Inflation Report

May 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.

This *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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David Clementi, Deputy Governor responsible for financial stability
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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.

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Overview

Prospects for the world economy, which deteriorated sharply in the second half of last year, have improved in recent months. But the immediate outlook is for modest growth of world output and trade. The expected slowdown in UK growth has occurred. Forward-looking survey measures, some of which had fallen precipitously, have now recovered to levels consistent with a pick-up in growth. Inflation on the RPIX measure has remained close to 2.5%, and future inflation expectations appear reasonably well anchored to the inflation target. Sterling has risen strongly, in particular relative to the euro, over the past three months.

In the world economy, the remarkable growth of domestic demand and output in the United States has continued, without evident inflationary pressure. In the euro area, growth and business confidence have weakened further, though the ECB's sharp interest rate reduction in April should help to support activity. It is unclear when Japan will emerge from protracted recession. Spreads on emerging market debt have moderated, there are signs of renewed growth in some countries affected by the Asian crisis, and Brazil has made progress towards stability. Trade imbalances among the major industrialised countries have widened.

In the United Kingdom, aggregate output growth slowed slightly earlier than believed at the time of the February *Inflation Report*. Growth in the third and fourth quarters of 1998 was revised down to 0.3% and 0.1% respectively, and the preliminary estimate of growth in the first quarter of this year was 0.1%. Service sector growth stands in contrast to declining manufacturing production. Forward-looking business survey indicators have risen uniformly in recent months, and there are some signs—for example in the housing market—of restored consumer confidence.

Output continued to rise because domestic demand growth offset the weakening external position. The trade balance made a negative contribution to growth for the third successive year, equivalent to 1.8 percentage points of GDP in 1998. Consumption growth picked up in the fourth quarter of last year, and investment demand has been stronger than expected. The extent of any inventory overhang seems to have been reduced. The March Budget left public expenditure plans and the overall stance of fiscal policy broadly unchanged.

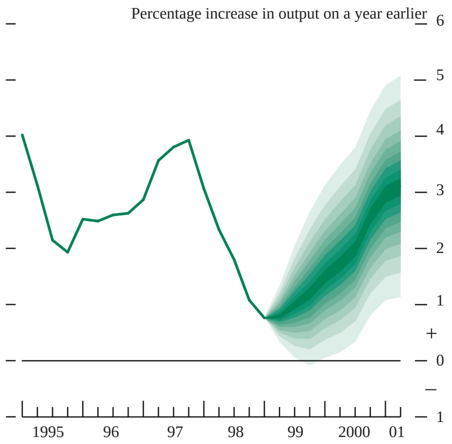
In line with the slowdown in GDP growth, broad money growth continued to moderate in the first quarter, largely reflecting reduced money holdings by the non-bank financial sector. Personal sector borrowing has shown signs of more rapid growth, however. Consistent with other evidence of renewed strength in the housing market, there have recently been marked increases in secured lending and loan approvals.

The labour market remains tight on most measures, but is not currently tightening further. Unemployment has increased slightly over the past three months, but remains close to its lowest level for twenty years. Aggregate employment has continued to grow quite robustly despite slower output growth, so measured productivity growth has fallen. Service sector employment has risen; that in manufacturing has fallen. Total hours worked have been broadly flat, so hours worked per head have fallen, reflecting less overtime and a growing proportion of part-time workers in the labour force. Vacancies remain high relative to unemployment. However, skill shortages appear to have eased, and survey data suggest that firms' employment intentions are significantly weaker than a year ago.

Publication of the official Average Earnings Index was resumed in March. According to the new headline measure, nominal earnings growth reached a peak of 5.7% in the second quarter of 1998—higher than previously thought—before easing to about 4.5% at the turn of the year. Evidence on private sector wage settlements also points to lower inflationary pressure in the labour market. At the same time, the substantial reduction that has occurred in inflation expectations means that real earnings growth has fallen by less than nominal earnings growth, and, on some measures, may have risen. Most measures of expected inflation are now consistent with the $2\frac{1}{2}$% inflation target.

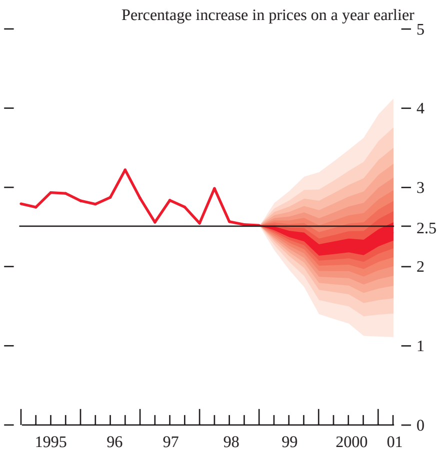
The implications for prospective inflation of reduced pay pressure and stronger sterling were the main factors that

Chart 1
Current GDP projection based on constant nominal interest rates at 5.25%



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 5.25%



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.

led the Monetary Policy Committee to reduce interest rates by a further 0.25% to 5.25% in April.

The MPC's current projection for the growth rate of GDP—based on the assumption that the Bank's repo rate remains constant at 5.25%—is shown in Chart 1. The central projection is for the four-quarter rate of GDP growth to rise later this year from its current level of between 1/2% and 1% to around trend by the middle of next year. The profile is similar to the February projection, but the pick-up in growth in the central projection begins slightly sooner, domestic demand growth is stronger, and net trade is weaker. The probability of a decline in output is judged to have fallen.

The corresponding projection for RPIX inflation is shown in Chart 2. The most likely path is for inflation to fall slightly below target over the next year or so, before rising to around 2.5% at the two-year forecast horizon. The projected decline in inflation in the near term is largely the result of lower nominal earnings growth and a higher starting-point for sterling than previously assumed. Inflation rises towards the forecast horizon as demand growth strengthens and as the restraining influence on prices of the strong exchange rate wears off. Indeed, the projection assumes that sterling declines from its present high level, at least in line with interest rate differentials.

The uncertainties surrounding the projection for GDP growth are broadly balanced. The possibility of a fall in equity wealth is a downside risk for consumption. Upside risks to activity arise from the possibilities that sterling will be weaker, and that stockbuilding will be less negative, than in the central projection. Assuming that the exchange rate is likely to decline by more than implied by interest rate differentials, the balance of risks to inflation is upwards. However, some Committee members see greater downside risks to inflation from a stronger exchange rate profile, weaker world activity and prices, and greater pressure on margins, than in the central projection.

The starting-point for sterling in the projection is 4 1/2% higher than assumed in the February *Report*. The rise in the exchange rate is likely to exacerbate the imbalance between the international and domestic sectors of the economy. It is also likely to bear down on inflation in the short term. The projection assumes that sterling will decline from its present high level. In that case, reducing interest rates further might risk overshooting the inflation target beyond the short term. But if sterling does not decline, then, depending on other developments in the economy, further easing of monetary policy might be needed to prevent undershooting of the inflation target.

The economy is now on course for growth with price stability. But exchange rate movements and other events affecting inflation are inevitably uncertain. As those events unfold, the Monetary Policy Committee will continue to set interest rates at whatever level it judges necessary to keep inflation on track to meet the $2\frac{1}{2}$% target.

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Money and financial markets 1

Annual growth in broad money continued to slow in the first quarter of 1999, largely reflecting a further decline in the rate of growth of non-bank financial sector holdings. Year-on-year growth in M4 lending slowed by less, leaving it slightly above the annual rate of growth in broad money. Growth in lending to individuals secured on dwellings increased in the first quarter of 1999, in line with strengthening activity in the housing market. Share prices rose internationally, in many cases to record levels. Following stronger-than-expected global economic data, conventional government bond yields rose in a number of G7 countries, including the United Kingdom. Sterling appreciated significantly, in particular against the euro.

At its March meeting, the MPC voted to leave interest rates unchanged at 5.5%. The MPC voted to cut the Bank's repo rate by 0.25 percentage points to 5.25% on 8 April. The MPC voted to leave interest rates unchanged at its meeting on 6 May.

1.1 Money and credit

Narrow money

The value of notes and coin in circulation increased by 0.7% in April, raising the twelve-month growth rate to 5.8% (see Table 1.A). Growth in notes and coin has been picking up since September. That is consistent with a fall in the opportunity cost of holding money as interest rates have been reduced. Annual growth in nominal retail sales also picked up slightly in 1999 Q1. However, the relationship between narrow money and nominal retail sales growth has not been as strong in this recovery as during the 1980s.

Table 1.A
Growth rates of narrow and broad money(a)

Per cent

		1 month	3 months (b)	6 months (b)	12 months
Notes & coin	Jan. 1999	0.5	6.1	6.1	5.4
	Feb.	0.5	6.5	6.1	5.4
	Mar.	0.5	5.7	5.7	5.6
	Apr.	0.7	6.5	6.3	5.8
M4	Dec. 1998	0.7	6.4	7.5	8.2
	Jan. 1999	0.1	4.4	5.1	7.6
	Feb.	0.5	5.4	6.2	7.2
	Mar.	0.4	3.9	5.1	6.9
M4 lending (c)	Dec. 1998	0.6	5.4	7.6	7.9
	Jan. 1999	0.5	4.9	6.6	7.8
	Feb.	0.5	6.5	6.1	7.0
	Mar.	0.7	7.1	6.2	7.4

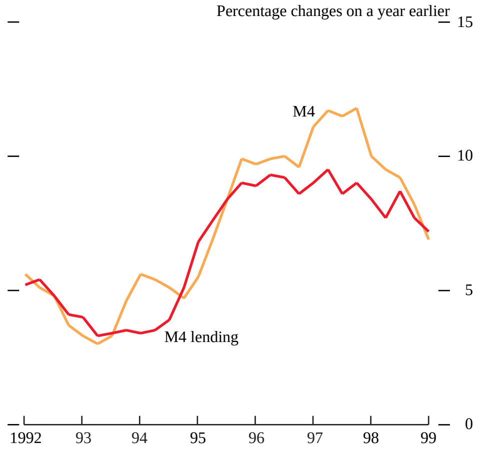
Source: Bank of England.

(a) Seasonally adjusted.
(b) Annualised.
(c) Excluding the effects of securitisations and other loan transfers.

Broad money

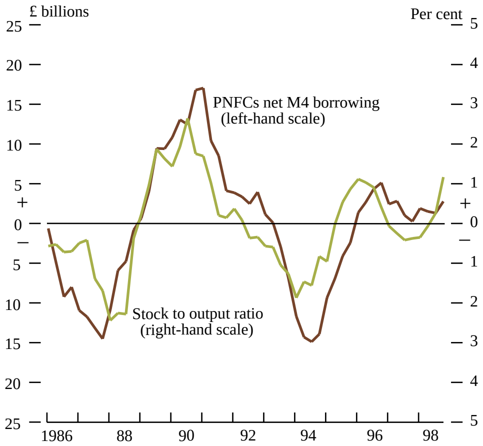
The rate of increase in broad money has continued to moderate. Annual growth fell by around 4 percentage points between 1997 Q1 and 1999 Q1, to 6.9%. Annualised short-term rates of growth remained below the twelve-month rate, suggesting that the annual rate may slow further. That would bring it more into line with the rate of broad money growth consistent with the MPC's central projections for activity and inflation,

Chart 1.1
Growth of M4 and M4 lending



Source: Bank of England.

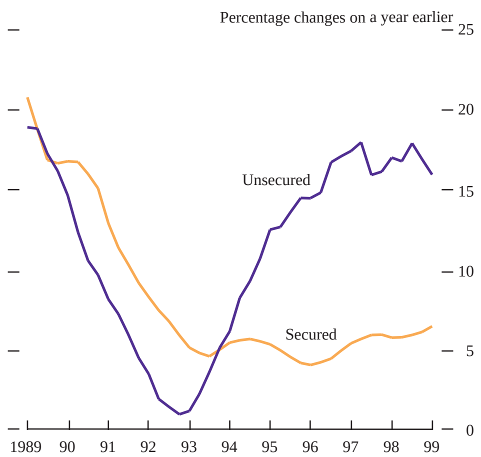
Chart 1.2
Net corporate borrowing(a) and the stock to output ratio(b)



Sources: Bank of England and ONS.

(a) M4 borrowing less deposits.
(b) Detrended using a Hodrick-Prescott filter.

Chart 1.3
Net secured and unsecured lending to individuals



Source: Bank of England.

given recent trends in velocity. The annual rate of increase in bank and building society lending to the rest of the private sector (M4 lending) was 7.2% in the first quarter of 1999, slightly above the growth in M4 deposits (see Chart 1.1).

Private non-financial corporations (PNFCs)

Net M4 borrowing (borrowing[1] minus deposits) by private non-financial corporations rose significantly between 1997 Q4 and 1998 Q4, as annual deposit growth fell from 6.7% to 4.3%, and growth in borrowing picked up from 3.4% to 6.3%. By 1998 Q4, the corporate sector financial deficit had reached 3% of GDP—its highest level since 1990. Net M4 borrowing by the corporate sector fell by £3.3 billion in the first quarter of 1999, reflecting both a drop in borrowing and an increase in deposits. However, private non-financial corporations can also raise funds through wholesale markets. Capital market issues rose by £6.1 billion in 1999 Q1, compared with a rise of £2.4 billion in 1998 Q4. So overall corporate sector borrowing remained strong in the first quarter of 1999.

Firms tend to finance temporary imbalances between current income and expenditure mainly through net borrowing from banks and building societies. There was a rise in the stock to output ratio relative to its long-run trend during the second half of 1998. Firms may therefore have borrowed more and/or run down their deposits with banks, in order to finance the cost of holding any excess stocks (see Chart 1.2). The increase in corporate sector borrowing relative to deposits may also have been linked to the strong rise in business investment in the second half of 1998.

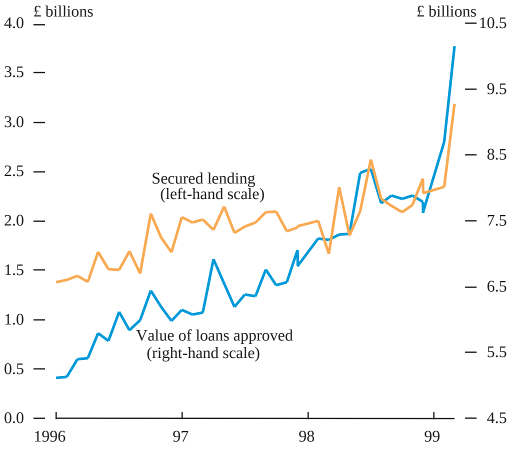
Household sector

Household sector broad money holdings grew by 6.5% in the year to the first quarter of 1999, the same rate of growth as in 1998 Q4. Lending[1] to households was 7.8% higher in 1999 Q1 than a year earlier, compared with an average rate of growth of 7.2% during 1998.

Bank and building society lending to individuals can be divided into lending secured on dwellings, which accounts for about 85% of the stock, and unsecured lending which accounts for the rest. Annual growth in net secured lending to individuals picked up from 5.5% in 1998 Q2 to 6.2% in 1999 Q1. On a wider measure,

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

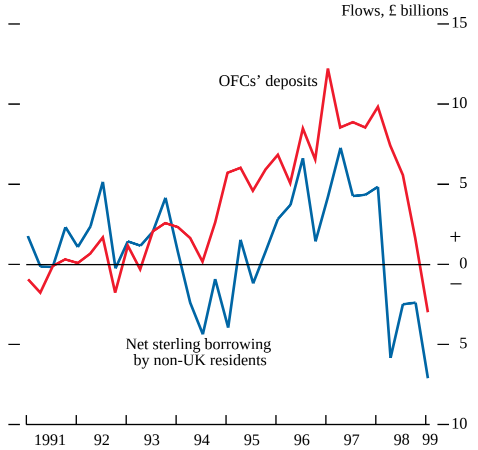
Chart 1.4
Secured lending to individuals and loan approvals(a)



Source: Bank of England.

(a) The definition of the value of bank approvals was revised in October 1997 to bring it into line with that for building societies.

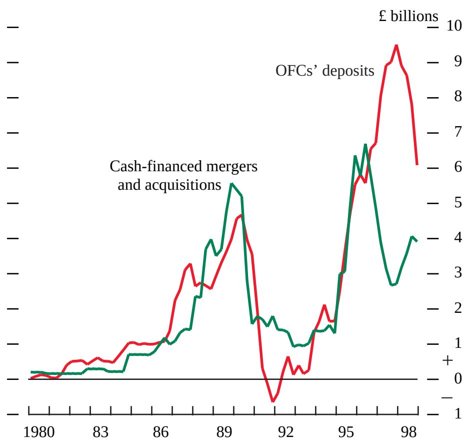
Chart 1.5
Net overseas borrowing(a) in sterling and OFCs' deposits



Source: Bank of England.

(a) Borrowing minus deposits of sterling from UK banks and building societies.

Chart 1.6
Quarterly flows of OFCs' deposits and cash-financed mergers and acquisitions(a)



Sources: ONS and Bank of England.

(a) Four-quarter moving average.

which includes lending by specialist institutions other than banks and building societies, annual growth in lending secured on dwellings was 6.4% in the first quarter of 1999. By contrast, growth in unsecured lending which had been rising very rapidly, appears to have stabilised in recent quarters, though it remained well above the growth in secured lending (see Chart 1.3).

The rise in secured lending in the first quarter of 1999 was consistent with other indicators of improving demand in the housing market. In March, the number of loans approved for house purchase rose to 101,000 from 89,000 in February, and the value of loans approved for secured lending rose to £10.2 billion. The value of loans approved, which includes re-mortgaging agreements, has tended to lead changes in secured lending by 4–6 weeks. That suggests that the growth in secured lending to individuals will remain robust in coming months (see Chart 1.4).

Other financial corporations (OFCs)

OFCs are non-bank financial intermediaries. After growing at an average annual rate of more than 22% between 1995 Q1 and 1998 Q3, growth in OFCs' M4 deposits slowed in 1998 Q4 and fell sharply to 6.6% in the first quarter of 1999. Annual growth in lending to the non-bank financial sector, which had averaged more than 16% during the same period, also slowed in 1998 Q4, and declined further to 8.4% in 1999 Q1.

The increase and subsequent contraction in OFCs' balance sheets has broadly coincided with changes in net sterling lending by UK banks and building societies to non-UK residents (see Chart 1.5). The average monthly flow in net sterling lending to non-UK residents was £1.1 billion between January 1996 and June 1998, compared with £0.2 billion during 1992–95. It has since fallen back sharply; overseas residents made a total net repayment of sterling loans of £7.1 billion in 1999 Q1.

It is possible, therefore, that the sterling borrowed by overseas residents was used to carry out transactions with UK financial intermediaries. However, there is little evidence that the funds were intended for the acquisition of UK companies. Chart 1.6 shows that cash-financed mergers and acquisitions activity has been relatively subdued during the past two years. Furthermore, the rise in OFCs' deposit growth since 1996 was not accounted for by an increase in M4

Chart 1.7
Contributions to the growth in OFCs' M4 deposits

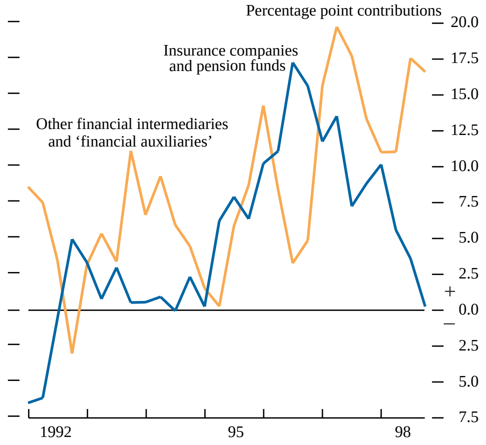
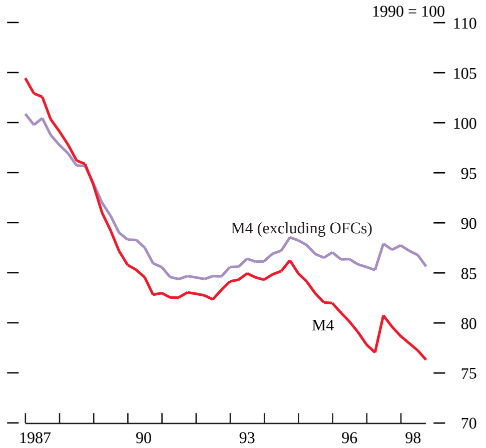
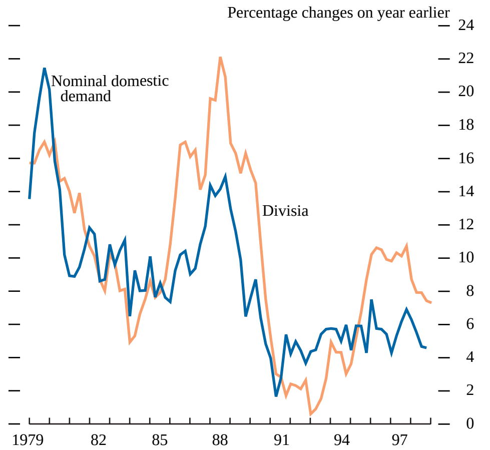


Chart 1.8
M4 income velocity and M4 income velocity excluding OFCs



Source: Bank of England.

Chart 1.9
Growth of domestic demand and Divisia



Sources: Bank of England and ONS.

holdings by insurance companies and pension funds, which hold around 60% of quoted UK equities by value. Instead the rise in deposits reflects increased holdings by the rest of the non-bank financial sector, which includes securities dealers (see Chart 1.7).

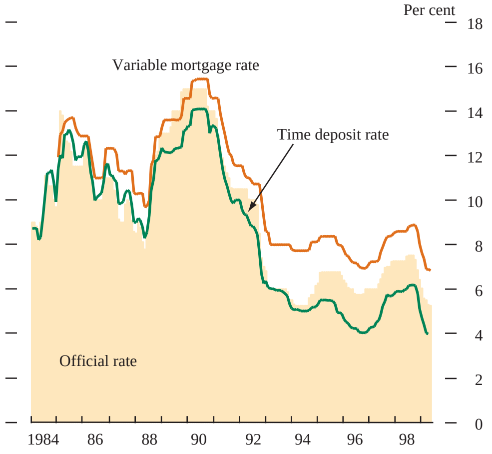
Another explanation for the increase in net sterling borrowing by non-UK residents may therefore be an increase in overseas demand for other UK securities. Alternatively, the observed correlation between the increase in OFCs' deposits and net overseas sterling borrowing may simply reflect a desire by UK banks and building societies to match their assets (in this case, sterling lending overseas) with deposits from the UK wholesale sector.

The reasons for the sudden reversal of net overseas borrowing in sterling in the first quarter of 1999 are similarly unclear. Nonetheless, to the extent that they are linked, further reductions in net overseas borrowing in sterling, and hence in OFCs' deposit growth, could help to stabilise broad money velocity, which has been falling since 1994. As Chart 1.8 shows, excluding the M4 deposits held by the UK non-bank financial sector, broad money has been growing in line with nominal GDP during the 1990s. A more stable, and hence more predictable, trend in M4 velocity would enhance the ability of broad money to act as a reliable indicator of inflationary pressure.

Divisia money

Another way of trying to gauge the extent to which the recent changes in the demand for money represent shifts in agents' current or future demand for goods and services is to compare the growth of M4 with growth in Divisia money. The Divisia index is constructed by weighting together the various components of money according to their liquidity, proxied by the inverse of their interest rates relative to a benchmark local authority deposit rate. More liquid assets carry lower interest rates, and so are more likely to be used for transactions purposes. Divisia money should therefore be more closely related to nominal spending than other broad measures of money. Divisia money grew by 7.3% in the year to 1999 Q1, broadly unchanged from 1998 Q4, but slightly faster than the rate of growth in M4 deposits. Chart 1.9 shows the positive correlation between Divisia money and nominal domestic demand over the past 20 years, though the relationship has been somewhat weaker since 1995.

Chart 1.10
Official interest and selected administered retail rates



Note: Retail rates are unweighted pre-1995 and weighted from then on.

Sources: Moneyfacts and Bank of England.

Table 1.B
Bank and building society advertised variable interest rates

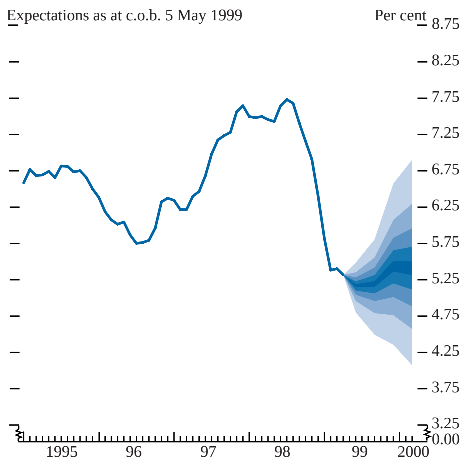
Cumulative change (percentage points)

		Oct. 1998 to end Mar. 1999	End Mar. to end Apr. 1999 (a)
Secured loan rates	Standard variable	-1.99	-0.07
Savings rates	Sight	-2.02	-0.08
	Time	-2.18	-0.04
Bank of England repo rate		-2.00	-0.25

Sources: Moneyfacts and Bank of England.

(a) Cumulative changes are to end April 1999, except that shown for standard variable secured loan rates which is to 5 May 1999.

Chart 1.11
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.

1.2 Interest rates and asset prices

Short-term interest rates

Short-term official interest rates have been reduced by 2.25 percentage points since October 1998. The short-run impact of changes in monetary policy on aggregate demand and the exchange rate will depend on a number of factors. These include the extent to which changes in the central bank's official short-term interest rate were anticipated and the speed with which they are passed on to consumers and firms.[1] Short-term administered rates, such as mortgage and deposit rates, generally respond fully to changes in official interest rates, but there can be significant time-lags (see Chart 1.10). The pass-through of the interest rate cut of 8 April has so far been less than complete (see Table 1.B), in contrast to the other cuts since the beginning of October which were passed through relatively quickly.

Risk-neutral probability distributions of expected three-month market rates derived from options prices on 5 May are shown in Chart 1.11. Uncertainty about the likely path of interest rates over the next year, as measured by the width of the blue fan, has narrowed a little on the downside since the February *Report*. Market expectations for the most likely outcome shown by the darkest blue band were, on balance, for rates to remain close to their current level, though there were some expectations of a rise in 2000.

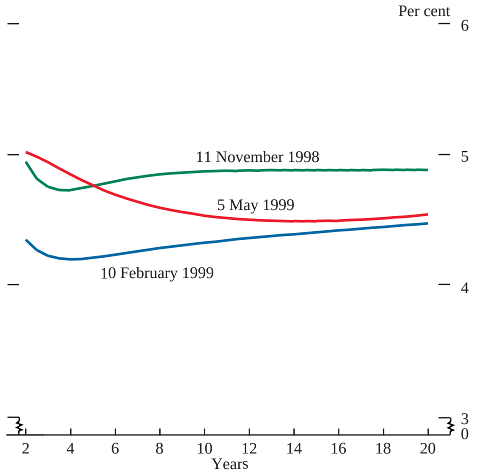
The European Central Bank cut its refinancing rate by 0.5 percentage points to 2.5% on 8 April. The market expects short-term rates in the euro area to remain close to their current level over the next year. The Bank of Japan cut its official target rate, the overnight call rate, by 0.1 percentage points to 0.15% on 12 February, and by a further 0.12 percentage points to 0.03% on 4 March. The US Federal Reserve has not changed rates since November.

Long-term interest rates

Nominal yields on UK government bonds at all maturities have fallen substantially since 1996, but have risen since the February *Report*. The nominal yield on ten-year gilts rose by 0.4 percentage points to 4.8% between 10 February and 5 May, largely driven by higher interest rate expectations at the shorter end of the

(1) For a discussion of how official interest rate decisions affect economic activity and inflation, see 'The transmission mechanism of monetary policy' in the May 1999 *Quarterly Bulletin*, pages 161–70.

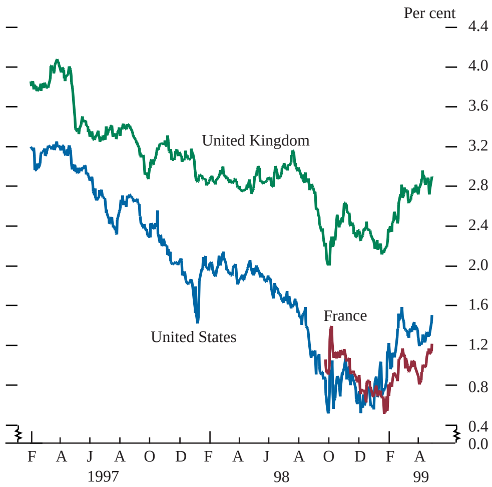
Chart 1.12
UK implied forward nominal interest rate curves(a)



Source: Bank of England.

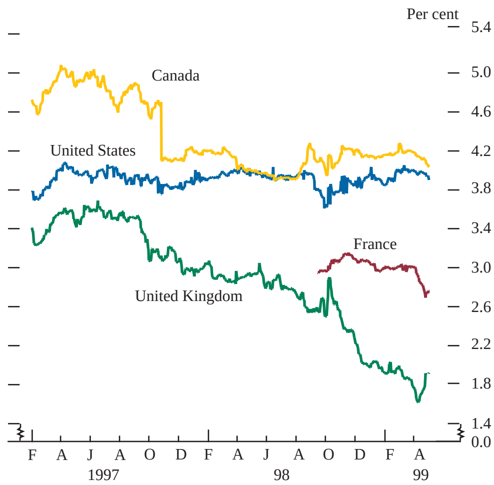
(a) Estimated from the prices of conventional gilts.

Chart 1.13
International ten-year break-even inflation rates(a)



(a) The break-even inflation rate is the average inflation rate over the life of the bonds which would equalise the returns from holding a conventional bond and an index-linked bond of similar maturity.

Chart 1.14
International ten-year real yields(a)



(a) Calculated using the appropriate market conventions.

curve (see Chart 1.12). The nominal yield on ten-year US and euro-area government bonds also rose over the same period, by around 0.5 percentage points, though this reflected higher short and medium-term interest rate expectations.

Changes in nominal interest rate expectations reflect revisions to expectations about inflation, real interest rates and/or risk premia. The recent increases in nominal bond yields appear to have been driven by higher inflation expectations. In addition, the forward real rate of interest in France also fell (see Charts 1.13 and 1.14).

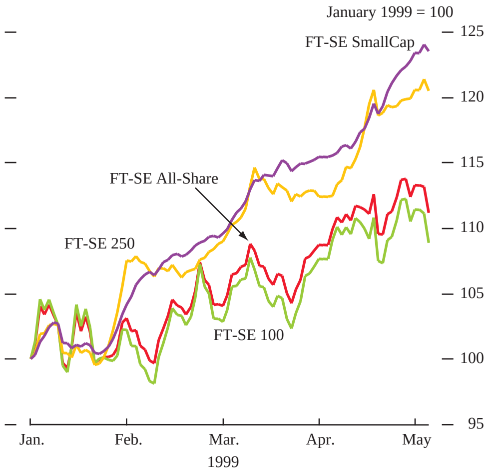
Despite the recent rise in UK long-term real yields, they remain close to their lowest levels since index-linked government bonds were first introduced in 1981; and well below those in other countries (see Chart 1.14). A number of UK-specific institutional factors could account for part of this difference. For example, the minimum funding requirement (MFR) for pension funds has led to strong institutional demand for bonds, particularly long-maturity and index-linked bonds. In addition, there has been substantial demand from insurance companies for bonds, perhaps to hold as a hedge against liabilities arising from guarantees of minimum returns on annuities sold when yields were higher than they are at present. These factors have led to a strong demand for sterling bonds, which has put upward pressure on the price of both conventional and index-linked UK government securities.

To the extent that yields on UK index-linked bonds have been depressed by these factors, measures of implied inflation expectations derived from the index-linked market will be exaggerated. The implied rate of inflation in five years' time derived from the bond market has risen by 0.4 percentage points since the February *Report* to 2.6%. That is a larger rise than is implied by measures derived from other sources. For example, inflation expectations over the same period derived from the Consensus Economics survey stood at 2.5% in April, 0.1–0.2 percentage points higher than in October. And shorter-term inflation expectations derived from a variety of UK surveys fell further in 1999 Q2 (see Section 3).

Equity prices

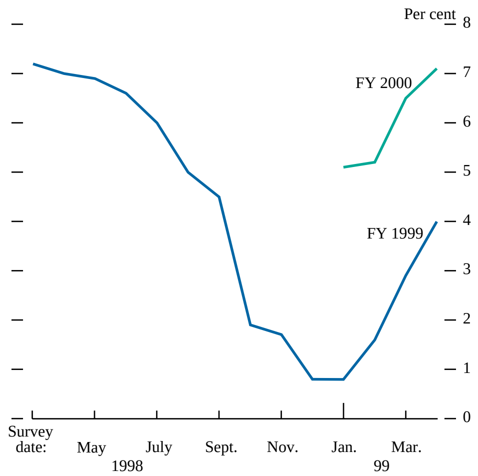
Since the publication of the February *Report*, share prices have risen sharply in most developed economies, to record levels in some cases, including in the United Kingdom. Share price indices of smaller and

Chart 1.15
UK share prices by company size



Source: Datastream.

Chart 1.16
Fund managers' forecasts of UK earnings per share growth



Source: Merrill Lynch.

medium-sized UK companies have risen particularly strongly since February (see Chart 1.15). Previous work at the Bank suggests that domestic economic prospects are more likely to influence changes in share prices of these companies than of larger companies, which tend to be more internationally orientated.

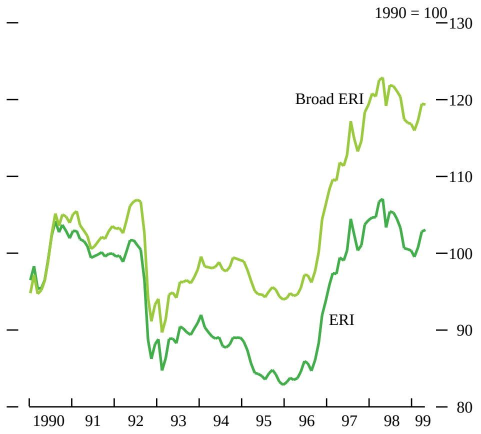
Equity prices are positively related to expectations about future profits, but are negatively related to risk. Uncertainty about the future level of UK share prices, as measured by options prices on the FT-SE 100, has fallen steadily since the beginning of 1999, more so than a similar measure for the United States. The latest Merrill Lynch survey of UK fund managers showed a positive balance of 33% who thought that the prospects for UK corporate profits were favourable—compared with a negative balance of 44% in February. These factors are consistent with the strong pick-up in expectations for UK earnings per share growth since the beginning of 1999, for both this year and next, as reported in the Merrill Lynch survey (see Chart 1.16).

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

Growth in the capital value of commercial property has been declining since the beginning of 1998. And there was a slight decline in the annual rate of growth in the rental value of commercial property. Inflation indicators in the housing market were more mixed. Despite a strong rise in March, on both the Halifax and the Nationwide measures annual house price inflation remained weaker in the first few months of 1999 than in 1998. Annual house price inflation in London and the South East, which has in the past led national house price inflation, weakened by less in the year to 1999 Q1. And the March Royal Institute of Chartered Surveyors (RICS) survey showed a net positive balance of 76% of estate agents reporting an increase in house prices in London, considerably higher than elsewhere. The RICS survey also reported a fall to historical lows in the number of properties on estate agents' books, which may constrain activity in the short run. However, as noted above, loan approvals nationally for house purchases rose strongly in 1999 Q1, indicating continued strength in demand.

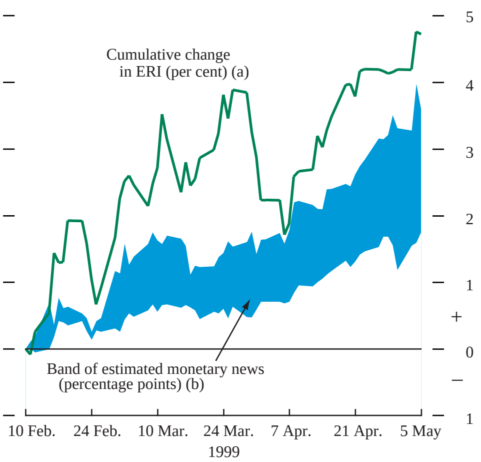
Chart 1.17
Sterling effective exchange rates(a)



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.

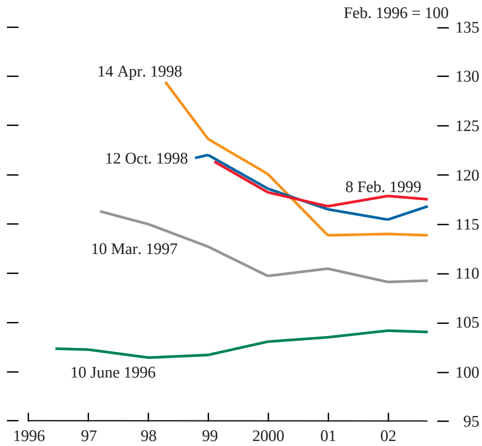
Chart 1.18
The exchange rate and monetary news



Source: Bank of England.

(a) The effective exchange rate index for sterling against the G7 economies.
(b) The band shows the estimated range as the time from which it is assumed that monetary policy no longer influences real interest rates varies from four to eight years.

Chart 1.19
Forecasts for the real sterling exchange rate against M6(a) **currencies**(b)



(a) Major six overseas economies.
(b) Derived from a combination of nominal exchange rate and inflation forecasts from Consensus Economics survey.

Exchange rates

The sterling effective exchange rate index (ERI) averaged 104.0 in the 15 working days up to and including 5 May (see Chart 1.17). This is the starting-point for the current projection and is around 4$^1/_2$% higher than the path assumed at the time of the previous *Report*. The level of the ERI is 23% higher than it was in August 1996, largely reflecting an increase of 29% in the value of sterling against euro-area currencies. Sterling has risen by around 5% against the US dollar. Since 1990, however, the appreciation of the broader measure of the ERI, which includes a number of emerging market currencies, has been greater than that of the narrower measure.

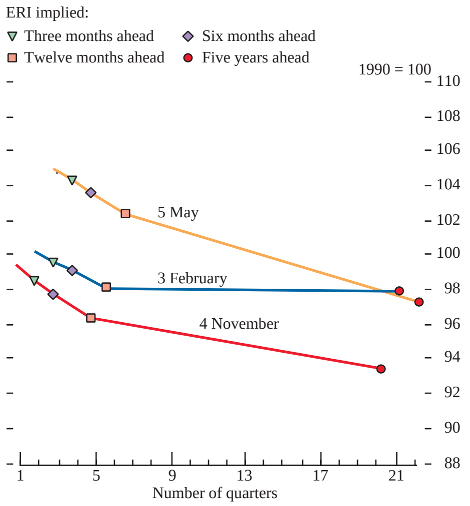
Previous *Reports* have discussed a number of possible explanations for the rise in the sterling exchange rate since August 1996. Around a half of the rise in the sterling ERI since February is consistent with the movements in the differential between expected UK interest rates and those overseas (see Chart 1.18). But estimates of monetary news based on relative yield curves can explain little of the overall increase in the ERI since August 1996.

There is considerable ambiguity about the link between the exchange rate and observable capital flows. But the record surplus on investment income, which contributed to UK current account surpluses in 1997 and 1998, may explain part of the strength of sterling. A permanent improvement in the UK investment income surplus would imply that UK residents would be able to finance a larger trade deficit than previously, without putting downward pressure on the exchange rate, making sterling assets relatively more attractive to hold.

International competitiveness depends on the level of the real exchange rate. By combining forecasts of the expected nominal exchange rate and inflation expectations from the Consensus Economics survey, it is possible to arrive at an estimate of the expected value of the real ERI. Chart 1.19 shows how successive expectations of a depreciation of the real exchange rate lessened over time.

Chart 1.20 shows the path for the sterling ERI implied by market nominal interest rate differentials. 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 forward rates are above those overseas, sterling is expected to

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.

depreciate. It shows that the markets expect the recent appreciation of sterling to unwind.

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 factors. In the central projection (the modal or most likely case), the sterling ERI is expected to depreciate by more than 4% to 99.6 by 2001 Q1. On average, sterling is expected to decline more steeply than in the central projection. Outside forecasts reported by Consensus Economics imply that the exchange rate is expected to decline more rapidly than in the central projection, reaching 96.7 after two years. But some Committee members consider that the balance of risks around the central projection for the exchange rate is on the upside.

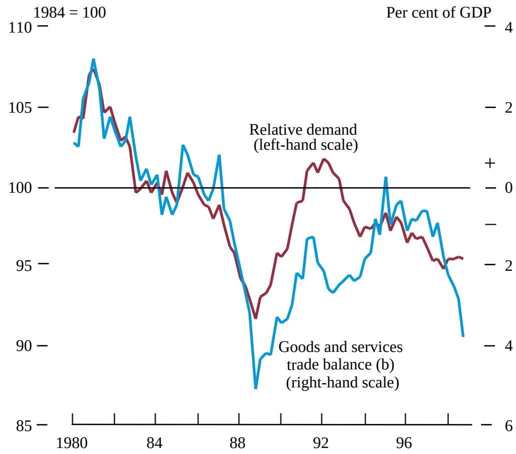
1.3 Summary

UK broad money growth has continued to ease, but M4 lending growth has declined less, reflecting a rise in secured lending to individuals. The past three years have been characterised by a significant build-up and subsequent contraction in UK financial intermediaries' balance sheets, which may have been linked to the behaviour of net sterling borrowing by overseas residents. There is some evidence of an increase in long-term global inflation expectations, but in the United Kingdom comparisons between conventional and index-linked yields may be distorted by institutional factors. Share prices have risen strongly, possibly reflecting a better-than-expected outlook for domestic and global growth. Sterling has appreciated significantly since the February *Report*, particularly against the euro.

2 Demand and output

The quarterly growth rate of GDP remained weak in 1999 Q1 and the level of output in previous quarters has been revised down since the February *Report*. However, survey measures of consumer and business confidence in the United Kingdom have rebounded and global economic prospects have improved slightly. In 1998 Q4, exports fell and imports rose, causing the goods and services trade deficit to widen further. This largely offset the impact on GDP of stronger consumption and investment growth.

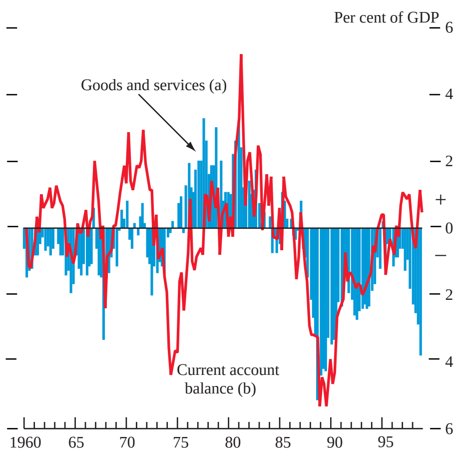
Chart 2.1
Relative demand(a)



Sources: ONS, BIS and Datastream.

(a) Ratio of UK trade-weighted domestic demand for the United States, Germany, France, the Netherlands, Italy, Spain, Japan, Sweden, Switzerland, Australia and Canada relative to UK domestic demand. These countries purchase about 60% of total UK exports.
(b) At constant 1995 market prices.

Chart 2.2
Trade balances



(a) At constant 1995 market prices.
(b) At current prices.

2.1 Net trade(1)

Net trade made a sizable negative contribution to output growth in 1998, the third consecutive year in which the increase in domestic demand has exceeded that of GDP. Chart 2.1 shows that movements in the trade position are strongly influenced by demand differences between the United Kingdom and its main trade partners. This effect was small in 1998, however, as UK domestic demand growth was broadly the same as the (weighted) increase in demand in these countries. Consequently, most of last year's rise in the trade deficit reflected other considerations, notably the sharp contraction in demand from the emerging market economies of Asia and the oil-exporting countries (which, together, account for only around 15% of UK exports), and the continuing effects of sterling's appreciation.

In 1998 Q4, the deficit on the United Kingdom's trade in goods and services reached 3.8% of GDP, its highest level in almost a decade. Export volumes of goods and services fell by 1.6%, reducing them to broadly the same level as a year earlier, while import volumes of goods and services increased by 1.3%, leaving them 6.2% higher than a year earlier. But despite these developments, the current account remained in surplus (see Chart 2.2), owing to terms of trade price effects and exceptionally low outflows of investment income—a number of foreign enterprises operating in the United Kingdom (primarily oil companies, banks, and securities dealers) made significant losses in the second half of 1998.

(1) For a detailed discussion of international economic developments, see 'The international environment' in the *Quarterly Bulletin*, May 1999, pages 152–60.

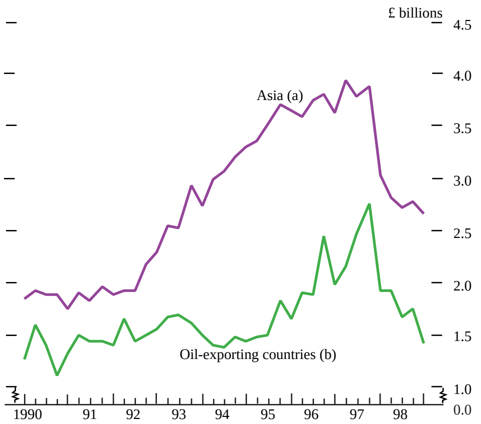
Table 2.A
UK goods export growth

Per cent

Region	Share of total UK goods exports in 1997	Average quarterly changes in export volumes (a)		
		1998		1999
		Q1–Q3	Q4	Q1
European Union	55.8	1.4	-1.2	n.a.
North America	13.9	4.3	-2.7	3.3
Oil exporters	5.5	-13.2	5.9	-19.5
Rest of the world	24.8	-2.8	-6.0	-3.6
of which, Asia (b)	*8.9*	*-9.5*	*2.9*	*-5.1*

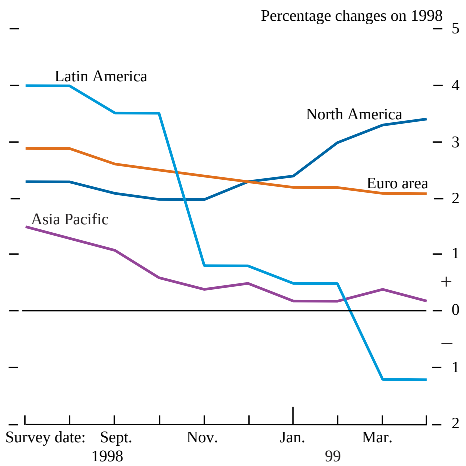
(a) Figures for exports to Asian countries are on an overseas trade statistics basis; all other exports are on a balance of payments basis. All non-EU export volumes are calculated by deflating export values using the aggregate price index for exports to non-EU countries.
(b) Asia comprises Japan, South Korea, Hong Kong SAR, Malaysia, Singapore, Taiwan, Thailand, China and the Philippines.

Chart 2.3
UK exports to Asia and oil-exporting countries



(a) China, Hong Kong SAR, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand; figures on an overseas trade statistics basis.
(b) Abu Dhabi, Algeria, Bahrain, Brunei, Dubai, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Sharjah, Trinidad and Tobago, and Venezuela; figures on a balance of payment basis.

Chart 2.4
Consensus forecasts for 1999 GDP growth



Source: Consensus Economics.

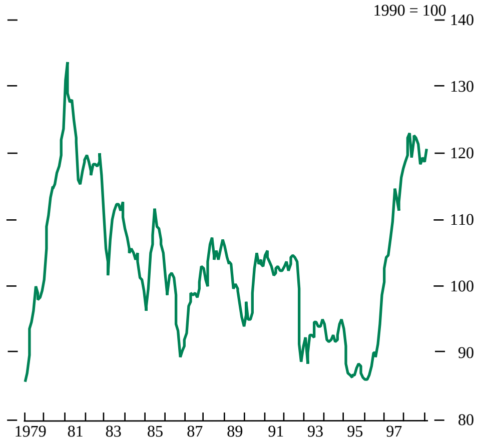
The weakness of exports in Q4 mainly reflected lower sales of goods to Europe and North America (see Table 2.A). Given that US demand has remained strong, the fall in sales to North America in Q4 was probably erratic; export volumes to this market recovered in Q1. In contrast, exports to the European Union continued to decline in January and February, reflecting the effects of sterling's appreciation against the euro-area currencies and weakening demand. Among the developing countries, there is increasing evidence that Asian demand conditions have begun to stabilise. As a result, the sharp decline in UK exports to this region has moderated since 1998 Q4 (see Chart 2.3). However, the recent increase in the price of oil has yet to feed through to stronger UK sales to the oil-exporting countries.

Looking ahead, the prospects for external demand seem a little brighter than the assessment made at the time of the February *Report*. In its April forecast, the IMF raised its projection for this year's world GDP growth by 0.1 percentage point, to 2.3%. This largely reflected a reassessment of prospects for the industrial countries, with expected growth in North America revised upwards significantly and prospective growth in Japan and the euro area revised downwards. Recent changes to private sector forecasts have generally followed these IMF revisions (see Chart 2.4). Overall, the IMF now expects the GDP of advanced economies as a whole to increase by 2.0% in 1999 (0.4 percentage points higher than its December forecast).

Large demand changes in the emerging market economies can also have a significant impact on the UK trade balance, as the Asian crisis demonstrated. Following the collapse of Brazil's exchange rate regime in January, private sector forecasts of Latin American growth in 1999 have been marked down by around 2 percentage points. The direct impact on the United Kingdom of lower growth in Latin America is likely to be small, however, since this region accounts for only about $2^1/_2$% of UK exports and less than 5% of total world trade. Contagion effects to other emerging market economies have generally been limited and growth projections for some of the Asia Pacific countries have now started to be revised up slightly.

Taking all these developments together, the prospects for UK trade-weighted world import growth have improved modestly, relative to the assessment made at the time of the February *Inflation Report*. The MPC has consequently revised up its central expectation for UK export market growth in 2000 to 5%–6%, and left the

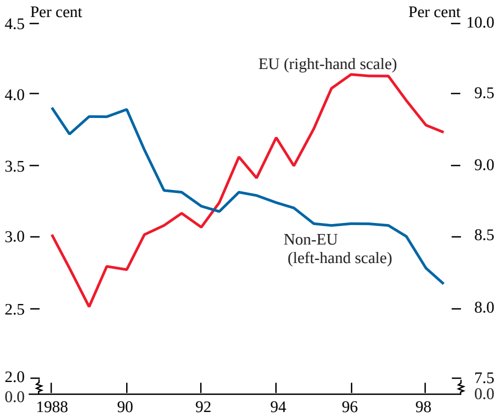
Chart 2.5
Sterling real effective exchange rate(a)



Source: IMF.

(a) Calculated using relative normalised unit labour costs in manufacturing and the nominal exchange rate index.

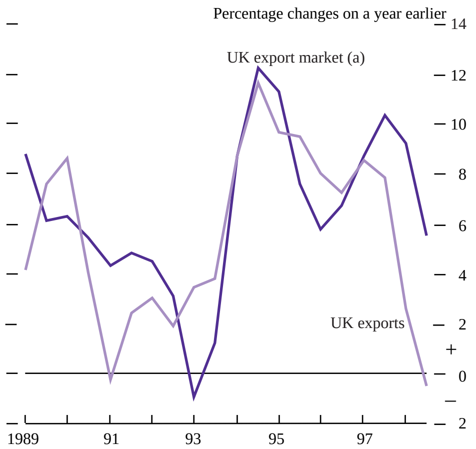
Chart 2.6
UK share of EU and non-EU goods markets(a)



Sources: ONS and OECD.

(a) UK exports relative to EU and non-EU imports; volume data scaled to actual market share in 1991.

Chart 2.7
UK export performance



Sources: ONS and OECD.

(a) Goods import volumes by the United Kingdom's trade partners, calculated using UK trade weights.

projection for this year unchanged at around 4%–5%. The MPC's central projection is for demand growth in the major six overseas economies to exceed UK domestic demand growth slightly this year.

Competitiveness effects have also contributed to the rising trade deficit. In particular, the real appreciation of sterling over the past three years (see Chart 2.5) has boosted imports and constrained exports. In addition, trade diversion arising from the depressed demand conditions in Japan and the rest of Asia may have increased the degree of global competition facing British firms.

Evidence of these competitiveness effects can be seen in both the United Kingdom's export and import performance. On the export side, firms located in the United Kingdom have accounted for a declining share of both EU and non-EU markets over the past two years (see Chart 2.6), as UK exports have failed to keep pace with the (weighted) import growth of the United Kingdom's trade partners (see Chart 2.7). This loss of trade share has been particularly striking in EU markets; prior to 1996, the United Kingdom had been increasing its trade share in these markets. And, on the import side, import penetration now appears to have been greater than previously thought; data revisions since the February *Report* have increased the share of imports in domestic demand in 1998.

Overall, relative demand conditions are likely to be broadly neutral for the trade deficit this year. Hence the dominant influence on the trade balance in 1999 is likely to be the strength of sterling and non-price competitiveness effects. The MPC's central projection is for net trade to make another negative contribution to GDP growth in 1999 and for this effect to be more negative than was assumed at the time of the February *Report*.

2.2 Domestic demand

Domestic demand increased by 1.0% in 1998 Q4, up from 0.5% in both Q2 and Q3. This increase reflected stronger growth in consumption and investment, as well as a rise in the contribution to growth from the change in inventories (see Table 2.B). Despite this faster quarterly growth, the annual rate of increase continued to slow—in the year to 1998 Q4, domestic demand grew by 2.7%, down from 3.3% in Q2 and Q3.

Table 2.B
Quarterly growth rate of GDP(a)

Percentage change

	1998 Q2	Q3	Q4
Consumption:			
Households	*0.5*	*0.1*	*0.6*
Non profit making institutions serving households	*0.4*	*0.2*	*0.2*
Government	*0.4*	*0.6*	*0.3*
Investment	-0.7	2.6	2.9
Final domestic demand	0.2	0.6	0.9
Change in inventories (b)(c)	-0.1	-0.1	0.0
Domestic demand	**0.5**	**0.5**	**1.0**
Net trade (b)	-0.3	-0.3	-0.9
GDP at market prices	**0.3**	**0.3**	**0.1**

(a) At constant 1995 market prices.
(b) Contribution to quarterly growth.
(c) Excluding quarterly alignment adjustments.

Chart 2.8
Household consumption growth

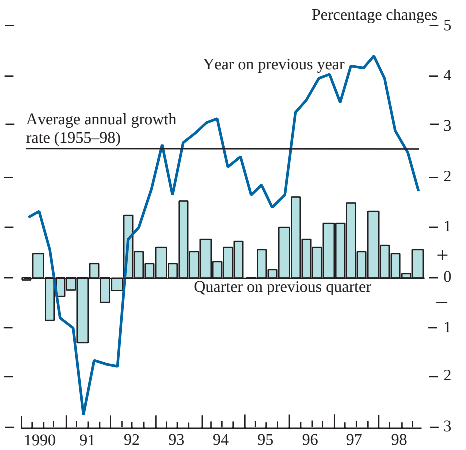
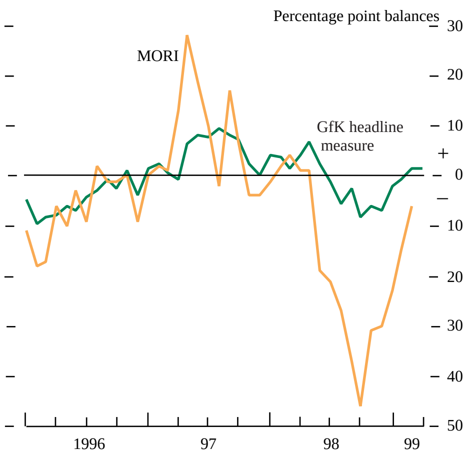


Chart 2.9
Consumer confidence



Sources: GfK and MORI.

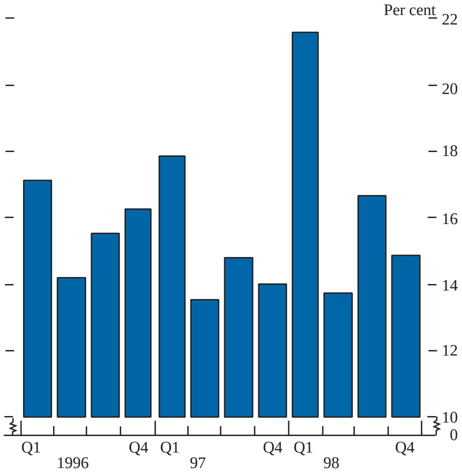
Consumption

Household consumption grew by 0.6% in the fourth quarter, up from 0.1% in Q3 (see Chart 2.8). Although the Q4 outturn was a little stronger than the MPC's central projection at the time of the February *Report*, the increase in spending was not evenly based. In line with the fall in retail sales volumes in Q4, spending on retail goods (which account for about 40% of total consumption) actually declined. The faster growth of total consumption reflected continued strong spending on most categories of services, combined with a rebound in expenditure on vehicles and energy products.

Evidence from retail sales and consumer confidence surveys suggests that household consumption may have grown at a similar rate in 1999 Q1. Following the decline in Q4, the volume of retail sales increased by 1.1% in the first quarter. Recent CBI Distributive Trades surveys have confirmed this picture of stronger retail spending and have indicated an expectation among retailers that this sales growth would be maintained in Q2. Similarly, survey measures of consumer confidence have improved considerably since their low points in October (see Chart 2.9). Consumer fears about higher unemployment have also partly receded and housing market activity, another indicator of consumer sentiment, has picked up since the end of last year.

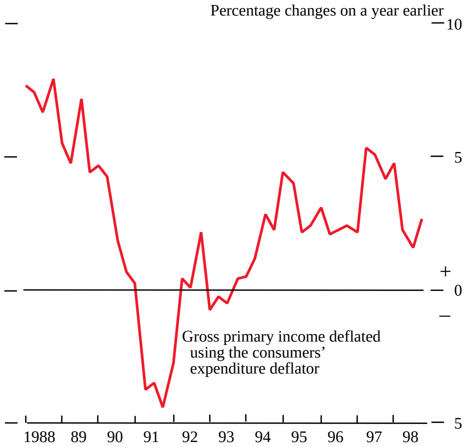
The previous *Inflation Report*, and minutes of recent MPC meetings, have noted that the slowdown in consumption growth during 1998 was sharper than the MPC had expected, and have discussed a number of possible reasons for this. One of these was that past fiscal tightening may have been greater than previously thought. Unfortunately, this has been difficult to assess, since a number of changes came into effect at around the same time. These included the July 1997 Budget measures, a new system of self-assessment for income tax, and an extension to the returns deadline. Since the third of these elements significantly altered the pattern of tax payments between 1997 Q4 and 1998 Q1 (see Chart 2.10), the full impact of the changes will not be known until the new seasonal pattern of receipts can be determined. On the basis of the available data, the effective tax rate on households' income is estimated to have increased by between $^1/_2$ and 1 percentage point in 1998, equivalent to 0.4%–0.7% of GDP. Higher taxes are therefore likely to explain some of the slowdown in the growth rate of consumption last year. The actual size of this effect will have been determined by whether households viewed the tax changes as temporary or

Chart 2.10
Household effective tax rate on income(a)



(a) Current taxes expressed as a percentage of gross primary income. Non seasonally adjusted data.

Chart 2.11
Real household pre-tax income growth



permanent, and by the extent to which the introduction of the new system of self-assessment encouraged an increase in tax compliance.

Looking ahead, the measures introduced in the March 1999 Budget are expected by HM Treasury to leave the effective tax rate on household incomes broadly unchanged over the next three years. Overall, therefore, the factors which may have caused consumption growth to slow by more than the MPC had expected in 1998—higher taxes, lower consumer confidence, and the unwinding of the windfall payout effects arising from the building society demutualisations—seem likely to have less of a restraining influence in 1999. This suggests that the growth rate of consumption will become more closely aligned with its fundamental determinants (labour income and total net wealth) this year.

As can be seen from Chart 2.11, the growth rate of real pre-tax primary incomes (wages and salaries plus net property income) slowed in 1998. This was largely because of higher net interest payments by the household sector and weaker growth in equity dividends; the growth rate of real wages and salaries remained reasonably robust. This slowdown in the growth rate of primary incomes is unlikely to continue in 1999. Households' net interest payments are likely to fall in 1999, as the rise in official interest rates over the 14 months to June 1998 has now been more than completely reversed. This fall in official interest rates tends to feed through to lower loan rates for households with a lag, partly because of the impact of fixed-rate loans (see Section 1). In addition, surveys by the British Chambers of Commerce (BCC) have found a recovery in firms' profit expectations in recent months, suggesting that the growth rate of dividend payments is unlikely to weaken much further in 1999.

Household spending will also be affected by wage and salary developments and wealth considerations. The MPC's central expectation is that this year's growth rate of real earnings may be slightly stronger than in 1998 (see Section 6). Furthermore, there are likely to be positive wealth effects on spending stemming from higher house and equity prices. Consequently, it seems likely that consumption growth will gradually return to around its trend rate of increase over the next twelve months.

Investment demand

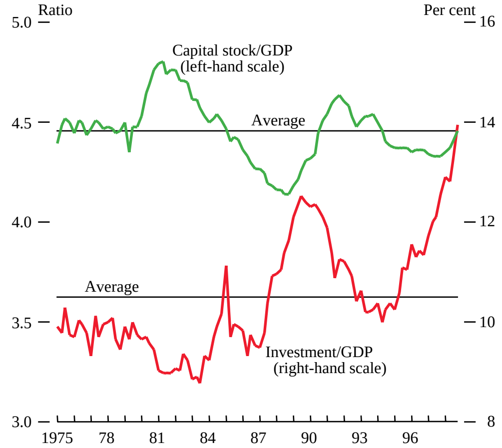
Whole-economy investment increased by 2.9% in Q4 and the level of investment in Q3 was revised up by 1% relative to the position reported in December. Business and government investment both increased strongly in the fourth quarter, more than offsetting a 5.7% decline in private sector spending on dwellings. The Q4 outturn for total investment was stronger than the MPC's central projection at the time of the February *Report*.

Investment reflects the difference between the current and desired levels of a firm's capital stock. This, in turn, is influenced by the current level of capacity utilisation, expectations about future output and profits, the firm's financial position, advances in technology, and the cost of capital. Unfortunately, the desired capital stock is not directly observable. As a result, attention (at the macroeconomic level) is generally focused on proxy measures, such as the estimated deviation from trend of the capital stock to GDP ratio and survey measures of capacity utilisation rates and investment intentions.

The ONS has recently published revised estimates for the capital stock, following the recommendations of a study undertaken by the National Institute.(1) This study highlighted the possibility that previous estimates of the UK capital stock were too large, since they failed to take enough account of capital scrapping in economic downturns and of the effects of rapid technological change. In particular, there may have been an increasing amount of investment in assets with shorter lives, notably computers and related equipment.

Chart 2.12 shows the business sector capital stock to output ratio on the basis of the new figures. As a result of revised assumptions about the service lives of assets, the estimated level of the net capital stock in 1997 is now around 4% lower than previously thought. Despite the strong growth in business investment over the past four years, the capital stock to output ratio has only just returned to its long-run average. The revisions may help to explain why business spending on capital has exceeded the MPC's expectations recently, and suggest that this year's growth rate of investment may not slow by as much as had been previously thought.

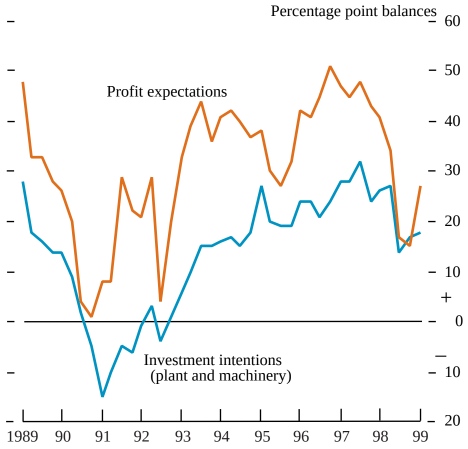
Chart 2.12
Real business investment and the net capital stock



Note: Averages are calculated over 1975–98.

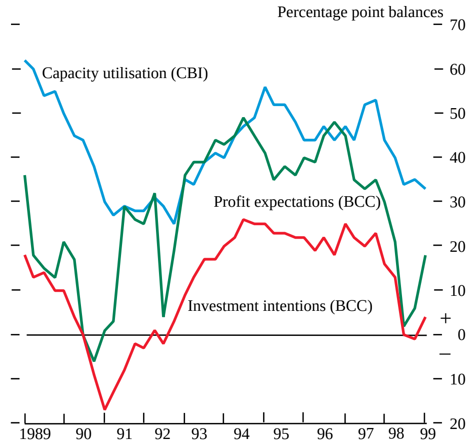
(1) See 'The capital stock of the United Kingdom—some new developments in coverage and methodology', *Economic Trends*, March 1999, and 'Improving the estimates of capital stock', *National Institute Economic Review*, February 1994.

Chart 2.13
Influences on services investment



Source: BCC.

Chart 2.14
Influences on manufacturing investment



Sources: CBI and BCC.

Turning to the other influences on investment, the real cost of borrowing faced by firms continues to fall. Interest rates have been reduced further in the past few months; the London clearing banks' base rate is now at its lowest level since 1994 Q3. And equity prices have rebounded strongly since October, with the FT-SE All-Share index reaching new highs in April (see Section 1).

The latest BCC survey found that profit expectations among service sector firms recovered in 1999 Q1. Correspondingly, investment intentions in the sector have also improved. Although these intentions remain below the levels observed in 1997, they are close to the balances recorded during 1994–96 (see Chart 2.13), suggesting that further growth in service sector investment is likely.

However, BCC survey results suggest that investment intentions among manufacturers remain significantly weaker than for service sector companies. The CBI's measure of capacity utilisation in manufacturing remains well below the levels reached at the end of 1997. And, although there has been an improvement in confidence about future turnover and profitability, the balance of manufacturing firms expecting to authorise more capital spending remains low by historical standards (see Chart 2.14).

The turn of the Millennium is also likely to affect the profile of investment between 1999 and 2000, with spending both on construction projects and IT equipment being brought forward, boosting investment this year. Around 40% of firms contacted by the Bank's Agents in April indicated that they still had outstanding Millennium-related investment spending plans. About two thirds of this expenditure was expected to be additional, rather than displacing other investment.

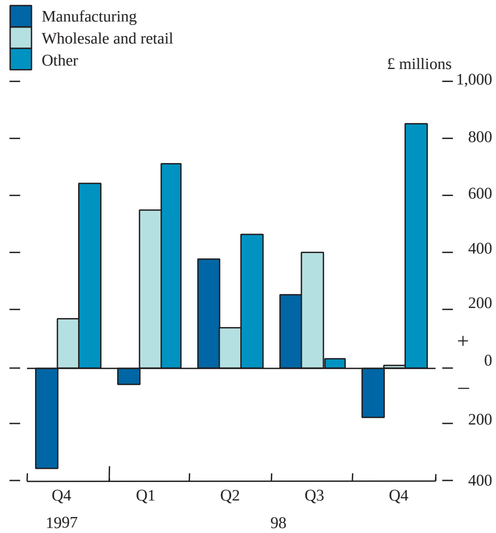
Overall, the prospects for business investment growth have improved relative to the position three months ago. The MPC has therefore revised its central projection upwards; in 1999, the annual growth rate of business investment is expected to slow to around its trend rate of increase. Given the recent improvement in indicators of housing market activity, private sector investment spending on dwellings (which makes up around 15% of total investment) is also likely to strengthen this year.

General government investment is estimated to have increased by 9.1% in Q4, and the level of public investment in the first three quarters of the year was also revised upwards since the February *Report*. The March Budget maintained the government's commitment to increase the ratio of public sector net investment to GDP to 1% by financial year 2001–02. Since net investment was only 0.4% of GDP in 1998–99, the growth rate of government capital expenditure is likely to remain robust.

Inventory investment

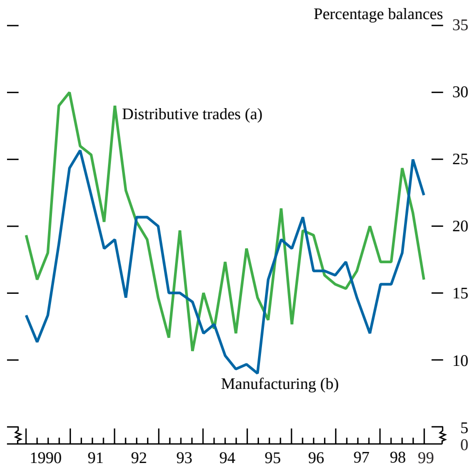
Whole-economy inventories (excluding the alignment adjustment) increased by £0.7 billion (at 1995 prices) in Q4, in line with the rise in Q3. Inventory levels in the distributive trades sector were broadly unchanged in the fourth quarter and they fell in the manufacturing sector (see Chart 2.15). Consequently, most of the stockbuilding was concentrated in other sectors of the economy. Evidence from the Bank's Agents and the CBI suggests that concern about stock levels among manufacturers and distributors diminished in 1999 Q1 (see Chart 2.16). However, there was a pick-up in the CBI Distributive Trades Survey measure of stocks relative to expected sales in April. Overall, the MPC's central projection continues to be that stockbuilding will detract from output growth this year. The recent improvement in the survey evidence does suggest, however, that the size of the unwanted inventory overhang may not be as large as the MPC had previously thought likely. Precautionary stockbuilding ahead of the Millennium may also affect the quarterly profile of inventory investment.

Chart 2.15
Change in inventories(a)



(a) At constant 1995 prices, excluding the alignment adjustment.

Chart 2.16
Survey evidence for inventories



Note: The chart shows quarterly figures derived as the average of monthly observations.

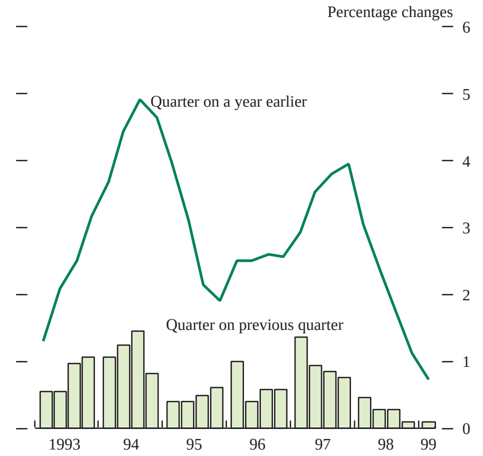
Source: CBI.

(a) Volume of stocks in relation to expected sales.
(b) Balance of firms reporting more than adequate stocks of finished goods.

Public sector demand

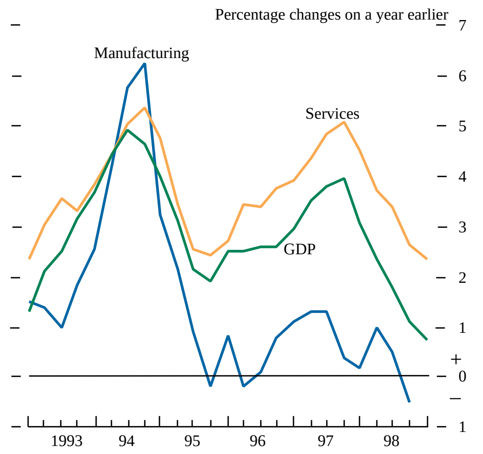
Real general government consumption increased by 1.7% in the year to 1998 Q4. In assessing the outlook for the public finances, the MPC has taken as its central case the nominal government expenditure plans and effective tax rates from the 9 March Budget statement. The Government intends to expand current nominal spending on goods and services by 5.3% this financial year. Given that current spending is estimated to have increased by 4.7% in 1998–99, the growth rate of real government consumption is likely to rise. But, the overall stance of fiscal policy is not expected to change much—HM Treasury estimate that the government's cyclically adjusted net borrowing position will decrease by 0.1% of GDP between 1998–99 and 1999–2000.

Chart 2.17
GDP growth rate(a)



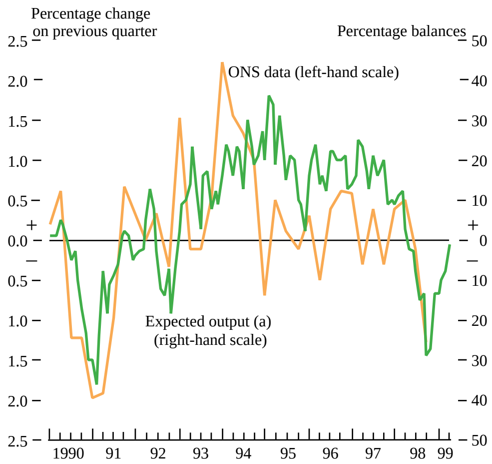
(a) At 1995 market prices.

Chart 2.18
Annual growth rate of GDP



Note: GDP at 1995 market prices, manufacturing and services output at 1995 basic prices.

Chart 2.19
Manufacturing output



Sources: CBI and ONS.

(a) Expected trend in output over next four months.

2.3 Output

According to the preliminary estimate, GDP (at constant market prices) increased by 0.1% in 1999 Q1. This, together with revisions to previous quarters, lowered the annual rate of increase to 0.7% (see Chart 2.17), a little below the MPC's central projection at the time of the February *Report*. The level of the basic price measure of GDP in 1998 Q4 has been reduced by 0.2% since the January National Accounts release, while the level of the market price measure has been lowered by 0.5%. These revisions were mainly the result of lower estimates of VAT receipts and company profits.

The strength of economic activity across different sectors of the economy continues to differ markedly (see Chart 2.18). Industrial production fell by 1.2% between December and February, leaving the average level in the first two months of 1999 0.2% lower than a year earlier. In contrast, service sector output increased by 0.4% in 1999 Q1, and by 2.3% in the year to Q1. Much of this divergence has been linked to the industrial sector's greater exposure to international competition. However, longer-term structural factors (such as technological progress) have also played a role in the growth of services relative to industrial production. Such considerations have been particularly pronounced in the communications sector (see the box opposite).

Manufacturing output fell again in February, its sixth monthly decline in seven months. Survey evidence suggests that output may have continued to fall in March. However, there are some signs that the rate of contraction may be easing. The CBI's measure of business optimism improved to -6 in April, from -40 in January, and the balance of firms expecting to increase output over the next four months has become steadily less negative since October (see Chart 2.19). Similarly, although the BCC's latest survey continued to indicate lower sales and orders in Q1, the pace of the contraction in orders appears to have moderated. And, although remaining below the neutral level of 50, the aggregate index of conditions in the manufacturing sector, produced by the Chartered Institute of Purchasing and Supply (CIPS), has been rising since October.

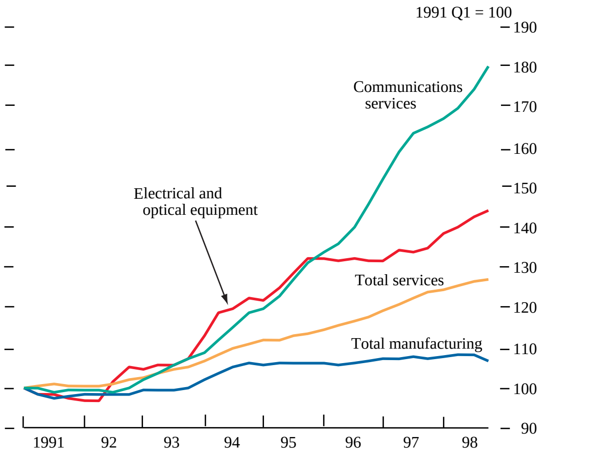
Construction output remained weak in the fourth quarter, rising by just 0.1%, following declines in Q2 and Q3. However, the growth rate of activity may have increased in Q1—the volume of new construction orders rose by 2.2% in the second half of 1998 and the CIPS survey of

The communications industry

The communications sector provides a good example of the way in which changes in technology and tastes have led to rapid expansion in the service sector.

The growth rate of the communications sector (defined as postal and telecommunications services) has averaged about 5% per year since 1960 and 10% per year since the 1990–92 recession. Communications has been one of the fastest-growing sectors of the economy, accounting for a rising share of output (up from around 1.4% of GDP in 1955 to 3.7% of GDP in 1998).

Chart A
Output by sector at 1995 prices

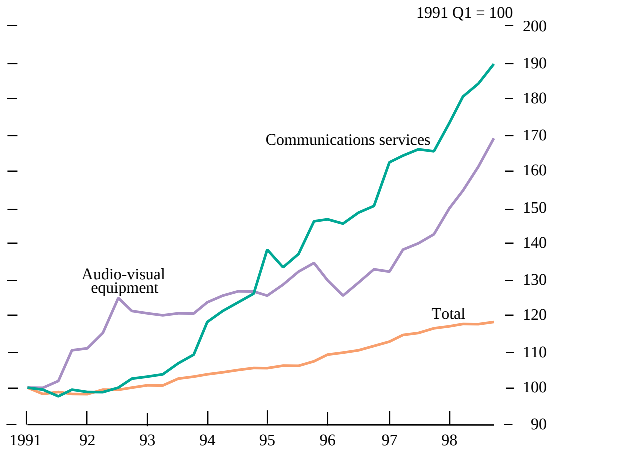


This rapid growth in demand for communications services has had beneficial spill-over effects for the manufacturing sector. As Chart A shows, production of electrical and optical equipment (which includes much of the hardware used in telecommunications) has increased by more than 40% since 1991, while total manufacturing output has increased by only around 9%. In addition, improvements in communications technology will also have had beneficial productivity effects for other sectors of the economy.

Similar trends are evident in households' spending patterns. In recent years, increases in spending on communications services and audio-visual equipment (which includes mobile phones and computers) have far exceeded the rise in total consumption (see Chart B). Total call minutes provided by the telecommunications sector have increased at an average annual rate of around 10% over the past four years. Given the rising demand for Internet services and mobile phones (subscriptions to mobile phone networks increased by almost 27% in the year to March 1998), further strong demand growth seems likely.

Reflecting these developments, increases in the share prices of telecommunications companies have far exceeded the rise in the overall stock market since 1980. The high price-earnings multiples for these companies

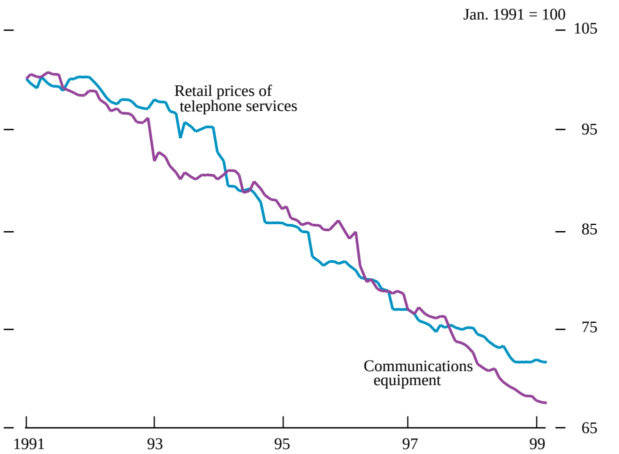
Chart B
Consumption by sector at 1995 prices



indicate that the market expects the sector's strong growth in turnover to continue.

Rising demand for telecommunication services has partly reflected sizable price reductions. Since 1992, prices for household telephone services have fallen on average by almost 3% per year. Given the rise in other retail prices over this period, the relative price of communications services has declined even more sharply (see Chart C).

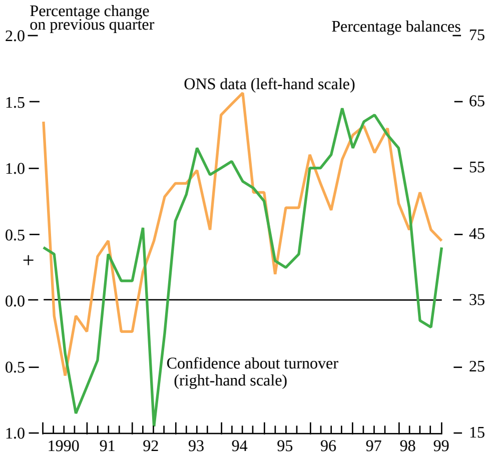
Chart C
Relative price of communications



Note: The price of communications-related equipment is defined relative to the producer price index. The price of telephone services is shown relative to RPIY.

These price declines have been driven by a number of factors. In particular, advances in technology have enabled significant productivity improvements. Since the beginning of the recovery in 1992, output per head has increased by about 75% in the communications sector, compared with 15% for the whole economy. This productivity improvement was also influenced by the privatisation of British Telecom, increasing competition, and the regulatory pricing formula used by Oftel.

Chart 2.20
Service sector output



Sources: BCC and ONS.

construction activity rose to 57.4 in April, up from 45.5 in Q4.

Despite the slowdown in the growth rate of services output in Q1, the sentiment of firms in this sector has improved in recent months. BCC measures of sales and orders for domestic and export markets rose in the first quarter, and confidence about turnover has bounced back from last year's lows (see Chart 2.20). Similarly, the CIPS indicator of service sector business expectations has improved steadily since September, and their overall index of current activity increased to 56.3 in April, above the neutral level of 50.

2.4 Summary

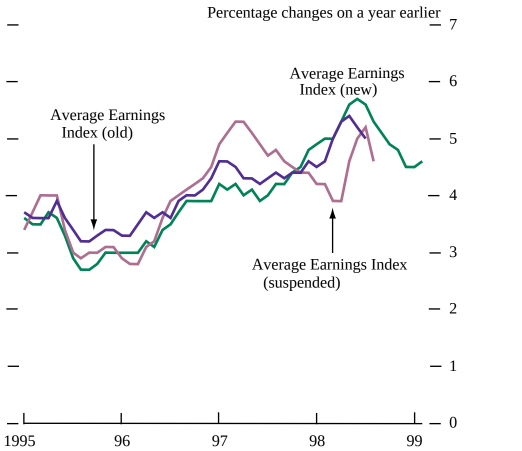
In the Committee's judgment, the prospects for overall activity have changed relatively little since the February *Report*, but the composition of demand is likely to be different. The central projection for domestic demand growth has been revised upwards, reflecting the pick-up in consumer and business confidence, stronger-than-expected investment, and the impact of lower interest rates. In addition, the downside risks to output from a significant stock cycle appear to have diminished relative to the position three months ago. But the stronger stimulus to output is likely to be largely offset by a weaker outlook for net trade. Reflecting these considerations, the MPC's central forecast continues to be for a gradual improvement in the growth rate of GDP during the course of 1999.

The labour market 3

Wage pressures have eased since last summer, although labour market conditions remain tight. Nominal earnings growth fell during the second half of 1998, according to the reinstated Average Earnings Index (AEI) and other indicators. The AEI headline rate picked up slightly to 4.6% in February, but other measures pointed to a further moderation in nominal earnings growth in the first quarter of this year. Earnings growth is likely to have been boosted in April by the introduction of the National Minimum Wage and the implementation of the public sector pay review body awards. Unemployment has risen slightly and total hours worked have been flat. But unemployment rates remain close to 20-year lows, and employment has continued to grow quite strongly, matched by a fall in inactivity. The number of job vacancies is still high relative to unemployment. But business surveys suggest that skill shortages have abated somewhat, and most measures of employment intentions have fallen further.

3.1 Earnings

Chart 3.1
Headline average nominal earnings growth(a)(b)



(a) Seasonally adjusted, whole-economy figures.
(b) Old and suspended series are lagged by one month to ensure comparability with the new measure.

The official Average Earnings Index (AEI) was reinstated by the ONS on 2 March, following an independent review of the series commissioned by the Chancellor. The box on the next page summarises the main findings of the review and the methodological changes made. Chart 3.1 compares the new headline measure of average earnings growth—a backward-looking three-month moving average rather than a centred measure as previously—with the version suspended on 2 November last year, and with its predecessor, which was last updated on 6 October. The new measure rises steadily from mid 1995 to a peak of 5.7% in June 1998—above the peaks in the previous two series—before falling back sharply to 4.5% in December 1998 and January 1999. Headline earnings growth rose slightly to 4.6% in February.

As the box discusses, the ONS is carrying out further work to improve the quality of the AEI. Until this work is completed, it is hard to know how much weight to place on the index. In some respects, the new series presents fewer interpretational difficulties than the suspended measure. First, there is no longer a marked

The review of the Average Earnings Index

Background

The Average Earnings Index (AEI) is a measure of the growth in whole-economy average weekly earnings per head. It is constructed from monthly survey data on the pay bills and employment of a sample of employers, grouped by size and industrial sector. To make the sample representative of the economy as a whole, returns from each employer in the sample are first scaled up by a 'grossing factor'. The less comprehensive the sample's coverage of that type of employer, the larger the grossing factor. Average earnings in each sector are calculated by dividing total pay by total employment. And whole-economy average earnings are derived from these industry measures, combined using sectoral employment weights.

The AEI was first published in its present form in 1989. The sample of employers was partly updated in 1994 and early 1998, but the grossing factors and sectoral employment weights remained fixed at their initial values until 14 October last year, when (among other things) the employment weights used in the published series were updated and the new Interdepartmental Business Register was used to reclassify firms and update the grossing factors. These revisions had a significant impact on the index, and on 23 October the Chancellor commissioned an independent review of the new series. On 2 November, the ONS decided to suspend the AEI while the review took place. The review was published on 2 March 1999.(1)

Main findings of the review

- The review found, first, that **responses from some individual firms in the sample were having an excessive influence on the AEI**. The AEI sample was known to under-represent some important parts of the economy, particularly those with a high concentration of smaller firms (mainly in the service sectors). To compensate for this, grossing factors applied to smaller firms in the sample were increased sharply in the October 1998 revisions. But this made the aggregate index much more sensitive to the returns of a relatively small number of employers, some of whom reported volatile wages from month to month. For example, the smallest size band in the financial intermediation sector consisted of only two firms. Between April and May 1998, large increases in these firms' reported wages contributed nearly 1 percentage point to the rise in the recorded growth rate of the suspended AEI.

  To bring the AEI up to best practice, the review emphasised that the sample must be expanded and made more representative. In the shorter term, it proposed that small financial intermediation firms be given a lower weight in the index, that the private health and social work sector be excluded from the index before June 1998, and that the 'other business services' sector be consolidated with the rest of the business services sector. The review also recommended that erratic individual returns or 'outliers' should be more formally analysed and—where particularly volatile—given a reduced weight.

- Second, **historical AEI growth rates were being influenced on a monthly basis not only by changes in respondents' average earnings, but also by changes in sample composition and changes in the grossing factors applied to firms**. If a firm paying relatively high wages fell out of the sample (because it had ceased to trade or had forgotten to report) measured growth in the old index would fall, even if the average earnings growth of all reporting firms remained the same. AEI growth rates were also being affected by monthly reassessments of firm size, which sometimes caused sharp changes in the grossing factors applied to individual firms.

  To address these problems, the review recommended that monthly AEI growth rates be calculated using only those returns from a 'matched sample' of employers reporting in both months. And the grossing factors applied to firms should be changed less frequently, at the same time as the sectoral employment weights, and in a way that did not affect monthly growth rates.

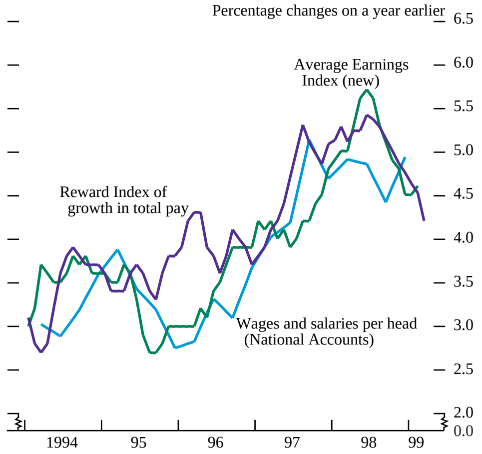
- Third, **the ONS had faced difficulties allocating some employers to sub-categories** within the public sector and, separately, within the agriculture, fisheries and foods sector. The review therefore recommended that each sector should be consolidated into a single unit.

Next steps

All of the short-term changes recommended by the review were adopted in the new AEI published on 2 March. Data based on the improved sample—which is crucial to help bring the AEI up towards best statistical practice—together with statistical measures of volatility in the AEI should begin to be available from September. The ONS is to report to the Economic Secretary to the Treasury by the end of 1999 on the progress made towards implementation of these and the other recommendations of the review.

(1) *Review of the revisions to the Average Earnings Index*: Report submitted by Sir Andrew Turnbull and Mervyn King to the Chancellor of the Exchequer, prepared by Peter Sedgwick and Martin Weale, The Stationery Office Limited, March 1999.

Chart 3.2
Alternative measures of average nominal earnings growth



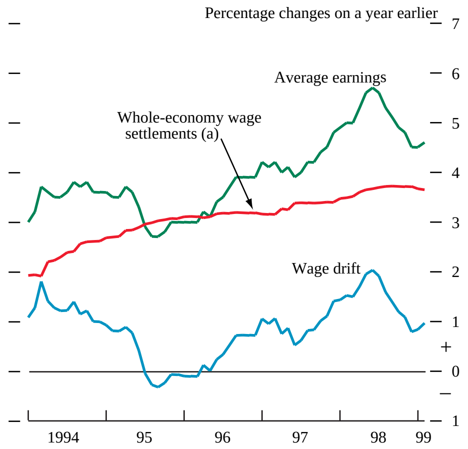
Sources: ONS and The Reward Group.

Table 3.A
Variability of official nominal earnings growth(a)

	Whole economy	Manufacturing	Services	Private	Public
New AEI	0.28	0.35	0.37	0.35	0.37
Suspended AEI	0.41	0.35	0.57	0.53	0.46
Old AEI	0.29	0.30	0.42	0.38	0.44

(a) Figures are the standard deviations of twelve-month earnings growth around a six-month centred moving average over a four-year period ending in April 1998.

Chart 3.3
Average nominal earnings growth, settlements and wage drift



Sources: ONS and Bank of England.

(a) Twelve-month employment-weighted mean from the Bank's database.

slowdown in earnings growth during 1997, a period when unemployment fell steeply and firms were reporting increasing difficulties in attracting suitably skilled staff. Second, the new series is, broadly speaking, more consistent with other earnings measures over the past few years (see Chart 3.2).(1) And third, measured earnings growth is less volatile than it was on the suspended measure (see Table 3.A). Nevertheless, the new AEI can still move sharply over short periods: for example, the pick-up in the headline measure in February partly reflected a rise in the twelve-month growth rate of earnings, from 4.2% in December 1998 to 5.0% in February. This makes it harder to draw inferences about the underlying trend of earnings growth. Other indicators—including the Reward Index and surveys from the Federation of Recruitment and Employment Services (FRES) on the pay of permanent and temporary staff—suggest that annual earnings growth continued to fall in the first quarter of 1999. The FRES measures picked up slightly in April.

Earnings growth can be expressed as the sum of wage settlements and a term known as 'wage drift'. The Bank's estimate of the twelve-month employment-weighted mean settlement has been stable between 3.6% and 3.7% since April 1998. So arithmetically, most of the sharp slowdown—and subsequent slight pick-up—in the annual growth of the official average earnings measure since June last year can be accounted for by changes in wage drift (see Chart 3.3). Wage drift includes factors such as bonuses, overtime payments, shift premia, merit pay, profit-related pay, and compositional shifts in the workforce. So movements in earnings growth since June primarily reflect changes in some or all of these components.

Some of the fall in wage drift probably reflects slower growth in bonuses. Until January this year, firms in the AEI sample were asked to record the amount of bonuses or commissions paid, but only if there had been a significant change. One difficulty with using these data to measure bonus growth is that bonuses not thought to have changed significantly would not have been

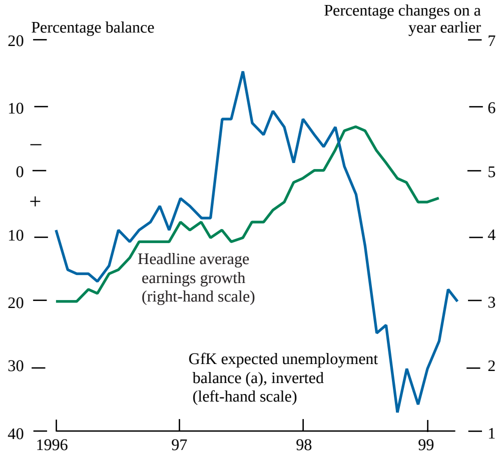
(1) The National Accounts wages and salaries measure is benchmarked on an annual basis to estimates of pay data compiled from employers' tax returns. These annual data are independent of the AEI, but are only available with a lag. The quarterly profile is based on data from the AEI, the Workforce jobs series and other sources, subject to a number of technical adjustments. Some of these adjustments had a significant effect on the growth profile during 1998, and are currently under review by the ONS.

Table 3.B
Annual growth in average nominal earnings(a)

	AEI	Excluding bonuses and commissions	Contribution to earnings growth from bonuses and commissions
	(1)	(2)	= (1)–(2)
1997 Q3	4.2	3.9	0.3
Q4	4.7	4.3	0.4
1998 Q1	5.2	4.4	0.8
Q2	5.7	5.0	0.7
Q3	5.0	4.6	0.4
Q4	4.5	4.5	0.0
1999 Jan.	4.4	4.5	-0.1

(a) Three-month moving averages of twelve-month growth rates (not seasonally adjusted).

Chart 3.4
Average nominal earnings growth and expected unemployment



Sources: ONS and GfK.

(a) Weighted balance of responses to the question 'How do you think the level of unemployment in this country will change over the next twelve months?'

captured. If some reporting firms thought that payments in a particular month had changed significantly in one year, but not in the same month in the previous year (or *vice versa*), measured twelve-month growth rates of bonuses would be biased. Subject to this caveat, Table 3.B shows that bonuses and commissions recorded in this way boosted earnings growth in the first half of 1998, but were having little or no effect on earnings growth by the three-month period ending in January this year.

One reason for paying bonuses is to reward staff for past productivity and profitability gains. So some of the fall in bonus growth in the second half of 1998 may reflect the slowdown in corporate profit and productivity growth. But bonuses are also paid to maintain and improve staff retention, so a decline in bonus growth may also signal looser labour market conditions. Although current unemployment has been close to 20-year lows, concerns about future unemployment rose sharply in the second half of last year, according to the GfK survey (see Chart 3.4). This may have reduced the need for firms to make special payments during that period to retain staff. Respondents to the GfK survey have become less concerned about future unemployment in recent months, consistent with the more general improvement in consumer confidence (see Section 2).

It is not possible to identify the contribution of bonuses to the rise in annual earnings growth in February. Starting from February, firms in the AEI sample have been asked to record all bonuses paid, and not just those they consider to be significant. In the longer run, this should remove the problems with the previous approach. But the substantially higher number of firms now reporting bonuses means that measured annual growth rates are likely to overstate the true rate of bonus growth until February 2000. In principle, this change should affect only the split of total recorded pay between bonus and non-bonus components: firms have always been asked to report their total gross pay. It is possible, however, that some firms have begun reporting bonuses as part of total pay, when previously they had not.(1) That would have raised the recorded annual growth rate of overall earnings in February. But the ONS says that it has found no evidence of this occurring.

(1) The AEI review noted that the reporting arrangements left a degree of ambiguity over whether or not to include bonuses in total pay. Firms have been reminded by the ONS of the need to include all bonuses.

Chart 3.5
Growth in overtime payments and GDP

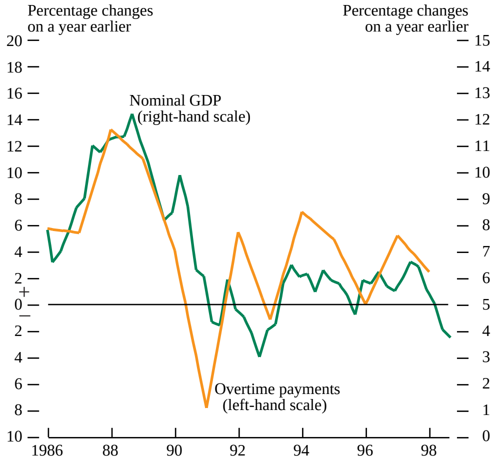


Table 3.C
Survey-based inflation expectations(a)

Percentage increases in prices

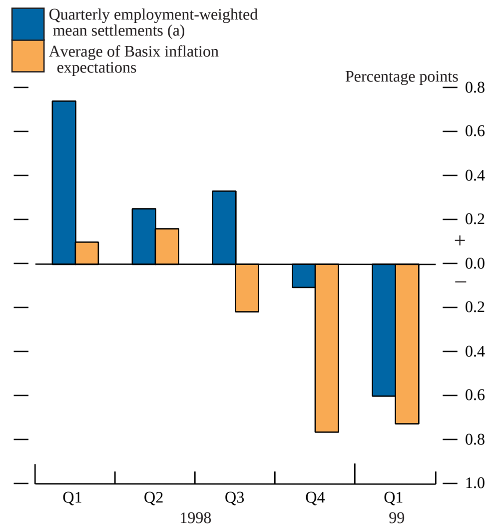
RPI inflation rate one year ahead

	1998 Q1	Q2	Q3	Q4	1999 Q1
General public	4.3	4.4	4.5	4.2	4.1
Trade unions	3.5	3.3	3.2	3.0	2.7
Finance directors	3.3	3.4	3.1	2.6	2.3
Business economists	3.0	3.1	2.6	2.1	2.1
Investment analysts	3.1	3.3	3.3	2.4	2.4
Academic economists	3.0	3.2	2.9	2.5	2.3

Source: Barclays Basix Survey.

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

Chart 3.6
Annual changes in wage settlements and inflation expectations



Sources: Bank of England and Barclays Basix Survey.

(a) Settlements data for 1999 Q1 are provisional.

Earnings growth has also been depressed by a fall in overtime payments in recent months. Overtime is sensitive to demand conditions: in the past, there has been a close relationship between the annual growth in overtime payments as measured by the New Earnings Survey and the annual growth of nominal GDP (see Chart 3.5). Consistent with the slowdown in output growth, the average number of paid overtime hours per worker in the six months to February was about 8% lower than in the same period a year earlier, according to more recent data from the Labour Force Survey.

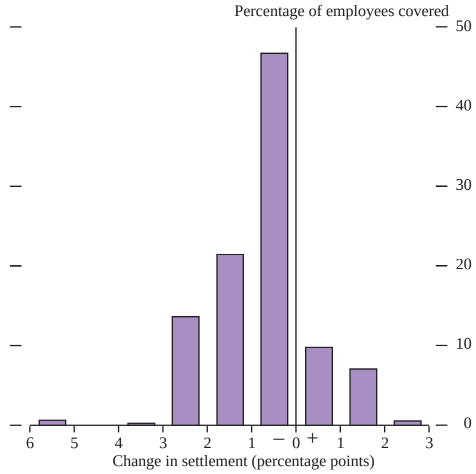
A third factor likely to have put downward pressure on nominal earnings growth is the fall in inflation expectations over the past twelve months. Wage-bargainers care about the expected real value of earnings—workers because it determines their expected ability to purchase goods and services, and firms because it determines their expected real labour costs. When inflation expectations fall, a given rise in expected real wages can be achieved with a lower increase in nominal wages. Most of the measures of one year ahead inflation expectations from the Barclays Basix Survey fell further between 1998 Q4 and 1999 Q1 (see Table 3.C), and have fallen markedly since the first half of 1998. Other surveys show a similar pattern.

Consistent with the fall in inflation expectations, average employment-weighted wage settlements in 1998 Q4 and 1999 Q1 were lower than in the same periods a year earlier, reversing the previous upward trend (see Chart 3.6). These declines were fairly broadly based. According to the Bank's database, more than 80% of employees covered by settlements concluded in the first quarter of the year received a lower settlement in 1999 than in 1998 (see Chart 3.7).

Increases in the pay of some workers to meet the requirements of the National Minimum Wage, outside the standard settlement, are likely to have put some upward pressure on earnings growth in recent months. The National Minimum Wage formally came into effect on 1 April, but there appears to have been significant anticipation, with some firms beginning to pay the National Minimum Wage last autumn and some implementing rises in stages over a period of time.

Earnings growth will also have been affected by the implementation of the public sector pay review body awards, which raised the wages of the 1.2 million workers covered by an average of 4.1% on 1 April.

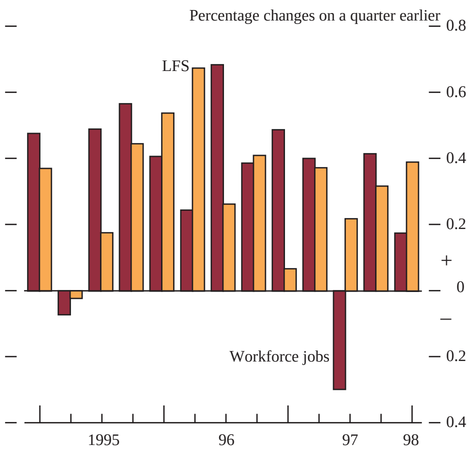
Chart 3.7
Differences between wage settlements in 1998 and 1999 for those settling in Q1 in both years(a)



Source: Bank of England.

(a) Whole-number changes in settlement have been allocated to the bar to the right of the relevant tick mark on the horizontal axis. So, for example, the bar between 1 and 2 shows the proportion of employees covered by settlements that rose by 1 percentage point or more, but by less than 2 percentage points.

Chart 3.8
Employment growth(a)



(a) The LFS and Workforce jobs measures differ, because the LFS measure is based on a rolling three-month survey of households on the number of people in work whereas the Workforce measure is based on the number of employee jobs, taken from a survey of firms on a specific date each quarter. In the chart, LFS data are centred around March, June, September and December, for comparability with the Workforce jobs measure.

Table 3.D
Growth in employment and hours

Percentage change: three months on previous three months

Three months ending	1998 Aug.	Nov.	1999 Feb.
Employment	0.5	0.3	0.3
Total hours worked	0.8	-0.2	0.0

The awards, which unlike last year's settlements will not be phased in over the year, are likely to add around 0.1 to 0.2 percentage points to annual growth in whole-economy average earnings between April and December. Average earnings in the public sector have been growing less rapidly than private sector pay since early 1993, but have slowed less sharply since the middle of last year.

Overall, however, the news since the February *Report* suggests that the pressures on nominal earnings growth have eased somewhat. In light of the slowdown in earnings growth since last summer, the fall in inflation expectations, the reduction in settlements during the first quarter of this year and evidence on the determinants of wage drift, the MPC has lowered the profile for nominal earnings growth in its central projection relative to that in the February *Report*.

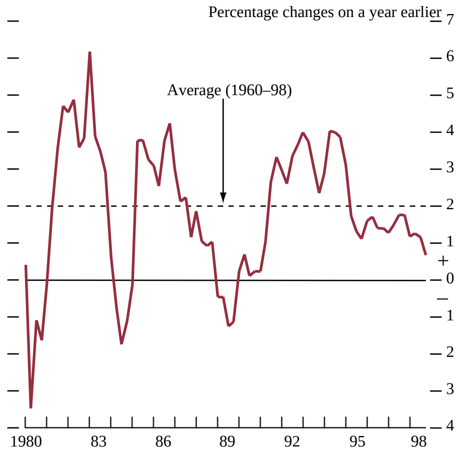
3.2 Employment and unemployment

Pay pressure is influenced by both the degree and the rate of change of labour market tightness. Although quantity indicators give a mixed picture, most suggest that labour market pressures have eased slightly, but remain significant by recent historical standards.

Whole-economy employment has continued to grow quite strongly (see Chart 3.8). Labour Force Survey (LFS) employment rose by 80,000 (0.3%) in the three months to February, and the Workforce jobs measure rose by 48,000 (0.2%) in 1998 Q4. But while the number of people in work rose, average hours worked fell, leaving total hours worked—in principle, a better measure of labour usage—unchanged in the three months to February (see Table 3.D). The fall in average hours reflected two main factors. First, average hours worked by those in full-time employment fell by 0.5% in the three months to February, consistent with a fall in overtime. And second, a relatively large proportion of recent employment growth was accounted for by a rise in part-time workers, who typically work about 40% of the hours of full-timers.

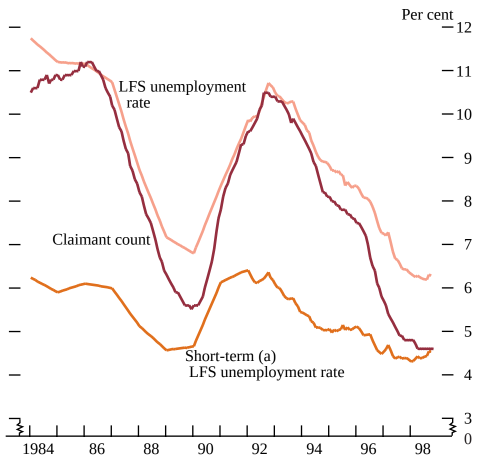
It is possible that some of the strength of recent employment growth may have reflected firms taking on staff in the expectation that demand growth will soon pick up again. The Bank's regional Agents conducted a survey of their contacts' employment intentions in March. Some of those planning to recruit were doing so even though they considered their staffing to be more

Chart 3.9
Whole-economy labour productivity growth(a)



(a) Official measure, defined as GDP at basic prices divided by the number of Workforce jobs.

Chart 3.10
Unemployment rates



Note: pre-1992 LFS figures interpolated from yearly observations.

(a) Those employed for less than a year (seasonally adjusted estimate).

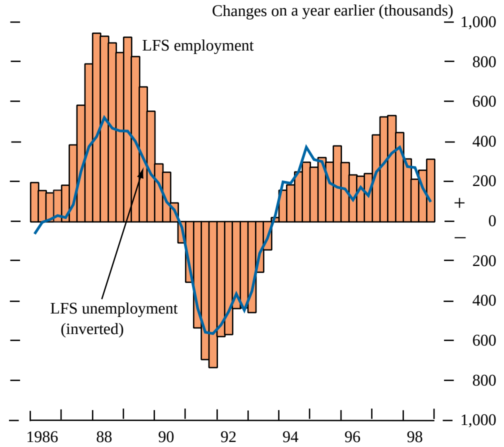
than adequate for their current needs, either because they were expecting a significant upturn in demand, or because they were seeking to adjust the mix of skills and job types.

Employment has grown relatively rapidly compared with the growth in output since the mid 1990s. Consequently, annual growth in the official measure of whole-economy labour productivity—the amount of output per employed person—has averaged only about 1½% since 1995, below the longer-run historical average of around 2% (see Chart 3.9). Developments in labour productivity are important for assessing inflationary pressures. A change in the rate of labour productivity growth which is not reflected in earnings growth affects firms' unit labour costs. And, in the longer run, real earnings should rise in line with trend productivity growth.

There is no strong evidence that the trend rate of labour productivity growth has shifted: since the start of the 1990s recovery, productivity growth has averaged just over 2%, in line with the longer-run average. But the cyclical behaviour of productivity growth does appear to have been different in the 1990s. Historically, productivity growth has tended to rise strongly during the early part of a recovery and to fall sharply during a downturn, reflecting the delayed response of employment to changes in output. During the 1990s, cyclical swings in productivity have been rather less pronounced. This is likely to have reflected a range of influences. But one possible factor is that the labour market reforms of the last two decades, together with other structural changes in the economy, have increased the speed and flexibility with which employers can adjust both the number of employees and the amount of hours worked in response to changes in demand. In its central projection for inflation, the MPC has assumed that productivity growth will continue to be somewhat less cyclical over the forecast period.

Aggregate unemployment has risen slightly, having been stable or falling during last year. LFS unemployment rose by 32,000 in the three months to February, and the claimant count increased slightly in February and March. The LFS measure of redundancies in the three months to February was 52,000 higher than a year earlier. Short-term LFS unemployment, the number of people unemployed for less than one year, has been rising since May last year (see Chart 3.10). The duration structure of unemployment may contain useful information on inflationary pressures in the labour market. Those in short-term unemployment are more likely to have the types of up-to-date skills and experience valued by employers. So, for a given level of unemployment, a rise in the share accounted for by the recently employed may increase the stock of relevant skills available to firms, putting downward pressure on wages. But if the recent rise in the number of short-term unemployed reflects an increasing mismatch between the skills demanded by firms and those offered by people who have recently moved into unemployment, the implications for wage pressure are less straightforward. Although both short-term and whole-economy unemployment measures have risen recently, unemployment rates remain low by recent historical standards (see Chart 3.10).

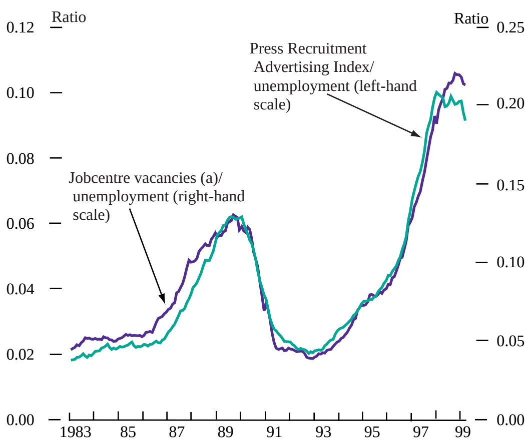
Chart 3.11
Changes in employment and unemployment



Note: Pre-1992 figures interpolated from yearly observations.

The recent rise in both employment and unemployment was associated with a decline in the number of people who are economically inactive (those who are neither employed nor actively searching for work). The inactivity rate has been falling since early 1998, having been broadly flat since the start of the 1990s recovery. The extent to which changes in employment are associated with changes in inactivity rather than changes in unemployment affects the prospects for inflation, because the inactive are assumed to exert less downward pressure on earnings than the unemployed. In the past, inactivity has tended to be counter-cyclical, falling in recoveries as people are attracted out of inactivity into searching for—and acquiring—work, and rising in downturns. So changes in unemployment have usually been rather smaller than changes in employment (see Chart 3.11). During the 1990s recovery, however, the normal cyclical pattern has been weakened by a trend rise in the number of students and long-term sick. The MPC has taken account of this in its inflation projections.

Chart 3.12
Vacancy-unemployment ratios

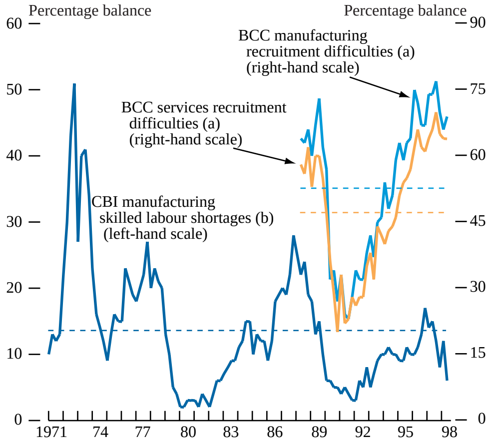


Sources: ONS and NTC Research.

(a) UK data, projected forward using a measure excluding Northern Ireland and West Midlands from the start of 1998. Data are also adjusted for an overstated stock of vacancies from 1996 Q2 onwards caused by difficulties with the Jobcentre computer system.

Indicators of job vacancies and skill shortages provide an alternative way of assessing the relationship between the supply of, and unsatisfied demand for, labour. Vacancy measures have fallen: in March, the official number of Jobcentre vacancies was 12,400 below its peak in November last year, and the NTC Press Recruitment Advertising Index was at its lowest level since December 1996. Recent Jobcentre data have been distorted by reporting problems in Northern Ireland and the West Midlands, the net effect of which is that the official vacancy data probably overstate the true rise in vacancies since early 1998. But even excluding these factors, vacancies remain high relative to unemployment when compared with the previous cycle (see Chart 3.12).

Chart 3.13
Skill shortages and recruitment difficulties



Note: Dashed lines indicate average balances over life of respective series.

Sources: BCC and CBI.

(a) Based on question asking if employers experienced any difficulties over the past three months in finding staff in the following categories: skilled manual, technical/professional, managerial/clerical and un/semi-skilled.
(b) Based on question asking if shortages of skilled labour are likely to limit output during the next four months.

Table 3.E
Surveys of employment intentions(a)

Percentage balance of employers planning to recruit staff

	Series average (b)	1998 Q2	Q3	Q4	1999 Q1
BCC (c)					
Services	12	20	14	15	11
Manufacturing	3	9	-1	-6	-6
CBI (d)					
Manufacturing	-21	-18	-26	-34	-30
Manpower					
Total	10	16	14	9	8
Services	12	17	17	13	13
Manufacturing	14	17	13	8	5

Sources: BCC, CBI and Manpower.

(a) Seasonally adjusted by the Bank.
(b) CBI averages from 1979; BCC from 1989; Manpower total from 1981; Manpower sectoral measures from 1988.
(c) Next three months.
(d) Next four months.

Alternative measures of the relationship between vacancies and unemployment, based on Jobcentre vacancy and unemployment inflows, suggest a similar picture. Skill shortages and recruitment difficulties have also eased since last year, according to business surveys (see Chart 3.13). The CBI survey suggests that the constraint on output posed by skill shortages is now well below average in manufacturing. But, despite recent falls, BCC measures of recruitment difficulties—which cover both skilled and unskilled labour—remain well above average in both services and manufacturing, consistent with continued labour market tightness.

Business surveys suggest that employment intentions have weakened since the middle of last year (see Table 3.E). After seasonal adjustment, the Manpower whole-economy survey balance stayed below its long-run average in 1999 Q1. The outlook for manufacturing employment is still weak on all measures, although the BCC and CBI surveys suggest that the rate of decline in employment intentions may have slowed in Q1. Employment intentions in the service sector—which accounts for a much larger share of total employment—remain rather stronger, according to the BCC and Manpower measures. The survey of contacts carried out by the Bank's regional Agents in March found a similar picture, with more than half of manufacturers reporting that employment levels were expected to be lower over the next six months, but more than three quarters of service sector firms expecting to maintain or raise employment.

Previous *Reports* have set out the MPC's analysis of the implications for inflation of recent Government policies designed to affect the supply of and demand for labour, including the New Deal and the Working Families Tax Credit. The March Budget contained a number of further measures. In forming its latest inflation projection the MPC has decided not to adjust its assumptions. But these assumptions will be kept under regular review as further data and research become available.

3.3 Summary

The labour market remains tight. Unemployment is close to 20-year lows, employment has continued to grow, inactivity has fallen, and the stock of job vacancies remains high relative to the level of unemployment. These factors, together with the implementation of the public sector pay review body agreements and the

National Minimum Wage in April, are likely to continue to underpin earnings growth in the next few months.

Nevertheless, there have been signs of an easing in labour market conditions since the February *Report*. Nominal earnings growth has moderated since last summer, according to the newly reinstated Average Earnings Index and other measures, and wage settlements have begun to fall, consistent with the slowdown in the growth of output and profits, and a reduction in inflation expectations. Unemployment has risen slightly, the number of hours worked has been flat, skill shortages have abated, and surveys of employment intentions suggest that employment growth may decline in the coming months. Taken together, and compared with the February *Report*, these factors point to somewhat weaker inflationary pressures from the labour market over the forecast period.

Costs and prices 4

RPIX inflation has remained stable and close to target since July 1998. The oil price has risen since the February *Report*, though prices of other commodities have generally continued to fall. And the appreciation of sterling's effective exchange rate since February is likely to place further downward pressure on imported goods prices. UK producer prices have reflected the rise in the oil price, but overall cost pressures in the manufacturing sector remain subdued. Inflation has remained higher for services than for goods, though business surveys suggest that cost pressures in the service sector have eased.

4.1 Raw materials and commodity prices

Brent crude oil prices rose to around $15 per barrel at the end of March, following a twelve-year low of less than $10 per barrel at the end of 1998. The rise in oil prices was prompted by production cuts by OPEC. Since these were introduced in April, prices have risen further, and averaged $16 per barrel over the two weeks to 5 May, similar to the prices prevailing at the end of 1997. The MPC has assumed that oil prices will remain around current levels over the forecast period.

Table 4.A
Non-oil commodity prices in US dollars: forecasts for 1999 and 2000

Annual average percentage changes on a year earlier

	1998 Outturn (a)	1999 (b)	2000
EIU	-16.1	-8.6	6.8
IMF	-14.8	-4.0	1.8
OECD	-14.0	-6.2	0.3
World Bank	-15.6	-10.6	3.0

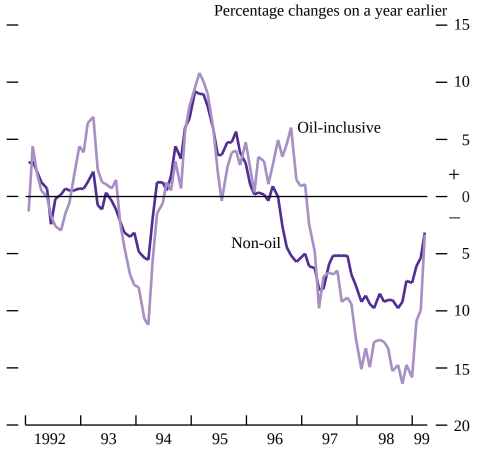
(a) 1998 outturns vary because of the different composition of the basket of goods used in the indices.
(b) All forecasts were published in April/May 1999.

In contrast to oil prices, world prices of raw materials and non-oil commodities have generally continued to fall. The *Economist* index of non-oil commodity prices measured in US dollars was around 5% lower in the three months to April compared with the previous three months, and some 17% lower than a year earlier. The IMF, World Bank, OECD and Economist Intelligence Unit (EIU) project lower average prices in 1999 than in 1998. That is largely a result of the further broadly based price falls seen in early 1999. Higher prices are forecast for 2000 than in 1999 (see Table 4.A).

The Bank's sterling non-oil commodity price index is weighted by UK demand and has a higher weight for wholesale food, including UK produce, than the *Economist* index.[1] Prices of some of the non-oil

(1) The Bank's index is available on a monthly basis and is compared with the *Economist* index because it is also updated frequently. The other indices which are shown in Table 4.A are available only on a quarterly basis, though are based on broader weights than the *Economist* index.

Chart 4.1
Bank's commodity price index[(a)]



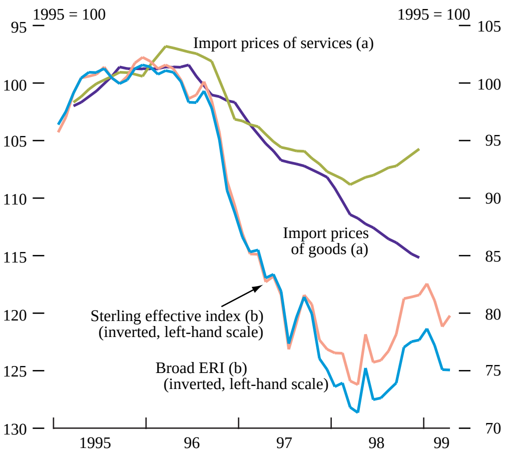
(a) Monthly average of prices of primary commodities weighted by their share in UK demand.

Table 4.B
Contributions of sub-components to changes in the Bank's non-oil commodity price index

	Weight in the index	Contributions to change in index (percentage points):(a) Since Dec. 1995	Three months on previous three months Sept.	Dec.	Mar.
Indigenous wholesale food	44.4	-10.1	-0.5	-0.5	1.3
Non-indigenous wholesale food	2.8	0.0	-0.3	-0.2	0.1
Non-food agriculture	6.9	-0.7	-0.1	-0.1	0.0
Metals	7.1	-2.6	-0.3	-0.5	-0.1
Non-oil fuels	38.8	-3.5	0.1	-1.1	-0.1
Total index	**100**	**-17.0**	**-1.1**	**-2.3**	**1.2**

(a) Figures may not sum to totals because of rounding.

Chart 4.2
Import prices of goods and services and the exchange rate



Note: The ERI is measured against 20 industrialised countries. The broad ERI is measured against 49 countries. The import price index covers imports from all countries.

(a) Based on quarterly National Accounts data.
(b) A fall indicates an appreciation.

commodities measured by the Bank index have risen since the beginning of the year and the annual rate of deflation of the index has declined (see Chart 4.1). The fall in wholesale food prices has accounted for more than half of the fall in the Bank's non-oil commodity price index since its peak in December 1995 (see Table 4.B). This partly reflects the impact of changes in sterling intervention prices under the Common Agricultural Policy (CAP), and falling livestock prices. But wholesale food prices have risen since January.

The February *Report* noted that, since 1 January 1999, intervention prices under the CAP have been calculated in euros and translated into sterling using the market exchange rate. Intervention prices in sterling fell during 1999 Q1 as sterling appreciated against the euro. The 'Agenda 2000' package, which includes further changes to the CAP, was agreed by EU Member States at the end of March. The agreed cuts to intervention prices are less than those originally proposed by the European Commission. Price reductions are to be phased in over a few years for cereals and beef, and the reduction in milk prices will not be implemented until 2005–06. The impact on the inflation rate is therefore likely to be negligible over the forecast period.

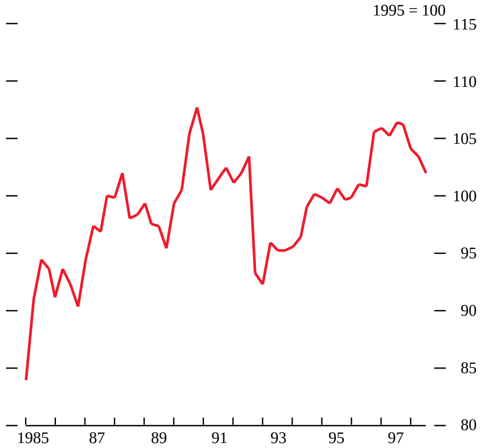
The MPC's central projection assumes that the fall in non-oil commodity prices comes to an end in 1999 and, in line with other forecasts, that dollar prices of commodities increase in 2000.

4.2 Import prices and the exchange rate

Sterling prices of imported goods and services fell by 5.7% in the year to 1998 Q4, and were 14.8% lower than in 1996 Q2, just prior to sterling's marked appreciation. Goods account for around 80% of total UK imports and services 20%. Since 1996 Q2, the prices of imported goods have fallen much more than those of services. Prices in sterling of imported goods have fallen by 16.5% since 1996 Q2, but those for services have fallen by 8.3%. Over the past twelve months the prices of imported services have risen.

Import prices both of goods and services were initially slow to respond to the appreciation of sterling. Despite falling world prices for manufactures during 1997–98, the decline in imported goods prices broadly matched the extent of the appreciation only by 1998 Q4 as sterling fell back a little (see Chart 4.2). Overseas exporters to the United Kingdom may have initially widened margins

Chart 4.3
Ratio of UK import prices to major six overseas economies' export prices(a)



Sources: ONS and Bank for International Settlements.

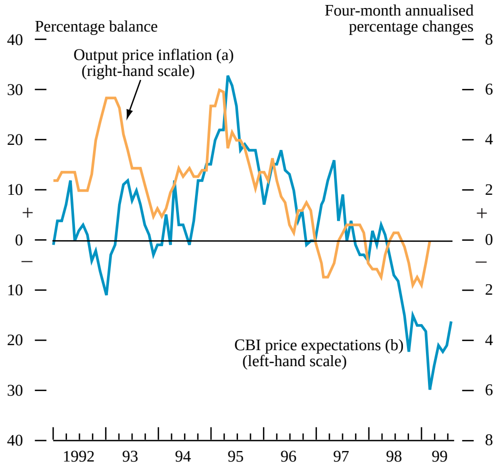
(a) The major six economies are the G7 excluding the United Kingdom. Export prices of goods and services are denominated in sterling and are weighted by UK imports of goods and services. The data for Germany and Italy pre-date ESA95 changes.

on UK sales, perhaps because they thought that the appreciation was temporary. Section 1 discussed how, in 1997 and 1998, Consensus Economics forecasts showed a sharper projected fall in the real exchange rate than actually occurred. The ratio of UK import prices of goods and services relative to average export prices of the United Kingdom's major trading partners rose in 1997 (see Chart 4.3). But it fell back in 1998 as overseas suppliers appear to have narrowed their relative margins on UK sales. Falling world prices for semi-finished and finished manufactures suggest that excess global capacity and the increased competitiveness of Asian exports in world markets may have had an effect.

Producer prices in local currencies in the major overseas economies, except the United States, continued to fall in January and February. That, combined with the recent appreciation of the exchange rate, suggests some further falls in UK imported goods prices are likely. The MPC's central projection assumes that sterling import prices will be weaker than expected at the time of the February *Report*. Import prices continue to fall in the first half of 1999 but rise thereafter, as the effects of sterling's appreciation fade and world demand growth picks up.

4.3 Costs and prices in manufacturing

Chart 4.4
Producer output price inflation and the CBI price expectations balance



Sources: CBI and ONS.

(a) Excluding excise duties.
(b) Balance of manufacturers expecting to increase prices over the following four months minus those expecting a reduction; lagged by four months.

Inflation in the manufacturing sector has remained subdued. Recent increases in fuel prices have broadly offset continued falls in both input and output prices of other manufactured goods. Input prices fell by 0.4% in 1999 Q1, the slowest rate of decline since 1997 Q3. And the April Chartered Institute of Purchasing and Supply (CIPS) survey of manufacturing pointed to less steep falls in input prices than in the previous nine months. Output prices rose in February and March as a result of changes to excise duties and higher fuel prices. Excluding excise duties, output prices were broadly flat in 1999 Q1 and were 0.7% lower than a year earlier. The CBI survey measure—which in the past has moved fairly closely with producer output prices (see Chart 4.4)—points to small falls in prices over the next four months.

4.4 Costs and prices in the service sector

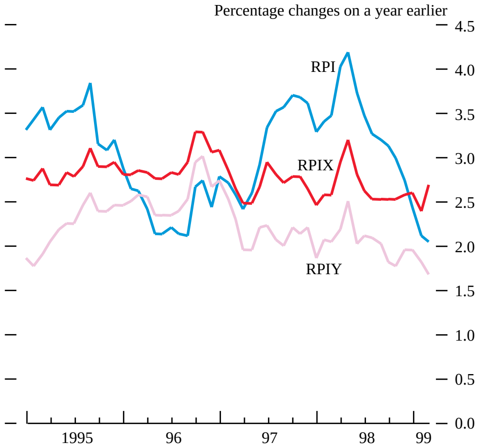
Survey data for the service sector pointed to lower costs and output price inflation in the second half of 1998, but survey balances rose a little in 1999 Q1. The CIPS services survey index of the cost of all inputs fell in the second half of 1998 but rose in the first four months of

1999. The CIPS survey measure of prices charged was above the neutral level of 50 in March and April, following five months when the balance of responses was consistent with downward pressure on prices. The BCC survey measure of output price inflation in the service sector was unchanged in 1999 Q1, though cost pressures from settlements and other overheads were reported to have increased.

The ONS is developing an aggregate measure of corporate services output inflation (see page 35 of the February 1999 *Report*). The twelve sub-component series which are published generally pointed to lower inflation in 1998 Q4: six pointed to lower price increases in 1998 Q4 than in Q3 and two showed no change. Three of the four series where price increases were higher related to the transport sector.

4.5 Retail prices

Chart 4.5
Inflation(a)



RPIX = Retail price index excluding mortgage interest payments.
RPIY = RPIX excluding VAT, local authorities' taxes and excise duties.

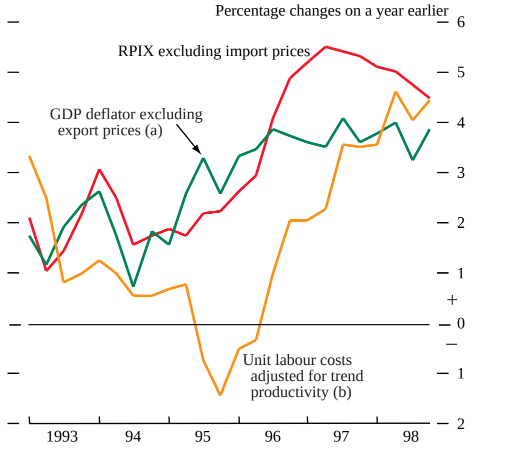
(a) Adjusted by the Bank of England for ONS error in under-recording aggregate price indices between February and May 1995. Other charts and tables in this *Report* that include measures of retail price inflation are similarly adjusted.

Retail prices excluding mortgage interest payments (RPIX) inflation remained close to target in 1999 Q1. The rise in RPIX inflation in March, to 2.7%, was a result of the temporary effect of changes in the timing of excise duties announced in the Budget (see below). RPIY inflation, which also excludes indirect and local authorities' taxes, fell to 1.7%. The headline RPI inflation rate was unchanged at 2.1%, as a fall in mortgage interest payments offset the impact of higher duties (see Chart 4.5).

The Budget in 1999 was earlier than in 1998, and increases in fuel duties took effect before the March collection date for the RPI. Fuel duties therefore affected the March RPI this year but not last year. Increases in tobacco duties were brought forward to March from December. These changes, if passed on in full, would have added around 0.4 percentage points to RPIX inflation in March. The increase will be largely reversed in April when the 1998 increase in road fuel duties (of close to 0.3 percentage points) drops out of the annual inflation rate. And in December 1999, the effect of last year's increase in tobacco duties will drop out of the annual inflation rate.

The February *Report* noted that services price inflation has been above that for goods since December 1996. The gap widened from 1.0 percentage points in 1997 Q1 to 2.3 percentage points in 1998 Q4, as falling import prices bore down on goods price inflation. The gap remained wide in 1999 Q1. Services price inflation was

Chart 4.6
Measures of domestically generated inflation



(a) Using GDP measured at market prices.
(b) Using gross value-added (GVA) at basic prices and the National Accounts measure of employee compensation.

a little lower at 3.4% in 1999 Q1, and goods price inflation rose by 0.1 percentage point to 1.3%.

Services price inflation has moved more closely with measures of domestically generated inflation (DGI) than goods price inflation over the past two years because of the lower import content of services. Measures of DGI provided mixed signals about the direction of inflationary pressure at the end of 1998 (see Chart 4.6). The measure of RPIX inflation excluding import prices fell to 4.5% in 1998 Q4, its lowest rate since 1996 Q3. Inflation measured by the GDP deflator excluding export prices has remained close to 4% since the beginning of 1996. The unit labour costs inflation measure rose to 4.4%, as productivity slowed.

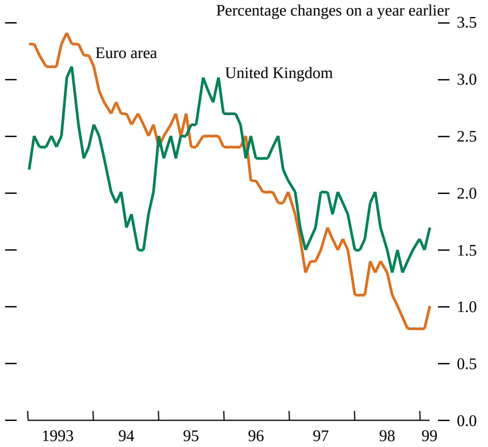
The DGI measures derived from RPIX and the GDP deflator are a combination of domestic weighted costs and a mark-up of prices over costs.(1) In the short run, pricing behaviour will depend on the reasons for changes in costs and their interaction with current and expected demand conditions. Firms may delay adjusting prices fully to an increase in costs if they view the change to be temporary. But firms may be quicker to respond to a change in costs that has affected all firms in the same way—for example, an increase in general wage pressure. There is also some evidence for the United Kingdom that the mark-up of prices over costs tends to rise when demand increases, but with a short lag. The strength of demand in 1997 and early 1998 probably boosted prices relative to costs. The subsequent slowdown in demand will tend to put downward pressure on prices relative to costs. Section 6 discusses the behaviour of prices relative to costs over the forecast period.

4.6 Other price indices

The Harmonised Index of Consumer Prices (HICP) is constructed from the same price quotes as RPIX but it has a different coverage, and a different method of index construction, so that it is directly comparable with HICP inflation rates of other EU Member States.(2) In March, UK HICP inflation was 1.7%, 0.7 percentage points higher than euro-area inflation. Eurostat has recently published estimates of HICP inflation for the euro area prior to 1997. UK HICP inflation was a little below that of the euro area between January 1993 and June 1995,

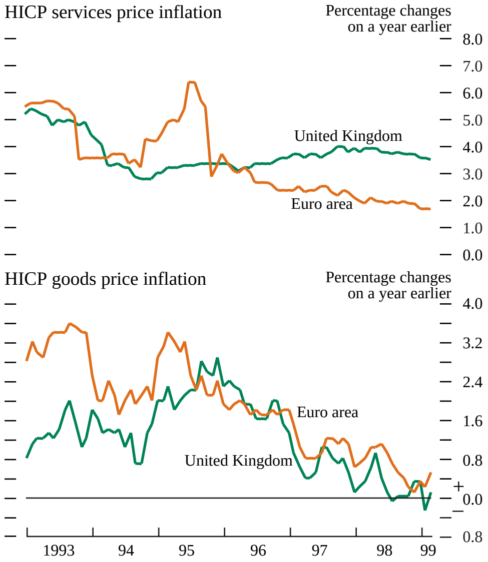
(1) An explanation of the domestically generated inflation measures (DGI) was given in the *Inflation Report*, August 1998, page 39.
(2) Further details on the construction of HICP were set out in the February 1999 *Report*, page 38 and in *Economic Trends*, December 1998.

Chart 4.7
HICP inflation(a)



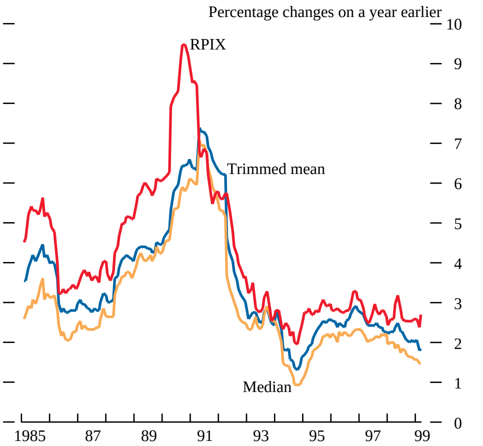
(a) HICP inflation rates prior to 1997 are estimated and are subject to revision.

Chart 4.8
HICP services and goods price inflation(a)



(a) HICP inflation rates prior to 1997 are estimated and are subject to revision.

Chart 4.9
Measures of core inflation



but has been above it since then (see Chart 4.7). UK services price inflation has been considerably higher than that in the euro area since 1996 (see Chart 4.8). That is perhaps a result of higher domestically generated inflation in the United Kingdom than in the euro area since then. By contrast, UK goods price inflation has generally been lower than that for the euro area. In the past two years that has probably reflected the rise in sterling's effective exchange rate.

Underlying developments in the rate of inflation are sometimes masked by sharp movements in individual prices. Such price changes should be included in a measure of the cost of living. But it is also useful to look at inflation rates excluding erratic price movements to gauge underlying inflationary pressure. The Bank looks at two measures which reduce the effect of extreme price movements: the median inflation rate and the trimmed mean inflation rate, which excludes the highest and lowest 15% of price changes. These measures usually lie below RPIX inflation, as the price increases excluded from the measures generally exceed the price falls excluded (see Chart 4.9). The measures showed a more gradual build-up in inflation towards the peak in the early 1990s. In the recent past they have reduced the fluctuations resulting from sharp movements in seasonal food price inflation, and changes in the timing of duties. Inflation on these measures fell slightly in early 1999.

Inflation measured by the consumers' expenditure deflator rose to 2.3% in 1998 Q4 from 2.0% in Q3. That led to a pick-up in the annual inflation rate of the GDP deflator at market prices, which measures whole-economy inflation. It rose to 2.6% in 1998 Q4 from 2.2% in Q3.

4.7 Summary

RPIX inflation has remained stable and close to target since July 1998. Oil prices have risen since the February *Report*, while the world prices of other commodities have continued to fall and import prices have declined further. UK manufacturing output prices were broadly flat in 1999 Q1. But in most major overseas economies they continued to fall. Combined with the higher exchange rate, that points to some renewed downward pressure on UK goods prices from abroad. Inflation in the service sector has persisted at annual rates of above 3%, though survey data have continued to point to lower increases in costs. There are some tentative signs that domestically generated inflation may be moderating. The recent appreciation of sterling may place renewed downward pressure on goods prices in the short run; thereafter, the gap between domestic and imported inflationary pressures is expected to narrow gradually.

5 Monetary policy since the February *Report*

This section summarises the economic developments and monetary policy decisions taken by the MPC since the February *Report*. The minutes of the February, March and April meetings and the press notice from the May meeting are attached as an Annex to this *Report*. The Bank of England's official dealing rate—the repo rate—was reduced from 5.5% in February to 5.25% in April, and was maintained at that level in May.

At the time of the February *Report*, the central projection was for RPIX inflation to remain close to target over the two-year forecast period. The risks around the projection were broadly balanced in the first year but were slightly on the downside in the second year. Greater than usual uncertainty surrounded the forecast, partly because of the difficulty of assessing labour cost pressure. Some Committee members took the view that the inflation profile should be somewhat lower, because of expectations of stronger productivity growth or weaker world prices than assumed in the central projection.

At its meeting on 2–3 March, the Committee noted that the prospects for global activity and prices were little changed since the February *Report*. Outside the major industrial countries, renewed difficulties in Brazil had led to a further weakening of the real; but other South American currencies did not appear to be under pressure. Though the risk of contagion remained, it had not materialised. The sterling effective exchange rate had risen by 2% since the February *Report*. Sterling had appreciated against the euro but depreciated against the US dollar; these movements possibly reflected changes in expectations about relative demand prospects for the euro area, United States and United Kingdom. The stronger exchange rate would, by itself, tend to reduce import prices and retail prices. But the Committee judged that it was too soon to tell whether the appreciation would persist.

There were two key domestic activity developments. First, the composition of expenditure had been published for 1998 Q4 and this included a small downward revision to the level of GDP at market prices. Inventory accumulation made a larger contribution to GDP growth than in Q3, offset by a larger negative contribution from net trade, primarily because of weaker exports. Second, surveys had picked up somewhat from lows in the autumn; and the improvement had been broadly based, including both domestic and export activity. These two developments could be interpreted in a number of ways. The lower level of GDP could point to weaker demand than previously thought. And the weaker outturn for exports could point to some of the downside risks to external demand feeding through. But the rise in survey data, albeit from low levels, might point to a slightly better picture than previously expected. Overall, the Committee judged that activity was in line with what had been expected at the time of the February *Report*, but the improvement in survey data, if sustained, could prove significant.

Nominal price and cost pressures appeared to have weakened in the second half of 1998. The Average Earnings Index (AEI) had been published again, following the independent review. The level of earnings at the end of 1998 on the newly published series was broadly in line with the assumption in the February *Report*. But earnings growth in the first half of 1998 had been higher than previously thought, and had then slowed more markedly than had been assumed. The rate of increase of wage settlements had also slowed, and the Reward Index had declined on a broadly similar path to the Average Earnings Index in 1998. The effective exchange rate was higher, though oil prices had also risen. On balance, these developments suggested slightly lower prospective inflation than thought at the time of the February *Report*.

In its discussion of the immediate policy decision, some members of the Committee considered that the news on the month did not amount to a sufficient case for a further reduction in interest rates. More evidence was required on the exchange rate, earnings and confidence. Another view was that the central projection in the February *Report* had been around 0.2 percentage points too high—the news on the month had suggested weaker activity and inflation, and so justified a cut in interest rates of 25–50 basis points. The Committee voted to leave the repo rate unchanged at 5.5%.

At its meeting on 7–8 April, the Committee discussed whether prospects for the world economy had improved over the previous month. In the United States, domestic demand had continued to grow strongly, with little sign of a pick-up in inflation. But there were few signs of recovery in Japan. Output remained below potential in a number of euro-area economies, though expectations of an easing of monetary policy had increased. Spreads on emerging market debt had narrowed during the month. Sentiment and, in some cases, activity was a little stronger in parts of Asia and Latin America. So the downside risks to activity highlighted in the February *Report* appeared to have diminished slightly. There were some signs that the fall in commodity prices was coming to an end, and oil prices had risen sharply. But with most economies outside the United States below their productive capacity, the Committee viewed the scope for a generalised pick-up in inflation as limited.

The main news on domestic activity was the revisions to the levels of GDP and composition of expenditure in 1997 and 1998. The estimated level of GDP at market prices in 1998 Q4 had been reduced by $^1/_2$%, but by only $^1/_4$% when measured at basic prices. The composition of expenditure showed an upward revision to consumption and investment, with business investment significantly higher. But the revisions resulted in a larger negative contribution from net trade, largely as a result of higher imports. At the same time, inventory accumulation was revised downwards, and suggested that the risks of a significant stock cycle in 1999 had diminished. Survey evidence suggested an improvement in business confidence, albeit from a low base. The Committee agreed that the Budget had little altered the outlook for inflation. Overall, the prospects for activity remained broadly as expected at the time of the February *Report*.

In assessing the prospects for inflation, the Committee discussed the implications of lower earnings growth and settlements. Earnings growth had remained on a downward trend; but the implications for inflation would depend on a variety of factors including productivity and margins. Productivity had been low relative to its long-run average over the past three years; so unit labour costs were correspondingly higher. But the pass-through from unit labour costs to prices was not straightforward. It would depend on cyclical conditions and on other input prices. The Committee decided to consider these issues further in the context of the May *Report*. The effective exchange rate had remained higher over the past month and was more than 2% higher than assumed in the February *Report*, which by itself would tend to dampen inflation.

In its discussion of the immediate policy decision, the Committee considered that the prospects for activity overall were little changed and that some of the previously identified downside risks to both the world and the UK economy appeared to have diminished. The prospects for inflation had shifted further towards the downside. The effective exchange rate was stronger, and nominal earnings growth seemed lower, than expected. Against this background, the Committee voted to cut the Bank's repo rate by 0.25% to 5.25%.

At its meeting on 5–6 May, the Committee voted to leave the repo rate unchanged at 5.25%.

6 Prospects for inflation

6.1 The inflation projection assumptions

This *Report*, which the Committee approved on 7 May, contains the Committee's assessment of developments in the economy since February, and prospects for the medium term. Charts 6.1 and 6.2 below 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 5.25% during the next two years, and are conditioned on the assumptions described below.

After successive downward revisions to global economic prospects through the autumn and winter months, there has been a slight improvement in the outlook for world activity since the February *Report*. Momentum in the US economy appears stronger than judged earlier, raising forecast GDP growth there in 1999. However, prospects for the euro area are slightly weaker than estimated three months ago. Recent GDP growth has been sluggish, although the 0.5% cut in ECB interest rates in early April should support future activity. The outlook for Japan remains depressed. Outside the major industrial countries, there are some encouraging signs of recovery in the emerging Asian economies. Interest rate spreads on emerging market debt over US Treasuries have fallen over the past three months, although they remain well above the levels of the first half of 1998. Overall, there has been a small upward revision to the central projection for global growth. The MPC now assumes that growth in UK-weighted export markets will rise from 4%–5% in 1999 to the 5%–6% range in 2000, still well below the average over the 1990s. Moreover, UK exporters may continue to lose market share, as the effects of the appreciation of sterling continue to work through.

Global inflationary pressures remain quite weak. Manufactured goods prices continue to edge down internationally as current demand falls short of production capacity. And although some rise in non-oil commodity prices is assumed over the forecast period, they fell further than expected over the winter months. In contrast, oil prices have risen sharply recently, in response to the OPEC plan to scale back production. The planned supply reduction has brought forward the recovery in oil prices projected in February. Oil prices are expected to be higher in the short to medium term than anticipated in February, but no change is expected in the long-run level. Taking these developments together, there is little change in the relatively subdued outlook for world inflation. However, import prices in sterling are likely to be weaker than expected in the February *Report*, given the further appreciation of the exchange rate.

The sterling exchange rate, as measured by the effective Exchange Rate Index (ERI), averaged 104.0 in the 15 working days up to and including 5 May. This forms the starting-point for the exchange rate profile assumed in the projection. It compares with a starting-point of 100.1 at the time of the February *Report* and an implied level of 99.4 for May. The starting-point for the exchange rate is thus some $4\frac{1}{2}$% higher than the path assumed in February. The recent rise has been particularly marked against the euro. Changes in market perceptions of future interest rates at home and abroad could account for a significant portion of the recent increase in sterling.

The MPC takes both interest rate differentials and risk factors into account in formulating assumptions on the path of sterling. In the central projection, the sterling ERI declines to 99.6 by the end of the two-year forecast period, consistent with bilateral sterling exchange rates of about $1.62 and 0.69 against the euro (equivalent to DM 2.82). On average, sterling is expected to decline more steeply than in the central projection. Outside forecasts reported by Consensus Economics imply that the exchange rate is expected to decline more rapidly than in the central projection, reaching 96.7 after two years. But some Committee members considered that the balance of risks around the central projection for the exchange rate was on the upside.

The MPC continues to base the central projection on the Government's announced public spending plans and forecasts of effective tax rates. The May projections are based on the March Budget. There is relatively little difference in the overall fiscal stance from the autumn pre-Budget statement, which formed the basis for the February projection. Lower levels of social security transfers offset the reduction in taxation announced in the Budget.

The National Minimum Wage came into effect on 1 April, following the introduction of the Working Time

Directive in October 1998 and the New Deal in early 1998. Previous projections incorporated assumptions about the effects of these labour market reforms. No changes have been made to these assumptions in the central projection, although the upside risk to earnings from a stronger minimum wage impact has been reduced.

6.2 The medium-term inflation projection

Output rose marginally in the first quarter of 1999 according to the preliminary GDP release in April. The outturn was close to the flat central projection in the February *Report*, and by itself contained little news. However, prior to this, the February GDP release and the National Accounts published in March revised down the level of GDP and altered the estimated composition of demand in recent quarters. At the end of 1998, the level of GDP measured at market prices was around $^1/_2$% lower than previously estimated, although only $^1/_4$% lower when measured in basic prices. The implications of those revisions to output for future inflation are ambiguous. On the one hand, the lower level of activity could indicate a reduction in pressures on capacity which, depending on the lags, could dampen future inflation. On the other, the short-run trade-off between activity and inflation could be less favourable than previously thought. The Committee concluded that, on either view, the revisions were not large enough to warrant a material change in the assessment of inflationary pressures.

The composition of demand in the second half of 1998 differed from the central projection in the February *Report* in three main respects. First, business investment rose strongly in the fourth quarter of 1998 and was revised up in earlier quarters. Second, the degree of inventory build-up was rather lower, largely offsetting the impact of higher fixed investment on total domestic demand. Third, net trade made a more negative contribution to GDP. Imports were stronger than projected.

The ratio of business investment to GDP rose further to a new record level. The Committee considered two explanations for this apparent strength. The first was that it might be linked to the Millennium, with companies bringing forward IT-related and construction spending. Evidence from a recent survey of Bank Agents' contacts provided some support for this view. The second explanation was that the desired level of business investment had been boosted, perhaps by higher IT-related spending which might have a shorter life-span than other components of the capital stock. The Committee assigned some weight to both explanations, and having regard also to survey data on investment intentions, raised the projection for investment, particularly in 1999.

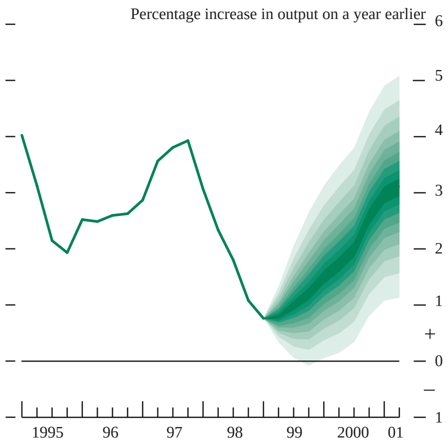
The lower-than-expected level of inventories in the second half of 1998 has reduced the risks of a major stock correction in 1999. Survey evidence suggests that manufacturers and retailers continued to shed stock in the early part of this year, but not sufficiently rapidly to lead to a dip in overall output. The latest CBI survey for manufacturing suggests that stocks remain above desired levels, but that the extent of any overhang has been reduced. However, the latest survey for distributive trades indicates that stocks were built up in April as demand failed to meet expectations. Further falls in stocks seem likely in the coming months to eliminate the remaining excess. This inventory reduction will detract from GDP growth. Precautionary stockbuilding ahead of the Millennium may affect the timing from quarter to quarter. The Committee judges that there is a risk that the aggregate stock-output ratio could fall less sharply than in the central projection, raising GDP and inflation.

After the data revisions, the share of imports in domestic demand in 1998 was higher than estimated at the time of the February *Report*. Bank Agents' contacts report continued pressure from foreign competitors in both domestic and international markets, exacerbated by the further rise in sterling in recent months. In assessing the overall prospects for net trade, the Committee judges that the dampening influences of stronger import penetration and the rise in sterling since February will outweigh the stimulatory effect of slightly stronger world trade growth. The central projection is that net exports will depress GDP growth in both 1999 and 2000, and by more than expected three months ago.

Although there were some modifications to the quarterly profile, consumer spending growth in the second half of 1998 was in line with expectations in the February *Report*. Sales over the Christmas period were sluggish. More recently, there have been tentative signs of recovery. The GfK consumer confidence indicator has returned to positive territory. Housing market indicators, which provide another barometer of consumer sentiment, have turned up. Personal lending figures are also rather stronger and mortgage approvals are up sharply, while the rise of over 10% in equity prices since the February *Report* has increased personal wealth. These indicators provide support for the central projection that consumer spending growth will strengthen in the coming months in line with expectations at the time of the February *Report*.

The Committee judges that the prospects for overall activity have changed relatively little from the February *Report*, although there are significant changes in some of the demand components. Stronger investment and the impact of lower interest rates have raised the central projection for domestic demand growth. But the additional stimulus to demand has been largely offset by a weaker outlook for net trade.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 5.25%



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.

The central projection is for the four-quarter growth rate of GDP at constant market prices to recover later this year from the current rate of between $^1/_2$% and 1%, as domestic demand growth strengthens, and to return to assumed trend rates by the middle of next year (see Chart 6.1).(1) The four-quarter growth rate continues to rise thereafter, as the period of weaker growth drops out of the calculation, before levelling off by the end of the two-year horizon.

Recent survey evidence is consistent with the recovery in growth in the central projection, as business confidence indicators on a broad front have risen from the very weak levels of last autumn. Indeed, the survey indicators are consistent with quarterly growth rates having passed their trough.

Although recent outturns for activity were broadly in line with expectations, news on nominal variables over the past three months suggests that underlying inflationary pressures are weaker than previously thought. The exchange rate has risen appreciably. Broad money growth has continued to slow to a pace more consistent with the inflation target. Surveys of inflation expectations have fallen further, which, other things being equal, should lead to lower growth in nominal wages and prices.

The Average Earnings Index (AEI) was reinstated in early March, following the review commissioned by the Chancellor. It will take time to implement all of the recommendations of the review and raise the quality of the index to the best statistical standards. In the interim, the index remains an uncertain guide. The revised AEI

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

suggests that nominal earnings growth fell more rapidly in the second half of 1998 than assumed at the time of the February *Report*, but from a higher peak in the spring. However, the revised data for January and the preliminary estimate for February suggest that earnings growth may no longer be declining. In contrast, wage settlements in the private sector appear to be lower than a year ago. It is possible that earnings growth remains substantially higher than settlements because of bonuses and merit-based pay, although this is hard to assess given a statistical break in the information on irregular pay from February. Increases in the pay of some workers to meet the requirements of the National Minimum Wage, outside the standard settlement, could also be a factor. Other indicators are mixed: the Reward Index of earnings growth continued to slow in the first quarter, while the Federation of Recruitment and Employment Services survey reported an edging up of pay rates in April. Implementation of the public sector pay review bodies' recommendations will have added to earnings growth in the public sector from April. But overall, the evidence from earnings and settlements, together with information from the Bank's regional Agents, indicates a weakening in nominal pay pressures. At the same time, the substantial reduction that has occurred in inflation expectations means that real earnings growth has fallen by less than nominal earnings growth and may on some measures have risen. The Committee has lowered further the central projection for nominal earnings growth since the February *Report*.

Over the past three months, employment has continued to rise, albeit at a slower pace than in the second half of last year. Unemployment has edged up from near 20-year lows, partly as a greater number of previously inactive individuals have sought work. The central projection continues to assume that employment growth will slow further, and indeed that employment may fall for a time while output growth is below trend.

Productivity growth has an important influence on firms' unit costs. As noted in the February *Report*, measured productivity growth has been below trend for several years. Moreover, productivity growth weakened further over the past year as employment continued to rise robustly when output growth was slowing. Various explanations for the recent behaviour of productivity have been reviewed further. In its central projection, the Committee has assumed that structural changes in the labour market have reduced the variability of productivity over the cycle. While the reforms are beneficial, they may have temporarily reduced measured productivity growth in recent years. Reforms may have encouraged firms to take on additional employees and to adjust hours worked more quickly than in the past, as well as leading to the creation of new jobs which may have lower than average levels of productivity. Although a natural corollary would be that firms would also reduce labour more quickly in a cyclical downturn, the combination of a relatively tight labour market and perceptions that the slowdown was likely to be relatively moderate may have pushed in the opposite direction in recent months. The Committee judges that productivity growth will return to its long-run historical average over the next two years, although the projected rise in measured productivity growth is somewhat less rapid than assumed in February.

Empirical evidence suggests that firms tend to lower prices in relation to weighted costs when demand falls relative to supply capacity, although the effect may take time to feed through fully. The central projection remains that companies will reduce price-cost margins further in response to the period of weak growth through late 1998 and 1999. The Committee judges the effects of a change in demand on pricing behaviour to be similar on average over the cycle to the assumptions embodied in the February *Report*, but the central projection incorporates the view that a more flexible labour market has reduced the extent to which production is below its desired level, and hence the degree of downward pressure on margins. The Committee recognises that the cyclical behaviour of productivity and price-cost margins is an area of considerable uncertainty.

The Committee's projection for the twelve-month RPIX inflation rate—based on the assumption that nominal interest rates are held constant at 5.25%—is shown in Chart 6.2.(1) It is presented alongside the projection from the February *Report*, which was based on constant interest rates at 5.5%.

There are some differences between the current inflation profile and that shown in February. The starting-point is slightly higher than in February, although this is entirely owing to the temporary effects on duties from the timing of the Budget. As this effect drops out in the second quarter, RPIX inflation is a little weaker than in the earlier projection: the combination of lower non-oil commodity prices, a higher exchange rate and slower earnings growth more than offset the impact of higher oil

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

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 5.25%

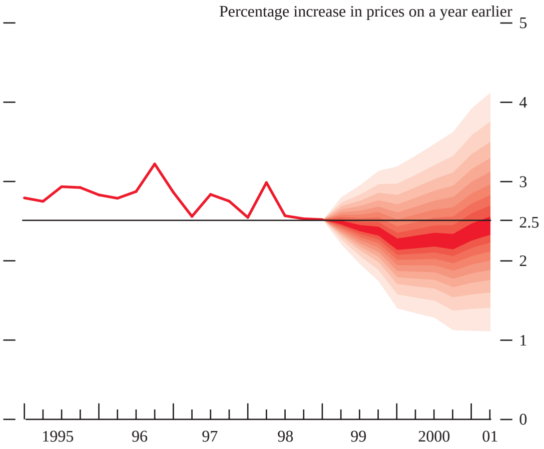
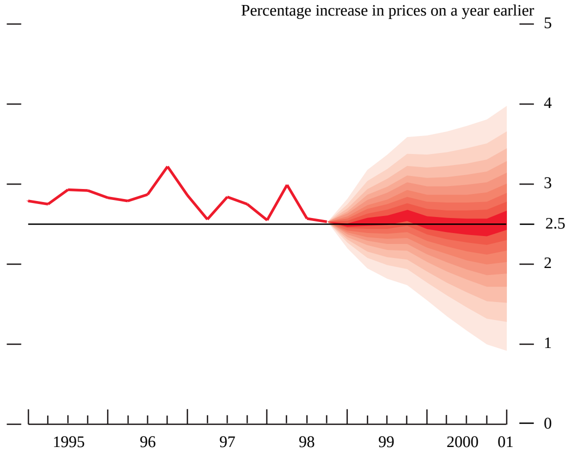


Chart 6.3
RPIX inflation projection in February based on constant nominal interest rates at 5.5%



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. See the box 'How fan charts are drawn' on page 52 of the February 1999 *Inflation Report*.

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 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
1999 Q4	1	13	43	33	9	1
2000 Q4	12	20	25	22	13	8
2001 Q2	10	15	21	21	16	17

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	6	32	43	17	2	0
2000 Q4	1	6	22	34	26	11
2001 Q2	0	4	14	29	30	23

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

prices. Inflation may fall below target for a time. As the temporary effect of the higher exchange rate on imported inflation fades, lower interest rates and slightly stronger prospective output growth than in February underpin the rise in inflation to the target level in early 2001.

Risks to activity are relatively evenly balanced throughout the forecast period, as the Committee judges that global prospects are no longer weighted to the downside around the central projection. A possible fall in equity prices is a downside risk for activity; the possibilities that sterling could be weaker and that stockbuilding could be stronger are counterbalancing upside risks. The risks to inflation are slightly on the upside in both years: the possibility that the exchange rate falls more than implied by interest rate differentials is the main factor. However, some Committee members see greater downside risks to inflation from a stronger exchange rate profile, weaker world activity and prices, and greater pressure on margins, than assumed in the central projection. Charts 6.4 and 6.5 show the overall balance of risks to inflation at the two-year horizon. Table 6.A presents the MPC's judgment of the probabilities of various outcomes for inflation and GDP growth.

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2001 Q2

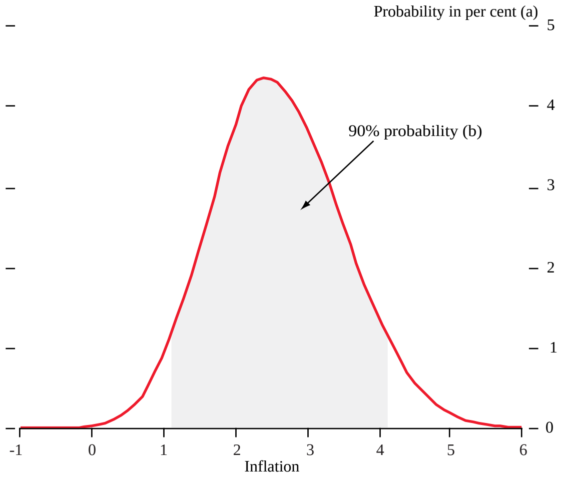
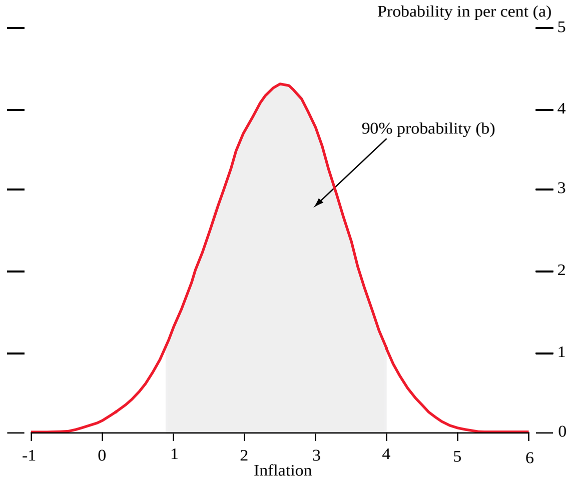


Chart 6.5
February projection for the percentage increase in RPIX in the year to 2001 Q1



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 4.5%.
(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, and the box on page 52 of the February 1999 *Report*.

The market expectation of the likely path of interest rates has risen slightly since the February *Report*. On 5 May, implied interest rates on short-sterling futures contracts suggested that the market expectation was, on balance, for official rates to remain close to current levels or a little below in the near term. There were some expectations of a small rise in rates in 2000. So the MPC's projections for inflation and output growth under the assumption that official rates follow market expectations are almost identical to the constant rate projection (see Charts 6.6 and 6.7).

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

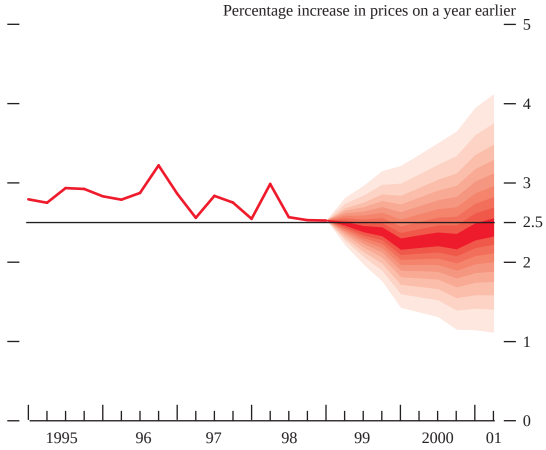


Chart 6.7
Current GDP projection based on market interest rate expectations

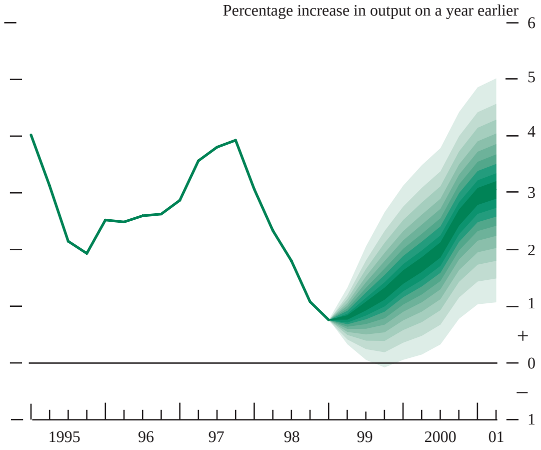
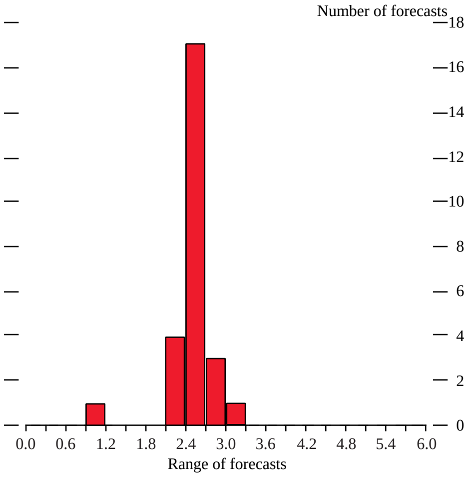


Chart 6.8
Distribution of RPIX inflation forecasts for 2001 Q2



Source: Forecasts of 26 outside forecasters as of 23 April 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 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
1999 Q4	10	23	41	19	6	2
2000 Q4	10	18	35	24	9	4
2001 Q2 (b)	8	15	32	29	11	6

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	9	37	36	14	3	1
2000 Q4	4	12	25	38	14	6
2001 Q2 (b)	3	8	20	37	22	10

(a) 27 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 8% to inflation turning out to be less than 1.5% in 2001 Q2. Rows may not sum to 100 because of rounding.
(b) 26 forecasters.

6.3 Other forecasts

Chart 6.8 shows the distribution of central forecasts for the twelve-month rate of RPIX inflation in 2001 Q2, based on information gathered from 26 forecasters surveyed by the Bank in late April. The mean forecast for the year to 1999 Q4 was 2.2%, rising to 2.3% in 2000 Q4, and reaching 2.4% in 2001 Q2. The estimates for 1999 and 2000 are slightly higher than the projections made at the time of the January survey. The forecasters assign a 45% probability to inflation being above the target in the second quarter of 2001, and a 55% probability to it being below (see Table 6.B). These estimates have changed slightly since the February *Report*, with more weight being placed on higher outturns for inflation.

The forecasters' average projection for GDP growth in the year to 1999 Q4 is $1^1/_4$% (with a range of projections from $^1/_4$% to $2^1/_4$%), rising to 3% in the year to 2001 Q2 (with a range of 2% to $3^3/_4$%). The mean projections are both half a percentage point higher than in January. The forecasters on average assign a 9% probability to output growth falling below zero in the year to 1999 Q4, compared with 20% at the time of the January 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 3–4 February 1999

1 While finalising its quarterly inflation and output growth projections, the Committee discussed the international environment, including world price developments; domestic monetary conditions; household balance sheets and consumption; and labour and product market conditions, including possible explanations for recent below trend productivity growth.

The international environment: activity

2 The Committee's interest rate reductions over the past few months had been heavily influenced by a weakening international environment. In preparing its February *Inflation Report*, it had assessed the cumulative news since its November projections.

3 The strength of the US economy continued to surprise. The official estimate of GDP growth in 1998 Q4 was significantly higher than the Committee had been expecting. The longer such strong growth persisted, the greater the risk that the economy would encounter capacity constraints and rising inflationary pressures, but so far US inflation had remained low. There was also a risk of a negative shock to demand. The strength in the US stock market, and therefore household wealth, was obviously contributing to buoyant consumption, encouraging low private sector savings out of income. The outlook was vulnerable to the possibility of a sharp equity market correction. It was also possible that the increasing trade deficit associated with such strong demand growth would intensify trade policy tensions, although it had to be recognised that the US economy was operating at or above capacity overall. Any possible trade tensions might be ameliorated by the recent appreciation of the yen, although that potentially exacerbated the weakness of aggregate demand in Japan. While continuing robust US demand growth was possible in the short run and was helping to sustain global activity, the balance of risks in the medium term was on the downside.

4 The prospects for the global economy would be better if there were a more positive outlook for demand growth in the euro area. While consumer confidence indicators were quite strong, measures of industrial sentiment were weak. It was not clear whether this reflected recent weakness in activity growth, or whether it was a leading indicator of further output weakness. Possible explanations for the fall in business confidence in continental Europe included the cumulative effects of the emerging market economy crises on export markets and import competition; and uncertainty about economic policies. There seemed to be divergent views in the euro area on the importance of supply-side policies, including structural reform of labour markets; and on the desirable mix of fiscal and monetary policy. A related area of uncertainty was the prospective policy response of the European Central Bank (ECB) if the outlook for demand remained sluggish. Some commentators had speculated that as long as inflation (as measured by the Harmonised Index of Consumer Prices) was in the range 0%–2%, the ECB's definition of price stability, ECB interest rate policy would be in a 'zone of inaction'; ie that the ECB might not respond to expected changes in inflation so long as it was set to remain in that range. Uncertainty about ECB policy at this early point was probably inevitable. It was also noted that the outlook in some of the smaller EMU countries was more buoyant than in Germany, France and Italy; and that the ECB's figures for the three-month centred average of the annual rate of growth of euro area broad money remained slightly above its 4.5% reference rate.

5 Japan remained a concern, with the recession likely to last longer than thought earlier and with the balance of risks in the short run on the downside. There were some positive signs that policymakers would tackle the structural problems in the financial sector. If embarked upon with determination, this would not only be beneficial in itself but might also give a positive signal about policy more generally, and so help to restore confidence. In addition, a consequence of the long recession was that corporate balance sheets were also generally weak, so that financial sector reform—while necessary and important—might well not be sufficient to restore growth.

6 In the emerging market economies, the main event since the Committee's January meeting had been the floating of the Brazilian real, and the questions which that had raised about Brazil's monetary policy and about fiscal sustainability given the structure of its domestic and external debt. So far direct spillover effects seemed to have been small, perhaps because the float had been discounted by markets. The spread of the yield on emerging market US $ bonds over US Treasury Bond yields had, however, risen back towards the highs seen shortly after Russia's default in mid-1998. The situation remained fragile.

7 Taking these developments together, the Committee agreed that the recent news about the international environment underlined its concerns about the world economic outlook, rather than substantially shifted its view compared with a month ago. In particular, the Committee remained concerned about the current and prospective imbalances in the global economy. Given reduced net capital flows to many emerging market economies, the industrialised world probably needed to stimulate domestic demand, to help offset weaker net trade, if world demand growth was to be sustained. So far, with domestic demand very weak in Japan and sluggish in the euro area, the United States had effectively been acting as 'consumer of last resort'. But it was uncertain how long that could last, given the already prolonged period of above-trend growth in the United States. While the balance of risks to activity in Japan was on the downside in the short run but possibly on the upside in the medium run, it was probably the other way round in the United States. The industrialised world therefore faced a formidable challenge in balancing current and prospective aggregate world demand with potential supply. It would be difficult to manage the scale and timing of any adjustments to domestic demand; and industrial countries would need to accept larger current account deficits (or smaller surpluses) while domestic demand was stimulated. The process might in principle be helped by exchange-rate adjustments amongst the major floating currencies, but this was highly uncertain in practice.

The international environment: prices

8 Against this background, the Committee debated the proposition that the world economy could conceivably be on a path to generalised price deflation. The prices of a range of internationally traded goods and services had been falling. Evidence from further along the price chain could be seen in UK manufacturing input and output prices: following a fall of nearly 9% in the twelve months to December, input prices were down to the level prevailing in 1986, and output price growth (which reflected labour costs as well as input prices) had been flat for the first time since 1960. The risk of domestic inflation expectations falling sharply could, on this view, be exacerbated by the coincidence of weak world prices with the prospect of the RPI falling to historically low levels on account of the recent reductions in mortgage interest rates.

9 A number of arguments were made against the prospect of global price deflation. First, the prices of some higher-value-added internationally traded goods and services were still rising. Second,

the path of sterling input prices over the past couple of years had been affected by sterling's large appreciation from August 1996. Third, many G7 central banks were pursuing *de facto* inflation targets (ie annual increases in average prices) of around 2%; for example, the UK's target was 2½% and the ECB defined price stability as 0%–2%. Achieving sustained low inflation was consistent with—indeed probably required—falls in the nominal price of some goods and services while those of others rose, reflecting for example different rates of productivity growth in different sectors, and/or shifting patterns of relative demand. Not all firms could rely on rises in the nominal price of their products and some might have to accept that their prices would normally be falling; but, given the UK's poor inflationary record over the past 25 years or so, it might take time for this to be reflected in firms' behaviour. Fourth, money growth in the United States and in Europe remained reasonably strong. In the medium to long run central banks should be able to determine the average rate of inflation, and the average rate of money growth was a reasonable broad indicator of the trend rate of increase of nominal variables.

10 Overall, the Committee agreed that in the short term there were downside risks to UK domestic prices from weaker than expected world prices. Judgments on the extent of this risk varied.

Monetary conditions

11 Sterling's effective exchange rate had not changed much over the past month. The Committee noted that its recent interest rate reductions had not been accompanied by a fall in sterling.

12 Inflation expectations, as measured by surveys, had fallen further over the past month. It was suggested that they might now be better anchored around the 2½% target.

13 The recent trend in the broad money numbers had been more comforting than during much of 1998. Annual growth in December was 8.1%, and the three and six-month growth rates slightly lower. M4 lending growth had also eased back. Much of the recent fall had been accounted for by the Other Financial Companies sector, and it was too early to tell whether this simply reflected a larger-than-usual seasonal shrinking of balance sheets around the year-end. Household broad money growth, at around 6½%, was higher in December than during most of 1998.

14 Unsecured consumer credit taken out by the household sector had continued to grow strongly. However, it appeared possible that over the past few years this had mirrored lower borrowing via mortgage equity withdrawal, which had been negative since the early 1990s. Work by Bank staff suggested that there had not been a marked change in the relationship between consumption and total borrowing for consumption (as measured by unsecured borrowing plus mortgage equity withdrawal).

15 Overall, the Committee judged that, since its November projections were finalised, the upside risks to inflation from cumulatively strong money growth had eased; and that there was a smaller risk of sterling depreciating by more than implied by interest rate differentials.

Domestic demand: household balance sheets and consumption

16 The Committee noted that the preliminary estimate of 0.2% GDP growth in 1998 Q4 was consistent with the degree of slowdown expected in its November central projection. Some members had feared lower growth, and the possibility of revisions remained. Surveys suggested that consumer and business sentiment had stopped deteriorating and had perhaps improved slightly, possibly helped by the 150 basis point reduction in official interest rates since October. The preliminary data on Q4 expenditure suggested, however, that household spending might have grown by less in relation to income and wealth than the Committee had assumed in November.

17 In this context, the Committee discussed the household sector balance sheet. The ratio of debt-to-net worth was lower than in recent cycles, but this was in part attributable to high equity prices, and so was potentially vulnerable to a fall in the stock market, which among other things might be triggered by a fall in the US market. The ratio of debt service charges-to-household income was also low by recent standards, although this largely reflected low nominal interest rates. On the other hand, the debt-to-income ratio was quite high. Overall the Committee did not regard this as a material concern: the personal sector had increased its debt following the financial liberalisations of the 1980s, so that earlier periods were not a good guide. On this view, the state of household balance sheets was unlikely to provide an explanation for the weaker-than-expected consumption.

18 The Committee noted that some savers had been adversely affected by the fall in interest rates. Some commentators had argued that this would reduce aggregate demand. A number of observations were made about this. The fall in medium-long run nominal interest rates—for example conventional gilt yields—largely reflected quite a large fall in expected inflation. The earlier higher nominal yields had been compensating for the erosion, via inflation, of the real value of their wealth, so that households may in the past have been consuming part of the real capital value of their investment. They could continue to do so in a low inflation environment, but this would mean realising part of their investment rather than spending from high nominal income receipts. It was possible that not all savers understood this, in which case lower nominal rates on savings products might have had a small dampening affect on consumption. But it was unclear why this inflation illusion should influence savers more than borrowers.

19 Against this background and its earlier discussions on this broad issue (reported in the minutes of its December meeting), the Committee noted that it had decided, in preparing its latest projections, to make some allowance for the possibility that consumption growth over the forecast period might not offset the weaker-than-expected outturns of the past few quarters.

Conditions in labour and product markets

20 The outlook for conditions in the labour market was very uncertain. In particular, the recent rate of earnings growth was unusually uncertain, given the continued absence of the Average Earnings Index; and it was unclear why measured productivity growth had recently been below trend.

21 As regards earnings growth, the Committee considered the outlook for pay settlements and for wage drift (the difference between earnings growth and settlements). Settlements had been fairly stable since the middle of 1998; and an informal survey undertaken by the Bank's regional Agents had recorded that more firms expected settlements in 1999 to be below the 1998 level than expected them to be above: wage drift also seemed likely to moderate. Average hours worked had in fact already fallen, so there had probably been a fall in overtime payments. The Reward Index was suggesting that earnings growth had been slowing. The Working Time Directive and the National Minimum Wage were, by contrast, likely to put upward pressure on labour costs. The Committee noted that lower growth in nominal earnings than previously expected would be consistent with the fall in survey-based measures of inflation expectations. The Committee also received an oral progress report on the independent review, commissioned by the Chancellor of the Exchequer, of the official Average Earnings Index. No figures were yet available for the Committee, but the indications were that the review would not be inconsistent at least with the starting point for the path of nominal earnings growth assumed by the Committee.

22 Some members of the Committee were concerned about the potential knock-on effects from the recently announced settlements for public sector workers. Other members thought that, with a reasonably integrated labour market, the public sector could be expected to settle close to the economy-wide average over time.

23 The Committee agreed to incorporate a materially lower profile for nominal earnings growth in its February projection compared with November, although its central projection was still above the average of outside forecasts.

24 There was considerable uncertainty about recent and prospective growth in productivity, and so in unit labour costs. Employment having risen strongly over the past few years, productivity growth had, at around $1^1/_2$% annually, been significantly below trend. The various possible explanations had quite different implications for the outlook for inflation. One possibility was simply mismeasurement. A second was that firms thought the slowdown in activity growth would not last long so that, given the costs of adjusting the size of their labour forces, they were content to employ more people than needed for current activity levels; ie they were hoarding labour. That would mean current levels of employment exaggerated the degree of capacity utilisation at present. Correcting for this would imply lower margins and inflationary pressures.

25 A third possibility was that as unemployment had fallen so had productivity growth, through people entering the workforce into lower productivity jobs, with lower pay, following the various structural reforms to the labour market. In that case, productivity would be expected to grow in the future at its past trend rate but starting from a lower average level. Productive capacity, at any particular level of employment, would in that case be lower than implied by previous relationships. This would have less benign implications for inflation than the labour hoarding explanation.

26 The Committee agreed to give some weight to each of these possible explanations in its central projection. However, some members did not attach weight to the third possible explanation, pointing to recent robust growth in labour productivity in the United States despite very low unemployment there; excluding it would reduce the central projection for inflation by around 0.2 percentage points.

The MPC's February projections

27 The Committee reviewed its projections, which were described more fully in the *Inflation Report* published in the week following the meeting.

28 Output growth was expected to fall during 1999 but to recover during 2000, partly reflecting planned increases in public sector spending. As in November, the balance of risks to activity was on the downside over the whole of the forecast period. The shape of the central projection for inflation was broadly flat over most of the forecast period, rising slightly towards the two year horizon. The balance of risks to inflation was slightly on the upside until the middle of the year 2000 and then slightly on the downside. Uncertainty about the projections (ie the variance) had been adjusted to reflect the continuing suspension of the Average Earnings Index.

29 For any given level of interest rates, the <u>level</u> of the projections for both output growth and inflation was lower than in November. The main changes to the output projection were lower consumption and the weaker outlook for world demand and UK exports. The inflation projection was also affected by the lower path assumed for nominal earnings growth. If interest rates were left at 6%, both the central projection for inflation and the average projection (taking account of the balance of risks)—ie both the mode and the mean—were materially below the $2^1/_2$% inflation target. The projections therefore pointed towards a further reduction in interest rates.

30 The Committee discussed the predictions of a sample of outside forecasters. The median forecast for inflation was around $2^1/_2$% in 2001 Q1. It was possible that this simply reflected a belief that the Committee would pursue a policy that would succeed in achieving the $2^1/_2$% target at that horizon. The assumptions of outside forecasters about interest rates were also likely to differ from the constant rate assumption used in the Bank's own projections.

31 The Committee noted that the level of short term interest rates implied by financial markets fell to around 5% by the end of 1999. Using market interest rates in the Bank's projections implied that both the central projection for inflation and the average projection (taking account of the risks) would be above the $2^1/_2$% target from the middle of 1999, and materially so by the end of the two year forecast horizon.

The immediate policy decision

32 The Committee discussed whether its latest projections for GDP growth and inflation had implications for the timing of any policy changes. In particular, should any further reductions in interest rates be made quickly given that the most significant weakness in activity was expected over the next six months? Would cuts now endanger the inflation outlook over the medium run given that towards the end of the forecast period output growth was expected to reach trend and inflation to be rising? The Committee agreed that various time paths for interest rates would be consistent with achieving the inflation target. Its central projection was for the annual rate of output growth to be below trend for the next six quarters, so that an immediate easing of policy could stimulate activity and reduce downward pressures on inflation in the short run without causing an overshoot of the target over the medium run. Policy might then have to be tightened at some point in the coming two years if output growth recovered as expected, but that could not yet be judged, and it did not need to be.

33 Against that background, there was agreement that interest rates needed to be reduced again. A 25 basis point reduction, taking the Bank's repo rate to 5.75% would leave the central projection below target throughout the second year of the forecast period. A 50 basis point reduction, to 5.5%, would bring the central projection broadly into line with the target throughout the forecast period. At the two year horizon, the central projection would be just a little above the target; the average projection (taking account of the balance of risks) would still be slightly below target. It was noted that some of the risks reflected in the forecast were of a kind to which the Committee could respond if and when they materialised. Setting aside risks of this kind, the average rate of inflation at the end of forecast horizon with constant 5.5% official interest rates was also close to the target. These considerations pointed towards a 50 basis point reduction.

34 A second argument made in favour of 50 basis points was that it would provide a degree of insurance against some of the downside risks. In particular, the international outlook looked slightly more fragile than a month ago, and there was a risk of labour market pressures proving materially weaker than assumed in the Committee's projections.

35 A third argument for 50 basis points was that any consequential fall in sterling would be helpful in alleviating the continuing imbalances in the economy, without endangering achievement of the inflation target.

36 One view was that at this point of the economic cycle interest rates should be close to, or possibly below, their 'neutral' level; ie, providing neither stimulus nor constraint to the economy. While that level could not be stimulated with great accuracy, a

reduction of 50 basis points, on this view, would take the nominal short term rate into its probable neutral range. Three reasons were given why, on this view, a reduction of more than 50 basis points might be needed. First, it might already be too late to stop RPIX inflation falling materially below target over the next year. In that case, a larger cut would help to anchor inflation expectations closer to the target over the medium run. Second, it was plausible, judging from the reports of the Bank's regional Agents and from surveys, that earnings growth would be lower in 1999 than in 1998, contrary to the assumption used in the Committee's central projection. Third, the Committee's inflation projection did not place enough weight on the possibility of world price inflation being weaker than assumed. However, evidence on each of these uncertainties would materialise over the next few months, and a larger than 50 basis point reduction now might unsettle financial markets. On this view, therefore, a cut of 50 basis points was the right step for now.

37 On another view, there were arguments for a reduction of 75–100 basis points. First, the central projection for inflation was around 0.2 percentage points too high because the level of productivity would be higher than assumed for the reasons explained in paragraph 26. The average (ie mean) projection for inflation, should also be lower both for that reason and also because of the possibility of weaker world prices. Second, given that monetary policy was expected generally to affect activity growth with a shorter lag than it affected inflation, it would be possible to ease policy by more than 50 basis points now with a view to supporting activity in the relatively near term without endangering achievement of the inflation target. On this view, these two factors together made a reduction in the range 75–100 basis points desirable.

38 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be cut by 0.50% to 5.5%. 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 0.75%.

39 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

40 Andrew Turnbull 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 29 January 1999, in advance of its meeting on 3–4 February 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 by 0.6% in January and the annualised three and six-month growth rates had picked up to 7.1% and 6.1% respectively, after adjusting for the effects of the introduction of the 50p and £2 coins. However, new estimates of seasonal factors had led to the December monthly growth rate being revised down from 1.2% to 0.6%. In the past, there had been some correlation between monthly changes in notes and coin and current and future changes in the value of retail sales.

3 The twelve-month growth rate of M4 had been 8.1% in December, the lowest since June 1995. Annualised three and six-month growth rates had been below the twelve-month rate. The slowdown had been driven by other financial corporations (OFCs): the twelve-month growth rate of OFCs' M4 in 1998 Q4 had been 16.0%, the lowest since 1995 Q2. This figure could have reflected a temporary contraction of OFCs' balance sheets at the end of the financial year.

4 Households' M4 growth had continued to pick up in 1998 Q4. The three-month annualised growth rate in the quarter had been 9.0%, the highest since 1997 Q1, and the six-month annualised rate of 8.1% had been the highest since 1997 Q2.

5 The £0.2 billion fall in private non-financial corporations' (PNFCs') deposits during 1998 Q4 had been the first fall since 1995 Q2. The twelve-month growth rate had fallen to 3.5% in Q4 from 5.2% in Q3. Firms may have been using bank deposits as a form of 'buffer stock' to smooth fluctuations in cashflows as they adjusted to changes in demand.

6 M4 lending had also continued to slow in December. The twelve-month rate, at 7.5%, had been the lowest since April 1995, while the three and six-month annualised growth rates had remained below the twelve-month growth rate. As with M4, the slowdown had been led by OFCs. The twelve-month growth rate of OFCs lending had fallen to 9.7% in 1998 Q4, down by 6.0 percentage points from 1998 Q3, and the lowest level since 1994 Q3. As with their M4 deposits, contraction of financial institutions' balance sheets at the year end had contributed to weak OFCs' lending in Q4.

7 M4 lending to the household sector had remained firm in 1998 Q4, growing by 7.5% on a year earlier. Within the comprehensive measure of lending to individuals, the growth of secured lending had been steady at 5.9%, despite a slowdown in the housing market. Growth in unsecured lending had remained high in Q4, at 16.3%.

8 The recent strength of unsecured lending contrasted with the relative weakness of consumption. One interpretation was that this was a shift from other forms of borrowing such as mortgage equity withdrawal. Wider measures of consumer borrowing, which included equity withdrawal, had continued to show a closer relationship with consumption in recent quarters.

9 The twelve-month growth rate of M4 lending to PNFCs had picked up in 1998 Q4 (by 0.5 percentage points, to 6.4%), although the three and six-month growth rates had remained below the twelve-month rate. Total external borrowing by PNFCs in Q4 had fallen slightly, by £0.3 billion to £7.3 billion, mainly reflecting lower net capital issues in foreign currency.

10 Banks and building societies had announced further cuts to standard variable mortgage rates following the reduction in official rates in January. Mortgage rates had been reduced by the full 150 basis point cut in the repo rate since October. Credit card rates had fallen again in December, especially among long-established lenders. This was indicative of competition from new entrants in the market.

11 Inflation expectations for 1999 as measured by surveys of professional forecasters, conducted by Consensus Economics (forecasts of average 1999 RPIX inflation), HM Treasury (forecasts of 1999 Q4 RPIX inflation) and the Merrill Lynch survey of fund managers (forecasts of RPIX inflation in the year to December 1999) had remained largely unchanged in January, and were between 20 and 40 basis points below the Bank's inflation target. Inflation expectations for 2000, measured by the same institutions and on the same basis, had all been 2.2%. The Merrill Lynch survey had been conducted prior to the cut in the repo rate on 6 January.

12 Estimates of short real rates had been made by subtracting the Merrill Lynch survey measure of inflation expectations from the corresponding-maturity wholesale money-market rate. This calculation had suggested that the one-year real forward rate for 2000 had fallen during December, by around 20 basis points.

II Demand and output

13 GDP had risen by 0.2% in 1998 Q4 and by 1.6% compared with a year ago. Service sector output had grown by 0.6%, compared with 0.8% in Q3. December manufacturing output data had not yet been published, but in the three months to November, output had fallen by 1.1%. Car production had fallen by almost 4% in 1998 H2 compared with 1998 H1: production for export markets had risen by 7%, whereas production for home markets had declined by 17%. But there had been anecdotal reports that export orders for cars were falling. Within services, distribution, hotels and catering output had been flat in Q4.

14 Retail sales volumes had fallen sharply in December, by 0.9%, more than reversing November's rise. In Q4 overall, sales volumes had fallen by 0.2%, the first quarterly fall since 1992 Q3. The annual growth rate had stood at 1.4% in Q4. The underlying trend in retail sales growth had still been downward.

15 Quarterly growth in retail sales and National Accounts data for spending on retail goods had not always been consistent. For example, there were different surveys for food. And car registrations data had implied a rise in spending on cars in Q4. It was possible that, overall, consumption growth in Q4 had not been as weak as the retail sales data suggested.

16 Surveys for plant and machinery investment had continued to indicate a slowdown in investment growth. The Confederation of British Industry (CBI) Industrial Trends and British Chambers of Commerce (BCC) surveys for Q4 had indicated that, on balance, manufacturers had intended to reduce investment, though there had been some easing in the CBI survey balance (from -32 to -21). The BCC survey balance for the service sector had continued to show positive investment intentions, though the balance had fallen from +27 in Q2 to +17 in Q4. Around 50% of whole-economy investment tended to be accounted for by investment in buildings. And construction new orders had been rising during 1998.

17 The CBI survey had suggested that although manufacturers had sharply reduced their stocks of finished goods in Q4—the balance had fallen to -14 from +3—stocks had remained high relative to expected demand. An unwinding of stocks had been consistent with falling manufacturing output in Q4. The CBI Distributive Trades survey had also indicated that retail stocks had remained excessive relative to demand in December.

18 The total goods trade deficit had widened in November, mainly because of a deterioration in the non-EU balance. The total deficit in the three months to November had been £6.3 billion, the highest since October 1989. In December, the non-EU goods deficit had narrowed slightly. For 1998 as a whole, the non-EU goods deficit had been a record £15.7 billion; the value of exports to South East Asia had fallen by 27%, and the value of imports from that region had risen by 3%. Total goods export volumes (excluding oil and erratics) had been falling—by 2.2% in the three months to November—whereas import volumes had risen by 2.7%. The fall in exports had been largely explained by cars and other consumer goods. The CBI export orders balances had recovered a little in Q4, but still pointed to falling export volumes.

19 The Halifax house price index had risen by 0.5% in January, after having fallen by 0.1% in December, taking the annual inflation rate to 4.4% from 4.5%. The Nationwide index had risen by 1.4% in January, with annual inflation up to 7.4% from 7.0% in December. Activity as measured by particulars delivered had been 8% down in the three months to December on the previous three months, and leading indicators of housing market transactions had pointed to flat or falling transactions in the coming months. New house-building activity had also remained weak, though the House Builders' Federation survey reported that nearly two thirds of builders planned to increase starts in 1999.

20 GfK consumer confidence had risen in January. But the survey balance was not seasonally adjusted, and tended to rise in January. It had remained negative (-2.2) and below its level a year earlier. The divergence between consumers' perceptions about the general economic situation and their own financial situation, which had emerged in mid 1998, had remained evident. Consumers had still expected the general economic situation to deteriorate, but had expected their own situation to improve.

21 Companies had appeared to be in a stronger financial situation than they were in the late 1980s-early 1990s. An examination of the distribution of gearing across quoted companies had suggested that most of these companies should have been able to service their debt with relative ease. And the market valuation of the corporate sector had suggested that future profits would also be high relative to the interest costs of servicing debt. But income gearing had been rising, and (possibly associated with that) the rate of insolvencies had begun to increase.

22 The deterioration in manufacturing survey balances for orders and expected orders had eased: the CBI export optimism balance had risen to -18, from -41 in 1998 Q3 and a low of -50 in Q2. But they had still pointed to a decline in manufacturing output in 1999 Q1. Supporting this, the Chartered Institute of Purchasing Supply (CIPS) manufacturing output index for January was 42.3: below the 50 'no change' level. The BCC home orders balance for the service sector had declined further in 1998 Q4, from +11 to +5, suggesting a further slowdown in service sector output growth in 1999 Q1. But the BCC survey had also indicated that the balance of firms in the manufacturing and service sector that had been operating at or above full capacity in 1998 Q4 had been relatively high.

III International environment

23 In the United States, GDP had risen by 1.4% in Q4. Consumers' confidence about current conditions had risen in January, but expectations of future conditions had continued to fall. Non-farm payrolls had risen sharply in December, keeping employment growth at 2.3% on a year earlier. However, there continued to be sharp sectoral differences: employment had been falling from month to month in manufacturing for most of 1998, while growth in the rest of economy was still robust. Capacity utilisation had fallen slightly in November. Survey measures of slack had also pointed downwards.

24 The trade deficit had widened to $15.5 billion in November, but the trend over recent months had been unclear. The overall consumer price index had increased 1.6% on a year ago in December. The difference in goods and service price inflation had persisted. This had partly reflected differences in labour cost inflation. The Employment Cost Index for services had risen more sharply than for manufacturing in 1998.

25 In Europe, recent production data had been stronger and consumption data had been weaker, somewhat against the recent trend. French industrial production had risen by 1.0% in November and by 0.7% in October. Italian industrial production had shown a stronger trend, but November production had fallen by 1.5% on a month ago. German industrial production had fallen by 2.2% in November, and manufacturing orders had pointed to a further sharp slowdown in the coming months. German GDP in the fourth quarter had probably fallen. French household consumption had fallen in December for the third consecutive month. Industrial confidence in the euro area had fallen to -9 in December, from -8 in November and +1 in December 1997. Consumer confidence had risen in December in most countries, although not in Spain or Germany. Euro-area HICP fell to 0.8% in December.

26 In Japan, the Economic Planning Agency had expected positive GDP growth in the fourth quarter, resulting from increases in private consumption, public investment and net trade. But despite discounting by retailers, Japanese retail sales had remained weak in December. Employment had continued to fall in manufacturing and the construction sectors, though public works spending had slowed the fall in construction. Central government new construction orders had increased from September onwards, but they had been more than offset by the contraction in local government new orders. Industrial production had risen strongly in December. But for 1998 as a whole, industrial production had fallen by 6.9%, the largest fall since 1975. Inventory levels and the inventory/shipments ratio had both fallen in December. Overall, there had been little evidence of a recovery in private sector activity. Bank lending had continued to decline at record rates, the outlook for consumption had remained weak, and public works spending had remained ineffective.

27 The Consensus Economics mean forecast for Japanese GDP growth had fallen by 0.5 percentage points to -1.1% for 1999; for US GDP growth, it had been revised up, from 2.3% in December to 2.4% in January; and for GDP growth in Germany in 1999, it had fallen from 2.0% to 1.8%.

Emerging markets

28 The devaluation and subsequent float of the Brazilian real had resulted in a 32% depreciation against the US dollar between 12 January and 3 February. Short-term interest rates had been increased by just over 9% since the devaluation, to 39%.

29 The more pessimistic scenarios that had been discussed in the market assumed financial contagion from Brazil to a much wider range of countries. There had been evidence of pressure on fixed exchange rates in, for example, Argentina and Hong Kong, but not as yet a wider impact such as that which had followed the Russian default. The pre-EU accession countries in central Europe had been in a position to borrow externally and to ease monetary policy. The Asian crisis countries (except Indonesia) had had some, albeit limited, access to external funds, in some cases with the guarantee of Japan or the World Bank. Nevertheless, the

external financing prospects of emerging countries in aggregate had continued to deteriorate.

IV The labour market

30 LFS employment had grown by 98,000 (0.4%) in the three months to November, compared with the previous three months, consistent with the Workforce jobs growth figure, released in the previous month, of a rise of 97,000 in the three months to September. The increase in LFS employment had been largely accounted for by a large rise in employees, but self-employment had also risen, ending the steep decline earlier in the year. The total number of hours worked had risen more slowly than employment (by 0.1% in the three months to November), implying a fall in the number of hours worked per person, consistent with the increase in LFS employment over this period being concentrated in part-time jobs. Hours worked per person were 0.8% lower than a year earlier.

31 Strong increases in employment had contrasted with survey evidence. The CIPS manufacturing and construction surveys for January had suggested that employment was continuing to fall. The CIPS services survey for January had suggested that employment was now falling in services too. Forward-looking surveys had suggested that this pattern might persist. The BCC services survey for Q4 had shown that employment intentions were broadly unchanged, while the manufacturing balance had become more negative. The CBI manufacturing survey balance had also become more negative, to its lowest level since 1992 Q3. The Federation of Recruitment and Employment Services survey had also suggested that the demand for employees was falling.

32 The number of new notifications at job centres had fallen by 3,500 in December, while the stock of vacancies had fallen by 3,900. The National Press Recruitment Advertising index had stabilised in recent months. The BCC survey for Q4 had suggested that recruitment difficulties in manufacturing and services had eased slightly. But the CBI Industrial Trends survey for Q4 showed a small rise in expected skill shortages in manufacturing in the next few months.

33 Both of the main measures of unemployment had fallen on the latest data. LFS unemployment had decreased by 26,000 in the three months to November. The LFS unemployment rate had been unchanged from the three months to October, at 6.2%. Claimant-count unemployment had fallen by 14,000 in December to its lowest level since June 1980, though the rate had also remained unchanged, at 4.6%. There had been little sign of increased redundancies in the claimant-count inflow numbers, while the exit rate from unemployment had remained high.

34 Labour market inactivity had not seemed to be following a normal cyclical pattern. It had been increasing in the first half of 1998, but had reversed since June. According to the LFS, inactivity had fallen by a further 33,000 in the three months to November. The fall in inactivity in this period had been smaller than in recent months and, in an accounting sense, this had explained why the latest employment increase had—unlike those of recent months—been accompanied by a fall in unemployment.

35 There had been no new official earnings data: the Average Earnings Index was still suspended. The Reward index of earnings growth had slowed further to 4.8% in December from 5.4% in June.

36 The twelve-month employment-weighted average settlements measure had remained flat in December, at 3.7%. But most settlements tended to be concentrated between January and April. Private and public sector settlements remained unchanged, at 4.0% and 3.3% respectively. The three-month employment-weighted mean increased from 3.8% in November to 4.1% in December, while the median fell from 3.8% to 3.7%.

37 Details of the settlements for public sector workers covered by the Pay Review Bodies had been announced on 1 February. Overall, the paybill of workers covered by the Review Bodies was to increase by 4.1% and the settlements would not be staged.

38 The Bank's regional Agents had conducted an informal survey of contacts on the prospects for earnings growth in 1999. Of the firms sampled that had a company-wide settlement, 46% had expected it to be lower in percentage terms in 1999 than in 1998. Only 13% of firms had expected their settlement to rise. But 29% of firms had expected growth in total earnings per employee to be higher in 1999, with 38% expecting it to be lower.

39 The inflation outlook and company prospects, particularly in the manufacturing sector, were highlighted by these respondents as factors likely to depress earnings growth in 1999. A majority had cited recruitment difficulties as an upward pressure on earnings growth. Other widely quoted upward pressures had included productivity growth and bonuses, the latter reflecting increased use of performance-related pay across firms. Some respondents had also mentioned the National Minimum Wage, the Working Time Directive and the phased end of Profit-Related Pay (PRP) tax benefits.

V Prices

40 On the basis of provisional data, in the Bank's index of commodity prices excluding oil had shown a small rise in December. The annual rate of inflation had risen slightly to -6.2% from -6.3%, and the underlying growth rate (three months on a year earlier) had risen to -5.3%, the highest rate since August 1997. That had been driven by recent growth in UK agriculture prices and a slowdown in metals price deflation. Nonetheless, market commentators had forecast a slight fall in commodity prices in 1999, before a pick-up in 2000. Commodity prices including oil had continued to fall, by 2.5% in December, according to the Bank's index.

41 Oil prices had risen to more than $12 per barrel at the beginning of January, following reports of a big fall in US oil inventories in the first week of December. But, thereafter, markets had been subdued by profit-taking and the lack of further OPEC production cuts. The price had fallen to $11.46 per barrel by 6 January.

42 Input prices had fallen again in December, by 1.2%, giving annual deflation of -8.9%. Since their peak in September 1995, input prices had fallen by 22.4%, and prices were at a level last recorded in 1986. Output prices excluding excise duties had been unchanged in December, giving annual deflation of -0.8%. And total annual output price inflation had fallen to zero, its lowest rate since March 1960. The CBI Industrial Trends survey had suggested a further fall in prices in January.

43 There had been no obvious reaction so far to sterling's depreciation from export or import price inflation. Total import prices from the world had fallen by 6.0% in the year to November (-7.0% to October), and total export prices to the world had fallen by 4.7% in the year to November (-5.5% to October).

44 RPI inflation had fallen by 0.2 percentage points to 2.8% in December. RPIX inflation had risen by 0.1 percentage points to 2.6% in December; RPIY inflation had risen by 0.2 percentage points to 2.0%. Seasonal food had become the most inflationary sector in the RPI, as unfavourable weather had again affected supply. Household goods prices had risen strongly, but over the past decade, household goods prices had risen in December and then fallen sharply in January 'sales'. The gap between goods and services price inflation had narrowed in December.

45 The only new data on other measures of inflation since the January MPC meeting had been on the retail sales deflator and the

harmonised consumer prices index (HICP). Retail sales deflator inflation had risen by 0.4 percentage points to 1.3% in December. HICP inflation had increased by 0.1 percentage points to 1.5%. The increase had been similar to RPIX and for the same reasons, but the 1.1 percentage point gap between the two inflation rates had remained unusually high. The effect of using the geometric mean in calculating HICP inflation had continued to account for much of that difference. The geometric mean effect had increased over the past decade, while inflation had declined.

46 The UK HICP had been 0.4 percentage points above the EU average in November. Although UK goods price inflation had been below the EU average in November, UK services price inflation had been well above average.

VI Agents' national summary

47 The Bank's regional Agents gave their assessment of economic developments, drawn from discussions with contacts over the past month. Construction output had continued to grow, boosted by Millennium, railway and public sector work, but growth had been expected to slow during the course of 1999, reflecting weaker orders. Housing starts had remained subdued, but there had been some evidence of a recovery in the secondary housing market in certain regions. Manufacturing contacts had continued to report falling output and excessive stocks, despite extended shutdowns in some areas. Competition from cheaper imports had remained intense. Further reductions in output had been expected in the first quarter of 1999, although there appeared to have been some recovery of manufacturing sentiment in some regions, reflecting an improvement in perceived export prospects.

48 Retailers had seen a late surge of sales before Christmas, and there had been quite a strong early start to the January 'sales'. But sales of most goods had subsequently fallen off, and most retail contacts still considered their stock levels to be excessive. Sales of consumer services had continued to grow, but at lower rates than earlier in 1998. Business service growth had remained strong in a number of regions.

49 Banks had been reporting lower demand for borrowing, as manufacturers deferred new investment plans. And several of the Bank's Agents had been told of a rise in late payments by small and medium-sized firms. But there was some evidence that banks had been attempting to address credit problems more proactively and earlier than they had done in the previous cycle.

50 Manufacturing employment had continued to fall. A spate of redundancy announcements in the durable goods sectors and elsewhere in recent weeks had yet to reach the official figures, and several firms had indicated that they would be reviewing employment levels again during the first quarter. Services employment had continued to grow, but at a lower rate.

VII Information from financial markets

Foreign exchange

51 The sterling effective exchange rate index had appreciated by 1.1% since the 6–7 January MPC meeting and by 0.2% from the (15-day average) starting-point in the November *Inflation Report*. The central projection in the November *Report* had assumed a small depreciation over this period and so 'news' about the exchange rate amounted to a small appreciation. But movements in yield curves in the United Kingdom and overseas had suggested that news about monetary policy had not explained the most recent appreciation. Outside forecasts for sterling made at the start of the year had been on average for a fall of nearly 4% in effective terms through 1999, slightly more than implied by forward rates.

52 Over the month as a whole, the dollar had strengthened markedly. The appreciation of the euro at the start of its life had been short-lived; soft data, particularly from Germany, had led to expectations of lower euro interest rates relative to those for the United States. Initially, the dollar had also fallen sharply against the yen (to a low of ¥108.2 on 11 January), as further short yen positions had been squeezed out. The floating of the Brazilian real had created some initial nervousness, but had had only limited impact on other currencies.

Government bond and money markets

53 UK data and survey releases had raised slightly interest rates implied by the nearest short sterling contracts. But the longer contracts and the UK bond market had rallied further. Nominal and real gilt yields had been very low by historical standards and by comparison with other countries with similar or lower inflation. Recovering market confidence and low gilt yields had led to some recovery in non-government sterling bond issuance in the fourth quarter, but a significant proportion had been by supranational bodies. The yield spread over gilts paid by credits below top quality remained high.

54 UK forward rates implied by gilt yields were below those implied by German government bond yields from five years out. However, forward rates from swap curves had shown UK-German convergence at medium (7–10 year) maturities. Institutional demand for gilts and limited net issuance might have been having a material effect on gilt yields, pushing them below the level implied by expectations of future interest rates.

Equity and corporate debt markets

55 Although the Brazilian real float had had a positive impact on the local stock market, it had checked the recovery of equity prices in most major countries, though not in Japan. In a number of countries, including the United Kingdom, bank share prices had both fallen absolutely and relative to general indices. Credit spreads in bond markets and in the swaps market had generally fallen, particularly for lower-rated companies. Spreads for UK bank bond yields over other UK corporates had also fallen.

56 Downward profit warnings by UK companies in January had again been more numerous than a year earlier. Trading statements from some general retailers had adversely affected their share prices, although the sector as a whole had not fallen relative to the market. Small company shares had continued to underperform. Underperformance had appeared cyclical.

Minutes of the Monetary Policy Committee meeting on 2–3 March 1999

1 The Committee discussed the prospects for the world economy; money and financial markets; demand and output; the implications of the Budget projections for the macroeconomic outlook; the labour market; prices; and other considerations bearing on the decision this month, before turning to its immediate policy decision.

The world economy

2 Activity in the United States economy had again been stronger than expected over the past month. Indeed, provisional estimates suggested it had contributed around half of the increase in world demand in 1998, well in excess of its 20% share of world output. The National Association of Purchasing Managers (NAPM) index had strengthened—partly reflecting an improvement in export orders. This was surprising given recent weakness in the world economy and the strength of the US dollar. There were, perhaps, some parallels with the UK survey data. However, the prospects for the US economy as a whole still seemed to be for slowing growth over coming quarters. On balance, prospects for growth in the euro area had weakened over the month, but with considerable inter-regional variation. The weak Q4 output data in Germany and Italy had more than counterbalanced some stronger than expected French data. In Japan, there were now signs that financial restructuring was taking place but, in the short run, this might exacerbate the weakness in credit conditions. The immediate prospects for activity there did not seem to have changed much over the past month. Overall, there seemed to be little change in the prospects for UK export demand from developments in other major industrial economies.

3 The situation outside the OECD had not changed much over the past month. There had been renewed difficulties in Brazil, and the real had weakened. There was still a risk of contagion, but other major countries in South America were not obviously under pressure. The lower oil price had already led to lower imports by the oil exporting countries and this could be seen in UK exports, but otherwise developments over the month were much as expected overall.

Money and financial markets

4 Narrow money growth continued to be quite strong, and was possibly being influenced by the past reductions in interest rates. Broad money growth was continuing to ease, and it was noticeable that the shorter three and six-month annualised growth rates were below the twelve-month growth rate. The risks from past rapid growth in broad money had diminished.

5 The sterling effective exchange rate was currently over 2% higher than the 15 day average used as the starting-point for the February *Inflation Report* projections. The FT-SE All-Share index had risen by 2% since the February *Report*. The rise in share prices was broadly based, with both the FT-SE 100 and Small Capitalisation indexes rising over the period. This was in contrast with earlier periods when the FT-SE 100 had grown faster than the Small Capitalisation index.

6 The rise in the sterling effective exchange rate reflected the balance of two offsetting bilateral movements; sterling had depreciated against the US dollar but had appreciated against the euro. The implications for UK inflation would depend on the reasons for the changes. Political and economic developments in the euro area probably accounted for some of the depreciation of the euro against the dollar and sterling over the past month. It was possible that the weakening euro reflected the market's expectation that prospects for euro-area demand and output growth were weaker than for the United States, and perhaps for the United Kingdom as well given the possibility of faster growth here in late 1999 and 2000. There was evidence that the movement in interest rate differentials could account for some of the rise in sterling.

7 The rise in the exchange rate and in equity prices would have opposite effects on the central projection for inflation, but the movement in the exchange rate was thought to be the more significant of the two. To the extent that sterling's strength persisted it would increase the imbalance between the traded and non-traded sectors of the economy, and would require a strengthening of domestic demand if inflation were not to fall below target.

Demand and output

8 The level of GDP in 1998 Q4 had been revised down by $^1/_4$% since the preliminary output estimate available at the time of the February *Inflation Report*. The expenditure composition had also been published, and this showed slightly weaker final domestic demand than assumed in the central projection. The rise in inventories had also been stronger than expected, leaving domestic demand growth a little stronger overall. But faster domestic demand growth had been offset by a larger negative contribution from net trade (primarily weaker exports), and so GDP growth in the fourth quarter was, at 0.2%, unchanged from the time of the February *Report*. The statistical discrepancy between the expenditure and average measure of GDP was 0.6% in 1998 Q4. But due to the suspension of the Average Earnings Index there was no income measure of GDP available for Q4. Within the output breakdown, the fall in construction output for the third successive quarter seemed surprising given recent orders and survey data.

9 Consumption growth had been revised down in 1998 Q3, but the level in Q4 was not materially different from that expected at the time of the *Report*. Hence, the puzzle as to why consumption growth had weakened so much through 1997–8 remained. Retail sales (around 40% of consumption) had recovered in January, but the underlying picture remained fairly weak. Consumer confidence in January had risen for the third successive month on the GfK measure. It was likely that the five reductions in interest rates since the autumn had played a material role in stabilising confidence, but it was difficult to be sure how robust the recent recovery was. More work was needed to understand how consumer confidence was affected by changes in interest rates. There were also some signs of a pick-up in the housing market, particularly in the indicators which are at the start of the house buying process, such as House Builders Federation site visits and reservations. There seemed little news in the latest house price figures.

10 The build-up in inventories appeared a little puzzling as it was not apparent in either the official manufacturing or retail distribution figures, where any signs of weaker than expected demand might be expected. The rise in stocks in the fourth quarter—and for 1998 as a whole—had been concentrated in the 'other industries' sector, which included the quarterly alignment adjustment (between the expenditure and output measures of GDP). It was possible that this rise in stocks could partly reflect a change in the pattern of car registrations this year, which would not as yet be accounted for in the usual seasonal adjustment.

11 The news in the national accounts and recent surveys could be interpreted in several ways. First, the lower level of GDP than in previous estimates, coupled with the build up of inventories, might point to a weaker picture for demand than previously thought. In particular, the weaker outturn for exports in Q4, and the sharp fall in the volatile non-EU exports figure in January,

might point to some of the downside risks to external demand coming through. But the changes in the composition and revisions to the level of GDP were not particularly large.

12 Second, the lower level of GDP, coupled with the latest survey data, raised the question of whether the low point in output growth might have come a little earlier than previously expected.

13 Third, the surveys, though generally remaining weak, had all been stronger over the past month. That uniformity was somewhat surprising, and might indicate a slightly better picture than previously thought. Some of the survey indicators were recovering towards levels recorded last summer, before the sharp deterioration occurred. Of particular note had been the improvement in export orders in both the CBI and CIPS surveys over the past month. So to the extent that the surveys had for a while been painting a weaker picture for exports than the ONS data, that gap now appeared to be closing.

14 Overall, the data did not significantly change the picture for demand and output. The improvement in survey data might prove significant, but had yet to be seen in the official data.

The forthcoming Budget

15 Prior to the meeting, the Committee was briefed by Treasury officials about the forthcoming Budget's expenditure and revenue projections and macroeconomic forecasts, but not the detailed measures. The overall fiscal position was reported to remain stable, and was in line with the assumptions in the February *Inflation Report*.

16 At the MPC meeting, the Committee briefly discussed the lower than planned Net Departmental Outlays seen in the first ten months of the 1998/99 fiscal year. This was primarily related to social security rather than other government departments' spending on goods and services. But since the control framework was new this year, it was not known what would happen to spending at the end of the year: departments had less of an incentive to spend their budgets in the final weeks of the fiscal year as they could carry spending forward to future years, which could have timing consequences for the pattern of real demand.

Labour market

17 The Committee had been briefed by Mr King and by Bank staff before the meeting on the review of the Average Earnings Index, which was published on 2 March. Earnings growth was now estimated to have reached a peak of 5.7% in May 1998, before falling back to 4.5% in November on the headline measure. Preliminary estimates of unit wage costs produced by Bank staff using the revised Average Earnings Index suggested a stronger picture for the first half of 1998 than previously thought, and a weaker picture in the second half of the year with the rate of change flat at around $3\frac{3}{4}$%.

18 The general pattern of earnings growth through 1998 was broadly consistent with the assumptions that had been made at the time of the February *Inflation Report*. That gave the Committee members somewhat greater confidence in the starting assumptions for earnings growth than they had felt at the time of the *Report*. However, the pace of slowdown in earnings growth was more marked than had been assumed: starting from a higher level and ending a little below the February assumption. The <u>level</u> of earnings at the end of 1998 was close to that assumed in the projections. A preliminary analysis suggested that after making a rough adjustment for hours worked, the profile of the growth of earnings per hour through the second half of the year was broadly flat. Hence the rise and fall in the headline measure through 1998 was, perhaps, consistent with a higher, then lower, contribution from overtime. More analysis of the new figures was needed, for example of the contribution of bonuses to earnings growth. The fall in earnings growth through 1998 would need to be reconciled with the rise in employment and fall in unemployment over this period. One possible explanation was the fall in inflation expectations discussed at previous meetings. Among the recommendations made in the review of the AEI were a number of further improvements to the way the series was compiled to bring it up to best practice. Hence the Committee concluded that it should not, as yet, place great weight on the index.

19 The Bank's settlements series showed some signs that the peak might have been passed on the twelve-month employment weighted mean measure. The Reward index had declined on a broadly similar path to the revised Average Earnings Index over 1998.

20 The Committee noted that its central projection for earnings growth remained towards the top end of the range of other forecasts, despite a broadly similar projection for inflation in these forecasts. The Committee had discussed this during the February *Inflation Report* round in the context of recent movements in productivity. It would be necessary to look at the reasons for the differences in projections of real earnings growth, and hence implied profit margins, in the light of the new earnings data.

21 The latest data continued to show rising employment and falling unemployment, though total hours worked had fallen in December. The rise in employment was partly accounted for by an increase in the number of women in part-time employment. Both the stock of vacancies and number of new vacancies seemed surprisingly high and seemed to bear out the picture in the employment and unemployment data, suggesting a still tight labour market. But the latest Federation of Recruitment and Employment Services (FRES) survey showed that the job market index was at its lowest level since 1992. The three CIPS surveys for manufacturing, construction and services all pointed to falling employment. It seemed likely that a turning point would soon be seen in the official data.

Prices

22 Non-oil commodity prices had risen in January in sterling terms. There were tentative signs that the deflation might be coming to an end. The level of commodity prices was still much lower than a year ago, but they would have to keep falling to lower the central projection for inflation compared with February.

23 Contacts of the Bank's regional Agents were increasingly mentioning that consumers were more 'price sensitive' than previously. The Committee discussed possible explanations for this. The comment might simply reflect inflation illusion. Lower inflation over recent years may have made it easier for people to distinguish movements in relative prices from general price inflation. It seemed likely that the comments also reflected continuing structural changes in the retail industry, for example through a greater use of discount stores, which might be lowering margins.

24 The Committee also noted the rise in inflation expectations at longer maturities over the past month, as measured by the difference between implied forward interest rates on nominal and index linked bonds. It was too early to place much weight on this movement, which was in any event small by historical standards. There had not been much movement in shorter-term survey-based measures of inflation expectations over the past month.

25 Inflation had turned out a little higher than expected in January, but this reflected movement in the highly volatile seasonal food component. It was possible that better weather in February would lower some seasonal food prices. This had no implications for inflation two years or so ahead. The Committee noted that the timing of the Budget would mean that annual changes in fuel duties—from the previously announced 'escalator'—would be included in the March RPI figure this year, rather than in April as had been the case in 1998. This would mean a temporary rise in

RPIX inflation in March, all other things being equal. The Committee noted that inflation outturns had been at, or above, $2^1/_2$% since the introduction of the new policy framework in 1997. These outturns were more surprising given the mainly dampening shocks to world demand and prices. It would be important to consider whether there were any lessons from this.

26 The GDP deflator had risen 2.8% in the year to 1998 Q4, and was the highest for some time. However, the increase in the annual rate partly reflected a low figure in 1997 Q4 dropping out of the comparison, as well as some terms of trade effects. The rise in the household expenditure deflator was still below 2% in the year to Q4.

Other considerations bearing on the decision this month

27 Before turning to the immediate policy decision, the Committee discussed a number of other considerations. First, should the Committee seek to offset the projected weak GDP growth in the first half of 1999? Even if demand and output were turning out weaker than expected, the lags in the operation of monetary policy had previously been assumed to be such that only a limited effect on activity would be possible. However it was possible that there were signs, for example in the confidence surveys, of a more rapid response to changes in interest rates than had been the case in the past. One possible explanation was that the new monetary policy regime provided greater confidence in the commitment to the inflation target which was consistent with the fall in inflation expectations, and might help to explain the moderation of earnings growth since mid 1998.

28 Second, the exchange rate had risen, especially in recent days, to a level above that implied by the central projection in the February *Inflation Report*, despite the 50 basis point reduction in interest rates at the previous meeting. By itself this would tend to reduce import prices and retail prices, and might justify a reduction in interest rates. But it was too soon to judge whether the rise would persist, and what reaction there would be to a further reduction in rates. In any case, it would not be sensible for policy to react to high frequency movements in the exchange rate, as this could lead to a volatile path for interest rates from month to month, and might make it more difficult for others to understand the motives for interest rate changes.

29 Third, the Committee considered whether there was any particular significance in changing interest rates so soon after an *Inflation Report* round. Some members felt that clear news was needed for rates to change so shortly after the last forecast; otherwise, it would appear to downgrade the value and role of the projections.

The immediate policy decision

30 There were four key developments over the month. First, the revised earnings data had been published. Second, the effective exchange rate had strengthened. Third, if anything, the GDP figures were weaker than expected, particularly if weight were placed on the rise in inventories and/or the sharper than expected fall in exports. Finally, there had been a uniform strengthening of survey measures, albeit from a low level. On balance, these four factors suggested slightly lower prospective inflation than thought at the time of the February *Inflation Report*.

31 Some possible reasons for a further reduction in interest rates were identified. If, for example, it was expected that the rise in sterling would be maintained, there might be a case for a 25 basis point reduction in interest rates this month. Second, maintaining rates at their current level this month might be interpreted as a signal that a floor in rates had been reached, which might stall—or even reverse—the recovery in business and consumer sentiment.

32 One view was that the news on the month did not, as yet, amount to a sufficient case for a further reduction in interest rates. It would be better to see more evidence, in particular whether the strength in the surveys was maintained and whether it began to feed through to the official data. There would also be a benefit in undertaking more analysis of the revised earnings data. On this view, the repo rate should be maintained at 5.5%. Among those members holding this view, some felt that it was now slightly more likely than a month ago that there would be a further reduction.

33 The Committee discussed whether, even though there was not a compelling case for an immediate 25 basis point reduction in rates, there might be a case for a smaller reduction. There could be a case for moving in smaller steps than 25 basis points if the data warranted it. However, since the Committee had not previously made changes in anything other than multiples of 25 basis points, there would be a risk of providing a confusing signal to markets. Some members also thought it would imply a degree of fine-tuning beyond what was sensible.

34 Another view was that interest rates should be close to or possibly below the 'neutral' level at this point in the economic cycle. On that view, the reduction in rates of 50 basis points at the February meeting had brought the level of interest rates into its probable neutral range. The news over the past month reinforced the view that interest rates might need to be reduced further. But we had only started to see the effects of previous interest rate reductions, and nominal long and short-term interest rates were now close to their lowest level for many years. The reactions of firms and households—both savers and borrowers—to such historically unusual levels were difficult to predict with much confidence. Although the direction of interest rates was still more likely than not to be down, there was no urgency this month and it was best to observe how the economy reacted to the earlier interest rate reductions. On this view, therefore, the repo rate should be maintained at 5.5%.

35 Another view in February had been that a reduction in rates of 75–100 basis points was required. That view had been predicated on the assumption that first, the central projection in the *Inflation Report* was around 0.2 percentage points too high; and second, that it was possible to ease with a view to supporting activity in the near term without endangering achievement of the inflation target. This was especially true if the transmission mechanism was faster than had, on average, been the case in the past. The news on the month suggested that both activity and inflation might be a little lower than expected, and could justify a reduction in interest rates over and above what had been thought necessary a month ago. On this view, a reduction of 25–50 basis points was now required.

36 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be maintained at 5.5%. 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 reduction of 0.4%.

37 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

38 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 26 February, in advance of its meeting on 2–3 March 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 Growth of notes and coin had picked up in February. After adjusting for the effects of the introduction of the new 50 pence and £2 coins, the three-month growth rate was 7.0%, compared with 6.7% in January, and the six-month growth rate was 6.2%, compared with 5.9% in January. The one-month growth rate was 0.5%, the same as in January and a little higher than the average figure for 1998. A small increase in these growth rates might have been expected following interest rate cuts in the second half of 1998, which reduced the opportunity cost of holding notes and coin.

3 The stock of M4 had fallen by £10 million in January. The twelve-month growth rate had fallen to 7.3%, the lowest since June 1995.

4 Within M4, the balances of other financial corporations (OFCs) had fallen by £2.6 billion in January, making it less likely that December's modest increase was a purely temporary effect associated with the end of the financial year. The twelve-month growth rate, at 11.0%, had more than halved over the past year.

5 Following the introduction of self-assessment, January had become a more important month for payment of income tax. It seemed unlikely that this had yet had its full effect on the estimated seasonal component, which may in turn explain why the strong flow into household sector M4 in December (+£5.5 billion) had been followed by a much weaker January (+£1.7 billion). Looking at the average flow over these two months, the gradual pick-up in household sector M4 towards the end of last year appeared to have continued.

6 Private non financial corporations (PNFCs') holdings of M4 had risen by £0.9 billion in January, largely reversing a £1.0 billion fall in December. Payments of corporation tax in January had been significantly lower than in recent years. Hence there was a risk that the process of seasonally adjusting the monetary aggregates, which looks at the past behaviour of each series, had artificially lowered PNFCs' M4 in December 1998 and artificially boosted it in January 1999. Averaging over these two months, the flow was close to zero.

7 Sterling lending by M4 institutions had grown by 0.5% in January, the same rate as in December. But the three, six and twelve-month growth rates had all fallen, and remained below rates during the first half of 1998.

8 M4 lending to OFCs had fallen by £0.3 billion in January. This was smaller than the fall in their M4 deposits, so OFCs' net recourse to banks had increased. During the fourth quarter of 1998, lending to OFCs had been underpinned by lending to financial leasing companies. According to less comprehensive data from the Major British Banking Group, the contribution of lending to financial leasing companies in January was again strong (up by 1.0%).

9 M4 lending to the household sector had risen by 0.6% in January. Total lending to individuals (excluding lending to unincorporated businesses, but including lending by a number of non-M4 institutions) had also risen by 0.6%. The twelve-month growth rate was 7.7%. Lending secured on dwellings had risen by 0.5% in January, as in each month since August 1998. There had been a small rise in the rate of unsecured credit growth, from 0.7% in December to 1.4% in January. The three and six-month annualised growth rates were 14.3% and 15.6% respectively, below those during the first half of last year.

10 Turning to price indicators of monetary conditions, more than half the institutions sampled by the Bank had not passed on in full the most recent cut in official rates to their standard variable mortgage rates. For the time being, this was probably of limited significance; since September 1998, standard variable mortgage rates had fallen by 198 basis points, only 2 basis points less than the fall in official rates over the same period.

11 Since the February MPC meeting, there had been some rise in medium to long-term inflation expectations (as derived from a comparison of the yield on nominal and index-linked gilts). Much of the rise, particularly at the ten-year horizon, occurred on 4 February, the day when official rates were reduced by 50 basis points. By contrast, there had been little change in survey measures of inflation expectations for end 1999 and end 2000. These remained at around 2.2% to 2.3%.

II Demand and output

12 GDP at constant market prices had grown by 0.2% in 1998 Q4, but the annual rate had been revised down to 1.3% from 1.6%. The expenditure breakdown had shown domestic demand growing by 1.2% in Q4, reflecting a sharp increase in investment and inventories. Net trade had made a negative contribution to GDP growth of -1.1%. The shortfall of the expenditure measure of GDP relative to the average measure was 0.6% of GDP in Q4.

13 Growth in household spending had increased to 0.4% from 0.1% in Q3. Bank staff had not expected total household spending growth in Q4 to be as weak as had been suggested by retail sales volumes. The level of spending in Q3 had been revised down by 0.1 percentage points, but there had been upward revisions in the first half of 1998.

14 Investment had grown by 2.0% in Q4. Growth had also been revised up in Q3 to 1.8% from 1.1%. The strength in Q4 was partly because of erratic factors. Nevertheless, sectoral growth rates had been broadly consistent with survey evidence on investment intentions: service sector investment growth had remained strong at 5.2%, and manufacturing investment had declined by 3.1%. The annual growth of whole-economy investment had slowed during 1998.

15 Inventories had risen sharply by £1.9 billion in Q4, but the level had been revised down by a cumulative £215 million in the first three quarters of 1998. Stock building in 'other industries' had accounted for £1.6 billion of the rise. This category includes the quarterly alignment, which was constrained to sum to zero in the year as a whole. Unless there had been very large revisions to the alignment adjustment—and stocks data had not supported this—it could explain only a part of the overall increase in other industries' stocks. 'Other industries' included car dealers, for whom stocks may have been boosted by the switch to twice-yearly registration periods starting in March. Stocks in the manufacturing and retail sector had made a negative contribution to GDP growth. Manufacturers' stocks of finished goods had risen by £113 million, less than half the increase in Q3. But survey evidence had indicated a continued stock overhang. The CBI monthly trends survey had recorded a small increase in the balance on excess

stocks of finished goods to +24 in February from +23 in January, and the balance had remained well above its long-run average.

16 In Q4, exports had declined sharply by 2.4%, and imports had increased by 0.9%. In 1998, there had been tentative signs that the slowdown in final demand had reduced import growth. Looking ahead, the CBI survey shows exporters increasingly less pessimistic about prospects, with the balance on optimism rising to -18 in January from -41 in October. But the CBI export orders balance had remained negative. Monthly trade data had shown that the decline in exports to non-EU countries had continued in January, with goods exports, excluding oil and erratic items, declining by 6.8%.

17 Manufacturing output had fallen by 1.3% in Q4. Service sector output had increased by 0.6%, compared with 0.8% in Q3. Within the service sector, output had continued to grow strongly in the transport/communications and finance/business sectors. Output had been unchanged in the distribution, hotels and catering sector, consistent with weak retail sales in Q4. Construction output had declined for the third quarter in a row, by 0.2%.

18 The gross operating surplus of corporations had declined by 0.2% in Q4.

19 Retail sales volumes had risen by 1.1% in January, more than reversing the decline in December. But the underlying trend had been unchanged, with sales volumes in the three months to January 1.5% higher than a year earlier. Sales of clothing, footwear and household goods had grown particularly strongly, partly because of sharp price-discounting. A survey by the Bank's regional Agents covering 108 retailers had supported the view that spending was weak. A majority of respondents had reported declining sales values in December and January relative to a year earlier. Consumer confidence was cited as a key reason. This had implied a sharper slowdown than indicated by the official data.

20 House price inflation had slowed. The Bank's house price index based on Land Registry data had risen 5.9% in the year to Q4 (down from 7.9% in Q3) and the Halifax house price index had risen by 3.7% in the year to February (down from 4.4% in January). There had been preliminary signs that activity might have turned up. The House Builders' Federation survey in January had shown the first positive balances in seven months on visitors to sites and on net reservations compared with a year earlier. These had been leading indicators of housing transactions in the past. Particulars delivered had risen in February for the second month running. But the recovery was from a low level, and transactions had been 3% lower than a year earlier. The firming-up in housing activity had been consistent with some recovery in consumer confidence. The GfK confidence indicator had risen to -0.6% in February from a trough of -8.2% in October.

21 Survey evidence had continued to indicate declining manufacturing output in the first two months of 1999 Q1. The output balance of the CBI Trends survey was -10 in February compared with -13 in January. The CIPS survey output balance had remained below 50 in February, for the eleventh month running. But there had been continued signs of an easing in the rate of decline of new orders, mainly because of a bottoming-out in export orders. In the service sector, the CIPS business activity index had remained below 50 for the fourth successive month, indicating contracting output, although the rate of decline had eased.

III International environment

22 US GDP had risen by 1.5% in the fourth quarter, according to the preliminary estimate. Industrial production was flat in January, and had been growing at around 1.7% on a year earlier for the past three months. Although monthly data had suggested some stabilisation in the trade balance, further falls in net exports were expected in 1999, reflecting slowing growth in the euro area and Latin America. Retail sales growth had slowed in January but this may have simply reflected one-off factors. Consumer confidence had risen again in February, most notably in the 'current conditions' index. Industrial confidence, as measured by the National Association of Purchasing Managers Index, had also risen in February. Manufacturing employment had continued to fall, but service sector job growth remained robust, so that overall employment growth remained above that of the labour force. Despite strong monetary growth and robust real GDP growth, annual inflation remained subdued and was unchanged in January at 1.6%.

23 In the euro area, imbalances between the consumer and producer sectors had persisted. Euro-area GDP had risen by 2.7% on a year earlier in the third quarter. French GDP had risen by 0.7% in the fourth quarter. In Germany, GDP had fallen by 0.4% in the fourth quarter. The contribution from net trade to quarterly German growth was -0.8 percentage points, the largest quarterly negative contribution since 1993 Q2. German services output had grown by 1.0% in the fourth quarter, compared with 1.1% in the previous quarter. The French survey of service sector output had tracked the official measure of output fairly closely in recent years, and pointed to a moderate slowdown in service sector growth in 1999 Q1. Euro-area industrial production growth had fallen by 0.4% in the year to December, compared with 3.2% in the year to October. Euro-area industrial confidence had stabilised in January, close to its historical average. Euro-area consumer confidence had risen to zero in January from -1 in December; this compared with -9 in January 1998. Inflation in the euro area on the harmonised measure fell to 0.8% on a year earlier in December, from 0.9% in November. In January, the three-month moving average of the twelve-month growth rate of M3 increased to 4.9%, compared with the reference rate of 4.5% set by the European Central Bank.

24 The Bank of Japan had lowered the overnight discount rate to a range below 15 basis points on 12 February. The Ministry of Finance had also partially reversed its position on Trust Fund Bureau purchases of Japanese government bonds (JGBs), allowing the Bureau to resume outright purchases of JGBs in the secondary market. The yen had subsequently weakened further and 10 year bond yields had fallen back below 2%. Retail sales had remained weak in January, falling by 4.5% on a year earlier. Industrial production had risen by 0.8% in January, but it was still down by 7.5% over the past twelve months. Industrial production had fallen by 6.9% in 1998 as a whole. The inventory index was at its lowest level since February 1995. The Japanese trade surplus had widened in January to 760 billion yen, compared with 386 billion yen in January 1998. The growth in the surplus had reflected the weak state of Japanese private demand in 1998. It had also reflected the fall in commodity prices which, alongside more recent strength in the yen, had lowered the value of imports. The Consensus Economics average of forecasts for GDP growth in 1999 was unchanged at -1.1% in February.

IV The labour market

25 Employment had continued to grow strongly at the end of 1998. According to the Labour Force Survey (LFS), employment in Q4 was 122,000 (0.4%) higher than in Q3, and 305,000 (1.1%) higher than in 1997 Q4. The main contribution to the rise in Q4 had come from growth in the number of employees, but the number of self-employed people had also risen, reversing the recent downward trend. A full sectoral breakdown was not yet available, but monthly data had showed that manufacturing jobs had fallen by some 2% in the year to Q4. The February manufacturing survey from the Chartered Institute of Purchasing and Supply (CIPS) had suggested that employment in the sector had continued to fall in early 1999, though at a slightly slower rate. The CIPS surveys on services and construction, and the report on jobs from the Federation of Recruitment and Employment Services

(FRES), had pointed to declines in employment, as they had for some time.

26 Though employment had continued to rise in 1998, hours worked had been broadly flat. Total hours worked had fallen by 0.2% in Q4, and average hours per worker were 0.6% lower. About half of the fall in average hours worked had reflected a rise in the number of part-time jobs. The other half had reflected a fall in average hours worked by full-time workers, consistent with a reduction in overtime working.

27 The number of jobs advertised in national newspapers had fallen in January, according to the Press Recruitment Advertising Index. The stock of unfilled Job-centre vacancies had also fallen, by 2,200 in January. But new vacancy notifications had remained at a high level, rising by 9,300 in January after falls in November and December. Overall, the Bank's regional Agents had reported a broadly unchanged level of skills shortages. But significant sectoral differences had persisted. Skills shortages were declining in the financial sector, according to the most recent CBI/Price Waterhouse Coopers survey, and were flat to falling in the small business sector, according to the Small Business Research Trust. But shortages in the construction sector were reported to be back at their 1997 peaks by the Federation of Master Builders.

28 The rise in employment in Q4 had been accompanied by further falls in both inactivity and unemployment. The LFS measure of unemployment had fallen by 15,000 in Q4, and the claimant count had fallen by 5,700 in January. But unemployment rates had been unchanged, at 6.2% and 4.6% respectively. There was still no evidence of the reported rise in redundancies in the inflows to the claimant count, which fell by a further 6,500 in January. Exit rates had remained at historically high levels. Unemployment of six months or more among 18 to 24 year olds had been falling by around 6,000 a month. Some of this probably reflected the impact of the Government's New Deal for young people. But, in net terms, all of the rise in employment in Q4 had been accounted for by workers aged 35 or over.

29 The Average Earnings Index had been reinstated on 2 March, following the conclusion of an independent review commissioned by the Chancellor. The headline earnings measure had been available up to July 1998 under the suspended series. According to the new series, headline whole-economy annual average earnings growth had fallen from 5.1% in August to 4.5% in November, reflecting a decline in the growth of both regular and irregular pay. There had also been extensive revisions to the back data, reflecting a number of changes in the method of calculation. In contrast to the suspended series—which had been relatively volatile—the new series showed headline earnings growth rising steadily from a trough of around $2\frac{1}{2}$% in 1995 to a peak of 5.7% in May 1998.

30 Other data had also suggested a more subdued outlook for settlements and earnings in recent months. The Reward index of annual earnings growth had continued to fall, from a peak of 5.4% in June 1998 to 4.6% in January. The Bank's employment-weighted twelve-month mean measure of whole-economy settlements had remained at 3.7% in January, but the private sector measure had fallen by 0.1 percentage points to 3.9%. In a matched sample of firms from the Bank's settlements database, 86% of employees settling in January had received a lower settlement in 1999 than they had in 1998. The employment-weighted mean for this sample had fallen from 3.8% in 1998 to 3.2% in 1999. The three-month settlements measures from the CBI, Industrial Relations Services and Engineering Employers' Federation had also all fallen in January. And the Bank's regional Agents reported that falling profits and subdued business optimism had led to an easing in pay pressures in manufacturing. But it was possible that there would be some rise in whole-economy settlements in April, when the National Minimum Wage and the settlement agreed by the Public Sector Review Bodies both came into effect.

V Prices

31 Commodity price deflation had continued to moderate; in January the Bank's (provisional) index, excluding oil, had fallen by 5.2% on a year earlier, compared with -7.4% in December. Natural disasters and sterling's depreciation had increased the sterling price of imported commodities in January; the (provisional) index had risen by 1.1%. Food price deflation had moderated following the unwinding of the downward shocks experienced since mid-1996. Annual inflation had been zero in December. But forthcoming potential reforms to the Common Agricultural Policy looked likely to decrease prices. The Ministry of Agriculture, Fisheries and Food was estimating a direct effect of up to -0.3 percentage points on the RPI in the year following implementation, assuming full pass-through of the cuts to retail prices.

32 The one-month futures price of Brent crude oil had averaged \$10.50 in February, down from \$11.09 in January—the effects of a report of falling inventories and cold weather in the United States in January had been short-lived. Manufacturers' material input prices had risen by 0.4% in January, reflecting the rise in oil prices, but there had been no clear change in the downward trend. Annual inflation had remained negative at -6.7%.

33 Manufacturers' output price inflation had remained at historically low levels. Excluding excise duties, prices had fallen for the seventh consecutive month in January, by 0.2%, leaving them 0.8% below their level a year ago. Total output prices had been flat year on year. The CBI industrial trends survey had pointed to further price falls.

34 Trade prices for goods had continued to decline in December. Total import prices of goods had fallen by 6.4% in the year to December; total export prices of goods had fallen by 3.8%. In contrast, national accounts data showed that services export prices had risen by 1.4% and import prices by 0.1% in Q4. The annual rate of increase of the GDP deflator had risen to 2.8% in Q4 1998, from 2.0% in Q3. The sharp rise was partly explained by the volatile path of quarterly inflation in 1997, and by increased contributions from government, trade and inventories prices. The household expenditure deflator, at 1.9%, had remained below RPIX inflation. That rise had led to a 0.8 percentage point rise in the GDP deflator based measure of domestically generated inflation, to 3.2%. The RPI-based measure had remained unchanged at 4.9%.

35 RPIX inflation had remained at 2.6% in January. RPIY inflation had been 2.0%. RPIX services inflation had fallen by 0.1 percentage points to 3.4%, and RPIX goods inflation had remained at 1.4%. Total food price inflation had risen above RPIX inflation.

36 HICP inflation had increased by 0.1 percentage points in January for the third consecutive month, to 1.6%. The difference between HICP and RPIX inflation had fallen by 0.1 percentage points to 1.0 percentage points, of which 0.5 percentage points was due to the method of calculation and 0.4 percentage points to the exclusion of various owner-occupied housing costs.

VI Agents' national summary

37 The Bank's regional Agents reported on their assessment of the economy drawn from their discussions with contacts over the past month. Overall, the recent decline in manufacturing activity appeared to have eased significantly, and destocking was well under way. Nonetheless, performance had remained dependent on sector. For example, railway and aerospace demand had been strong, while textiles, ceramics and electrical components manufacturers had continued to suffer from intense import competition. There had been few reports of any increases in output. One exception had been exports to Europe, where some contacts had won back orders as sterling had depreciated. But demand from

France and Germany had begun to decline by the end of the period. Construction sector activity had remained buoyant, but enquiries and orders had begun to decline. Demand for commercial developments had been weaker in the north of the United Kingdom than in the south east. Housing market activity had increased since January, especially at the higher-quality end of the market. Increased investment in city-centre property had been reported. Growth in output of business services had declined, reflecting weak manufacturing activity. For example, hauliers had reported falling demand, and corporate travel suppliers had noted trading-down to less expensive travel options. But demand for financial services and telecommunications had remained strong. Retail sales growth had been weak in February; as yet, retailers had reported little increase in consumer demand following the recent interest cuts. Consumer demand for leisure services, such as gymnasiums, overseas holidays and restaurants had remained strong.

38 In the manufacturing sector, employment had fallen and the decline was expected to continue. That had increased concern about employment prospects, and had reduced wage demands. Declining activity had lowered overtime and bonus payments. Growth in service sector pay settlements had remained above manufacturing but had continued to fall, reflecting a decline in activity. Skill shortages had persisted (heavy goods vehicle drivers, precision engineers, accountants and lawyers, for example), but not worsened. Raw materials, intermediate and finished goods prices had continued to fall. Retailers had continued to cut prices in order to reduce high stock levels. Investment intentions had declined across the board. Manufacturers had continued to invest to improve productivity, rather than to expand capacity. And an increasing number of service sector contacts had postponed expansion plans.

VII Information from financial markets

Foreign exchange

39 The US dollar had continued to strengthen since the previous meeting, and now stood about 7% higher against both the yen and the euro compared with the beginning of the year. The yen had weakened following a cut in interest rates, and there had been statements by the Japanese authorities indicating that they were more comfortable with a weaker yen. The euro had weakened following the release of weaker-than-expected economic data for the euro area.

40 Sterling had appreciated in effective terms, although it was now at an 18-month low against the stronger dollar. Sterling's implied volatility had risen since the previous MPC meeting, but was still lower than at the beginning of the year. Options data suggested that the probability of a large sterling fall against the euro had declined.

Government bond and money markets

41 Expectations for UK interest rates in 1999 had fallen, but had risen looking two years or more forward. The market's reaction to the minutes of the previous MPC meeting had been a major reason for this. Three-month Libor rates were now expected to rise after falling to a level of 5%. In the United States, rates expected for next year and beyond had risen by around 50 basis points, primarily because of Fed Chairman Greenspan's Humphrey-Hawkins testimony. Near-term euribor rates had remained broadly unchanged. The gilt yield curve had flattened, with yields rising most for maturities between five and ten years. In general, bond prices abroad had also weakened since the previous meeting, with the exception of Japan.

Equity and corporate debt markets

42 The UK stock market had risen, and the FT-SE 100 index had touched an all-time high. In contrast, the US market had fallen since the previous MPC meeting, driven by the Humphrey-Hawkins testimony. The other main international indices had remained broadly unchanged.

43 In the United States, credit spreads for the most highly rated firms had fallen by 8 basis points, but spreads for lower-credit firms had risen by 5 basis points. In the United Kingdom, credit spreads for highly rated firms had fallen by about 15 basis points, and by more than 30 basis points for lower-credit firms. Swap spreads in the United States had risen slightly, but had fallen at all maturities in the United Kingdom.

44 Analysts' and fund managers' forecasts of corporate earnings in 2000 had been revised up slightly since the previous MPC meeting. Profit warnings had declined in February compared with the previous three months, and for the first time in several months the level was below that recorded a year ago. Compared with February 1998, there had been a sharp decline in the proportion of firms citing the strength of sterling or problems in emerging markets as the reason for their worsened performance.

Text of Bank of England press notice of 3 March 1999

Bank of England maintains interest rates at 5.5%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.5%.

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

Minutes of the Monetary Policy Committee meeting on 7–8 April 1999

1 The Committee discussed the prospects for the world economy; the exchange rate, money and credit; demand and output (including business confidence indicators); the housing market; the labour market; prices; and other issues including tactics, before turning to its immediate policy decision.

The world economy

2 The Committee discussed whether the prospects for the world economy had improved over the past month. In the United States, domestic demand in particular had continued to grow strongly, with little sign yet of any slowdown in growth or any pick-up in inflation. Supply side developments in the United States appeared to be more favourable than in the euro area, although in several European countries output remained below potential. Growth was sluggish and industrial sentiment weak, particularly in Germany. Meanwhile expectations had grown of a reduction in interest rates by the European Central Bank (ECB). In Japan, the Nikkei had recovered strongly in the last few weeks of the financial year, with buying from foreign investors amid signs of a higher probability of corporate restructuring. But any recovery in business sentiment had been muted—and might be reversed—while consumer confidence could be further damaged by record levels of unemployment.

3 Outside the major industrial countries, spreads on emerging market sovereign dollar debt—as measured by J P Morgan—had fallen by over 200 basis points during the month. Sentiment—and in some cases activity—was a little stronger in East Asia and Latin America, where some countries had benefited from higher oil prices. The markets appeared to have discounted a deterioration in prospects in Russia. So in general, developments in the world economy seemed much as expected in the February *Inflation Report*, although the downside risks to activity might have diminished somewhat. A major uncertainty was over the events in Kosovo, where the effects on consumer and business confidence elsewhere, and on the budgetary positions of the NATO countries, were not yet clear.

4 There were some signs that commodity prices had begun to bottom out, and oil prices had risen sharply as a result of agreed cutbacks in supply. While it was too soon to judge whether these increases would persist, the cutbacks appeared to have greater credibility in the market than had sometimes been the case. The downward pressure on world prices from oil and other commodities might therefore be less than in the recent past. But with most economies outside the United States below productive capacity, the scope for a generalised pick-up in inflation was limited.

The exchange rate, money and credit

5 For most of the month sterling had been stronger than at the time of the previous meeting of the Committee, particularly against the euro, although it had weakened a little in recent days. But the effective exchange rate index remained over 2% higher than implied by the central projection in the February *Inflation Report*. Many possible explanations had been advanced for sterling's strength, and discussed by the Committee in this as in previous meetings. If this strength in the exchange rate were sustained, it would tend to dampen inflation, and also activity in the internationally traded sectors of the economy.

6 So far as money was concerned, growth rates for M4 had continued to slow, as expected, with a sharp decrease in the contribution from other financial corporations (OFCs). Growth in M4 lending had also slowed further.

Demand and output

7 The Committee discussed the revisions made to the estimates of the level and composition of GDP for 1997 and 1998. Since the February *Inflation Report*, the estimated level of GDP at market prices in 1998 Q4 had been reduced by $^1/_2$%, although by only $^1/_4$% when measured at basic prices. This had consequences for measures of the output gap and labour productivity. The implications for future price developments were unclear. On one interpretation, this implied that there was less pressure on capacity and that, given the lags involved, the effects of slower GDP growth had yet to feed through fully into lower inflation. On an alternative view, it suggested a less favourable short-run trade-off between activity and inflation; inflation was unchanged and either capacity utilisation was lower, core inflation higher or estimates of capacity had been reduced. But the size of the changes had not been large, and it was not clear on either view how much significance should be attached to this.

8 Estimates for the growth of GDP in 1998 Q4 had also been revised downwards, to 0.1% over the previous quarter. Within this total, the weakest demand components had been government consumption and net trade. In contrast private consumption and investment had been revised up, significantly so in the case of business investment. At the same time, the downwards revision to inventories suggested that the risks of a significant stock cycle in 1999 had diminished, particularly since stocks held by manufacturers and retailers appeared under control. This interpretation was in line with earlier survey evidence for these sectors. But because of the downwards revision to the level of GDP, the estimated stock-output ratio was little changed.

9 Retail sales volumes had declined in February, and on a three month average had been only 1% above the levels of a year earlier. But the CBI distributive trades survey suggested that a trough might have been reached, and spending on services, which was not included in retail sales, had continued to grow faster than spending on goods. The GfK consumer confidence index was now positive for the first time in nine months. When taken together with other information on consumer spending, the data appeared in line with the *Inflation Report* projections for consumption in the first quarter of 1999.

10 The Committee considered the prospects for investment. The financial deficit of the private non-financial corporations (PNFCs) had widened to 3% of GDP, the highest level since 1990. This might in part reflect the growth of business investment in the second half of 1998. The increase appeared to have been most marked in the services sector, and might represent a bringing forward of IT-related spending ahead of the millennium. The millennium might also boost spending on construction this year, with signs, perhaps, that next year would be less buoyant. All this might have implications for the profile of activity over the next two years. But work by Bank staff suggested that movements in the credit and money holdings of the PNFCs were consistent both with the recent strength of investment, and continued growth in 1999.

11 The Committee agreed that the Budget contained little that altered the outlook for inflation. At its previous meeting it had decided that the figures for the overall fiscal position, on which the Committee had been briefed, were in line with the assumptions made in the February *Inflation Report*. Following the Budget itself, an analysis of the implications of the detailed measures for the composition of demand suggested that these should not have a significant additional effect on the prospects for activity and inflation over the forecast period.

12 Forward-looking survey evidence continued to suggest an improvement (from a low base) in business confidence in all sectors of the economy. But official data and that from surveys indicated that manufacturing output was still declining, and information from the Bank's regional Agents suggested that in this sector in particular, confidence remained fragile. By contrast, the CIPS index for services output had risen above 50, indicating growth rather than contraction, for the first time since October. The sharp fall seen in the second half of 1998 might have been partly in response to events in financial markets at that time. A recovery in confidence had therefore been expected, with the readings now consistent with the central projection for output in 1999 contained in the February *Inflation Report*. The CIPS survey for construction had also strengthened, in line with other indicators for that sector.

13 All in all, the data suggested that the prospects for activity were little different from those expected at the time of the February *Inflation Report*. The downwards revision to the level of GDP had been interpreted by some commentators as reducing inflationary pressures, but the size of the revision of GDP measured at basic prices was small, and the implications for inflation ambiguous. At the same time, significant changes had been made to the composition of demand, particularly to investment and stockbuilding. While the recovery in business confidence had yet to be reflected in official figures, this was to be expected given the lags involved.

The housing market

14 There had been a sharp increase in the Halifax and Nationwide house price indices in March. Data from the House Builders Federation on net reservations and site visits, together with figures on loan approvals and particulars delivered, suggested that turnover in the housing market had risen. The increase had followed a sharp fall towards the end of 1998, and the turnaround might have been influenced by the fall in interest rates since October.

The labour market

15 Employment had continued to rise, with the LFS measure increasing by 119,000 in the last three months. However, much of this increase had been in part-time employment, and on a full time equivalent basis the increase had probably been closer to 50,000. Total hours worked had fallen, and the unemployment rate had risen. The effects of this on consumer confidence may not yet have been seen. The surveys were mixed; while some suggested a sharp downturn in the demand for labour, with the Manpower survey showing the weakest job prospects since 1993, the CIPS employment index had risen slightly, but remained below 50.

16 The latest data for average earnings growth continued the fall seen since the new series was released. The headline figure had reached 4.3% in December. This decline was linked to a reduction in hours worked per head, and to a negative contribution from bonuses.

17 Data on settlements also indicated a decline in nominal wage pressures, although inflation expectations appeared to have fallen by even more. The decline in settlements was not yet apparent from the headline twelve month figures, but for a matched sample of firms from the Bank's database, settlements this year were running at 3.3% in January and February, as against 4% the previous year.

Prices

18 The implications of a reduction in earnings growth for inflation would depend on a variety of factors, including developments in productivity, margins and import prices. Productivity growth over the past three years had been below its 40 year average. It was difficult to know how much weight to attach to observed productivity growth over such a short period. But relatively small differences in assumptions about productivity could have a material effect on the projections for inflation over the next two years. More generally, the pass-through from unit labour costs to prices was not straightforward. It would depend, among other things, on cyclical conditions and on other input prices. These issues would be looked at again in the forthcoming *Inflation Report* round.

19 Oil prices were much higher than a month ago, although some rise had already been assumed in the central projection in the February *Inflation Report*. These increases would exert some upwards pressure on input prices, particularly since the falls in non-oil commodity prices might be coming to an end. Depending on the path of the exchange rate, domestic inflationary pressures might come more to the fore in determining the path of RPIX, even if competition from imports remained intense. On the other hand, the recent falls in non-oil commodity prices had been steeper than expected, and the exchange rate had strengthened. The balance between domestic and international inflationary pressures would be examined in the context of the next *Inflation Report*.

20 The most recent figure for RPIX inflation—at 2.4%—had been below the target for the first time since the Committee had been established. This had been despite some strength in the price of seasonal foods, which might unwind in coming months. But the difference from the 2.5% target was very small, and of little relevance to the prospects for inflation two years ahead. Next month it was very likely that RPIX inflation would be above target as a result of the timing of Budget measures, which would affect petrol prices in March as compared with April last year. But this effect would last for only a month, and should have no implications for inflation in two years' time.

Tactical considerations

21 The Committee noted that a reduction in rates was widely expected this month, although rather less universally than had been the case a week earlier. There was also a growing feeling in the market that the ECB might reduce its rates later that day. Should either factor influence the Committee's thinking?

22 It was possible that a decision to leave interest rates unchanged would be interpreted as a signal that current levels would be the trough of this interest rate cycle. It was also possible that a similar conclusion might be reached from an unexpectedly large reduction in rates. Given that any decision was open to misinterpretation, the Committee agreed that this was not a factor which it would take into account.

23 There was also the issue of the exchange rate. While this was little changed from its level at the time of the previous meeting, its strength against the euro continued to surprise many observers. But the reaction of sterling to any change in UK interest rates was unclear.

The immediate policy decision

24 Over the past month, there had been further revisions to the level and composition of GDP, a continuing recovery in survey data from the low points reached in the latter part of 1998, and some easing in labour market pressures, including lower settlements and earnings growth. This was against the backdrop of a world economy in which some of the downside risks had diminished, oil prices had risen sharply, and the exchange rate was over 2% higher than assumed in the February *Inflation Report*.

25 Given this background the Committee discussed the case for no change to rates, a reduction of 25 basis points, and a reduction of 50 basis points.

26 The Committee considered various developments which could have suggested leaving rates unchanged this month. The prospects for activity were much as expected, with some signs that past reductions in interest rates were beginning to sustain activity. The changes to the composition of demand were at least as important as the downwards revision to GDP, and suggested that the downside risks to output from a stock cycle or weak investment during 1999 were less now than previously thought. Financial wealth had risen, with share prices up further during the month and the housing market showing signs of recovery. Survey measures of confidence had also recovered somewhat. Overall, the evidence appeared consistent with positive, if slow, growth in GDP during the rest of this year, as set out in the central projection of the February *Inflation Report*. And while there were signs that labour market pressures had begun to ease, the evidence was not conclusive (for example on earnings per hour) and the link between this and prices required further analysis. Finally, oil prices were sharply higher.

27 But other developments pointed to the need for a further reduction in interest rates. The effective exchange rate had been stronger throughout most of the previous month. Earnings growth seemed to be lower than expected, a view supported by information on settlements, although assessing the implications of this for prices required more work. Finally, confidence, although improved, probably remained fragile. With a reduction in interest rates widely expected a decision to maintain rates at their current levels could be seen as a policy tightening, which might have an unnecessarily damaging effect on confidence and activity.

28 The previous month several members had felt that not much additional news would be required to justify a further reduction in rates. They took the view that the balance of evidence since then supported a reduction in interest rates this month. While the prospects for activity were little changed over the month, the risks to the inflation outlook had shifted somewhat to the downside. It was therefore appropriate to reduce rates by 25 basis points in order to meet the inflation target.

29 Another view which favoured an immediate reduction in the repo rate of 25 basis points was that there was a growing risk that the inflation target would be undershot, given the lags between output and inflation, the intensity of price competition from overseas and the deceleration seen in settlements and earnings. Short-term inflation expectations as measured by surveys had declined, and might fall further given the sharp decline in the RPI measure of inflation. The size of the PNFC deficit was a concern, and the growth in investment might well be a temporary pre-millennium effect. Finally, the intensifying Balkans conflict increased the downside risks of a further blow to confidence in the global economy. It was therefore necessary to keep interest rates on a downwards path, and a reduction in rates of 25 basis points this month was appropriate.

30 Another view was that in March, a reduction of 40 basis points had been required. Since then the revisions to GDP had contained little news, although given the underspend in 1998, it was possible that government final demand might increase by less than planned. With price developments favourable, and the future earnings profile likely to be below that contained in the February *Inflation Report*, it was preferable to reduce the repo rate by 50 basis points now, in order to prevent inflation falling below the target and to underpin activity.

31 The Governor invited members of the Committee to vote on the proposition that the Bank’s repo rate be reduced by 25 basis points to 5.25%. 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 reduction of 50 basis points.

32 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

33 Andrew Turnbull 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 1 April, in advance of its meeting on 7–8 April 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 The international economy

2 In the United States the final estimate of GDP in 1998 Q4 had been 1.5%, in line with the preliminary estimate. Some special factors which may have supported robust growth in Q4, such as the seasonality of trade data, had possibly begun to unwind in Q1. The trade deficit had widened to $17.0 billion in January from $14.1 billion in December. However, other factors supporting rapid growth in Q4 had persisted in early 1999. The outlook for consumption had been little changed: retail sales growth had remained rapid in the first two months of the year and consumer confidence had risen again in March. The NAPM index of industrial sentiment had risen further in March. The sharpness of the rise in the NAPM index in recent months had suggested at least that the slowdown in industrial production growth might have bottomed out. Employment growth had been strong in February, but had weakened in March. This month-to-month volatility may have reflected some weather-related erratic influences. The unemployment rate had fallen to 4.2% in March. Annual growth in average hourly earnings had continued to ease, falling to 3.6% in March, and consumer price inflation had remained muted. Since the March MPC meeting, market expectations of interest rates in the United States had declined, while equity prices in mid-1999 were expected by the market to be slightly higher.

3 Within the euro area, Italian GDP had declined by 0.3% in 1998 Q4. This decline had been exaggerated by the smaller number of working days in the quarter compared with Q3, though the data had still revealed unexpected weakness in domestic demand growth. In the euro area as a whole, industrial sentiment had weakened slightly in February. The western German Ifo index had fallen in February to its lowest level since August 1996. Yet consumer confidence had remained buoyant. French retail sales had fallen in February but underlying growth had remained robust. The three-month centred moving average of annual broad money growth in the euro area had risen to 5.1% in January from 4.9% in December. Monthly data showed that year on year growth had slowed to 5.2% in February from 5.6% in January, partly reflecting weaker growth of overnight deposits. Annual growth in the euro-area HICP had remained at 0.8% in February, and there had been little sign of inflationary pressure from intermediate prices. Since the previous MPC meeting, the euro had depreciated against the dollar and market expectations of short-term interest rates had declined. In its spring forecast, the European Commission had revised down its projections for GDP growth in the euro area in 1999 and 2000, to 2.2% and 2.7% respectively.

4 Japanese GDP had fallen by 0.8% in 1998 Q4. There had been evidence of earlier fiscal stimulus in the data on government investment, which had contributed 0.9 percentage points to growth in that quarter. But all other major components of GDP had remained weak in Q4. In February, the unemployment rate had risen to a record high of 4.6% and inactivity had increased. Employment had continued to fall. In February, personal incomes had continued to decline. Real consumption had fallen by 3.8% in the year to February. The March Tankan survey of industrial sentiment had recorded a slight improvement in business confidence, owing primarily to an easing of financial conditions. But other indicators within the Tankan had remained weak. Since the March MPC meeting, ten-year government bond yields had continued to fall, by around 25 basis points. Market expectations of Japanese short-term interest rates had remained relatively stable, as had the yen.

5 Spreads on government bonds in emerging markets over US Treasuries had narrowed over the month, although they remained higher in Latin America than in Asian countries. Agreement on a new IMF financial package for Brazil had been reflected in the appreciation of the Brazilian real since the previous MPC meeting. But available data for the first two months of this year had shown that capital flows to emerging markets were unlikely to be markedly larger in Q1 than in Q4.

II Monetary and financial conditions

6 Growth of notes and coin had remained stable in March. After adjusting for the effects of the new 50 pence and £2 coins, the one-month growth rate had remained at 0.5%, as in January and February. The annualised three-month growth rate had fallen to 6.0% in March from 6.9% in February.

7 The stock of M4 had increased by £4.2 billion in February compared with £1.2 billion in January. The February figure included a £3.9 billion rise in repos (not seasonally adjusted). The slowdown in annual M4 growth had continued in February: the twelve-month growth rate of M4 had fallen to 7.4%, from 7.7% in January.

8 The growth of M4 lending had been relatively weak in February at £3.6 billion, despite strong reverse repo activity, partly reflecting a substantial securitisation. The twelve-month growth rate of M4 lending had been 6.9% in February compared with 7.8% in January (after adjustment for the securitisation, the twelve-month growth rate was 7.1%). This slowdown had partly reflected strong February 1998 figures dropping out of the calculation.

9 Private non-financial corporations' (PNFCs') holdings of M4 had grown by 1.6% in February. The strong flow had been distorted by the proceeds of a large corporate debt issue being held on deposit. Excluding the estimated effects of this issue, the twelve-month growth rate had risen to 6.2% in February from 5.8% in January. When adjusted in the same way, the three and six-month growth rates in February had fallen below their rates in January. M4 lending to PNFCs had fallen by £0.2 billion in February. Analysis by Bank staff had suggested that the coincident pick-up in the growth of PNFCs' M4 lending and slowdown in M4 deposits over the previous six months might have been due to the strength of business investment in 1998 H2. The same analysis had indicated that the current level of PNFCs' M4 deposits and lending might suggest that business investment would remain relatively robust this year.

10 Households' holdings of M4 had increased by £2.0 billion in February, compared with an increase of £1.9 billion in January. The weak figure for January had been attributed, in part, to the effects of concentrated income tax payments following the introduction of self-assessment. While it was possible that these effects had also been present in the February data, the new information might imply a more general slowdown. Households' M4 borrowing had remained steady at £3.2 billion in February. Total lending to individuals had increased by 0.6% in February, much the same as the average since February 1998. Within individuals' lending, secured lending had increased by 0.5% in February. Again this was broadly in line with one-month changes since February 1998. But the one-month growth rate

of unsecured lending had fallen from 1.3% in January to 0.9% in February.

11 The stock of M4 held by other financial corporations (OFCs) had increased by £0.3 billion in February compared with a fall of £1.8 billion in January. The twelve-month growth rate in OFCs' M4 had fallen to its lowest level since 1995 Q1. M4 lending to OFCs had increased to £1.7 billion in February from £0.3 billion in January.

12 Turning to price indicators of monetary conditions, sterling interest rate expectations had fallen since the March MPC decision. Short-term interest rates had implied that financial market participants expected the repo rate to fall to around 5% during 1999. Longer-term nominal interest rates had also fallen: three-year forward rates had fallen by around 20 basis points since the March MPC meeting. The falls had been concentrated at the short end of the yield curve.

13 Measures of short-term inflation expectations from monthly surveys had remained broadly unchanged at 2.2% to 2.3%. Measures of two-year inflation expectations from quarterly surveys had shown falls for almost all groups surveyed: for example, the Barclays Basix survey had reported that trade unions' average RPI inflation expectations for the next two years had fallen by 40 basis points since the 1998 Q4 survey. Inflation forward rates, derived from index-linked bond yields, had shown little change since the March MPC meeting. Since the February *Inflation Report*, however, inflation forward rates at all maturities had risen from a range of 2.5% to 2.9% to around 3%. One explanation offered by Bank staff was that nominal yields may have been artificially depressed earlier this year as a result of institutional investors' demand to hold liquid instruments.

14 The FT-SE 100 index had risen by 6.8% since the March MPC meeting. Implied volatility had fallen further, and to below the levels seen before the Russian debt crisis. The FT-SE SmallCap index had risen more than the rest of the market, reflecting in part the strength of the General industrials sector over the period. The Resources sector had also performed very strongly alongside the rise in oil prices.

15 The effective exchange rate had fallen in recent days, after an earlier appreciation, to stand 0.3% lower than at the March MPC meeting. Sterling had changed little against the euro and had depreciated slightly against the US dollar.

III The Budget

16 Staff presented a short summary of the Chancellor's recent Budget. HM Treasury's forecast of PSNB (including the windfall tax) for 1998/99 had been revised up slightly. Lower receipts had more than off-set lower spending. The Budget had announced measures that would increase borrowing by £1 billion in 1999/00, £1.4 billion in 2000/01 and £3.6 billion in 2001/02. However, other changes to HM Treasury's forecasts for spending and receipts over these years had led to lower projected borrowing over the same period. Lower forecasts for social security payments and debt interest payments had more than offset lower projected receipts.

17 Overall, the outlook for the fiscal stance was little changed since the *Pre-Budget Report*: a small deficit had still been projected in 1999/00 and 2000/01 but this was cyclical in nature; the structural deficit had been projected to be broadly balanced. The 'Golden Rule' was expected to be met with a small margin of safety over the next three years. The net debt to GDP ratio had been projected to fall well below 40% by 2001/02.

18 The Budget measures had been aimed at targeting help on families with children, improving work incentives and promoting enterprise through microeconomic reform. These had included reductions in personal income tax rates; changes to National Insurance contributions; measures to reduce taxation for small businesses; and the introduction of a Children's Tax Credit along with increases in existing benefits to families with children.

IV Demand and output

19 The 1998 Q4 National Accounts release had included revisions back to 1997 Q1. The level of GDP at constant market prices in 1998 Q4 had been 0.3 percentage points lower than the February estimate, and 0.5 percentage points lower than the preliminary estimate. Revisions to GDP at constant basic prices had been more limited. Downward revisions to the level of the income and output based measures of GDP had reduced the shortfall of expenditure relative to the average measure. In 1998 as a whole, GDP had grown by 2.1% (revised from 2.3%) compared with 3.5% (unrevised) in 1997. The quarterly growth rate of GDP at constant market prices in Q4 had been revised down to 0.1% from 0.2%. Within the expenditure measure of GDP, upward revisions to consumption and investment growth and the contribution of net trade had been matched by a large downward revision to changes in inventories.

20 Household spending growth in Q4 had been revised up to 0.6% from 0.4%, following an outturn of 0.1% in Q3. Spending on vehicles and energy had been particularly volatile in Q3 and Q4. Household spending growth had slowed overall in 1998: the annualised rate of growth had eased to 1.2% in 1998 H2 from 3.0% in H1. Despite strong consumption growth, the household saving ratio in Q4 had risen to 7.4% from 6.3%. This had reflected a sharp decline in tax payments which had led to an increase of 1.8% in post-tax income. Compensation of employees had risen by 1.5% in nominal terms in Q4. The erratic path of tax payments and household income during 1998 had partly been related to the introduction of self-assessment. The level of tax payments made by households had risen sharply in 1998 by 17%, leading to virtually no growth in real post-tax household income.

21 Whole economy investment growth in Q4 had been revised upwards to 2.9% from 2.0%. Business investment had grown by 5.5%. The ratio of business investment to GDP had increased sharply in recent years—in line with the ratio in the US—to exceed its previous peak in 1989 Q3. But the increase in the capital stock to output ratio had been more moderate. In both the UK and the US part of the recent strength in business investment was due to IT spending.

22 Changes in inventories in Q4 had been revised downwards to £0.9 billion from £1.9 billion. If alignment adjustments are excluded, stockbuilding had increased by less in Q4 than in Q3. The revisions had been concentrated in 'other industries' and manufacturing. Manufacturers and retailers had destocked in Q4, consistent with earlier survey evidence. But lower stockbuilding had been to some extent offset by a downward revision to output so that the stock-output ratio had been little changed. The March CBI monthly Industrial Trends survey had continued to indicate that stocks were more than adequate: the balance had been +20, above its average of +13 since 1985.

23 The contribution of net trade to GDP growth in Q4 had been revised to -0.9 percentage points from -1.1 as a result of upward revisions to exports and imports. The level of exports and, to a larger extent, imports back to 1997 Q1 had also been revised upwards. The revisions to imports had helped to reduce the puzzle about their relative weakness following sterling's appreciation. Monthly trade data for January had shown a sharp decline in exports to EU and non-EU countries (of 3.3% and 6.7%) and a continued rise in imports. Though the decline in exports to non-EU countries had unwound in February, overall these data had suggested another negative net trade contribution to GDP growth in 1999 Q1.

24 Service sector output growth in Q4 had been revised down to 0.5% from 0.6%. Manufacturing output had declined by an unrevised 1.3% in Q4. Construction output growth had been revised up to 0.1%. On the income side of the accounts, the main news had been the decline in financial company profits in Q4.

25 Retail sales volumes had declined by 0.3% in February, following January's strong rise. Though the three month annual growth rate declined further to 1.0%, the CBI Distributive Trades survey had suggested that the decline in sales volumes growth might have reached a trough. The balance on reported sales in March had risen to +14—the highest since September 1998—and the orders balance had risen for the second month running. New car registrations had fallen sharply in January and February relative to a year ago, but had been difficult to interpret because of changing seasonal patterns following the change in registration practices.

26 Industrial production had declined by 0.5% in January—because of a sharp fall in output in the energy extraction and supply industries—but had risen by 0.1% in February because of a rise in energy-related output. Manufacturing output had shown a small increase of 0.1% in January, following five successive monthly declines, but had fallen by 0.1% in February. Growth in industrial production over the three months to February compared with the previous three months had been -1.0% (-0.9% in January); and for manufacturing output it had been -0.8% (-1.0% in January). The CBI and CIPS surveys had indicated another decline in manufacturing output in 1999 Q1, though it appeared that this would be less than in 1998 Q4.

27 The CIPS Report on Services had reported a rise in all indices in March: the output index had risen from 49.5 to 53, the first positive reading since October 1998; the incoming new business index had also risen above 50 to 53.9, the highest level since June 1998 and above the average for 1998 as whole; and the business expectations index had risen to 76.4 from 72.1 in February.

28 The Nationwide house price index had increased by 1.5% in March—the largest monthly rise since June 1997—and had been 7.6% higher than a year earlier; the Halifax index had increased by 1.2% in March and had been 4.5% higher than a year earlier. The RICS survey had suggested price rises across all regions in February. The HBF survey balances on site visitors and net reservations had continued to indicate an increase in housing transactions in coming months. Particulars delivered had increased for a third consecutive month, to stand 4.5% higher in the three months to February compared with the previous three months. The GfK consumer confidence indicator had risen for the third month running.

V Labour market

29 LFS employment had grown by 119,000 (0.4%) in the three months to January, compared with the previous three months, somewhat stronger than the Workforce Jobs figure of 69,000 in the three months to December. The difference between the two measures, probably due to timing and the coverage of the surveys, was accounted for by the larger rise in employees in the LFS, driven by a large increase in part-time jobs. Total hours worked had fallen by 0.2% in the three months to January, and average hours per worker had been 0.7% lower. The fall in average hours worked had reflected the large rise in part-time employment and a 0.7% fall in average hours worked by full-time workers, consistent with a reduction in overtime working.

30 The strong increases in employment had contrasted with survey evidence. The CIPS surveys for March had suggested that employment was continuing to fall in the manufacturing and construction sectors, though there had been a small increase in employment in the service sector. Forward-looking surveys had suggested that this pattern might persist. The Manpower survey for Q1 had shown the weakest job prospects since 1993, for the second quarter in succession. The outlook in manufacturing had worsened, while employment intentions in the service sector had been little changed.

31 The stock of unfilled job-centre vacancies had edged down by 3,500 in February and the number of jobs advertised in national newspapers had fallen, according to the Press Recruitment Advertising Index. But the number of permanent placements by job agencies had increased in March for the first time in six months, according to the FRES survey on the demand for staff.

32 LFS unemployment had risen by 37,000 in the three months to January, taking the rate to 6.3%. This had been the first rise in the rate, in non-overlapping periods, since early 1993. The number of people unemployed for more than one year had fallen by 17,000 in the three months to January, offset by a rise in short-term unemployment. Claimant unemployment had risen by 4,300, but the rate had remained unchanged at 4.6%. Inflows into unemployment had been broadly flat, and the exit rate from unemployment had fallen, but remained at a high level. The rise in employment had been associated with a fall in inactivity of 117,000. In net terms, all of the rise in employment had been concentrated among workers more than 25 years old, which had been roughly matched by falls in inactivity.

33 Headline whole-economy annual average earnings growth had fallen to 4.3% in December, reflecting a decline in the growth of irregular pay. The slowdown in headline earnings growth since the peak in May had been sharp, but this measure referred to growth in earnings per head. It was likely that the growth in earnings per hour had fallen less rapidly, reflecting the reduction in average hours worked over this period. The Reward index of annual earnings growth had continued to fall, from a peak of 5.4% in June 1998 to 4.5% in February. The growth of wages and salaries had been broadly flat since mid-1997. The rise in 1998 Q4, which had contrasted with the fall in growth measured by the Average Earnings Index over the same period, could be explained by volatility in pension contributions and balancing adjustments between different measures of GDP.

34 The Bank's employment-weighted twelve-month measure of whole economy settlements had remained at 3.7% in February, but the three-month measure had fallen by 0.3 percentage points to 3.3%. In a matched sample of firms from the Bank's settlements database, mean settlements in January and February had fallen to 3.3% in 1999, from 4% in 1998. The proportion of employees in this sample who had received a lower settlement in 1999 had been 78%. The three-month measure from Industrial Relations Services had also fallen in February.

35 Annual productivity growth had fallen from 1.1% in Q3 to 0.7% in Q4, the lowest rate since 1991. The revisions to Workforce Jobs, announced in December, had caused a generally downward revision to productivity growth. Because the growth of wages and salaries per head had increased and productivity growth had fallen in Q4, the growth of unit wage costs had continued to rise.

36 The Bank's regional Agents had conducted a survey of their contacts about employment prospects and the adequacy and quality of their labour force. They had asked whether contacts had expected employment to change over the next 6 months: 36% of respondents had reported that the level of employment was expected to be unchanged, whereas the number of companies who had been planning to increase staff had been the same as the number planning to shed labour (32% each). Over 50% of manufacturers had reported that employment levels were expected to be lower whereas in the service sector over 40% of respondents expected higher employment. There had also been some differences across regions, but most had presented a picture consistent with the overall results.

37 The Agents had also asked about the adequacy of the existing labour force in relation to current output. About 30% of respondents had reported that their current employment was more than adequate, whereas less than 20% had reported that their labour force was less than adequate. In manufacturing, there had been many more firms who had reported that they were over-staffed than under-staffed, whereas in the service sector, there had been slightly more firms reporting an under-resourced rather than over-resourced labour force. Some contacts had been recruiting staff even if their existing workforce had been more than adequate, either because they were expecting a significant upturn in demand conditions or because they had been recruiting different types of staff, perhaps with specialist skills.

38 The Agents also asked whether the quality of recruits had changed in the last 12 months. Around two-thirds of their contacts had reported that the quality of recruits had been the same recently. There had been little evidence of lower quality recruits overall. However, in the service sector, especially retail, there had been more dissatisfaction with the recent quality of recruits than in manufacturing.

VI Prices

39 Oil prices had risen by over 20% in March in response to an agreement to new OPEC production cuts. The effect on RPIX inflation and GDP if oil prices were to remain at these levels was likely to be limited. The Bank's index of commodity prices excluding oil had fallen by 0.4% in February, and 1.2% including oil prices. The trend in both measures had continued to be one of moderating deflation. The measures to reform the Common Agricultural Policy (CAP), which had been agreed at the Berlin summit in March, included smaller and later price cuts than in the original proposals. The 0.3% (upper-limit) effect on the RPI which had been estimated by MAFF on the basis of the original proposals was likely to be smaller in light of the agreement. Producer price inflation had remained weak in February: input prices fell by 0.1%—as in January, the movement had been largely accounted for by the oil price (10% of the index); output prices excluding excise duties had risen by 0.2%, to a level 0.6% lower than a year earlier. The CIPS and CBI surveys had continued to suggest further falls.

40 Import prices had fallen by 0.6% in January whereas export prices had risen by 0.6%. The difference between the annual rates of export and import price inflation had reached 1.5 percentage points in January, the largest difference since June 1997—though both had remained sharply negative (imports -4.9%, exports -3.4%). The GDP (market prices) deflator in the year to the fourth quarter of 1998 had grown by 2.6%, revised down from 2.8%. The equivalent measure for the implied household consumption deflator had been revised up by 0.4 percentage points to 2.3%—close to the annual rate of RPIX inflation in the fourth quarter (2.5%). The unit labour costs based measure of domestically generated inflation had become available again, and had continued to rise in the fourth quarter of 1998.

41 RPIX inflation had fallen by 0.2 percentage points to 2.4% in February; both RPIY and RPI inflation had also fallen, to 1.8% and 2.1% respectively. The fall had been largely due to goods price inflation falling by 0.3 percentage points to 1.1%. The HICP inflation rate had also fallen, by 0.1 percentage points to 1.5%, for the same reasons as RPIX. Annual RPIX inflation was likely to increase temporarily in March—largely due to the difference of timing of the budgets in 1998 and 1999—and fall in April.

VII Reports by the Bank's Agents

42 The Agents had reported on their general discussions with contacts. Firms in the service sector had tended to report slower growth. But conditions had remained fairly positive overall, particularly in leisure, finance and business services. Growth in the retail sector had continued to be relatively weak, though there had been an increasing polarisation in performance between stores reporting quite strong growth and those reporting no growth or even falling sales volumes. Service firms with an exposure to the manufacturing sector—such as road hauliers—had experienced adverse trading conditions. But Agents had felt that the rate of deterioration in manufacturing activity may have eased. Stock corrections that had started in 1998 Q4 had largely been completed. But competition in the domestic market from imports had been increasing, particularly from European-based firms as European markets had remained relatively weak. The exchange rate had remained a concern for UK exporters and was considered an obstacle to recovery. Demand from the United States had continued to be strong and some East Asian markets had seen a rise in trade enquiries.

43 Construction sector activity had remained buoyant and this was expected to continue into next year. Housing market activity had shown signs of improvement although it had remained fairly subdued in many areas. But there was less construction work available beyond mid-2000. Firms had suggested that public sector work was likely to be an important factor next year. The outlook for investment more generally had remained positive, though still cautious, and the focus of spending had continued to be on improved efficiency and product development. Investment in some sectors—such as oil and steel—had been reduced or moved overseas.

44 The service sector had continued to be the main provider of new jobs, though tighter control on numbers and increased flexibility had been evident. More firms had been introducing annualised hours contracts and making more use of part-time and temporary contract staff. There had been evidence that some firms were reluctant to shed staff as demand slowed because of likely recruitment difficulties in any upturn. Natural wastage had been employed to reduce staff numbers by small amounts. Pay awards had moderated in both the manufacturing and service sectors, more so in manufacturing where there had also been a rise in the number of zero or deferred awards.

VIII Market intelligence

45 There had been a broad market consensus that interest rates would be lowered in April, based on the improving inflation picture, with some also expecting an ECB rate cut. Survey and asset price evidence had suggested a wider divergence of views on UK rates over the next year or two, based on alternative forecasts for growth and inflation up to 2000. Long-term rates had fallen slightly over the past month. Sterling had appreciated during 1999 versus the euro, and had appeared little affected by domestic factors in the month. Some of the factors influencing sterling—such as demand related to merger and acquisition business—were thought to have been temporary, and there had been some evidence that the market saw downside risks over the next year.

Text of Bank of England press notice of 8 April 1999

Bank of England reduces interest rates by 0.25% to 5.25%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 5.25%.

The minutes of the meeting will be published at 9.30 am on Wednesday 21 April.

Text of Bank of England press notice of 6 May 1999

Bank of England maintains interest rates at 5.25%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.25%.

The Committee considered how policy should be set in the light of its latest inflation projection. Since the February *Inflation Report,* there have been encouraging signs of recovering growth, and over the forecast period inflation is expected to be broadly in line with the $2^1/_2$% target. The projection takes account of the rise since February in sterling's effective exchange rate, and assumes a decline from its present high level, at least in line with interest rate differentials. If sterling were not to weaken as assumed, it is likely that inflation would undershoot the inflation target over the coming two years. In those circumstances, depending on other developments in the economy, there might, therefore, need to be further easing of interest rates in order to keep inflation on track to meet the $2^1/_2$% target.

The latest projections and analysis will appear in the *Inflation Report* to be published on Wednesday 12 May.

The minutes of the meeting will be published at 9.30 am on Wednesday 19 May.

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.
Reward Index: a three-month moving average measure of growth in total pay in the United Kingdom, produced by The Reward Group.
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.

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

Abbreviations

BCC: British Chambers of Commerce.
BIS: Bank for International Settlements.
BRC: British Retail Consortium.
CBI: Confederation of British Industry.
CIPS: Chartered Institute of Purchasing and Supply.
EIU: Economist Intelligence Unit.
FRES: Federation of Recruitment and Employment Services.
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.
MFR: Minimum funding requirement.
MPC: Monetary Policy Committee.
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.

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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