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MINUTES OF MONETARY POLICY COMMITTEE MEETING

8 and 9 September 2004

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 September 2004.

They are also available on the Internet (http://www.bankofengland.co.uk/mpc/mpc0409.pdf).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 6 and 7 October will be published on 20 October 2004.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 SEPTEMBER 2004

1 Before turning to its immediate policy decision, the Committee discussed developments in financial markets; the international economy; money, credit, demand and output; and the labour market, costs and prices.

Financial markets

2 Price movements in financial markets had been more significant than in recent months, with falls in short-term market interest rates and a depreciation of sterling against other major currencies.

3 In addition to international factors, short-term sterling market interest rates had moved lower in response to the statement accompanying the August MPC decision and the Minutes, and in the light of UK data and surveys relating to the housing market, consumer spending and industrial production. Forward sterling interest rates pointed to a strong expectation that the Committee would leave the repo rate unchanged this month and expectations of any further rise before the end of the year seemed to have become less firmly held. None of the respondents to the Reuters survey of economists had expected a change in rates this month and the average of their expected rates for the end of the year had fallen slightly, to just under 5%.

4 In contrast to the falls at shorter maturities, implied forward sterling real interest rates and inflation expectations had changed little on the month at maturities beyond five years.

5 Since the previous meeting, the sterling effective exchange rate had fallen by nearly 3% to its lowest level since February. Market contacts had attributed the fall mainly to downward revisions to the expected path of sterling official interest rates. But movements in sterling market interest rates relative to overseas rates had been small and could account only for a small part of the steady depreciation over the month. At this stage the Committee found it difficult to assess what lay behind the depreciation and therefore whether it was likely to persist.

6 Major equity markets had risen over the month, apparently partly in response to the fall in oil prices.

The international economy

7 The broadly based global upswing looked set to continue, more or less in line with the August *Inflation Report* projections. Growth in the United States and Japan had slowed in Q2 from the brisk pace in Q1, but seemed likely to pick up again in the second half of the year. In the euro area, overall growth appeared steady at near its trend rate. However, the news over the past month was consistent with some increased downside risks to global growth.

8 In the euro area, GDP growth in Q2 had been estimated at 0.5%. The expenditure breakdown suggested that net trade had made a larger-than-expected contribution to growth. Final domestic demand had continued to contract in Germany but had grown strongly in France and expanded in the euro area as a whole, although at a slower rate than in Q1. Euro-area retail sales growth in June and July had suggested that private consumption would continue to grow in Q3. Although the Purchasing Managers Indices for manufacturing and services had fallen a little in August, they were consistent with further expansion. Headline CPI inflation had been unchanged in August but had eased from May and June.

9 Final domestic demand growth in Germany had been relatively weak since early 1999. One likely explanation was that German real household disposable income had been flat since 2001, partly reflecting falling employment. Much of the decline in employment had been in the construction sector, and construction investment had also been falling as a percentage of GDP since the mid-1990s, in part still a hangover from the construction boom following reunification. Another factor was likely to be uncertainty about various proposed structural reforms; this might lie behind the rise in the German household saving ratio in recent years. Recovery in German domestic demand growth remained uncertain, although continued weakness in Germany seemed unlikely to undermine the upturn in the rest of the euro area.

10 In the United States, estimated Q2 GDP growth had been revised downwards to 0.7%, below the pace of growth in recent quarters. A marked slowdown in private consumption growth was perhaps in part related to the impact of higher oil prices on disposable incomes. But other factors might also have been important, including a slowing in the growth rates of both housing and net financial wealth, and

temporary effects such as wet weather in June and reduced incentives to buy motor vehicles. Real consumption and retail sales had both risen in July following falls in June, with increased spending across many categories, including motor vehicles, but some of the indicators for August were more mixed. The rate of future consumption growth seemed likely to pick up in Q3, although not at the brisk pace of Q1. Survey-based measures of consumer confidence had weakened in August compared with July, and the Federal Reserve's Beige Book had reported that consumption growth might have eased in August from July. In part this might have been in response to the weak growth in non-farm payrolls in July, with consumers having a slightly less confident assessment of current labour market conditions. Non-farm payrolls had, however, risen by 144,000 in August and the estimated July increase had been revised upwards. But this rate of increase was still barely sufficient to keep pace with the growth in the US population of working age. Partly depending on the strength of the labour market, downside risks to future consumption growth had probably increased, although growth would remain underpinned by the continuing highly stimulatory stance of monetary and fiscal policies, and the steady rise in house prices.

11 On the output side, US indicators were consistent with continuing robust growth. Both the manufacturing and non-manufacturing headline Institute for Supply Management indices had fallen back a little in August from July, as had their new order components. But they remained well above 'no change' levels. Business investment had grown strongly in the first half of the year.

12 In Asia, Japanese GDP growth in Q2 had also been weak, and heavily dependent on net trade, but again this slowdown seemed likely to be transitory. A pickup in machinery orders might signal stronger investment growth in the second half of the year. From the perspective of demand for UK goods and services, weaker growth in Japan in Q2 had been more than offset by rapid rates of expansion elsewhere in Asia, with inflationary pressures building in some of these economies.

13 Despite the sharp rise during August, oil prices had declined somewhat over the month. OPEC oil supply had risen in July and there had been a build-up in US gasoline stocks as a result of weaker-than-expected US demand. The oil futures curve continued to point to a fall in prices to below US$35 per barrel. But the implied distribution of future oil prices derived from options markets remained skewed towards higher prices, suggesting a perceived risk of a more pronounced rise in oil prices. And oil prices had risen steadily since the beginning of 2004. If the current level was sustained, it would depress global economic growth to some extent, although the major economies were less sensitive to high oil prices than in previous decades.

Money, credit, demand and output

14 In the United Kingdom, output and demand growth had been above trend in Q2. Continued robust GDP growth was likely in the second half of the year, although there were signs that the pace of growth might slow a little in Q3 and be slightly weaker than in the August *Inflation Report* projections. In particular, growth of consumer spending appeared to be slowing in Q3. There had been more signs that the housing market was starting to cool.

15 The ONS had estimated GDP growth in Q2 of 0.9%, unchanged from its preliminary estimate and in line with what the Committee had expected. Output growth had been broadly based, with the output of services and the production industries increasing at similar rates.

16 There were, however, signs of a slight easing in the pace of growth in Q3. Manufacturing output was estimated to have fallen by 0.2% in July, although upward revisions to estimated growth in the first half of the year had left the reported level of manufacturing output 0.6% higher than previously estimated. Business surveys had presented a mixed picture. For manufacturing, the output and new orders balances in the CIPS purchasing managers index had fallen sharply in August from July, although still indicating continuing expansion. But the *CBI Monthly Trends Inquiry* and the Bank's Agents had suggested a pickup in orders and output expectations. In the services sector, the CIPS index of business activity had risen in August, having fallen in the previous three months, but the index of incoming new business had continued to edge a little lower while remaining consistent with continuing growth. The Bank's regional Agents had reported an acceleration of activity in business services but a modest deceleration in consumer services.

17 On the demand side, private consumption was estimated by the ONS to have grown strongly, by 1.1%, in Q2 following the weaker growth of 0.6% in Q1. This profile might have reflected a pickup of estimated growth in consumption of services and net tourism in the second quarter. The Committee judged that consumption growth over the first half of the year was likely to have been smoother than currently reflected in the official data.

18 There were signs that consumption growth might have slowed in Q3. Retail sales volumes had fallen in July, the first monthly fall since May 2003. The Bank's Agents had reported some easing in household spending. The *CBI Distributive Trades Survey* and BRC retail sales monitor had indicated

that the annual growth rate of retail sales had fallen again in August. The GfK survey in August had suggested that consumer confidence had ticked down, with a reduction in willingness to make a major purchase. Private car sales had been lower than in the equivalent month in 2003 for five consecutive months to August. The flow of secured and unsecured lending to individuals had fallen in July. Growth of notes and coins had also declined, although the twelve-month growth rate of households' holdings of broad money (M4) had increased.

19 It was unclear to what extent any easing in consumption growth might be temporary, perhaps connected to the unusually wet weather. The Committee had been expecting some slowing, reflecting in part that official interest rates had risen by 1.25 percentage points since November 2003.

20 An increasing weight of evidence suggested that the housing market might be cooling, with a range of indicators pointing in the same direction. House price inflation had been lower on both lenders' indices in August, with the Halifax index falling 0.6% compared with the previous month. The July RICS survey of estate agents had shown a further fall in the balance of survey respondents reporting price rises in the previous three months. Indicators of housing market activity had also continued to weaken: new mortgage approvals for house purchase had fallen sharply in July and the July RICS survey had indicated a further fall in the ratio of respondents' sales to stocks. But even if the market had begun to cool, it remained highly uncertain how rapidly and by how much house price inflation would moderate, or indeed if it might pick up again for a time. The impact of any given change in house prices on consumption was also uncertain. The Committee judged that a turnaround in the housing market would restrain consumer spending to some extent. But as explained in the August *Inflation Report*, the weaker association between house prices and consumption in the past few years had led the Committee to judge that the relationship might also be less strong in the future as house price inflation slowed.

21 Of the other components of domestic demand, growth in business investment had been estimated at 0.5% in Q2. But this was a volatile series. The Committee continued to expect robust growth in business investment as indicators of investment intentions suggested. Bank borrowing by private non-financial corporations had risen sharply in July, possibly linked to financing of investment plans. The twelve-month growth rate of M4, at 8.8%, was the highest since 2001. If sustained, this might be consistent with continued strong growth of nominal GDP.

The labour market, costs and prices

22 The news from the labour market over the past month had been on the weak side. Although still tight, it was unclear that the market was tightening further.

23 Employment had fallen in Q2, with the employment rate falling 0.2 percentage points, back to its level in 2003 Q2. The counterpart had been mainly a rise in inactivity, but unemployment had also increased. It was possible that these fluctuations reflected sampling error, with the pickup in the employment rate in Q1 being erratically strong and the underlying picture one of more stable employment over the recent past. Employment surveys continued to point to growth in the demand for labour. But the Bank's Agents had reported that growth in demand for workers in the private sector had eased slightly.

24 It was puzzling that pay pressures had so far remained subdued given continued robust output growth and the apparently tight labour market. Whole economy wage settlements had been unchanged at 3.3% in July; annual growth in regular pay and overall earnings growth had been flat in June. Three-month on three-month growth in regular pay, a measure of current pay pressures, had fallen in June to an annualised rate of 4.1%, which was lower than the increase over the same three months a year earlier.

25 CPI inflation had fallen to 1.4% in July from 1.6% in June, as the contribution from higher petrol prices had moderated and the 'base effect' from falls in petrol prices in June 2003 had dropped away. In line with the pre-release arrangements, an advance estimate of CPI inflation in August had been provided to the Governor 3½ working days ahead of publication, and this had suggested a further fall in the rate to 1.3%, which was in line with the Committee's expectations.

26 Inflationary pressures continued to be felt along the supply chain, as rising demand for goods and services put pressure on firms' capacity to produce them. Producer output prices had been rising and manufacturers appeared to have widened margins. Surveys in August had indicated a larger balance of respondents in services and manufacturing expecting to increase output prices than in any period since 2000 and 1997 respectively. But these pressures had not fed through into consumer prices yet. Partly this might have reflected a squeeze on distributors' margins, but it was not clear whether this would persist or go further or whether it might to some extent prove to have been a cyclical phenomenon that would reverse.

The immediate policy decision

27 There had been quite a lot of news on the month. The picture of a broadly based world recovery and a robust UK GDP growth outlook drawn in the August *Inflation Report* remained intact. But it seemed that the pace of UK growth in Q3 might be a little slower than had been envisaged, although it was too soon to judge with any certainty at this stage. The recent labour market data had also been surprisingly weak, though inflationary pressures were still evident in the supply chain. Some downside risks had perhaps increased. First, future US economic growth might be weaker if consumption growth picked up less briskly from the second quarter. Second, the further signs that the UK housing market was cooling might mean a greater risk of a more abrupt correction to house price inflation and the Committee may have underestimated the potential for an associated downward impact on consumption. Sterling had depreciated over the month. If that persisted, it would be likely to add to inflationary pressures, which would tend to offset the slightly weaker news about economic activity.

28 The Committee considered the arguments for keeping the repo rate unchanged at 4.75%, to which different members gave different weights. The August *Inflation Report* central projection, based on the market yield curve, had been for CPI inflation to remain below the target for the immediate future, picking up steadily to meet the target around the two-year point. The 25 basis points increase in the repo rate in August reflected a movement at least as fast as that implied by the market rate curve on which the August projections had been based and the news about economic activity was, on balance, slightly weaker on the month. Medium-term inflation expectations appeared to remain well anchored to the target. So there was no case for a further rise in rates at this meeting.

29 Some members also considered arguments for raising the repo rate by 25 basis points. The economy was, most probably, set to continue to grow at or above trend, and so to put gathering pressures on supply with little or no remaining spare capacity. Inflationary pressures would have been increased by a lower exchange rate and a shift down in the money market yield curve. If the lower level of market yields persisted, this might rekindle unwelcome strength in the household sector. Taken as a whole, the Committee did not find these arguments sufficient to justify a rise in the repo rate.

30 The Governor invited members to vote on the proposition that the repo rate should be maintained at 4.75%. 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

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 September 2004, in advance of its meeting on 8-9 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 Financial markets

A2 Short-term interest rates in the United Kingdom and the United States had fallen since the Committee's previous meeting, but had changed little in the euro area. Internationally, the most significant falls in short-term interest rates had followed the weaker-than-expected July US non-farm payrolls report on 6 August. In the United Kingdom, short-term interest rates had also fallen following the MPC decision on 5 August, the release of the MPC *Minutes* on 18 August and on weaker-than-expected housing market data. Economists polled by Reuters had not expected the MPC to raise rates at the September meeting, consistent with anecdote from the Bank's market contacts. On the month, the average of economists' expectations for policy rates at the end of this year had edged down, by 5 basis points to 4.98%. Market expectations of future three-month interest rates, implied by short sterling futures contracts, for December 2004 and December 2005 had also fallen, by 18 basis points to 5.09% and 31 basis points to 5.25% respectively.

A3 Overall, ten-year forward nominal government bond yields had remained broadly unchanged in the euro area and the United Kingdom, while they had fallen in the United States. International nominal forward rates had initially fallen following the weaker-than-expected July US non-farm payrolls report. Rates had decreased further in the United States following other US data releases. In the United Kingdom, the largest changes in nominal gilt yields had been at the shorter end of the curve, with forward rates at two to four-year horizons falling by 13 to 22 basis points. These moves seemed to have been accounted for mostly by falls in real interest rates. UK inflation expectations, both survey-based and as implied by comparison of nominal and index-linked gilt yields, had been broadly unchanged since the Committee's previous meeting, remaining close to levels consistent with the 2% CPI inflation target.

A4 The sterling effective exchange rate index (ERI) had fallen by 2.9%, to 103.3, since the Committee's previous meeting. It had remained within the range in which it had traded since February this year, although it had approached the lower edge of this range. Sterling had depreciated by 2.3%, 2.8% and 4.0% against the dollar, the euro and the yen respectively. Market commentary had related the depreciation of sterling to lower expectations of future UK monetary tightening and the release of weaker-than-expected housing market data. According to market contacts, a concentrated unwinding of long speculative positions in sterling (notably against the dollar) and establishment of short speculative positions in sterling versus the euro had possibly contributed further to the weakening of sterling. Despite the depreciation, sterling uncertainty, as measured by implied volatility from option prices, had changed little, remaining at relatively low levels. Since the Committee's previous meeting, the dollar ERI had fallen by 1.0%. The dollar had fallen by 0.6% against the euro and by 1.8% against the yen. It had depreciated in the first part of the period, following weaker-than-expected economic data, most notably the July non-farm payrolls report, and concerns about the effect of high oil prices on the US recovery. In the latter part of the period, the dollar had risen, following the decline in oil prices and the release of the August non-farm payrolls report. However, the rise in the dollar had been reversed after FOMC Chairman Greenspan's testimony before the House Budget Committee on 8 September.

A5 The major international equity indices had risen over the month. In local-currency terms, the FTSE All-Share had increased by 3.6%, the S&P 500 by 1.6%, the Dow Jones Euro Stoxx 300 by 2.4% and the Topix by 2.6%. Uncertainty about the future level of the FTSE 100, as measured by three and twelve-month implied volatilities from options, had fallen over the period. Sterling, dollar and euro-denominated investment-grade option-adjusted spreads had narrowed.

II The international environment

A6 According to the preliminary estimate, US GDP had risen by 0.7% on the quarter in 2004 Q2, revised down from the advance estimate of 0.8%. Within this total, the estimate for private consumption growth had been revised up to 0.4%, from 0.3% in the advance estimate. Private fixed investment growth had also been revised up, to 3.1%, from 2.7% in the advance estimate. Government spending growth had been unrevised in the preliminary estimate, at 0.6%. Stocks had contributed 0.2 percentage points to quarterly GDP growth, revised up from the advance estimate of 0.1 percentage points. The net trade contribution to GDP growth in 2004 Q2 had been revised down, to –0.3 percentage points, from zero in the advance estimate. Non-farm business sector labour productivity had risen by 0.6% in 2004 Q2, following a rise of 0.9% in Q1. Unit labour costs had risen by 0.4% in 2004 Q2, following a fall of 0.4% in Q1.

A7 US industrial production had risen by 0.4% in July compared with the previous month, following a fall of 0.5% in June. New orders for non-defence capital goods had risen by 9.2% in July compared with the previous month. The Institute for Supply Management (ISM) manufacturing index had fallen to 59.0 in August, from 62.0 in July. The ISM non-manufacturing index had fallen to 58.2 in August, from 64.8 in July.

A8 US non-farm payrolls had increased by 144,000 on the month in August, following a rise of 73,000 in July, which had been revised upwards from 32,000. Real consumption had increased by 0.8% in July, following a fall of 0.4% in June. Real personal disposable income had increased by 0.1%, having been unchanged in June. The saving rate had fallen to 0.6% in July, from 1.3% in June.

A9 Nominal US retail sales had risen by 0.7% on the month in July, following a fall of 0.5% in June. The Conference Board measure of consumer confidence had fallen to 98.2 in August, from 105.7 in July, reflecting falls in both the present situation index and the expectations index. The University of Michigan headline index of consumer confidence had fallen to 95.9 in August (revised up from 94.0 in the preliminary release), from 96.7 in July.

A10 US producer prices for finished goods had increased by 4.0% in the year to July. Annual headline consumer price inflation had been 3.0% in July, compared with 3.3% in June. Annual core consumer price inflation (which excludes food and energy prices) had been 1.8% in July, compared with 1.9% in June. The core measure of the private consumption expenditures deflator had risen by 1.5% in Q2 compared with a year earlier.

A11 According to the first release, euro-area GDP had increased by 0.5% on the quarter in 2004 Q2, following an increase of 0.6% on the quarter in Q1. Within this total, private consumption had increased by 0.3%, investment had increased by 0.1% and government consumption had increased by 0.6%. Net trade had contributed 0.4 percentage points to growth in 2004 Q2, while inventories had subtracted 0.1 percentage points.

A12 German GDP had increased by 0.5% on the quarter in 2004 Q2, following growth of 0.4% in Q1. Within total German GDP, private consumption had increased by 0.1% in 2004 Q2, having been unchanged in Q1. Investment had fallen by 1.0% in 2004 Q2, having fallen by 2.8% in Q1. Government consumption had risen by 0.3%, having fallen by 0.3% in Q1. Net trade had contributed 0.5 percentage points to growth in 2004 Q2, while inventories had made a zero contribution. French GDP had increased by 0.8% on the quarter in 2004 Q2, following an increase of 0.8% in Q1. Private consumption had increased by 0.7%; total investment had increased by 1.8%; and government consumption had risen by 0.9%. Net trade had subtracted 0.8 percentage points from quarterly GDP growth, while inventories had contributed 0.6 percentage points. Italian GDP had risen 0.3%; Spanish GDP had risen 0.5%; Belgian GDP had risen 0.8%; and Dutch GDP had fallen 0.2% in 2004 Q2.

A13 According to Eurostat, euro-area industrial production had fallen by 0.4% in June, having increased by 0.6% in May. Industrial production in Germany had fallen by 2.0% in June, having increased by 1.0% in May. French industrial production had increased by 0.2% in June, following an increase of 0.4% in May. Italian industrial production had fallen by 0.7% in June, following a fall of 0.3% in May. The purchasing managers' index for the manufacturing sector in the euro area had fallen to 53.9 in August, from 54.7 in July, and the index for the service sector had fallen to 54.5 in August, from 55.3 in July. The German IFO index had fallen to 95.3 in August, from 95.6 in July.

A14 The euro-area unemployment rate had been 9.0% in July, unchanged from June. The German unemployment rate had been unchanged in August, at 10.6%. According to Eurostat, the volume of retail sales in the euro area had increased by 0.4% on the month in July, following an upwardly revised increase of 2.1% in June.

A15 Annual inflation in the euro area, as measured by the harmonised index of consumer prices (HICP), had fallen to 2.3% in July, from 2.4% in June. Annual core inflation (excluding energy, food, alcohol and tobacco prices) had fallen to 1.8% in July, from 1.9% in June. According to the Eurostat flash estimate, euro-area annual HICP inflation had been unchanged at 2.3% in August. Annual producer price inflation (excluding construction) had increased to 2.8% in July, from 2.4% in June.

A16 According to the first estimate, Japanese real GDP had risen by 0.4% in 2004 Q2, compared with a 1.6% increase in Q1. Within the total, private consumption had increased by 0.6%, business investment had been unchanged and government consumption had risen by 0.4%. Net trade had contributed 0.3 percentage points to quarterly growth, and domestic demand had contributed 0.1 percentage points.

A17 Industrial production in Japan had been unchanged in July, following a fall of 1.3% in June. The workers household survey had reported a 2.9% rise in real spending in the year to July, compared with a fall of 1.3% in the year to June. Annual growth in export volumes had been 11.8% in July, down from 17.9% in June. Annual growth in import volumes had slowed to 3.7% in July, from 10.0% in June. The all-activity index had increased by 0.6% on the month in June, having fallen by 0.8% in May.

A18 Since the Committee's previous meeting, the spot price of Brent crude oil had fallen by $1.49 to $40.64 per barrel. *The Economist* dollar non-oil commodity price index had risen by 0.4% over the same period.

III Money and credit

A19 The annual growth rate of notes and coin (adjusted for special factors) had fallen to 5.3% in August, from 5.9% in July. Annual growth of M4 had risen to 8.8% in July, from 7.7% in June. Annual growth of M4 lending (excluding the effects of securitisations) had risen to 12.7% in July, from 12.2% in June. Excluding other financial corporations (OFCs), the annual growth rate of M4 had risen to 9.3% in July, from 9.1% in June, whereas the annual growth rate of M4 lending (excluding the effects of securitisations) had risen by 0.4 percentage points, to 12.2%.

A20 The annual growth rate of households' holdings of M4 had risen to 8.6% in July, from 8.4% in June, whereas annual growth of M4 lending to households (excluding the effects of securitisations) had fallen to 13.9%, from 14.0%. Within total net lending to individuals – a measure that includes lending by a broader set of institutions than the banks and building societies that account for M4 lending – annual growth of secured lending had fallen to 15.1% in July, from 15.3% in June, and annual growth of unsecured lending had fallen to 11.8% in July, from 11.9% in June. The annual growth rate of credit card borrowing had risen to 16.2% in July, from 15.9% in June, and the annual growth rate of other unsecured borrowing had fallen to 9.9%, from 10.1%.

A21 The average standard variable rate on mortgages quoted for existing customers had risen by 1 basis point in August, to 6.33%, and the average two-year fixed rate on mortgages had fallen by 5 basis points, to 5.48%. Announcements by mortgage lenders since the August repo rate rise had suggested that this rise would be passed through nearly fully to mortgage borrowers on variable-rate mortgages. According to the latest data from the Council of Mortgage Lenders, the share of new mortgages (by volume) that had fixed rates had risen to 38% in July, from 34% in June.

A22 The average instant-access deposit rate had risen by 1 basis point in August, to 1.02%. The average quoted interest rate on credit card borrowing had risen by 16 basis points. Interest rates on personal loans and overdrafts quoted by banks and building societies had changed little in August. The average quoted rate for a personal loan of £10,000 had fallen by 97 basis points between the end of October 2003 and the end of August 2004, to 7.43%. This fall had continued a trend of narrower spreads over the Bank repo rate on unsecured debt.

A23 The number of loan approvals for house purchase had fallen to 97,000 in July, from 112,000 in June. The number of loan approvals for purposes other than house purchase or remortgaging had also fallen, to 94,000 in July, from 97,000 in June. Unsold stocks of properties, measured by the Royal Institution of Chartered Surveyors, had risen to 60 per surveyor in July, from 58 in June, whereas the number of sales per surveyor had fallen to 28 in July, from 29.

A24 The annual growth rate of M4 deposits held by private non-financial corporations (PNFCs) had risen to 12.3% in July, from 12.0% in June. The annual growth rate of M4 lending to PNFCs (excluding the effects of securitisations) had risen to 6.9% in July, from 5.2% in June. Total external finance, a broader measure of PNFCs' funding, had been £5.0 billion in July, compared with £1.8 billion in June.

IV Demand and output

A25 Estimated quarterly growth of GDP at constant market prices had been unrevised in the 2004 Q2 Output, Income and Expenditure release, at 0.9%.

A26 On the output side of the accounts, estimated quarterly service sector output growth had also been unrevised at 0.9% in 2004 Q2. Within the service sector, output of the business services and finance sector had risen by 0.9%, output of the distribution, hotels and catering sector had risen by 1.1%, and output of the transport, storage and communications sector had risen by 0.8%.

A27 Estimated quarterly production sector output growth had been unrevised, at 0.9% in 2004 Q2. Within that, manufacturing output had also been estimated to have risen by 0.9% on the quarter, but this had subsequently been revised up to 1.2% in the July Index of Production release. Construction output had also been estimated to have risen by 0.9% in Q2.

A28 On the expenditure side of the accounts, real household consumption (including that of non-profit institutions serving households) had been estimated to have increased by 1.1% in 2004 Q2. Real government consumption had risen by 1.0% and whole-economy investment had risen by 1.4%. Within whole-economy investment, business investment had risen by 0.5% on the quarter, with a fall in private services investment offset by increases in manufacturing and ‘other’ investment.

A29 Final domestic demand had risen by 1.1% in 2004 Q2. The change in inventories (including the statistical alignment adjustment) had contributed –0.2 percentage points to quarterly GDP growth in Q2, so that domestic demand had risen by 0.9% on the quarter.

A30 Total exports had risen by 2.2%, while imports had risen by 1.9% in 2004 Q2. Overall, the contribution of net trade to quarterly GDP growth had been zero. Adjusting for the effects of missing trader intra-community (MTIC) VAT fraud, export and import growth had been estimated at 2.4% and 2.2% respectively.

A31 Turning to indicators of expenditure in 2004 Q3, retail sales had fallen by 0.4% on the month in July. The Confederation of British Industry (CBI) *Distributive Trades Survey* retailers’ sales balance had pointed to a fall in annual retail sales volumes growth in August: the balance had fallen to +2, from +24 in July.

A32 The Nationwide house price index had risen by 0.1% in August, while the Halifax house price index had decreased by 0.6%. This had reduced the three-month on three-month house price inflation rates to 4.1% and 3.9% respectively, the third consecutive month of falls in both these inflation rates.

A33 Turning to indicators of output in 2004 Q3, the Index of Production release had indicated that manufacturing output had fallen by 0.2% in July, having fallen by 0.6% in June. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey output index had fallen to 53.5 in August. The new orders index had also fallen to 53.5 in August. The August *CBI Monthly Trends Enquiry* total orders balance had picked up to +2 in August, from –7 in July. The expected output balance had risen to +19 in August, from +6 in July. The CIPS services survey business activity index had increased slightly, to 56.9 in August. The index of new orders had fallen slightly, to 56.2.

V The labour market

A34 According to the Labour Force Survey (LFS), employment had decreased by 53,000 in Q2 compared with Q1. The quarterly changes in employment had been volatile in recent quarters. The 16+ employment rate had decreased by 0.2 percentage points in Q2, to 59.9%, but had been flat compared with the same quarter a year earlier. Total hours worked had decreased by 0.4% in Q2, and had been unchanged on a year earlier. Average hours worked had decreased by 0.2% in Q2 and by 0.6% compared with the same quarter a year earlier.

A35 The overall CIPS employment survey for August had continued to suggest employment growth. All three sector indices (construction, manufacturing and services) had remained above the 'no change' level of 50, but the index for manufacturing had eased slightly. The average level of vacancies in the three months to July had increased by 12.7% compared with the same period a year earlier. According to the August Recruitment and Employment Confederation (REC) survey, the demand for agency staff had continued to increase, while availability of agency staff had continued to fall.

A36 LFS unemployment had risen by 27,000 in Q2, and had been 33,000 lower than a year earlier. The LFS unemployment rate had increased by 0.1 percentage points, to 4.8% in Q2, and had fallen by 0.1 percentage points compared with the same quarter a year earlier. The claimant count unemployment rate had been unchanged, at 2.7%, in July. The level of 16+ inactivity had increased by 96,000 in Q2. The 16+ inactivity rate had risen by 0.1 percentage points, to 37.0% in Q2, compared with both the previous non-overlapping quarter and the same period a year earlier.

A37 According to settlements information available to the Bank, the mean whole-economy twelve-month average earnings index (AEI)-weighted settlement had been 3.3% in the year to July, unchanged on the equivalent figure for June. The twelve-month mean settlement in the private sector (AEI-weighted) had been 3.3%, down 0.1 percentage points on the year to June; that in the public sector (sample-weighted) had been 3.0%, unchanged on the year to June.

A38 Overall annual whole-economy earnings growth had been 4.4% in Q2, unchanged on the three months to May. Private sector pay growth had decreased by 0.1 percentage points, to 4.3%, within which private sector services pay growth had decreased by 0.3 percentage points, to 4.0%. Public sector pay growth had been 4.4% in Q2, and had risen by 0.1 percentage points on the three months to May. Whole-economy earnings growth in the year to June had increased by 0.1 percentage points, to 4.3%. Annual earnings growth, excluding bonuses, had been 4.2% in Q2, unchanged on the three months to May. The comparable public sector growth rate had increased by 0.1 percentage points, to 4.5%, whereas the comparable private sector growth rate had fallen by 0.1 percentage points, to 4.1%. Shorter-run measures of earnings growth, excluding bonuses, had fallen slightly below the twelve-month rates.

VI Prices

A39 Since the Committee's previous meeting, sterling oil prices had fallen by around 1%.

A40 Manufacturing input prices had risen by 0.6% in July. This meant that the annual inflation rate had fallen to 3.0%, from 3.5% in June. The CIPS *Report on Manufacturing* had pointed to continued rises in input prices in August, although the input price balance had fallen to 64.7 in August, from 65.2 in July.

A41 Manufacturing output prices excluding duties (PPIY) had risen by 0.2% in July. But owing to base effects, the annual inflation rate had fallen to 2.5%, from 2.7% in June. Survey data had pointed to further rises in output prices in the future: the balance on expected output prices from the *CBI Monthly Trends Enquiry* had risen to +11 in August, from +6 in July.

A42 According to the ONS's experimental corporate services price index (CSPI), corporate services prices had risen by 1.1% in Q2. This meant that the annual inflation rate had been 2.4% in 2004 Q2, unchanged from Q1. The CIPS *Report on Services* had pointed to rising output prices in August: the balance of average prices charged had risen to 55.1, from 53.4 in July.

A43 According to the ONS's Output, Income and Expenditure release, the annual inflation rate of the GDP deflator at market prices had fallen to 2.2% in 2004 Q2, from 2.4% in Q1. Within this, the annual rate of inflation of the household consumption deflator had fallen to 1.5% in 2004 Q2, from 1.8% in Q1. The annual inflation rate of the government consumption deflator had fallen to 2.3% in 2004 Q2, from 2.5% in Q1. The annual inflation rates of the imports and exports deflators had been –0.7% and –0.9% respectively in 2004 Q2.

A44 Annual CPI inflation had fallen to 1.4% in July, from 1.6% in June. Within this, annual goods price inflation had fallen by 0.3 percentage points, to –0.3%, while annual services price inflation had risen by 0.1 percentage points, to 3.4% in July. Annual RPI inflation had been 3.0% in July, unchanged from June, whereas annual RPIX inflation had fallen by 0.1 percentage points, to 2.2% in July.

VII Reports by the Bank's Agents

A45 The Bank's regional Agents reported that there was further evidence that annual growth in retail sales had continued to ease in the past month. New car sales had remained weak and contacts had expected sales in September to be at best unchanged on a year earlier. And there had been signs of slower growth in spending on consumer services. Underlying trends in consumer spending had been difficult to discern, because of earlier-than-usual summer sales and because the recent wet weather had affected spending patterns. Even so, with many retailers having to discount by more than usual to attract consumers, it appeared that consumer sentiment had weakened.

A46 Evidence from contacts suggested that employment had continued to increase but that its growth rate had slowed, with many employers expressing caution regarding the short-term outlook for activity and profits. For some of those contacts, labour costs had been reduced either by relocating work overseas or investing in labour-saving technology. Export orders and sales had continued to grow. But, according to contacts, the depreciation of the US dollar in 2002 and 2003 had reduced price competitiveness and profit margins, particularly in those markets where demand growth had been strongest recently, notably Asia, the Middle East and the United States.