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MINUTES OF MONETARY POLICY COMMITTEE MEETING 3 and 4 September 2003

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 September 2003.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0309.pdf>).

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



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 3-4 SEPTEMBER 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 news about the world economy suggested a strengthening recovery in the United States; there were also some more positive indications of recovery in Japan. Activity in the euro area, however, appeared to be stagnant and continued to fall short of expectations. Exchange rate movements broadly reflected this divergent news on growth prospects, with both the US dollar and the yen appreciating in effective rate terms while the euro had depreciated. Equity prices were up in all major markets, but particularly in Japan.

3 In the United States, estimated growth in the second quarter had been revised up to 0.8%, with upward revisions to growth of consumption, government spending and private sector investment and a smaller drag on growth from net trade. The early indications were that the pick-up in growth in the first half of the year had continued into the third quarter. Retail sales values increased by 1.4% in July, suggesting that consumption growth remained robust; new orders of non-defence capital goods continued to pick up modestly, consistent with a steady revival in investment; and the indicators of output were also encouraging, with industrial production up in July and the ISM manufacturing PMI up strongly in August. The ISM indicator for non-manufacturing business activity was not yet available for August, but it had improved sharply in June and July. All these indicators were above market expectations – though broadly consistent with the recovery embodied in the August *Inflation Report* – and pointed to a strong recovery in activity in the second half of the year.

4 It was noteworthy that short and medium-term US bond yields had continued to rise. A month ago, it had been suggested that part of the increase in yields during July was a temporary consequence

of the re-hedging of mortgage-backed security portfolios, and so would unwind. That it had not done so suggested a continuing market reappraisal of US growth prospects, and so of the likely path of official interest rates. The extent of the upward shift was, nonetheless, remarkable. It was possible that markets had previously overreacted to earlier official comments about the risks of deflation, driving yields to artificially low levels, and now believed that recovery was firmly established. The spread between yields on ten-year nominal and index-linked government bonds had also increased, which might imply an increase in inflation expectations. But it had only returned to levels seen earlier in the year.

5 The key question now was about the durability of the US recovery. Among the positive factors were that consumption growth remained resilient, despite the weak labour market; that non-residential investment was stronger, backed up by an improvement in corporate profits; and that both fiscal and monetary policy continued to provide a strong stimulus. But some caution was warranted. The recent strength of consumption might in part be the result of tax cuts and rebates, which would boost the level of consumption but have only a temporary effect on its growth rate. Furthermore, part of the increase in retail sales in July was accounted for by car purchases, in response to a fresh round of incentives; it might therefore reflect simply a shift in the timing of these purchases. There was now less scope for profitable refinancing of mortgages, and consumer confidence was still somewhat subdued – probably reflecting job market uncertainties. The medium-term outlook for investment was also unclear: the recent recovery might reflect delayed replacement investment, rather than investment in new capacity, and the large fiscal deficit might eventually put upward pressure on the cost of capital (though the evidence on the strength of such ‘crowding out’ effects was ambiguous).

6 In Japan, the recent news was also encouraging. GDP was currently estimated to have grown by 0.6% in the second quarter, among the fastest of the G7 countries and well above expectations. But it seemed possible that this might be an over-estimate, as it was based on expenditure data and, in nominal terms, there had been growth of only 0.1%: the expenditure deflator had decreased faster than other price indices and its fall might be overstated. Output-based indicators were also consistent with more modest growth. But equity prices had risen by more than 10% over the month, and orders data had been stronger, so the improvement should not be wholly discounted. Even if the equity gains did not themselves support demand, they would at least help to ease the pressures on banks’ balance sheets.

7 Elsewhere in Asia, the easing in growth was in line with expectations and seemed likely to be temporary, recovering in part as the effects of the SARS epidemic unwound. Growth in China remained robust in the second quarter, and indeed might be seen as evidence that activity in the region was becoming less dependent on the external stimulus traditionally provided by the US economy: for example, China was increasing in importance as a destination for exports from other countries in the region.

8 In marked contrast to this positive news from the United States and Asia, activity in the euro area continued to fall short of expectations. The flash estimate pointed to no growth in GDP in the second quarter. Moreover, this estimate did not incorporate the latest data for France, where GDP was estimated to have been 0.3% lower in the second quarter than in the first. This fall – like that in Germany – reflected a weaker net trade position. Activity in some of the smaller euro-area countries that were important UK export markets had also been weak in the second quarter. Industrial production in the euro area was 0.8% lower in the second quarter as a whole, and the sharp fall in May had been followed by a further fall in June. There were, nonetheless, some possible grounds for optimism about near-term prospects: the continued rise in equity prices should support domestic demand; business confidence had improved, the manufacturing PMI had increased in August – the second successive improvement – and the services PMI was above 50 and at its highest level since July 2002; and fewer banks were reporting tighter credit conditions. In addition, the German IFO index had registered its fourth successive monthly increase (though the improvement was largely in the expectations component and this index had given false encouragement in the past). The full effects of the 50 basis point interest rate reduction in June were still to feed through, and the recent partial reversal of the appreciation in the euro effective exchange rate would also help, through its impact on net trade. Overall, however, prospects for the euro area still seemed to depend on the US recovery rather than on domestic sources of growth.

Financial markets, money and credit

9 Against this background, the strengthening in the US dollar exchange rate against the euro was perhaps not surprising. The relative growth rates of the two regions – both absolutely and relative to expectations – meant that US dollar assets would be seen as continuing to offer relatively attractive returns.

10 Sterling's effective exchange rate, which had enjoyed a long period of relative stability in a range around 106 until it began to depreciate in February, now seemed to have stabilised in a similar range centred just below 100 and had changed little since the Committee's August meeting. The market expectation, as reflected in Consensus forecasts, was that it would remain at about this level; uncertainty about sterling had fallen and the risks around its current level – as implied by option prices – were close to balanced. That seemed reasonable, as the estimated UK current account deficit was small given the United Kingdom's relative cyclical position. But there were risks in both directions. On the one hand, the profitability of the UK tradeable goods and services sectors might still not be high enough to sustain the current net trade position in the longer term, which would imply that sterling could depreciate further. On the other hand, the scale of the US current account deficit suggested that the US dollar would eventually weaken. If it did so while growth prospects in the euro area were also weak, sterling could become an attractive alternative for international investors currently accumulating US dollar assets.

11 Other UK asset prices were broadly consistent with the improved macroeconomic outlook: the increase in equity prices, for example, was broadly based and suggested both improved expectations of corporate earnings and (relative to the market trough) a lower risk premium. Indices based on equities of smaller companies had generally made larger gains than the main indices. Such companies tended to be more sensitive to the business cycle and investors were, perhaps, regaining their appetite for riskier assets. In addition, the increase of around 30 basis points in shorter-term sterling bond yields – though less marked than that in dollar bond yields – also pointed to a more optimistic market view of economic prospects.

12 UK money and credit indicators showed a slowing in household deposit growth in July, but a further increase in the twelve-month growth rate of household borrowing. There had been a gap between the growth rates of these two measures for some time, but it had widened further. Of course, whereas these borrowing data covered the majority of household borrowing, the deposits data represented only part of households' acquisition of financial assets. The widening gap might be accounted for by households' increased accumulation of other financial assets such as unit trusts.

Demand and output

13 The disjunction between indicators of output and expenditure in the United Kingdom had, if anything, increased as a result of data releases in the past month. Contrary to the Committee's expectation a month ago, GDP growth in the second quarter was still estimated to have been only 0.3%. But consumption was estimated to have increased by 1.3% in the second quarter. This was well above expectations, as was the 1.0% increase in final domestic demand. With inventories (including the statistical alignment adjustment) adding 0.4 percentage points to growth in the quarter, compared with an expectation of no contribution, total domestic demand had been substantially stronger than was embodied in the August central projection. The latest GDP release did not, however, incorporate any of the recent fraud-related adjustments to trade. When those adjustments were made, the drag on GDP growth in the second quarter from net trade would be smaller. Further, upward, revisions to exports were also likely, as delays in the processing of incomplete shipment details were rectified.

14 The implausibility of this pattern of demand, and the prospect of further revisions to net trade, implied either that there would be some large downward revisions to components of domestic demand or that output growth would be revised up. Though consumption was, historically, less subject to revision than other components of demand, recent outturns were unusually volatile. In addition, the reported strength of retail sales in recent months was hard to reconcile with survey information, and overall consumption growth seemed remarkably strong even if those data were taken at face value. Inventory accumulation was another obvious candidate for revision. On the basis of the current data, however, it was difficult to be at all confident that the current estimates of quarterly growth rates were reliable. It was as a result difficult to determine whether there had been a slowing in the underlying pace of consumption growth in the first half of the year, or whether there had simply been a temporary dip in the first quarter.

15 Despite these puzzles about the second quarter data, most of the information so far available about the third quarter was consistent with GDP growth returning to around trend, as projected in the August *Inflation Report*. Retail sales had fallen back in July, although by less than expected. This tended to suggest that the June data were perhaps less erratically strong than previously thought, and so pointed to underlying strength in retail sales. There was also clear evidence of a revival in the housing market. The slowing in house price inflation seemed to have paused in the past few months, contrary to the Committee's projection of continued easing; survey data from the Royal Institution of

Chartered Surveyors were much more positive; loan approvals and particulars delivered had increased; and the Agents' contacts reported a pick-up in market activity. In addition, equity prices had risen and the growth rate of secured borrowing had increased. Both implied a more buoyant near-term outlook for household consumption growth than expected a month or two ago. Growth in notes and coin had, however, eased and consumer confidence was a little softer, so the indications were not unambiguously strong. On the output side, business surveys – particularly those undertaken for the Chartered Institute of Purchasing and Supply – were also indicative of a return to trend growth in the third quarter, in line with or a little above the August *Inflation Report* projection.

16 Though house price inflation was not now falling as fast as expected, it was premature to conclude that the slowing would not resume. There had been no change in the underlying reasons for expecting house price inflation to ease, though – as before – it was hard to know at what level house prices would be in equilibrium with household incomes. The regions in which prices were now increasing fastest were those which historically showed the least cyclical variation; and the sharpest slowdown had occurred in London and the South East, historically the most cyclical regions.

The labour market, costs and prices

17 Employment was continuing to grow steadily, despite the apparently slow growth in output in the first half of the year, and the overall employment rate to edge upwards – with increases in the employment rate of older people more than offsetting falls in younger age-groups. Unemployment had fallen a little, though the trend could still be characterised as flat. The data implied that productivity had not changed much in the first half of the year, in either heads or hours terms, which lent some support to the suggestion that the estimate of output in the second quarter was likely to be revised up. In terms of annual rates, however, hourly productivity growth was close to its historical average and the employment data could be reconciled with output by the increase in the share of part-time employment and by the persistent downward trend in average hours per worker.

18 There was little news on pay, with the fall in headline earnings growth largely accounted for by the timing of bonus payments. The wide differential between public sector and private sector earnings growth, which had opened up in recent quarters, was little changed. Pay settlements had edged up but remained surprisingly muted, given the April increase in National Insurance contributions and other

factors reducing the growth of real personal disposable incomes. Overall, there were still few signs of inflationary pressure from the labour market.

19 RPIX inflation had been 2.9% in July, a little stronger than expected, and there might be some upside risks to the projection in the near term as a result of the impact of recent hot weather on food prices and of the faster-than-expected pace of house price inflation. But there was no clear reason to revise the assessment that inflation would fall back towards target in the second half of the year, as recent temporary upside influences ceased to affect the index.

20 There were some indications of pressures further back in the pricing chain, with input price inflation picking up in recent months, to 2.9% in July. Most of the increase was accounted for by oil prices and domestic food prices. Similarly, output price inflation (excluding duties) had also picked up – though only to 1.3%. The rate excluding petroleum products was, at 1.2%, the fastest for nearly seven years. Again, food prices had played a part but the increase seemed to be broadly based. Metals prices too were higher. But these were volatile and accounted for only a small share of costs, and so were of limited significance in terms of pressures on RPIX inflation.

Other considerations

21 The Reuters poll of economists showed a mean probability of 85% attached to a ‘no change’ decision this month, with none of the respondents expecting the Committee to vote to change the repo rate. A slightly greater likelihood was attached in this poll to a reduction than to an increase, but a clear majority believed that rates were now at a trough.

The immediate policy decision

22 The Committee agreed that recent outturns were broadly consistent with the central projections for activity and inflation included in the *August Inflation Report*, though the balance of risks might now be rather different. The policy decision this month therefore depended mainly on the assessment of how those risks might have changed, in three key areas: first, the strength and durability of the world recovery, and its implications for UK external demand; second, the prospects for UK domestic demand, given the unexpected resilience of consumption growth and the continued rapid accumulation

of debt by households; and third, the extent of the pass-through to RPIX inflation of sterling's depreciation since last autumn.

23 Overall, most members judged that the world recovery was broadly in line with their central expectation – though perhaps, given the disappointing euro-area data, a little weaker in terms of its implications for UK external demand. Some members, however, while conceding that the past month's data on euro-area activity were weaker than expected, took comfort from the rather more positive current and forward-looking survey indicators that the euro area was now more likely to match expectations in the second half of the year. In addition, for most members, the near-term downside risks to world activity appeared to have receded in the past month and the projected recovery – at least, in the second half of this year – now seemed to be more assured. But there remained uncertainty about the strength and durability of the US recovery: the weak labour market continued to represent a downside risk to consumption, and it was not yet clear that the investment recovery would be sustained.

24 In terms of output in the United Kingdom, the downside news, relative to the *August Inflation Report*, was that the estimate of output in the second quarter had not been revised up. Indicators of output growth in the third quarter were, however, consistent with the projection that growth would quickly return to trend. In addition, the consumption growth recorded in the second quarter was surprisingly strong. There were also a number of indications – in the revival of activity in the housing market, in the retail sales data and in household borrowing growth – that this strength had continued into the third quarter. Taken together, this raised the possibility that consumption growth had not in fact started to slow, but had simply been temporarily weak in the first quarter, and that the projected profile for consumption growth might therefore be understated, particularly in the near term. If so, the stimulus provided to domestic demand by the current level of interest rates might prove to be more than was needed – given the projected recovery in external demand – to maintain prospective demand in line with the economy's supply capacity in the medium term.

25 Related to the apparent strength of consumption, the continued rapid growth of household debt suggested to some members that the current pace of consumption growth might be based on over-optimistic expectations of future income growth or real interest rates. The longer that continued, the greater was the risk of a sharp downward adjustment to consumption, threatening the achievement of the inflation target in the longer term.

26 Recent data on costs and prices suggested little change in the prospects for RPIX inflation in the medium term. Pay pressures remained muted, though they could increase if concerns about the possibility of unemployment were to ease or if there was a delayed reaction to the increases earlier in the year in National Insurance contributions and other taxes. Members agreed that, given sterling's depreciation since last Autumn, imported goods and services were the more likely current source of inflationary pressures. Pressures at the input price and output price levels had if anything increased a little, but by no more than was consistent with the assumptions made in recent *Inflation Report* projections about the extent and timing of the pass-through of sterling exchange rate movements to UK domestic prices. Inflation expectations seemed to be firmly anchored to the target.

27 All members of the Committee agreed that it was particularly difficult to assess the current state of the UK economy, given the great uncertainties surrounding recent GDP data. Those uncertainties might be reduced by data releases in the coming month and by the accumulation of more information about output and demand in the third quarter.

28 The Committee agreed that these considerations, taken together, suggested that it was not necessary to change interest rates this month in order to meet the inflation target.

29 For most members, this decision was clear-cut, although for some it was more finely balanced. The decision to reduce the repo rate in July had in part been precautionary, in the face of external and domestic downside risks. Now that those risks had eased, the need for that additional stimulus to UK demand and activity, to ensure that inflation remained on target in the medium term, was to those members no longer so clear. Concerns about the longer-term sustainability of the current pace of consumption growth and household debt accumulation also suggested to some members that an increase in interest rates might soon become necessary. However, market interest rates had already firmed a little. That would restrain consumption growth somewhat, even in the absence of an immediate increase in official rates.

30 The Governor invited members to vote on the proposition that the repo rate should be maintained at 3.50%. The Committee voted unanimously in favour of the proposition.

31 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

Gus O'Donnell was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 29 August 2003, in advance of its meeting on 3-4 September. 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 According to the preliminary estimate, US GDP had risen by 0.8% on the quarter in 2003 Q2, higher than the 0.6% growth previously suggested in the advance estimate. Within this total, the estimate of consumption growth had been revised up to 0.9% from 0.8%, private investment growth to 1.7% from 1.6% and the growth of government spending to 2.0% from 1.8%. The estimated net trade contribution to GDP growth in 2003Q2 had been revised to –0.3 percentage points, from –0.4 percentage points. Growth in non-farm business sector labour productivity in 2003 Q2 had risen to 1.4% on the quarter, following a rise of 0.6% on the quarter in 2003 Q1. Unit labour costs in Q2 had fallen by 0.5% on the quarter after an increase of 0.4% in Q1.

A3 US industrial production had risen by 0.5% on a month earlier in July, following no growth in June. Manufacturing output had risen by 0.3%, following a similar rise in June. This had reflected increases of 2.9% in the production of motor vehicles and parts and 0.8% in information, communications and technology (ICT) goods production. New orders for non-defence capital goods had continued to pick up, rising by 1.2% in July compared with the previous month. The Institute for Supply Management (ISM) manufacturing index had risen to 54.7 in August, from 51.8 in July.

A4 Real consumption in the United States had grown by 0.6% in July, compared with growth of 0.4% in June. Nominal retail sales values had risen by 1.4% in July, following an upwardly revised increase of 0.9% in June. Excluding sales of automobiles, retail sales had risen by 0.8% in July, following an increase of 1.0% in June. The Conference Board measure of consumer confidence had increased to 81.3 in August, from 77.0 in July. The ‘expectations’ sub-component of the headline index had risen to 94.4, from 86.3, while the ‘present situation’ sub-component had fallen to 61.6, from 63.0. The University of Michigan headline index of consumer confidence had fallen to 89.3 in

August, from 90.9 in July. The fall in the headline index had reflected small falls in both the current conditions index and in the expectations index.

A5 Annual headline consumer price inflation in the United States had been 2.1% in July, unchanged from its level in June. Annual core consumer price inflation (which excludes food and energy prices) had been 1.5% in July, also unchanged from June. US producer prices had risen by 3.0% in the year to July, after an increase of 2.9% in the year to June. Core US producer prices had risen by 0.2% in the year to July, after falling by 0.3% in the year to June.

A6 According to Eurostat's flash estimate, euro-area GDP had been flat on the quarter in 2003 Q2. German GDP had fallen by 0.1% on the quarter, following a fall of 0.2% in 2003 Q1. Within total German GDP, private consumption was flat in Q2, compared with a rise of 0.5% in 2003 Q1. Total investment had risen by 0.2%, after falling by 1.2% in Q1. Government consumption had grown by 1.3%, after falling by 0.1% in 2003 Q1. Inventories had contributed 0.1 percentage points to quarterly GDP growth in Q2, while net trade had subtracted 0.5 percentage points. French GDP had fallen by 0.3% on the quarter in 2003 Q2, following an increase of 0.2% in 2003 Q1. Private consumption had fallen by 0.2%, total investment had fallen by 0.2% and government consumption had risen by 0.1% on the quarter. Net trade had subtracted 0.2 percentage points from quarterly growth and inventories had subtracted 0.1 percentage points. Italian GDP had declined by 0.1% and Dutch GDP had fallen by 0.5% on the quarter in 2003 Q2.

A7 Industrial production in the euro area had fallen by 0.1% on the month in June, following a decline of 0.9% in May. In June, according to the Eurostat release, industrial production had risen in France, remained flat in Italy and fallen in Germany. The Purchasing Managers' Index for the manufacturing sector in the euro area had risen to 49.1 in August, from 48.0 in July. The Purchasing Managers' Index for the euro-area service sector had risen to 52.0 in August, from 50.2 in July. The West German IFO index had increased to 90.8 in August, from 89.3 in July. The working day and seasonally adjusted volume of euro-area retail sales was unchanged on a month earlier in June.

A8 Annual inflation in the euro area, as measured by the harmonised index of consumer prices (HICP), had fallen to 1.9% in July, from 2.0% in June. Annual core inflation (excluding energy, food, alcohol and tobacco) had fallen to 1.6% in July, from 1.8% in June. According to Eurostat's flash

estimate, euro-area annual HICP inflation had risen to 2.1% in August. In Germany, annual HICP inflation had increased to 1.1% in August, from 0.8% in July, according to the preliminary estimate.

A9 According to the preliminary estimate, Japanese real GDP had risen by 0.6% in 2003 Q2, compared with a 0.3% increase in the previous quarter. Within the total, private consumption had grown by 0.3%, business investment had increased by 1.3% and total government expenditure had fallen by 0.5%. Net trade had contributed 0.2 percentage points to quarterly growth and inventories contributed 0.1 percentage points. Japanese tertiary activity had grown by 0.8% in 2003 Q2 compared with the previous quarter, and the all-activity index had risen by 0.1%.

A10 Industrial production in Japan had risen by 0.5% on a month earlier in July, following a 1.2% fall in June. Japanese core domestic private machinery orders (excluding orders of ships and electrical power) had increased by 3.4% on the quarter in 2003 Q2, after rising by 5.8% in Q1. Japanese nominal retail sales had declined by 3.0% on a year earlier in July, compared with a fall of 2.2% on a year earlier in June. The workers' household survey had reported a decline of 6.0% in real spending in the year to July, compared with a 0.4% annual increase in June. Annual growth in export volumes had been 3.7% in July, compared with a fall of 1.2% in June. Annual growth in import volumes had slowed to 4.6% in July, from 13.7% in June.

A11 Since the Committee's previous meeting, the spot price of Brent crude oil had fallen by \$1.51 per barrel to \$28.17, and *The Economist* dollar non-oil commodity price index had risen by 2.8%. Major international equity indices had risen since the Committee's August meeting. In local currency terms, the Wilshire 5000 had risen by 6.9%, the Dow Jones Euro Stoxx had risen by 8.5% and the Japanese Topix had risen by 12.0%.

II Monetary and financial conditions

A12 The twelve-month growth rate of notes and coin had fallen to 7.7% in August, from 7.9% in July. Annual growth of M4 had also eased, to 7.5% in July from 7.8% in June. In contrast, the twelve-month growth rate of M4 lending (excluding the effects of securitisations) had risen to 12.5% in July, the highest rate since February 2001, and up from 11.9% in June.

A13 The twelve-month growth rate of households' M4 had fallen to 7.7% in July, from 7.9% in June. The twelve-month growth rate of households' M4 borrowing (excluding the effects of securitisations) had edged up by 0.1 percentage points, to 14.8%, in July. Annual growth of the broader measure of total net lending to individuals had risen by the same amount, to 14.0% in July. Within this measure, the annual growth rate of secured lending had risen to 13.9% in July, from 13.8% in June, while the annual growth rate of unsecured lending to individuals had fallen to 14.2% in July, from 14.6% in June.

A14 The number of loan approvals for house purchase, after adjusting for the number of working days in the month, had risen to 108,000 in July, compared with 102,000 in June. The House Builders Federation monthly survey had shown that the balance of members reporting an increase in net reservations compared with the corresponding month of the previous year had risen sharply in July, after allowing for seasonal factors, and had become positive for the first time since December 2002. The number of particulars delivered had risen to 115,000 in July, from 103,000 in June.

A15 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had fallen to 8.1% in July, from 8.4% in June. In contrast, the twelve-month growth rate of PNFCs' M4 borrowing (excluding the effects of securitisations) had increased to 11.6% in July, from 11.3% in June.

A16 The annual growth rate of M4 deposits of other financial corporations (OFCs) had fallen to 6.7% in July, from 7.3% in June. Meanwhile, the twelve-month growth rate of OFCs' M4 borrowing (excluding the effects of securitisations) had risen sharply, to 7.3% in July from 4.9% in June.

A17 The FTSE 100 index had risen by 4.7% between 6 August and 3 September. The FTSE All-Share index had risen by 5.4% over the same period. All of the main sectoral indices within the FTSE All-Share had risen. Uncertainty about the FTSE 100, as measured by implied volatility derived from options prices, had fallen slightly over the month. The number of downward profit warnings by UK companies in August 2003 had fallen to the lowest level for over three years.

A18 Short-term nominal forward interest rates had risen between 6 August and 3 September, and by around 40 basis points at the two-year horizon. The standard deviation of six-month interest rate expectations had fallen slightly over the month, but had remained at a higher level than for most of

2003. Nominal forward interest rates had risen by around 10 basis points up to the ten-year horizon, but had been little changed at longer horizons. Real forward interest rates had risen by around 10 basis points at the ten-year horizon, but had been little changed further out.

A19 Between 6 August and 3 September, forward implied inflation expectations had risen at horizons up to around ten years, but were little changed further out. In contrast, there had been little change in survey measures of short-term inflation expectations. According to the HM Treasury survey, mean RPIX inflation expectations for 2003 Q4 and 2004 Q4 had been unchanged in August, at 2.5% and 2.3% respectively. According to the Consensus Economics survey, mean RPIX inflation expectations for 2003 as a whole and 2004 as a whole were also unchanged in August, at 2.7% and 2.3% respectively.

A20 Quoted interest rates on household borrowing had generally fallen further in August. The average standard variable mortgage rate (SVR) quoted for existing borrowers had fallen by 18 basis points in August, reflecting the repo rate reduction in July. However, the average two-year fixed mortgage rate had risen by 48 basis points.

A21 The sterling effective exchange rate index (ERI) had risen by 0.8%, to 99.5, between 6 August and 3 September. Much of this movement could be accounted for by changes in relative interest rates. Sterling had appreciated by 2.3% against the euro, but had depreciated by 2.6% against the dollar, during this period.

III Demand and output

A22 Estimated GDP growth at constant market prices in 2003 Q2 had been 0.3% in the Output, Income and Expenditure release, unrevised from the preliminary estimate. The annual growth rate had also been unrevised, at 1.8%. GDP excluding the primary sectors (agriculture, mining and utilities) had risen by 0.3% in Q2.

A23 Service sector output growth had been revised down by 0.1 percentage points, to 0.3%, in 2003 Q2. Within the service sector, output growth of the distribution, hotels and catering sector had been revised down by 0.1 percentage points, to 1.1%. Output in the transport, storage and communication sector had grown by 0.3%, while output in the government and other services sector had risen by

0.4%. Output in the business services and finance sector had fallen by 0.4%. Manufacturing output had risen by 0.1% for the second consecutive quarter, while construction output had risen by 0.8%, following a fall of 1.9% in 2003 Q1.

A24 On the expenditure measure of GDP, private sector consumption (including that of non-profit institutions serving households) had grown by 1.3% in Q2, up from 0.2% in Q1. Real government consumption had risen by 1.1%, while whole-economy investment had fallen by 0.3%. Within whole-economy investment, business investment had fallen by 1.1%, reflecting a 10.2% fall in private manufacturing investment.

A25 Total exports had fallen by 2.9% in 2003 Q2, while total imports had risen by 0.5%, so that net trade had reduced GDP growth by 1.1 percentage points on the quarter. But the import data had not included the adjustments to estimates of goods imports to take account of the impact of missing trader intra-Community (MTIC) VAT fraud. Adjusting the import data for MTIC fraud implied a less negative net trade contribution in Q2. The ONS had announced that the revised import data would be incorporated in the Quarterly National Accounts release, due on 30 September.

A26 Final domestic demand had risen by 1.0% in 2003 Q2. The change in inventories (including the alignment adjustment) had made a 0.4 percentage point contribution to GDP growth, so domestic demand had risen by 1.4% on the quarter.

A27 Turning to indicators of expenditure in Q3, retail sales volumes had fallen by 0.4% in July, following a rise of 2.0% in June. The Confederation of British Industry (CBI) Distributive Trades survey had pointed to a further fall in annual retail sales volumes growth in August: the reported retailing sales balance had fallen to +12, from +27 in July.

A28 The headline GfK consumer confidence indicator had fallen back slightly in August, to -3, from -1 in July. This was driven by small falls across all five constituent balances. House prices, as measured by the Nationwide index, had risen by 1.1% on the month in August, up from 1.0% growth in July. The annual inflation rate had fallen to 16.6%, from 17.9% in July. The Halifax house price index rose by 1.3% on the month in August, down from 1.4% in July. The annual inflation rate (adjusted for reporting errors) rose to 23.0%, from 20.4% in July.

A29 Turning to indicators of output in Q3, the Chartered Institute for Purchasing and Supply (CIPS) services activity index had risen to 57.0 in August, from 56.6 in July. The incoming new business index had also picked up, to 57.5, from 56.0 in July. Both balances had reached their highest levels since early 2001.

A30 The August CBI Monthly Trends Enquiry had suggested continued weakness in the manufacturing sector, although the total orders balance had risen to -24, from -37 in July, bringing it broadly in line with its long-run average. The balance on expected output had picked up slightly, to -3, in August, from -4 in July. The CIPS manufacturing output index had risen further, to 55.8, in August, from 53.7 in July. The new orders index had also risen, to 53.3, from 51.7 in July.

IV The labour market

A31 According to the Labour Force Survey (LFS), employment had increased by 63,000 in 2003 Q2, compared with 2003 Q1. The working age employment rate had increased by 0.1 percentage points on the quarter, to 74.7%, and was up 0.2 percentage points from a year earlier. Average hours had decreased by 0.2% on the quarter, to 32.2 hours per week in 2003 Q2.

A32 The CIPS employment survey for August had suggested an expansion in employment for the first time since May 2001. The CIPS manufacturing, services and construction indices had all ticked up, and only the CIPS manufacturing employment balance had been negative. The August REC survey had revealed that demand for agency staff had grown more rapidly than in July, and availability of staff had increased more slowly.

A33 The LFS measure of unemployment had fallen by 42,000 in 2003 Q2, while the rate had decreased by 0.1 percentage points to 5.0%. The claimant count had fallen by 8,800 in July, following a revised fall of 2,300 in June. Outflows from the claimant count had been little changed, but inflows had fallen by 8,200 in July. Inactivity amongst those of working age had risen by 25,000 in 2003 Q2 but the inactivity rate had remained unchanged at 21.3%.

A34 Headline (three-month average) whole-economy annual earnings growth had fallen by 0.3 percentage points on the quarter, to 3.1%, in 2003 Q2. Headline annual earnings growth in the private sector had fallen by 0.4 percentage points, to 2.6%, over the same period; headline earnings

growth in the public sector had been unchanged at 5.1%. Actual whole-economy earnings growth had been 3.3% in the year to June, up 0.1 percentage points from May. Private sector earnings growth had been 2.7% in the year to June, down 0.2 percentage points on May, and public sector earnings growth had been 5.5%, up 0.9 percentage points from May. Whole-economy regular pay growth (not seasonally adjusted) had fallen by 0.2 percentage points, to 3.4% in the year to June. Overall, bonuses had been lower than a year earlier and had reduced annual earnings growth by 0.1 percentage points.

A35 According to the Bank's settlements database, the whole economy twelve-month Average Earnings Index (AEI)-weighted mean settlement had ticked up by 0.1 percentage points, to 3.1% in July. The twelve-month AEI-weighted mean settlement for the private sector had remained unchanged at 3.0% in July.

V Prices

A36 Sterling oil prices had fallen by around 3% since the August MPC meeting but had been higher, on average, in August compared with July.

A37 Manufacturing input prices had risen by 1.8% in July, mainly because of higher oil prices. As a result, the annual inflation rate had risen to 2.9%, from 1.8% in June. But the CIPS manufacturing survey had pointed to future falls in input prices: the input price balance had fallen to 45.3 in August, from 46.1 in July.

A38 Manufacturing output prices excluding duties (PPIY) had risen by 0.3% in July, while the annual inflation rate had risen to 1.3%, from 1.1% in June. Looking ahead, survey data had continued to point to downward pressure on output prices. The balance on expected output prices from the CBI Monthly Trends survey had been broadly unchanged in August, at -14.

A39 The ONS's experimental corporate services price index (CSPI) had suggested that annual corporate services price inflation had risen to 3.1% in Q2, from 2.7% in Q1.

A40 According to the ONS's Output, Income and Expenditure release, the annual inflation rate of the GDP deflator at market prices had risen to 2.8% in Q2, from 2.7% in Q1. Within this, the annual rate of inflation of the household consumption deflator had risen by 0.2 percentage points, to 1.1% in Q2. The annual inflation rate of the government consumption deflator had fallen to 4.4% in Q2, from 6.4%

in Q1. The annual inflation rates of the imports and exports deflators had been -0.1% and 1.2% respectively.

A41 Annual RPIX inflation had risen to 2.9% in July, from 2.8% in June. Within this, annual goods price inflation had risen by 0.1 percentage points, to 0.3% , and annual services price inflation had risen by 0.2 percentage points, to 4.2% . Annual RPIY inflation had also risen by 0.1 percentage points, to 2.8% . Annual RPI and HICP inflation had both risen by 0.2 percentage points, to 3.1% and 1.3% respectively.

VI Reports by the Bank's Agents

A42 Contacts seen by the Bank's regional Agencies had generally presented a more optimistic picture of economic conditions. They had reported a modest recovery in manufacturing orders, resulting from growth in demand from the Far East. Although European demand had remained weak, the appreciation of the euro had gradually boosted the competitiveness of UK manufacturers, both in the UK domestic market and in markets where they faced competition from European exports. The increased level of enquiries had slowly evolved into higher orders. As a result, business confidence had improved but remained fragile.

A43 In terms of manufacturing output, the stronger sectors had continued to be those supplying the public sector, especially health and defence. Construction-related manufacturing and food processing had also remained buoyant. There had also been some signs of a pick-up in output of electronics and semi-conductors, whereas that of capital goods had remained weak. The transfer of manufacturing capacity to overseas locations had continued.

A44 Agencies had reported a further strengthening of export margins as the effects of the appreciation of the euro had worked through. But the effect had been eroded somewhat as trading partners in the euro area had sought a share of the exchange rate gain. Domestic margins had remained weak, though they had declined at a slower rate than six months ago.

A45 There had been an improvement in manufacturing investment, as some companies had begun to activate previously deferred investment plans. But for many companies, particularly in the engineering sector, investment had remained below replacement levels.

A46 There had been further signs of recovery in consumer and business services, which had resulted in a modest recovery in investment from the trough in 2003 Q1. Domestic tourism services had benefited from good weather; and ticket sales by budget airlines had continued to grow strongly. Business travel had begun to pick up, but often with reduced spending per trip. The increase in mergers and acquisitions activity in the City had begun to filter out to other regions. But advertising and marketing had remained flat.

A47 Retail sales figures had been volatile over the summer, but Agencies had reported that much of this was weather-related. Growth in retail sales had been expected to continue at a slower rate than last year. Hot weather might also have affected sales of new cars in August, but contacts had expected a more general slowdown in demand for new cars in the autumn.

A48 Significant regional differences had persisted in the housing market, with some northern regions reporting double-digit house price increases while other regions had seen more moderate increases or even falling prices. But estate agents had appeared more confident and some had revised up their expectations for activity this autumn.

VII Market intelligence

A49 On 3 September, interest rates implied by short sterling futures contracts had been higher than on 6 August, with the change more pronounced further out along the curve. The rate implied by the December 2003 contract was 17 basis points higher, at 3.90%, and that implied by the December 2004 contract 38 basis points higher, at 4.93%. Generally stronger-than-expected US economic data and surveys had led market participants to expect stronger US growth in 2003 H2, contributing to the rise in rates. Some stronger-than-expected UK data, including RPIX and consumer borrowing and house price data, had also led to expectations of more robust UK household consumption and a more robust UK housing market.

A50 Market participants had not expected a change in the repo rate at the MPC's September meeting. Economists polled by Reuters between 26 and 28 August had attached a mean probability of 85% to no change in the Bank's official repo rate at the September meeting, and a mean probability of 10% to

a 25 basis point reduction. The mean expectation for the level of the repo rate at end-2003 was 3.43%, up 4 basis points from July and, for end-2004, 3.87%, unchanged from July.

A51 Between 6 August and 3 September, sterling had fallen by 2.6% against the dollar and risen by 2.3% against the euro. The effective exchange rate, at the end of the period, was 0.8% higher. Sterling had remained fairly stable over the month, with bigger moves seen in the dollar, euro and yen. The dollar had appreciated against most major currencies. In particular, the dollar had risen by 5.1% against the euro. Movements in the sterling ERI over the month had been almost entirely consistent with the move in the euro-dollar rate, given the historical correlation.