

Inflation Report

February 1999

The *Inflation Report* is produced quarterly by Bank staff under the guidance of the members of the Monetary Policy Committee. It serves two purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among MPC members as an aid to our decision making. Second, its publication allows us to share our thinking and explain the reasons for our decisions to those whom they affect.

Although not every member will agree with every assumption on which our projections are based, the fan charts represent the MPC's best collective judgment about the most likely path for inflation and output, and the uncertainties surrounding those central projections.

The *Report* has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

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The Overview of this *Inflation Report* is available on the Bank's web site: www.bankofengland.co.uk/infrep.htm. The entire *Report* is available in PDF format on www.bankofengland.co.uk/ir.htm.

Overview

Inflation on the RPIX measure was close to the 2½% target level for most of last year. Since the summer, however, economic developments both internationally and in the UK have substantially shifted the balance of risks to future inflation. This sharp deterioration in prospects for the world economy has worsened the outlook for UK exports, and domestic consumption growth has weakened. Moreover, the available evidence from the labour market and international price developments suggest that, in relation to demand, inflationary pressures have eased, at least for the time being. The Monetary Policy Committee has therefore reduced interest rates in recent months with the aim of keeping inflation on track to meet the target.

Growth in the world economy in 1998 is likely to have been broadly as expected at the time of the November *Inflation Report*, but prospects for the period ahead have worsened. The difficulties facing some emerging market economies were highlighted by the collapse in mid January of the exchange rate regime in Brazil. Net capital flows to emerging market economies are likely to fall further, which entails weaker net exports for industrialised countries as a whole. If world demand growth is not to decline, higher domestic demand growth in those countries will be needed to offset weaker net trade.

The recession in Japan appears likely to be more protracted than previously anticipated. Prospects for growth this year have weakened in the euro area. And there are downside risks to the remarkable buoyancy of domestic demand and output growth in the United States, where large external imbalances have been accumulating for some time. The probable consequences of these international developments and risks for the UK are weaker export growth, and even lower imported inflation.

Aggregate output growth in the UK has slowed broadly as expected at the time of the November *Inflation*

Report. Growth in the third quarter of last year was revised down slightly to 0.4%, and the preliminary estimate of fourth-quarter growth was 0.2%. Survey measures of business and consumer confidence have stabilised since the autumn, albeit at low levels, and there is now somewhat less of a contrast between indications from official and survey data. But the sharp contrast remains between output growth in the manufacturing and service sectors.

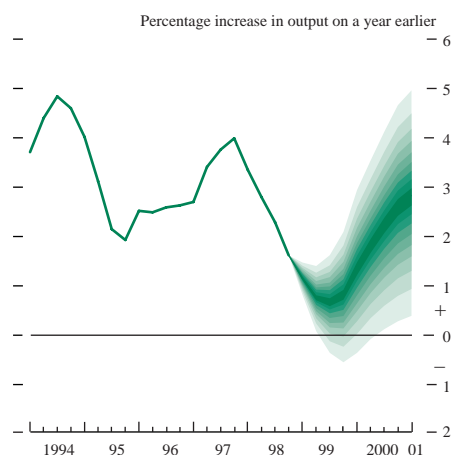
Household expenditure has been weaker than expected in relation to income and wealth, and part of this weakness is expected to persist. Inventories have grown more than anticipated, perhaps in large part involuntarily, and a substantial unwinding of stocks remains likely in the period ahead. Public expenditure is set to grow significantly, particularly for investment. But business investment growth, which has so far remained robust in the service sector, will probably slow sharply despite falls in the cost of capital.

Annual broad money growth has continued to ease, in line with slowing nominal demand growth. Total credit growth has also moderated. Within this, unsecured lending to the personal sector continues to grow fast, but there is evidence that this is partly displacing other forms of household borrowing. The financial positions of both the personal and company sectors appear reasonably sound overall.

Unemployment has declined slightly over the past three months, and the claimant count is at its lowest level since 1980. Employment growth has been strong, despite the slowdown in output growth, though hours worked have grown more moderately. But recent evidence on vacancies, recruitment intentions and reported skill shortages indicates that the labour market is no longer tightening.

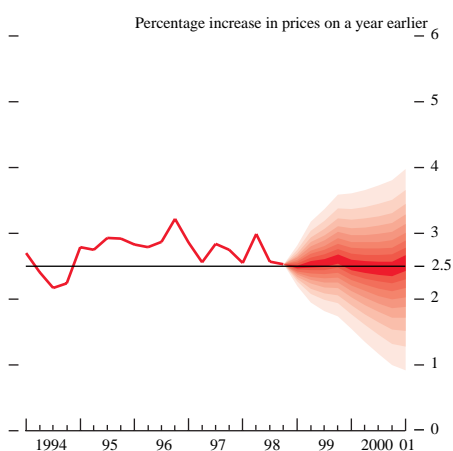
The degree of inflationary pressure in the labour market is especially hard to gauge given the continued suspension of the official Average Earnings Index pending the independent review commissioned by the Chancellor. The available evidence, including information from the Bank's regional Agents, suggests that private sector wage settlements have stabilised over the past nine months, despite the cumulative tightening of the labour market. Wage drift—the difference between earnings growth and settlements—is likely to be decreasing at the current stage of the cycle. Although recent public sector pay settlements were higher than a

Chart 1
Current GDP projection based on constant nominal interest rates at 5.5%



The fan chart depicting the probability distribution for output growth is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for output. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

Chart 2
Current RPIX inflation projection based on constant nominal interest rates at 5.5%



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

year ago, and both the Working Time Directive and the National Minimum Wage are likely to increase labour costs to some degree, upward pressure on overall pay growth appears to be easing. This has led the Committee to lower significantly its profile for nominal earnings growth.

This is consistent with lower inflation expectations. Measures of expected inflation—whether based on surveys or on the difference between nominal and index-linked bond yields—have fallen steadily over the past year, in many cases to levels around the 2½% inflation target. And headline RPIX inflation is likely soon to fall below RPIX inflation for a period as recent cuts in interest rates reduce mortgage interest payments.

The current projection for the growth rate of GDP—based on the assumption that the interest rate remains constant at 5.5%—is shown in Chart 1. The central projection is for the four-quarter rate of GDP growth to slow to between ½% and 1% during this year before recovering to around trend by the middle of 2000 as domestic demand picks up. Quarterly growth is expected to be close to zero in the first half of this year.

The corresponding projection for RPIX inflation is shown in Chart 2. The most likely path is for inflation to stay close to target over the next two years. But there is considerable uncertainty surrounding this projection, not only because of the current difficulty of assessing labour cost pressure. Indeed, some Committee members took the view that the inflation profile should be about 0.2 percentage points lower because of somewhat stronger productivity growth, or weaker world prices, than assumed in the central projection.

The Monetary Policy Committee has acted in response to deteriorating prospects for external and domestic demand, and the more benign prospect for both imported and labour cost inflation, by reducing interest rates from 7.5% to 5.5% over the past several months. Output growth at home has fallen—although broadly as expected in the *November Report*. The prospect remains one of a temporary slowdown followed by a pick-up of growth to around trend next year. The inflation outlook is uncertain. Inflation outturns in the past six months, inflation expectations on most measures, as well as the Committee's central projection for inflation, are all now close to the 2½% target level. Future changes in interest rates will depend upon how the outlook for inflation evolves.

Contents

1	Money and financial markets	3
1.1	Money	3
	Other financial corporations	4
	Household sector	5
	Private non-financial corporations	5
1.2	Credit	5
	Other financial corporations	6
	Private non-financial corporations	6
	Household sector	6
1.3	Interest rates and asset prices	7
	Short-term interest rates	7
	Long-term interest rates	8
	Equity prices	10
	Property prices	10
1.4	Exchange rates	12
1.5	Summary	13
	<i>Box: Sectoral equity prices</i>	11
2	Demand and output	14
2.1	External demand	14
2.2	Domestic demand	16
	Consumption	16
	Investment demand	19
	Inventory investment	21
	Public sector demand	21
2.3	Output	22
2.4	Summary	23
3	The labour market	24
3.1	Earnings	24
3.2	Employment and unemployment	27
3.3	Reforms affecting the labour market	30
3.4	Summary	32
	<i>Box: The Working Families Tax Credit</i>	31
4	Costs and prices	33
4.1	Raw materials and commodity prices	33
4.2	Import prices and the exchange rate	34
4.3	Costs and prices in the service sector	35
4.4	Costs and prices in manufacturing	35
4.5	Retail prices	36
4.6	Other price indices	37
4.7	Summary	38

5	Monetary policy since the November <i>Report</i>	40
6	Prospects for inflation	43
6.1	The inflation projection assumptions	43
6.2	The medium-term inflation projection	45
6.3	Other forecasts	53
	<i>Box: How fan charts are drawn</i>	52
	Annex: Minutes of the Monetary Policy Committee	55
	November meeting	57
	December meeting	66
	December Press Notice	73
	January meeting	74
	January Press Notice	81
	February Press Notice	81
	Glossary and other information	82

Links to Quarterly Bulletin

Section 2

The international environment
 Quarterly Bulletin, February 1999, pages 20–32.

Section 4

Inflation and growth in a service economy
 Quarterly Bulletin, November 1998, pages 338–46.

Annual broad money growth has been slowing since 1997 Q4. It eased further in the last three months of 1998, largely reflecting a contraction of balance sheets by the non-bank financial sector. Total M4 lending growth also slowed in 1998 Q4, even though unsecured lending to individuals grew by close to 20% on a year earlier. World financial markets remained volatile. Government bond prices rose, particularly in the United Kingdom. And despite a temporary decline following the devaluation of the Brazilian real, equity prices in most major industrialised countries were higher than in the autumn.

The MPC has voted to cut the Bank's repo rate on three occasions since the November *Report*, by a total of 1.25 percentage points, to 5.5%.

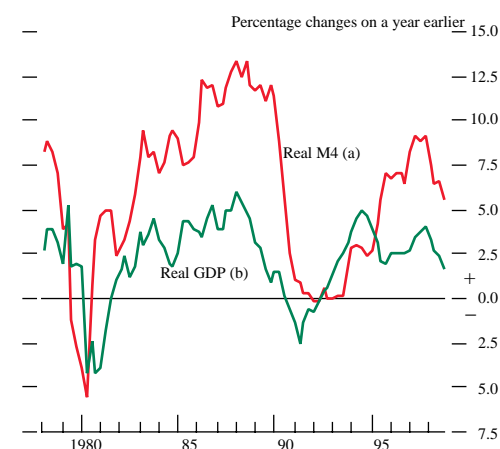
Table 1.A
Growth rates of M4 and M4 lending^(a)

Per cent		1998	3 months (b)	6 months (b)	12 months
M4	Q1		8.1	9.4	10.0
	Q2		9.0	8.6	9.4
	Q3		8.7	8.9	9.2
	Q4		6.3	7.5	8.1
M4 lending	Q1		9.1	9.0	8.4
	Q2		6.9	8.0	7.6
	Q3		9.4	8.1	8.6
	Q4		4.9	7.1	7.6

Source: Bank of England.

(a) Seasonally adjusted.
(b) Annualised.

Chart 1.1
Real M4 and GDP growth



Sources: Bank of England and ONS.

(a) Deflated by RPIX.
(b) Gross domestic product at market prices.

1.1

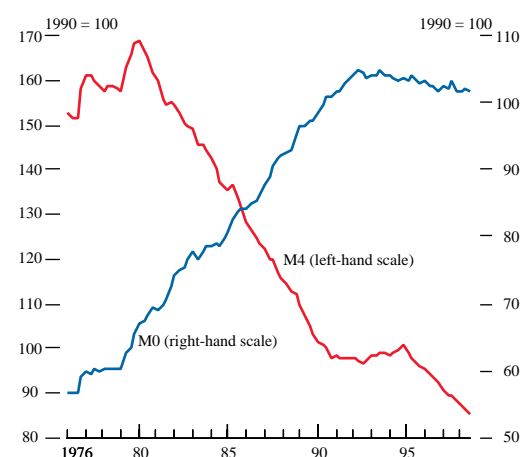
Money

Notes and coin in circulation rose by 0.6% in January 1999. The three-month annualised growth rate in notes and coin rose to 6.2% in January, compared with an average rate of growth of 5.3% in 1998. Growth in notes and coin has in the past been correlated with nominal retail sales, but the rise in notes and coin since October could also have reflected the falling opportunity cost of holding non interest bearing money as interest rates were lowered.

Annual growth in broad money slowed to 8.1% in the final quarter of 1998, its lowest rate of growth since 1995 Q2 and down from 11.9% in 1997 Q4 (see Table 1.A). Annualised short-term rates of growth were below the twelve-month rate, indicating that annual growth is likely to slow further. Adjusting for inflation, real broad money growth in the year to 1998 Q4 was 5.6%, down from its peak of 9.1% in 1997 Q2, but still above the average rate of growth since 1992 of 4.3%. The slowdown in real M4 growth is consistent with the weakening outlook for real activity, but historical comparisons suggest that there is often a lag between real M4 and GDP growth (see Chart 1.1).

The medium-term implications of broad money growth for inflation depend on the relationship between nominal

Chart 1.2
M4 and M0 income velocity^(a)



Sources: Bank of England and ONS.

(a) Defined as the ratio of nominal GDP to the stock of money.

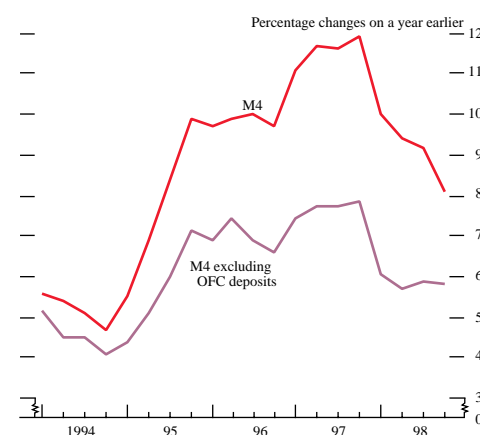
Table 1.B
Sectoral contributions to total M4 growth

Percentage point contribution to annual change (a)

	1996	1997	1998			
	Q4	Q4	Q1	Q2	Q3	Q4
OFCs	4.3	5.6	5.0	4.8	4.5	3.5
PNFCs	1.2	0.9	0.8	0.7	0.8	0.5
Households	4.1	5.3	3.9	3.6	3.8	4.0
Total M4	9.7	11.9	10.0	9.4	9.2	8.1

(a) Columns do not sum owing to seasonal adjustment.

Chart 1.3
Alternative measures of broad money growth



Source: Bank of England.

expenditure and the stock of broad money—the velocity of M4. But M4 velocity has been unstable over recent decades. Chart 1.2 shows that the ratio of nominal GDP to the stock of broad money fell sharply in the 1980s and, after stabilising in the early 1990s, has fallen again since 1995. There was a corresponding rise in M0 velocity during the 1980s (see Chart 1.2). The shifts in broad and narrow money velocity in the 1980s reflected the impact of financial liberalisation and a variety of financial innovations, which increased sterling deposits but reduced the demand for notes and coin. These factors appear to have been less important in the 1990s, which would be consistent with the stabilisation of M0 velocity since 1992, but does not explain the continued fall in M4 velocity.

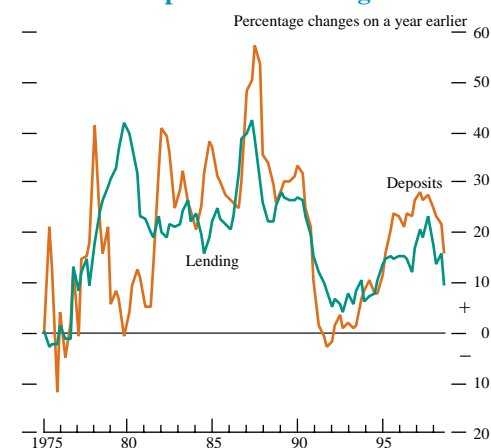
Other financial corporations (OFCs)

At a sectoral level, the fall in M4 velocity since 1995 has primarily been accounted for by higher deposits by other financial corporations (see Table 1.B). OFCs are non-bank financial intermediaries, which specialise in buying and selling financial contracts and securities. As such, this category covers a wide range of institutions including securities and derivatives dealers; mutual, unit and investment funds; and institutional investors such as pension funds and insurance companies.

The annual rate of growth in OFCs’ deposits has slowed during the past year. But growth of 16.0% in the year to 1998 Q4 was still considerably stronger than the growth in either personal or corporate sector deposits. Annual growth in deposits held by non-bank financial intermediaries has averaged 22.3% since 1995, compared with growth of 6.6% and 6.5% in household and corporate deposits respectively. So although they hold only around one fifth of the stock of M4, OFCs have accounted for 45% of the increase in aggregate broad money since 1995. Chart 1.3 shows that excluding these deposits, the rise in broad money growth since 1995 has been much less marked, and remained close to 6% during 1998. The velocity of M4 excluding other financial corporations has therefore also been more stable since 1995 than aggregate M4 velocity.

The implications of the behaviour of deposits held by non-bank financial intermediaries for activity and inflation are not straightforward. Their demand for money depends largely on portfolio considerations such as the relative rates of return in the money, equity and bond markets, and on assets such as physical capital or land, rather than on the demand for goods and services.

Chart 1.4
OFCs' M4 deposits and lending^(a)



Source: Bank of England.

(a) Excluding the effects of securitisations and other loan transfers.

Previous *Reports* have highlighted the upside risk to consumption if these balances were run down through purchases of financial assets. But changes in other financial corporations' M4 deposits have been closely correlated with changes in their borrowing since 1990 (see Chart 1.4). And there was a corresponding slowdown in borrowing by non-bank financial institutions in 1998 Q4 (see Section 1.2). According to the latest Merrill Lynch-Gallup survey, UK fund managers planned to reduce the proportion of their holdings in cash in January for the fifth successive month; and the share of M4 in pension fund assets fell to 5.3% in January from 6.4% in November. If OFCs' M4 growth continues to decline, that could stabilise M4 velocity.

Household sector

Households' M4 deposit growth had been on a downward trend since 1997 Q4. But it picked up in 1998 Q4, and was 6.4% higher than a year earlier, compared with a rise of 6.0% in the previous quarter. One possibility is that the rise in households' M4 deposit growth reflected a rise in precautionary saving, which would be consistent with the slowdown in consumer spending.

Private non-financial corporations (PNFCs)

Corporate M4 deposits fell by 0.2% in 1998 Q4, and were only 3.5% higher than a year earlier. Lower corporate deposit growth could be consistent with the slowdown in nominal demand and a reduction in cashflow (see Section 2).

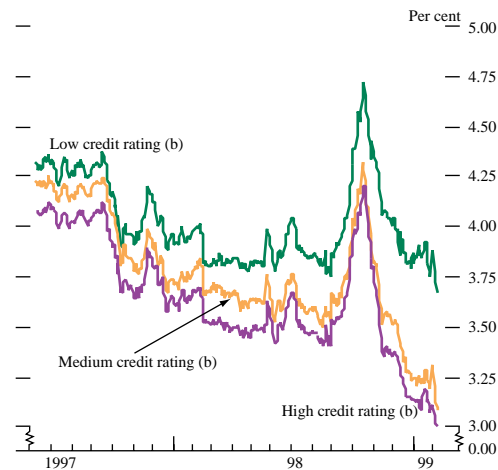
1.2

Credit

Annual growth in bank and building society lending to the rest of the private sector (M4 lending) has slowed in the past year, from 9.0% in 1997 Q4 to 7.6% in 1998 Q4 (see Table 1.A).

Concerns about a possible sharp restriction in the amount and/or increase in the price of credit, following the financial turbulence in the autumn, have eased further. The devaluation of the Brazilian real had a significant impact on emerging market debt spreads. But there was little impact on credit spreads in the major industrialised economies, which remain above their levels at the beginning of 1998, but have fallen since October. Bank estimates of the real yields on corporate debt for all but the lower credit-rated companies have fallen back to

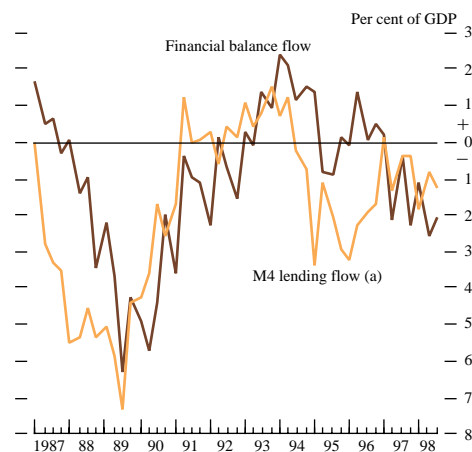
Chart 1.5
Average real yields^(a) for UK corporate bonds issued in sterling



Sources: Bloomberg and Bank of England.

- (a) Real yields are calculated as the nominal corporate yield minus a measure of inflation expectations for the appropriate maturity derived from the gilt market.
- (b) These labels are categorisations of credit ratings based on a combination of Standard and Poor's and Moody's credit ratings.

Chart 1.6
Corporate financial balance and M4 lending flow



Sources: Bank of England and ONS.

- (a) A positive balance indicates a net repayment of debt.

levels well below those at the end of 1997 (see Chart 1.5).

Other financial corporations

In line with slower growth in OFCs' M4 deposits, annual growth in M4 lending to the non-bank financial sector has fallen markedly since the end of 1997. More recently, this slowdown in borrowing has been evident in OFCs' reverse repo activity. Reverse repos, which are mostly conducted with OFCs, were £5 billion lower in 1998 Q4 (not seasonally adjusted) than in the previous quarter, and have made a negative contribution to aggregate M4 lending in four of the past five months. Within the non-bank financial sector, borrowing by securities dealers fell by £11.5 billion (seasonally unadjusted) in 1998 Q4. Lower borrowing probably reflected a desire by the non-bank financial sector to reduce the size of its balance sheets towards the end of the year, in the light of financial market uncertainty and in advance of the introduction of the euro. These effects could therefore partly be temporary and may subsequently be unwound.

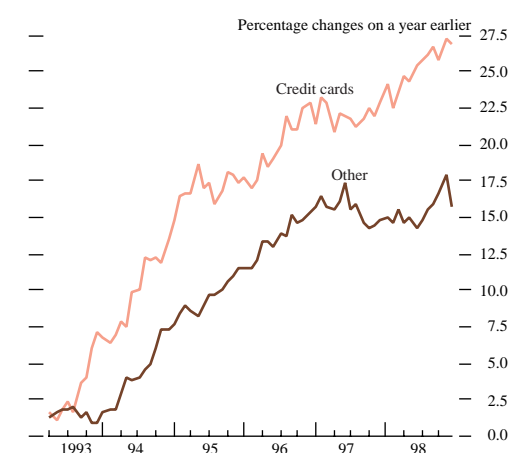
Private non-financial corporations

The annual rate of growth in M4 lending to the corporate sector rose to 6.4% in 1998 Q4, compared with an average rate of growth of 4.2% since 1992. That indicates the continued availability of credit to the UK corporate sector. Chart 1.6 shows that firms tend to finance imbalances between current income and expenditure mainly through borrowing from banks and building societies, rather than through changes in other forms of borrowing or asset holdings. Many firms rely on short-term debt to finance inventories and working capital, and it is possible that the strength of corporate borrowing has been associated with recent higher levels of inventories (see Section 2).

Household sector

In contrast with the decline in households' deposits growth since 1997 Q4, the annual growth rate of M4 lending to households picked up during 1998. The amount outstanding was 7.5% higher in the final quarter of 1998 than a year earlier. Total lending to households can be divided into lending secured on dwellings and unsecured lending. Secured lending, which accounts for about 85% of the stock of borrowing by individuals, has been growing annually by around 6% since 1997 Q1. But growth in unsecured lending, which accounts for the

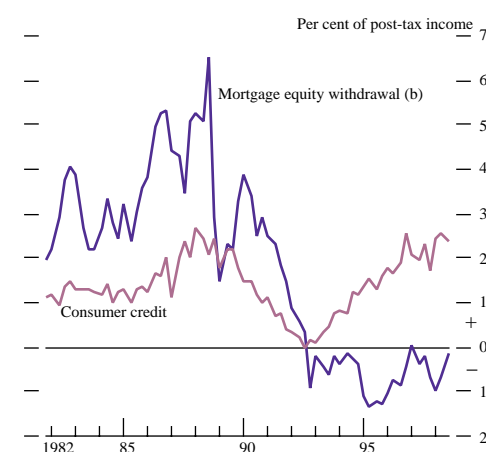
Chart 1.7
Annual growth in consumer credit^(a)



Source: Bank of England.

(a) Excluding the effects of securitisations and other loan transfers.

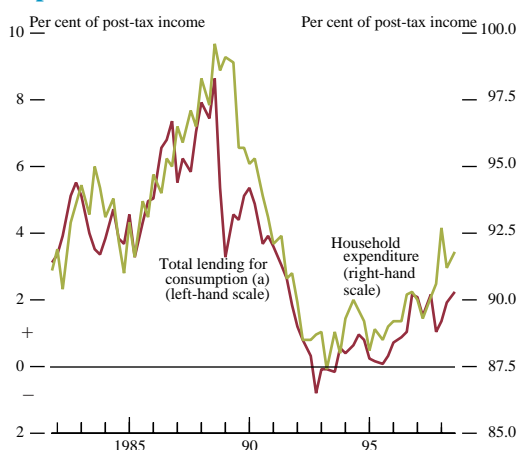
Chart 1.8
Lending for consumption^(a)



Source: Bank of England.

(a) Quarterly flows.
(b) Estimated as the sum of new loans and government capital grants for housing, minus housing investment and sales of dwellings by local authorities.

Chart 1.9
Lending for consumption and total household expenditure



Source: Bank of England.

(a) Sum of mortgage equity withdrawal and consumer credit.

rest of borrowing by individuals, has picked up markedly during the past four years, and was nearly 19% higher than a year earlier in 1998 Q4 .

As a proportion of consumption, unsecured lending rose from almost zero in 1992 to 2.4% in 1998 Q3. But this may partly reflect a substitution away from other forms of borrowing. Unsecured lending accounted for only 13.5% of total lending to individuals at the end of 1997, but for nearly one third of the rise in borrowing by individuals during 1998. Credit card borrowing has been particularly strong (see Chart 1.7). That probably reflects the growing use of credit cards as a means of payment, and more competitive supply conditions. The share of new credit card business accounted for by market entrants since 1990 rose from 10.7% in January 1995 to 22.6% in January 1999. Conversely, net mortgage equity withdrawal, which was an important source of funding for consumption in the late 1980s, has been negative during much of the present recovery, and was close to zero in 1998 Q3 (see Chart 1.8). Lower net mortgage equity withdrawal could reflect a number of factors. In particular, the gradual recovery in the housing market since 1990 probably reduced the demand for equity withdrawal. Housing turnover has been considerably lower in the 1990s than it was in the previous decade, and house prices remain below their previous peak in real terms.

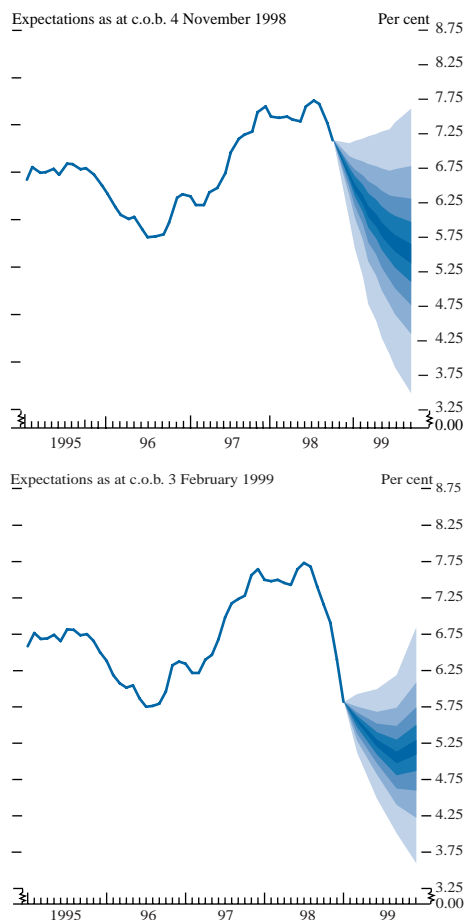
However, the rise in total borrowing for consumption—consumer credit and mortgage equity withdrawal—does not look remarkable in relation to total household spending (see Chart 1.9). Compared with the stock of wealth, which has been boosted by the rise in share prices, the level of total indebtedness remains historically low. And in relation to total income, the level of household debt has been broadly constant during the present recovery, at slightly below the level at the end of the 1980s. (See Section 2 for a more detailed discussion of recent trends in consumption.)

1.3 Interest rates and asset prices

Short-term interest rates

The MPC voted to cut the Bank’s repo rate by 0.5 percentage points to 6.25% at its meeting on 9–10 December, and by a further 0.25 percentage points, to 6.0%, on 6–7 January. At its 3–4 February meeting, the MPC voted to reduce the Bank’s repo rate by another 0.5 percentage points, to 5.5%.

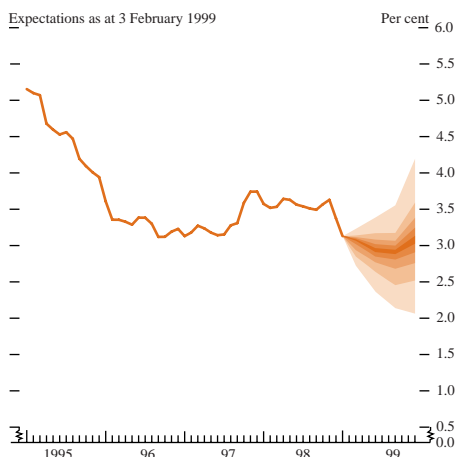
Chart 1.10
Implied distribution for sterling
three-month interest rate



Sources: LIFFE and Bank of England.

The chart depicts the probability distribution for short-term interest rates and is rather like a contour map. So at any given point, the depth of shading represents the height of the probability density function implied by the markets over a range of outcomes for short-term interest rates. The markets judge that there is a 10% chance of interest rates being within the darkest, central band at any date. Each successive pair of bands covers a further 20% of the probability distribution until 90% of the distribution is covered. The bands widen as the time horizon is extended, indicating increased uncertainty about interest rate outcomes.

Chart 1.11
Implied distributions for euribor
three-month interest rates



Sources: LIFFE and Bank of England.

Risk-neutral probability distributions of expected three-month market rates derived from options prices on 4 November and 3 February are shown in Chart 1.10. Uncertainty about the likely path of interest rates over the next year, as measured by the width of the blue fan, has diminished since November and since interest rates began to be reduced in October. A smaller weight is being attached to the possibility of a rate rise. Market expectations as at 3 February for the most likely outcome, shown by the darkest blue band, were for a further fall in interest rates over the next year, to between 5% and 5¼% by the final quarter of 1999.

The US Federal Reserve cut its official rate by 0.25 percentage points on 17 November. Short-term interest rates among countries participating in EMU converged at 3.0% in advance of the introduction of the euro on 1 January. Probability distributions of expected three-month market interest rates for the euro area, derived from option price data on euribor contracts, show that short-term rates in the euro area are expected to remain close to their current level over the next year (see Chart 1.11).

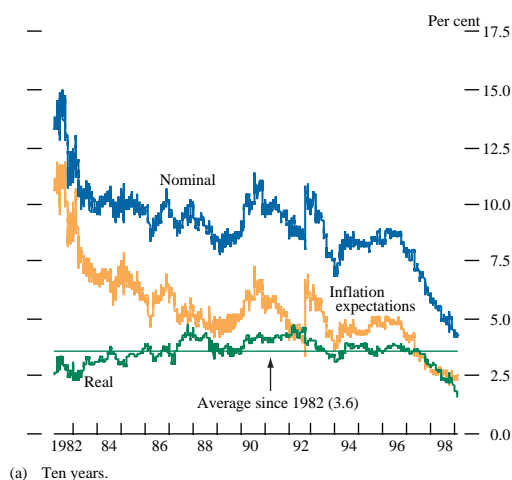
The impact of monetary policy on the real economy depends on the real rate of interest, which is not directly observable and depends on inflation expectations. Survey-based measures of UK inflation expectations for the next two years fell during 1998 and are now on average close to the inflation target. So adjusting the nominal UK interest rate of 5.5% for inflation expectations, the current short-term real rate is likely to be around 3%. That is somewhat below the average long-run real rate derived from the gilt market since 1982 (see Chart 1.12).

Long-term interest rates

Nominal yields on UK government bonds at all maturities have been falling since 1996, but have fallen particularly sharply since the November 1998 *Report*. For example, between 11 November and 3 February, two, ten and fifteen-year yields fell by 74, 71 and 65 basis points to 4.73%, 4.23% and 4.27% respectively.

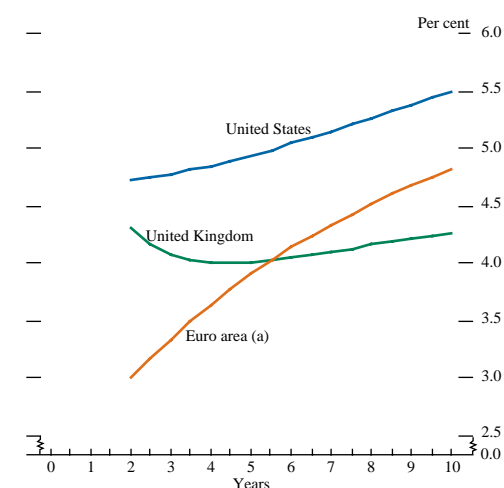
Many of the factors underlying the falls in long-term nominal UK bond yields are likely to be international, rather than specific to the United Kingdom. But the fall in UK bond yields has been more marked than elsewhere. The differential between the ten-year UK spot yield and the US Treasury spot yield was negative

Chart 1.12
Decomposition of forward nominal UK
interest rates^(a)



(a) Ten years.

Chart 1.13
Implied forward nominal interest rate as at
3 February 1999



Source: Bank of England.

(a) Derived from combined French and German government bonds.

Table 1.C
General government gross financial liabilities

Percentage of nominal GDP

	Average of:		Estimates and projections:			
	1990–95	1996	1997	1998	1999	2000
United States	60.8	61.3	59.1	57.4	57.2	55.9
Euro area	67.6	78.2	78.0	76.7	75.9	74.9
United Kingdom	49.1	60.0	59.1	57.2	56.2	55.6
G7	63.7	71.2	71.3	72.3	73.3	74.0

Source: OECD *Economic Outlook*, December 1998.

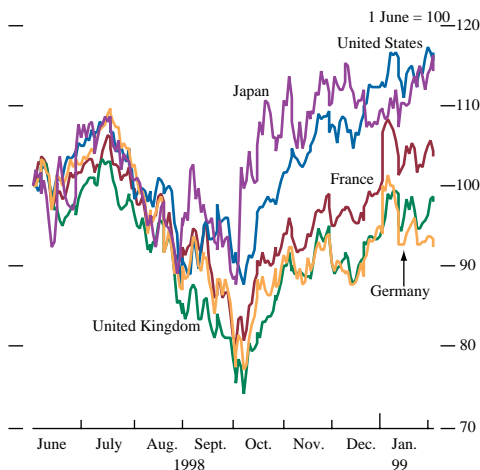
in December for the first time since 1986, and the differential with German Bunds is at its lowest since 1983. Chart 1.13 shows a combined yield curve derived from German and French government bonds, which can be thought of as representing market interest rate expectations in the euro area. It shows that implied long-run forward interest rates for the United Kingdom are below those for the euro area and the United States. However, information derived from swaps data, which includes an implicit credit risk, suggests that sterling nominal forward interest rates are expected to converge with those in the euro area.

Changes in nominal interest rate expectations reflect revisions to expectations about inflation or real interest rates, or both. A risk premium may also be priced into the nominal yield curves of some countries, reflecting past inflation surprises. Chart 1.12 shows ten-year forward nominal interest rates since 1982.

The expected rate of inflation in the United Kingdom over the next ten years, inferred from conventional and index-linked gilt prices, has fallen sharply since 1997. But it has been little changed since November, at slightly above the inflation target of 2½. The fall in nominal yields since November largely reflects a fall in the real UK yield. The real yield on index-linked UK government bonds has been falling since 1996, and particularly since October, to below 2%—its lowest level since index-linked bonds were first issued in 1981.

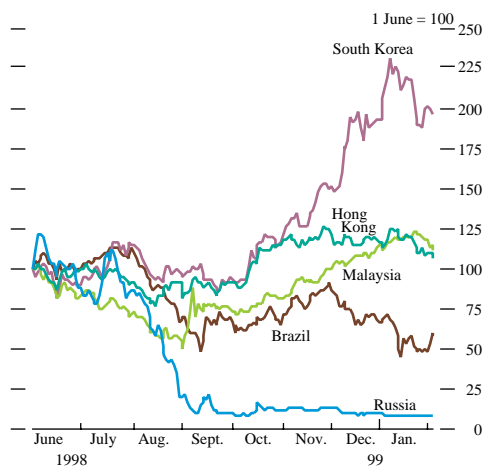
International comparisons of real long-term yields are difficult to make, because of the scarcity of index-linked bond issues. But there has not been a corresponding fall in the real yield on index-linked US bonds. Previous research suggests that fiscal considerations are important determinants of long-term real world interest rates. With the exception of Japan, the ratio of debt to GDP has fallen in most major economies since 1996. Moreover, the move into budget surplus in the United States and the signing of the Stability and Growth Pact by prospective EMU participants suggest that this trend is unlikely to be unwound during the next few years (see Table 1.C). Institutional factors, such as the minimum funding requirement for pension funds, may also have put upward pressure on the price of UK index-linked bonds by raising demand relative to supply. Nonetheless, the sharp fall in UK real yields relative to those overseas remains difficult to explain, given the underlying determinants.

Chart 1.14
Selected G7 share prices^(a)



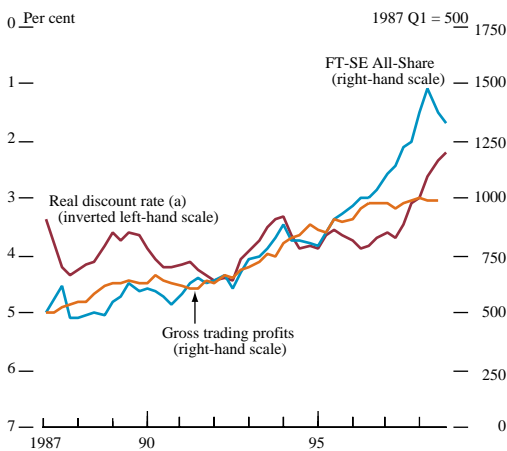
(a) In US dollars.

Chart 1.15
Selected emerging markets share prices^(a)



(a) In US dollars.

Chart 1.16
Equity prices, profits and the real discount rate



Source: Datastream.

(a) Defined as yield on ten-year index-linked gilts, forward rate.

Equity prices

Share prices in the United States, France and the United Kingdom had by mid January reversed most of their falls in the autumn (see Chart 1.14). There was also some recovery in share prices in a number of emerging market economies, with the exceptions of Russia and Brazil (see Chart 1.15). The devaluation of the Brazilian real on 13 January led to an immediate fall in global equity prices. The subsequent decision to allow the real to float triggered a recovery in most of the major markets.

There are a number of possible explanations for the rise in share prices since October. The value of an equity can be thought of as the discounted stream of real dividend payments derived from that equity. So changes in equity values reflect changes either in expectations about future real earnings, or in the discount factor, which is made up of a risk-free real return and a risk premium.⁽¹⁾ The risk-free real return as proxied by the real yield on government bonds has fallen, as noted above. Chart 1.16 shows that the recent rapid increase in the FT-SE All-Share Index appears to be more closely correlated with falling real bond yields than with rising profits. Estimates of the equity risk premium vary widely, but most have fallen in recent years. In general, the recovery in share prices in industrialised economies has not been evenly spread between different industrial sectors and firm size. The box on page 11 considers the sectoral equity price split in the United Kingdom, the major European markets and the United States.

The MPC assumes that there is a greater risk of a fall in UK equity prices than of a further rise, relative to the central case assumption of growth in line with nominal demand.

Property prices

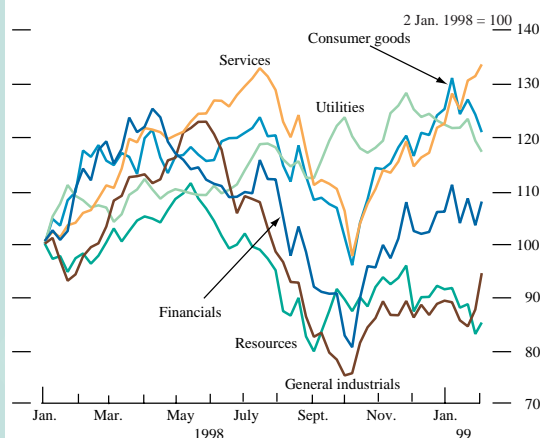
According to data from the Richard Ellis Research Consultancy, annual growth in the capital value of commercial property slowed in December, in line with the decline in rental value for industrial property. Expectations of future rental values are an important determinant of current property prices, in much the same way that current share prices depend on expected future dividends. Property company share prices have fallen relative to the FT-SE All-Share index since May 1998, and were around 20% lower at the end of 1998 than at the beginning of the year. According to the Merrill

(1) See the box on page 12 of the August 1998 Report for a more detailed discussion.

Sectoral equity prices

Share prices in most of the major industrialised countries have risen since October (see Chart 1.14 in the main text). But this masks significant differences in share price movements between industrial sectors and between firms of different sizes. Chart A shows the performance of different sectoral share prices in the United Kingdom since the start of 1998. Share prices in the utilities, consumer goods and services sectors rose by around 20% between October and the beginning of February, to close to their peaks of mid 1998. But share prices in general industrials have recovered significantly less of the ground they lost in the summer.

Chart A
UK share prices by sector



Source: Datastream.

During 1998, UK share prices have risen most in sectors that are relatively less exposed to overseas developments. Chart B shows a similar pattern in other major EU markets. This could suggest that market confidence in either the future growth of export markets or the ability of firms to compete with imports from outside the EU, is less robust than that for the domestic EU economy.

Chart B
Major European^(a) share prices by broad sector

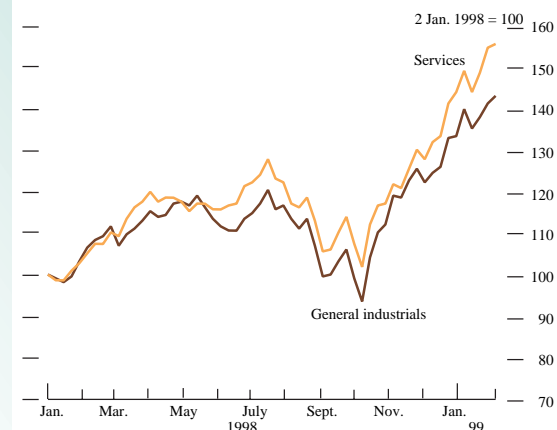


Source: Datastream.

(a) German, French and Italian prices weighted by market capitalisation.

In the United States, however, share prices of general industrials and services have moved more closely together (see Chart C). That may reflect the relatively smaller share of trade in US GDP, notwithstanding the recent weakness in US industrial production and profits.

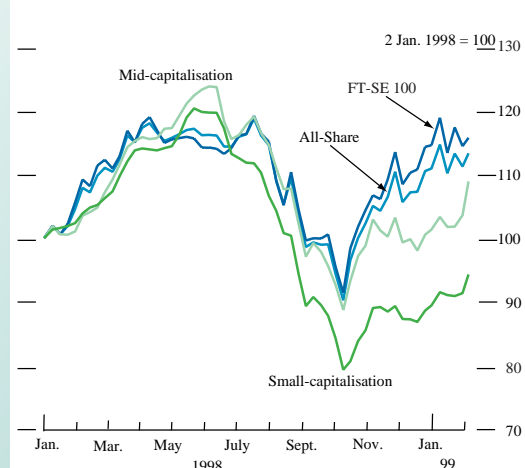
Chart C
US share prices by broad sectors



Source: Datastream.

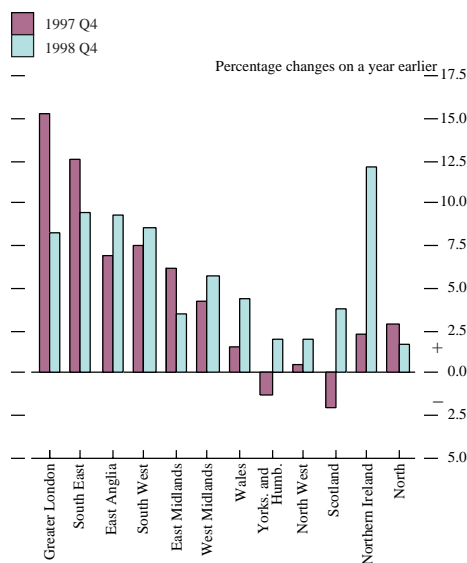
The share prices of different-sized UK firms have also varied widely. Chart D shows that since October, share prices of small-capitalisation companies have risen by considerably less than the average. Another way of looking at relative share price performance is to relate the change in share prices to earnings. The price:earnings ratio on the FT-SE Non-Financials index reached an all-time high of 24 in January. That compared with a value of 21 before the stock market crash in 1987. By contrast, the price:earnings ratio on small-capitalisation firms was less than 16, down from 29 in March 1998. It is difficult to find a single explanation for these differences, but one possibility is a rise in the return investors require for holding less-liquid stocks.

Chart D
United Kingdom share prices by company size



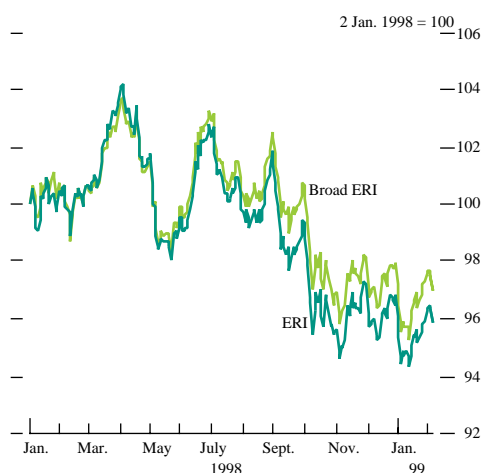
Source: Bloomberg.

Chart 1.17
Halifax regional annual house price inflation



Source: Halifax plc.

Chart 1.18
Sterling effective exchange rates^(a)



Source: Bank of England.

(a) The ERI is a trade-weighted index of 20 countries' exchange rates against sterling. The broad ERI is constructed using 49 countries' exchange rates.

Lynch-Gallup survey of fund managers, the net balance expressing a desire to buy property shares has been negative since July 1998.

Housing market activity and house price inflation have continued to ease. The Nationwide measure of annual house price inflation was 7.4% in January, nearly 6 percentage points below its peak at the beginning of 1998. The Halifax measure of annual house price inflation fell to 4.5% in January, below the 5%–6% band in which it had been for most of 1998. The less timely measure calculated by the Bank based on Land Registry data also showed a slowdown in annual inflation, to 7.6% in the year to 1998 Q3, compared with 8.9% in the previous quarter. Regional differences in house price inflation, as measured by the Halifax, have narrowed slightly since 1997 Q4, mainly owing to slowing house price inflation in Greater London and the South East (see Chart 1.17).

1.4 Exchange rates

The sterling effective exchange rate index (ERI) averaged 100.1 in the 15 working days up to and including 3 February. This is the starting-point for the current projection, and is slightly above the central projection for 1999 Q1 implied in the November forecast.

Sterling was little changed since November on both the narrow and the broader measure of the ERI. The latter also includes some of the Asian and Latin American economies (see Chart 1.18). And sterling has traded within a fairly narrow range against the euro, between 0.72 and 0.69, since its introduction (see Chart 1.19).

Chart 1.20 shows the path for the ERI implied by market nominal interest rate differentials, calculated by comparing UK expected interest rates at different maturities with expected rates overseas. This method is based on the assumption that, other things being equal, currencies should adjust to equalise the rate of return on assets across countries. So if UK rates are expected to be above those overseas, sterling is expected to depreciate. As the chart shows, the path based on expected interest rate differentials implies a slight depreciation of sterling up to the forecast horizon. But further out, sterling is expected to stabilise and then to appreciate, reflecting expectations for lower relative UK nominal interest rates, as discussed above.

Chart 1.19
Euro exchange rates

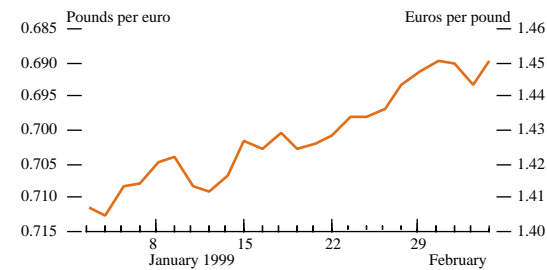
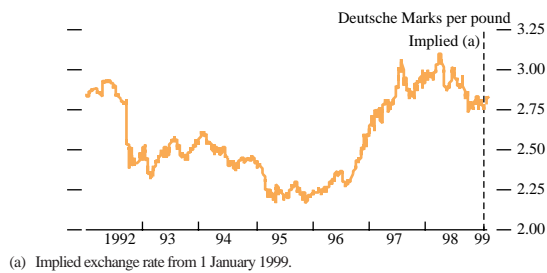
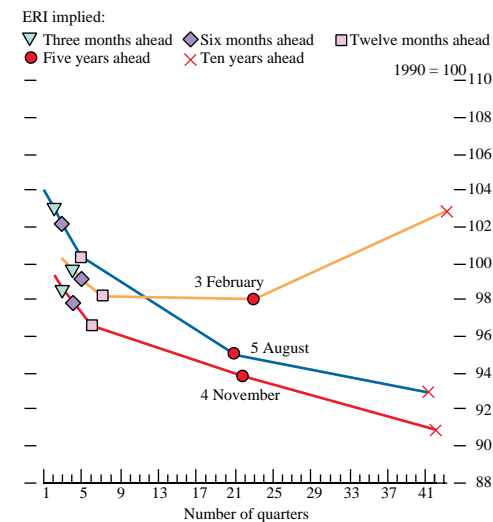


Chart 1.20
UK effective exchange rate profiles^(a)



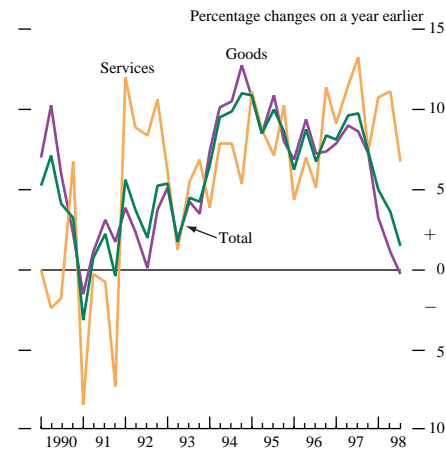
Sources: Bank for International Settlements, Datastream and Bank of England.
 (a) Assuming uncovered interest rate parity.

In constructing its forecast, the MPC makes assumptions about the future path for sterling, conditional on unchanged UK interest rates. In judging the most likely path for sterling, the MPC takes into account both interest rate differentials and risk considerations. In the central projection (the modal or most likely case), the sterling ERI is expected to fall to 97.6 at the two-year horizon, but the MPC judges that a larger fall is more likely than a significant rise. So on average, the sterling ERI is expected to fall to 96.3 in two years' time.

1.5 Summary

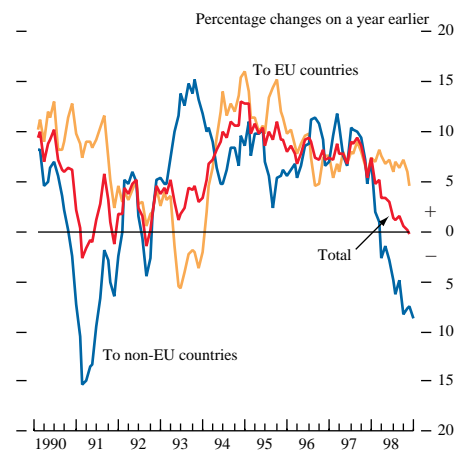
UK broad money growth has continued to ease, in line with slowing nominal demand growth. Unsecured lending to individuals has continued to grow at close to 20% on a year earlier, but this probably reflects a substitution away from other forms of borrowing. Global yields on government bonds continued to fall in line with lower global inflation expectations and lower expected real yields. The fall in nominal UK bond yields was particularly sharp, primarily reflecting lower real yields, the reasons for which remain something of a puzzle. The exchange rate was little changed since the November *Report*, but is expected to depreciate up to the forecast horizon.

Chart 2.1
UK exports of goods and services



(a) At 1995 market prices.

Chart 2.2
UK exports of goods^(a)



(a) Three-month moving averages using volume data; balance of payments basis.

Table 2.A
UK export growth

Region	Share of total UK goods exports in 1997	Annual growth in goods export volumes (a)	
		1998 Q3	1998 Q4
European Union	55.8	7.1	n.a.
North America	13.9	9.2	9.1
Oil exporters	5.5	-28.2	-33.0
Rest of the world	24.8	-13.0	-13.2
of which, Asia (b)	8.5	-22.8	-24.2

(a) Figures for exports to Asian countries are on an OTS basis; all other exports are on a balance of payments basis. All non-EU export values are deflated by the aggregate price index for exports to non-EU countries.

(b) Asia comprises Japan, South Korea, Hong Kong, Malaysia, Singapore, Taiwan, Thailand, and China.

UK exports of goods and services fell in 1998 Q3 and global economic prospects have continued to deteriorate, increasing the downside risks for UK trade and output. Consumption growth has also slowed, consumer confidence has fallen sharply, and business confidence remains low. Reflecting these developments, GDP increased by only 0.2% in 1998 Q4, its slowest quarterly growth rate since 1992 Q2.

2.1 External demand⁽¹⁾

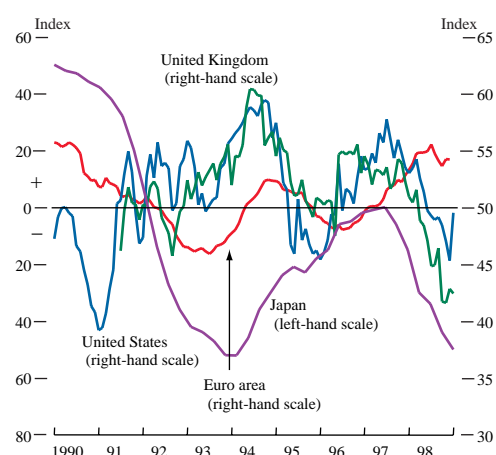
The growth rate of UK export volumes for goods and services has slowed markedly since mid 1997, largely reflecting weaker exports of goods to non-EU countries (see Charts 2.1 and 2.2). In particular, the recession in Japan, the financial crisis in East Asia, and the marked fall in the price of oil since January 1997 have caused a sharp contraction in demand among Asian economies and oil-exporting nations (see Table 2.A). Even though these countries are the destination for only about 15% of UK exports, the decline in their demand for UK goods has been large enough to offset the continued growth in exports to other regions.

In contrast, activity has so far been sustained in Europe and stronger than expected in North America (the destinations for two thirds of UK exports). Euro-area GDP rose by 2.4% in the year to 1998 Q3, and US GDP increased by 4.1% in the year to 1998 Q4. However, even in these countries, the impact of the Asian downturn and the slowdown in Middle Eastern and South American economies is beginning to be felt. Business confidence fell last year in both Europe and the United States (see Chart 2.3), and the growth rate of industrial production has also slowed (see Chart 2.4). Consequently, growth prospects for most industrialised countries have worsened.

World trade forecasts have been revised downwards as a result of these developments. Between October and December, the IMF lowered its projections for world trade growth in 1998 and 1999 by a further 0.3 and

(1) For a detailed discussion of international economic developments, see 'The international environment' article in the *Quarterly Bulletin*, February 1999, pages 20–32.

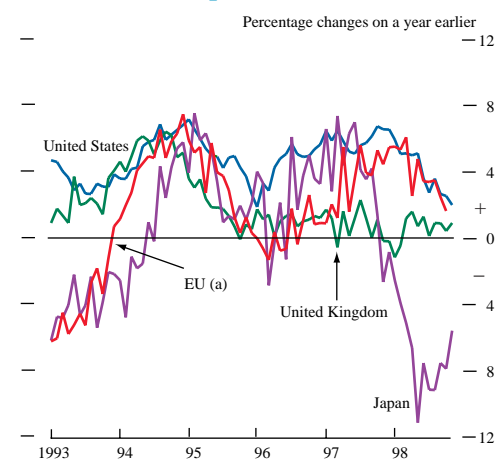
Chart 2.3
Business confidence^(a)



Source: Datastream.

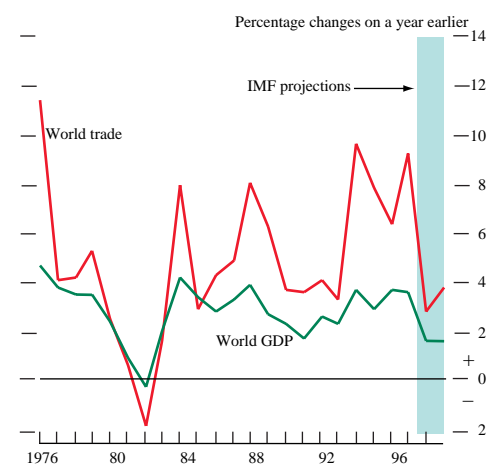
(a) Indicators are not directly comparable across countries.

Chart 2.4
World industrial production



(a) EU aggregate derived from a UK trade-weighted average of Germany, France, Italy, the Netherlands, Finland, Portugal, Spain, Belgium and Luxembourg.

Chart 2.5
World GDP and trade growth



Source: IMF.

0.2 percentage points, to 3.4% and 4.4% respectively (see Chart 2.5 and Table 2.B). These figures are well below the growth rate recorded in 1997. However, because Asian countries account for around 27% of world trade flows, but make up less than 9% of UK exports, the slowdown in the growth rate of UK export markets is unlikely to be as sharp as the slowdown in world trade.

Despite the stronger-than-expected growth in the United States, global economic conditions have continued to deteriorate. Consequently, some of the downside risks to external demand identified in the November *Inflation Report* have materialised, and the MPC has revised down its expectation for UK export market growth in 1999 and 2000 to around 4%–5%. These projections are about 2 percentage points lower than at the time of the November *Report*. Moreover, given the lagged effects of sterling's appreciation, UK exports are likely to grow less quickly than (weighted) UK export markets.

Taking exports and imports together, net trade detracted from GDP growth in 1998 Q3—the sixth time this has happened in the past seven quarters. This reflected both relative demand developments and the competitiveness effects associated with sterling's appreciation (see Chart 2.6). Given the slowdown in the domestic economy, demand growth in the major six overseas countries could well exceed that in the United Kingdom this year, and so start to support net trade. But without a recovery in demand in Asia and the oil-exporting nations, it seems unlikely that the United Kingdom's overall trade position will improve significantly.

Competitiveness effects are also likely to limit the extent of any turnaround in the UK trade position. The real sterling effective exchange rate appreciated by around one third (depending on which price deflator is used) between the beginning of 1996 and mid 1998. This was sterling's largest real appreciation since the early 1980s, and only a small part of it has since been unwound. Given the size of this competitiveness loss, the deterioration in the net trade position in the six quarters to 1998 Q3 was smaller than anticipated. This was mainly because of weaker-than-expected import penetration.

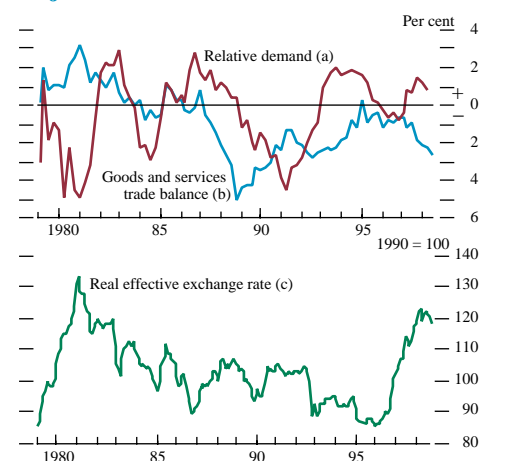
So it remains likely that net trade will make another negative contribution to growth this year. The risks to this central projection are more balanced than at the time of the November *Report* but probably still lie marginally

Table 2.B
Successive IMF world growth projections^(a)

WEO issued in:	1998		1999	
	GDP	World trade	GDP	World trade
October 1997	4.3	6.8	4.4	n.a.
December 1997	3.5	6.2	4.1	n.a.
May 1998	3.1	6.4	3.7	6.1
October 1998	2.0	3.7	2.5	4.6
December 1998	2.2	3.4	2.2	4.4

(a) Year-on-year percentage changes.

Chart 2.6
Major influences on the trade balance



(a) Difference between GDP growth in the United Kingdom and rest of G7.
 (b) As a percentage of GDP.
 (c) Calculated using relative normalised unit labour costs in manufacturing and the nominal effective exchange rate index.

Table 2.C
Quarterly growth rate of GDP^(a)

Percentage change	1998		
	Q1	Q2	Q3
Consumption:			
Households	0.5	0.5	0.3
Non profit making institutions serving households	0.1	0.4	0.2
Government	0.9	0.4	0.2
Investment	1.9	0.0	1.1
Final domestic demand	0.9	0.3	0.6
Change in inventories (b)(c)	-0.3	0.2	0.2
Domestic demand	0.6	0.5	0.8
Net trade (b)	-0.3	-0.1	-0.5
GDP at market prices	0.5	0.5	0.4

(a) Constant 1995 prices.
 (b) Contribution to quarterly growth.
 (c) Including quarterly alignment adjustment.

on the downside. First, import penetration may rise, partly as a result of continued weak import prices—excess world capacity for a number of commodities and traded goods is likely to persist in 1999. Second, given the continued weakness of the Japanese economy, the emerging market nations in Asia are likely to try to expand their exports to Europe and North America, which would increase the competition faced by internationally exposed UK firms. And third, the Brazilian authorities' decision to float the real is likely to have further unsettled international investor sentiment. Depending on the degree of contagion, this may cause another fall in capital flows to emerging market economies, forcing these countries to adjust their current account balances by reducing imports and expanding exports. The counterpart will be larger current account deficits (or smaller surpluses) in advanced economies, including the United Kingdom.

2.2 Domestic demand

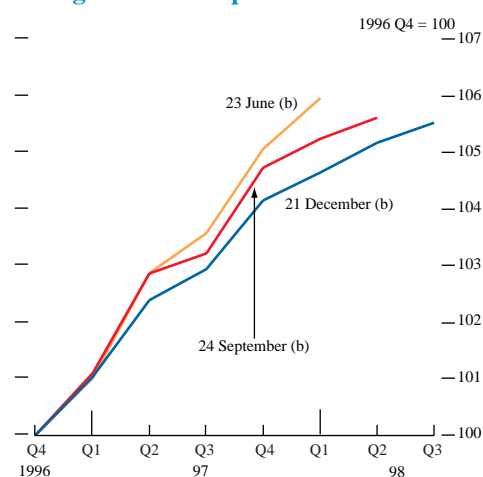
Despite slower private and government consumption growth, domestic demand increased by 0.8% in 1998 Q3, up from 0.5% in the second quarter. This was mainly because of stronger investment (see Table 2.C). In the year to 1998 Q3, domestic demand increased by 3.7%, well above trend. However, the level of domestic demand in the first half of 1998 was revised down by 0.5%.

Consumption

Household consumption growth has weakened since the November *Report*—the quarterly growth rate slowed to 0.3% in 1998 Q3, lowering the annual rate of increase to 2.6%. In addition, the ONS has revised down the profile of consumption back to the start of 1997 (see Chart 2.7). Although the latest annual growth rate is close to the long-run average (see Chart 2.8), the slowdown in 1998 was sharper than the MPC had expected, given the continued strong increases in pre-tax income from employment (up by around 4% in real terms in the year to 1998 Q3) and the large rise in households' real wealth in recent years.

In Q4, retail sales volumes fell by 0.2%, suggesting that total household consumption growth may have continued to slow in the last three months of the year. Surveys by the British Retail Consortium and the CBI found that retail sales growth declined markedly towards the end of the year. And both the MORI and GfK

Chart 2.7
Changes to consumption data^(a)



(a) Constant 1995 prices.
(b) Publication dates.

Chart 2.8
Household consumption growth

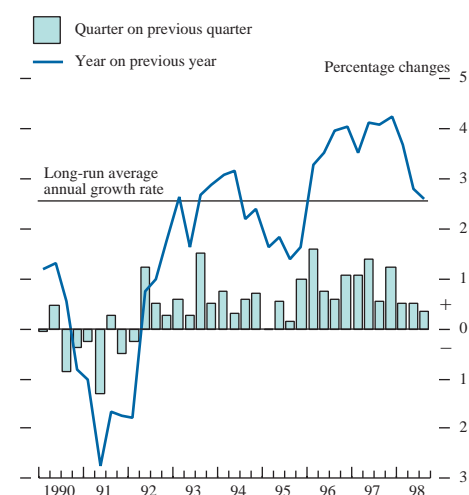
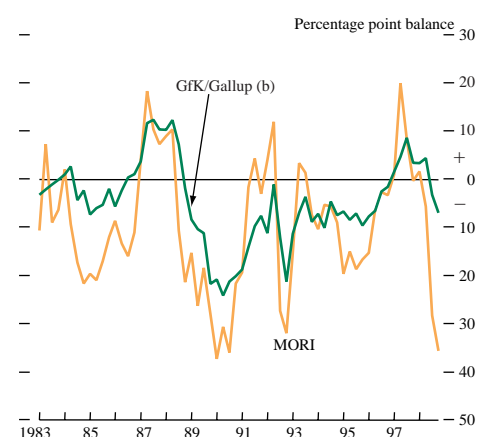


Chart 2.9
Consumer confidence^(a)



(a) Quarterly averages derived from monthly headline measures of consumer confidence.
(b) Gallup prior to July 1995.

measures of consumer confidence declined further in the fourth quarter, with a particularly pronounced fall in the MORI measure (see Chart 2.9). However, these indicators may overstate the weakness of consumption—retail sales account for less than half of total consumption, and survey measures of individuals' confidence in the general economic situation have recovered slightly since October.

The slowdown in consumption in the third quarter was accounted for by lower expenditure on both durable and non-durable goods; spending on services remained strong. Movements in these household expenditure components have diverged for some time, in contrast with the more synchronised nature of the slowdown prior to the 1990–92 recession. As Chart 2.10 shows, the annual growth rate of spending on non-durable goods peaked in 1996 Q3 and has since declined steadily, whereas the deceleration in durable goods spending began only in 1998 Q1, and the growth rate of spending on services has yet to moderate.

The relative weakness of spending on durable and non-durable goods in 1998 is a puzzle. To some extent, the former was influenced by the pattern of windfall payouts arising from the demutualisation of a number of large building societies (see Chart 2.11). These payouts totalled around £37 billion in 1997 (equivalent to 7½% of annual household consumption). In August 1997, the Bank commissioned MORI to survey the beneficiaries of these demutualisations to find out what they were likely to do with their windfall payouts.⁽¹⁾ Using this information, the MPC estimated that domestic demand expenditures would be boosted between 1997–99 by £6–12 billion, with the most likely outcome towards the top of this range.

Survey respondents also indicated that around three quarters of the windfall spending would be on durable goods and home improvements. Although difficult to measure precisely, there is some evidence that spending on these items was boosted above trend by around £4–6 billion in the past two years. So the sharp slowdown in the growth rate of durable goods spending in 1998 may have reflected the unwinding of this effect. However, there is little evidence that spending on non-durable goods was boosted by windfall payouts. This suggests that the overall windfalls impact on consumption was probably less than the MPC had previously assumed.

(1) See the box on page 20 of the November 1997 Report.

Chart 2.10
Comparison of household consumption behaviour

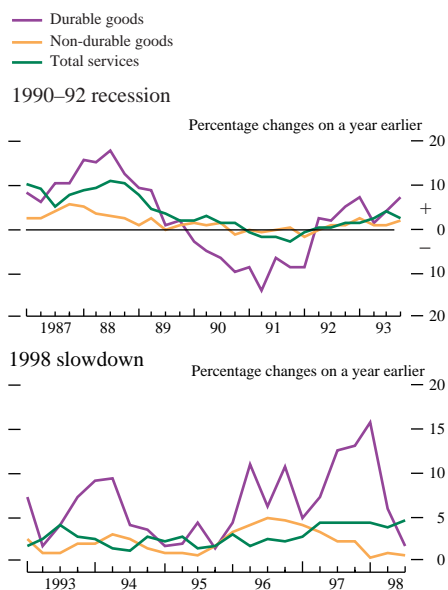


Chart 2.11
Windfalls and real consumption growth

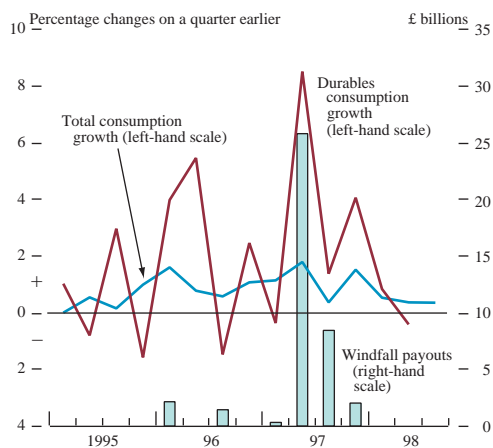
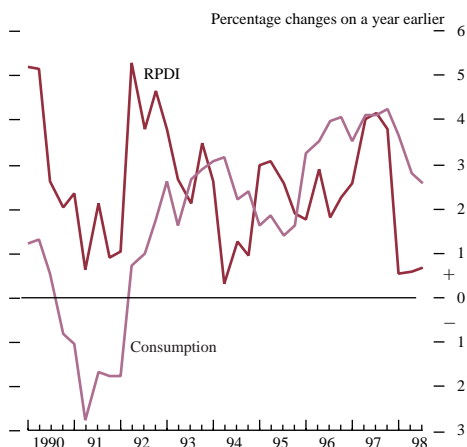


Chart 2.12
Real personal disposable income and household consumption growth



There are a number of other possible reasons for the slowdown in household expenditure, but no single factor provides a convincing explanation. The first possibility is that concerns about future economic prospects adversely affected consumer confidence and households' employment expectations. This is likely to have been associated with increased uncertainty about future income, and may have led consumers to postpone expenditures on big-ticket items, thereby raising precautionary saving. But this explanation does not explain the weakness of spending on non-durable goods.

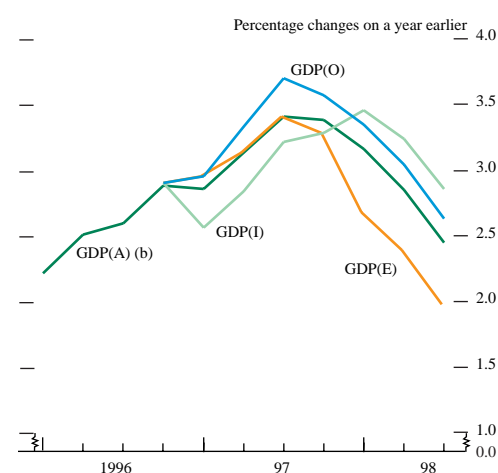
A second possibility is that fiscal tightening embodied in recent tax changes affected consumption more than previously thought. Some evidence to support this can be found in Government revenue figures—in the first three quarters of 1998, income taxes were more than 14% higher than in the same period in 1997. This effect, combined with a sharp fall in net property income (which includes equity dividends), produced a marked slowdown in the growth rate of real personal disposable income (see Chart 2.12).

In its previous projections for the public finances, the MPC took as its central case the effective tax rates embodied in the Chancellor's Budget statements. These incorporated estimates of the effects of the July 1997 Budget changes on dividend tax credits, which led to significant increases in net income tax receipts. They also made allowance for the introduction of the new system of Self Assessment (SA) for income tax. However, since there were no changes in personal tax rates accompanying the introduction of SA, HM Treasury assumed that the new system would have only a small positive impact on the effective tax rate. This assumption now appears to have been an underestimate. One possible explanation for this is that the increased publicity surrounding the launch of the new forms and their more comprehensive and structured layout may have increased the rate of tax compliance by more than was expected. Unfortunately, it is still too early to draw any firm conclusions, as the seasonal pattern of tax payments will have changed as a result of the extension to the returns deadline from 1 January to 31 January.

A third potential explanation for lower-than-expected household expenditure growth relates to the uncertain impact of wealth effects on consumption. Although net wealth has increased strongly in each of the past four years, real long-term interest rates have also fallen significantly (see Section 1). These two developments

are likely to be linked, and may have opposing effects on consumption. Higher wealth is beneficial for consumers, but the impact of lower real interest rates is less certain. As real interest rates fall, households may choose to reduce current consumption out of wealth, in order to maintain their desired future income and consumption—the income effect. But the returns on new saving also decline, so individuals will tend to save less and consume more—the substitution effect—unless the reduction in the real interest rates is itself the result of a desire to save more. The overall impact on household expenditure will therefore depend on the balance between the income, substitution and wealth effects. The worse-than-expected consumption outturn could be related to a larger-than-expected income effect.

Chart 2.13
Alternative measures of GDP growth^(a)



- (a) Volume indices at 1995 basic prices.
(b) GDP(A) is the average growth rate derived from GDP(I), GDP(O) and GDP(E).

Alternatively, consumption growth may have been underestimated last year. In the four quarters to 1998 Q3, the income-based measure of GDP (GDP(I)) increased by 2.9%, the output-based estimate (GDP(O)) rose by 2.6%, and the expenditure-based estimate (GDP(E)) grew by 2.0% (see Chart 2.13). There is therefore a reasonable chance either that GDP(I) will be revised downwards during the annual balancing of the national accounts, or that GDP(E) will be revised upwards, or both. Such revisions would help to explain the apparent weakness of consumption relative to the strength of income from employment. The ONS generally considers GDP(O) to provide the best estimate of recent quarterly growth,⁽¹⁾ which adds weight to the idea that GDP(E) could be revised up and GDP(I) revised down.

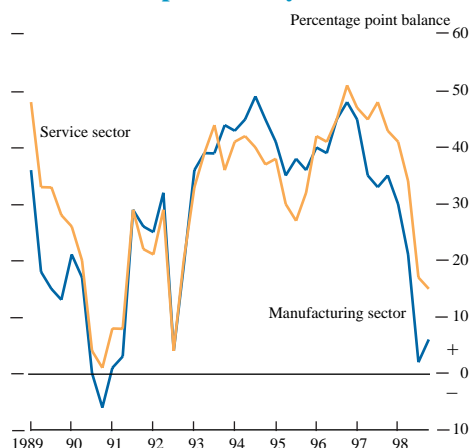
Overall, the Committee decided not to treat all of the weaker outturn for consumption as erratic. The central projection for the level of consumption in relation to income has therefore been revised down from the November projection.

Investment demand

Although investment growth slowed last year, it remained relatively robust. Whole-economy investment expenditure increased by around 1% in Q3, driven by higher business and general government investment; private sector spending on dwellings declined. The ratio of business investment to GDP reached another post-war peak in 1998 Q3.

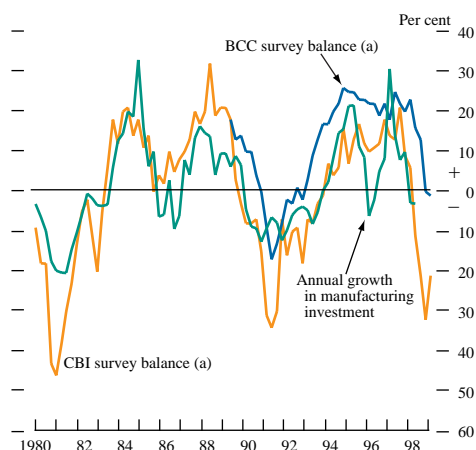
(1) See Cope, I, 'Data sources for the quarterly account', *The United Kingdom National Accounts CSO Methodological Paper*, Number 3, April 1995.

Chart 2.14
Confidence in profitability



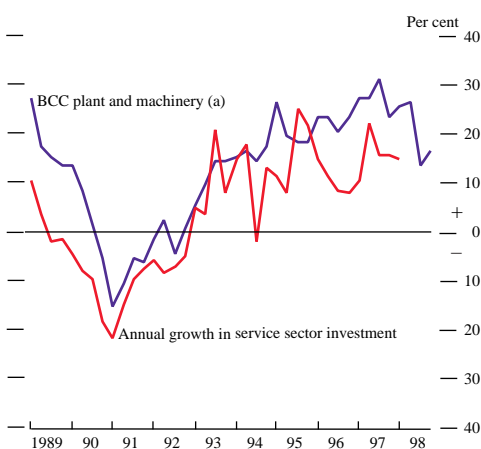
Source: BCC.

Chart 2.15
Manufacturing investment intentions



(a) Survey balances determined by subtracting the percentage of companies reporting decreases from the percentage of companies reporting increases. Survey balances have been advanced two quarters, as they relate to intentions.

Chart 2.16
Service sector investment intentions



(a) Survey balance determined by subtracting the percentage of companies reporting decreases from the percentage of companies reporting increases. The survey balance has been advanced two quarters, as it relates to intentions.

Firms' investment intentions are influenced by their capacity utilisation positions, their expectations about future output and profits, their financial positions and the cost of capital. Most of these indicators suggest that the pace of investment growth will slow this year. Capacity utilisation in the manufacturing sector has fallen relative to its January 1998 peak, reducing the short-term need for new investment. And the number of UK companies issuing profit warnings increased by more than 50% in the year to 1998 Q4 (albeit from a low base). The British Chambers of Commerce (BCC) survey similarly found that firms' confidence in profitability remained low in both the manufacturing and service sectors in 1998 Q4 (see Chart 2.14).

Because retained earnings provide the largest share of investment financing for most firms, expected lower profits will affect capital expenditure decisions in 1999. However, external financing is also important. The real cost of borrowing faced by firms is likely to have fallen in the last few months, because of lower interest rates charged by banks, lower real bond yields and increased equity prices (see Section 1). Overall, therefore, the real cost of capital faced by most firms seems unlikely to be a constraint on investment decisions at present. Survey evidence supports this conclusion—in recent CBI surveys, only a small fraction of manufacturing firms reported that the cost of finance was likely to limit capital expenditure in the next twelve months.

Survey evidence suggests that the overall growth rate of business investment will slow sharply this year and may well turn negative (see Charts 2.15 and 2.16).

Investment intentions in the manufacturing sector remain very subdued. They have also weakened in the service sector, though the latest BCC survey balance remained positive, indicating continued increases in capital expenditure.

Real general government investment in the second and third quarters of 1998 was 2.4% higher than in the same period a year earlier, following a fall of more than 12% in financial year 1997/98. As the November *Pre-Budget Report* indicated a 5.6% increase in the nominal capital budget for this financial year, it seems likely that the growth rate of real government investment will continue to increase in 1998 Q4 and 1999 Q1.

Looking further ahead, the Government has committed itself to doubling the ratio of public sector net investment to GDP over the next three years. So the growth rate of government capital expenditure is likely

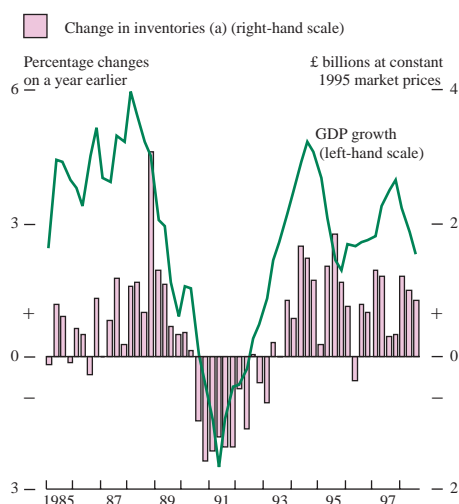
to increase sharply in the next financial year. Millennium-related construction spending will probably also boost investment this year and may bring some expenditures forward, though it may lead to some substitution between private and public investment spending.⁽¹⁾

Inventory investment

There is evidence that the slowdown in consumption growth took some firms by surprise, causing an involuntary accumulation of inventories. Between the first and third quarters of 1998, manufacturing and retail sector stock-output ratios for finished goods increased by $1\frac{3}{4}$ percentage points and $2\frac{3}{4}$ percentage points respectively. In addition, CBI surveys have found that the balance of manufacturing firms reporting more-than-adequate inventory levels increased in both Q3 and Q4 last year, to the highest levels since 1991. However, there appears to be less of an inventory overhang in the retail and wholesale sectors: the number of firms reporting to the CBI Distributive Trades Survey that stock levels increased relative to expected sales fell back in Q4, and the January balance for this question was around its long-term average value.

At the whole-economy level, inventories (excluding the alignment adjustment) increased by £0.8 billion in 1998 Q3, slightly less than in the first and second quarters (see Chart 2.17). This pushed the whole-economy stock-output ratio up by 0.1 percentage point. As in the November central projection, it is likely that inventories will detract from GDP growth this year.

Chart 2.17
Change in inventories



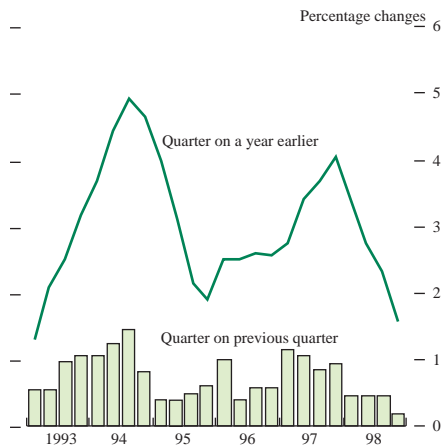
(a) Excluding alignment adjustments.

Public sector demand

Real general government consumption increased by 2.2% in the year to 1998 Q3, broadly in line with this year's planned spending. In assessing the outlook for the public finances, the MPC has taken as its central case the nominal government expenditure plans and effective tax rates from the pre-Budget statement published on 3 November. The Government intends to expand current nominal spending by almost 6% in financial year 1999/2000, up from around $3\frac{1}{2}\%$ in the current financial year. On the basis of the MPC's latest inflation forecast, this implies that the growth rate of real spending will also increase.

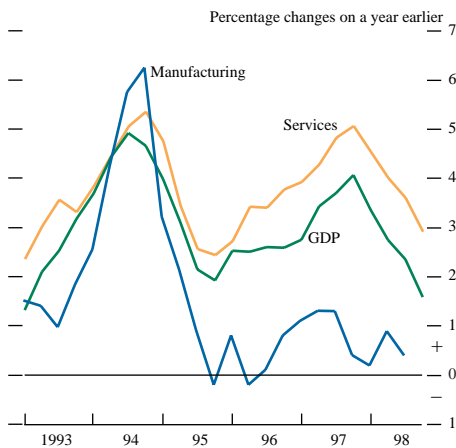
(1) For more details, see box on page 20 of the November 1998 Report.

Chart 2.18
GDP growth rate^(a)



(a) At 1995 market prices.

Chart 2.19
Annual growth rate of GDP



Given the larger-than-expected increase in income tax payments, the overall fiscal stance in 1998 was probably tighter than the MPC had previously assumed. On the basis of already-announced government expenditure plans, the overall stance of fiscal policy, on a cyclically adjusted basis, is unlikely to change much between this financial year and the next.

2.3

Output

According to the preliminary estimate, the quarterly growth rate of GDP (at constant market prices) decreased to 0.2% in 1998 Q4, from 0.4% in the third quarter. This lowered the annual rate of increase to 1.6% (see Chart 2.18), in line with the MPC's central projection at the time of the *November Report*.

The growth rates of industrial production and service sector output still differ markedly, largely because the industrial sector is more exposed to international trade (see Chart 2.19). Although service sector output growth slowed to 0.6% in 1998 Q4, the 2.9% annual rate of increase remains above its long-run trend. By contrast, industrial production fell by 0.8% in the three months to November, and the average level of production in October and November was only 0.6% higher than a year earlier.

In the manufacturing sector, output fell in November for the fourth month in succession, leaving it 0.2% below a year earlier. Survey evidence continues to indicate very weak business confidence. Although the CBI's measure of overall optimism about the business situation improved in January, the balance remains at its lowest level since January 1991. The balance of manufacturing firms expecting output to rise over the next four months was at broadly similar levels. And the Chartered Institute of Purchasing and Supply (CIPS) general index fell to 42 in 1998 Q4, well below the neutral level of 50.

Construction output declined by 0.6% in 1998 Q3, after a 3½% fall in Q2. As a consequence, the annual growth rate has slowed sharply, to 0.4%. Furthermore, activity does not seem to have picked up much in the fourth quarter; new construction orders in October and November were much lower than the average Q3 level. Similarly, the CIPS survey measure of construction activity averaged 45.5 in 1998 Q4, well below the balance of 51.5 in the third quarter. In contrast, activity in the energy extraction and supply industries has been

more buoyant—in the three months to November, output in these sectors was 4.2% higher than in the same period a year earlier.

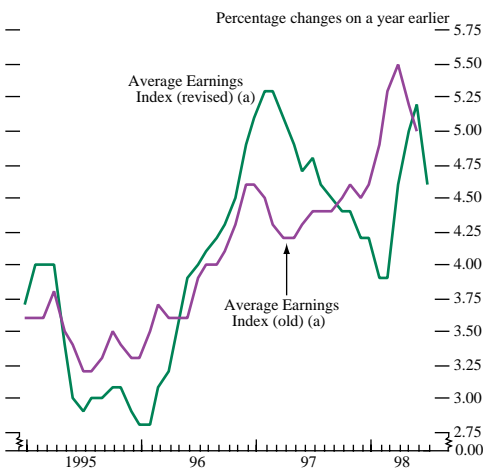
Survey evidence suggests that service sector activity will continue to slow this year. The BCC's measure of turnover confidence among service sector firms fell for the fifth successive quarter in 1998 Q4, as the balance of firms reporting a rise in both domestic and export orders declined. Similarly, the CIPS indicators of service sector activity also deteriorated in the fourth quarter. The business activity index averaged 49.1 in 1998 Q4, down from 54.7 in the third quarter, and the measure of incoming new business fell by 5 points to 47.4. In both cases, readings below 50 indicate falling activity.

2.4

Summary

Global economic conditions have continued to deteriorate since the November *Inflation Report*, with the impact of the sharp contraction in demand in Asia and the oil-exporting countries increasingly evident in UK export figures. Domestically, although the slowdown in GDP growth to 0.2% in 1998 Q4 was consistent with the MPC's central expectation at the time of the November *Inflation Report*, the composition of this growth differed from that anticipated. In particular, consumption decelerated faster than expected. And consumer confidence, business optimism and investment intentions remain weak, suggesting that activity is likely to be subdued in the first half of this year.

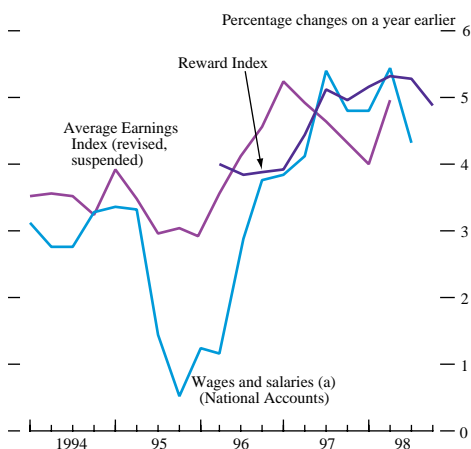
Chart 3.1
Old and revised headline measures of the Average Earnings Index (suspended)



Note: The Average Earnings Index was suspended on 2 November 1998.

(a) Seasonally adjusted, whole-economy figures.

Chart 3.2
Alternative measures of nominal earnings growth



Sources: ONS, Bank of England and the Reward Group.

(a) Calculating by dividing wages and salaries by total employees in employment.

Employment growth has been strong and inactivity has fallen. Unemployment has continued to edge down, but the LFS unemployment rate, which stands at 6.2%, has been relatively stable in recent months. Recent survey evidence suggests a moderation in recruitment intentions and some alleviation of skill shortages.

Last November, the ONS suspended publication of the Average Earnings Index, pending the outcome of an independent review commissioned by the Chancellor. Other evidence on nominal earnings behaviour, including settlements, analysis of the components of wage drift, and a fall in inflation expectations, appears consistent with an easing of upward pressure on nominal earnings growth.

3.1

Earnings

The underlying rate of earnings growth, a key indicator of domestic inflationary pressure, remains hard to assess. The rebasing of, and revisions to, the official earnings data in October 1998 made the growth of the Average Earnings Index (AEI) volatile and difficult to reconcile with other information on pay and on the state of the labour market generally.⁽¹⁾ Chart 3.1 shows the reported profile of nominal earnings growth under the old and revised AEI measures. The two series differ considerably, especially during 1997 and in 1998 Q1. Consequently, on 2 November, the ONS announced a suspension of the AEI, pending an independent review of the series commissioned by the Chancellor. The suspension means that there is greater-than-usual uncertainty about recent earnings behaviour and its likely future path.

There are a number of sources of information about earnings growth other than the AEI. Chart 3.2 compares the revised AEI with wage and salary data from the National Accounts, and earnings growth based on the Reward Index, an independent survey covering some 860,000 employees. Growth in National Accounts measures of wages and salaries per head was estimated at 4.4% in the year to 1998 Q3, compared with a revised

(1) See the November 1998 *Report* for a detailed discussion of the difficulties posed by the revised earnings data.

Chart 3.3
Wage settlements by sector

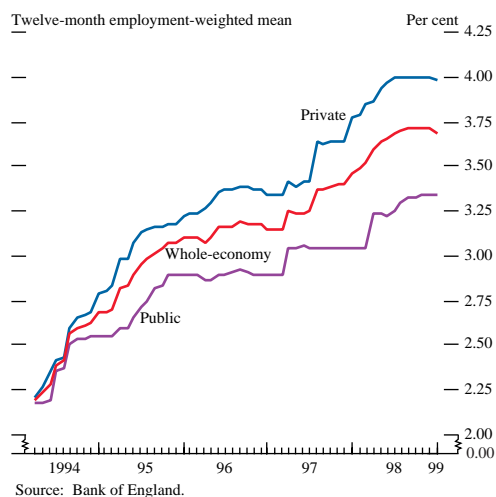
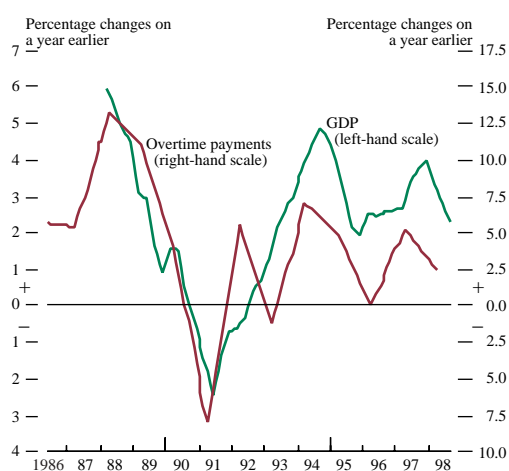


Chart 3.4
Growth in GDP and overtime payments
1986–98



5.1% in 1998 Q2. These estimates are partly derived from the AEI, and its suspension has meant that the ONS has based its measure of wage and salary growth on other sources. So it is difficult to draw clear inferences from these data. But the Reward Index also suggests that earnings growth may have slowed in recent months.

Data on wage settlements also shed light on earnings behaviour. Basic wages account for a substantial proportion of total earnings, so there is a close relationship between wage settlements—the annual increase in the basic wage—and earnings growth.⁽¹⁾ The Bank's estimate of the twelve-month employment-weighted mean wage settlement has been unchanged for the past nine months, at around 3.7%. Estimates of private and public wage settlements have also changed little since the November *Report* (see Chart 3.3).

On 1 February, the Government announced its decision to accept all the main pay recommendations of the pay review bodies. For the 1999/2000 financial year, the results of the review bodies imply an average rise of 4.1% in public sector pay for the employees concerned, to be met from resources allocated under the Comprehensive Spending Review. These pay settlements will not be staged. Settlements were paid in two stages during the 1998/99 financial year, in April and December. So public sector earnings growth between April and December 1999 will be temporarily higher than the average rise, to the extent of the second-stage payments.

Wage drift, the difference between earnings growth and settlements, incorporates factors such as overtime payments, shift premia and bonuses. The components of wage drift are likely to be responsive to demand conditions. As Chart 3.4 shows, there has been a close correlation between the growth of overtime payments, as measured by the New Earnings Survey (NES), and the growth of GDP since the mid 1980s. And the available evidence, including that from the Bank's regional Agencies presented to the July meeting of the MPC, suggests that an important factor underpinning bonuses is corporate profits, particularly in the year preceding bonus payments. Corporate profit growth slowed during 1998. More recent evidence from the Agencies has

(1) The May 1997 *Report* and a box on page 27 of the August 1993 *Report* discuss the relationship between wage settlements and earnings inflation in depth. They note that turning-points in settlements and earnings roughly coincide and that, if anything, past experience suggests that earnings growth appears to lead settlements. So settlements may, in part, consolidate past wage drift.

pointed to lower overtime and bonus payments. So whole-economy wage drift may have lessened in recent months.

The Bank's regional Agents reported that more companies are expecting lower settlements this year than higher. But the outlook for growth in total earnings per head is less clear. Some firms cite the inflation outlook and company prospects as important factors exerting downward pressure on earnings growth; but other factors, such as the need to retain and recruit staff, have contributed to upward pressure on earnings growth, particularly in the service sector. The effects of the Working Time Directive (WTD) and the National Minimum Wage may also be influencing the outlook for growth in earnings per head—a number of firms have not yet adjusted wages to take account of these policy changes.

Table 3.A
The recent evolution of inflation expectations^(a)

Percentage increases in prices

RPI inflation rate one year ahead

	1998			
	Q1	Q2	Q3	Q4
Academic economists	3.0	3.2	2.9	2.5
Business economists	3.0	3.1	2.6	2.1
Finance directors	3.3	3.4	3.1	2.5
Investment analysts	3.1	3.3	3.3	2.4
Trade unions	3.5	3.3	3.2	3.0
General public	4.3	4.4	4.5	4.2

RPI inflation rate two years ahead

Academic economists	3.1	3.1	3.0	2.7
Business economists	2.9	2.9	2.4	2.3
Finance directors	3.3	3.2	2.9	2.9
Investment analysts	3.3	3.3	3.1	3.0
Trade unions	3.9	3.8	3.6	3.2
General public	5.1	5.1	5.1	4.7

Source: Barclays Basix Survey.

(a) Figures refer to RPI inflation, except for General public, for which the measure of inflation is not specified.

Wage-bargainers implicitly negotiate over expected future real wages, which depend on expected future inflation. In particular, lower inflation expectations tend to result in lower rates of increase in nominal wages. As noted in Section 1, financial market based measures of inflation expectations have been steadily falling since 1997. RPI inflation expectations according to the Basix Survey have also fallen. The survey captures the inflation expectations of a broad range of labour market participants and others, and so is perhaps more likely to shed light on the wage bargain than measures derived from financial market data. As Table 3.A shows, one and two year ahead inflation expectations of business people, academics, trade unions and the general public mostly fell significantly between 1998 Q3 and 1998 Q4.

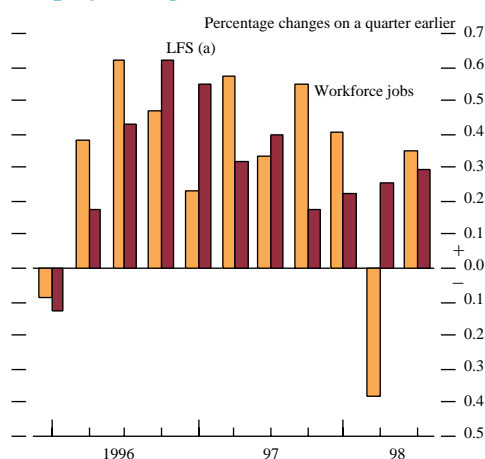
When bargaining over real wages, employers focus on the real product wage, which compares total labour cost per employee with the post-tax price of goods and services sold. Employees, on the other hand, care about the real consumption wage—the wage received relative to retail prices and personal taxation. If the prices of goods and services charged by domestic producers, net of tax, were expected to rise at a different rate from prices of goods and services bought by workers, this could drive a wedge between the growth rates of real product and consumption wages. The wedge might increase if there were a fall in the terms of trade (the price of exports relative to imports) or if taxation increased. This would tend to reduce labour supply relative to demand, and could raise the level of real wage pressure in the economy.

Measures of real consumption and product wages would ideally incorporate expectations of the appropriate consumer and producer price indices. But such measures are either imprecise or unavailable, and so actual price outturns must be relied upon to calculate the real wages relevant to firms and households. Estimates based on the National Accounts suggest that real product wages grew at an annual rate of 3.4% in the year to Q3, compared with real consumption wage growth of 1.0%. This might seem to imply some upward real wage pressure. But part of the reason why real product wages have outpaced real consumption wages lies in increased mortgage interest payments, a reduction in mortgage interest relief and increased council taxation. This has led to relatively higher inflation in the Tax and Price Index (TPI), used to calculate the real consumption wage. The recent cuts in interest rates are likely to reduce inflation as measured by the TPI (see Section 4), and so the wedge is likely to diminish.

In judging the most likely path for nominal earnings, the MPC has taken into account the fall in inflation expectations in recent months and has lowered the inflation expectations profile used in the central projection. And in light of the evidence from settlements, the components of drift, and alternative measures of earnings, the MPC has decided to further lower the profile for nominal earnings growth in the central projection, compared with the *November Report*. The MPC has taken account of the more-than-usual uncertainty surrounding the news on earnings by increasing the variance around its projections for earnings growth.

3.2 Employment and unemployment

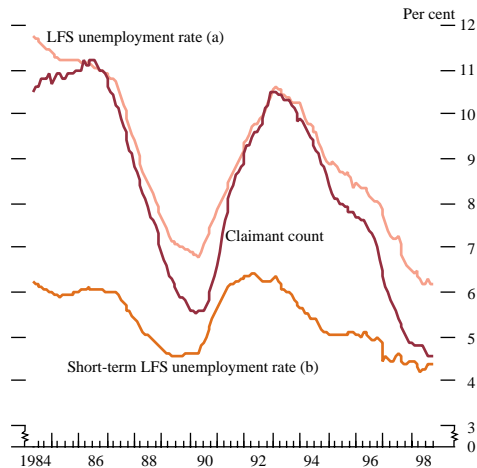
Chart 3.5
Employment growth



(a) Note: LFS data centred around March, June, September and December.

Recent employment data have been strong (see Chart 3.5). Employment, as measured by the LFS, rose by 98,000 (0.4%) in the three months to November. The employment rate rose to 73.8% in October from 73.2% a year ago—its highest level since 1990. And according to the Workforce jobs survey, employment increased by 97,000 in 1998 Q3, a rise of 0.4%, after falling in 1998 Q2. Recent revisions to the Workforce jobs survey have increased the estimated level of employee jobs by some 450,000 since September 1997, and increased the rate of employment growth during 1997. The two measures differ because the Workforce measure is based on a survey of the number of employee jobs, whereas the LFS measure is based on the number of people in work. But both suggest that employment rose

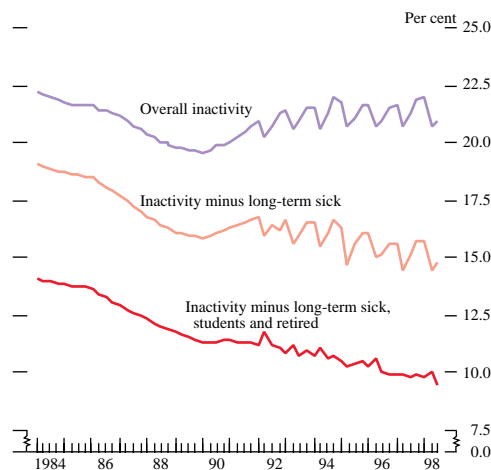
Chart 3.6
Unemployment rates



Sources: ONS and Bank of England.

- (a) LFS unemployment measures started in 1984.
- (b) Short-term unemployment refers to those employed for less than a year (seasonally adjusted estimate).

Chart 3.7
LFS inactivity rates^(a)



Sources: ONS and Bank of England.

- (a) Data refer to Great Britain only. Based on non seasonally adjusted annual data before 1992 and quarterly data thereafter. The data have been adjusted for a discontinuity in the series in 1992.

substantially, by more than 250,000 in the year to 1998 Q3. The MPC's projections for inflation and output are based on the LFS measure, and are therefore unaffected by the revisions to the Workforce jobs survey.

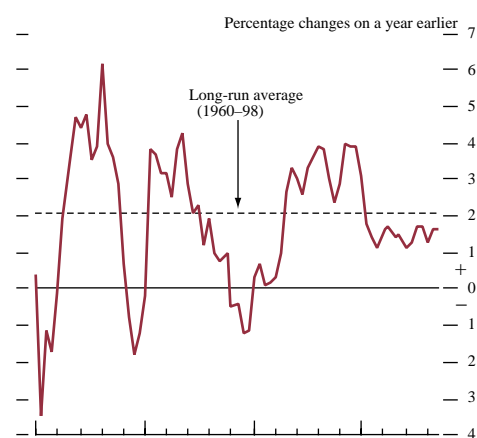
The increase in employment has been reflected in falls in both unemployment and inactivity. According to the most recent data, LFS unemployment fell by 26,000 in the three months to November, compared with the previous three months, and claimant unemployment fell by 14,000 in December. Chart 3.6 shows the recent behaviour of LFS, claimant-count and short-term unemployment. These measures all suggest that unemployment remains very low by recent historical standards—the claimant unemployment rate is at its lowest level since 1980. But there are signs that the downward trend in unemployment has flattened. Both the LFS unemployment rate and the claimant-count rate have edged down only slightly in recent months, and were at 6.2% in the three months to November and 4.6% in December respectively. So the relatively stable behaviour of unemployment in the face of rising employment is largely accounted for by falling inactivity.

Inactivity fell by 36,000 in the three months to November, and by 0.9% on a year earlier. This reflects a fall in the number of people not wanting a job, including, among other things, an increase in part-time work by women not previously counted as part of the labour force. Overall inactivity rates have been largely unchanged since 1992. But when allowances are made for the long-term sick, the early retired and students, inactivity rates have been falling (see Chart 3.7). The decline in inactivity rates, adjusted for those factors, is consistent with continuing labour market tightness.

Labour usage, as measured by total hours worked per week, rose by 0.1% in the three months to November, and by 0.3% on a year earlier. Employment growth has outpaced the growth in total hours worked, so average hours worked per head have fallen. This is consistent with both a rise in part-time work and a fall in overtime. So earnings per hour may have been growing by more than earnings per head.

The continued growth of employment, in the face of slowing output growth, has meant that measured productivity growth, per hour or per head, has fallen. Whole-economy measured productivity growth rose by 1.6% in the year to 1998 Q3. Productivity growth since 1995 has averaged around 1.6%, below its long-run

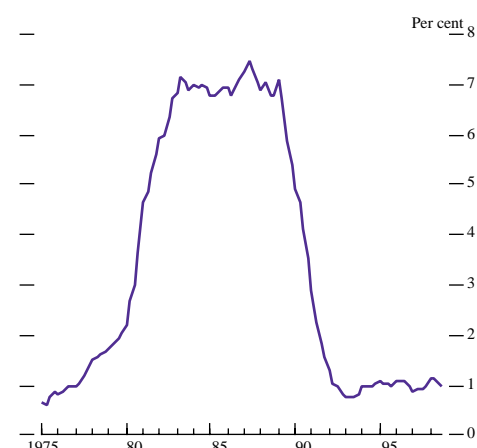
Chart 3.8
Whole-economy measured productivity growth^(a)



Source: ONS.

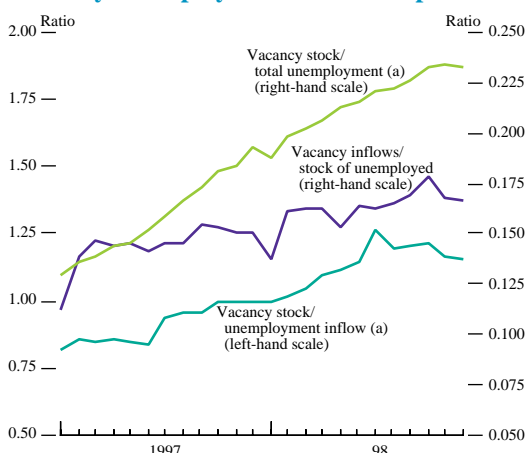
(a) Defined as output divided by Workforce jobs.

Chart 3.9
The extent of regional mismatch^(a)



(a) Defined as the variance of the absolute deviations of regional unemployment from national unemployment, weighted by regional labour share.

Chart 3.10
Vacancy-unemployment relationships^(a)



(a) Adjusted to allow for the overstated stock of vacancies from 1996 Q2 onwards and the subsequent correction by the ONS.

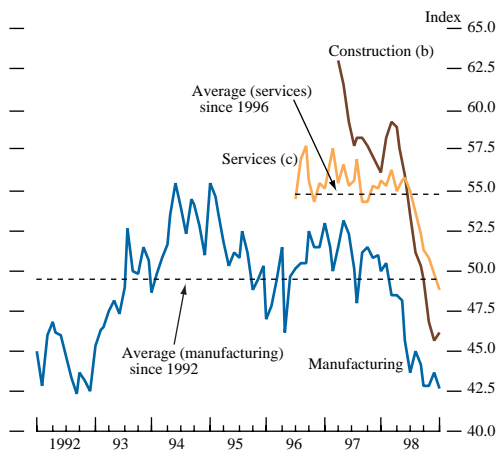
historical average growth rate of around 2.1% (see Chart 3.8). It is extremely difficult to judge the future path of productivity growth. This is because it depends partly on how quickly firms adjust their demand for labour, and on their choice of adjusting between average hours worked and the number of people employed. If firms regard slower economic activity as transitory, then they would be unlikely to reduce employee numbers, given hiring and firing costs. This could lower productivity growth. It is also possible that there has been a level shift in trend productivity. Labour market reforms may have encouraged new workers into the workforce, or created new jobs with lower-than-average productivity. Such factors could act to reduce the level of whole-economy measured productivity. The MPC judges that productivity growth will slow during 1999, before picking up towards the end of the forecast period.

Wage pressure is also influenced by the geographic distribution of unemployment. If there are imbalances between the distribution of unemployed workers across different regions, such regional mismatch will affect wage pressure at any given level of aggregate unemployment. Chart 3.9 shows how one measure of regional mismatch has changed over time; it remains low relative to the level in the 1980s. So lower regional mismatch could be a factor contributing to the apparent weakness of upward pressure on earnings growth, despite low aggregate unemployment.

Another measure of mismatch that can be used to gauge labour market tightness is the ratio of the stock of reported vacancies to total unemployment. This ratio can be interpreted as a comparison of unsatisfied labour demand with available supply. The extent to which the unemployed are able to fill available vacancies is likely to affect wage pressure significantly at any given level of unemployment. Chart 3.10 shows that the labour market is much tighter now than in 1997 on this measure, though the most recent data suggest that the ratio may be stabilising. Two alternative measures of the relationship between vacancies and unemployment, which stress the roles of vacancy inflows and inflows into unemployment, are also shown. They also suggest a moderation in labour market tightness.

Surveys provide a forward-looking perspective of the state of the labour market, and can shed light on near-term employment prospects. Recent CIPS reports pointed to sharp falls in construction and manufacturing employment, and a contraction in service sector

Chart 3.11
CIPS surveys^(a)



- (a) The Chartered Institute of Purchasing and Supply. Respondents were asked to compare the level of employment at their unit with the situation one month ago. A result greater than 50 indicates an increase in employment.
- (b) The construction series began in April 1997.
- (c) The services series began in July 1996.

Table 3.B
Surveys of employment intentions^(a)

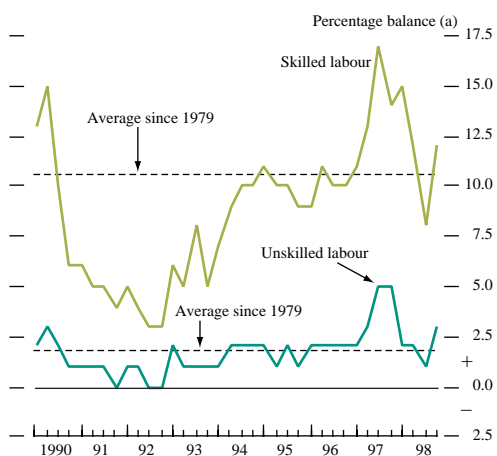
Percentage balance of employers planning to recruit staff

	Series average (b)	1998			
		Q1	Q2	Q3	Q4
BCC (c)					
Services	12	22	20	14	15
Manufacturing	3	7	9	-1	-6
CBI (d)					
Manufacturing	-21	-19	-18	-26	-34
Manpower					
Services	11	18	17	17	12
Manufacturing	14	20	17	13	9

Sources: British Chambers of Commerce, CBI and Manpower.

- (a) Seasonally adjusted by the Bank.
- (b) CBI averages from 1979; BCC from 1989; Manpower from 1988.
- (c) Next three months.
- (d) Next four months.

Chart 3.12
CBI measures of labour shortages



Source: Confederation of British Industry.

- (a) Difference between those respondents answering 'yes' and those answering 'no' when questioned on factors likely to limit output during next four months.

employment (see Chart 3.11). And as Table 3.B shows, there has been a deterioration in recruitment intentions. The Manpower survey in December indicated the lowest net balance for five years. But when seasonal adjustment is taken into account, the balance is much closer to its average level since 1988.

Chart 3.12 shows evidence from the CBI suggesting that reported shortages of both skilled and unskilled labour have decreased in recent quarters, though these have risen slightly on the latest data. Shortages in the skilled and unskilled sectors of the labour market are often cited by employers as an important factor underpinning wage pressure. The reduction in the percentage balance of employers reporting labour shortages, from levels reported in mid 1997, is consistent with an easing of upward pressure on pay growth.

3.3 Reforms affecting the labour market

Prospects for the labour market are affected by microeconomic policies that aim to influence the demand for and supply of labour. Measures such as the New Deal and the Working Families Tax Credit (WFTC) are designed to increase labour market participation. A box on page 31 considers the impact of the WFTC on labour market supply, and concludes that implementation of the reform is likely to result in a moderate increase in labour market participation. The MPC judges that it is unlikely that the WFTC will significantly influence the profile of inflation over the forecast period.

However, the Working Time Directive (WTD) may result in increased effective hourly wage costs for employers, a reduction in total hours worked and lower potential output. The cost effects of the WTD, which came into effect on 1 October 1998, chiefly consist of restrictions on hours worked, direct costs from paid holiday entitlements, fixed costs of health assessments for night-workers, and costs of administration.⁽¹⁾ The Bank's regional Agents have reported that a number of contacts expect increased wage bills, due to more generous holiday entitlements. But how far the WTD decreases employment in equilibrium will depend on how flexibly firms are able to adjust hours worked and numbers of people employed. In the November Report, the MPC noted that risks to inflation from the WTD warranted a small positive skew in the first year of the inflation projection. Following further Bank work, the

(1) A box on page 30 in the November 1998 Report describes the WTD in more detail.

The Working Families Tax Credit

The Working Families Tax Credit (WFTC) is an in-work benefit for low-income households with dependent children, and is intended to replace the existing Family Credit scheme from October 1999.⁽¹⁾

Like Family Credit, the WFTC will be paid to families where at least one adult works more than 16 hours per week. Under the Family Credit scheme, families earning below £79 per week received a flat-rate maximum payment. Above that level, benefits were withdrawn by 70 pence for every £1 of additional income. Under the WFTC, the earnings threshold has been raised to £90, and the withdrawal rate for households earning above this threshold has been reduced to 55 pence in the pound. Recipients of the WFTC are also entitled to help with 70% of childcare costs, subject to a ceiling determined by the number of children in the household. The WFTC has the potential to increase participation in the labour market and hence the supply of labour available to meet labour demand.

The WFTC is likely to have different effects on the labour supplied by different groups of people. For some individuals, such as lone parents, the WFTC should raise the incentives to work, because of the increase in the threshold, the reduction of the withdrawal rate and the fall in childcare costs. For other people, such as partners of WFTC recipients, the incentive to work may be reduced. This is because the WFTC reforms could entail an increase in family income for a partner when they do not work, increasing their desire to move out of work. This effect may be counteracted by the childcare credit, as both partners in a couple must be working to receive help with childcare costs. But since a significant amount of childcare is informal, introduction of the WFTC may lead to some substitution from informal to formal childcare.

The impact of the WFTC on the number of hours worked is also likely to vary between groups. When in-work benefits are withdrawn as earnings rise, the incentive to work an extra hour is reduced. For some households, this disincentive will lessen with the WFTC, because of the raising of the earnings level at which withdrawal starts, and the lowering of the withdrawal rate. But there will be some people who will be better off overall by receiving WFTC, but who do not currently receive Family Credit. This group will face the additional 55% withdrawal rate of WFTC on top of the marginal withdrawal rate, produced by income tax and National Insurance, that they already faced. This may cause them to reduce labour supply.

For the population as a whole, a reliable guide to the impact of the WFTC can only be provided by a simulation based on a representative sample of households. Independent research⁽²⁾ by the Institute of Fiscal Studies has attempted to quantify the labour market impact of the WFTC, using its tax and benefit simulation model (TAXBEN) and data from the Family Resources Survey. They divide recipients into two groups—lone parents, and couples with children. Their analysis indicates that the WFTC is likely to increase the participation of lone parents in the labour market. Among couples, the effects on male participation are estimated to be small, while there is a moderate decrease in labour supplied by women as a result of the incentives to move out of work highlighted above. Their provisional findings suggest that the increase in total economy-wide participation, which depends on how far the childcare subsidy is taken up, would lie between 10,000 and 45,000 workers, with a point estimate of 30,000 in the event of a 100% take-up of childcare subsidy. In the MPC's judgment, numbers of this magnitude are unlikely materially to affect whole-economy labour supply. So it is unlikely that the WFTC will significantly influence the profile of inflation over the forecast period.

(1) For a detailed discussion of the policy, see 'The Modernisation of Britain's Tax & Benefits System—the Working Families Tax Credit and Work Incentives', *Treasury Budget Paper* No 3, 1998.

(2) The Bank of England has contributed towards the cost of this study.

MPC has now incorporated an effect from the WTD into its central projection, rather than as a risk, but it remains small.

3.4

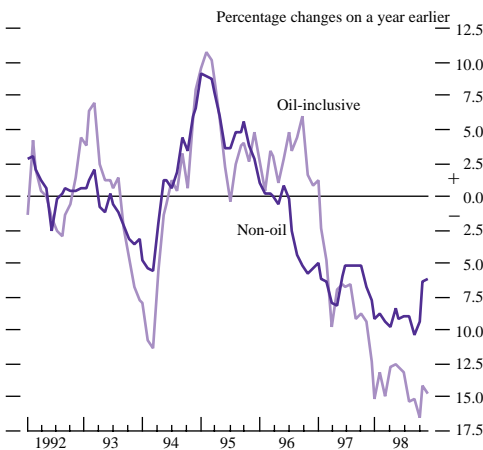
Summary

The labour market appears tight by recent historical standards. Employment growth continues to be strong, leading to falls in both unemployment and inactivity. The LFS unemployment rate stood at 6.2% in the three months to November, slightly lower than in the preceding three months. But recent survey evidence points to a moderation in recruitment intentions and some alleviation of skill shortages. So a turning-point in labour market conditions may have been reached.

The ONS has suspended publication of the Average Earnings Index, pending the outcome of an independent review commissioned by the Chancellor. Inflation expectations have fallen significantly further in recent months. This, together with the available evidence on nominal wage behaviour, notably from settlements and analysis of the components of wage drift, appears consistent with an easing of upward pressure on earnings growth over the forecast period.

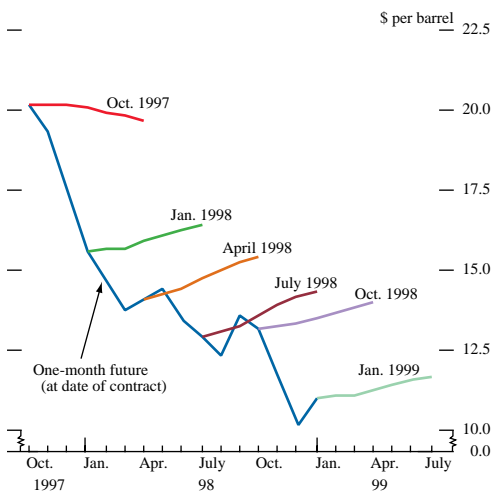
Costs and prices

Chart 4.1
Bank's commodity price index^(a)



(a) Monthly average of prices of primary commodities weighted by their importance in UK demand.

Chart 4.2
Forward curves of Brent crude dollar oil prices^(a)



Source: International Petroleum Exchange.

(a) Derived from futures prices. All prices are monthly averages of daily data.

RPIX inflation was close to target throughout the second half of 1998. World prices of commodities, which have fallen further since the November *Report*, have resulted in falling producer prices in the major economies. UK import prices have continued to decline, and in December, manufacturing output prices were flat or lower than a year earlier. Output price inflation in the service sector has been higher than in manufacturing, but evidence from the CIPS survey suggests that cost pressures may be easing there. The limited information available, from the National Accounts and surveys, points to a moderation in nominal unit labour cost growth since the middle of 1998.

4.1 Raw materials and commodity prices

World prices of raw materials and commodities have fallen sharply over the past three years. The *Economist* dollar index of world non-oil commodity prices has fallen by more than 20%, and the dollar oil price has fallen by almost 40%. The Bank's commodity price indices, which are weighted by UK demand, have also declined sharply over the past three years—excluding oil prices, they have fallen by 18%, and including oil, by 24% (see Chart 4.1).

Brent crude oil prices fell from a peak of \$24 per barrel in January 1997 to a trough of just below \$10 in December 1998, and remained low at \$10–12 throughout January (oil prices were lower only in July 1986 and prior to that 1973). The decline reflects the contraction of Asian demand and expectations of subdued world demand in 1999. The forward prices for Brent crude, which were revised down throughout 1998 as spot prices fell, suggest that prices will remain broadly flat, far below their 1997 levels (see Chart 4.2). Oil consumption per unit of output by OECD countries has fallen by around 40% since the 1970s, so the impact of lower oil prices on those countries may be less marked than in the past. The United Kingdom is a small net exporter of oil, so lower prices may reduce income and therefore restrain demand, though net trade in oil now accounts for a much lower proportion of GDP than it did in the early or mid 1980s. There may also be indirect effects on UK demand and prices, resulting from a shift in the

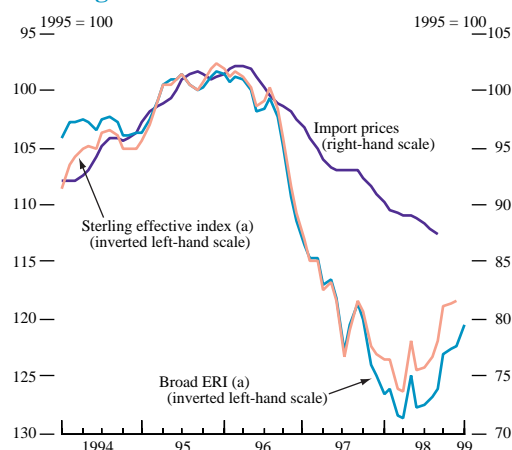
composition of global demand from oil-exporting to oil-importing countries. The implications for UK net trade are discussed in Section 2.

Non-oil commodity prices have been depressed by weaker world demand. Wholesale food prices in the United Kingdom—which account for just under half of the Bank’s non-oil commodity price index—have been further reduced by the strength of sterling against other European currencies over the past two and a half years.

The introduction of the euro has changed the way that intervention prices are calculated under the Common Agricultural Policy. Since 1 January 1999, intervention prices have been calculated in euros and translated into sterling using the market exchange rate against the euro rather than the green pound, which has been abolished. Intervention prices were little changed in January, as sterling traded in a narrow range against the euro. As noted in previous *Reports*, some intervention prices may fall from 2000, if the European Commission’s Agenda 2000 proposals are accepted.

The MPC’s central projection assumes that world commodity prices in dollars will be broadly flat in 1999, before rising in 2000. Lower oil prices are assumed to have similar effects on the UK economy to lower prices for other commodities.

Chart 4.3
Import prices of goods and services and the exchange rate



Note: The ERI is measured against 20 other industrialised countries. The broad ERI is measured against 49 other countries.

(a) A fall indicates an appreciation.

4.2 Import prices and the exchange rate

Sterling prices of imported goods fell by 6% in the twelve months to November, and by 13% since August 1996, when sterling began to appreciate. The fall in import prices has been less marked than sterling’s appreciation since 1996, though the decline in sterling’s ERI and in the broad ERI since April 1998 has narrowed the gap (see Chart 4.3). Import prices have remained high relative to the average export prices of the United Kingdom’s major trading partners, suggesting that suppliers may have used sterling’s appreciation to widen their margins on UK sales. The response of import prices may also have been tempered if overseas exporters to the United Kingdom thought that sterling’s appreciation was temporary. That may also have an effect on the extent and timing of the response to the recent depreciation of sterling.

As discussed in Section 2, prospects for global growth and trade have deteriorated further since the November *Report*, and the outlook for world inflation remains

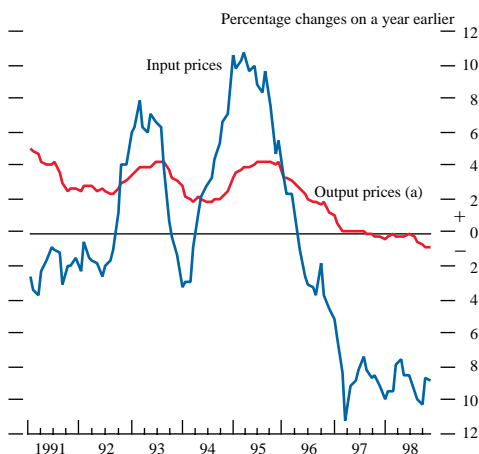
subdued. The MPC has revised down its projection for import prices in 1999, reflecting weaker prospects for world growth and lower world inflation.

4.3 Costs and prices in the service sector

There are some signs that cost pressures in the service sector are easing. The Chartered Institute of Purchasing and Supply (CIPS) measure of the cost of all inputs fell from a peak of 58.8 in 1998 Q2 to 54 in Q4. Although above the neutral level of 50, which indicates no change in costs compared with the previous period, that was below the average for the series, which began in July 1996.

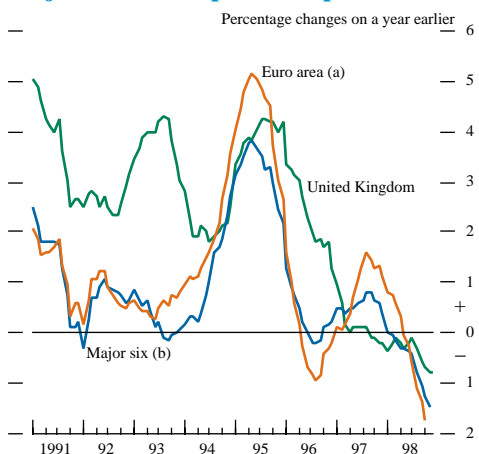
A measure of corporate services output inflation is being developed by the ONS. At present, it is experimental and only twelve series are published (a further 36 series will eventually be included in an aggregate index). Of the twelve published series, seven pointed to lower inflation in 1998 Q3 than in Q2, four pointed to higher inflation, and one showed no change. Survey data suggest that services output price inflation has eased since then. The CIPS survey index for average prices charged fell from 52.2 in 1998 Q1 to 47.8 in Q4; as that is below the neutral level of 50, it would be consistent with a fall in prices between the third and fourth quarters. And the index remained below 50 in January. But the BCC survey pointed to higher service sector inflation in 1998 Q4 than in Q3, because of the cost of overheads and pay settlements.

Chart 4.4
Producer price inflation



(a) Output prices excluding excise duties (PPIY).

Chart 4.5
Major economies producer price inflation



(a) The euro-area data are GDP-weighted.

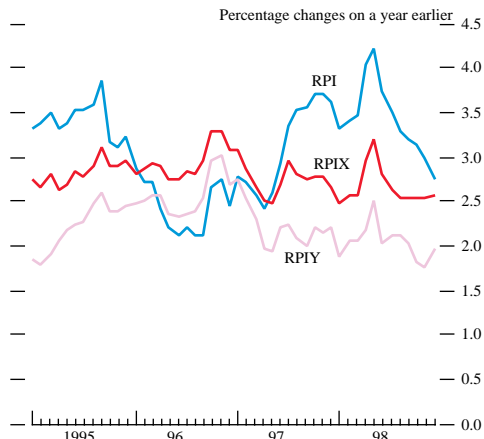
(b) The major six economies are the G7 excluding the United Kingdom. Data are UK trade-weighted.

4.4 Costs and prices in manufacturing

Input prices continued to fall throughout the second half of 1998, and were 9.3% lower than a year earlier in 1998 Q4; excluding food, drink, tobacco and petroleum, prices were around 5% lower. Output prices have held up relative to input prices (see Chart 4.4). That probably reflects past increases in the cost of labour or bought-in services, which together account for around half of manufacturers' total costs. But in 1998 Q4, all measures of output prices were flat or lower than a year earlier.⁽¹⁾ Both the BCC and CBI survey measures pointed to a further decline in UK output prices. The latest available data for 1998 for other G7 countries and the euro area as a whole also show producer prices falling (see Chart 4.5), which suggests further downward pressure on UK import

(1) The ONS is to improve the Producer Price Index by changing the sample and raising the representation of small firms in the index. Significant changes are not expected until February 2001. Further details are set out in *Economic Trends*, December 1998.

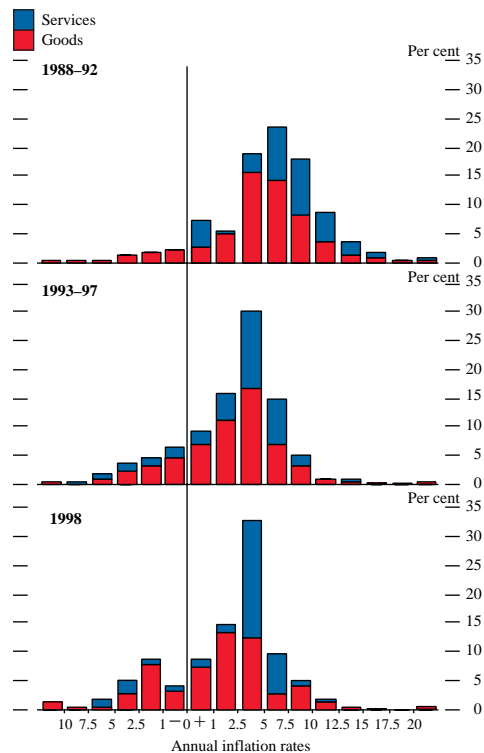
Chart 4.6
Inflation^(a)



RPIX = Retail price index excluding mortgage interest payments.
RPIY = RPIX excluding VAT, local authority taxes and excise duty.

(a) Adjusted by the Bank of England for ONS error in under-recording aggregate price indices between February and May 1995. Other charts and tables in this *Report* that include measures of retail price inflation are similarly adjusted.

Chart 4.7
Distribution of weighted annual inflation rates of RPIX goods and services^(a)



(a) Weighted share of inflation rates, for the 77 categories of goods and services within RPIX, falling within a given range.

prices as recent reductions in global producer prices are passed on.

4.5

Retail prices

Annual inflation in retail prices excluding mortgage interest payments (RPIX) was close to target at 2.6% in December, following four months when inflation had been exactly at the target rate of 2.5%. RPIY, which also excludes indirect and local authorities' taxes, rose to 2.0%. The headline RPI inflation rate fell to 2.8% (see Chart 4.6).

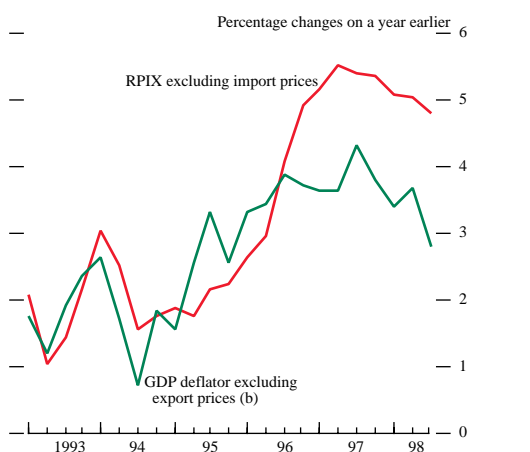
The small increase in RPIX inflation in December was the result of a sharp rise in seasonal food prices, caused by bad weather, and a bigger increase in household goods prices than the previous December—prices often rise in this sector in advance of discounting for the January 'sales'. Neither of these upward influences on inflation is expected to persist.

The average RPIX inflation rate was 2.6% in 1998, and it has been between 2% and 3% in every year since 1993. The November *Report* noted that RPIX inflation has been very stable recently. It is also useful to look at the distribution of inflation rates within RPIX, to see whether stable inflation rates have been accompanied by smaller relative price changes. Chart 4.7 shows the distribution of weighted twelve-month price changes in the 77 categories of goods and services included in RPIX inflation. As well as moving down with lower inflation since the late 1980s, the distribution of prices has also narrowed slightly, which means that the variance of relative price movements has been a little lower. Price cuts have become more common: in 1998, 20% of prices in RPIX were lower than a year earlier, compared with around 6% in 1988-92. This is particularly true for goods prices—27% fell in 1998, compared with 14% of services prices.

Services price inflation has been above that of goods since December 1996. The gap between RPIX services and goods price inflation narrowed a little in December; services price inflation remained at 3.5%, whereas that for goods rose to 1.4%. But the gap between services and goods price inflation was even wider when measured by RPIY, as petrol prices excluding excise duties were lower than a year earlier.

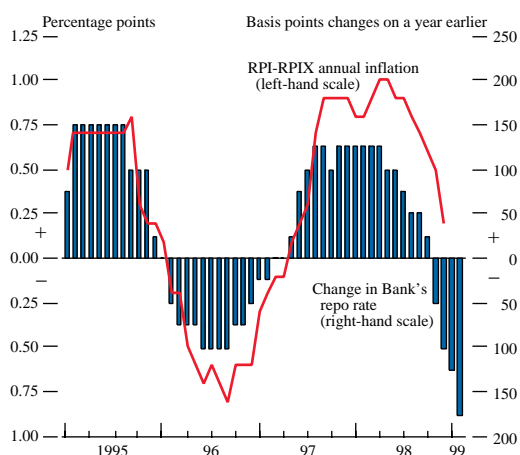
The current size of the gap is partly due to goods prices having a higher import content than services, so an

Chart 4.8
Measures of domestically generated inflation^(a)



(a) Unit labour costs measure suspended on account of Average Earnings Index.
(b) Using GDP measured at basic prices.

Chart 4.9
The difference between headline RPI and RPIX inflation and changes in interest rates



exchange rate appreciation lowers goods prices relative to services. But that difference should diminish once an exchange rate appreciation ends or reverses. However, since 1977 there have only been short periods when UK services price inflation has not exceeded that of goods, and the empirical evidence is similar for other countries. That is likely to be the result of lower productivity growth in the service sector than for goods, though it is difficult to measure the quality, and therefore productivity growth, of services precisely.⁽¹⁾

The lower import content of services than goods means that the inflation rate of services has been closer to domestically generated inflation (DGI) than that of goods in the past two years. DGI inflation measures have fallen back in recent quarters (see Chart 4.8). One measure of DGI, the GDP deflator excluding export price inflation, fell to 2.8% in Q3. A second measure, RPIX inflation excluding import prices, fell below 5% for the first time since 1997. A third measure, an estimate of unit labour cost growth, is derived from data based on the AEI, which has been suspended (see Section 3). Unit labour cost estimates are therefore less firmly based than usual. Upward revisions to employment, and small revisions to wages and salaries, mean that labour costs per unit of output appear to have been higher in 1997 than previously thought. But recent estimates suggest that wage pressures eased in 1998 Q3: annual unit wage cost growth fell from 3.5% in Q2 to 2.8% in Q3.

Since 1997, headline RPI inflation has been above RPIX inflation, because of the interest rate rises between May 1997 and June 1998 (see Chart 4.9). Between October 1998 and February 1999, the MPC reduced the official repo rate by 2%. Headline RPI inflation should, therefore, fall below RPIX inflation in the next few months as the reduction in official interest rates feeds through to lower mortgage rates, and as the April 1998 reduction in Mortgage Interest Relief at Source (MIRAS), falls out of the annual comparison.

4.6 Other price indices

Other measures of retail price inflation remained flat or fell slightly during 1998 Q4. Inflation in the Harmonised Index of Consumer Prices (HICP) rose by 1.5% in the twelve months to December, somewhat higher than the averages for the euro area and the European Union as a

(1) These issues are discussed in more detail in Julius, D and Butler, J, 'Inflation and growth in a service economy', *Bank of England Quarterly Bulletin*, November 1998, pages 338-46.

Chart 4.10
HICP and RPIX inflation

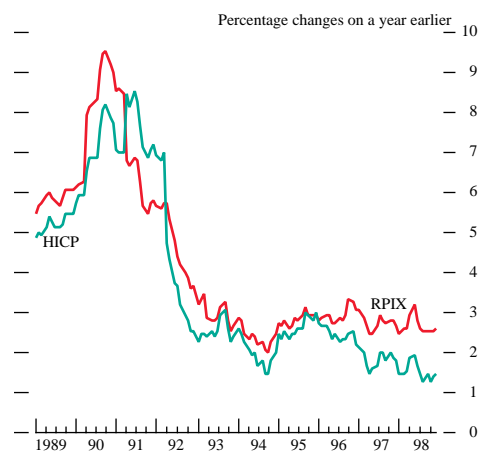


Table 4.A
Differences between HICP and RPIX inflation^(a)

Percentage points

	Use of geometric mean	Coverage (b)	Total
1989	-0.2	-0.4	-0.7
1990	-0.3	-0.8	-1.1
1991	-0.4	1.1	0.7
1992	-0.3	-0.1	-0.4
1993	-0.4	-0.1	-0.5
1994	-0.4	0.0	-0.4
1995	-0.4	0.2	-0.2
1996	-0.4	0.0	-0.5
1997	-0.5	-0.4	-0.9
1998 (c)	-0.5	-0.6	-1.1

(a) Figures may not sum because of rounding.

(b) The HICP excludes council tax and owner-occupiers' housing costs, it has a different coverage and measurement of insurance, and it excludes some other goods and services, for example, NHS prescription charges.

(c) January to September 1998.

whole. The GDP deflator measure of whole-economy inflation fell to 1.8% in 1998 Q3.

The ONS has recently constructed HICP inflation rates for the United Kingdom over a long period.⁽¹⁾ HICP inflation rates back to 1989 were calculated using individual price quotes (see Chart 4.10). HICP inflation was above that of RPIX for the twelve months from April 1991. This was a result of a cut in local authorities' taxes, partly financed by an increase in VAT—local authorities' taxes are included in RPIX but are excluded from the HICP, whereas VAT is included in both indices. But on average, HICP inflation has been 0.5 percentage points lower than RPIX inflation since 1989. HICP inflation rates were estimated for 1975–88 assuming that the use of the geometric mean (see below) has a downward effect on the inflation rate of 0.25 percentage points. Between 1976 and 1988, HICP inflation was on average 0.5 percentage points lower than RPIX inflation.

The gap between RPIX and HICP inflation is accounted for by differences in coverage and the use of different methods of combining price quotes at the lowest level. Using the geometric (instead of the arithmetic) mean in the HICP results in a lower inflation rate than the methods used in RPIX. That is because when relative prices change, the geometric mean method in effect increases the weight on goods whose relative price has fallen (it is as though consumers are assumed to switch spending towards cheaper substitutes), whereas the arithmetic mean method has fixed weights. This has accounted for 0.2–0.5 percentage points of the difference between the two inflation rates since 1989 (see Table 4.A). Coverage differences have had varying effects across years. HICP inflation is currently 1.1 percentage points below RPIX inflation. The 0.6 percentage points of the current difference that is not explained by the use of the geometric mean reflects the exclusion from the HICP of local authorities' taxes and owner-occupiers' housing costs (housing depreciation is included in RPIX).

4.7

Summary

Inflation was exactly on target between August and November 1998, and remained close to target in December. Weaker commodity and input prices have

(1) Details on the construction of the HICP can be found in *Economic Trends*, December 1998. HICP price indices are still under development. From December 1999, the coverage of goods and services included in the HICP will be extended, and the population coverage will be expanded to include foreign nationals' spending in the United Kingdom.

been reflected in subdued manufacturing output prices. Surveys and falling producer prices overseas suggest that this weakness is set to continue. Service sector output price inflation also appears to have moderated during the second half of 1998.

Domestically generated inflation has been significantly higher than imported inflation in the past two years. Similarly, services price inflation has been higher than that for goods. Over the forecast period, weaker domestic demand and the lagged effects of sterling's recent and expected depreciation should gradually narrow the gap between domestically generated and imported inflation. The MPC's central projection assumes that import prices rise more slowly throughout 1999 than was expected at the time of the November *Report*.

5 Monetary policy since the *November Report*

This section summarises the economic developments and monetary policy decisions taken by the MPC since the *November Report*. The minutes of the November, December and January meetings are attached as an Annex to this *Report*. The Bank of England's official dealing rate—the repo rate—was reduced from 6.75% in November to 6.25% in December, 6.0% in January, and 5.5% in February.

At the time of the *November Report*, the central projection was for RPIX inflation to rise slightly above target over the following twelve months, before returning to around 2.5% at the two-year forecast horizon. The small rise in projected inflation reflected higher earnings growth, including the effects of the National Minimum Wage. Risks to the inflation outlook were thought to be symmetric—downside risks from weaker growth were expected to be balanced by upside risks from past strong money growth and from the possibility of a more rapid fall in the exchange rate.

At its meeting on 9–10 December, the Committee noted that the prospects for global activity and prices had deteriorated further over the month. Business confidence in the major economies had weakened and commodity prices, particularly oil, had fallen further. Trade data had suggested that the effects of slower world demand were now emerging, in addition to the impact of sterling's appreciation. There had been an easing of monetary policy in the United States and the euro area. The main domestic news concerned consumption, though other indicators of domestic activity were also showing signs of softening. In particular, pressures in the labour market appeared to have eased. However, aggregate M4 growth had continued at annual rates of more than 9%, and asset prices remained firm.

Many of the Committee's concerns related to the prospects for consumption and confidence. Consumption growth in Q3 had been below the November central projection, and retail sales growth pointed to further weakening in Q4. Various reasons for the slower-than-expected household spending were suggested, and are detailed in the Annex. These included the possibility that the consumption effects of

windfall payouts in 1997 had been more bunched than expected; that consumers were more worried by the outlook for employment and were saving more; and that consumers had not reacted to increases in wealth in the same way as in the past. But the Committee judged that none of the explanations on its own was sufficient to explain the slowdown in consumption.

In assessing the inflation outlook, the Committee noted that the mean of the two year ahead RPIX projection had already been below 2.5% in November. The weaker global and domestic situations suggested that the balance of risks to UK activity was now even further on the downside, so the expected inflation rate two years ahead had fallen since the November *Report*.

The Committee therefore agreed that there was a clear case for a further cut in interest rates during the month. It considered whether it was helpful to judge the appropriate level of nominal interest rates by reference to a ‘neutral’ level that provided neither restraint nor stimulus to the economy. Proxies for the neutral interest rate could, in principle, be determined by combining short-term inflation expectations with an estimate of the short-run real interest rate. But in practice, measurement of the neutral nominal rate was difficult and imprecise; estimates lay between 4.5% and 6.5%. Though some Committee members found the concept useful, others judged that the uncertainty surrounding its level was too large for it to be a practical guide to policy. The widely held view was that an immediate cut in interest rates of 50 basis points was justified by the news over the month. Accordingly, the Committee voted to reduce the repo rate from 6.75% to 6.25%.

At its meeting on 6–7 January, the Committee again considered the prospects for global activity and prices. Views varied on whether there had been a further deterioration in external demand over the month, or whether international developments had principally reflected the continuing pass-through and unwinding of previous negative shocks. However, commodity prices had remained weak—the fall in world oil prices to around \$10 per barrel prior to the December meeting had largely persisted, and non-oil commodity prices had increased only slightly in November. Overall, the Committee felt that the prospects for global activity and prices had changed little since December, and that the risks to both inflation and activity remained clearly on the downside.

The main domestic news on activity had been the small downward revision to the level of GDP and the change in the composition of growth. Consumption had been revised down, and the contribution from net trade and inventory accumulation had been revised up. The lower estimate for the level of GDP suggested that pressure on capacity was likely to have been less than previously thought. The news from retail sales had been mixed, while monetary growth and world stock markets pointed to a stronger outlook for activity. The Committee concluded that recent indicators suggested that GDP growth in 1998 Q4 would turn out broadly as expected at the time of the November *Report*.

Given this picture for activity, nominal price and cost developments continued to be more benign than expected at the time of the November projections and, on the view of some Committee members, than expected in December. Producer input prices had continued to fall, and wage settlements had been flat for many months. Depending on wage drift developments, this suggested a somewhat lower path for earnings growth than previously expected.

In its discussion of the immediate policy decision, the Committee largely focused on two considerations. First, the adjustment in the world economy was likely to prove more prolonged than previously assumed, so there was less need for policy to put downward pressure on domestically generated inflation. Second, revisions to the expenditure composition of domestic demand, together with the potential easing in the labour market and the apparent moderation of inflation expectations, suggested weaker prospects for inflation. Against this background, the Committee voted to cut the Bank's repo rate by 0.25% to 6.0%.

At its meeting on 3–4 February, the Committee voted to reduce the repo rate by 0.5% to 5.5%.

6.1 The inflation projection assumptions

This *Report*, which the MPC approved on 5 February, contains the Committee's assessment of developments in inflation in the economy since November, and prospects for the medium term. Charts 6.1 and 6.2 show projections for GDP growth and RPIX inflation up to two years ahead, and the uncertainties surrounding them. The projections assume that the Bank's repo interest rate will remain unchanged at 5.5% during the next two years, and are conditioned on the assumptions described below.

There has been a further downturn in the prospects for world demand and inflation since the November *Report*. The outlook for Japan appears even weaker than three months ago, and prospects for growth in the euro area have deteriorated. This has to some extent been offset by stronger demand in the United States. Outside the major industrial economies, prospects for some emerging market economies look weaker, particularly following the floating of the Brazilian real. The Committee now assumes that UK-weighted export markets will grow by 4%–5% in both 1999 and 2000, well below the average over the 1990s. As in recent projections, the slowdown in the growth rate of UK-weighted export markets is likely to be less severe than the slowdown in total world trade, because of the compression of intra-Asian trade. But the UK share of its export markets is likely to continue to fall during the next two years, because of the lagged effects of the past appreciation of sterling.

Moreover, although the MPC considers the risks to output to be broadly balanced in the first year of the projection, there is a downside risk to UK demand from lower world growth in the second year of the projection. In particular, the slowdown in activity in industrial countries could prove protracted and hence lead to weaker UK net trade. One particular risk is that US domestic demand growth, having been very strong, will slow more sharply than assumed in the central case, perhaps following a fall in stock-market values.

The weaker outlook for world activity has also led to the prospect of a softer profile for world inflation in the

short run, and hence for lower imported inflation, than expected at the time of the November *Inflation Report*. In particular, commodity prices remain low. Given the exchange rate assumptions outlined below, the central projection is for the fall in import prices in sterling terms to end. There is a risk that world export prices could be weaker than in the central projection, which would lead to lower UK inflation.

The sterling exchange rate, as measured by the effective exchange rate index, averaged 100.1 in the 15 working days up to and including 3 February. This is the starting-point for the exchange rate profile assumed in the projection. It compares with an average of 100.0 at the time of the November *Report* and an implied level of 99.7 for February then. So the starting-point for the exchange rate now is a little higher than in the November projection.

In judging the path for sterling, conditional on unchanged UK nominal interest rates, the MPC has taken into account both interest rate differentials and risk considerations. In the central projection, the sterling ERI declines to 97.6 by the end of the two-year forecast period, and this implies bilateral sterling exchange rates of about \$1.67 and €0.72 (equivalent to DM 2.71). By itself, the introduction of the euro has no direct implications for UK monetary policy, at least in the near term. In the MPC's view, there is still a somewhat greater risk of a fall in the sterling ERI than a rise, relative to the central projection. On average, the sterling ERI is expected to decline more steeply than in the central projection, reaching a level just above 96 in two years' time.

The November *Inflation Report* projections allowed for a small risk of a marked reduction in the supply of credit to UK companies and households, following the global financial turbulence earlier in the year. That risk did not materialise, and the MPC has decided to remove this small downside risk to demand and inflation.

The plans announced in the autumn pre-Budget statement made by the Chancellor on 3 November were incorporated into the November projections, and these figures remain the basis for the February projections. Given the Government's announced plans and the Committee's latest central projection for inflation, the likely profiles for real government consumption and investment are similar to those assumed by the Committee in November.

Previous projections have already incorporated assumptions about the effects of the National Minimum Wage, the New Deal and the Working Time Directive (WTD). There was a small upside risk to inflation from the introduction of the WTD in the November projection. Further analysis has not altered the MPC's view that the effects of the WTD on inflation and output are likely to be relatively small, but the Committee decided to allow for an effect in the central projection. Preliminary results of independent research by the Institute for Fiscal Studies on the impact of the Working Families Tax Credit (WFTC) have also been made available to the Committee (see page 31). The Committee judges that the reduction in inflation up to the forecast horizon following the introduction of the WFTC is likely to be very small, and decided not to make any allowance in its projections. There is no change to the assumptions made in recent *Reports* on the effects of other labour market reform measures.

6.2 The medium-term inflation projection

The preliminary estimate of output growth in the fourth quarter of 1998 released in January was close to the central projection made in the November *Report*, and hence by itself contained little news. However, the previous month's National Accounts release of data for Q3 had contained some revisions to the level of output, and to the composition of demand growth in recent quarters. The level of output was around 0.2% lower than previously thought, but this revision was not large enough to warrant a significant change of view on the extent of inflationary pressures in the economy. Final domestic demand growth (ie excluding inventory accumulation) was a little lower than expected at the time of the November *Report*, largely because of weaker consumption growth.

The Committee discussed various possible explanations for lower-than-expected consumption growth in Q3 and in preceding quarters that had been revised, and concluded that none was compelling on its own. One possibility was that consumption had recently been erratically low, and would at some stage recover to its equilibrium level in relation to labour income, wealth and interest rates. There was also a chance that the data would be revised. Other possibilities were that the windfall effect from demutualisations or the wealth effect from rising equity prices had been smaller than assumed in previous projections. The Committee decided not to treat all of the weaker outturn for

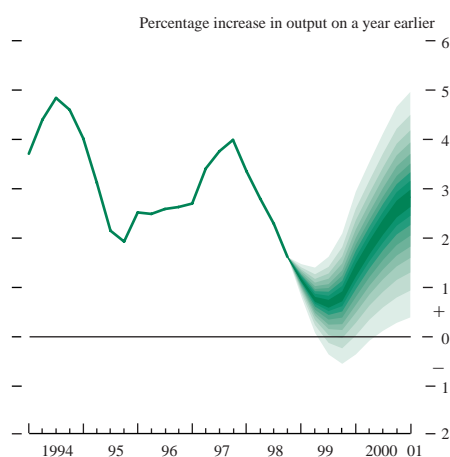
consumption as erratic, and so the central projection is for a slightly lower level of consumption in relation to income through the forecast period than assumed three months ago.

Investment in Q3 was a little stronger than expected at the time of the *November Report*, and was also revised upwards in earlier quarters. But investment intentions in manufacturing remain very subdued, and have also weakened in the service sector. The Committee reduced its central projections for investment growth markedly at the time of the *August 1998 Report*, partly on account of the survey evidence, and it judges that no further adjustment is warranted. The central projection remains that the growth rate of business investment is likely to slow sharply this year and may well turn negative.

The contribution to GDP growth in the third quarter from the change in inventories was stronger than expected at the time of the previous *Report*, but revisions to earlier quarters lowered the measured stock-output ratio. It remains likely that a reduction in inventories will significantly detract from GDP growth in the period ahead.

The central projection is that net exports are likely to depress GDP growth in both 1999 and 2000. However, the weaker outlook for world demand and UK exports is largely offset by weaker UK domestic demand and imports, so the deterioration in net trade is little changed relative to the *November Report* projections.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 5.5%



The fan chart depicting the probability distribution for output growth is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for output. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See box on page 52.

Although the outturn for Q4 GDP was in line with the *November* central projection, the MPC judges that the prospects for activity in the period immediately ahead have deteriorated somewhat. There are two main reasons: first, a downward revision to the projection for domestic demand, particularly consumption, linked to the outlook for the labour market discussed below; and second, a further deterioration in the prospects for world demand and UK exports.

The central projection is for the four-quarter growth rate of GDP at constant market prices to slow to between $\frac{1}{2}$ % and 1% during this year, before recovering to around trend by the middle of 2000 as domestic demand picks up (see Chart 6.1).⁽¹⁾ The trough in the central projection for growth is a little deeper than at the time of the *November Report*. Quarterly growth is expected to be close to zero in the first half of this year. The central

(1) Also shown as Chart 1 in the Overview.

projection for the next few quarters is broadly consistent with Bank staff analysis of the recent evidence from the CBI, BCC and CIPS surveys. These surveys, although much weaker than their past historical averages, also point to broadly flat GDP at the start of 1999.

As well as some deterioration in the immediate prospects for output, there has also been news over the past three months about nominal variables. Broad money growth has slowed, consistent with a gradual slowing of demand. Inflation expectations have fallen on a number of measures over the past quarter. This is likely to lead to lower wage and price-setting. In addition, the reduction in interest rates in recent months means that headline RPI inflation is likely to fall below RPIX inflation for a period, which may further moderate pressure on pay settlements.

The suspension of the Average Earnings Index last November, pending the outcome of the independent review, makes analysis of the labour market more than usually uncertain, and this is reflected in the greater width of the inflation projection fan chart than would otherwise be the case. Given the further tightening of the labour market in the past year, settlements might have been expected to rise over the past few months. In fact, settlements were flat on the twelve-month employment-weighted measure for the past nine months. It also seems probable that wage drift is now contributing less to the growth of earnings per head than it has been, especially given the recent fall in average hours worked per employee and hence the likely reduction in overtime pay. The recent survey by the Bank's regional Agents for the February MPC showed more companies expecting lower settlements this year than higher, though the same survey showed a less clear picture for growth in earnings per head. Although the recent public sector pay settlements were higher than a year ago, and both the Working Time Directive and the National Minimum Wage are likely to increase labour costs to some degree, upward pressure on overall pay growth appears to be easing. This has led the Committee to lower both the starting-point and central projection for nominal earnings growth compared with the November *Report*.

LFS unemployment has declined slightly over the past three months, claimant-count unemployment is at its lowest level since 1980, and employment has continued to rise. Overall, the data suggest that the labour market has reached a turning-point. The Committee's central

projection is that employment may fall for a time, reflecting a period of output growth below trend. This will ease pressures on pay. The LFS measure of inactivity has been rising, but this reflects a long-term structural increase due to such factors as the rise in the number of long-term sick. After adjusting for these, the inactivity rate is likely to be cyclical and to rise a little as the economy slows. This matters for the projection because the inactive are assumed to exert much less downward pressure on the level of real earnings than the unemployed.

Over the past three years, as employment has grown strongly, measured productivity growth has been 1½%, somewhat below trend. Whole-economy productivity growth is judged likely to remain below its long-run average in 1999, before increasing towards the end of the forecast period. There are several possible explanations for weaker-than-average productivity growth over the recent past. First, productivity may have been mismeasured. Second, the strength of employment growth as activity slowed has been surprising. This may reflect a timing effect as firms expect the slowdown in demand to be temporary, in which case measured productivity may eventually return to its long-run trend level. A third possibility is that the rate of increase in productivity has been temporarily weaker than its average historical rate because of structural changes in the labour market. For example, it is possible that labour market reforms have encouraged new workers into the labour market, or created new jobs, with lower-than-average productivity, which reduced the measured level of productivity growth while the adjustment was taking place. Thereafter, productivity growth would be expected to return to its long-run average. These alternative possibilities have different implications for price-cost margins. A rapid rise in employment consistent with firms assuming that weakening demand was temporary would suggest that productive capacity is greater than previously thought, and hence put downward pressure on margins. But a shift in the level of average productivity would imply lower capacity and less downward pressure on margins. The central projection attaches some weight to all of these explanations, and taken together they raise the projection for inflation compared with the productivity assumption in the November *Report*. But there is a great deal of uncertainty, and on balance there is a small downside risk to inflation from these factors relative to the central projection. The sensitivities are such that if one took the view that there had not been any shift in

the level of average productivity, then the central projection for inflation would be about 0.2 percentage points lower.

Survey measures of capacity utilisation from the BCC and CBI are broadly consistent with estimates based on an examination of output relative to inputs of capital and labour. A fall in capacity utilisation was already under way at the end of 1998, which does not seem surprising given the slowing of output growth compared with its trend. The prospective fall from peak to trough is likely to be much smaller than in the early 1990s. This partly reflects the starting-point: capacity utilisation measures were much higher in the late 1980s than in the late 1990s. The effect of capacity utilisation on prices (relative to weighted costs) seems to be pro-cyclical. But prices respond to capacity utilisation with a lag, so the central projection is that the reduction in utilisation rates will continue to put downward pressure on inflation as growth picks up.

The MPC's projection for the twelve-month RPIX inflation rate—assuming that nominal interest rates are constant at 5.5%—is shown in Chart 6.2.⁽¹⁾ The November projection, which corresponds to a 1.25% higher interest rate assumption, is shown alongside it (Chart 6.3). The most likely path is for RPIX inflation to stay close to the 2½% target for the next two years.

The profile for inflation through this year is a little lower than in the November projection for 1999, but is broadly the same as in November by the end of the forecast period. This reflects a number of factors. The downturn in prospects for world activity implies a weaker outlook for both UK exports and world prices, and so lower UK inflation. And the starting-point and profile for the sterling effective exchange rate is a little higher than in November. There is also a prospect of slower growth of consumption and hence domestic demand. The starting-point and profile for earnings growth are lower in the current projection. But some factors have raised the central projection since November. Interest rates were reduced by 0.5% in December, 0.25% in January and 0.5% in February.

The balance of risks to output is on the downside throughout the forecast period, as at the time of the November *Report*. Overall, the risks to inflation are broadly balanced in the first year of the projection, but are slightly on the downside through the second year of

(1) Also shown as Chart 2 in the Overview.

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 5.5%

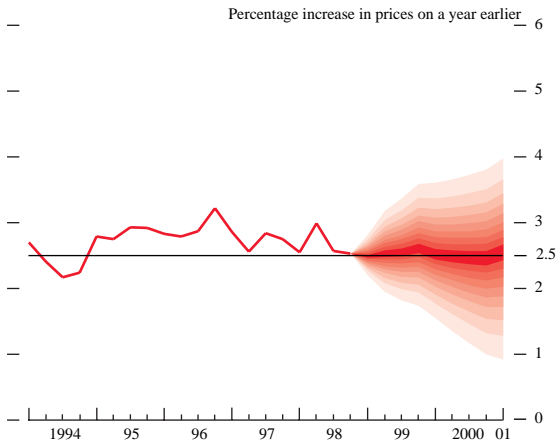
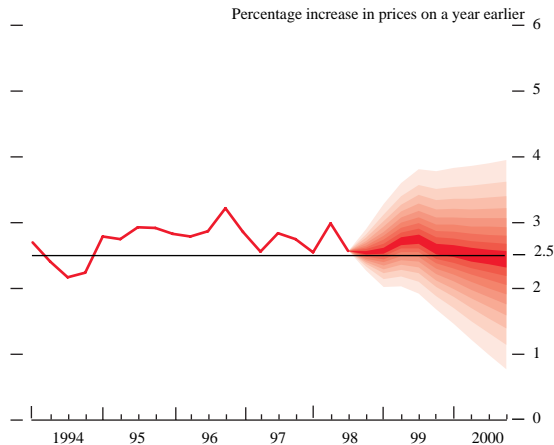


Chart 6.3
RPIX inflation projection in November based on constant nominal interest rates at 6.75%



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See box on page 52.

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2001 Q1

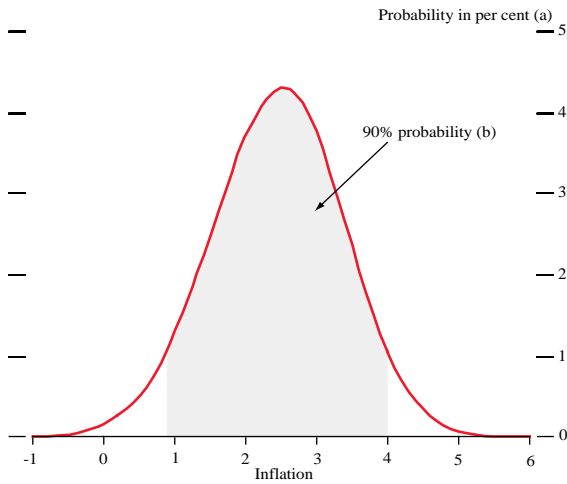
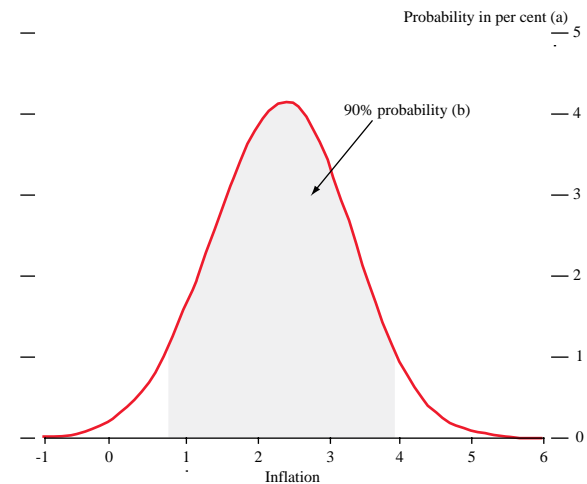


Chart 6.5
November projection for the percentage increase in RPIX in the year to 2000 Q4



Source: Bank of England.

- (a) Probability of inflation being within ± 0.05 percentage point of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (between 2.45% and 2.55%) in the current projection is around 4%.
- (b) The areas shaded light grey contain 90% of the probability, and are consistent with the widest bands shown in Charts 6.2 and 6.3. For further details see 'The *Inflation Report* projections: understanding the fan chart', February 1998 *Quarterly Bulletin*, pages 30–37.

Table 6.A
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates^(a)

RPIX inflation					
Probability, per cent	Range:				
	less than 1.5%	1.5% to 2.5%	2.5% to 3.5%	more than 3.5%	
1999 Q4	2	37	54	7	
2000 Q4	15	39	36	10	
2001 Q1	16	35	36	13	

GDP growth						
Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
1999 Q4	19	40	32	8	1	0
2000 Q4	3	10	22	30	23	12
2001 Q1	3	8	19	28	25	17

(a) These figures are from the same distributions as the GDP and inflation fan charts, Charts 6.1 and 6.2.

the projection. The box on page 52 explains in more detail how fan charts are drawn, and Charts 6.4 and 6.5 show the overall balance of risks to inflation at the end of the forecast period. Table 6.A shows the MPC's assessment of the probabilities of various outcomes for inflation and output growth.

The market expectation of the likely path of interest rates has fallen since the November *Report*. On 3 February, implied interest rates on short-sterling contracts suggested that the market expectation was for a fall in official interest rates to around 5% by the end of 1999. The MPC's projections for inflation and output growth under the assumption that official interest rates follow market expectations differ somewhat from those in the central projection (see Charts 6.6 and 6.7). The path of interest rates is below the constant interest rate assumption, implying slightly faster growth and consequently higher inflation than in the central projection which, at the two-year horizon, is above the target.

Chart 6.6
Current RPIX inflation projection based on market interest rate expectations

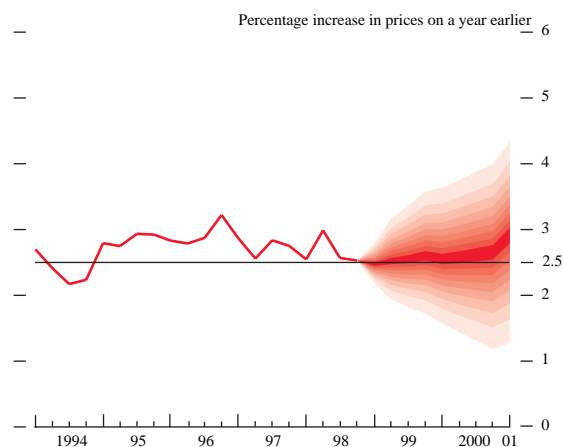
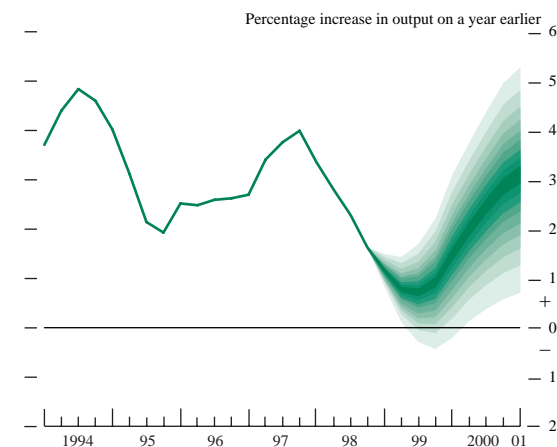


Chart 6.7
Current GDP projection based on market interest rate expectations



How fan charts are drawn⁽¹⁾

The MPC cannot accurately predict the future: there are considerable uncertainties surrounding any economic projection. These uncertainties are illustrated explicitly in the *Inflation Report* fan charts for growth and RPIX inflation. But how should the *Inflation Report* fan charts be interpreted?

The fan chart probability distributions contain more information than a simple point forecast. The width of the fans measures the overall degree of uncertainty, which may change from quarter to quarter as the assessment of risks evolves. How far the bands stretch out on one side of the central band compared with the other—the skew of the distribution—is determined by an assessment of the balance of risks. Again, this can change from quarter to quarter.

Fan charts are shaded rather like a contour map in the following sense. Pick a particular date in the forecast period. The fan chart at that point shows the MPC's judgment of the probability of various ranges of outcomes. As with a contour map, it represents a simplified version of a cross-section of a hill. Figure 1 illustrates a 'probability hill'.

The probability of any specific inflation number occurring is close to zero, so it is better to think of the probability that inflation will fall within a particular range. That is what the fan chart illustrates. The width of the band shows a range. The central band (around the peak in Figure 1) defines the range within which there is a 10% chance of inflation occurring. This area is shaded deep red. Each successive pair of lighter-shaded red bands is drawn in a similar way by adding another 10% of the probability and moving further down the probability hill. Taken together, the shaded areas contains 90% of the probability distribution.

The same method is used for each point in time over the forecast period. The fan chart is drawn by joining up the individual probability distributions through time. As with a contour map, the darkest band corresponds to the highest part of the probability hill. It is the narrowest range of outcomes for inflation that contains 10% of the probability. In other words, the likely outcomes are clustered round the central point. Uncertainty increases as the forecast period moves forward, so the width of the bands increases.

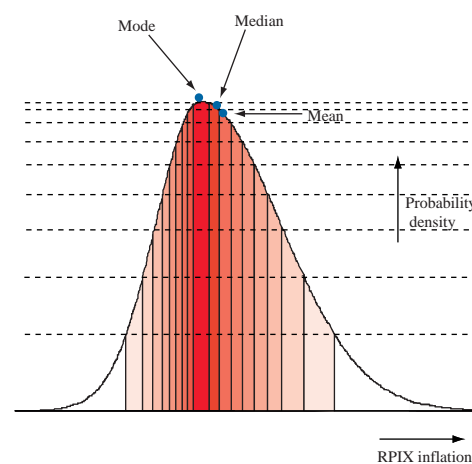
Some of the risks that the MPC discusses when making the *Inflation Report* projection will

materialise, and others will not. So the economy is unlikely to move along the band containing the central projection throughout the forecast period, or any other particular shaded band in the fan chart. It is, for example, quite possible that inflation will be above the central projection in the first year, but will fall below the central projection in the second year (or *vice versa*).

There are numerous different possible paths for the economy, and the fan chart tries to capture these outcomes in a single chart. Taking an average of all these possibilities gives the mean of the distribution.

If the distribution of outcomes is symmetric, then the modal (ie most likely) outcome will equal the mean outcome, and both will lie exactly at the centre of the darkest band. But this will not be the case if the risks are asymmetric. If the risks to inflation are more on one side of the central case than the other, then the distribution will be skewed, with the average (mean) outcome above or below the most likely (modal) outcome. If the distribution is sufficiently skewed, the mean will lie outside the central band.

Figure 1

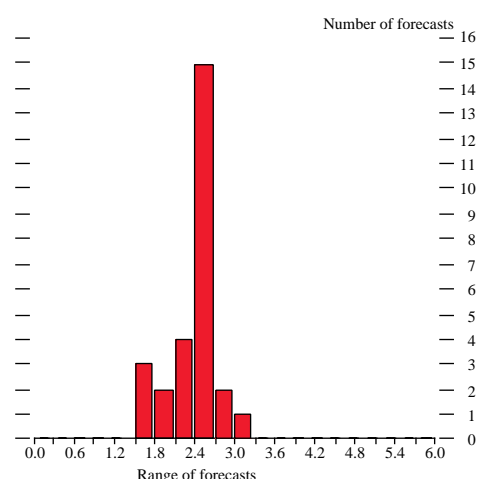


The median outturn defines the point in the distribution at which there is an even chance of higher or lower inflation. In a skewed distribution, the median will lie between the mean and mode.

There are many alternative ways of illustrating pictorially the same underlying probability distribution. But different methods of illustration do not alter what is being illustrated. Policy is unaffected by how a fan chart is drawn.

(1) For further details, see 'The *Inflation Report* projections: understanding the fan chart', February 1998 *Quarterly Bulletin*, pages 30–37.

Chart 6.8
Distribution of RPIX inflation forecasts
for 2001 Q1



Source: Forecasts of 27 outside forecasters as of 29 January 1999.

Table 6.B
Other forecasters' expectations of RPIX inflation
and GDP growth^(a)

RPIX inflation

Probability, per cent	Range:			
	less than 1.5%	1.5% to 2.5%	2.5% to 3.5%	more than 3.5%
1999 Q4	17	51	27	5
2000 Q4	18	44	29	9
2001 Q1 (b)	16	41	31	11

GDP growth

Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
1999 Q4	20	38	29	10	3	1
2000 Q4	7	14	27	36	12	5
2001 Q1 (c)	5	11	22	34	18	10

(a) 29 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table represents the means of the responses for each range. For example, on average, forecasters assign a probability of 16% to inflation turning out to be less than 1.5% in 2001 Q1. Rows may not sum to 100 because of rounding.

(b) 27 forecasters.

(c) 26 forecasters.

6.3

Other forecasts

Section 3 described the fall in survey measures of inflation expectations for the next one to two years. That fall is mirrored in the information gathered from 29 forecasters surveyed by the Bank. The median forecast for the year to 1999 Q4 was 2.1% in January, rising slightly to 2.3% for 2000 Q4, and reaching 2.5% in 2001 Q1. The estimates for 1999 and 2000 are a little lower than the projections made at the time of the October survey. Chart 6.8 shows the distribution of central forecasts for the twelve-month rate of RPIX inflation in 2001 Q1.

The forecasters surveyed by the Bank also provided their assessments of the probabilities that they attach to various outcomes for inflation and growth (see Table 6.B). They assign just over 40% probability to inflation being above the target in the first quarter of 2001, and just under 60% probability to it being below. These estimates are broadly the same as at the time of the October survey. The average projection for GDP growth in the year to 1999 Q4 is $\frac{3}{4}\%$ (with a range of projections from $-\frac{3}{4}\%$ to $1\frac{3}{4}\%$), rising to $2\frac{1}{2}\%$ in the year to 2001 Q1 (with a range of $\frac{3}{4}\%$ to $3\frac{1}{2}\%$). The estimate for 1999 Q4 is similar to that at the time of the November Report. Overall, the forecasters assign a 20% probability to output growth falling below zero in the year to 1999 Q4, compared with 21% at the time of the October survey.

The implications of the latest projections for the stance of monetary policy are discussed in the Overview at the beginning of the Report.

**Annex:
Minutes and Press Notices
of the monthly
Monetary Policy Committee
meetings**



Minutes of the Monetary Policy Committee meeting on 4–5 November 1998

1 In the context of completing its quarterly inflation and activity projections, the Committee discussed the indications from surveys and from the Bank's regional Agents of a sharp slowdown in economic growth; how to gauge labour market conditions given the problems with the Average Earnings Index (AEI); the world economic outlook; and monetary and financial market conditions, including whether a material tightening of credit conditions had occurred or was in prospect. Prior to the meeting, the Committee was briefed by Treasury officials on the Chancellor's latest projections for economic activity and the public finances.

Survey evidence, domestic demand, activity

2 The evidence of a sharp slowdown in domestic output growth was strongest in the surveys and in reports from the Bank's regional Agencies. Both business and consumer confidence had continued to deteriorate during October. Survey indicators of export orders had been very weak for some time, but the domestic activity indicators had fallen sharply in the latest month, and this had extended to services as well as manufacturing; the CIPS measure of incoming new business, for example, was below 50, although business expectations remained quite buoyant. There had not been such an abrupt change in sentiment in manufacturing—as measured by the CBI Industrial Trends Survey of business optimism—since the early 1980s. It was, however, difficult to make comparisons with the past as there were now many more surveys, mostly with relatively short histories.

3 The Bank's regional Agents had for some time been indicating that the economy was slowing, but their reports over the past two months indicated a sharper slowdown. The Committee noted that the Agents had identified evidence of the downturn in the early 1990s before it had become apparent in the official data.

4 This latest evidence suggested that the slowdown was more marked than predicted in the Committee's August central projection, although measured GDP growth in Q3 was slightly stronger than expected. In judging how much weight to place on survey data, the Committee discussed possible causes and its consistency with recent data on demand and activity.

5 One source of accumulating stress had been the substantial appreciation in the real exchange rate from mid-1996. This had not immediately hit confidence, in marked contrast to some earlier episodes when sterling had risen sharply, for example in the 1970s and early 1980s. And its impact on net trade had in fact taken much longer to emerge than the Bank had originally expected. There were various possible explanations for this, each of which probably had some validity. Some firms had initially had in place financial market hedges against currency movements, but anecdotal evidence suggested probably not much beyond a year. Similarly some firms would have enjoyed a degree of stability until contracts with overseas trading partners matured and were renegotiated. There might also have been a delayed effect where plans and major investment and expansion projects were reviewed at infrequent intervals. And, more generally, businesses had had to judge how persistent sterling's appreciation would be. As discussed at previous meetings and in earlier *Inflation Reports*, these and other factors might have contributed to long lags in the impact of sterling's appreciation on export volumes. As the effects became evident, the implications for the economy generally of a slowdown in the trade of externally exposed businesses might have become more apparent to firms in relatively more sheltered sectors and to consumers. For example, just as a buoyant services sector and strong domestic demand growth had probably helped to sustain growth in manufacturing for a while, so services would not be insulated from a manufacturing slowdown.

6 In the absence of other factors, the slowdown brought about by sterling's appreciation and the tightening of monetary and fiscal policy could plausibly have been associated with a gradual decline in domestic sentiment rather than the sharp fall indicated by surveys. But the world economic outlook had been affected over the summer by a series of adverse shocks, which would further reduce external demand for UK exports and sharpen price competition from imports. Confidence in the financial services industry had been hit; optimism in the financial sector, as measured by the CBI Financial Services Survey, was lower in 1998 Q3 than for eight years. Well publicised job cuts in a range of sectors, whether or not directly affected by general economic conditions, had probably increased awareness of the changing outlook.

7 The preliminary official estimate suggested that Q3 GDP growth was unchanged at 0.5%, still close to trend. But the latest industrial production numbers showed that output had recently been falling; in particular, manufacturing output fell by 1.1% between July and September, with falls in most parts of the production industries. These numbers were more consistent with what recent surveys had been indicating, and gave grounds for thinking that the Q3 GDP number might be revised down. Separately there were signs in recent surveys—for example in the monthly CBI Industrial Trends Survey and the CBI Distributive Trades Survey—that recent output growth might have been associated with greater than planned stockbuilding, with production not yet fully adjusted to weakening demand.

8 On the expenditure side, the Committee noted that the latest data showed falling retail sales growth, and lower turnover in the housing market compared with a year ago. Despite the recent sharp rebound, the equity market was 15% lower than its peak in July, which would tend to reduce consumption growth via its effect on households wealth, and reduce investment demand via a higher cost of capital.

9 There were, therefore, signs in the data that a slowdown, as indicated by surveys, was occurring. The direction of change was clear. But it was quite possible that the surveys were painting too bleak a picture. For example, the equity market had not fallen to a level that would reduce consumption to the extent suggested by surveys. And the surveys had historically been more volatile than recorded output and so could mislead. Moreover, the tone of some public comment had moved from predicting a slowdown through a downturn, to a recession and even a slump. That was extreme, and might be contributing to deteriorating confidence. It could, therefore, have some effect on spending.

10 In the light of all these considerations, the Committee judged that the forward-looking evidence from surveys and the Bank's regional Agents should be given increased weight in assessing the outlook for activity and inflation. The Committee thought that the economy should, however, be better placed to face adverse shocks than in the early 1990s, in large part because both corporate and personal sector balance sheets (especially in the housing market) and liquidity were stronger now than then, and inflation had already reached the target. Moreover, monetary growth remained robust. The most likely outcome was for continuing positive output growth in 1999, though at a lower rate than expected in August, and the downside risks had increased.

Implications of the world economic environment

11 The international environment remained fragile. There was still considerable uncertainty about the prospects for recovery in the

Japanese economy. The recession there was deeper than had been assumed in the Committee's August forecast. Most forecasters had revised down their projections for continental European growth. According to the initial estimate, Q3 growth in the United States had been stronger than expected, although some of that strength might be the result of involuntary inventory accumulation. US broad monetary growth remained quite strong. The risks of further contagion and shocks to emerging market economies seemed to have reduced somewhat over the past month, and the extreme uncertainty in some markets had lessened, perhaps helped most recently by the G7 statement.

12 An important element of the Committee's analysis was the deteriorating outlook for world trade given the poor prospects in Japan and some emerging market economies. Between 1980 and 1993 world trade had grown at an average annual rate of 4%. This had risen to around 9% in 1994–97, but was projected by the international organisations to fall to 4%–6% over 1998–2000. Part of the expected fall was attributable to (perhaps temporarily) reduced intra-Asian trade, which had accounted for much of the earlier increase. The Committee thought that the near term growth rate of the UK's export markets should fall by less than overall world trade. But on the other hand the strength of sterling, although less pronounced than in August, was likely to mean that UK exports would grow less quickly than UK export markets over the forecast period. The Committee agreed that it was most likely that net trade would contribute negatively to output growth over the next two years.

13 The weakening in the external environment had also had a material effect on world prices. Commodity prices were still falling, as were input prices more generally. Looking forward, the expected rate of world price inflation had fallen compared with a quarter ago, reducing expected imported inflation and thus the outlook for RPIX. This was an important factor in the Committee's inflation projection. In addition, domestic output price inflation was at its lowest level since 1975. Both CBI and BCC surveys indicated further falls.

The labour market

14 The Committee discussed a range of labour market indicators. LFS employment had risen quite strongly in the three months to August, as had total hours worked. On the other hand, LFS unemployment had increased slightly. The number of economically inactive people had fallen. Overall the latest quantity data suggested that conditions were still tight but might no longer be tightening.

15 Earnings growth was a key indicator of domestically generated inflation. While labour market pressures should abate and earnings growth ease as the economy slowed, the implications for inflation would also depend on the current rate of earnings growth. There was greater than normal uncertainty about this, given the problems with the AEI. The Committee agreed to reflect this in its forecast variance.

Monetary and credit conditions

16 The future path of interest rates expected by the market was lower than a month ago, and much lower than at the time of the August *Inflation Report*. Taken together with the Committee's 25 basis point cut at its October meeting, this had delivered some easing in monetary conditions.

17 Sterling had fallen $4\frac{1}{4}\%$ from the 15-day average used in the projections published in the August *Inflation Report*. This would tend to reduce the restraining effect on inflation from sterling's earlier appreciation. The Committee judged that the balance of risks was still in the direction of sterling falling by more than assumed in its central projection, although the downside risk was not as large as in August.

18 The Committee noted that broad money and credit growth remained robust. High broad money growth remained an upside risk to the inflation outlook. Unsecured lending to the personal sector continued to grow rapidly, although the macroeconomic consequences were possibly not great as it accounted for only around 20% of the stock of lending to the personal sector.

19 Of more immediate interest was whether there were signs of a material tightening in credit conditions. The spread of corporate bond yields over government bond yields had increased significantly since the Russian and Long-Term Capital Management crises, corporate issuance was lower than usual, and actual and implied volatility were higher in a number of markets. But, perhaps in contrast to the United States, there was no evidence that the credit process had been significantly interrupted in the United Kingdom. Corporate bond and swap market spreads had eased slightly from the peaks, but were still high by previous standards. There had recently been some domestic corporate bond issuance in sterling, as well as a more marked return of issuance in international bond markets. Perhaps more significantly, UK banking markets seemed to have been less affected by the turbulence than capital markets. Conditions in wholesale money markets seemed reasonably calm. The syndicated credit markets had remained open; spreads had risen in this market too, but by rather less than in capital markets. The September M4 numbers did not suggest emergency drawing down of deposits, and showed continued robust growth in lending to the corporate sector. It was possible that that reflected reintermediation into the banking sector of some borrowing that would previously have been undertaken in the capital markets. This was widely believed to be occurring in the US, but dependence on capital market borrowing was much greater there. Evidence of this happening in the United Kingdom was less clear. The UK banking sector was, on the basis of currently available information, well capitalised by the standards of recent decades and so prospectively capable of reintermediating credit flows if that were to prove necessary.

20 The Committee agreed that so far there was no evidence of a 'credit crunch' in the sense of a material tightening of credit conditions for a given general level of interest rates and borrower credit risk. The environment had nevertheless changed somewhat. On the one hand, the general level of medium-longer maturity interest rates had fallen in recent months, so that the level of nominal yields (and probably real yields) on corporate bonds had fallen for at least the highest credit ratings, notwithstanding the widening of spreads. This would tend to be supportive of activity. On the other hand, as the economy slowed and as the shocks from the external environment affected the UK, the creditworthiness of some borrowers was deteriorating, which would affect the terms on which they could obtain credit. The corporate sector as a whole was, however, stronger financially than in the late 1980s-early 1990s, and thus should generally be better able to withstand a downturn.

21 The Committee agreed that world financial markets were calmer than a few weeks earlier. But the possibility of a tightening of credit conditions in the future needed to be kept under careful review.

The MPC's November forecast

22 The Committee reviewed its forecast, which was described fully in the *Inflation Report* published in the week following the meeting.

23 The general *shape* of the projections was as follows. Output growth was expected to fall for a year or so before recovering, principally via stronger domestic demand growth. In the second half of the forecast period and beyond, an important source of this increased demand was public sector consumption and investment, but there was some uncertainty about the timing of public investment spending. The balance of risks to activity were on the

downside, largely on account of the external environment and risks to consumption. The central projection for inflation rose somewhat in the short run before falling. The balance of risks to the inflation outlook were modestly on the upside until mid-2000 and then modestly on the downside, but overall closer to neutral throughout the forecast period than in August when the balance of risks had clearly been on the upside.

24 There was a more important difference from the August forecast. For any given level of interest rates, the level of the projections for output growth and inflation were now both lower. If interest rates were left at 7.25%, the central projection for inflation would undershoot the target at the end of the forecast period.

25 The Committee discussed whether there were any major eventualities not captured in the forecast. It had increased the short-term uncertainty underlying the published projections to reflect the problems with the AEI numbers, but it was very difficult to judge the degree of extra uncertainty created. It was possible that further adverse news about the world economy could dent the outlook for output growth still further. And it was possible that weak world price inflation and the fall in domestic inflation expectations would have a bigger than assumed impact on RPIX. On the other hand, the recent recovery in the equity market meant that at the time of the meeting equity prices were 6% higher than the 15-day average used in the forecast. Overall the Committee felt that the important factors were reflected in the forecast.

26 The Committee noted that the shape and level of the projections were different when made using market expectations of the likely path of interest rates (as derived from the short sterling futures contract adjusted for the typical premium between unsecured interbank deposit rates and gilt repo rates). Faster growth was implied, and a central projection for inflation which was above the target throughout 1999 and 2000. The *Inflation Report* would show the difference between projections based on constant interest rates and market rates (as at 4 November).

27 The Committee discussed the predictions of a sample of outside forecasters. The average forecast of GDP in the year to Q4 1999 was down by one percentage point since August. Most forecasters predicted recovery in 2000. Inflation profiles were generally lower than three months ago. The average of outside forecasts was similar to the Bank's central projection.

Tactical considerations

28 While reiterating its earlier expressed view that there could be no mechanical or precise link between the forecast and policy settings, the Committee agreed that its latest forecast clearly pointed to a further cut in official interest rates. Before turning to the immediate policy decision, members first discussed a number of tactical considerations.

29 Was there a case for delaying part of any desired rate cut on the grounds that some of the uncertainty about the earnings data should be resolved by the December or January meetings? The Committee agreed that this should not affect its immediate decision. It would need to take account of the new information about earnings as and when it became available, changing interest rates then if necessary.

30 What would be the impact of different sized cuts on confidence and expectations in the real economy and financial markets? A range of views was expressed on this. One possible view was that, taken in isolation, a cut of more than 25 basis points might create the misleading impression that the outlook was worse than implied by the Committee's central projection on the grounds that (i) financial markets thought the most likely outcome of the meeting was a cut of 25 basis points; and (ii) the Committee had so far moved (in both directions) in steps of 25 basis points. But, against this, any move would in fact be followed by publication of

the *Inflation Report* a week later. Whatever the Committee's decision, policy would then be seen in the light of its forecast for inflation.

31 A second possible view was that there would be positive merit in moving by more than 25 basis points in order to display that, as the Committee had said before, it was prepared to move in larger steps. The Committee agreed that while that might be a welcome by-product of a cut of more than 25 basis points, it could not be part of the reason for such a cut, which had to depend on its assessment of the inflation outlook. A similarly welcome by-product, but again not one that could affect the decision, was that a larger than expected cut would underline the symmetry of the Committee's remit, ie that a prospect of falling below the 2½% target was taken as seriously as exceeding the target.

32 A third possible view was that the Committee should err on the side of a larger cut in order to underpin business and consumer confidence in the economy. Against this it was felt that, whatever its size, the effect of a reduction in interest rates on confidence would depend on the justification for it. The Committee also needed to bear in mind that the larger the cut, the more likely it was that sterling would fall, which would tend to increase the price level and thus temporarily increase future expected inflation.

The immediate policy decision

33 By way of background, the Committee noted that over the past six years the economy had on average grown above trend, and until quite recently had still been growing at a rate that could not be sustained given the economy's productive capacity. That had been the justification for the past tightening of monetary policy. Relatively high short-term real rates of interest, fiscal policy tightening and the appreciation of the exchange rate had all helped to keep inflation in check, but it had still not fallen below 2½%, which was indicative of the strength of domestically generated inflationary pressures. Since August there had been a lot of news affecting the outlook for activity and inflation, including the fall in sterling, the shocks to the world economy, and the evidence from surveys and the Bank's regional Agents of a sharp fall in business and consumer confidence. The extent of the lags between these developments and their effect on growth and inflation was highly uncertain, but they implied lower activity growth and inflation than expected in August.

34 Against this background, the Committee discussed the arguments for interest rate cuts of 25 basis points, 50 basis points, and of up to 75 basis points.

35 Possible arguments identified for a 25 basis point cut were that the unusually high uncertainty about the earnings data pointed to caution in any move; that the Committee should avoid surprising financial markets given the risk of sterling falling if it did so; and that the Committee should avoid taking actions that could be construed as trying to fine tune output growth in 1999. On the first of these points the Committee agreed that if the earnings data were substantially revised upwards the interest rate move might need to be reversed, but that was not per se an argument for moving in small steps now. On the second point, the Committee agreed that the risk of surprising the financial markets could not justify limiting the cut to a size that would leave the central projection for inflation materially below the target in the second year of the forecast. On the third point, the Committee agreed that monetary policy could not have a significant impact on output growth in 1999 given the lags in its effects. But this did not amount to an argument for a 25 basis point cut.

36 The arguments identified for a 50 basis point cut, supported in varying degrees by those members of the Committee who voted for this course of action, were as follows. First, on the central projection, with a 50 basis point cut inflation would rise slightly above the target before returning to around 2.5% at the two year

horizon, with the risks initially on the upside and later on the downside, and with uncertainty greater at the longer horizons. By contrast, if rates were cut by 75 basis points, inflation would be above the target throughout the year 2000 on the central projection and up to the third quarter of 2000 even if the balance of downside risks assumed in the forecast materialised. Second, a larger cut might cause sterling to fall by more than was taken into account in the forecast. Third, notwithstanding the opportunity to explain any policy decision in the following week's *Inflation Report*, there could well be a prolonged effect on perceptions of the Committee's assessment of the outlook, with a risk that people, businesses and markets mistakenly concluded that the Committee knew something that it had not disclosed about the outlook.

37 Among those members favouring an immediate 50 basis point cut, there was a range of views on the likely future course of policy. On one view, it was more likely than not that further cuts would at some point be needed, but the lags in the economy meant that it was not optimal to make those cuts now. It was argued that further cuts could over time be necessary because at 6.75% official rates would still most probably be above the 'neutral' rate implied by an equilibrium real interest rate and the 2½% inflation target. It was also possible that the near-term downward pressures on UK domestic prices might be greater than reflected in the projection. On another view, the short run outlook for future policy was more evenly balanced, bearing in mind continued domestically generated inflationary pressures.

38 The arguments identified for a cut of up to 75 basis points were as follows. First, given that the balance of risks to inflation was on the downside at the end of the forecast period, inflation could be expected to undershoot the target in about two years' time if rates were cut by only 50 basis points. The size of cut should take account of these risks. A cut of more than 50 basis points—possibly 75 basis points, possibly in between—could be viewed as

taking out insurance against those risks, with the precise size depending on the weight given to the downside risks and the value placed on insurance. Second, a larger cut might fortify otherwise fragile business and consumer confidence, helping to guard against the effects of encircling gloom and thus worse outcomes than featured in the Committee's forecast. Third, while a larger cut might well surprise the markets, it could be carefully explained in the *Inflation Report*, so that the cost of any surprise should be short-lived. Fourth, cutting by more than 50 basis points was preferable to cutting by 50 basis points with an expectation of making further cuts later.

39 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be cut by 50 basis points to 6.75%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Alan Budd, Charles Goodhart, DeAnne Julius, Ian Plenderleith and John Vickers) voted for the proposition. Willem Buiter voted against, preferring a cut of 75 basis points.

40 The following members of the Committee were present:

Eddie George, Governor
Mervyn King, Deputy Governor responsible for monetary policy
David Clementi, Deputy Governor responsible for financial stability
Alan Budd
Willem Buiter
Charles Goodhart
DeAnne Julius
Ian Plenderleith
John Vickers

41 Gus O'Donnell was also present as the Treasury representative.

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 30 October 1998, in advance of its meeting. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I Financial markets

Foreign exchange

2 Between 6 October and 8 October, \$/yen had fallen from 132 to 112. DM/yen had fallen by almost as much. The trigger for these unusually large fall may have been the perception that progress was being made to resolve the banking problems in Japan. Poor liquidity had exacerbated the fall in the \$/yen exchange rate, as participants who had borrowed cheap yen to fund positions elsewhere had attempted to unwind their positions. After that, the yen had stabilised, perhaps reflecting a perception that a rate just below 120 was closer to its 'equilibrium' value. One-month implied volatility for \$/yen had remained at historically high levels, even though it had halved since 8 October. The dollar had also fallen against other major currencies in recent months, reflecting expectations of interest rate cuts (which had been borne out) and concerns about the impact on the US trade balance of a Latin American recession. However, on a broader measure of the effective exchange rate the dollar had only fallen by 4%.

3 The correlation between movement in the dollar and sterling had remained strong, and had possibly strengthened. The 8 October MPC announcement cutting rates by 25 basis points and the 14 October downward revision to average earnings had coincided with significant moves in sterling, although the former came at the height of the \$/yen turmoil, which appeared to have exaggerated the upward move.

Government bond and money markets

4 Implied interest rates had fallen at the short end of the yield curve following the MPC's 25 basis point cut in October, and again after the US cut. At longer maturities, the recovering equity market and sharp currency moves had been associated with higher yields. Most international bond markets had fallen following the sharp appreciation in the yen. At the same time, market participants in the United States and United Kingdom had begun to expect more aggressive monetary easing, and this had been reflected in less inverted bond yield curves. But the currency movements had also meant that some market participants had looked to close out their positions and, coupled with poor liquidity, these technical factors had probably exacerbated the yield changes. Implied volatility in the long gilt future had fallen from a peak of around 13%, but had remained high, and futures turnover had fallen, suggesting that the markets remained less liquid than usual.

5 In the futures market, implied interest rates had fallen by about 30 basis points since the previous MPC meeting, whereas longer contracts had been at roughly the same level, implying that the market had brought forward when it expected rates to be cut, but not the extent of the easing it expected. There had been a spread of 100 basis points between current three-month Libor and the short sterling March contract, implying that significant cuts in rates were expected before Easter. A few market participants had expected a 50 basis point cut in November, although most had anticipated 25 basis points.

6 The spread between interbank and CD rates and gilt repo had been unusually high in late October. This could be argued to have understated the rise in credit risk premia demanded by the market, because some weaker credits might have withdrawn from the

market. On the other hand, an increase in short term deposits at the major banks, subject to sterling stock liquidity requirements, would have tended to increase their demand for liquid assets including repo, and this could have worked to widen the interbank-repo spread.

Equity markets

7 Equity indices had risen since the previous MPC meeting in most international markets. In the United Kingdom, the relative fall in banking sector share prices in September had been reversed, while indices for utilities, property and food retailers, which had been seen as 'safe havens' during market turbulence, had underperformed the market. Implied volatilities for the FT-SE 100 and S&P 500 had declined from their September peak, but remained above their 1998 averages. Analysts' forecasts for growth in earnings per share over the next year had declined further. But analysts' longer-term outlook for growth in earnings per share had remained constant, as they had done for most of 1998. The number of profits warnings had been higher than a year earlier, with concerns about demand and problems in emerging markets frequently cited as reasons.

II Monetary and credit conditions

Monetary quantities

8 The (provisional) twelve-month growth rate of notes and coin (adjusted for 50p and £2 coin effects) had been 5.2% in October, compared with 5.7% in September. The three and six-month annualised growth rates had also fallen in October. Annual growth in broad money (M4) had been 9.0% in September, compared with 8.7% in August. M4 growth in the third quarter of 1998 had been slightly up on the second quarter (2.2% in Q3, compared with 2.1% in Q2).

9 Households' M4 had grown by more in September (£1.6 billion) than in August (£1.1 billion), with the twelve-month rate at 6.1%. The twelve-month rate of growth of M4 of Other Financial Corporations (OFCs) had been 19.2% in September. According to the Merrill Lynch survey of fund managers, the ratio of cash to portfolio value of Insurance Companies and Pension Funds (ICPFs) had risen from 4.9% in September to 6.9% in October.

10 The slight pick-up in annual growth in aggregate Divisia in the third quarter (7.8%, compared with 7.7% in the second quarter) had been broadly similar to the pattern in the M4 data. Within the aggregate, household Divisia growth had been unchanged in the third quarter at 6.6%; the annual growth in OFCs' Divisia had fallen back from 16.8% in the second quarter to 16.2% in the third; and the growth in Divisia of Private Non-Financial Corporations (PNFCs) had increased from 5.6% to 7.5% in the third quarter.

11 Aggregate M4 lending had been £6.2 billion in September, similar to August (£6.6 billion). M4 lending to households had been increasing, with three and six-month annualised growth rates higher than the annual growth rate of 7.4%. Within lending, annual growth in total secured lending to individuals, at 5.9%, had picked up slightly in the third quarter. There had been a third consecutive monthly fall in the number of loan approvals for house purchase in September. The annual growth in unsecured lending to individuals had remained strong (19.0% in the third quarter) and net credit card borrowing had also increased in September (by £439 million compared with £406 million in August), with the twelve-month growth rate at 26.5%. There had been anecdotal evidence of a modest rise in arrears. The twelve-month growth rate in lending to OFCs had been weaker in September, with a flow of £1.7 billion

compared with £2.1 billion in August, with the annual rate of growth at 16.6%.

Monetary prices

12 The 8 October cut in the Bank's repo rate had not yet been passed on by banks and building societies into standard variable-rate mortgages; but many had announced that they would reduce standard variable rates from November. In the secured market, fixed rates on mortgages had continued to fall, reflecting falls in comparable swap rates.

13 There was no direct measure of ex ante short-term real interest rates, but a measure could be constructed using the Merrill Lynch survey of fund managers' short-term inflation expectations for the end of 1999. This suggested that the real forward rate for 1999 had fallen from 4.3% in September to 4.1% in October.

Have UK corporate credit conditions tightened?

14 Bank staff had examined whether the UK company sector had experienced a tightening in credit conditions. Spreads on corporate bond yields over gilts had fallen since the previous MPC meeting, although they had remained at high levels relative to the 1990s average. Similarly, US corporate bond indices had shown the credit spread on investment grade bonds to be at or near their highest levels in the 1990s. A similar picture had emerged when looking at spreads in the swaps markets, both in the United States and the United Kingdom.

15 The syndicated loan market remained open, although spreads had widened by about 10 basis points for higher grades and more for lower-rated companies. Conversations with market participants had suggested that some loan demand had been deferred; others had borrowed before the recent turbulence hit the markets, and thought that it might be more difficult to borrow now.

16 Bankers had reported there had been no material change in the terms applied to customers of a given risk. However, the creditworthiness of some firms had fallen with the worsening in the economic outlook. A survey of major clearing banks had revealed that the demand for finance from small firms had been steady in the past six months, and for large firms had, if anything, increased.

17 Annual growth in PNFCS' M4 deposits had been 6.5% in the third quarter, compared with 5.9% in the second quarter. Growth in M4 lending to PNFCS had risen in the third quarter, to 6.0% compared with 5.1% in Q2. Neither had suggested a rationing of credit, nor an emergency drawdown of deposits. Total external finance had been steady at £3.2 billion in September.

18 One question had been whether the banking system's capital could support a material reintermediation of credit if capital market borrowing remained low for a prolonged period. The capital positions of the large UK banks in 1998 H1 had shown risk-asset ratios above the Basle 8% minimum.

19 Other evidence from the CBI Industrial Trends Survey in October 1998 had shown that 6% of firms thought that constraints on external finance might limit their ability to undertake investment. This had been the highest proportion since January 1993. But uncertainty about demand had been reported as a larger constraint on investment (56%, compared with 50% in September).

20 As to the financial strength of the corporate sector if credit conditions were to tighten, PNFCS' capital gearing in 1998 Q2 (defined as the ratio of net debt outstanding to the market valuation of the capital stock), at 24.5%, was well below its previous peak (41.4% in 1990 Q3). However, this partly reflected the rise in equity prices in recent years. PNFCS' income gearing, at 20.9%, had been well below the peak of 39.0% in 1990 Q2, although it had risen from the low of 16.7% in 1996 Q2 to 20.9% in 1998 Q2. This had probably been related to repo rate rises over the period, and weakening profits. Unlike companies in the United States, PNFCS

in the United Kingdom had modest non-equity capital market obligations, compared with their liquid assets.

III The international economy

21 In the United States, a slowdown in the real economy had become more evident. Quarterly consumption growth in 1998 Q3 had slowed to 1.0% from 1.5% in both Q1 and Q2, and investment growth had fallen to 0.4% in Q3, from 4.7% in Q1 and 3.1% in Q2. Overall, US GDP had grown by 0.8%, to 3.4% higher than a year before.

22 Industrial production in the United States had fallen by 0.3% in September, to 2.5% higher than a year earlier. Capacity utilisation had been 81.1% in September and, although distorted by the GM strike, had been trending lower since the end of 1997. The NAPM index had fallen to 48.3 in October, from 49.4 in September. The US trade balance had widened to \$16.8 billion in August from \$14.5 billion in July. This had been because of a larger goods deficit; the services surplus had remained little changed. Export volumes had fallen year-on-year for the second consecutive month, while the growth in import volumes had slowed. US consumer confidence had fallen by 9 points in October, its fourth consecutive monthly fall, to its lowest level since October 1997. Annual CPI inflation had fallen to 1.4% in September from 1.7% in August, and annual average earnings growth had fallen to 4% in the year to September, from 4.1% in August. The IMF had forecast US GDP growth to be 2.0% in 1999, down from 3.5% in 1998.

23 In the prospective euro area (EU11), industrial confidence had fallen further in August and September in most member countries. Industrial production had rebounded in Germany, rising by 3.1% on Q2, but had fallen back in France (-0.1%) and Italy (-0.9%). Consumer confidence in the EU11 had fallen by 1 percentage point between July and September. Annual EU11 consumer price inflation on the harmonised measure had fallen to 1.0% in September down from 1.2% in August. Harmonised inflation had fallen in Germany (to 0.6%) and France (to 0.5%). Money supply across the EU11 had grown by 4.7% in the year to July, down from 5.7% in June.

24 Japan's industrial production had fallen 8.4% in the year to September. Inventories had fallen by 1.8% over the year. Total employment had fallen by 1.1% over the year to September, with job losses concentrated in the construction and manufacturing sectors. Retail sales in Japan had fallen by 5.1% in September from a year ago. Imports had fallen by 9.3%, while exports had grown 3.9% over the year to September. Japan's trade surplus with the United States was ¥0.7 trillion in September, and ¥0.4 trillion with the European Union. Deflationary pressures had been continuing—wholesale prices in September had fallen by 1.5% on an annual basis, and annual consumer price inflation in September had fallen to -0.2%. The IMF had forecast a fall in GDP in 1998 of 2.5% and a rise of 0.5% in 1999.

IV Demand and output

25 The preliminary estimate for GDP growth in 1998 Q3 had been 0.5%, the same rate as in Q2. The annual rate of growth had slowed from 3.0% in the year to Q2 to 2.5% in the year to Q3. Service sector output had grown by 0.6% in Q3, the same rate as in Q2. Manufacturing output had fallen by 0.6% in August and 0.4% in September. Survey evidence had suggested that the fall in manufacturing output would be the beginning of a sustained decline. Manufacturing output over the third quarter had fallen slightly, by 0.1%, in contrast to ONS indications in the GDP preliminary estimate for the third quarter of 'a small increase'. This had raised the possibility of a downward revision to GDP growth in 1998 Q3.

26 The boost to GDP growth from utilities output in 1998 Q2 had not unwound in Q3 so the level remained relatively high.

Monthly industrial production data had shown that electricity, gas and water supply had increased by 1.1% in 1998 Q3, though output had fallen by 1.6% in September. The ONS had also reported that construction and agricultural output had risen overall in Q3.

27 On the expenditure side, retail sales had fallen by 0.4% in September, having increased in the previous two months. Annual growth over the latest three months had increased to 3.1% in September from 2.4% in August. This had partly reflected weak sales in September 1997. Nonetheless, ONS data had suggested that, although slowing, growth had remained above average, a stronger out-turn than indicated by either the CBI Distributive Trades Survey or data from the British Retail Consortium. Quarterly growth in retail sales volumes in Q3 had been 0.7%, compared with 0.2% in Q2 (though consumption of retail goods in the National Accounts had increased by 0.9% in Q2). Services consumption had fallen in Q2, because of lower catering and financial services spending. Output data so far available had suggested that another fall in the third quarter was unlikely. Overall, it was possible that household spending would increase by more in Q3 than in Q2 (0.4%).

28 Analysis of surveys of consumer confidence supported a picture of an underlying slowdown in consumption growth. The GfK and MORI surveys had declined further in October. The MORI balance had fallen to -46 from -37 in September, as low as in October 1992 and September 1990. The aggregate GfK balance had fallen to -8.2, 18 points below its recent peak. In the past, the level of consumer confidence had been a timely, coincident indicator of household spending growth. The recent deterioration in the GfK survey had been because of deteriorating sentiment about the general economic situation. Perceptions about households' own situations had held up better. Analysis had shown that survey responses to general economy-wide questions had been, if anything, better correlated with spending growth in the past than household-specific questions. Analysis had also suggested that consumer confidence contained additional information about spending over and above other determinants of consumption such as income, wealth etc; and that it had some predictive power for future spending as well as current spending.

29 The Halifax and Nationwide prices indices had both recorded increases in October. But housing turnover had fallen in September, with particulars delivered 5.7% lower than a year ago, though 4.8% higher over the latest three months than the previous three months. Net lending secured on dwellings had fallen in September, leaving the twelve-month growth rate unchanged at 5.8%; and loan approvals had fallen to their lowest level in 1998. Survey data from RICS and HBF had also indicated activity moderating.

30 Service sector investment intentions for plant and equipment had fallen from a balance of +27 to +14 in the latest British Chambers of Commerce (BCC) survey, though they had remained around their average level since 1989. Manufacturing investment intentions had fallen from a balance of +13 in Q2, to 0 in Q3. In the October CBI quarterly Industrial Trends Survey, the balance had fallen from -21 to -32 for plant and equipment, and from -26 to -36 for buildings. However, construction orders had remained relatively high, rising by 6% in the three months to August. The CIPS Report on Construction had indicated falling orders in October for the first time this year, although the optimism index had remained strong.

31 There had been some evidence of rising stocks in the manufacturing and retail sectors in survey data. The CBI Industrial Trends Survey had reported a rise in the balance of firms reporting excessive stocks (+26 in October). The CBI Distributive Trades Survey had recorded a higher balance of retailers reporting high stocks relative to expected sales: +23 in October, compared with an average balance since 1992 of +19. Retailers were likely to unwind any excess inventories fairly quickly.

32 The PSNCR had been £1.6 billion in September, and £2.7 billion over the first six months of the financial year 1998/99. Spending had been 2.7% higher over the first six months of 1998/99 compared with a year earlier. This had suggested continued growth in government consumption in 1998 Q3.

33 Goods trade data had pointed to a negative contribution from net trade in 1998 Q3. There had been little change in the trade deficit in August: £1.2 billion compared with £1.4 billion in July (excluding oil and erratics). The deficit with EU countries had narrowed, while the deficit with non-EU countries had widened. And there had been a large increase in the deficit with non-EU countries in September. Import and export volumes had both increased in the three months to August, but imports by more. For 1998 Q3 as a whole, imports from non-EU countries had risen by 4.6%; exports had fallen by 0.7%.

34 Surveys suggested that business sentiment had continued to weaken. The BCC survey had reported negative balances for home deliveries and home orders in the manufacturing sector of -12 and -16 respectively for Q3, compared with +3 and +2 respectively for Q2. And there had been further sharp falls in export orders and deliveries. This had brought the BCC survey more in line with the CBI survey, both indicating further falls in manufacturing output. BCC services balances had remained positive, but had fallen. Home orders and deliveries balances had fallen for the third consecutive quarter, and by the largest degree between Q2 and Q3 since the previous recession, consistent with a slowdown in services output growth in Q4.

35 There had also been a further decline in CBI Industrial Trends survey balances. The business optimism balance had fallen to its lowest level since July 1980. This might be a better indicator of output in the manufacturing sector rather than GDP given the nature of the downturn. Sentiment towards exports had stabilised, but at very low levels. In contrast, indicators of domestic activity had fallen sharply: the reported output balance from -4 to -30, expected output from -8 to -29. The CIPS Report on Manufacturing output index had fallen to 41.6 in October, a new low, and the largest monthly fall since the survey began in 1991. The CIPS Report on Services had shown the first fall in the incoming new business index since the survey began in mid 1996. And the outstanding business index had continued to fall, and by its largest amount in October (44.9).

V Labour market

36 The Labour Force Survey (LFS) measure of employment had risen by 122,000 (0.5%) in the three months to August, compared with the previous three months. If anything, the rate of increase had appeared to be rising—the average quarterly increase over the past year had been 77,000. Thus the contrast between the strength in LFS employment and the weakness in recent Workforce Jobs figures had become even more marked, though more weight should be attached to the LFS figures (given their lower sampling variance and the possibility of special factors affecting the Workforce Jobs data). The increase in LFS employment in June to August had reflected a large 222,000 (0.9%) increase in employees, partly offset by a 94,000 (2.9%) fall in the numbers self-employed. And it had been more than accounted for by an increase in full-time employment (part-time employment fell slightly). Total hours worked had increased by 0.6% over the quarter, so hours per head were broadly unchanged.

37 Turning to survey information, the CIPS October surveys had suggested that employment growth in services had been weakening but remained positive, construction employment had been unchanged, and the rate of job loss in manufacturing had been increasing. This sectoral picture was broadly consistent with reports from the Bank's regional Agents. The BCC survey for Q3 had shown a fall in employment intentions in services, though they had remained positive, while the balance of manufacturers

expecting to recruit staff had fallen sharply to almost zero. The CBI Industrial Trends Survey for Q3 had also shown a large deterioration in manufacturing employment intentions, the seasonally adjusted balance falling to its lowest level since 1993.

38 New notifications of vacancies had risen by 4,000 in September, with the stock of vacancies broadly unchanged. National press advertising had risen to another high in August, reflecting sustained demand for staff at the top end of the labour market. The FRES report had showed that recruitment agency business had continued to increase in September, but the rate of growth had fallen back to its weakest this year. The BCC survey had shown some easing in recruitment difficulties in both manufacturing and services, though they still persisted. And the CBI Industrial Trends survey for Q3 had shown a further fall in the balance of manufacturers quoting skill shortages as a factor likely to limit output.

39 LFS unemployment had increased by 9,000 in the three months to August, compared with the previous three months. The rise had partly reflected a 28,000 increase in unemployment among 16–17 year olds. Despite the rise, the rate of LFS unemployment remained unchanged to the nearest decimal point at 6.3%. The claimant count had continued to fall in September (by 12,000), with part of the fall likely to have reflected a New Deal effect.

40 According to LFS figures, the number of economically inactive people of working age had fallen by 93,000 in the three months to August, which contrasted with the increases recorded in the previous three quarters.

41 The ONS had announced a further set of revisions to the earnings data on 14 October following a rebasing exercise, which had resulted in significant revisions to the earnings data going back to 1991. The key factors behind the revisions had been: the use of new employment weights to aggregate earnings in different industries; the application of new grossing factors to firms in different size bands to make the sample more representative; and the use of a new public/private sector classification, which reflected legal as well as industrial status. However, there were a number of features of the revised data that had been difficult to understand and, partly for this reason, an external enquiry into the figures had been set up. The ONS subsequently issued a press release on 2 November suspending publication of the figures until it was satisfied about their quality.

42 According to the revised figures, headline annual earnings growth had peaked in 1998 in June (at 5.2%), not in April as previously thought, and had dropped back to 4.6% in July. But more puzzling was that the revised series had suggested that aggregate earnings growth had fallen rather than risen in 1997, at a time when the quantities data had suggested that the labour market was tightening. This change in profile was more pronounced in the services data; the manufacturing profile was much more similar to the old data.

43 Another puzzle in the revised data had been that they suggested that public sector earnings had accelerated from mid-1997, not grown at a broadly constant rate of around 2.5% to 3.0% as had previously been thought. On the new figures, headline public sector earnings grew by 4.6% in the year to July (up from 4.5% in June), which compared with private sector earnings growth of 4.7% (down from 5.4%).

44 A further puzzle in the new data concerned bonuses. Previously it had been thought that irregular pay had constantly made a positive contribution to the annual growth of average earnings in 1997 and 1998. But according to the new figures, the contribution had been erratic, and the large positive contribution of bonuses and other irregular payments in March 1998, seen in the unrevised data, was no longer apparent.

45 The revised figures had seemed difficult to reconcile with other measures of earnings, none of which had suggested weaker

growth during 1997. The growth rate of the National Accounts measure of wages and salaries per head had increased during 1997–98, though these figures were partly derived from the Average Earnings Index and were therefore subject to be revised if the quality of the new series was confirmed. The Reward Index of earnings growth had also been stronger than the revised Average Earnings Index in 1997 and 1998, despite having dropped back recently (to 5.1% in September). And a comparison with figures from the annual New Earnings Survey also suggested that earnings growth in recent years had if anything been closer to the old average earnings series, than the revised one.

46 The view that wage pressure had eased in 1997 was also not supported by evidence from wage settlements which had increased through 1997 and the early part of 1998. And there had been no evidence of a slowdown in wage settlements in recent months: the twelve-month employment weighted mean measure remained at 3.7% in September for the fifth consecutive month.

VI Prices

47 Commodity prices had continued to fall in September. The Bank index excluding oil had fallen by 0.6% in September, mainly because of metals and food prices. The index had fallen by 18% since its peak in March 1996. But United Nations data had suggested that the recent weakness of commodity prices relative to consumer prices was in line with the trend change over the previous thirty years. Input price deflation had persisted: prices had fallen by 1.1% in September and by 9.8% since September 1997. The price of Brent crude oil had fallen to \$13.19 a barrel by 28 October.

48 Annual output price inflation had fallen to its lowest rates for over twenty years in September: output price inflation excluding excise duties (PPIY) to -0.6% (its lowest rate since 1975) and total output price inflation to 0.3% (its lowest rate since 1960). The CBI and BCC surveys had continued to suggest that output price inflation might fall further. Their weakness relative to the official data might have been explained by the split between gross and net output price inflation. The gross index, which includes intermediate prices within the manufacturing sector, had been falling, while the net index had risen slightly, implying intermediate price deflation. It was possible the survey balances had reflected gross output price deflation better than the net numbers published in the headline producer price index. Trade prices had also continued to fall. Export prices to the European Union had fallen by 0.4% in August. Import prices had fallen further in 1998 from countries outside the European Union (-9.4% in the year to September), but had remained broadly unchanged from other EU countries (-5.9% in the year to September).

49 RPIX inflation had remained at 2.5% in September, while RPIY and RPI inflation had both fallen by 0.1 percentage point, to 2.0% and 3.2% respectively. RPIX services prices had risen by 3.5% in the year to September, up from 3.2% in August. That had reflected the reduction of the VAT rate payable on domestic fuel in September 1997, which had fallen out of the annual inflation rate. Household services had risen sharply, partly owing to private school fees. The HICP inflation rate had risen by 0.2 percentage points in September to 1.5%, whereas the RPIX inflation rate had remained unchanged. But the difference had been almost entirely due to rounding. The retail sales deflator had been revised as part of the rebasing of the retail sales index, which had been published since the previous MPC meeting. But annual retail sales price inflation had remained close to its previous rates and stood at 0.6% in September.

VII Reports by the Bank's regional Agents

50 The Bank's regional Agents had undertaken a survey of their contacts on domestic credit conditions. They had asked whether the demand for finance had changed over recent months. 40% of

respondents reported unchanged usage of finance, 48% increased use and 12% reduced use. Of those who had increased their demand for loans, some had done so because of deteriorating trading conditions. They had also asked whether firms thought that the terms and conditions of finance offered by banks had worsened. Most contacts had said that they had not. 10% of contacts had reported that they had recently had a loan request turned down. The Agents had also contacted local clearing bank representatives. They had suggested that they had for some time been seeking to improve loan quality and exercising more due diligence, and that this had not been connected with the recent turbulence in financial markets. Some contacts had reported that the terms of syndicated loans had tightened.

51 Looking ahead, the Agents reported that contacts had expected credit conditions to tighten in the future as the economy slowed. Some respondents had thought that small and medium-sized enterprises would have been most affected by this. The Agents had also asked about the exposure of their contacts to

emerging markets, which had appeared to be limited. For example, although 60% of manufacturing firms had some sales exposure, only 20% of these had more than 10% of their sales in emerging markets.

52 The Agents also reported on general discussions with their contacts. The outlook for activity reported by manufacturing firms had been more in line with the deterioration recorded in the survey data than the most recent ONS data. All Agents had reported further declines in orders, and there were particular concerns about the first half of 1999. Export orders had remained extremely weak and some firms had reported a loss of domestic market share to importers. Services growth had continued to slow, and had spread to sectors such as catering and leisure. Retail spending had slowed, with firms reporting falling sales of clothing and household goods in late September and October. In the labour market, regional divergence had increased: skill shortages had persisted in parts of the service sector in the south-east of England, but elsewhere prospects had deteriorated.

Minutes of the Monetary Policy Committee meeting on 9–10 December 1998

1 The Committee discussed the prospects for global activity and prices; slower-than-expected consumption growth; other indicators of domestic activity; the mixed signals from the labour market; monetary conditions and financial market data; and other issues including tactics; before turning to the immediate policy decision. Prior to the meeting, the Committee were briefed orally by Bank staff on the progress of the investigation into the Average Earnings Index, publication of which had been suspended by the Office of National Statistics (ONS) on 2 November 1998.

The prospects for global activity and prices

2 Stronger-than-expected data on employment and GDP in the third quarter had suggested that the United States economy continued to be surprisingly robust. However, expectations were that US growth would be slower in the coming year. The Japanese economy had weakened further, with GDP falling in Q3 by 0.7%.

3 In Europe, Japan and the United States, there seemed to be a continuing downward trend in business confidence—despite the strong GDP figures in Germany and the United States. This might mean that businesses were beginning to feel the trade effects arising from the crises in Asia and other emerging markets. The declines in business confidence might also reflect a squeeze on profits as weakening world demand had increased competition and contributed to downward pressure on world prices. Since the previous meeting, the OECD, the World Trade Organisation and the World Bank had revised down their forecasts for world trade in 1999. Although domestic demand in the industrialised countries remained relatively robust so far, declines in business confidence were consistent with a prospective slowdown in world trade. It was clear that the expected changes in world trade implied larger current account deficits in the industrialised countries, but it was not clear how these would be spread across countries.

4 Oil and other commodity prices had continued to fall. The one-month price of Brent crude had fallen below \$10 per barrel at the time of the meeting. Although caused partly by a fall in world demand, the fall in oil prices should act as a positive supply shock to industrialised countries and would therefore be supportive of future activity. However, the effects could be de-stabilising in the short run: the terms-of-trade effect would be a significant negative shock for those countries heavily dependent on oil revenues.

5 Although the world financial situation had improved slightly, and backward-looking data for the real economies of the United States and Europe had remained firm, the Committee concluded that the forward indicators of world activity and prices were probably softer than at the time the November *Inflation Report* projections were finalised.

Consumption

6 Consumption growth in Q3 had been below that assumed in the November *Inflation Report* central projection and retail sales growth suggested that the weakening of consumption growth had thus far continued into Q4. Looking back at the out-turns for consumption in 1998, growth had been systematically lower than the Committee had expected earlier in the year. While the forecast errors were within the usual statistical error bands on models of consumption behaviour, it was important to try to understand the possible causes of the apparent slowdown in consumption.

7 The out-turns for consumption growth did not appear to be entirely consistent with its fundamental determinants: labour

income had continued growing strongly and total net wealth had remained high throughout 1998.

8 Leaving aside the possibility of inaccurate data, the Committee discussed a number of potential reasons for the slower-than-expected consumption growth. One was that the effects on consumers expenditure of windfall payouts to consumers in 1997, following the conversion of a number of financial institutions from mutual to PLC status, might have been more bunched than expected. The Bank's analysis of windfall spending had suggested that some consumers would bring forward their purchases of consumer durables. If this had distorted the natural replacement cycle, the 1998 data might be reflecting a negative effect as fewer replacement items were purchased.

9 A second possible explanation was that consumers were worried about the outlook for employment and hence had been saving more than had been assumed in the Bank forecast.

10 A third possible explanation was that consumers had not reacted to the measured increases in wealth in the same way as the average of their past responses. The reaction to an increase in asset prices, in particular equity prices, might also depend on what had caused the price rise. Consumers might react differently to changes in the discount rate (the real interest rate appeared to have fallen) than to changes in expected post-tax corporate earnings. And changes in discount rates might themselves be a reflection of changing household preferences (because of demographics for example) as between present and future consumption. Consumers might also have perceived the rise in equity prices to be temporary.

11 It was also possible that the effects of the fiscal tightening might not have been captured fully in earlier forecasts of consumption. The changes in the last two Budgets had had much of their initial impact on the corporate sector, and hence on the personal sector via its ownership of the corporate sector. It was difficult to be sure that the tax changes had been properly captured in the relationship between consumption and measured wealth and income.

12 A fifth possible explanation was that weak consumer confidence could lead to a self-fulfilling outcome of weaker demand, which would have the effect of justifying and adding to the initial pessimism.

13 A sixth possible explanation was that consumers might now be more price sensitive and so were waiting for retailers to cut prices further before spending. For example, the Bank had received anecdotal evidence from the regional Agents that discount clothing stores had been expanding their market share at the expense of traditional established department and chain stores.

14 The Committee considered these possible explanations but concluded that none of the six explanations proposed was sufficient on its own.

15 One of the counterparts to weaker consumption growth had been a bigger-than-expected build-up in inventories. In the third quarter there had been a marked accumulation of manufacturing inventories of finished goods, while retail inventories had been growing steadily over the year. The November *Inflation Report* had already built in a significant negative effect on GDP growth from an inventory cycle during 1999 but the latest data perhaps increased the downside risk to that projection.

Other activity indicators

16 GDP growth in Q3 had been revised down from 0.5% to 0.4%. This was the first quarter of growth clearly below trend since 1996 Q2. The National Institute of Economic and Social Research's monthly estimate of GDP was indicating zero growth in the three months to the end of November. It was, therefore, now possible that the fourth quarter could be even weaker than the *Inflation Report* central projection of a small positive growth rate.

17 The survey data had continued to deteriorate. The three surveys from the Chartered Institute of Purchasing and Supply (CIPS) for manufacturing, services and construction were now all indicating falls in output. The Committee noted that the trend in activity growth indicated by the surveys remained downward. Although it was not yet clear whether Q4 growth would be weaker than expected, the downside risks had increased since the Committee's previous meeting.

18 The Committee considered the possibility that the BRC's 'like-for-like' adjustment was distorting downwards its measure of underlying retail sales growth and that the unadjusted measure (which had been closer to ONS data in recent months) was a better guide.

19 The trade data in Q3 had shown a significant widening of the trade deficit reflecting strong import growth, possibly reflecting the strong investment and inventories numbers. The Committee was reluctant to read too much into quarterly swings in the external accounts. The negative effects of weaker world demand and the appreciation of sterling had been clear in the trend for exports for some time.

Labour market

20 The labour market quantities data had continued to indicate growth in employment, but at a somewhat slower rate. Unemployment data were beginning to show small increases. Business surveys, such as the CIPS employment survey and the Federation of Recruitment and Employment Services survey, both for November, generally showed a weaker employment picture.

21 Data on pay settlements were relatively stable at around 3³/₄%. Wage drift was perhaps more likely to be falling than rising, given the slowdown in output growth. So, although the labour market remained tight, it was possible that it was no longer tightening and some indicators suggested that it might even be beginning to ease. On the other hand the Reed Personnel Services skill shortages index showed a further rise for Q4 and official figures on the stock of unfilled vacancies were at a record high. National press advertising had also remained buoyant.

22 The Agents had reported considerable concern amongst contacts about the effects of the Working Time Directive, mainly about the level of bureaucracy and the minimum holiday entitlement. It was not clear how big an effect the directive would have on costs or prices.

Prices and inflation expectations

23 Inflation forecasts, surveys of financial market professionals and derived inflation expectations from index-linked gilts all seemed to be broadly consistent with the 2¹/₂% RPIX inflation target. It was possible that surveys of the inflation expectations of the general public, which remained above 2¹/₂%, would decline towards the target as RPI inflation fell relative to RPIX inflation. This reduction in inflation expectations might diminish some of the upside risks to inflation.

Monetary conditions

24 Aggregate M4 growth had continued at annual rates of over 9% and the Committee discussed whether it was possible to have

low output growth when real broad money was growing so strongly. Historical evidence suggested that real M4 growth had not always weakened before a slowdown in activity growth, so the Committee could not infer much about the imminent risks to activity. Furthermore, stripping out the contribution of Other Financial Corporations (OFCs) to broad money growth gave somewhat lower annual growth rates of around 6%.

25 Other monetary and financial indicators had remained firm: notes and coin were growing at over 5% per annum, equity prices had remained at high levels, and house price inflation was easing, but remained at 4.9% and 6.9% per annum on the Halifax and Nationwide measures. If activity growth continued to slow, one might expect a simultaneous slowdown in broad money growth, possibly alongside a fall in asset prices.

26 On the credit side, there had been few signs of distress borrowing in the corporate sector, and the growth of lending to the personal sector had remained strong—particularly for unsecured credit.

The level of interest rates

27 The Committee discussed whether it was helpful to think about the appropriate level of nominal interest rates by reference to the concept of a 'neutral' level, which provides neither stimulus nor restraint to the economy. A broad estimate of the neutral short nominal interest rate could in principle be estimated by combining short-run inflation expectations with an estimate of an average short real interest rate.

28 Inflation expectations appeared to have fallen and it was no longer implausible to think of them as being broadly consistent with the 2¹/₂% target for RPIX inflation. Some members of the Committee concluded that the appropriate assumption might be a little higher than this given that domestically generated inflation was probably well above 2¹/₂% and was likely to be more persistent than imported inflation.

29 There was more difficulty in estimating the neutral short real rate. Alternative approaches gave different estimates. For example, one could use as a guide historical averages of ex post real returns on nominal government bonds, cross-country comparisons, or long-term forward real rates derived from index-linked gilts. These gave a range perhaps as wide as 2%–4%. On this basis, estimates of the neutral nominal rate fell in a range of around 4¹/₂% to around 6¹/₂%.

30 While some members of the Committee found the concept of the neutral rate useful in deciding on interest rate policy, other members found the uncertainty surrounding its level so large that the concept was of little use as a practical guide to policy.

Other considerations bearing on the decision this month

31 The Committee noted that much of its concern related to the prospects for consumption growth and confidence. Since a large share of consumer spending happened around the Christmas period it was possible that a move this month would have a larger effect in supporting activity in the short run than a delayed move, without damaging the prospects for inflation over the medium term.

32 The Committee also discussed the new evidence since the *Inflation Report* was published. It was noted that, with the risks on the downside, the mean of the RPIX projection 2 years ahead published in November had already been below 2¹/₂%. Since then the global situation (including commodity prices) appeared to have weakened further and domestic indicators suggested that the balance of risks to UK activity was even further on the downside,

so that the expected inflation rate two years ahead had fallen since the November *Inflation Report*.

33 As usual, the Committee considered whether a change in rates would disturb financial markets. A number of economic commentators were predicting that the Committee would make a cut of 0.25% and many thought a larger cut was warranted. An immediate cut of 0.50% was within the range of outcomes the market had factored in by the start of the meeting so it was unlikely that a similar size cut would have an unsettling effect. It was difficult to judge the market consequences of a different decision. The reaction of sterling might depend on whether markets interpreted the change in terms of stronger or weaker prospects for activity growth.

The immediate policy decision

34 The Committee concluded that the prospects for global activity and prices had weakened over the month. Business confidence had been declining across the major economies and commodity prices, particularly oil, had fallen further. The global financial situation was probably no worse, but UK trade data showed that the effects of slower world demand were beginning to come through on top of the impact of sterling's appreciation. The United States and the euro area had both cut rates since the previous MPC meeting. The main domestic news seemed to be in respect of consumption growth, which had been slower than expected during 1998 as a whole and, on the basis of retail sales growth, was still slowing. There were a number of possible explanations for this, but none was sufficient on its own.

35 Other indicators of domestic activity also showed a continuing softening. The CIPS surveys were now indicating negative growth in all the main sectors of the economy. In contrast, the available data suggested that the labour market remained tight although there were now some signals that the situation might be beginning to ease. Money growth remained strong and asset prices remained firm.

36 Taking all the news together, the Committee concluded that there was a clear case for a further cut in rates this month. The question was how much.

37 An argument for a 0.25% cut was identified. The data might be sufficient to justify a cut of 0.50% but the uncertainty and the remaining upside risks arguably made it slightly preferable to cut by 0.25% this month with another 0.25% to come in January if the analysis was supported by the data.

38 The widely held view was that an immediate cut in rates of 0.50% was justified in terms of incremental news on the month. In particular the downside risks to both activity and prices appeared to have increased with the unexpected weakness in consumption being a major concern.

39 Some Committee members found it helpful this month to consider where we were in relation to an estimate of the neutral

level of nominal rates. Although subject to a wide range of uncertainty, the neutral rate was likely to be somewhat below the current level of 6.75%. Therefore a cut of 0.50% this month would be consistent with the news and a step towards neutral.

40 Among those who questioned the practical use of the concept of the neutral rate it was recalled that similar arguments about the level of rates had been used in the mid-eighties to justify lowering rates to levels which subsequently turned out to be too expansionary. On these grounds one should be cautious about the use of such calculations to justify changes in policy.

41 On another view, a neutral rate would probably be significantly lower than the current rate of 6.75% and the conjuncture indicated that we should be below neutral rather than above. However, a sequence of cuts would have a greater impact than a single cut of substantially more than 0.50%, which would be seen as an over reaction and might, on this view, be an unnecessary shock to financial markets. On these grounds an immediate cut of only 0.50% was appropriate.

42 A further view was that there had been a case for cutting by more than 0.50% the previous month and, with the news this month, this suggested that a larger reduction than 0.50% was now appropriate. Short rates were too high, both in comparison with long rates and compared with short rates in other countries. On this view, there was no good reason for cutting rates in steps. The Committee was learning all the time about the response of the economy to shocks and it appeared that the real side of the economy had responded faster to events than the Committee had expected. On this view there should be an immediate cut of more than 0.50%.

43 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be cut by 50 basis points to 6.25%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Alan Budd, Charles Goodhart, DeAnne Julius, Ian Plenderleith and John Vickers) voted for the proposition. Willem Buiter voted against, preferring a cut of 75 basis points.

44 The following members of the Committee were present:

Eddie George, Governor
 Mervyn King, Deputy Governor responsible for monetary policy
 David Clementi, Deputy Governor responsible for financial stability
 Alan Budd
 Willem Buiter
 Charles Goodhart
 DeAnne Julius
 Ian Plenderleith
 John Vickers

45 Gus O'Donnell was also present as the Treasury representative.

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 4 December 1998, in advance of its meeting. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I Monetary conditions

2 Notes and coin in circulation had increased by 0.6% in November, after adjusting for the introduction of the new 50 pence and £2 coins. The twelve-month growth rate had been 5.1%.

3 The twelve-month growth rate of M4 had remained at 9.1% in October and the monthly flow, at £4.9 billion, was close to the average for the first three quarters of 1998. The entire addition to the stock of M4 had come from the household and Other Financial Corporations (OFC) sectors. The deposits of Private Non-Financial Corporations (PNFCs) had fallen over the month, by 0.2%. Twelve-month growth rates for the household sector, PNFCs and OFCs had been 5.6%, 5.2% and 22.6% respectively.

4 The one-month growth rate of aggregate M4 lending had remained at 0.7% in October, which pushed the twelve-month change up to 9.1%. Annual growth in M4 lending to the household sector had remained unchanged at 7.4% in October. Total secured lending to individuals had continued to grow at an annual rate close to 6%, despite a slowdown in housing market activity; anecdote suggested that mortgage equity withdrawal might have been a contributory factor. In contrast, the annual growth in unsecured lending to individuals had remained strong, at 17.2% in October; it had been close to this level since the beginning of 1997. M4 lending to OFCs had increased by 1.3%, raising the annual growth rate to 18.4%. However, M4 lending to PNFCs had risen by £0.4 billion, compared with an average flow of £1.1 billion during the first nine months of the year, reducing the annual growth rate to 5.8%. PNFCs' total external finance, which includes foreign currency borrowing and capital issues, remained robust.

5 Net recourse to banks by PNFCs (defined as the difference between M4 lending to PNFCs and their M4 deposits) had also remained strong. In the year to 1998 Q3, a number of the larger sub-sectors, including manufacturing, had used a greater proportion of the sterling facilities granted to them by banks.

6 Turning to financial prices, it appeared that the 25 basis point cut in official rates in October had already been passed through fully to variable rate mortgages advertised by banks and building societies, and that the 50 basis point cut in official rates in November would, likewise, soon be passed on.

7 Short-term inflation expectations (as surveyed) had remained close to the inflation target, and short-maturity nominal interest rates had fallen. By implication, there had been a further reduction in short-maturity real interest rates.

8 An empirical analysis of the average real rate earned on a variety of different instruments, in some cases using data back to 1797, suggested a value for the neutral real rate of interest—defined as the rate that would prevail if the economy were at, and set to be at, capacity and inflation was in line with the target—of between 2% and 4%. Assuming that short-term inflation expectations were close to the inflation target implies a neutral nominal interest rate of between $4\frac{1}{2}\%$ and $6\frac{1}{2}\%$.

II Demand and output

9 GDP at market prices had grown by 0.4% in 1998 Q3, revised down by 0.1 percentage point from the preliminary estimate, and the annual rate had been revised down to 2.3% from 2.5%. This was consistent with earlier data on manufacturing output and industrial production, which had pointed to a downward revision. The expenditure breakdown had shown domestic demand growing by 0.9% in Q3, reflecting a sharp increase in investment. Net trade had made a negative contribution to GDP growth of 0.6 percentage points. Recent trade data, the scale of the alignment adjustment in the first three quarters of 1998, and the usual revisions reflecting new information had all suggested that the next GDP release could include revisions to the composition of expenditure throughout 1998. The implications for GDP growth were not clear.

10 Household consumption had remained weak, rising by 0.4%, the same as in Q2. The Q2 figure had included falls in catering and financial services, which were thought to be erratically weak. The Q3 release suggested either that the bounceback in these sectors had not been as large as expected, or that other sectors had weakened—so there might have been an underlying slowdown in consumption. Government consumption had risen by 0.6%, compared with 0.9% in the previous quarter.

11 Investment had recovered very strongly following a weak Q2, rising by 2.5% on the quarter. A fall in manufacturing investment of 4.5% had been more than offset by a rise in service sector investment of 7.4%. No known erratic components had accounted for the strength of business investment in Q3. Bank staff had considered whether business surveys might provide an explanation of the current strength of investment, and whether this would be sustained. Investment intentions did suggest a slightly higher level of investment in Q3, consistent with the provisional estimate. But the surveys had also suggested the level of investment over the next year would be roughly flat.

12 Inventories had continued to increase in Q3, rising by £1.7 billion. There had been a large accumulation of stocks of manufactured finished goods (up £589 million), and retail inventories had risen by more than £250 million for the third successive quarter. A large increase in stocks of other industries had also pointed towards a significant positive contribution from the alignment adjustment. Taking the first three quarters of 1998 together, expenditure appeared to have fallen short of output. Bank calculations suggested that the alignment adjustment had reached around £1.4 billion; since it must sum to zero over the year, this pointed either to revisions to the first three quarters, or a large negative contribution in Q4. Looking ahead, the Confederation of British Industry (CBI) monthly trends survey had suggested that a stock overhang continued; the balance reporting excessive stocks was +28 in November. The Chartered Institute of Purchasing and Supply (CIPS) survey had pointed to falling stocks, though not in the consumer goods sectors.

13 Net trade had made a negative contribution to GDP growth of 0.6% in Q3; export volumes had fallen by 0.6%, while import volumes had expanded by 1.2%. But the UK trade data published after the GDP release had pointed to even faster import growth in Q3 (goods volumes had risen by 3.7%), and suggested that a much bigger negative contribution from net trade might be included in the next GDP release (to be published on 21 December). But this did not necessarily imply a downward revision to Q3 GDP. In the past year, just under half of the widening of the deficit could be accounted for by a bigger deficit on trade with Asia, including

Japan. The non-EU trade deficit had narrowed in October, but the trend had remained downward.

14 Manufacturing output had fallen by 0.1% in Q3, while services output had grown by 0.6%, the same as the previous quarter. Construction output had fallen by 0.7%, owing to a contraction in repairs and maintenance; new building output had continued to grow. In October, manufacturing output had contracted by 0.4%—the third consecutive monthly fall. However, as in the previous few months, industrial production had held up, and was unchanged on the month. Oil and gas extraction had increased by 0.8%, and utilities supply had remained high, reportedly because of worse-than-usual weather conditions in October.

15 Retail sales volumes had fallen by 0.4% in October, the second consecutive decline. Survey evidence had continued to point to weaker retail sales. The CBI Distributive Trades survey had again been weak in November (the balance declined to -9 from -4). The CBI retailing business confidence indicator had been at its lowest level since the survey began in 1983. And, the Bank's regional Agents' reports suggested falling retail sales turnover in all regions outside Greater London, southern and south east England. At a national level, the Agents' reports had pointed to an overall fall in turnover in the latest three months.

16 House price inflation had slowed. The Halifax house price index had risen by 4.9% in the twelve months to November (down from 6.7% in October); the Nationwide index had risen by 6.9% (down from 7.5% in October); and the Bank's index, based on Land Registry data, had declined by 7.5% in the four quarters to Q3, from 8.9% in Q2. Housing turnover had also slowed—particulars delivered had been 5% lower in October, and the trend had been clearly downwards. Secured lending had been marginally weaker in October, at £2.1 billion, and the trend in approvals had been downward. The House Builders' Federation survey had continued to report negative balances for net reservations (-9) and site visits (-28).

17 The survey evidence had remained weak in November; sentiment towards the domestic outlook had deteriorated further, while export expectations had stabilised somewhat. The CBI Monthly Industrial Trends survey had reported total orders balances unchanged at -47, implying a decline in domestic orders, while the balance for export orders improved slightly to -51, from -55. Output expectations had improved marginally to -27 in November, from -29 the previous month. The CIPS manufacturing orders index had reached a record low of 36.4 in November, and its services survey had indicated a contraction in service sector business activity for the first time since the survey began in July 1996.

III The international economy

18 Economic conditions in Japan had continued to deteriorate. GDP had fallen by 0.7% in Q3 and by 3.6% on a year earlier; however, growth in 1997 had been revised up. In October, retail sales had fallen 4.8% on a year before, and the unemployment rate had remained at 4.3%. Reflecting this deteriorating situation, the Japanese government had announced in November a further fiscal package to stimulate domestic demand, reported to include ¥18 trillion (3.6% of GDP) of extra spending and ¥6 trillion (1.2% of GDP) in tax cuts.

19 In Europe, German GDP had increased by 0.9% in Q3 (2.7% on a year before), and French GDP was up by 0.5% (2.8% on a year before). In both countries import growth had slowed. Survey data for the prospective euro area indicated that, between September and October, industrial confidence had fallen from a balance of -2 to -5, while the balance for consumer confidence had picked up from -5 to -3. Average inflation had remained subdued in October, at 1.0%.

20 In contrast, activity in the United States had generally turned out to be stronger than expected. The second estimate of Q3 GDP had shown a rise of 1.0% on a quarter ago (revised up from 0.8%). In October, annual M2 money growth had increased to 8.5%, up from 7.9% in September, and retail sales were 5.7% higher than a year ago. In November, non-farm payrolls had increased by 267,000, well above the average monthly rise of 189,000 in June-October, and the Conference Board Index of consumer confidence had increased to 126.0, from 119.3 in October. However, annual average hourly wage growth had fallen from 3.8% in October to 3.7% in November, and the twelve-month growth in industrial production had fallen to 2.1% in October—the lowest annual growth rate since the 1991 recession.

21 The OECD, World Bank, and World Trade Organisation (WTO) had all released new forecasts during the month. In each case projections for world GDP and trade growth in 1998 had been revised down. World trade growth was expected to slow from 9.5% in 1997 to 5.3% (World Bank), 4.6% (OECD), and 4.5% (WTO). Thereafter trade growth was expected to increase. Other forecasters had also revised down output growth projections. Bank staff had used UK export trade shares to weight together the 1999 GDP growth forecasts, compiled by Consensus Economics Inc., for the major six (M6) economies (US, Japan, Germany, France, Italy and Canada). This forecast indicator of M6 GDP growth had fallen from 2.4% in July to 1.9% in November. On the same basis, consensus forecasts for M6 CPI inflation in 1999 had been revised down from 1.6% to 1.3%.

IV Labour market

22 Labour Force Survey (LFS) employment had grown by 124,000 (0.5%) in the three months to September, compared with the previous three months. This rise was concentrated in full-time employee positions: full-time employment had increased by 158,000, and the number of employees by 199,000 (0.8%). In contrast, the number of self-employed workers had fallen by 79,000 (2.4%), and part-time employment dropped by 34,000. Total hours worked were only 0.1% higher over the quarter, implying that hours per head had fallen by 0.4%.

23 Business surveys had suggested a weaker employment picture than the LFS data. The composite CIPS measure of employment had shown a sharp deterioration in job growth through 1998 Q3, with the survey indicating falls in overall private sector employment in October and November. At the sectoral level, the CIPS November survey reported that manufacturing employment had continued to decline sharply, and that construction employment was now starting to fall, whereas services employment had continued to expand, albeit at a markedly slower rate. This sectoral picture had been broadly corroborated by the reports of the Bank's regional Agents. The Federation of Recruitment and Employment Services (FRES) report had shown a modest decline in permanent recruitment business in November, whereas temporary postings had still been rising, although at a slightly slower rate. It also reported that the availability of staff to take up positions had improved in November.

24 Vacancies at job centres had remained at historically high levels. Notifications of new vacancies had increased by 14,000 in October, and the stock of unfilled vacancies had risen by 10,000 to a record level. However, the government's initiative for job centres to improve the marketing of their services, including the introduction of Saturday opening, may have partly explained these high levels. National press advertising had also been buoyant, but had shown signs of flattening off in recent months.

25 LFS unemployment had increased by 3,000 in the three months to September, compared with the previous three months. Short-term unemployment (duration under twelve months) had increased by 44,000, but this had been almost entirely offset by a decline in the numbers unemployed for more than one year. The

LFS unemployment rate had been unchanged at 6.2%. LFS figures showed that there had been a fall of 87,000 in the number of economically inactive people in the three months to September, which contrasted with the increases that had been recorded in the first half of the year.

26 Claimant-count unemployment had risen by 7,000 in October, following a revised fall of 4,100 in September. October's data had possibly been affected by seasonal adjustment problems following the introduction of the Jobseeker's Allowance, offsetting the distortion to July's figures. Taking this into account, the trend for falling unemployment had probably continued. Evidence had started to emerge of an impact from the New Deal, as participants had left the Gateway. There was no firm indication that increased redundancies had yet affected the claimant count. Inflow rates to the count remained low by historic standards, while LFS data suggested that redundancies during summer 1998 had been at similar levels to the previous two years.

27 Turning to skill shortages, the Bank's regional Agents had reported some easing of recruitment difficulties, though the level had remained higher than normal, and regional and industrial variations persisted. Sectoral surveys generally supported this picture. As well as the CBI manufacturing survey and the British Chambers of Commerce (BCC) surveys reported a month ago, the CBI/Price Waterhouse survey had also found some easing in recruitment difficulties in Q3. However, skills shortages in construction had continued to rise, according to the Confederation of Master Builders survey, and Reed Personnel Services had also reported more severe skill shortages.

28 The rebased earnings data had been suspended by the Office for National Statistics (ONS) on 2 November, and were the subject of an independent review. In October, the Bank's measure of the whole-economy employment-weighted mean wage settlement (twelve-month moving average) had remained at 3.7% for the sixth consecutive month. Private sector settlements had been unchanged at 4.0% in October, and public settlements at 3.3%. Using a matched sample (ie only including firms where data are available for both years), the mean settlement had increased to an annual rate of 3.8% for the four months to October 1998, from 3.4% one year earlier, similar to the pattern in the whole-economy twelve-month measure. Other evidence suggested that broader earnings pressures may have moderated; the Reward Index of earnings growth had declined to 5.0% in October, from 5.4% in June, and the Bank's regional Agents had reported falls in overtime and hours worked, which would lower wage drift.

V Prices

29 Commodity prices had fallen again: the Bank's sterling oil-inclusive index had fallen by 15.9% since October 1997, the sharpest annual deflation rate recorded since the index started in January 1992. Excluding oil, the Bank's index had fallen by 8.7%. This was broadly in line with the *Economist* Index in October (in both sterling and dollar terms) which showed that prices had fallen by 16.1% and 17.5% respectively. The one-month future price of Brent crude had declined by nearly 20% during November, and had reached \$9.98 per barrel at the close of business on 9 December. However, RPI petrol prices were unlikely to fall by the same percentage amount, because of the effects of taxes, excise duties and the potential for retailers to widen their margins.

30 Producer prices had also remained weak: annual input price inflation had fallen to -9.8% in October, and annual output price inflation, excluding taxes, had reached -0.7%—its lowest rate on record. Surveys had suggested that producer price inflation may fall further: both the CIPS indicator of manufacturing input prices and the CBI series of output prices reached all-time lows in November. Annual trade price inflation had remained negative, with export prices to the world unchanged in September, and import prices 0.7% lower (the corresponding figures for

non-EU trade prices in October were -1.1% and -0.7% respectively).

31 Other measures of inflation had also fallen since the November MPC meeting. Annual inflation, as measured by the retail sales deflator, had fallen to 0.7% in October, its lowest rate since May 1997. And the annual inflation rate of harmonised consumer prices had fallen by 0.2 percentage points to 1.3%, equalling its lowest rate on record. The GDP deflator had only increased by 1.8% in the year to the third quarter.

32 RPIX inflation had remained at target for the third consecutive month in October. Both RPI and RPIY inflation had fallen slightly since September, to 3.1% and 1.8% respectively. RPIY goods inflation had continued to fall, and had become (marginally) negative for the first time in October.

VI Financial markets

Foreign exchange

33 Sterling and the dollar had strengthened during most of the month, though both had fallen more recently. Developments in Latin America had been an important influence for the dollar. Looking toward the end of the year, a number of contacts suggested that sterling might be volatile around that time, associated with the move from the ecu to the euro, although there was little sign of this yet.

34 Within Europe, the process of short-term interest rate convergence ahead of the introduction of the euro was almost complete. The co-ordinated interest rate cut in Europe on 3 December took all prospective euro countries' short-term interest rates to 3%, except Italy, where the discount rate was reduced to 3.5%.

35 The sterling ERI had appreciated by 0.3% during the month, to 99.6 on 9 December. It was little changed against the dollar and Deutsche Mark at \$1.66 and DM 2.77 respectively. While some of the news during the month had been negative for sterling (the larger-than-expected repo rate cut; the release of the MPC minutes; some weaker-than-expected macroeconomic data) the pound had, until recently, appreciated steadily against the Deutsche Mark, supported by merger and acquisition activity. The path implied by an uncovered interest parity condition under constant UK nominal interest rates was very close to the central projection in the November *Inflation Report*.

Government bond and money markets

36 Short-term interest rate expectations had fallen during the month, particularly in the final few days of November and early December. The gilt-edged market had been stronger than overseas bond markets, with a sharp fall in gilt yields. Ten-year gilt redemption yields had fallen by about 55 basis points during the month and, at 4.50%, were now just below those in the United States, though higher than those in Germany (3.77%). There had been a number of reasons for gilts' outperformance during the month: weaker macroeconomic survey data; the larger-than-expected UK repo rate cut; the MPC minutes and TSC evidence, which together were interpreted as suggesting greater willingness by MPC to cut rates for a given economic outlook than the market had thought; and also strong institutional demand for gilts ahead of the payment of gilt coupons on 7 December. This last factor suggests that the decline in yields was not solely attributable to interest rate expectations.

37 Short-term interest rate expectations, as measured by short sterling futures, had fallen. Since the November MPC, rate expectations had declined by 22 basis points according to the December 1998 short sterling futures contract. Further along the curve, expectations had fallen by around 40 basis points. But rate

expectations for the end of 1999 had risen, owing to concerns about liquidity at the end of that year and in early 2000. The behaviour of very short-term interest rates suggested that the market expected a cut in the repo rate on 10 December, but this might be exaggerated by year-end demand for gilts on repo.

Equity and corporate debt markets

38 Equity prices had initially strengthened in the first half of November but had fallen back toward the end of the month. Since the previous MPC, the Standard and Poor's composite share index had reached a new high, but the FT-SE All-Share index had been unchanged at 2586, with declines again in the General Industrials sector and the Resources sector. There had been more company profit warnings in November than in the same month a year earlier. Analysts' forecasts of corporate earnings growth for this financial year had been revised down again, to under 1%, but the fall in the risk free real interest rate was an offsetting influence on share prices. The recent rise in the Japanese equity market probably largely reflected the global recovery in equity markets.

39 In the capital markets, corporate bond yields had fallen during the month over a range of credit ratings, and international bond and syndicated loan issuance by UK corporates had increased since August (usually a quiet month). UK corporate bond spreads (over the gilt yield curve) had fallen some ten to fifteen basis points across the board. However, while short maturity sterling swap spreads had also narrowed, ten-year spreads increased by around 13 basis points. Real yields on UK corporate debt had changed little during the month. In October, PNFCs total external financing, which measures their new borrowing from all sources and in all currencies, had turned out broadly in line with the average for the past six months.

VII Reports by the Bank's regional Agents

40 The Bank's regional Agencies had contacted 162 companies from the manufacturing, retail, other services and construction sectors to investigate the reported sharp deterioration in survey measures of business optimism. They had sought to discover whether the factors that most influenced optimism had been firm-specific, industry/sector-specific, or related to general economic factors. This survey had been conducted after the 50 basis point interest rate cut in November. Nonetheless, the Agents confirmed that overall business optimism had been lower

than three months ago; more than half the manufacturers and retailers, and over a third of the construction and other service sector companies, had been less optimistic. The survey had found that, independent of a firm's own performance, companies attached considerable weight to general UK and global economic news when gauging their optimism. Respondents said the November interest rate cut had positively influenced their optimism, but had been outweighed by other news. The Agents had reported widespread concern about prospects for global economic growth. However, concern about future demand and output had now become focused more on domestic considerations.

41 The Agents had also reported the results of more general discussions with their contacts. Economic conditions were largely seen as unchanged from a month earlier. With the exception of the West Midlands and North East, most respondents felt that talk of a recession had been overdone. Nevertheless, uncertainty about future prospects had continued to dampen demand. Although the recent cuts in interest rates had been welcomed, most consumers and firms seemed to be waiting for further reductions before undertaking major purchase and investment decisions.

42 As had been evident in the ONS data, the economic slowdown had not been evenly distributed across industrial sectors. Contacts in the services sector had reported reasonable growth in demand, albeit with some signs of weakness; retailers generally had only modest expectations for the Christmas period. Conditions in the manufacturing sector had been widely reported as being difficult, with weak order books for the first half of 1999. Demand for manufacturing output had fallen, while trading conditions had become more competitive owing to sterling's appreciation and increased import penetration.

43 The automobile sector had been especially hard hit. Global oversupply, falling demand for new cars, and the adverse competitiveness effect of sterling's appreciation had created particularly difficult conditions for UK automobile producers. This, in turn, had reduced demand for the large number of firms who supply parts and services to car manufacturers. The Agents reported that firms had cut costs in response to these pressures, and that this had included some job losses.

44 Respondents generally had noted that while labour market conditions had remained tight, conditions had begun to ease. In particular, wage pressures had diminished somewhat, with most wage settlements at, or below, the RPI inflation rate.

Text of Bank of England press notice of 10 December 1998

Bank of England reduces interest rates by 0.50% to 6.25%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.50% to 6.25%.

Since the November *Inflation Report*, the prospect for global activity appears to have weakened and commodity prices have fallen further. In the UK, GDP growth in the third quarter was revised down, and surveys of activity have continued to indicate a deterioration across the economy, although the labour market is still tight and monetary and financial indicators remain relatively strong. The Monetary Policy Committee judged that the downside risks to both activity and inflation have increased, and therefore reduced interest rates by 0.50% to keep prospective inflation on track to meet the 2.5% target.

The minutes of the meeting will be published at 9.30 am on Wednesday 23 December.

Minutes of the Monetary Policy Committee meeting on 6–7 January 1999

1 Before turning to its immediate policy decision, the Committee discussed the prospects for global activity and prices given continued downward revisions to published forecasts; exchange rates and financial markets; money and credit; demand and output in the context of the National Accounts revisions; the labour market; and other issues including tactics.

The prospects for global activity and prices

2 A key issue remained how much of a depressing influence the international economy would have on the domestic economy, and hence on the prospects for UK inflation. The outlook for the world economy had clearly deteriorated over recent months, and this had been a material factor in the Committee's decisions to reduce rates in October, November and December. Views varied on whether there had been much sign of a further international deterioration over the past month, or whether international developments had principally reflected the continuing pass-through and unwinding of previous negative shocks to demand in the world economy.

3 Some outside forecasts of world trade were being revised down further—for example, the IMF had updated its WEO projections in December. The latest Consensus Economics survey showed that forecasts for Germany and other euro-area economies had been revised down in December. Over the past month business confidence in the euro area had continued to weaken. The Japanese economy continued to deteriorate. The Tankan survey had weakened further, returning to the very low level recorded in 1994. The latest indicators for the United States continued to be quite strong, and the Consensus Economics survey showed that some growth forecasts for 1999 had been revised up in December. It was also necessary to take account of the easing of policy in the United States and in the euro area since the autumn and the effects were unlikely to have been seen in the official data yet. Overall, the situation in the major industrial countries was not obviously worse than a month ago, but was no better than expected.

4 Some of the forward-looking indicators in the United States—such as the National Association of Purchasing Managers index—were a little weaker. This weakening, in common with that in other OECD countries, perhaps related more to the manufacturing rather than service sectors of the economy. Though it seemed likely that robust US growth would continue over the next two or three quarters, there was a risk of a substantial slowdown looking further ahead. One possibility was a weakening of demand, if for example there were an adjustment of equity prices; another possibility was that supply constraints would begin to slow growth, although there were few signs of that in the current price and cost data.

5 Non-oil commodity prices had risen slightly in November, following the fall in the previous month. But despite the military action in the Gulf, the fall in world oil prices to around \$10 per barrel that had occurred prior to the December meeting had largely persisted. For the world as a whole there had been a negative shock to aggregate demand following the crisis in East Asia and the Russian financial problems, so that it was likely that demand had fallen further below capacity, putting downward pressure on world prices and possibly real interest rates. Commodity prices had been especially sensitive to this shock. For the United Kingdom, goods price inflation excluding taxes was currently running significantly below aggregate RPIX inflation, given falls in the price of tradeables and the effect of past tax increases.

6 The external environment would be a key consideration in the quarterly *Inflation Report* forecast round. The risks to both

inflation and real activity remained clearly on the downside, and might have increased. The Committee discussed the risks and possible ramifications of further serious problems in emerging market economies, and agreed that policy could react if these downside risks materialised.

Exchange rates and financial markets

7 The sterling effective exchange rate had appreciated a little prior to Christmas, but had depreciated slightly at the turn of the year. The Bank had monitored the introduction of the euro, which had gone smoothly, and the Committee agreed that this did not, for the time being, have any material implications for the outlook for inflation and the conduct of monetary policy in the United Kingdom.

8 The yield on index-linked government debt had continued to fall, and was now around 2% at a maturity of ten years. Real yields were now at their lowest level since such bonds were introduced in the United Kingdom in 1981. Regulatory changes for pension funds that came into force in April 1997—namely the minimum funding requirement—may have made it more attractive for them to hold index-linked debt relative to some other assets. But the effects of these changes were likely to be spread over a number of years following the initial announcement, and it seemed unlikely that this could explain the very recent fall in UK real yields. There had been a corresponding fall in long-term nominal yields: implied inflation expectations remained broadly unchanged over the recent past. It was not clear what had caused the fall in UK long-term real interest rates, and therefore what the consequences would be for the economy. Although it was difficult to explain the fall in long-term real yields in the United Kingdom relative to overseas, it was noted that there had been a general decline in global real yields over the past year. One possible explanation of the most recent fall was linked to the downward shock to world demand, which might imply a reduction in the real rate of interest that would balance global saving and investment.

9 Most major international stock markets had risen over the past month, and the FT-SE All-Share index was 13% above the level assumed in the November *Inflation Report* central projection. It was difficult to explain fully the rise in equity prices, but it was possible that it was related to the fall in real interest rates.

10 The spreads of yields on UK corporate bonds over government bond yields remained higher than they had been prior to the shocks of summer 1998. But the level of nominal yields on these bonds had fallen over the same period.

Money and credit

11 The growth rate of notes and coin had been robust through the autumn, even after adjusting for the introduction of the £2 coin. This added weight to the picture painted by the official retail sales figures, which had been stronger than much of the survey evidence had suggested. The provisional December figure for notes and coin had been particularly strong, but this could not sensibly be assessed in isolation because of the uncertainty surrounding the seasonal adjustment to the Christmas month figures.

12 Aggregate M4 growth had slowed in November, and had been matched by slower growth of lending. The slowdown in the growth of M4 and M4 lending was in large part accounted for by a reduction in the stocks of deposits and outstanding loans held by other financial corporations (OFCs). Within OFCs there had been anecdotal evidence that securities dealers, in particular, had been contracting their balance sheets by more than normal towards the

end of 1998. This was consistent with some of the data (for example, the fall in sterling lending by the major British banks to securities dealers).

13 Overall, some members thought that the latest monetary data were consistent with a gradual slowing of demand.

14 Lending to households continued to be robust, and had grown by 7½% in the year to November. This did not seem to be significantly out of line with nominal consumption growth. However, the high rate of increase in the smaller non-secured component of lending (which accounted for around 20% of the stock) continued to be puzzling.

15 Bank lending to companies had continued to grow steadily. Bond issuance had been low at the end of 1998. But it usually was at that time of year, so underlying conditions were difficult to assess. The number of insolvencies had risen but from a relatively low level. The Committee concluded, as in previous months, that recent indicators did not suggest a material impairment of the supply of credit.

Demand and output

16 Although there had been no change to the estimate of GDP growth in the third quarter of 1998, there had been revisions both to the composition of GDP growth in Q3, and to its rate of growth in earlier quarters. The level of output was now around 0.2% lower than previously estimated, so pressure on capacity was likely to have been a little less than previously thought, all other things being equal. The three measures of GDP—income, expenditure and output—were diverging and that made it more difficult to judge the pace at which the economy was growing. Within the Q3 GDP figures, growth of final domestic demand had been revised down and the contribution from net trade and inventory building had been revised up. In particular, consumption growth had been revised down, and the pattern was of a more gradual slowdown over the past year than had previously been estimated. Consumer confidence remained weak.

17 With the exception of the mortgage lending figures, the indicators suggested that housing market activity was slowing. Particulars delivered were now quite low compared with the past. The Halifax house price index had recorded a fall in prices for the second successive month. One view was that this provided further evidence of a loss of consumer confidence over the summer. However, the housing market was sensitive to interest rates, so a degree of slowing was to be expected following the tightening of monetary policy through 1997 and the first half of 1998. And members agreed that the relatively moderate rate of house price inflation over the past year was a welcome sign of greater stability than in past cycles.

18 The contribution of stockbuilding to GDP growth had been revised up in the third quarter of 1998, but there had been a downward revision to stock levels. In particular, stocks of finished manufactures had been revised down significantly. However, there seemed to be little news overall in the revisions to aggregate inventories, some of which reflected statistical changes in the National Accounts. Nonetheless, the balance of risks remained that the build up in inventories would be unwound by more than expected.

19 The CBI Distributive Trades survey for December was less weak than the previous month's survey, but this news was probably offset by the weaker CIPS services survey. It was too soon to glean any reliable impression of the state of consumer spending over the Christmas/New Year period. Overall, the latest evidence from surveys and monthly indicators did not suggest that the latest best estimate for GDP growth in the fourth quarter was very different from that in the central projection in the November *Inflation Report*.

Labour market

20 The labour market data continued to show rising employment and falling inactivity. But there were now further indications that unemployment was probably no longer falling. The recent data had shown a fall in long-term unemployment more than offset by a rise in short-term unemployment. The three CIPS surveys for manufacturing, services and construction were now all pointing to falling employment.

21 The number of jobs recorded by the ONS Workforce survey had been revised up by 450,000 implying lower productivity and higher unit labour costs data. The Committee noted that its November *Inflation Report* projections had been based on the Labour Force Survey measure of employment, which was not affected by this revision.

22 The Committee thought that the labour market remained tight, but that it seemed to have reached a turning point, and there were some signs of an easing of labour market pressures from the indicators of skill shortages and signs on pay settlements. The twelve-month employment-weighted average of pay settlements had been flat for many months and, depending on wage drift, this suggested a somewhat more benign path for earnings growth than had been expected around six months ago given the apparent tightening of the labour market. The Bank's regional Agents had reported some easing of upward pressure on pay growth. The current level of settlements was not especially comforting given the normal level of pay drift, but with the economy slowing members thought that there should be reduced pressure on pay from this source. And the reduction in interest rates over recent months would tend to lower RPI inflation relative to the target measure of RPIX in the short-term, which might influence settlements in coming months. Inflation expectations were important for wage setting, and had fallen in the latest surveys. These expectations might also be better anchored, following the monetary policy regime change, than had been the case in the past.

23 According to the National Accounts estimate of wages and salaries per head, nominal growth had fallen to 4.4% in the year to Q3. Estimates of the real wage paid by producers—based on the GDP deflator at basic prices—showed that the rate of growth was still rising, and was consistent with past tightening of the labour market. However, the rate of increase of the real wage received by workers had been decreasing during 1998. The wedge of over two percentage points between the two measures could be explained by past increases in taxes and changes in employers' contributions.

24 The Committee noted that their assumption for earnings growth in 1999 used in the November *Inflation Report* central projection was towards the top end of the range of outside forecasts made in November and December, and agreed that it would return to the issue in its discussion of the forecast for the February *Inflation Report*.

Other considerations bearing on the decision this month

25 There were a number of reasons for expecting significant news over the next month. A large share of consumer spending happened around the Christmas period, and at the time of the January meeting the official estimate of retail sales in December was not available. But given the difficulty in seasonally adjusting the data at this time of the year, it would be some time before the full picture became clear. The first estimate of Q4 GDP would also become available by the time of the February meeting. In addition, it would be possible to observe the first settlements relating to January, which is an important month for pay agreements. Furthermore, it was still early to assess the impact of the introduction of the euro.

The immediate policy decision

26 The Committee concluded that the prospects for global activity and prices were as bad as expected a month ago, and that the risks remained clearly on the downside. Some Committee members thought that these risks had increased somewhat in the past month, and that it seemed likely that the adjustment of the world economy to past demand shocks would prove more prolonged than some forecasts currently assumed.

27 The main domestic news on the real side of the economy had been the small downward revision to the level of GDP and the change in the composition of GDP growth, especially the downward revision to consumption. On the other hand the recent news on retail sales was mixed, while the data on notes and coin, and world stock markets pointed to a stronger outlook for activity. And some of the surveys were perhaps not as weak as they had been a month ago. Nonetheless, recent indicators suggested that GDP growth in the fourth quarter of 1998 would turn out broadly as expected at the time of the November *Report*. The labour market remained tight, but seemed to have reached a turning point.

28 Given the picture for activity, nominal price and cost developments continued to be more benign than expected at the time of the November projections and, on the view of some members, than expected in December. The fall in the oil price in November had largely persisted through December. Producer input prices had continued to fall. Evidence from wage settlements and the Bank's regional Agents suggested an easing of upward pressures on the rate of increase of pay.

29 On one view, given that there was not much news on the month, there was merit in waiting to gather another month's evidence and for the quarterly *Inflation Report*. The coming month would see some important data on Q4 GDP and settlements, and it was possible that the outcome of the Average Earnings Index review would be known. There were just enough signs of continuing demand growth in the recent data for the next month's data to be important to the policy decision. The quarterly forecasting round would provide an opportunity to reassess the level of interest rates. On balance, there was a case for pausing and making no change in interest rates this month. If in the event the evidence warranted it, a larger reduction in rates could be made next month.

30 Members identified several possible reasons for an immediate reduction in rates. The adjustment in the world economy was likely to prove more prolonged than previously assumed, with external demand for UK goods and services through 2000 correspondingly weaker. If so, there was less need for policy to put downward pressure on domestically generated inflation. In addition, the November *Inflation Report* central projection had also assumed robust real earnings growth and consumption. The revisions to the expenditure composition of domestic demand, together with the potential easing in the labour market and the

apparent moderation of inflation expectations, suggested that the prospects for inflation looked weaker. A combination of these external and domestic factors suggested that a reduction in rates of 0.25% (or possibly more in the view of some) was now warranted. If a reduction of 0.25% to interest rates were made at the January meeting it was difficult to see that being inappropriate by the time of the February meeting. The probability of a reversal in rates seemed small, and reversals justified by economic news were anyway not problematic.

31 Another view was that a cut of 0.75% would have been preferable at the time of the December meeting on the basis of the news available then. With little, if any, news during the past month, a reduction of 0.25% was still needed, and should be made now.

32 Another view was that a reduction of 0.25% would still leave rates above their neutral level, which was too high in the context of the current conjuncture. So the issue was how fast to reduce rates. There were three reasons for moving in steps rather than in one large reduction. First, a series of reductions might have a greater impact on consumer and business sentiment. Second, it might allow the Committee to learn more about the way the economy was responding to past shocks and policy changes. Third, it was important not to out-pace significantly the expectations of financial markets, as this could have unwanted consequences for asset prices and the exchange rate. Even though it was appropriate to move in a series of steps, the current level of rates was sufficiently above the rate required at this point in the cycle that a reduction of 0.50% was needed now.

33 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be cut by 0.25% to 6.0%. Seven members of the Committee (the Governor, Mervyn King, David Clementi, Alan Budd, Willem Buiter, Charles Goodhart and John Vickers) voted for the proposition, and two (DeAnne Julius and Ian Plenderleith) voted against. DeAnne Julius preferred an immediate cut of 0.50%, and Ian Plenderleith preferred to maintain the Bank's repo rate at 6.25%.

34 The following members of the Committee were present:

Eddie George, Governor
 Mervyn King, Deputy Governor responsible for monetary policy
 David Clementi, Deputy Governor responsible for financial stability
 Alan Budd
 Willem Buiter
 Charles Goodhart
 DeAnne Julius
 Ian Plenderleith
 John Vickers

35 Gus O'Donnell was present as the Treasury representative.

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 4 January 1999, in advance of its meeting on 6 January 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I Monetary conditions

2 Notes and coin had risen in December by 1.2%. The twelve-month growth rate had increased by 0.6 percentage points to 5.7%. Seasonal factors were typically harder to establish in the Christmas period, making the December data especially hard to interpret.

3 The monthly flow of M4 in November, at £2.1 billion, was well below the average over the rest of 1998, and the twelve-month growth rate had fallen to 8.3%, the lowest since July 1995. This was largely accounted for by a £0.7 billion decline in Other Financial Corporations' (OFCs') balances in November and a slightly lower rate of increase of Household sector deposits. The deposits of Private Non-Financial Corporations (PNFCs) had risen strongly in November, following a small fall in October. Taking the two months together, PNFCs' deposits in October and November were in line with the 1998 average.

4 The increase of £1.8 billion in M4 lending in November was the lowest since December 1996. The sectoral pattern largely mirrored that on the deposits side: OFCs had made a net repayment of £4.0 billion in November while PNFCs borrowing had increased quite sharply, to £1.9 billion. Anecdotal evidence suggested that the OFC sector may have chosen to shrink balance sheets by more than has been typical ahead of the year-end. Major British Banks' lending to securities dealers had fallen by £1.5 billion in November, consistent with that interpretation.

5 Households' borrowing had remained steady in November at £3.0 billion, and the twelve-month growth rate was still 7.4%, around 0.5 percentage points higher than at the start of 1998. There had been no slowdown on the month in secured borrowing or the number of loan approvals for house purchase. Unsecured credit growth had remained strong: the comprehensive measure of unsecured credit, which includes lending by non-M4 institutions, had increased by 17.3% on a year earlier.

6 Net external finance raised by PNFCs had risen by £1.4 billion to £4.4 billion in November. This included an increase in PNFCs net recourse to banks and a reduction in net capital issues. As for capital market conditions, the spread between swaps and government debt, and between corporate bonds and government debt, had both been broadly constant during December. These spreads remained high by historic standards but were below the peaks observed in the autumn.

7 Turning to price indicators of monetary conditions, the 50 basis point cut in official rates in November had already been fully passed through to variable-rate mortgages advertised by banks and building societies; announcements had been made by lenders that the 50 basis point cut in official rates in December would soon be passed on.

8 Survey measures of short-run inflation expectations had fallen by between 10 and 20 basis points during November, lying largely in a range between 2.2%–2.3%. These surveys had predominantly been undertaken before the reduction in official interest rates on 10 December. Measures of professionals'

expectations of average annual inflation over the next two years, derived from Consensus Economics and Basix surveys, had fallen by between 25 and 50 basis points on a quarter earlier. Estimates of short real interest rates could be made by subtracting survey measures of inflation expectations from a corresponding maturity wholesale money market rate. These calculations suggested that short real rates had fallen again during November, by around 20 basis points. Estimates of average real interest rates over the next two years derived from the Consensus survey enabled international comparisons to be made; they suggested that over Q4 real rates had fallen by substantially more in the United Kingdom (around 60 basis points) compared with either the United States (around 15 basis point fall) or Germany (around 30 basis point fall).

9 The Basix general public's inflation expectations for the next two years had also fallen markedly over Q4. The mean inflation expectations for one year ahead had fallen from 4.5% to 4.2% over the quarter. Expected inflation two years ahead had fallen from 5.1% to 4.7% over the quarter. There had also been a shift in the distribution of inflation expectations away from 4% or above, to 3% or below. The expectations of inflation formed by the general public still remained well above other measures.

II Demand and output

10 According to the National Accounts release, GDP at market prices had grown by an unrevised 0.4% in 1998 Q3 on a quarter earlier, and by 2.3% at an annual rate. But downward revisions to growth in 1997 and the first half of 1998 had reduced the level of GDP by around £350 million (or 0.2%). There had been revisions to the expenditure composition of growth in Q3, with a slightly stronger contribution from net trade offsetting weaker domestic demand. And the divergence between the output and expenditure measures of GDP had widened markedly to £865 million, compared with almost zero in 1997 Q3.

11 Household consumption growth in Q3 had been revised down from 0.4% to 0.3%. Within this, service sector spending had grown by 1.4%, but expenditure on both non-durable and durable goods had fallen. Analysis by Bank staff suggested that part of the recent decline in durables spending might reflect the unwinding of unusually high spending in 1997 and the start of 1998. This high spending had perhaps been caused by building society windfalls, though this effect appeared to have been rather smaller than expected and had been contrasted with a marked weakening in the growth of consumption of non-durables since 1996.

12 Investment growth in Q3 had been revised down from 2.5% to 1.1%, but the level of investment had been revised up by 0.6%, reflecting new information about investment in previous quarters. (Business investment had been revised up by 2.8%). These upwards revisions had been concentrated in the private services sectors, and mainly reflected increased spending on machinery and equipment.

13 A rise in inventories—most marked in the manufacturing and retail sectors—had contributed 0.2% to GDP growth in Q3. But the cumulative increase in stocks through 1998 as a whole had been revised down by around £1.8 billion. It was possible that there was now less of an overhang in stocks than previously thought. But interpretation was complicated by the fact that the reduction had largely reflected a reallocation out of the alignment adjustment and into the statistical discrepancy. Evidence from the Confederation of British Industry (CBI) monthly Industrial Trends survey suggested that manufacturers' stocks had risen further above desired levels in Q4.

14 Government consumption growth had been revised down by 0.4 percentage points in Q3 to 0.2% and by 0.5 percentage points in Q2 to 0.4%.

15 The current account had been in surplus by £2.3 billion in Q3, but this was accounted for by a large surplus on investment income, reflecting losses on overseas investments by foreign-owned financial institutions based in the United Kingdom. Net trade had continued to deteriorate, making a -0.5 percentage point contribution to GDP growth in Q3 (revised up slightly from -0.6 percentage points). This fourth consecutive quarterly negative contribution had reflected a rise in the deficit on trade in goods to the highest level since 1990 Q2. Trade in services had continued to provide a small positive contribution to GDP growth, despite a fall in services exports, as lower spending abroad by UK residents had reduced services imports. Net trade in goods appeared to have weakened further in Q4: exports to the non-EU had fallen by 1.9% in November and imports had risen by 2.2%. But the deficit with the EU had remained broadly stable.

16 Retail sales had risen by 0.8% in November, in contrast to the British Retail Consortium (BRC) and CBI Distributive Trades surveys which had indicated a continuing decline. Part of the difference might be explained by the broader sample used by the ONS. On an annual basis, comparing the three months to November with the same period a year ago, retail sales had grown by 2.6%, closer to the BRC's total sales volume measure, but still rather stronger than the CBI survey. Consumer confidence had remained weak: the GfK index had fallen back in December from -5.8% to -6.9%, and the MORI balance had been -30 in November. Most indicators had suggested a continued moderation in the housing market. Compared with a year earlier, the Nationwide house price index had grown by 7% in December; and the Halifax index had grown by 4.6%; particulars delivered had fallen to 103,000 in November—the lowest for over two years—and the House Builders Federation survey of new house building had remained weak.

17 Manufacturing output had fallen by 0.4% in October, the third consecutive monthly fall. Lower demand in domestic markets had appeared to be the main reason for lower car production and engineering new orders. Both the CBI and British Chambers of Commerce (BCC) surveys had pointed to a fall in manufacturing output in Q4 as a whole. But there was some evidence from the CBI and Chartered Institute of Purchasing Supply (CIPS) surveys that the pace of decline had bottomed out. Growth rates derived from the BCC survey for Q3 suggested that service sector output had grown at around trend in Q4, but the CIPS survey had pointed to a fall in service sector activity in December for the second consecutive month.

III The labour market

18 Both of the ONS measures of employment had increased according to the latest data. LFS employment had increased by 80,000 (0.3%) in the three months to October compared with the previous three months, while the Workforce jobs measure had bounced back in Q3, rising by 97,000 (0.4%) after a fall in Q2. The two measures were consistent in showing employment growth of around 1% over the past year. And, as over the previous year, the rise in Workforce jobs in Q3 was accounted for by a strong rise in employees, partly offset by a fall in the number of self-employed. By industry, the recent rise in employee jobs had been in the services and construction sectors, partly offset by falls in manufacturing and in the other sectors. Within services, industries which had experienced strong employment growth over the past year included distribution, hotels and restaurants; finance; and transport and communications. Within manufacturing, more than half the net loss in jobs over the past year had been in textiles, although recent falls in employment had been more evenly spread.

19 Revisions to the Workforce jobs data in the latest release had increased the level of employee jobs by around 430,000 in September 1997, and had increased the rate of employment growth during 1997. These changes, along with GDP revisions, had reduced productivity growth since 1997. Productivity had grown by 1.6% over the year to 1998 Q3.

20 Turning to other measures of employment demand, LFS total hours worked had increased by 0.3% in August-October, although there had been no change in average hours per worker. The CIPS employment surveys had reported sharp falls in employment in both construction and manufacturing in December. Service sector employment had edged down for the first time since the survey began in 1996. The Manpower survey of employment intentions had shown a sharp deterioration looking ahead to 1999 Q1. The net balance was at its lowest for 5 years, though after seasonal adjustment by Bank staff it remained around its historical average since 1981.

21 Notifications of new vacancies had fallen by 13,000 in November, although they remained high. The stock of unfilled vacancies had increased by 4,000 to a new record. But press advertising had shown a slightly weaker picture, with National Press Recruitment Advertising index beginning to turn down, according to the Federation of Recruitment and Employment Services survey. And reports from the Bank's regional Agents suggested that there had been a downturn in local press advertising in recent months.

22 Both LFS unemployment and claimant unemployment had started to rise according to the latest data. LFS unemployment increased by 16,000, though the rate remained unchanged at 6.2%. Within that rise, the number unemployed for less than one year had risen by 38,000, partly offset by a 21,000 fall in the long-term unemployed. Claimant unemployment had risen by 6,000 in November, and unlike October's data, there were no special factors to explain the rise. The rises in claimant unemployment had mainly been in the regions with higher unemployment rates. Inflows into the claimant count had increased by 9,000 in November, although they remained low by historical standards.

23 The rise in both LFS employment and unemployment was reconciled by a fall in inactivity. This fall was concentrated entirely among those not wanting a job, suggesting a slight increase in labour market attachment.

24 There were no new ONS earnings data, the Average Earnings Index having been suspended in November. The Reward index suggested that earnings growth had slowed a little in November to 4.9%.

25 Turning to settlements, the Bank's measure of the twelve-month employment weighted mean wage settlement had remained at 3.7% for the seventh successive month in November. But most settlements were concentrated between January and April, so the twelve-month measure tended to be relatively stable during other periods. Private and public sector settlements were unchanged at 4.0% and 3.3% respectively. The three-month employment-weighted mean settlement increased from 3.7% to 3.9%, while the median was unchanged at 4.0%. Using a matched sample (ie only including firms where data were available for both years) suggested that settlements had been higher in the five months to November 1998 than in the previous year. 74% of employees covered by the Bank's database (and 55% of firms) awarded higher settlements in 1998 than in 1997. On a sectoral basis, 77% of service sector employees had received higher settlements in 1998, compared with just 43% in the production sector.

26 In the absence of average earnings data, the ONS had used other sources of data to estimate the growth in wages and salaries for the National Accounts. The ONS suggested that wages and

salaries per head had increased by 4.4% in Q3, and growth in Q2 was revised down from 5.6% to 5.1%. Despite this, unit wage cost growth was revised up in the year to 1998 Q1 because of changes to the productivity data. The ONS estimated that unit wage costs had risen by 3.5% in the year to Q2 and by 2.8% in the year to Q3.

27 Real consumption wages had grown by 1% in the year to Q3 because the taxes and prices index (TPI) had risen by over 3%. Real product wages, on the other hand, had grown more strongly, by 3.4%. Real product wages are deflated by the GDP deflator (at basic prices), which had grown less strongly than the TPI, explaining the large difference.

IV Agents' national summary

28 The Bank's regional Agents reported on their assessment of the economy drawn from their discussions with contacts over the past month. The slowdown in activity had become more widespread. The fall in manufacturing output and orders had persisted; domestic demand in particular had weakened and import competition had strengthened. But the decline in export demand had begun to ease somewhat. Service sector growth had continued to slow, with a significant fall in demand from manufacturers. Consumer demand had weakened: inward tourism demand in 1999 was expected to be below that of 1998. However, telecoms and IT firms had reported strong growth and warehouse activity reflected the high stock levels. Manufacturers had reported high levels of unwanted stocks of finished goods and some had extended their Christmas stoppages to help unwind that position. The growth in the official retail sales data in November contrasted with reports from Agents' retailing contacts, which suggested that there had been sluggish sales growth, more in line with the CBI Distributive Trades survey. Sales growth in the first half of December had also been weak but there had been a noticeable pick-up in the week before Christmas. Price discounting in December had been greater than in 1997.

29 Upward pressure on wages had continued to ease. Even sectors of previously intense pressure (such as IT) had reported some easing. An increasing emphasis on job security had lowered wage expectations. The Working Time Directive would increase firms' costs not only through increased paid holiday provision and lost shift flexibility, but also via increased administration and monitoring. A number of contacts had sought opt-out agreements with their staff. Employment growth had continued, albeit more slowly, in the service sector, which contrasted with the decline in the November CIPS survey. Nonetheless, overall unemployment was expected to rise in 1999 as service sector growth would no longer balance job losses in manufacturing.

V International environment

30 Evidence from the United States had remained mixed. GDP growth in Q3 had been revised down slightly, to +0.9%, reflecting weaker net exports. Industrial production had continued to weaken, growing by 1.5% in the year to November. Consumer confidence had remained strong in November, but optimism about future employment and incomes had fallen. Non-farm payrolls had also continued to grow strongly in November, but this was due to seasonal effects, and the annual growth rate had been slowing since August. Nominal retail sales had grown by 0.6% in November, but real personal consumption had remained unchanged. M2 increased 8.8% in the year to November.

31 There were few signs that activity had bottomed-out in Japan. The December Tankan survey had been weak: the balance for large manufacturers had been recorded at -56 and was now back to February 1994's low point. The balance of firms with above-desired levels of employees continued to increase. The average propensity to consume had fallen in November, and retail sales had fallen 1.5% on a year earlier (the seventh consecutive

month of annual decline). The Tankan survey showed that corporate financial conditions had continued to deteriorate and that banks remained unwilling to lend (confirmed by official data which showed that bank lending had fallen 4.0% on a year earlier in November, although this may have been overstated as a result of debt write-offs). There was little evidence of fiscal policy supporting public construction orders—these had fallen 14.7% on a year earlier.

32 The quarterly growth rate of the EU5 (France, Germany, Italy, the Netherlands and Spain) had remained broadly unchanged in Q3. Private consumption had held up in Germany, France and Italy. While net trade had contributed positively to GDP growth, largely reflecting weaker import growth, this had been offset by weaker stockbuilding. In Q4, industrial confidence had continued to weaken, the annual rate of industrial production growth had continued to slow, and euro area capacity utilisation had fallen for the first time since 1997 Q1. Against this, consumer confidence had continued to strengthen in November. Inflation had remained weak (0.9% on the harmonised measure), and growth of the ECB's new euro area M3 measure had been close to the reference rate.

33 December Consensus Economics forecasts for 1999, were stronger for the United States, unchanged for Japan, and had been revised down for Germany, France and Italy.

34 Between October and December, the IMF had revised down its 1999 GDP forecasts, most significantly for Japan. World trade forecasts had also been revised down slightly.

VI Prices

35 The Bank's index of commodity prices excluding oil had risen by 0.8% in November, the biggest monthly rise since June 1997. The annual rate of inflation had risen to -6.7% in November from -9.2%. But the suggestion that non-oil commodity price deflation had started to abate had not been supported by the most recent three-month-on-three-month data: at -3.2% the rate of deflation had been the strongest since January. And commodity prices including oil continued to fall, by 1.1% in November according to the Bank's index.

36 Oil prices had stabilised in December following the sharp fall during November. Despite a brief increase at the beginning of the air strikes against Iraq, the one-month future price of Brent crude oil had risen to \$10.53 by the end of December from \$10.46 at the beginning. The effect on the UK real economy of low oil prices was likely to be small relative to the mid 1980s as oil's share of output, profits and net exports had declined significantly. And the effect on retail prices inflation had continued to be more than offset by taxes and excise duties. The rate of fuel price inflation in the United Kingdom had been the highest of any EU country in October.

37 Producer prices had fallen again in November: input prices had fallen by 0.6%, as in October, and output prices (excluding excise duties) had fallen by 0.1%. The CIPS and CBI surveys had suggested further falls in December.

38 Other measures of inflation had remained almost unchanged since the December MPC meeting. Annual retail sales deflator inflation had remained at 0.9% in November. The GDP at market prices deflator had increased by 1.8% in the year to the third quarter.

39 RPIX inflation had remained equal to the target for the fourth consecutive month in November; RPIY inflation had remained at 1.8%. RPI inflation had fallen by 0.1 percentage points since October, to 3.0%. Goods price inflation had remained much lower than that in services: RPIY goods inflation had remained just below zero in November.

VII Information from financial markets

Foreign exchange

40 Since the previous MPC meeting, the dollar had weakened by about 4.4% against the yen. The dollar had remained fairly constant against the Deutsche Mark, with a temporary weakness within the month around the time of developments in the Clinton impeachment case. Contrary to market expectations sterling had initially moved higher against both the dollar and the Deutsche Mark before falling back in the last few days. Since 29 December the sterling ERI had fallen by around 2%, returning it to the levels prevailing at the previous MPC meeting.

41 The transition to the euro had been smooth. In its first 24 hours of trading, the euro had appreciated against most other currencies, including sterling.

Government bond and money markets

42 Since the previous MPC meeting, the short-term interest rates implied by short sterling futures contracts had fallen further, and indicated that the current interest rate cycle was expected to bottom out in June 2000. New economic data had had little impact on expectations. The implied two-week repo rate two weeks forward was 14 basis points below the prevailing two-week repo rate. This was consistent with anecdotes suggesting that the market believed there was an evens chance of a 25 basis point cut in rates this month.

43 Euro-area rates had fallen, while United States rates had mainly risen. United Kingdom rates were close to short dollar rates from December 2000 onwards.

44 There had been a large rise in Japanese bond yields of around 80 basis points over the month. Market commentators had suggested that this was associated with an announcement that government trust funds would not buy a material amount of bonds in the current year, when bond issuance is set to rise.

45 United Kingdom yields at medium maturities were around 45 basis points below those in the United States, and some 60 basis points above those in Germany and France. In forward rate terms, this meant that United Kingdom yields beyond 5 years were now below German levels.

46 The United Kingdom had experienced a decline in index-linked government bond yields that had not been shared with other countries. This was sufficient to explain the fall in nominal yields, especially at the long end, but was not itself easily explained.

Equity and corporate debt markets

47 Most equity markets had risen since the last MPC. The US market was 7% above the July pre-crisis peak. The Japanese market had fallen a further 10%. The rise in the UK market had been broadly based, possibly reflecting lower real interest rates.

48 Analysts' forecasts of the growth in earnings per share for FT-SE 100 companies for the current financial year had continued to be revised downwards, and the median forecast had become negative. The path of revisions seen during 1998 was much sharper than since 1992.

49 The number of profit warnings was running at a higher level than last year. Fewer companies were citing the level of sterling as a cause of the lower profits, but more were citing weak domestic demand.

50 The level of equity market uncertainty, as measured by implied volatility, was slightly down since the previous MPC meeting, but was still higher than before the recent turbulence.

51 There had been little movement in credit spreads in the United Kingdom or the United States. The yield spread of an index of UK bank bonds over high-rated corporates had remained at a high level, possibly reflecting greater uncertainty over the outlook for banks since the Russian crisis.

Text of Bank of England press notice of 7 January 1999

Bank of England reduces interest rates by 0.25% to 6%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 6.0%.

Since the Committee's December meeting, domestic data and survey evidence have, on balance, shown a continuing slowdown in the UK economy. The labour market remains tight but it seems to have reached a turning point. Evidence from wage settlements and the Bank's regional Agents suggest an easing of upward pressures on growth in pay. The risks from the international environment remain clearly on the downside. In these circumstances the Committee judged that a further reduction in interest rates of 0.25% to 6.0% was appropriate in order to maintain a path for inflation consistent with the target.

The minutes of the meeting will be published at 9.30 am on Wednesday 20 January.

Text of Bank of England press notice of 5 February 1999

Bank of England reduces interest rates by 0.5% to 5.5%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.5% to 5.5%.

Taking account, in particular, of the prospects for international activity and prices, domestic costs and consumer demand, the Committee's latest inflation projections implied that a further reduction in interest rates was necessary to keep inflation on a path consistent with the target of 2½%. The latest projections and analysis will appear in the *Inflation Report* to be published on Wednesday 10 February.

The minutes of the meeting will be published at 9.30 am on Wednesday 17 February.

Glossary and other information

Glossary of selected data

AEI: Average Earnings Index.

DGI: domestically generated inflation.

Divisia money: a measure of the money stock in which each component is weighted according to an estimate of its likely use for transactions.

ERI: Exchange rate index.

HICP: Harmonised Index of Consumer Prices.

M0: notes and coin in circulation outside the Bank of England and bankers' operational deposits at the Bank.

M4: UK non-bank, non building society private sector's holdings of notes and coin, together with all sterling deposits (including certificates of deposit) held at UK banks and building societies by the non-bank, non building society private sector.

PPI: Producer Prices Index.

PPIY: Producer Prices Index excluding excise duties.

RPI inflation: inflation measured by the retail price index.

RPIX inflation: inflation measured by the RPI excluding mortgage interest payments.

RPIY inflation: inflation measured by the RPI excluding mortgage interest payments and the following indirect taxes: council tax, VAT, duties, car purchase tax and vehicle excise duty, insurance tax and airport tax.

TPI: Tax and Price Index.

Three-month annualised: the percentage change in a series over three months, expressed as an annual rate.

Abbreviations

BCC: British Chambers of Commerce.

BRC: British Retail Consortium.

CBI: Confederation of British Industry.

CIPS: Chartered Institute of Purchasing and Supply.

EFSR: Economic and Fiscal Strategy Report.

EMU: Economic and Monetary Union.

ERM: Exchange rate mechanism.

ESA: European System of Accounts.

FT-SE: Financial Times Stock Exchange.

GfK: Gesellschaft für Konsum, Great Britain Ltd.

ICPFS: Insurance corporations and pension funds.

IDBR: Inter-Departmental Business Register.

IMF: International Monetary Fund.

LFS: Labour Force Survey.

MORI: Market Opinion Research International.

MPC: Monetary Policy Committee.

NES: New Earnings Survey.

OECD: Organisation for Economic Co-operation and Development.

OFCs: Other financial corporations.

OFIFAs: Other financial intermediaries and financial auxiliaries.

ONS: Office for National Statistics.

PNFCs: Private non-financial corporations.

RICS: Royal Institute of Chartered Surveyors.

WFTC: Working Families Tax Credit.

WTD: Working Time Directive.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Office for National Statistics (ONS).
n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.

Other information

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This *Report* is available at: <http://www.bankofengland.co.uk/>