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MINUTES OF MONTHLY MONETARY MEETING: 5 JUNE 1996

These are the minutes of the meeting held on 5 June 1996 between the Chancellor of the Exchequer and the Governor of the Bank of England to review monetary developments.

The next set of minutes, for the meeting held on 3 July 1996, will be published on Wednesday 14 August 1996 at 9.30 am.

Provisional dates for the next two Monetary Meetings are 30 July and 4 September 1996.

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Public Enquiry Unit
HM Treasury
Room 110/2
Treasury Chambers
Parliament Street
London SW1P 3AG

Tel: 0171 270 4558

MONTHLY MONETARY MEETING: 5 JUNE 1996

The Chancellor of the Exchequer and the Governor of the Bank of England met, together with officials, on 5 June 1996, to review monetary developments.

Monetary and Economic Developments

2. Latest monetary and economic data (reviewed by officials before the meeting) again indicated that cost and price pressures had eased, with activity growth remaining below trend.

Inflation Indicators

3. Underlying inflation (RPI excluding mortgage interest payments - RPIX) was unchanged in April, at 2.9 per cent. All-items RPI inflation fell by 0.3 percentage points, to 2.4 per cent, as recent mortgage rate cuts took effect.

4. Other price and cost indicators confirmed that inflationary pressures remained subdued:

- sterling non-oil commodity prices rose by 2.4 per cent in May, but remained below their peak in early 1995. However, oil prices had fallen to $18.65 per barrel;

- sterling's effective exchange rate index rose by 2 per cent over the period since the last meeting, to stand at 86.5[1];

- total non-oil import prices rose by 0.3 per cent in the three months to March compared to the previous three months; and non-EC import prices rose by 0.4 per cent in the three months to April, with the annual rate falling from 4.3 per cent to 3.1 per cent;

[1] As of close 04/06/96.

- producer input prices for manufacturing (excluding food, beverage, tobacco and petroleum industries) rose by 0.3 per cent in April; but the 12-month inflation rate fell to -0.3 per cent, down from 0.5 per cent in March. The CIPS input price index rose in May, but remained well below the 'neutral' level;

- producer output prices for manufacturing (excluding FBTP) rose by 0.1 per cent in April; and the annual inflation rate was 2.8 per cent, down from 3.4 per cent in March;

- the CBI price expectations balance fell sharply between April and May;

- the annual growth rate of underlying average earnings was unchanged in March, at 3¾ per cent;

- IRS median pay settlements fell from 3½ per cent to 3 per cent between March and April.

Monetary and Financial Indicators

5. Growth in notes and coin was unchanged at 0.4 per cent in May, but the annual growth rate fell slightly, to 6.1 per cent, down from 6.3 per cent in April.

6. M4 grew by 0.6 per cent in April, down from 1.0 per cent in March. However, the 12-month growth rate rose slightly, to 10.0 per cent, up from 9.9 per cent in March (although the growth rate was boosted by the introduction of the gilt repo market). Growth in M4 lending was unchanged in April, at 0.6 per cent.

7. The Halifax house price index rose 1.0 per cent in May. The index had risen for 10 successive months, and was now 4.6 per cent up on a year earlier. In contrast, the Nationwide

index fell 0.2 per cent in May, leaving the index 1.4 per cent up on a year earlier. However, housing market transactions remained more subdued; particulars delivered (which lag actual transactions) in the three months to April were 0.4 per cent down on the previous three months, and 9.0 per cent lower than a year earlier.

8. Short-term interest rates had risen slightly (by around 5 basis points) in both the US and Germany since the last meeting, but had fallen by around 10 basis points in Japan. UK short-term interest rates remained around 6 per cent. Forward interest rates implicit in short-sterling futures contracts rose slightly at the short end, but had fallen by around 25 basis points at the long end.

9. Long rates in both the US and Germany had fallen slightly (by around 4 basis points and 7 basis points respectively). Long rates in Japan had also fallen, by around 28 basis points. In the UK, yields on conventional gilts had fallen by around 20 basis points at all maturities; the differential between 10-year gilts and bunds had fallen by around 15 basis points, and the differential between gilts and US government bonds had fallen by around 18 basis points.

10. Since the May meeting inflation expectations implied by the gilt yield curve (calculated by the Bank from the difference between the yields on conventional and index-linked bonds) had fallen by around 8 basis points and 14 basis points for 5 years ahead and 10 years ahead respectively.[2]

Activity Indicators

11. Overseas data suggested that activity in Germany in particular remained weak. However, US data were stronger, and there were further signs of recovery in Japan:

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[2] Measured as the average over the five working days before each meeting. These estimates are likely to overstate inflation expectations because inflation risk premia are lower for index-linked gilts than for conventionals. However changes in them should provide a guide to changes in expectations.

- in Germany industrial production rose by 0.9 per cent in March, following a fall of 2.8 per cent in February. However, GDP was provisionally estimated to have fallen in the first quarter of 1996 by 0.4 per cent;

- in the US industrial production rose by 0.9 per cent in April, following a fall of 0.5 per cent in March. GDP was provisionally estimated to have grown in 1996 Q1 by 0.6 per cent;

- in Japan industrial production grew by 3.9 per cent in April, following a fall of 6.0 per cent in March.

12. There were no revisions to the preliminary estimate of UK GDP. Other activity data were also consistent with growth overall continuing below trend:

- manufacturing output rose by 0.2 per cent in March. In the three months to March it was 0.5 per cent higher than a year earlier;

- total industrial production rose by 0.3 per cent in March, and in the latest three months was up 1.0 per cent on a year earlier;

- claimant unemployment fell by 3,200 in April, although the unemployment rate was unchanged at 7.8 per cent. Unfilled vacancies at Jobcentres rose by 1,400;

- retail sales rose by 0.2 per cent in April. In the three months to April, sales were 2.2 per cent higher than in the same period a year earlier;

- survey indicators in the retail sector were also strong: consumer confidence rose slightly, and in the April CBI Distributive Trades Survey the balance of retailers expecting higher sales remained at a high level by historical standards.

Summary of discussion

13. The Governor said that the Bank's assessment of the economic situation and prospect had not much changed over the past 2-3 months. Inflation currently remained subdued. Overall activity had probably been growing a bit below trend, held down by slow growth in manufacturing; and there remained a more serious downside risk to manufacturing output (from destocking and exports to Europe), though that risk had not yet materialised. Were that risk to materialise it could affect the outlook for inflation. But as it was, monetary growth and other forward-looking indicators pointed to developing strength of consumer demand, and to some recovery in investment and exports, which suggested that on a two-year view the risks to the inflation target were probably on the upside.

14. Apart from oil (perhaps temporarily), and some food prices (meat and cereals - though cereal prices had fallen back again in the last week), producer prices had not changed much in the past 3 months: ex FBTP, input prices had actually fallen (by 1.4 per cent at an annual rate) and output prices had risen only modestly (by 1.3 per cent). Also there was no clear evidence of increasing pressures in the labour market. Wage settlements on the Bank's 3-month employment-weighted measure rose marginally to an average 3.5 per cent in April (from 3.4 per cent in March), although average underlying earnings growth (which had been steady at 3¼ per cent in the second half of 1995) had picked up to 3¾ per cent in February and March, and to 4¼ per cent in the private sector, as a result of higher bonuses, perhaps associated with the spread of profit-related pay.

15. Retail price inflation had edged down - from 2.9 per cent to 2.8 per cent (adjusted for the ONS' error last year) in the year to April on RPIX, and to 2.4 per cent (adjusted) on the headline figure. The Bank continued to expect it to edge further downwards in the near term.

16. Turning to activity, the Governor noted that GDP as a whole (and excluding oil) had grown by 0.4 per cent in Q1. Services output rose by 0.6 per cent and industrial production by 0.2 per cent (despite a similar fall on the quarter in manufacturing output), but construction was weak (falling by 0.9 per cent). On the demand side, net exports had a negative effect (-0.2 per cent of GDP). So, too, did stock building (-0.1 per cent of GDP) although stocks actually increased by more than had been expected. Much of this increase was by retailers and wholesalers and there was some evidence in the CBI distribution survey that some of it at least might have been voluntary - in anticipation of further growth in consumption. But there appeared also to have been a rise in manufacturers' stocks of finished goods - with the May CBI industrial trends survey showing the highest balance of firms with more than adequate stocks since 1991. The CIPS survey, too, implied that manufacturers' stocks were quite high.

17. The short-term downside risks to activity from the weakness of demand in Continental Europe and from the stock overhang had been recognised for some time. They had so far turned out to be no worse than expected - in fact the stock adjustment had been relatively modest and manufacturing output had in fact grown modestly in each of the past 3 months. But the risk clearly remained, and both the CBI and CIPS surveys were generally fairly gloomy on orders.

18. On the other hand, the Governor said, there was accumulating evidence of strengthening consumer demand - in the 0.8 per cent consumption increase in Q1, in the pick-up in retail sales volume growth since last autumn (a rise of 0.6 per cent in the latest 3 months to April), in the surveys of both retailers' expectations and consumer confidence, in the strong growth of consumer credit, and in the continuing recovery in house prices for example. And there was some evidence too - in the housing starts and construction orders data - that at least these elements of investment spending might improve. Underpinning the growth of domestic demand

might be a lesser fiscal tightening than was intended. The unexplained fall in effective tax rates (both VAT and taxes on income) had now been joined by an unexpectedly high contribution of real public expenditure growth in Q1.

19. And monetary growth remained strong - though no worse than before. Narrow money (notes and coin) continued to grow by about ½ per cent in April and May, the average monthly rate since the beginning of last year. Broad money (M4) actually slowed a little - increasing by 0.6 per cent in April compared with an average monthly rate of 0.8 per cent in 1995 (before the introduction of the gilt repo market). Individuals' deposits were particularly weak in April, after two strong months. But it would be wrong to put too much weight on one month's figures - the 12-month growth rate of M4 was still some 10 per cent, and of individuals' deposits some 6¾ per cent.

20. The Governor said that, pulling all this together in the Inflation Report three weeks ago, the Bank had recognised that there were short-term risks to activity. If those risks were realised that would affect the prospect for inflation - which would also be improved if the recent strengthening of the exchange rate was sustained. But the Bank did not expect activity to turn down even in the short term on a central view - though the Bank was not looking for an acceleration until into the second half of 1996 and 1997. Looking two years ahead the Bank thought it probable that interest rates would need to rise at some point to protect the inflation target. This essentially remained the Bank's view. It did not exclude the possibility of a need for a further reduction in interest rates if there was clear evidence of overall activity slowing significantly over the next few months. But there was not such evidence at this point - apart from the suggestions in the CBI and CIPS surveys for manufacturing.

21. If interest rates were held and the economy did weaken significantly, probably not much would be lost given that the weakness was likely to be associated with stock adjustment - which was temporary by its nature - or with exports, which the authorities could not do much about especially in the short term. If rates were reduced now, in order to try to guard against the risk to activity in the short term which then failed to materialise, then this would simply exacerbate

the potential inflation pressure further ahead by adding to domestic demand which already - on the evidence currently available - looked set to accelerate. The Bank's advice, therefore, as last month, was to leave interest rates unchanged for the time being - and that again was what financial markets expected.

22. The Chancellor recalled that at the last meeting the issue had been whether to leave rates unchanged or to reduce them. In his view, this was still the issue. The new information available since the last meeting had strengthened the case for a reduction in interest rates. Output growth was still quite subdued, especially in manufacturing. He expected output growth to be weaker in the first half of the year, strengthening in the second half, as consumer demand picked up. But as yet there was no evidence of a rapid pick-up.

23. GDP growth in 1996Q1 had remained at 0.4 per cent on the previous quarter and had not been revised up when the second estimates were published. The economy had now been growing at an annual rate of 2 per cent for a year. Manufacturing output had risen only slightly over the past 6 months, and had fallen marginally in 1996Q1. This relatively subdued picture in manufacturing was confirmed by the CBI and CIPS surveys. The CIPS survey in particular had revealed gloomy orders expectations - this survey had a short history, but a relatively good track record. Manufacturers were still building up stocks and there was a risk of a marked slowdown if there was a sudden reaction to slower than anticipated demand. Conventional wisdom was that the slowdown in manufacturing was due to depressed activity in Europe, but the recent trade figures had been good. It was likely that subdued output expectations were due not so much to a drop in demand in overseas markets, as to subdued demand at home.

24. The Chancellor said it was important not to overplay any weakness in domestic activity. Consumer demand was picking up, but the pick-up was not even across the country and it was not rapid. Retail sales in the three months to April were up 2.2 per cent on a year ago, and were up 0.7 per cent on the previous three months. The housing market figures remained difficult to interpret. The Halifax house price index had been picking up for ten months, probably reflecting

a shortage of properties especially at the top end of the market, although the Nationwide figure had fallen slightly in May. There was still very little sign of a strong increase in transactions.

25. The monetary data had been a cause of concern in recent months, but last month they had fallen back slightly. Notes and coins growth had stabilised at 0.4 per cent a month in the last 3 months. M4 was still growing at around 10 per cent a year, but this had been boosted somewhat in recent months by the gilt repo market.

26. The Chancellor said that the most important point was that the price data had remained very encouraging since the last meeting, with little sign of inflation pressures. Input price inflation had fallen to 1.0 per cent (ex FBTP) in the year to March, and output price inflation was also still falling. The signs in the labour market were mixed. Earnings growth had ticked up, but settlements remained very moderate. The exchange rate had strengthened by almost 3 per cent over the past month (probably because sterling had previously been undervalued). He had no exchange rate target, and the pound was still below its level at the start of 1995. Nevertheless, the strengthening in the exchange rate would improve the outlook for inflation, if it was sustained.

27. The Chancellor said that he was inclined to cut interest rates by ¼ per cent. The further evidence of a lack of cost pressures had improved the outlook for inflation; and he was content that a ¼ per cent cut was sufficiently small not to cause any significant inflationary risk, while reducing the downside risks to the recovery. If consumer demand started growing too strongly, and put the inflation target at risk, then rates could be raised when this became evident.

28. In discussion the following points were made:

- activity continued to vary across sectors. Manufacturing output remained weak, and the latest survey results had fallen back again. Construction output had also

fallen in the first quarter. But services activity (which accounted for around two-thirds of GDP) was strong - both in the data and in surveys;

- while growth was still expected to pick up in the second half of the year, firm data to confirm that would not be available for some months yet. On the first quarter's data GDP growth remained below trend. As always, the dilemma was whether to act on the basis of partial evidence of some weakening in the economy (which might damage credibility if it subsequently had to be reversed), or to wait for harder evidence (which risked acting too late);

- monetary growth rates (both narrow and broad) had edged down slightly in the last month. But they remained high, and were probably still consistent with demand picking up through this year and next;

- the exchange rate had appreciated in the last month. But it was uncertain whether the rise would be sustained, and the ERI was still below its level of early 1995. If it were sustained, the stronger pound would tend to reinforce other indicators of weakening cost pressures, and lower inflation;

- real short-term interest rates in the UK were currently higher than in the US, Germany and Japan; but they were below their average level in the 1980s. At unchanged nominal levels, real interest rates would tend to rise if inflation and inflation expectations came down as expected; and the effect would be likely to vary across sectors.

Conclusion

29. Summing up, the Chancellor said that the lack of inflationary pressures meant that he was confident interest rates could be reduced by a ¼ point, consistent with meeting the inflation target.

30. The Bank announced a ¼ per cent cut in interest rates at 9.45am the following day.

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