GOVERNANCE AND PUBLIC POLICY

Diploma stage examination

8 June 2006

From 2.00pm to 5.00pm
plus ten minutes reading time from 1.50pm to 2.00pm

Instructions to candidates

*Answer **four** questions in total.*
One** compulsory question from **Section A
One** compulsory question from **Section B
Two** out of the three questions from **Section C

The question in Section A carries, in total, 50 marks.
The question in Section B carries, in total, 20 marks.
The questions in Section C each carry a total of 15 marks.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

AT THE HEART OF
YOUR CAREER

PRE-SEEN MATERIAL

MINUTES OF MONETARY POLICY COMMITTEE MEETING 3 and 4 August 2005

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 August 2005.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2005/mpc0508.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 7 and 8 September will be published on 21 September 2005.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 AUGUST 2005

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed developments in financial markets; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 In the United Kingdom, short-term market interest rate expectations had changed little over the past month, with a 0.25 percentage point rate cut priced in for this month's decision, a strong expectation of a second rate cut later in the year and the possibility of a further reduction in early 2006. In the latest Reuters poll, 43 out of 47 economists had expected a 0.25 percentage point reduction in interest rates at the August meeting, and slightly under half of the sample expected at least one further reduction this year. Financial markets had priced in a somewhat larger reduction in official interest rates over the next year than expected by economists, although the difference appeared to have narrowed somewhat in recent days.

3 It was possible that the market expectation of more than one interest rate reduction was based on extrapolations of past Committee voting patterns. Furthermore, some commentary on the UK indicators seemed surprisingly gloomy and that may have affected market sentiment. It was important not to attach too much weight to the market's central expectation; option prices suggested that market participants attached weight to a range of possible outcomes. The implied probability of a fall in interest rates had increased following the release of the Committee's July minutes. Long-term forward interest rates were little changed on the month in either the United Kingdom or overseas. Credit spreads had fallen slightly.

4 The sterling effective exchange rate index (ERI) had depreciated by 1% over the month, and had fallen by more than 3% since the May *Inflation Report*. That was one of the largest changes in the exchange rate between *Inflation Reports* since the Committee's inception in 1997. The recent depreciation could be explained only partly by movements in relative interest rates. It was possible that it reflected further reaction to previous soft UK data releases and changing views about monetary policy. Much of the fall in sterling over the quarter occurred at the end of June and early July, coinciding with the release of the National Accounts for 2005 Q1 and the *Blue Book* revisions to historic data. But the pattern of depreciation did not fit particularly closely with any single piece of data – which made it hard to pinpoint the source of the change in view on sterling. It was also possible that some of the weaker UK data had been put into a sharper contrast by a backdrop of slightly stronger news about the global economy.

5 Equity prices had increased over the past month in the United Kingdom, the United States and the euro area. As with the exchange rate, the movements in equity prices between *Inflation Reports* had been substantial; in the United Kingdom, the FTSE All-Share index had risen around 8% since the May *Report*.

6 The Committee noted that movements in most asset prices following the terrorist attacks on the 7 and 21 July appeared to have been short-lived. However, since the counterfactual path for these prices was unknown, it was difficult to conclude with certainty that there had been no longer-term effects.

The international economy

7 Economic developments in the euro area had seemed slightly more encouraging and, looking ahead, pointed to a moderate recovery in growth. The second release of the euro area national accounts data for 2005 Q1 contained relatively little news, with GDP growth unchanged at 0.5%. Industrial confidence had picked up a little in the larger euro-area economies, and both the manufacturing and services purchasing managers' indices had risen a little in July. Employment was growing moderately, and bank lending to private non-financial companies had picked up. The depreciation of the euro against the dollar over recent months should help to boost net trade. So the climate in the corporate sector seemed to have improved recently – though industrial confidence still remained below its level at the end of 2004. The outlook for consumption growth, however, continued to look a little weak, given the data on retail sales and consumer confidence. Core producer price inflation had ticked down again, while headline consumer price inflation remained above 2%.

8 In the United States, GDP growth in 2005 Q2 had been in line with expectations. Final domestic demand and net trade had both been a little stronger than expected, offset by unexpectedly weak stockbuilding. Most indicators for consumption, investment, and the labour and housing markets suggested that prospects remained firm. Both core producer and consumer price inflation had eased in June. The Committee noted the upward revisions to the core personal consumption expenditure (PCE) deflator – the preferred inflation measure of the Federal Reserve.

9 The main news from Asia had been the move to a more flexible exchange rate regime in China. The initial 2% revaluation should have a negligible impact on the pattern of global production and trade, but did raise the possibility of further revaluations in the future. The annual rate of Chinese GDP growth remained strong and had shown no sign of slowing in 2005 Q2. There had been little news from Japan, on the month. UK trade-weighted Asian import growth had picked up in May and June.

10 The oil price had risen around 5% over the past month, and was just over 20% higher than its level at the time of the May *Inflation Report*. Looking over a longer time period, what continued to differentiate the recent rise in the spot oil price from some previous sharp movements was the parallel upward shift in oil futures prices; implying that market participants expected the rise in spot prices to persist for some time. Existing spare oil production capacity was historically low and new supply capacity – through, for example, development of new oil and gas fields and building of refineries – would take a considerable time to come on-stream in response to expectations of sustained higher prices. Continued robust expansion of world activity was unlikely to be consistent with a significant easing in the growth of oil demand. So there was a risk of a further rise in the oil price.

11 Overall, there were some mildly encouraging signs in the UK's primary export markets, consistent with continuing steady growth in world demand. Corroborative evidence of this view came from the rise in equity prices and from the Bank's regional Agents, whose contacts reported an improvement in export prospects.

Money, credit, demand and output

12 The preliminary estimate of UK GDP growth was 0.4% in 2005 Q2, a little weaker than expected. Official estimates of GDP growth had now been below trend for four consecutive quarters, although such early estimates were highly uncertain. The main factor underlying this weakness had been the below average growth rate of the service sector over this period.

13 The official estimates of service sector output continued to look somewhat weaker than the picture painted by the service sector surveys. The pattern of past revisions to the official data, coupled with the survey data, suggested that services sector output growth might eventually be revised upwards. But the survey-based estimates of output were subject to a significant margin of error, and it was possible that they were not providing an accurate reading at present. Surveys could fail to capture slowdowns that were particularly concentrated in a few sub-sectors, and survey balances might not capture the intensity of changes in business conditions. Some of the surveys, such as the CIPS services survey, excluded the distribution sector which had been a major contributor to weak output growth in recent quarters. The evidence from the labour market was also broadly consistent with growth somewhat below trend. Nevertheless, on balance it still seemed likely that recent ONS output data would eventually be revised up a little.

14 The June Index of Production release had been provided to the Committee ahead of publication. The June outturn, together with revisions to earlier months, suggested stronger-than-expected manufacturing output in Q2. On the basis of these numbers, it was possible that the ONS might subsequently revise up the preliminary GDP growth estimate in the next release.

15 The survey indicators in July had been mixed, but had not shown signs of a further slowing of GDP growth in Q3. The CIPS services index had risen a little, as had the output index of the CIPS manufacturing survey. However, there had been falls in the CIPS manufacturing new orders index, and the quarterly BCC survey balances looked a little weaker, particularly for the service sector Overall, the indicators had pointed to service sector growth in Q3 at around the same rate as in Q2, and flat manufacturing output.

16 Turning to consumption, retail sales had bounced back strongly in June. Anecdotal evidence from the Agents suggested that sales might have been boosted by protracted discounting, although the series itself was an erratic one. Retail sales

data, coupled with a modest recovery in private car registrations, had pointed to stronger consumption growth in Q2.

17 The latest indicators for household spending in Q3 were mixed. The *CBI Distributive Trades Survey* for July remained weak. In contrast, the GfK survey had risen slightly on the month, and had shown a pickup in confidence about making major purchases. The July terrorist attacks in central London had seemingly not had much effect on consumer confidence or the recorded number of people entering shops across the United Kingdom as a whole. But it was possible that some of the indicators and official data would be more volatile than normal over the summer. House prices and mortgage approvals had been broadly flat. Unsecured lending growth had continued to weaken, although it remained robust. The Bank's regional Agents had reported a somewhat slower growth rate of consumer services. Overall, the indicators did not yet provide a clear steer as to whether the stronger consumption growth now expected for Q2 would be maintained into the second half of the year, or whether the weakness over the first half of the year – taking Q1 and Q2 together – would continue.

18 Contacts of the Bank's regional Agents suggested that investment intentions had fallen in both manufacturing and services. That picture had been broadly corroborated by the latest business surveys. This softer outlook had been factored into the Committee's near-term projections for investment.

Costs and prices

19 There had not been much labour market news on the month, but the data still seemed consistent with a gentle labour market loosening since the turn of the year. That was, in turn, consistent with below trend output growth over the past few quarters.

20 Since the beginning of the year, total weekly hours and the employment rate had fallen while both measures of unemployment had risen a little. Business surveys generally also pointed to a slight softening of labour market conditions. The Agents had undertaken a survey this month which had suggested a further slight weakening in employment growth prospects.

21 Average earnings growth, as measured by the average earnings index (AEI), had eased a little since the start of the year, and contacts of the Bank's regional Agents had suggested a slight easing in total labour costs per employee. The Office for National Statistics' new experimental measure of annual growth in average weekly earnings (AWE) appeared to be easing, suggesting that the contrast between the rising AWE measure and weakening AEI measure of regular pay growth had weakened somewhat.

22 The news on prices in the supply chain had been mixed over the past month. On the one hand, private sector unit labour costs had continued to rise. But the annual rate of increase in unit labour costs had returned only to around the average of the past decade and, given the prospective weakness of the employment data relative to the output data in Q2, unit labour costs growth was quite likely to fall back. Manufacturing input price inflation had risen on the back of the latest rises in oil prices, and was at its highest rate since the current index began in 1986. On the other hand, manufacturing output price inflation had eased further, albeit from a relatively high level. The CIPS survey balances for both input and output price inflation had eased in the service sector. The fall in input and output price balances across a range of manufacturing and services surveys over recent months had been striking, leaving many close to their series averages.

23 CPI inflation was on target at 2.0% in June, a little higher than expected. Although there was continuing uncertainty about the reasons for the recent increases in CPI inflation, the oil price was likely to have played a sizable role through both direct and indirect channels, and looked set to do so for some time given the continued rise in oil prices. The pressure of demand on supply in early 2004 was also likely to have played a significant role in the rise in inflation towards the target.

The August GDP growth and inflation projections

24 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 10 August.

25 The Committee's central projection, based on its collective judgement and the assumption that official interest rates followed the declining path implied by the market yield curve, was for output growth to remain subdued in the near term, reflecting the continued sluggishness of domestic demand. Growth then picked up as the impetus from recent movements in asset prices worked through to consumption, investment and net trade. The profile was weaker in the near term than in the May *Report*, but stronger further out.

26 The central projection for CPI inflation, on the market-based assumption about the path of official interest rates, was for it to move above the 2% target in the near term and then to dip, as the impact of recent increases in oil prices moderated and pressures on capacity eased. Inflation was then projected to rise above the target once more, as output growth picked up and the contribution from import prices increased. The central projection was a little higher in the near term, and also somewhat higher in the final year of the projection, than in the May *Inflation Report.*

27 The Committee's best collective judgement was that the key risks to the central projection related to: the near-term momentum in consumer spending; the sources of the recent pickup in inflation; and the outlook for oil prices. While there was a range of views among members, the Committee's best collective judgement was that, relative to the central projection, the balance of risks for activity was slightly to the downside in the near term. The balance of risks to inflation was correspondingly slightly on the downside further out.

28 Under the alternative assumption of constant interest rates, output growth was slightly weaker, so the pickup in inflation towards the end of the projection was less marked. If interest rates were to remain unchanged at 4.5% that might be a significant surprise to financial markets which were pricing in a further reduction in interest rates. That could prompt larger movements in equity prices and the sterling exchange rate than had been assumed in the constant rate projection, constituting a downside risk to activity and inflation relative to the *Inflation Report* central projection.

The immediate policy decision

29 There had been relatively little news on the international economy over the past month. The prospect seemed to be one of continuing steady growth, with some mildly encouraging signs in the United Kingdom's primary export markets. ONS estimates of UK output growth had turned out weaker than expected in Q2. The latest indicators pointed to similar growth in Q3. But there remained uncertainty about the prospects for revisions to the data, especially in the service sector. On the expenditure side, the indicators pointed to some recovery in consumption growth in Q2, but there was uncertainty as to whether this would be maintained into the second half of the year.

30 Since the turn of the year, there seemed to have been a gentle labour market loosening, consistent with below trend output growth since the middle of last year. There was mixed news in the supply chain, with producer input prices continuing to rise sharply, but output price inflation easing. Oil prices had risen further both on the month and since the previous *Report*, and continued to be a major influence along the UK supply chain. CPI inflation was expected to rise above the target in the near term.

31 There had been relatively little news in financial markets over the past month, but there had been considerable news over the past quarter. In particular, the fall in market interest rates compared with the flat yield curve at the time of the May *Report* implied that the market expected the official interest rate to fall towards 4%. The effective exchange rate had fallen, while equity prices had risen. Taken together, these movements in asset prices had a material impact on the projections for output growth and inflation based on market interest rates.

32 The Committee's projections implied that inflation was likely to move significantly above target in the medium term if interest rates were to move in line with the market yield curve. The constant rate projection showed slightly lower activity and inflation in line with the target at the two year horizon.

33 For some members, a 0.25 percentage point reduction in official interest rates was necessary this month. In the first half of the year, output growth in the United Kingdom had been subdued. Household spending and business investment growth had slowed. Although there had been some signs of a pickup in consumer spending in Q2, downside risks remained in the near term given the loosening in the labour market and uncertainty about the underlying strength of consumer spending in the first half of the year. It seemed likely that the combined effect of high levels of household debt and the lagged impact of past interest rate increases had accounted for some of the unexpectedly sharp slowdown in consumer spending through 2004 and into the first quarter of 2005. It was possible that the uncertainty created by the ongoing adjustment in the housing market had also had some effect on spending. Higher oil prices might raise inflation further in the short term, but the slackening in the pressure of demand on supply capacity in the first half of the year should lead to some moderation in inflation looking further ahead. There was also a possibility that import prices might provide a smaller contribution to inflation than had been assumed in the central projection. And there had been a sharp fall in some of the price surveys, indicating less pressure along the supply chain than had been apparent a few months ago. Although the path of market interest rates should prove supportive of household spending, it was necessary to validate those expectations to some degree. A failure to reduce rates now might damage confidence. Early action would reduce the risk that greater changes in the policy rate would be needed at some point in the future, and would not preclude a rise in

rates in the future if the data warranted it. For these members, there was no presumption on the future direction of interest rates.

34 For other members, the evidence did not require a change in official interest rates this month. While the growth in aggregate output had slowed, and the labour market had eased a little, the economy was still operating close to full capacity. Looking ahead, activity was likely to be supported by fiscal policy and the continuing strength of the world economy. Some of the most recent domestic indicators had been a little stronger than expected. The services surveys were consistent with slightly stronger growth than in the official data, and the recent industrial production data had been stronger than expected. The money and credit data had not pointed to a marked further softening in activity; rather, they were consistent with a recovery in consumption and GDP growth in the second half of the year. The housing market appeared to be stable, with house prices broadly flat and activity indicators picking up a little. With oil prices likely to remain strong, producer input prices rising sharply, and an acceleration in unit labour costs since the turn of the year, it was too early to conclude that inflationary pressures had abated. Adding to the strength of the recovery would risk adding to inflationary pressures while costs were still working their way through the supply chain.

35 For these members, while it was possible to build a case for a precautionary reduction in interest rates, based on the near-term downside risk to consumption, there appeared to be little risk in waiting for further data. Given the difficulty in explaining a reversal of a decision soon after a turning point, should that prove necessary in the light of future data, it was advisable to accumulate a little more evidence than usual before changing interest rates. While a decision not to cut rates would be a significant surprise, the Committee's latest projections did not support the current market view that a sequence of interest rate cuts was likely to be needed to meet the inflation target in the medium term.

36 The Governor invited members to vote on the proposition that the repo rate should be reduced by 25 basis points to 4.5%. Five members of the Committee (Kate Barker, Charles Bean, Richard Lambert, Stephen Nickell and David Walton) voted in favour. Four members of the Committee (the Governor, Rachel Lomax, Sir Andrew Large and Paul Tucker) voted against, preferring to maintain the repo rate at 4.75%.

37 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
Richard Lambert
Stephen Nickell
Paul Tucker
David Walton
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 29 July, in advance of it's meeting on 3-4 August. 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 Since the Committee's July meeting, short-term sterling market interest rates implied by December 2005 futures contracts had risen by 11 basis points; dollar and euro implied rates for similarly dated contracts had risen by 18 and 10 basis points respectively. In the Reuters poll of economists published on 29 July 43 of 47 economists had expected the UK policy rate to be cut at the August MPC meeting. The mean expectation of economists for the Bank's repo rate at the end of 2005 had fallen to 4.39%, from 4.46% at the time of the July MPC meeting.

A3 Medium to long-term nominal forward rates had risen a little over the period. Ten-year rates had risen by 6, 11 and 7 basis points in the United Kingdom, the United States and the euro area respectively. In the United Kingdom, an increase in real rates had accounted for most of the increase in nominal forward rates, while implied inflation and/or inflation risk premia had accounted for most of the increase in the United States and the euro area beyond about seven years. Long-term inflation expectations in the United Kingdom, as proxied by breakeven inflation rates, had remained stable

A4 The sterling effective exchange rate (ERI) had fallen by 1.1% to 98.9 since the Committee's previous meeting. Sterling had depreciated by 1.9% against the euro, but had appreciated by 1.3% against the dollar and by 0.6% against the yen. The sterling ERI had fallen by 1% following the London bombings on 7 July and had fallen further following publication of the MPC minutes. Over the month, the US dollar ERI had fallen by 1.9%; the dollar had depreciated by 3.2% against the euro and by 0.6% against the yen. The euro ERI had risen by 1.9% over the period. Uncertainty surrounding exchange rates, as inferred from options prices, had fallen for dollar-sterling, dollar-euro and sterling-euro bilateral exchange rates.

A5 The major international equity indices had increased since the previous MPC meeting, with the FTSE All-Share, S&P 500 and Eurostoxx indices increasing by 2.1%, 4.2% and 3.8% respectively, in local currency terms. The increases had been broadly based across industrial sectors. Market views on uncertainty surrounding the major international equity indices, as inferred from option prices, had ended the period little changed. Sterling, dollar and euro-denominated investment-grade and non-investment-grade corporate bond spreads had narrowed on the month, as had emerging market sovereign and corporate bond spreads.

II The international environment

A6 According to the advance estimate, US GDP had risen by 0.8% in 2005 Q2, following a rise of 0.9% in 2005 Q1. Compared with a year earlier, GDP had risen by 3.6%. US final domestic demand had increased by 1.0% in 2005 Q2. Within this, private consumption had expanded by 0.8% on the quarter and private fixed investment had risen by 2.2%. Government spending had increased by 0.5% Imports had fallen by 0.5% and exports had risen by 3.0% in Q2, such that net trade had made a 0.4 percentage point contribution to GDP growth. Stockbuilding had subtracted 0.6 percentage points from GDP growth on the quarter. Revisions to past data had lowered annual US GDP growth by 0.3 percentage points on average between 2002 and 2004.

A7 US non-farm payrolls had increased by 146,000 in June. That followed a 104,000 increase in May, an upward revision from the increase of 78,000 in the previous release. The unemployment rate had fallen to 5.0% in June, from 5.1% in May. Consumption had grown by 0.8% in June compared with a month earlier, after a 0.1% fall in May. Saving as a percentage of nominal personal disposable income had fallen to 0.0% in June, from 0.4% in May. The saving ratio had been revised up between 2002 and 2004 and down slightly during 2005.

A8 US industrial production had risen by 0.9% in June following a downwardly revised increase of 0.3% in May. The University of Michigan consumer confidence measure had increased to 96.5 in July, from 96.0 in June. The Conference Board consumer confidence measure had fallen to 103.2 in July, from 106.2 in June. The headline Institute for Supply Management (ISM) manufacturing index had risen to 56.6 in July, from 53.8 in June. The ISM non-manufacturing business activity index had fallen to 60.5 in July, from 62.2 in June.

A9 US producer prices for finished goods had increased by 3.6% in the year to June, compared with a rise of 3.5% in the year to May. The US headline consumer price index had risen by 2.5% in the year to June, compared with a 2.8% rise in May. The core CPI, which excludes energy and food, had increased by 2.0% in the year to June, compared with a 2.2% rise in May. The core measure of the personal consumption expenditures (PCE) deflator had increased by 1.9% in the year to June, compared with 2.0% in May. The core PCE deflator had also been revised up in 2004 from 1.5% to 2.0%. Employment costs had risen by 0.7% in 2005 Q2 compared with a quarter earlier, the same rate of increase as in Q1.

A10 In the euro area, the second estimate of quarterly GDP growth in 2005 Q1 had been unrevised at 0.5%, although there were small offsetting changes to some components and revisions to past data. Private consumption growth had been unrevised. Investment growth had been revised upwards to –0.4% in Q1, from –0.7% previously. Government consumption growth had been revised upwards to 0.0% in Q1, from –0.2% in the first release. Estimated export growth had been –0.6%, revised down from 0.2% previously. Import growth had also been revised down, to –1.6% from –1.1% in the first release. Stock building had contributed 0.0 percentage points to quarterly growth, unrevised from the first release.

A11 The euro-area Purchasing Managers’ Index (PMI) for the manufacturing sector had risen to 50.8 in July, from 49.9 in June. The service sector PMI had risen to 53.5 in July, from 53.1 in June. The European Commission measure of industrial confidence had risen to –8 in July, from –10 in June. The German IFO index had risen to 95.0 in July, from 93.3 in June. Industrial production (excluding construction) in the euro area had fallen by 0.3% in May, after increasing by 0.7% in April.

A12 The European Commission measure of consumer confidence had been –15 in July, unchanged from June. Total euro-area retail sales had increased by 0.4% on the month in June, following an increase of 1.1% in May.

A13 Annual harmonised consumer price (HICP) inflation in the euro area had risen to 2.1% in the year to June, from 2.0% in the year to May. According to the Eurostat flash estimate, annual HICP inflation had risen to 2.2% in the year to July. Core HICP inflation, which excludes energy, food, alcohol and tobacco, had been 1.4% in the year to June, compared with 1.6% in May. Annual producer price inflation had increased to 4.0% in June, from 3.5% in May. Annual producer price inflation (excluding energy and construction) had fallen to 1.7% in June, from 1.9% in May.

A14 In Japan, industrial production had risen by 1.5% in June compared with a month earlier, following a fall of 2.8% in May. According to the Household Survey, workers' real expenditure had been unchanged on the quarter in 2005 Q2, down from growth of 3.2% in 2005 Q1. Export volumes had risen by 0.4% in the year to June, having fallen by 2.5% in the year to May. Estimated GDP in China had grown by 9.5% in the year to 2005 Q2, up slightly from 9.4% in the year to 2005 Q1.

A15 Since the Committee's previous meeting, the spot price of Brent crude oil had risen to US $60.28 per barrel. *The Economist* dollar non-oil commodity price index had risen by 0.5% over the same period.

III Money and credit

A16 The twelve-month growth rate of notes and coin, adjusted for special factors, had increased to 4.7% in July, from 3.9% in June. The three-month annualised growth rate had increased to 4.8% in July, from 2.7% in June. The annual growth rate of aggregate M4 had fallen to 11.0% in June, from 11.6% in May. The annual growth rate of M4 lending (excluding the effects of securitisations) had fallen to 12.2% in June, from 12.6% in May. Excluding other financial corporations, annual M4 growth had fallen to 9.1% in June, from 9.2% in May, whereas annual M4 lending growth (excluding the effects of securitisations) had risen to 11.8%, from 11.5% in May.

A17 The annual growth rate of households' M4 had increased by 0.2 percentage points, to 8.9% in June. The annual growth rate of total net lending to individuals, a wider measure than M4 lending that includes lending by a broader set of institutions than banks and building societies, had fallen by 0.4 percentage points, to 11.1% in June. The annual growth rate of secured lending to individuals had decreased to 10.8% in June, from 11.1% in May, while the annual growth rate of unsecured lending to individuals had fallen to 12.5% in June, from 13.2% in May. Within unsecured lending, the annual growth rate of credit card lending had decreased by 1.4 percentage points, to 18.1% in June, and the annual growth rate of other unsecured lending had weakened by 0.4 percentage points, to 10.3% in June.

A18 At 6.60%, the average standard variable rate on mortgages quoted for existing customers had been unchanged in July, while the average two-year fixed rate on mortgages had fallen slightly, to 4.70%. The effective mortgage rate had been unchanged, at 5.51% in June. According to the latest data from the Council of Mortgage Lenders, the share of new mortgages (by volume) with fixed rates had risen to 47% in June, from 45% in May. The average quoted interest rate on postal and telephone deposits had risen slightly, to 3.86% in July. The average quoted deposit rates for time and instant access accounts had been unchanged in July. The average quoted interest rate on credit card borrowing had increased slightly in July, while the effective rate for a personal loan had edged upwards to 8.89% in June, from 8.86% in May.

A19 The annual growth rate of private non-financial corporations' (PNFCs') holdings of M4 had declined to 9.8% in June, from 10.9% in May. The annual growth rate of M4 lending to PNFCs (excluding the effects of securitisations) had risen to 14.5% in

June, from 12.3% in May. The monthly flow of total finance raised in the United Kingdom by PNFCs (excluding the effects of securitisations) had averaged £4.3 billion in Q2, rising from a monthly average of £4.0 billion in Q1. Within total finance, the flow of bond, equity and commercial paper issuance (denominated in sterling and foreign currencies) had averaged –£0.8 billion a month in Q2, falling from its Q1 monthly average of –£0.6 billion.

IV Demand and output

A20 In the preliminary GDP release, the ONS had estimated that GDP at market prices had grown by 0.4% in 2005 Q2, following growth of 0.4% in Q1. Annual GDP growth at market prices had fallen to 1.7%, from 2.1% in Q1. Whole-economy gross value added had also been estimated to have grown by 0.4% on the quarter in Q2.

A21 In the preliminary GDP release, output growth in the service sector had been estimated at 0.6% in 2005 Q2. Output growth in the production sector had been estimated at –0.4% on the quarter, with a fall of 0.7% in manufacturing output.

A22 Retail sales volumes had risen by 1.3% in June. In Q2 as a whole, retail sales volumes had grown by 0.7%, compared with a 0.1% increase in Q1. The *CBI Distributive Trades* retailers' sales balance was broadly unchanged at –18 in July, while the GfK consumer confidence balance had risen by 2 points in July, to –1.

A23 Preview data from the Royal Institution of Chartered Surveyors (RICS) indicated that the balance of new buyer enquiries had fallen to +5 in July, from +9 in June. The RICS sales to stocks ratio had ticked up slightly in July. Mortgage loan approvals had been unchanged at 96,000 in June. Both the Nationwide and Halifax house price indices had risen by 0.2% in July. The three-month on three-month inflation rates of the two indices had both risen, to 0.8% and –0.3% respectively in July. The RICS balance of estate agents expecting prices to rise over the subsequent three months had risen to –10 in July, from –19 in June.

A24 Most surveys of business confidence had fallen slightly in Q2. In the service sector, the British Chambers of Commerce (BCC) survey's balance for confidence regarding profitability had fallen to +29 in Q2, from +38 in Q1. The Chartered Institute of Purchasing and Supply (CIPS) service sector index of business expectations balance had fallen to 72.6 in July, from 72.9 in June. In the manufacturing sector, the BCC survey's balance for confidence regarding profitability was unchanged at +34 in Q2. The *CBI Quarterly Industrial Trends Survey* business optimism balance in the manufacturing sector had fallen to –16 in Q2, from –15 in Q1.

A25 Surveys of investment intentions in the services sector had eased slightly in Q2; the BCC services investment intentions balance had fallen to +8 in Q2, from +11 in Q1. In the manufacturing sector, there had been a decrease in the BCC manufacturing investment intentions balance to +9 in Q2, from +10 in Q1. The CBI manufacturing investment intentions balance had risen to –15, from –16, over the same period.

A26 Looking ahead to Q3, the CIPS *Report on Services* business activity index had increased to 56.in July, from 55.8 in June. The new orders index had increased to 56.8 in July, from 56.2 in June. The BCC services domestic orders balance had fallen to +12 in Q2, from +23 in Q1.

A27 In the manufacturing sector, the CIPS manufacturing survey output index had risen to 51.0 in July, from 50.1 in June. But the new orders balance had fallen to 49.4, from 50.7 in June. The BCC manufacturing domestic orders balance had risen to +18 in Q2. The CBI total new orders balance had risen to −7 in Q2, from −18 in Q1.

V The labour market, costs and prices

A28 According to the Labour Force Survey (LFS), employment had fallen by 72,000 in the three months to May compared with the three months to February. The 16+ employment rate had fallen by 0.2 percentage points in the latest quarter to 60.0%, and had been unchanged compared with the same period a year earlier. The BCC survey of employment intentions for 2005 Q2 had suggested weakening employment in both the manufacturing and service sectors.

A29 The Bank's regional Agents had conducted an informal survey of around 200 private sector firms covering around 260,000 employees on the prospects for employment. Weighted by employment, the net balance of employment growth had been +12% over the past 6 months, and had been expected to be - 2% for the next 6 months. Within that, only retail firms had suggested expectations of higher employment growth over the next 6 months compared with the previous 6 months. Demand had been highlighted as the main factor causing firms to expect both higher and lower employment, while productivity and costs had been suggested as likely downward influences on employment over the next 6 months.

A30 The LFS unemployment rate had been 4.8% in the three months to May, unchanged compared with the previous non-overlapping quarter. The 16+ inactivity rate had risen to 37.0% in the three months to May, up by 0.3 percentage points compared with the previous non-overlapping quarter.

A31 According to settlements information available to the Bank, the twelve-month average earnings index weighted mean settlement had been 3.6% in the year to June, up by 0.1 percentage points on the equivalent figure for May.

A32 Overall annual whole-economy earnings growth had been 4.1% in the three months to May, 0.5 percentage points lower than in the three months to April. Private sector pay growth had fallen by 0.8 percentage points, to 3.8% in the three months to May. Public sector pay growth had increased by 1.0 percentage points, to 5.6% in the three months to May. Whole-economy annual earnings growth excluding bonuses had fallen by 0.1 percentage points, to 4.0% in the three months to May, compared with the three months to April. On the non-seasonally adjusted Average Weekly Earnings measure, overall average earnings growth had fallen by 0.7 percentage points, to 4.2% in the three months to May, compared with the three months to April. The equivalent average earnings growth excluding bonuses series had been flat at 4.3% over the same period.

A33 Manufacturing input prices had risen by 2.1% in June. The annual inflation rate had risen to 12.1% in June, up from 8.1% in May. The CIPS *Report on Manufacturing* input price balance had risen to 52.0 in July, from 49.4 in June.

A34 Manufacturing output prices excluding duties (PPIY) had been unchanged on the month. Annual inflation had fallen to 2.5% in June, from 2.9% in May.

A35 Annual CPI inflation had been 2.0% in June, up 0.1 percentage points on May. Within this, annual goods price inflation had risen by 0.3 percentage points to 0.2%, and annual services price inflation was unchanged, at 4.2%. Annual RPIX inflation had been 0.1 percentage points higher in June, at 2.2%, than it had been in May. Annual RPI inflation in June had been unchanged on the figure for May, at 2.9%.

VI Reports by the Bank's Agents

A36 The Bank's regional Agents reported that service sector output growth had eased recently. Growth in business services had remained strong but had eased in recent months, although there had been some regional variation. Professional service companies had continued to perform the most strongly, while companies selling services to consumer-facing firms such as retailers — for example, logistics and advertising — had seen the most pronounced weakness. Growth in consumer services turnover had remained much weaker than for business services, although stronger than retail sales. But consumer services growth had also eased — partly reflecting the subdued housing market, but also slower growth in sales at restaurants and pubs.

A37 Construction sector output growth had weakened over the past month, although overall it remained fundamentally strong. There had been some slowing in the pace of public sector projects coming to the market, and house builders had cut back on new starts. Contacts had also reported that some further easing in construction sector output growth was expected.

A38 Agents' contacts had also reported an easing in investment intentions in recent months. But intentions in both services and manufacturing had still been positive, albeit only slightly for the manufacturing sector. The easing in intentions had been attributed to weakening confidence, associated with some uncertainty about the outlook for the economy. However, there was no widespread sense of serious concern, and the general expectation had been that any downturn in the economy would be fairly short-lived.

SECTION A – (Compulsory)

1

- **Requirement for question 1**

A principal objective of any central bank is to deliver price stability through monetary policy.

(a) (i) Explain the nature of monetary policy including an outline of the implications of the Fisher equation which laid the foundations for monetary policy. *4*

(ii) Which institution currently has responsibility for managing UK monetary policy? What change has there been in this institutional responsibility since 1997 and why did this change take place? *4*

(iii) Outline the relative importance attached by the authorities to fiscal and monetary policy as tools of economic management since the early 1980s. *4*

The UK monetary authorities currently seek to achieve an inflation target of 2%, as measured by the annual rate of inflation based on the Consumer Price Index (CPI).

(b) (i) What are the key negative effects of excessive inflation that the UK monetary authorities are seeking to avoid? *3*

(ii) What action would you normally expect the UK monetary authorities to take if the rate of inflation were to rise and threaten to remain persistently above the 2% inflation target? *2*

(iii) The aim of the UK monetary authorities is not to achieve the lowest possible inflation rate. Inflation below the target of 2% is judged to be just as undesirable as inflation above the target. Why is this? *3*

The monetary authorities of some countries focus on exchange rate targeting, rather than inflation targeting, as their objective of monetary policy because they recognise that it is not possible to target, simultaneously and successfully, both the exchange rate and the rate of inflation.

(c) (i) Explain why it is not possible to target simultaneously and successfully, both the exchange rate and the rate of inflation. *4*

(ii) The UK monetary authorities do not target the sterling exchange rate, but they do consider exchange rate movements as part of their interest rate decision-making process. Explain why the authorities monitor exchange rate movements. *4*

(d) In August 2005, the UK monetary authorities reduced the UK Repo rate by 25 basis points to 4.50%. This was the first change in the Repo rate since August 2004 and the first reduction in the Repo rate since July 2003. But the decision to cut rates in August 2005 was carried by the smallest possible majority of 5 votes to 4 in the Monetary Policy Committee (MPC).

(i) Explain the information and arguments put forward by those members of the MPC who favoured a cut in interest rates in August 2005. *11*

(ii) Explain the information and arguments put forward by those members of the MPC who favoured leaving interest rates unchanged at 4.75% in August 2005. *11*

(50)

SECTION B – (Compulsory)

2

Hannah recently joined the Corporate Services Team of Birlshire County Council as an accountant. She has been asked, along with two other new and relatively junior finance recruits, to investigate the Council's difficulty in attracting and retaining high-quality finance staff.

The core objective of the three-person team is to recommend an improved remuneration package that should help to overcome the recruitment and retention problem. Each member of the team has been assured that their own remuneration package will be adjusted to bring it into line with any new package that is recommended by the team and then agreed by the Council.

The team, after undertaking detailed research and consultation, concludes that the Council's existing remuneration package will need to be significantly enhanced and brought more closely into line with private sector schemes, if the recruitment and retention problem is to be resolved.

Hannah and the two other new finance recruits are therefore faced with the dilemma of proposing a remuneration package that would provide significant improvements to recipients generally and to them personally.

- **Requirement for question 2**

(a) Outline CIPFA's six fundamental ethical principles, indicating which of them are relevant to the situation being faced by Hannah and the two other members of the team. *10*

(b) Explain the course of action you feel that Hannah and the two other members of the team should take in this situation. *6*

(c) Demonstrate how your recommended course of action for Hannah and the two other members of the team fits with the relevant fundamental ethical principles that you identified in 2 (a) above. *4*

(20)

SECTION C – (Answer two questions from this section)

3

The relationships between UK central government and "government outside of Whitehall" are complex. But many analysts assert that, despite policies of regional devolution, there has been a general trend in which central government has been assuming increasing overall governmental control.

- **Requirement for question 3**

(a) It is sometimes argued that the relationship between central government and local government is one where local government acts as agent for central government. Explain what is meant by this view and outline models that seek to describe alternative views of the relationship between local and central government. *6*

(b) Devolved regional government in the UK has so far been restricted to Northern Ireland, Scotland and Wales. Outline the arguments for extending the devolution of government to the English regions. *6*

(c) Has the devolution of political power in the UK eroded the sovereignty of parliament? *3*

(15)

4

Pressure groups are important institutions in modern democratic societies. On the one hand, they help to give people a sense of belonging and social involvement and allow them to co-operate to achieve collective goals. On the other hand, they are also one of the most important ways that citizens can express their democratic rights and influence government.

- **Requirement for question 4**

(a) Select any three of the many different categories of pressure groups. Explain the characteristics of each category that you have selected and name at least one example of a pressure group that falls into each of your selected categories. *6*

(b) Three principal models are normally used to explain the ways in which pressure groups interact with government. Identify each of these models, explain the process of interaction associated with each one, and comment on the extent to which each model is an accurate description of the current relationship between government and pressure groups in the UK. *9*

(15)

5

Since the early 1980s, financial management in the UK public sector has gradually evolved from a totally bureaucratic approach through to the current devolved market-based system.

- **Requirement for question 5**

Regarding public sector financial management, outline from the perspective of financial managers, government departments, customers and taxpayers the key advantages and disadvantages of:

(a) the bureaucratic approach; and *8*

(b) the market-based approach. *7*

(15)