions to the estimated composition of aggregate demand suggested that business investment had been considerably higher in the recent past, so the capital stock and potential supply would now be somewhat higher than previously thought. Second, data for costs and for retail prices were unchanged. If the balance of aggregate supply and demand had implied less downward pressure on inflation than previously believed, some other factor must have offset this. For example, product market competition might have squeezed margins more than had been appreciated; or domestic producers' margins might have been more compressed by the past strength of sterling.

15 Furthermore, looking forward, since the current level of business investment now appeared to be higher than previously thought, the capital stock and potential supply would be growing more rapidly than believed hitherto. However, the data revisions also increased the uncertainty about the prospects for investment. On the one hand, as the capital stock was likely to be higher than estimated before, there would be less need for investment to achieve a given desired capital stock. On the other hand, given that the relative price deflator for capital goods had fallen more sharply than previously thought, firms might want a bigger capital stock than previously realised.

16 As well as affecting estimates of aggregate demand and potential supply, the data revisions – which included for the first time an allowance for unreported imports related to VAT fraud – changed the picture of the pattern of growth in the past. Real consumption had not increased quite as rapidly as had previously been believed, and the negative contribution to growth from net trade had been less, so the divergence between domestic and external demand now looked less pronounced. Also, the improvement in the terms of trade since 1996 now appeared a little less marked, and hence more likely to be sustainable. However, the recent current account deficit appeared to have been larger than previously thought.

17 The upward revision in the estimate of GDP growth in 2003 Q2, to 0.6%, and the downward revision to consumption growth, made it easier to reconcile the output and expenditure data for the

second quarter. Last month, there had been the puzzle that apparently weak second-quarter output growth could only be reconciled with the estimated strong domestic demand growth by a large negative net trade contribution; but that had seemed unlikely, given the trade data (after allowing for the impact of VAT fraud). The revision to overall output growth in the second quarter was largely due to a substantial upward revision in the estimate of construction output, particularly in the public sector. Construction output in the first quarter had been surprisingly weak. This series tended to be volatile, though, so the new second-quarter figure might be erratically strong. Estimated service sector growth had been revised down from 0.3% to 0.2%. That looked weak given business survey data, so there might be subsequent upward revisions, but it was also possible that there was less momentum in this sector than had been thought.

18 The 0.9% fall in industrial production in August was greater than expected, but was nonetheless consistent with output growth in Q2 and Q3 being close to trend. The CIPS surveys of manufacturing, services and construction all pointed to a steady increase in the pace of activity through the third quarter; the CIPS activity index for services in September reached its highest level since April 2000. The CBI surveys of financial services and distributive trades were also encouraging.

19 On the demand side, the consumption profile now looked more plausible, with quarterly growth averaging 0.6% across the last quarter of 2002 and the first half of this year. However, at the time of the August *Inflation Report*, the Committee had expected consumption to slow significantly in the second half of this year, and it was not clear that that was happening. Retail sales had picked up in August, with volumes rising 0.2%. Unemployment remained low and there were signs of continued strength in the housing market; both of these factors would tend to sustain consumption growth.

20 The corporate sector, too, appeared to be performing more strongly than had been thought: according to the latest data, firms had been investing and building up stocks more than previously realised, and rates of return in manufacturing and services had been a little higher. The number of profit warnings had fallen and UK equity prices had been relatively resilient. New orders for investment goods were increasing significantly.

21 The estimate of real government consumption corresponded to an unusually rapid increase in the government spending deflator, which might have been exaggerated by the lack of adjustment for quality improvements in public services. It might in part also reflect the short-term sunk costs of IT

projects and organisational change that would generate efficiency gains in the future. If real government spending had been increasing faster than measured, for given inputs, that would not increase inflationary pressure, as faster productivity growth in the public sector would not have affected private sector costs and the output gap significantly.

The labour market, costs and prices

22 Now that estimates of output in the first half of the year had been revised upwards, recent labour market data were more comprehensible: measured labour productivity growth was no longer surprisingly low, and there had probably been less labour hoarding than previously thought. The working-age employment rate rose a little in the three months to July and the unemployment rate, on the Labour Force Survey measure, was unchanged. The claimant unemployment rate had been constant since January 2001.

23 There was some evidence that the demand for labour in the private sector was picking up. For the first time in four years, the CIPS employment surveys for manufacturing, services and construction all reported increased employment in September. Both the CBI and the Bank's regional Agents reported some worsening of skill shortages, and an informal survey by the Agents suggested that private sector firms expected stronger employment growth over the rest of the year.

24 So far, this apparent increase in labour demand did not appear to have affected the growth of earnings. Whole-economy average earnings growth was still within the 3-3½% range prevailing so far this year, and private sector pay settlements continued to average around 3%. The increase in labour demand, together with the sharp rise in the rate of increase of the Tax and Price Index over the past year, was likely to put upward pressure on pay at some stage. The National Minimum Wage increased on 1 October from £4.20 an hour to £4.50; a further increase, to £4.85 an hour, was planned for 1 October 2004. The most recent upward step exceeded the growth of average earnings, so a larger proportion of the workforce was likely to be affected; that might entail a bigger impact than before on the aggregate wage bill and prices, but the overall effect was nonetheless expected to be small.

25 The annual rate of RPIX inflation had been 2.9% in August, the same as in July, and broadly as expected. The differential between the annual inflation rates for goods and services had narrowed, and was now the smallest it had been since September 2001. In line with established pre-release

arrangements, an advance estimate of the RPI had been provided to the Governor 3½ working days ahead of publication. This suggested that annual RPIX inflation had been 2.8% in September. The short-run outlook seemed a little stronger than a month ago.

Other considerations

26 Outside observers regarded a rise in the repo rate as slightly more likely this month than last, but an increase would nevertheless be a surprise. According to the Reuters poll, taken between 30 September and 2 October, respondents attached a mean probability of 20% to a 25 basis point rise and 78% to 'no change'. The mean of external forecasts of the policy rate at the end of 2003 was 3.54% and at the end of 2004 was 4.05%, both up a little on the month. Since the poll, there had been more discussion in the press about the possibility of a rate rise. One factor affecting market expectations was speculation about the timing of the Chancellor's proposed switch to an inflation target based on the Harmonised Index of Consumer Prices and about the level at which the new target might be set.

27 The Committee considered the implications of the fact that, were the repo rate raised at this meeting, it would be the first increase for well over three years. An increase might be regarded as signalling the start of a succession of increases in the repo rate, and might therefore have a larger-than-usual effect on market rates. Although financial market participants now generally expected the next move in rates to be upwards, they would probably be surprised if the increase were agreed at this meeting; for that reason as well, there might be a sharper-than-normal market reaction.

The immediate policy decision

28 The Committee agreed that the decision this month was between whether to raise the repo rate or to hold it at its current level. As far as the international environment was concerned, the outlook was stronger for the United States and possibly for Japan than for the euro area. The US recovery was broadly on track, but there was still uncertainty about whether consumption would remain resilient in the face of a weak labour market and whether the pick-up in business investment would be sustained. Significant sectoral imbalances remained, which might at some stage trigger changes in spending and further depress the dollar. But US fiscal and monetary policies remained expansionary and were likely to do so for some time; expectations to that effect were reflected in the US yield curve. Some

members placed more emphasis than others on the recent increase in non-farm payrolls and the possible benefits of rapid productivity growth for demand in the near term; on one view, the downside risks to US demand identified at the time of the August *Inflation Report* had receded somewhat. The level of economic activity in the euro area continued to disappoint. It was unclear whether recovery had been delayed a little or whether a more extended period of subdued growth was now in prospect. Some members were inclined to put more weight than others on the signs of strengthening in euro-area business surveys. Recent data from Japan pointed to a pick-up in growth there, but doubts remained about their reliability. Growth in the rest of the world had been robust; whether it would remain so were US growth to falter was uncertain. In one member's view, the geopolitical risks to world growth had if anything increased somewhat, as reflected, for example, in the higher-than-expected dollar price of oil. Overall, most members concluded that the prospects for UK external demand in the near term were a little weaker, both on the month and relative to the August *Inflation Report* projections.

29 In the United Kingdom, data revisions had raised the estimate of the recent path of aggregate demand. But the impact of these revisions on inflation prospects would depend on the extent to which potential output too had been higher than previously thought. Some members thought that the net effect of the revisions would be to raise the Committee's projection of inflation, although by how much was uncertain; others were less confident, and thought that further analysis in the context of the preparation of the November *Inflation Report* would be necessary before conclusions could be safely drawn.

30 The Committee agreed that house prices, housing market activity and mortgage borrowing all suggested that consumption growth would not moderate as quickly as previously expected. It seemed likely that the ratio of house prices to earnings would peak at a higher level than projected in August. The continuing rapid build-up of household indebtedness risked, in the view of some members, a larger and more abrupt increase in planned saving at some stage in the future, which would make it more difficult to meet the inflation target at that time. The outlook for investment was also uncertain. Some members argued that the corporate sector was stronger than previously believed, and noted the relative strength of UK equity prices; on one view, firms had less reason to defer investment because of financial weakness or uncertainty about UK recovery. Overall, the prospects for UK domestic demand appeared stronger, both on the month and relative to the August *Inflation Report*. Committee members also agreed that labour market activity had strengthened, which, together with factors such as the increase in National Insurance contributions, would tend to put upward pressure on private sector

pay. However, unemployment had been low for some time without earnings growth having picked up. There was a range of views about whether it might do so in the near future by more or less than projected in August.

31 It was noted that interest rates were below plausible estimates of the neutral rate, so the monetary policy stance was expansionary, and would remain so even if the repo rate were raised by 25 basis points.

32 In the light of these considerations, some members concluded that, at the current level of interest rates, inflation was now clearly likely to be above target in two years' time, primarily because of higher domestic demand, and that an increase in the repo rate was appropriate this month. It was in their view not necessary to wait for a revised forecast. Some other members took the view that the reduction in rates in July had been warranted on precautionary grounds, because the balance of risks to inflation had then been on the downside. Since then, some of the major downside risks – for example, those associated with the pace of the US recovery – had diminished, and some upside risks – for example, to consumption from the housing market – had increased. Hence it was now appropriate to withdraw the precautionary stimulus.

33 However, a majority of members were to varying degrees less confident that inflation would exceed the target in the medium term, or that the balance of risks had changed substantially. A premature rise in the repo rate might choke off the improvement in business conditions. Data revisions had had little impact on nominal GDP, and it was the ratio of nominal GDP to real aggregate supply that was most relevant for assessing inflationary pressure. Further consideration of the complex questions raised by the revised UK data during the coming forecast round would help to clarify some important issues relating to the evolution of potential supply and the relationship between activity and inflation.

34 The Governor invited members of the Committee to vote on the proposition that the repo rate should be maintained at 3.50%. Five members (the Governor, Rachel Lomax, Charles Bean, Marian Bell and Richard Lambert) voted in favour. Four members (Andrew Large, Kate Barker, Stephen Nickell and Paul Tucker) voted against, preferring an increase in the repo rate of 25 basis points.

35 The following members of the Committee were present:

Mervyn King, Governor

Rachel Lomax, Deputy Governor responsible for monetary policy

Andrew Large, Deputy Governor responsible for financial stability

Kate Barker

Charles Bean

Marian Bell

Richard Lambert

Stephen Nickell

Paul Tucker

Jon Cunliffe 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 3 October 2003, in advance of its meeting on 8-9 October. At the start of the Committee meeting itself, members were made aware of the information that had subsequently become available, and that information is included in this Annex.

I The international environment

A2 The final estimate of US GDP growth in 2003 Q2, at 0.8% on the quarter, was unchanged from the preliminary estimate. Annualised GDP growth had been revised up to 3.3% in 2003 Q2, from the preliminary estimate of 3.1%. Government spending growth had been revised up to 2.1% on the quarter, from 2.0%. Export growth had been revised up to -0.2% on the quarter, from -0.3%, and import growth had also been revised up, to 2.1% on the quarter, from 1.9%, while the net trade contribution had been unchanged at -0.3 percentage points.

A3 Manufacturing output in the United States had fallen by 0.1% in August, following an increase of 0.6% in July. Total capacity utilisation was 74.6% in August, unchanged from July. Production in the information, communications and technology (ICT) sector had increased by 2.3% in August. The Institute for Supply Management (ISM) manufacturing index had fallen to 53.7 in September, from 54.7 in August, although the index for new orders had increased. The ISM non-manufacturing index had fallen to 63.3 in September, from 65.1 in August.

A4 The Conference Board measure of US consumer confidence had fallen to 76.8 in September, from 81.7 in August. The University of Michigan headline index of consumer confidence had fallen to 87.7 in September, from 89.3 in August. This had reflected a fall in both the expectations index and the current conditions index. US non-farm payrolls had risen by 57,000 in September, following a fall of 41,000 in August (revised from a fall of 93,000). New orders of non-defence capital goods had fallen in August, while defence orders had increased strongly.

A5 Annual headline consumer price inflation in the United States had increased to 2.2% in August, from 2.1% in July. Annual core consumer price inflation (which excludes food and energy prices) had fallen to 1.3% in August, from 1.5% in July. US producer prices had risen by 3.4% in August on the previous year, compared with a rise of 3.0% in the year to July.

A6 Euro-area GDP had contracted by 0.1% on the quarter in 2003 Q2. On the latest estimate, GDP had been unchanged on the quarter in 2003 Q1, revised down from growth of 0.1%. Final domestic demand had made a 0.1 percentage point contribution to quarterly GDP growth in 2003 Q2. Private consumption had grown by 0.1%, compared with 0.5% in 2003 Q1. Investment had fallen by 0.4%, after a fall of 1.2% in the previous quarter. Government consumption had grown by 0.7%, compared with 0.3% in 2003 Q1, and net trade had subtracted 0.2 percentage points from GDP growth. Recent data releases had indicated that import growth in the euro area in 2003 Q1 had been weaker than previously estimated, but the effect of this on GDP growth had been largely offset by downward revisions to export growth. Stockbuilding had made no contribution to GDP growth in 2003 Q2. According to Eurostat, the volume of retail sales in the euro area had been unchanged on a year earlier in July. German retail sales had fallen by 1.3% on the month in July, after having increased by 1.0% on the month in June. French household consumption of manufactured goods had fallen by 2.7% on the month in August, after having increased by 1.1% on the month in July.

A7 Industrial production in the euro area had increased by 0.6% on the month in July, following an increase of 0.1% in June. In July, industrial production (excluding construction) had increased by 2.2% on the month in Germany. German manufacturing orders had grown by 0.6% on the month in August, after having been flat in July. French industrial production had fallen by 0.3% on the month in July, following (revised) growth of 1.0% on the month in June. According to the European Commission survey, euro-area business confidence had increased in September, to just below its long-term average. The euro-area consumer confidence indicator had been unchanged in September compared with August; while it had recovered somewhat from its trough in March, it had remained below its long-run average. The euro-area purchasing managers' index (PMI) for manufacturing had increased to 50.1 in September, from 49.1 in August. The PMI for the services sector had risen to 53.6 in September, from 52.0 in August.

A8 Annual inflation in the euro area, as measured by the harmonised index of consumer prices (HICP), had increased to 2.1% in August, from 1.9% in July. Annual HICP core inflation (excluding

energy, food, alcohol and tobacco) had been unchanged at 1.6% in August. According to Eurostat's flash estimate, euro-area annual HICP inflation had been 2.1% in September, unchanged from August.

A9 According to the second release, real GDP in Japan had grown by 1.0% on a quarter earlier in 2003 Q2, compared with a 0.6% estimate in the first release. This upward revision had reflected revised investment data from the Ministry of Finance Corporate Survey: in the second release, business investment had grown by 4.7% on the quarter, adding 0.8 percentage points to GDP growth. The value of new machinery orders had fallen by 4.3% in August. All households' real living expenditure had risen by 1% in August, compared with a year earlier. The rate of unemployment had fallen to 5.1% in August, from 5.3% in July.

A10 The Japanese tertiary activity index had fallen by 2.5% in July compared with the previous month, while the all-activity index had fallen by 1.5%. Industrial production in Japan had fallen by 0.5% in August. According to the Bank of Japan's September Tankan survey, the large manufacturers' business conditions diffusion index had risen again, to reach 1%, the first positive reading since December 2000, while the large non-manufacturers' diffusion index had been unchanged at -13%.

A11 Since the Committee's previous meeting, the spot price of Brent crude oil had increased by \$1.00 per barrel to \$29.20, and *The Economist* dollar non-oil commodity price index had increased by 1.4%. In local-currency terms, the Dow Jones Euro Stoxx index had fallen by 5.2% since the Committee's previous meeting. In contrast, the Wilshire 5000 index had risen by 0.9% and the Japanese Topix index by 2.1%.

II Monetary and financial conditions

A12 The twelve-month growth rate of notes and coin had been unchanged at 7.8% in September. Annual growth of M4 had fallen to 6.6% in August, from 7.7% in July. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 11.7% in August, from 12.4% in July. Excluding other financial corporations (OFCs), the annual M4 growth rate had risen slightly to 7.8% in August, from 7.6% in July, and the annual M4 lending growth rate (excluding the effects of securitisations) had fallen to 13.4% in August, from 13.9% in July.

A13 The twelve-month growth rate of households' M4 had increased slightly to 7.7% in August, from 7.6% in July. The twelve-month growth rate of M4 lending to households (excluding the effects of securitisations) had fallen to 14.7% in August, from 14.8% in July. Within total net lending to individuals – a measure that includes borrowing from a broader set of institutions than just banks and building societies – the annual growth rate of secured lending had been unchanged at 13.9% in August. The annual growth rate of unsecured lending had fallen to 13.7% in August, from 14.2% in July.

A14 The average standard variable mortgage rate (SVR) quoted for existing borrowers had been unchanged in September, at 5.32%. However, the average two-year fixed mortgage rate had risen by 29 basis points, and the average two-year discounted mortgage rate had risen by 8 basis points. Average quoted rates on personal loans in excess of £10,000 had fallen by 16 basis points.

A15 The number of loan approvals for house purchase, when adjusted for the number of working days in the month, had risen to 125,000 in August, compared with 111,000 in July. The number of particulars delivered had fallen to 105,000 in August, from 115,000 in July. Mortgage equity withdrawal (MEW) was estimated to have been £11.3 billion in 2003 Q2, slightly lower than in 2003 Q1. The Q1 figure had been revised down following an increase in the ONS estimate of private housing investment in that quarter.

A16 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 8.5% in August, from 7.5% in July. In contrast, the twelve-month growth rate of M4 lending to PNFCs (excluding the effects of securitisations) had fallen to 9.8% in August, from 11.4% in July.

A17 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had fallen to 2.3% in August, from 7.9% in July. The twelve-month growth rate of M4 lending to OFCs (excluding the effects of securitisations) had also fallen, to 5.6% in August, from 6.9% in July.

A18 Between 3 September and 8 October, short-term nominal forward interest rates had risen up to the one-year horizon, but had fallen at other maturities out to the six-year horizon. Longer-term nominal forward interest rates had changed little over the period. Movements in UK nominal yields had been smaller over the month than those seen in the United States. Real yields had fallen at all horizons, with the largest falls of 10-15 basis points around the three-year horizon.

A19 Forward inflation expectations implied by index-linked and nominal gilt yields had risen slightly between 3 September and 8 October. According to the HM Treasury survey, mean RPIX inflation expectations for 2003 Q4 had risen to 2.6% in September, from 2.5% in August, while those for 2004 Q4 had been unchanged at 2.3% in September. According to the Consensus Economics survey, mean expectations for average RPIX inflation in 2003 had risen to 2.8% in September, from 2.7% in August, and those for average inflation in 2004 had risen by 0.1 percentage points to 2.4% in September.

A20 Between 3 September and 8 October, the FTSE All-Share index had fallen by 0.2%, while the FTSE 100 had risen by 0.2%. The FTSE 250 and FTSE Small Cap had both fallen by 1.7%. The uncertainty around future equity prices, as measured by implied volatility from option prices, had risen on the month, but had remained below its average since March 1992.

A21 Between 3 September and 8 October, the spread (over government bonds) of the Merrill Lynch index of investment-grade sterling corporate bonds had declined, reflecting a slightly larger fall in corporate bond yields than in government bond yields.

A22 The sterling effective exchange rate index (ERI) had fallen by 1.4% to 98.1 between 3 September and 8 October. Sterling had appreciated by 5.8% against the dollar and depreciated by 3.0% against the euro. Changes in relative interest rates could account for part of the movement in the dollar-sterling exchange rate, but could not account for movements in the euro-sterling exchange rate. The latest Consensus Economics survey had continued to suggest that the sterling ERI was expected to remain relatively stable over the next two years. Option-based implied volatility had suggested that there had not been much change in forward-looking uncertainty about the sterling-euro exchange rate.

III Demand and output

A23 The Monetary Policy Committee was briefed on information contained in the Quarterly National Accounts release for 2003 Q2, published on 30 September. This release was consistent with data which would be published in “2003 National Accounts – The Blue Book” on 24 October. In addition to routine Blue Book revisions, these data also incorporated the effects of the move to annual chain-linking and of adjustments for the effects of missing trader intra-community (MTIC) fraud.

A24 Real quarterly GDP growth at market prices in 2003 Q2 had been revised up to 0.6%, from 0.3% in the previous release. The cumulative revisions to the growth rate had been such that the level of real GDP had been revised up by around 0.9% by 2003 Q2. Most of those revisions to the level had been in data for 1999 and 2000.

A25 On the output measure, GDP growth at basic prices in 2003 Q2 had been revised up to 0.5%, from 0.3% in the previous release. Within total output, construction output growth had been revised up to 4.4%, from 0.8%; service sector output growth had been revised down to 0.2%, from 0.3%; and manufacturing output growth had been revised up to 0.5%, from 0.1%. The cumulative revisions to past growth rates had implied that the level of service sector output had been about 1% lower by 2003 Q2, while the level of manufacturing output had been around 3% higher.

A26 On the expenditure measure, the cumulative effect of past revisions meant that the level of real whole-economy investment had been revised up by 12.7% by 2003 Q2; the level of real households' consumption, government consumption and domestic demand had been revised down by around 2.6%, 3.9% and 1.8% respectively. Quarterly final domestic demand growth in 2003 Q2 had been revised down to 0.8%, from 1.0% in the previous release. Within that, the growth of households' consumption (including that of non-profit institutions serving households) had been revised down, to 0.7%, from 1.3%, and business investment growth had been revised up, to 2.0%, from -1.1%. The growth of business investment had been revised up, such that it was now estimated to have been growing broadly in line with GDP since around 1998. That was in contrast to the previous estimates, which suggested that business investment had been growing more slowly than GDP in recent years.

A27 The level of stocks during the previous three years had been revised, such that the ratio of stocks to GDP was broadly flat during that period, in contrast to the previous estimate which had pointed to a significant fall. Domestic demand growth in 2003 Q2 had been revised down to 0.5%, from 1.4% in the previous release.

A28 Import growth had been revised down to -2.5% in 2003 Q2, from 0.5% in the previous release, while the changes in exports had been revised up, to -2.6%, from -2.9%. Quarterly export and import growth rates excluding the effects of MTIC fraudulent activity in 2003 Q2 had been positive at 0.1% and 0.2% respectively. The estimated contribution of net trade to GDP growth had been revised up, to 0.1 percentage points, from -1.1 percentage points. Overall, the cumulative impact of past revisions to

the trade data had raised the level of exports by about 1.1%, and lowered the level of imports by about 2.2% by 2003 Q2.

A29 Households' real post-tax income had risen by 0.5% in 2003 Q2. Cumulative revisions to the past data implied that the level of real post-tax income had been revised down by about 1.4% by 2003 Q1. The households' saving ratio had fallen to 4.8% in 2003 Q2. The level of the saving ratio had generally been revised up since 2000 Q1. But the revisions also implied that the saving ratio had fallen more sharply between 2001 Q1 and 2003 Q1 compared with the previous estimates. The households' net financial balance had deteriorated in 2003 Q2 to -1.2% of GDP. Households' capital gearing had been little changed in 2003 Q2.

A30 The gross operating surplus of private corporations (excluding the alignment adjustment) had risen by 1.0% in 2003 Q2 and the gross trading profits of non-oil private non-financial corporations had risen by 1.9%. Private corporations' financial balance had decreased to 1.4% of GDP in 2003 Q2. The level of the corporate sector financial balance had generally been revised down since 2000, compared with the previous estimates. That had mainly been driven by upward revisions to investment and downward revisions to private corporations' gross operating surplus. But the broad trend of the corporate sector moving from financial deficit to financial surplus had not been significantly affected by those revisions. Estimates of corporate sector capital gearing had been little changed in 2003 Q2.

A31 The current account deficit had widened to £8.6 billion in 2003 Q2. That had been driven mainly by a reduction in investment income. The current account balance had been revised down since 2001 Q1. That had mainly reflected the inclusion of estimates of MTIC fraud and, specifically in 2003 Q1, lower investment income compared with the previous estimate. The public sector net financial deficit had widened further in 2003 Q2.

A32 Turning to indicators of output and activity in 2003 Q3, the latest Index of Production release indicated that manufacturing output had fallen by 0.6% in August. The Chartered Institute of Purchasing and Supply (CIPS) services activity index had strengthened further to 58.7 in September. The activity and new orders balances had both risen to their highest levels since April 2000 and August 1999 respectively. The CIPS manufacturing survey output index had fallen to 54.0 in September, but the new orders index had risen to 56.3. The Confederation of British Industry (CBI)

Monthly Trends survey balance on total orders for the manufacturing sector had fallen to –33 in September, from –24 in August.

A33 Retail sales data had been revised back to the 1980s. Those revisions had mainly reflected a combination of new information and a rebasing of the weights used to aggregate the components of retail sales. In 2003, monthly retail sales growth rates had been revised down in January and June, compared with the previous estimates. Data for July and August consistent with these revised retail sales data had not yet been made available. The Nationwide and Halifax indices had indicated that house prices had increased by 1.0% and 1.5% respectively in September. The regional indices had indicated that house price inflation had risen in London and the South East in 2003 Q3, but had fallen elsewhere. According to data supplied by the Society of Motor Manufacturers and Traders (SMMT), new private car registrations in September had been 4.1% higher than a year earlier. Over the three months to September, new private car registrations were 3.7% higher than in the same period a year earlier.

IV The labour market

A34 According to the Labour Force Survey (LFS), employment had increased by 63,000 in the three months to July, compared with the previous three months. The rise in employment in the three months to July had reflected a 91,000 rise in full-time employment. The working-age employment rate had increased 0.1 percentage points in the three months to July, to 74.6%, and was up 0.3 percentage points from a year earlier. Average hours had increased by 0.7% to 32.3 hours per week in the three months to July.

A35 The Bank's regional Agents had conducted an informal survey of 230 firms (covering 265,000 workers) on employment and employment intentions in 2003. The survey had suggested that private sector employment growth had been negligible so far this year, but was set to strengthen. Job creation in construction, retail and other services had offset job losses in manufacturing, with these losses mainly in larger firms. The main reasons for firms having changed the size of their workforce had been an imbalance between actual and desired numbers employed; changes to product demand; productivity; and labour costs. The main reasons for new jobs had been higher customer demand, while the main reasons for cuts had been rising productivity and labour costs.

A36 The CBI Industrial Trends Survey for September had reported that skill shortages had increased sharply in consumer services, but had remained low in business and professional services. The CIPS employment survey for September had suggested a further expansion in employment. The CIPS manufacturing, services and construction indices had all reported increased employment. The September REC survey had revealed that the demand for agency staff had increased again while the availability of such staff was no longer increasing.

A37 The LFS measure of unemployment had fallen by 1,000 in the three months to July compared with the previous three months, while the rate was unchanged at 5.1%. The claimant count had fallen by 6,900 in August, following a revised fall of 10,300 in July. Outflows from the claimant count had fallen by 5,800, while inflows had fallen by 2,400 in July. Inactivity among those of working age had fallen by 22,000 in the three months to July and the inactivity rate had decreased by 0.1 percentage points, to 21.3%.

A38 Headline (three-month average) whole-economy annual earnings growth had increased by 0.3 percentage points, to 3.4%, in July. Headline annual earnings growth in the private sector had increased by 0.4 percentage points to 3.0% over the same period; headline earnings growth in the public sector had been unchanged at 5.1%. Actual whole-economy earnings growth had been 3.7% in the year to July, up 0.5 percentage points from June. Private sector earnings growth had been 3.3% in the year to July, up 0.6 percentage points on June; public sector earnings growth had been 5.2%, down 0.2 percentage points from June. Whole-economy regular pay growth (not seasonally adjusted) had increased by 0.4 percentage points, to 3.7%, in the year to July. Overall, bonuses had increased earnings growth by 0.2 percentage points.

A39 According to the Bank's settlements database, the whole-economy twelve-month Average Earnings Index (AEI)-weighted mean settlement had remained unchanged at 3.1% in August.

V Prices

A40 Sterling oil prices had fallen by around 2% since the September MPC meeting, and were also lower on average in September than they had been in August.

A41 Manufacturing input prices had risen by 1.1% in August, mainly owing to higher oil prices. This meant that the annual inflation rate had risen to 3.0% in August, from 2.7% in July. But the CIPS

manufacturing survey had pointed to falling input prices in September, although the input price balance had risen slightly, to 49.7, from 46.6 in August.

A42 Manufacturing output prices excluding duties (PPIY) had risen by 0.2% in August. This meant that the annual inflation rate had risen to 1.5% in August, from 1.4% in July. Looking ahead, survey data had continued to point to downward pressure on output prices. Although the expected output price balance from the CBI Monthly Trends survey had risen, it had remained negative at -12 in September.

A43 The Quarterly National Accounts release for 2003 Q2 contained significant revisions to the main expenditure deflators. The annual inflation rate of the GDP deflator at market prices had been 3.1% in 2003 Q2, compared with the ONS's initial estimate of 2.8%. Within this, the annual inflation rate of the household consumption deflator had been revised up to 1.3% in 2003 Q2, from 1.1% in the initial release. The annual inflation rate of the government consumption deflator had been revised up more sharply, to 7.6% in 2003 Q2, from 4.4% in the initial release. The annual inflation rates of the imports and exports deflator had been -0.5% and 0.8% respectively in 2003 Q2.

A44 Annual RPIX inflation had been unchanged at 2.9% in August. Within this, annual goods price inflation had risen by 0.3 percentage points, to 0.6%, while annual services price inflation had fallen by 0.2 percentage points, to 4.0%. Annual RPI and RPIY inflation had both fallen, to 2.9% and 2.7% respectively. Annual HICP inflation had risen to 1.4% in August, from 1.3% in July.

VI Reports by the Bank's Agents

A45 The Bank's regional Agents reported that business confidence and output in the manufacturing sector had continued to improve gradually. There had been tentative signs of a recovery in exports to the United States, together with reasonable growth of exports to Asian markets. But the European market had remained weak. The recovery in the services sector had been somewhat stronger than in manufacturing. That had partly been due to strong demand for consumer services and by the public sector. There had been early signs of a recovery in activities related to corporate finance and some evidence of a modest improvement in demand in the information technology sector.

A46 The growth of retail sales had continued, if at a slower rate. New car sales in September had been a little weaker than expected. Total car sales in 2003 had been expected to be at a similar level to

the previous year. There had been some pick-up in the housing market, although significant regional variation had remained. House price inflation had picked up a little recently, but the annual rate of increase had continued to come down gradually.

A47 There had been reports of some increases in manufacturers' input prices, notably for utilities, metals and agricultural products, with some further increases in food input and retail prices expected in the coming months. There had been some impact on input prices from the depreciation of sterling against the euro. Upward pressure on retail prices had increased a little in those parts of the services sector where demand had been strongest. Some businesses in parts of the service sector had been expecting the October increase in the National Minimum Wage to affect their labour costs significantly.

VII Market intelligence

A48 On 8 October, interest rates implied by short sterling futures were marginally higher for the contract maturing in December 2003 than they had been on 3 September, but lower at longer maturities. The rate implied by the contract maturing in December 2004 was 15 basis points lower. Sterling implied rates had fallen on weaker-than-expected US data including the August employment report (released in early September), retail sales data and Chicago PMI data, but they had increased later in the period following the stronger-than-expected US September employment report. Over the month, sterling implied rates had fallen less than similar rates in euro and dollar markets, reflecting some UK-specific factors including the market reaction to the minutes of the September MPC meeting. UK government bond yields had fallen slightly over the period, by 2 basis points at the ten-year horizon, again a smaller fall than for euro-area and US government bonds.

A49 Economists polled by Reuters between 30 September and 2 October had attached a mean probability of 78% to no change in the Bank's official repo rate at the October meeting, and a mean probability of 20% to a 25 basis point increase. Their mean expectations for rates at the end of 2003 and 2004 had increased, to 3.54% and 4.05% respectively.

A50 Between 3 September and 8 October, sterling had risen by 5.8% against the dollar and fallen by 3.0% against the euro; the sterling ERI had fallen by 1.4%.