

Inflation Report

May 2000

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

Overview

In the first quarter of 2000, output in the UK economy was 2.9% higher than a year earlier, and inflation on the RPIX measure was 2.0% in March. Final domestic demand, led by household consumption, grew strongly last year. Net external demand, which had picked up in mid-1999 with the recovery in world trade, subsequently weakened. Manufacturing output has declined in recent months, but robust service sector growth continues. The labour market remains tight. Pay growth rose sharply around the turn of the year, probably in large part because of temporary factors. The exchange rate has continued to strengthen, particularly in relation to the euro.

World economic prospects have improved further. Momentum remains strong in the US economy. Activity in the euro area has continued to strengthen, and forward-looking indicators suggest a firm outlook for demand and output growth. The Japanese economy remains subdued, but emerging market economies in East Asia and elsewhere have strengthened their recoveries from the downturns that followed the financial disruptions of 1997–98. The oil price rose above \$30 per barrel in early March before falling back as OPEC eased production restraints. Consumer price inflation has picked up in the United States and the euro area. The Federal Reserve and the ECB are among the central banks that have raised interest rates since February. Though the world economic outlook appears more positive than for some time, risks remain. These continue to relate primarily to the possibility of sudden adjustment—perhaps involving sharp movements of financial asset prices—to growing imbalances within and between major economies.

According to the preliminary estimate, output in the UK economy grew by 0.4%—less than expected—in the first quarter. But output in the second half of last year is now estimated to have been somewhat higher than thought at the time of the *February Report*. There is renewed divergence between output trends in different sectors of the economy, reflecting in part the strength of sterling against the euro. Manufacturing output has fallen in recent months, but robust overall growth has continued in the service sector. Business survey indicators and reports from the Bank's regional Agents highlight the contrast between the pressures on industries particularly

exposed to international competition and the broadly positive outlook of those serving domestic markets.

Final domestic demand, which excludes inventory investment, accelerated towards the end of last year and was 4.4% higher in Q4 than a year earlier. Household expenditure has grown strongly, buoyed by rising real incomes, wealth and borrowing. These factors should continue to support consumption growth going forward, but consumer confidence measures have recently fallen back. Business investment picked up in 1999 Q4. The recent trend in inventory investment is hard to judge, in part because millennium-related factors may have affected patterns of stockholding around the year-end.

The Chancellor made his Budget statement on 21 March. The future profiles for government consumption and investment have been increased, but in the context of a substantially tighter fiscal position than expected at the time of the Treasury's Pre-Budget Report in November. The overall macroeconomic impact of these fiscal developments in the near-term is unlikely to be large.

UK export growth has been volatile in recent quarters. Exports fell back in Q4 from their previous sharp rise, but exports to non-EU countries have picked up again in recent months. Import growth has been boosted by the strength of both sterling and domestic demand. Net trade—exports less imports—made a large negative contribution of minus 1.2 percentage points to GDP growth in the fourth quarter. Despite the continuing improvement in prospects for world trade growth, the outlook is for further deterioration of the UK trade balance if the exchange rate remains high.

Year-end distortions having passed, narrow money is growing robustly, at an annual rate of 8% or so. Broad money growth, whose movements have for some time been dominated by swings in the sterling deposits of non-bank financial companies, has recovered from very low levels to around 5%. Credit growth has strengthened further. Lending to households, which is mostly secured on housing wealth, was about 10% higher in Q1 than a year earlier, and loan approvals for house purchase have picked up again. External financing by the corporate sector has also been strong, especially from capital markets.

The Bank's official short-term interest rate has remained at 6% since February. Near-term nominal interest rate expectations derived from financial markets have in

recent months reversed some of their rises since the autumn. As measures of inflation expectations have on the whole remained steadily consistent with the 2½% inflation target, real interest rates have moved with nominal rates. Technology-related share indices have fallen sharply from the peaks that they reached in March, but broad equity price measures are not much lower than three months ago.

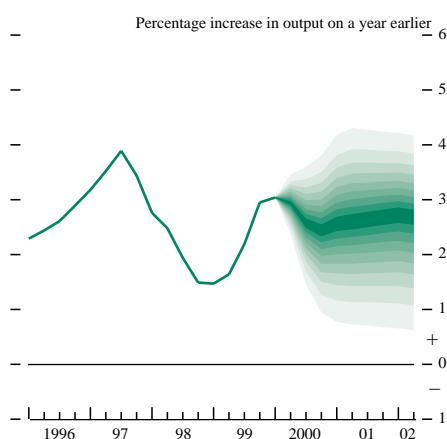
The labour market remains tight. Steady overall employment growth has continued, and the unemployment rate on the Labour Force Survey measure has declined to 5.8%. Claimant count unemployment has also fallen further, to its lowest level for 20 years. Survey indicators point to further employment growth overall, but employment intentions in manufacturing have weakened. Reports of labour shortages remain widespread.

Pay growth has risen sharply. The Average Earnings Index in the three months to February was 6.0% higher than a year earlier—considerably stronger than expected at the time of the last *Report*. Wage settlements have not increased, so growth in other components of pay has risen further. Part of the explanation may be temporary factors—for example related to Y2K—which have few, if any, implications for prospective inflation. But part may be a reflection of labour market tightness. The consequences for inflation of nominal pay growth depend on productivity growth, which has recently picked up.

The majority of UK trade in goods is with countries in the euro area. The continued decline in the euro since the last *Report* has therefore been mirrored by a substantial further rise in sterling’s effective exchange rate index. In the 15 working days to 3 May, sterling’s ERI averaged 110.7, which is 1½% above the central path assumed in the February *Report*. This is the starting-point for the Committee’s projections described below, which assume, in the central case, that sterling’s ERI declines to 108.9 at the two-year forecast horizon. The central projection is a benchmark around which there is large uncertainty.

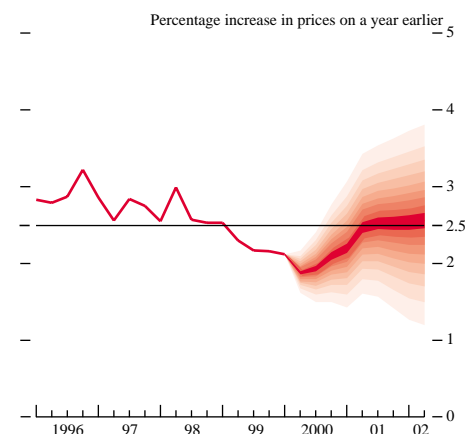
The MPC’s best collective judgment of the prospects for GDP growth—on the conditioning assumption that the official interest rate remains at 6%—is shown in Chart 1. In the central projection, annual growth eases from its present rate to around 2½%–2¾%—at or above trend—for most of the two-year forecast period. The profile is

Chart 1
Current GDP projection based on
constant nominal interest rates at 6%



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 6%



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.

slightly firmer than in the February *Report*, largely because of stronger domestic demand. The recent rise in sterling offsets the effect on external demand of the stronger outlook for world activity.

The corresponding projection for RPIX inflation is shown in Chart 2. The most likely path is for inflation to remain below target for the next year before rising to around the 2½% target. This is similar to the February profile, in part because the recent rise in the exchange rate broadly offsets the stronger-than-expected pay growth.

All Committee members agree that inflation and growth prospects are surrounded by large uncertainties, and not every member shares the central assumptions upon which the projections shown in Charts 1 and 2 are based. Relative to those projections, some members would prefer, as a central case, to assume a steeper decline in the exchange rate and less structural compression of profit margins. Others would prefer to assume a constant nominal exchange rate and more downward pressure on prices on account of greater competition and higher productivity growth. Alternative combinations of assumptions could raise or lower the inflation profile by up to ½% at the two-year forecast horizon.

The paramount objective of UK monetary policy is to meet the 2½% inflation target. The further rise in the exchange rate—if sustained—will exert additional downward pressure on inflation in the near-term. But final domestic demand growth will probably need to slow if cost pressures—especially in the labour market—are not to increase further. The Monetary Policy Committee will continue to set interest rates in response to changing economic conditions so as to keep prospective inflation on track to meet the target.

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Link to Quarterly Bulletin

Section 1

Money, lending and spending: a study of the UK non-financial corporate sector and households
Quarterly Bulletin, May 2000, pages 159–67.

Market and operations
Quarterly Bulletin, May 2000, pages 117–34.

An effective exchange rate index for the euro area
Quarterly Bulletin, May 1999, pages 190–94.

Section 2

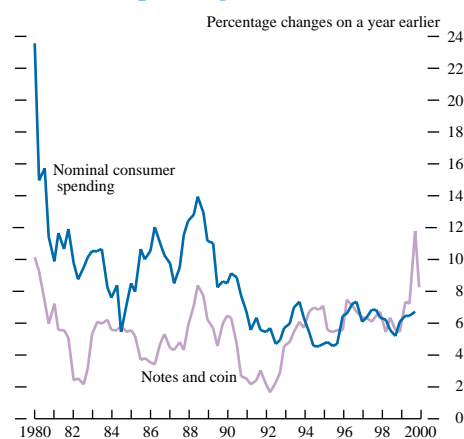
The international environment
Quarterly Bulletin, May 2000, pages 135–49.

Annual narrow money growth has been stable in recent months, following large swings over the year-end, but remains well above nominal spending growth. Broad money growth picked up in 2000 Q1, owing to a sharp rise in deposits held by non-bank financial corporations. By contrast, annual household M4 growth was steady and private non-financial corporations' M4 deposits grew more slowly. Lending remains buoyant, with growth at its highest annual rate since 1991.

The Bank of England official rate stands at 6%, unchanged since the February *Report*. In the euro area and the United States, official interest rates have risen in recent months. In the United Kingdom, the markets still expect official rates to rise over the next year, but now anticipate a lower peak in rates than at the time of the previous *Report*. Long-term market interest rates have also fallen.

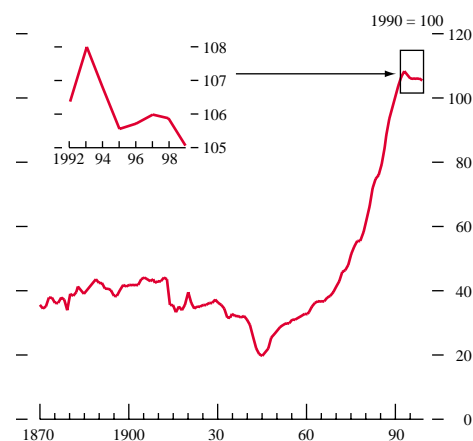
The sterling effective exchange rate remains very high, largely due to sustained euro weakness. Aggregate UK equity prices are slightly lower than in February, with share prices in high-technology sectors falling particularly sharply. House prices continue to rise rapidly but there are some tentative signs that house price inflation may be easing.

Chart 1.1
Growth of notes and coin and nominal consumer spending



Sources: ONS and Bank of England.

Chart 1.2
Narrow money velocity^(a)



Sources: Capie, F and Webber, A (1985), Feinstein, C (1972) and Bank of England.

(a) Defined as the ratio of annual consumer spending to the average annual M0 stock.

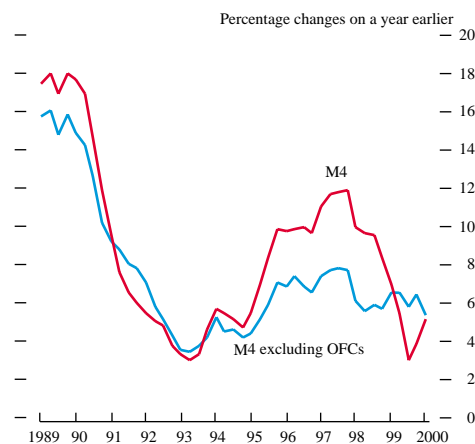
1.1 Money and credit

Narrow money

Annual narrow money growth has weakened from the unusually high rates associated with the transition to the new millennium. But growth of notes and coin in circulation remains higher than at any time since the late 1980s and is well above growth of nominal consumer spending (see Chart 1.1).

For most of the period since the Second World War, narrow money holdings have grown more slowly than nominal spending (ie narrow money velocity has risen), as new payment technologies, such as the introduction of credit and debit cards, have allowed agents to economise on cash holdings (see Chart 1.2). But in the early 1990s velocity rose less rapidly. And in recent years velocity has actually fallen.

Chart 1.3
Growth of M4 and M4 excluding OFCs



Sources: ONS and Bank of England.

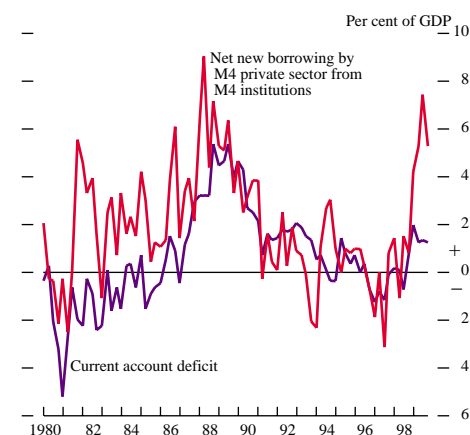
Table 1.A
Growth rates of notes and coin, M4 and M4 lending^(a)

Per cent		3 months (b)	6 months (b)	12 months
Notes and coin (c)	2000 Jan.	30.1	17.6	13.0
	Feb.	6.0	7.2	8.4
	Mar.	-6.5	8.3	8.4
	April	-9.9	8.3	8.2
M4	1999 Q2	3.4	3.4	5.5
	Q3	0.7	2.1	3.0
	Q4	8.2	4.4	3.9
	2000 Q1	8.3	8.3	5.1
M4 lending	1999 Q2	8.3	7.6	7.6
	Q3	7.6	8.0	6.9
	Q4	11.7	9.7	8.6
	2000 Q1	12.9	12.3	10.1

Source: Bank of England.

- (a) Seasonally adjusted.
- (b) Annualised.
- (c) Growth rates based on an average of weekly observations in the month.

Chart 1.4
Net new M4 borrowing by the M4 private sector^(a) and the current account deficit



Sources: ONS and Bank of England.

- (a) Sterling M4 lending flows minus sterling M4 deposit flows.

One potential explanation for falling velocity in recent years is that the costs of holding cash have fallen. Cash holdings earn no interest and their purchasing power is eroded by inflation. It is possible that persistently low nominal interest rates and inflation in the 1990s relative to previous decades may have raised agents' desired holdings of cash. The box on page 5 reports similar velocity behaviour in other countries that have experienced falls in inflation and nominal interest rates in recent years. Looking forward, the relationship between narrow money growth, future activity and inflation will depend partly on the extent to which agents have adjusted their cash holdings to a low-inflation environment. If this adjustment is continuing, further falls in velocity would be consistent with less inflation at any given narrow money growth rate. But as this adjustment nears completion, velocity may rise again reflecting continuing innovation in payment systems.

Broad money and credit

Annual M4 growth picked up to 5.1% in 2000 Q1, from 3.9% in the previous quarter (see Chart 1.3). During 1999, a rundown in deposits held at banks and building societies by other financial corporations (OFCs) led to weak growth of total M4. However, OFCs' M4 deposits rose sharply at the end of 2000 Q1, more than accounting for the pick-up in annual M4 growth. As discussed below, it seems unlikely that this increase in OFCs' deposits has major implications for aggregate demand. Excluding OFCs, annual broad money growth eased slightly in 2000 Q1 (see Chart 1.3).

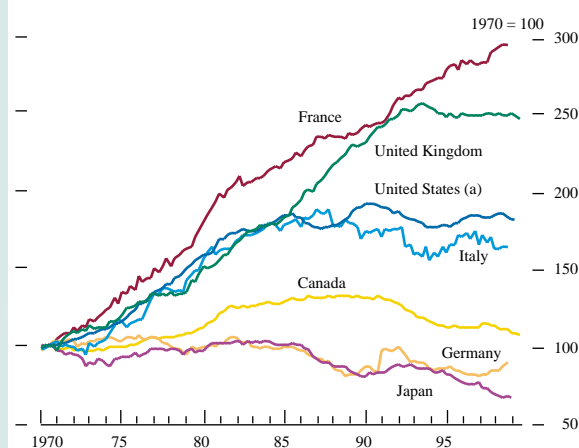
Bank and building society lending to the M4 private sector rose by 10.1% in the year to 2000 Q1 (see Table 1.A), the highest annual rate since 1991. Over the past year, a substantial gap has emerged between M4 and M4 lending flows. In the past, divergences between M4 and M4 lending have been associated with movements in the UK current account balance (see Chart 1.4). Aggregate imbalances between the income and spending of the UK public and private sectors have to be financed, in an accounting sense, by the acquisition of foreign assets or liabilities, either directly with non-residents, or intermediated via the banking system. Recent financial deficits in the private sector have more than offset the public sector financial surplus, consistent with a movement into current account deficit. On past relationships, that would suggest a widening gap between M4 and M4 lending. However, Chart 1.4 suggests that in 1999 sterling funds from overseas

International trends in narrow money velocity

Understanding the behaviour of narrow money velocity—defined as nominal spending relative to cash in circulation—is important for assessing the information content of narrow money for activity and inflation. An examination of overseas velocity behaviour may provide insights into recent trends in UK narrow money velocity.

Chart A shows that the shift to stable and gently falling narrow money velocity in the United Kingdom in the 1990s is not exceptional by international standards. In fact, velocity has been broadly flat or falling in almost all G7 economies for much of the 1990s.

Chart A
Narrow money velocity in the G7



Sources: Bank of England, BIS, Federal Reserve Bank of St Louis, IMF and ONS.

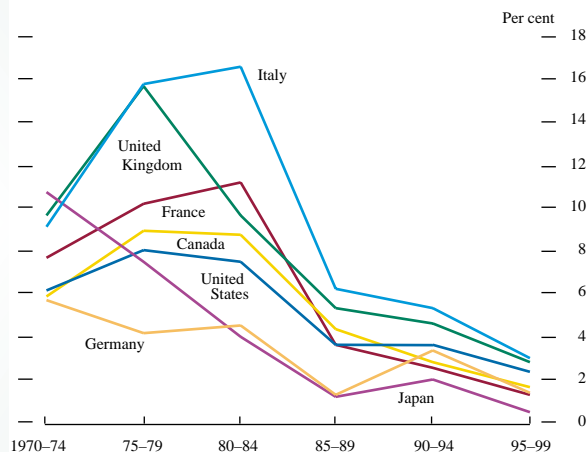
(a) Based on an estimate of currency held by US residents.

There are many possible explanations of the paths of narrow money velocity across economies over this period.⁽¹⁾ An important common contributory factor to rising velocity in some economies in the 1970s and 1980s was the introduction of cash-saving financial innovations. Greater use of bank accounts, the spread of automated cash dispensers, and the proliferation of credit, debit and store cards are all likely to have reduced agents' demand for cash—and raised the velocity of circulation.

But financial innovation is a less satisfactory explanation of velocity behaviour in countries, such as Germany and Japan, with flat or falling velocity for most of the period. And falls in velocity in other countries in the 1990s seem at odds with continuing rapid innovation in cash-saving technologies.

Another potential factor contributing to velocity behaviour (and cash demand) in recent decades may be the differing inflationary experiences of countries (see Chart B). High and variable inflation in some countries in the 1970s and 1980s increased the costs of holding notes and coin relative to interest-bearing deposits or real assets, and that is likely to have reduced cash demand. It may also have provided a further spur to innovation in cash-saving payment technologies, also raising velocity. Consistent with this explanation, velocity in the 1970s tended to rise most sharply in countries that experienced high and variable inflation, such as Italy, the United Kingdom and France. By contrast, velocity rose less, or fell, in countries with lower and more stable inflation and nominal interest rates, such as Germany and Japan.

Chart B
Period average annual inflation^(a) in the G7



Sources: IMF and ONS.

(a) Defined as average annual change in CPI over specified period (RPI for United Kingdom).

More recently, changes in velocity trends appear to have been related to the transition of countries to lower-inflation environments, and sometimes the implementation of new monetary regimes. Successful new regimes may lower private sector inflation expectations, and so raise the demand for cash and reduce the velocity of circulation. For example, US velocity, based on an estimate of currency held by US residents, rose in the 1970s.⁽²⁾ But it stabilised in the early 1980s following the introduction of a new monetary control regime and sharp falls in inflation. In Canada, velocity began to fall in the early 1990s following falls in inflation and the implementation of inflation targeting in 1991. And the stabilisation and subsequent fall in velocity in the United Kingdom in the 1990s broadly coincided with the start of inflation targeting in 1992.

(1) See for example Janssen, N, 'Can we explain the shift in M0 velocity?', *Bank of England Quarterly Bulletin*, February 1996, pages 39–50.

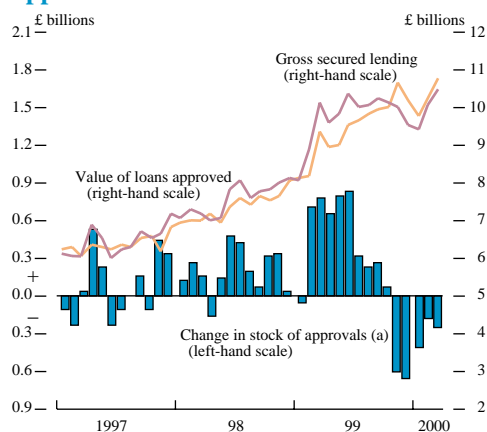
(2) Estimates of US residents' currency holdings are taken from Anderson, R and Rasche, R, 'The domestic adjusted monetary base', *Federal Reserve Bank of St Louis Working Paper*, January 2000.

flowing through the UK banking sector were considerably larger than the current account deficit.

Household sector

Household sector M4 grew by 6.1% in the year to 2000 Q1, the same rate as in the previous quarter. An alternative indicator of deposits likely to be used in nominal spending is the Divisia index, which places a higher weight on more liquid deposits. Annual growth in household sector Divisia eased slightly to 5.9% in 2000 Q1, partly owing to the sharp fall in notes and coin in circulation after the turn of the millennium. Looking forward, households' M4 may be boosted in coming months by payments associated with the demutualisation of Scottish Widows.

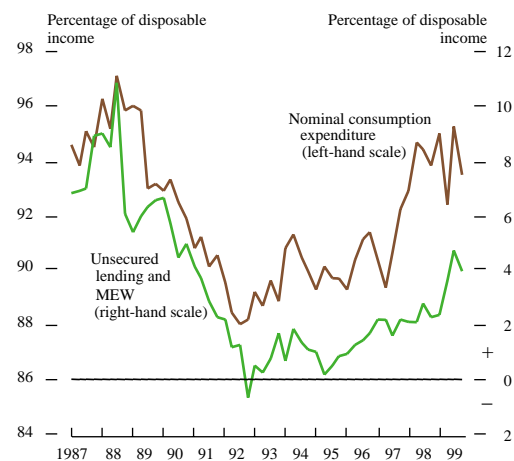
Chart 1.5
Secured lending to individuals and loan approvals



Source: Bank of England.

(a) Defined as gross approvals net of cancellations and gross lending.

Chart 1.6
Total lending for consumption and household expenditure



Sources: ONS and Bank of England.

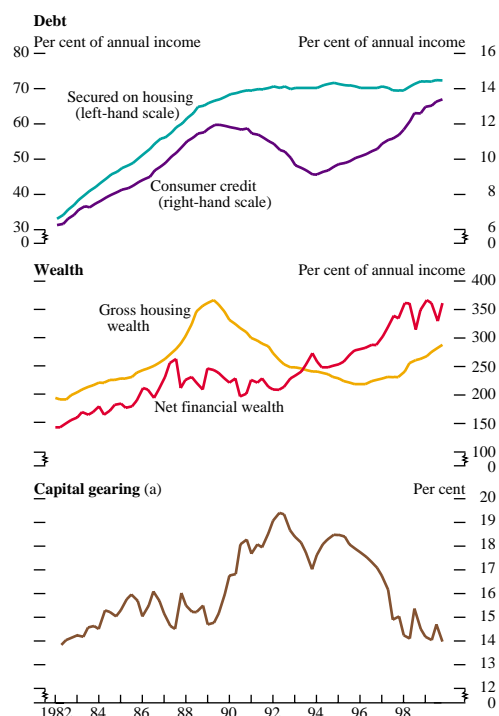
Annual growth in lending to households⁽¹⁾ rose further to 9.9% in 2000 Q1, the highest rate since 1991, although shorter-term growth measures suggested no further increase from the high growth rates reached in late 1999. Annual growth in a broader measure of total lending to individuals by banks, building societies and other specialist lenders also edged up, to 9.7% in 2000 Q1.

Within the total, net secured lending to individuals grew by 8.7% in the year to 2000 Q1. For much of 1999, new loan approvals were well above gross new lending, leading to a substantial build-up in the stock of unused mortgage approvals (see Chart 1.5). Around the turn of the year, there was a slowdown in loan approvals. Although lending also eased somewhat, it remained stronger than new approvals as this stock was run down. More recently loan approvals and lending have picked up once again, suggesting that current housing market activity remains relatively firm.

Annual growth in unsecured consumer credit remained robust at 14.3% in 2000 Q1, but the pace of growth has moderated slightly over the past year. One reason for slower growth in unsecured credit may be that households have increasingly financed their spending at lower interest rates with borrowing secured on rising housing equity. The Bank estimate of mortgage equity withdrawal (MEW) in 1999 Q4 was £2.5 billion, slightly weaker than in the previous quarter. But the estimated total flow of MEW in 1999, at £8.2 billion, was equivalent to around a quarter of total net secured lending over the year. Taking consumer credit and

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

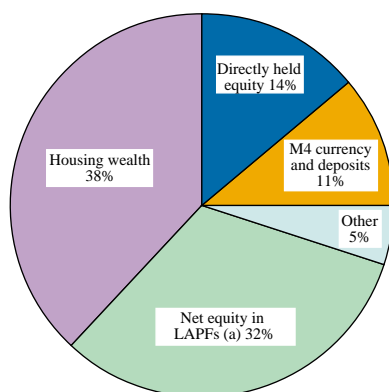
Chart 1.7
Household balance sheets



Sources: ONS and Bank of England.

(a) Defined as the stock of M4 lending to the household sector as a share of gross housing and net financial wealth.

Chart 1.8
Household sector gross assets in 1999 Q4



Sources: ONS and Bank of England.

(a) Life assurance and pension funds.

MEW together, total borrowing for consumption in 1999 rose to its highest share in household disposable income since 1990 (see Chart 1.6).

Strong borrowing growth over the past year has raised household debt to historic highs relative to income (see Chart 1.7). The ability of households to service this higher indebtedness and maintain future consumption plans partly depends on changes in the value of their assets. The largest components of total household wealth are housing, equities and assets held indirectly in life assurance and pension funds (LAPFs) (see Chart 1.8). In recent years, rising house and equity prices have increased valuations of these components substantially, more than offsetting rising debt. In fact, as Chart 1.7 shows, the ratio of household sector debt to wealth—known as capital gearing—is lower than for many years.

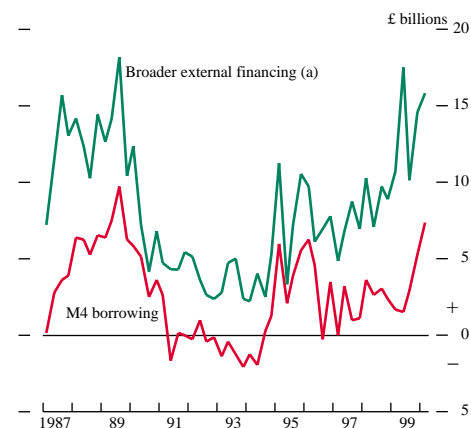
Rising wealth might mean that households are willing to add to existing debt and that lenders are prepared to extend further credit. But several factors might limit this effect. One possibility is that those households who wish to take on more debt are not the same as those who have seen rising asset values. Another is that as debt rises further relative to current income, borrowers (and lenders) might become more concerned about potential debt-servicing burdens should there be large changes in asset values.

Private non-financial corporations

Annual growth in private non-financial corporations' (PNFCs') M4 deposits slowed sharply to 2.4% in 2000 Q1 from 7.3% in the previous quarter. One possible explanation is that deposit flows weakened in 2000 Q1, as PNFCs unwound a precautionary build-up in liquidity in advance of the millennium date change. Bank and building society sterling lending to the sector picked up to 8.9% in 2000 Q1, its highest rate since 1996. PNFCs have also raised substantial funds from capital markets over the past year (see Chart 1.9). Higher PNFCs' borrowing and slower deposit growth are consistent with the rising financial deficit of the sector over the past year.

The implications of rising PNFCs' indebtedness for future activity depend on its cause. At an aggregate level, higher borrowing has been associated with strong investment relative to corporate profits. Sectoral data on bank lending also support this interpretation. For

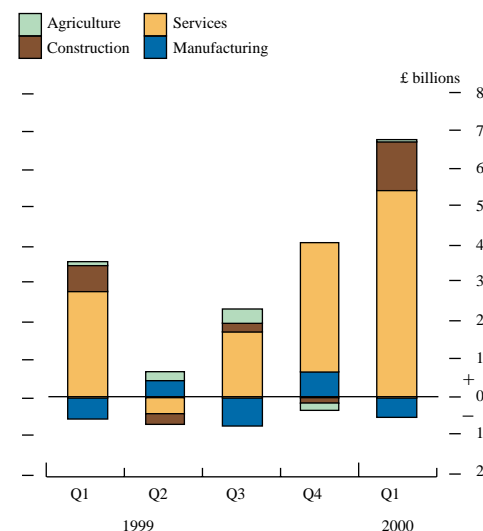
Chart 1.9
PNFCs' external finance



Source: Bank of England.

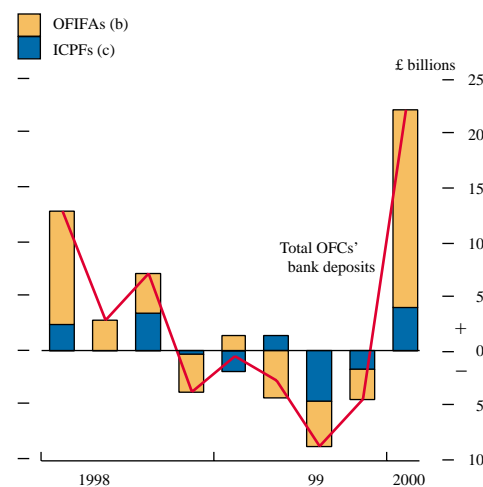
(a) M4 borrowing plus capital issues and foreign currency borrowing from banks and building societies.

Chart 1.10
Industrial breakdown of bank lending^(a)



(a) Not seasonally adjusted.

Chart 1.11
Quarterly OFCs' bank deposit flows^(a)



Source: Bank of England.

(a) Not seasonally adjusted.
(b) Other financial institutions and financial auxiliaries.
(c) Insurance companies and pension funds.

example, the recent strength of sterling lending to the service sector and the weakness of manufacturing borrowing from banks (see Chart 1.10) are consistent with the relative investment trends in these sectors, discussed in Section 2.⁽¹⁾

Other financial corporations

M4 deposits held at banks and building societies by OFCs rose by 4.4% in the year to 2000 Q1, reversing the weakness of these deposits in recent quarters. Rising deposit growth was matched by higher growth in OFCs' M4 borrowing, which increased to 14.2% in the year to 2000 Q1. The OFC sector comprises insurance companies and pension funds (ICPFs) and other financial institutions and financial auxiliaries (OFIFAs), such as securities dealers. Much of the bounceback in OFCs' M4 deposits in the first quarter reflected sharply higher deposits placed at banks by OFIFAs (see Chart 1.11), particularly securities dealers. Movements in securities dealers' deposits tend to be a by-product of their financial intermediation business and have no obvious implications for nominal spending.

1.2 Interest rates and asset prices

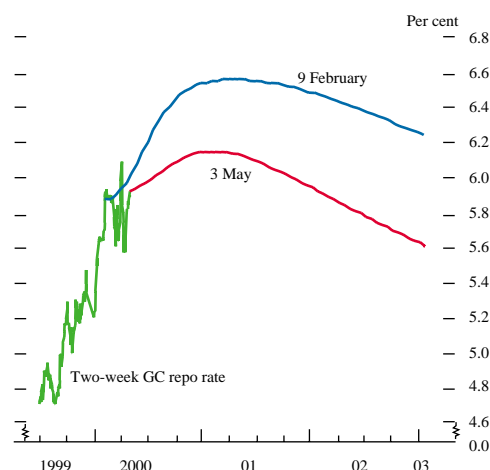
Short-term interest rates

The Bank of England official repo rate stands at 6%, unchanged from its level at the time of the February Report. Official rates overseas have risen further. The European Central Bank has increased its official rate on two separate occasions by a total of 50 basis points to 3.75%. And the US Federal Open Market Committee raised the federal funds target rate by 25 basis points to 6.0% on 21 March.

Market expectations of official rates over the coming year have risen somewhat in the euro area and the United States since the February Report. In the United Kingdom, markets still expect official rates to rise in the near term but now anticipate that rates will peak at a lower level than thought in February. Chart 1.12 shows two-week forward interest rates derived from the prices of government bonds and gilt repo rates on 9 February and 3 May. Expected rates over the next three years have fallen by around 50 basis points since the previous Report. The market expects gilt repo rates to peak early

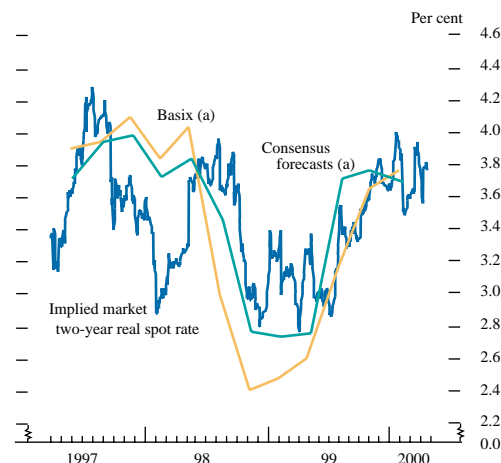
(1) For a discussion of possible relationships between PNFCs' investment and their borrowing from banks and building societies, see Brigden, A, Chrystal, A and Mizen, P, 'Money, lending and spending: a study of the UK non-financial corporate sector and households', *Bank of England Quarterly Bulletin*, May 2000, pages 159–67.

Chart 1.12
Two-week forward rates



Source: Bank of England.

Chart 1.13
Market and survey-based two-year spot real interest rates



Sources: Barclays Bank and Consensus Economics.

(a) Derived as the difference between two-year spot nominal interest rates and derived two year spot inflation rates from each survey. Basix survey inflation expectations are an average of all groups except the general public.

Table 1.B
Selected sterling nominal spot bond yields

Per cent	2000		Basis points change since 9 Feb.
	9 Feb.	3 May	
Spot nominal government bond yields			
3 year	6.42	5.96	-46
5 year	6.24	5.71	-53
10 year	5.52	5.14	-38
25 year	4.24	4.19	-5
Spot nominal corporate bond yields (A-rated)			
5 year	7.43	6.99	-44
10 year	7.13	6.88	-25
25 year	6.55	6.54	-1

Sources: Bloomberg and Bank of England.

next year, with an implied peak in official rates of between 6¹/₄% and 6¹/₂%.⁽¹⁾

The impact on the economy of changes to market interest rates will partly depend on whether they reflect changes in expected real interest rates, inflation expectations and/or inflation risk premia. Estimates of real interest rates can be derived directly from the prices of index-linked gilts. An alternative approach is to compare market nominal interest rates with survey evidence on inflation expectations. Chart 1.13 compares two-year real interest rates derived from index-linked gilt prices with measures estimated from market nominal interest rates and survey-based inflation expectations. Both measures suggest that most of the rise in two-year nominal interest rates since last autumn has reflected increases in real interest rates, rather than a pick-up in inflation expectations over this period.

Long-term interest rates

Ten-year nominal bond yields in the United Kingdom were 5.1% on 3 May, about 40 basis points lower than in February (see Table 1.B). Part of this fall in spot rates reflects the reductions in UK short-term interest rate expectations discussed above. But part appears to be an international phenomenon, with government bond yields overseas also falling since the previous Report (see Chart 1.14). Table 1.B also shows that UK 25-year bond yields are broadly unchanged since February. This differential movement of longer-term rates might partly reflect the impact on long gilt prices of higher-than-anticipated supply: on 21 March the Debt Management Office announced that future gilt issuance is to be more heavily weighted towards medium and long maturities than previously expected.⁽²⁾

Table 1.B also shows that ten-year corporate bond rates have fallen by slightly less than government bond yields over the past three months, suggesting a moderate widening in spreads. In part, this might reflect higher corporate issuance in the recent past. In coming months, issuance may rise further as companies raise finance for third generation mobile phone licences, as discussed in the box on page 10.

(1) Market gilt repo rates tend to be lower than official repo rates due to technical factors. These rates, with an appropriate upward adjustment, are used to construct the inflation and GDP projections based on market interest rate expectations shown in Section 6.

(2) The impact of the Debt Management Review on gilt yields is discussed at greater length in the 'Market and operations' article, *Bank of England Quarterly Bulletin*, May 2000, pages 117–34.

Implications for monetary policy of the third generation mobile spectrum licence auctions

The UK Government has allocated the limited spectrum for third generation mobile telecommunications licences (3G) for a 21-year period by means of an auction. The five licences have been sold for a total of around £22.5 billion. It is likely that this will be paid in the current financial year. This box addresses the possible implications for UK monetary policy of this windfall to Government finances.

Although the auction revenue will have a substantial impact on the public sector net cash requirement (PSNCR) for the financial year 2000/01, it will have a much smaller effect on public sector net borrowing (PSNB), the Government's preferred measure of the stance of fiscal policy. The PSNB is the difference between current spending plus net investment and total revenues, in which the licence revenue is spread over the full 21-year licence period, while the PSNCR records the actual cash flows. Relative to the Budget assumptions, the Chancellor has indicated that the extra funds are likely to be used to reduce the level of public sector net debt. Debt management issues arise from this decision, but these can largely be separated from monetary policy, and they are primarily issues for the Debt Management Office (DMO) and the Treasury.⁽¹⁾

There will be some continuing impact on Government finances of the lower net debt level, reflecting the fall in interest costs. This will be of the order of a little over £1 billion per annum in a full year. To leave the Government finances in a similar position as before, either taxes could be slightly lower than otherwise or public spending could be slightly higher. But the effects are small relative to the size of total Government current spending of a little over £300 billion. And as plans have already been announced, there will be no change in fiscal policy in the near term. As the Government's debt-servicing requirements fall, the prospective position for present and future taxpayers is equivalently slightly improved. Given higher prospective lifetime after-tax incomes, consumer spending could rise a little, but the scale of the effects will be too small and uncertain to have a significant effect on prospects for GDP growth or inflation.

Since the companies purchasing the licences will have to finance these payments, their net indebtedness will rise. So the reduction in Government net debt may be offset by an increase in corporate debt. There may also be a wealth effect for shareholders and bondholders of the bidding companies resulting from a new market

valuation of these companies. The size and direction of this will depend on whether the markets fully anticipated the cost of the licences and how they now value the likely profitability of 3G activities.

The increased relative supply of corporate debt may raise the spread between corporate bond rates and gilts, and have an effect on the term structure of bond yields—depending on the maturity structure of the resulting debt sales and purchases. But it is likely that any resulting portfolio shifts will be small relative to the aggregate size of the capital markets, in which case they would have little direct effect on the overall balance of saving and investment in the economy. Accordingly, there should be little direct effect on the equilibrium level of real interest rates. There may, however, be some effects on money and credit aggregates.

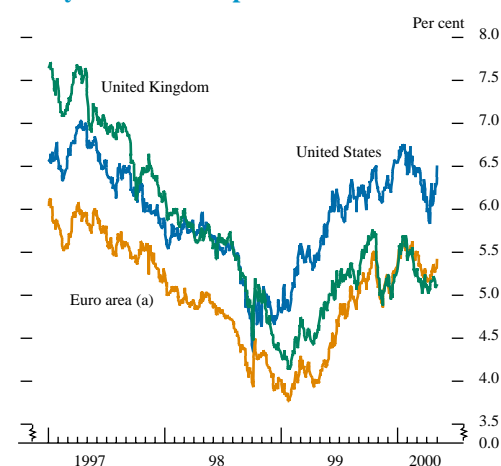
To the extent that some of the corporate debt issuance is in foreign currency, or the Government chooses to run down foreign currency debt (or purchase foreign currency assets), there may be a temporary impact on the exchange rate because of the potentially large flows involved. Foreign currency financing of the licence purchase for example would increase demand for sterling, and foreign currency investment of the proceeds would increase supply of sterling in the foreign exchange markets. However, the MPC has not changed the assumed exchange rate profile over the forecast period on this account.

Innovations such as the new 3G telecommunications services may have effects on relative prices and on the productivity and output of firms affected. However, the introduction of new products is happening all the time as part of a continuing process of technological advancement. Such innovations have implications for relative product prices, but not for the rate of inflation of goods and services prices in general, which is determined ultimately by the stance of monetary policy.

In short, the MPC has not changed any of its assumptions relating to the fiscal stance, other components of aggregate demand or trend supply capacity as a result of the 3G spectrum auctions. The sums of money involved are substantial for the companies concerned and the windfall for the Government represents a significant reduction in Government net debt. However, none of this is on a sufficient scale to change the MPC's inflation forecast or to alter the required course of monetary policy.

(1) For a discussion of the links between the size and structure of government debt and monetary conditions, see: *Government debt structure and monetary conditions*, Chrystal, K A (ed), Bank of England, December 1999.

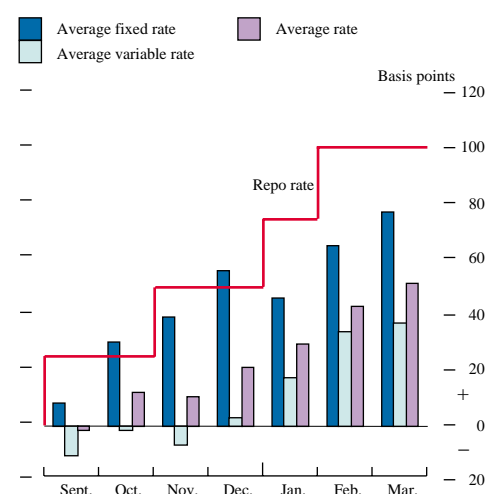
Chart 1.14
Ten-year nominal spot interest rates



Source: Bank of England.

(a) Calculated from the prices of French and German government bonds.

Chart 1.15
CML estimates of cumulative mortgage rate changes since August 1999^(a)



Sources: Council of Mortgage Lenders and Bank of England.

(a) CML estimates of rates initially charged on new mortgages.

Table 1.C
Changes in selected world equity indices to 3 May^{(a)(b)}

Percentage changes from specified dates:

	End-1998	End-1999	9 Feb. 2000
FTSE 100	9.8	-6.6	-0.4
FTSE All-Share	14.2	-5.6	-0.7
S&P 500	20.5	0.7	2.2
Nikkei 225	37.1	5.2	-0.1
Datastream European	15.6	1.0	-1.5

Sources: Bloomberg and Primark Datastream.

(a) 15 working day average basis.

(b) In domestic currency terms.

Retail rates

Longer-term interest rates can also affect the cost of borrowing in the household sector through their impact on fixed-rate mortgages. Lenders typically set fixed-rate mortgages in relation to swap rates. Like long bond yields, swap rates reflect market expectations of the future path of short-term interest rates. They also measure the cost to lenders of exchanging fixed-rate income from mortgages with variable-rate income, which allows them to hedge their interest rate exposure.

Since the autumn of 1999 swap rates have risen by less than official interest rates. Consistent with this, the Council of Mortgage Lenders (CML) estimates that the average cost of new fixed-rate mortgages has so far risen by around three quarters of the increase in official rates over this period (see Chart 1.15). The chart also suggests that competition in the discounted mortgage market has intensified in recent months. The increase in the CML measure of average variable mortgage rates, which includes discounted mortgages, has been less than half that seen in official rates. Overall, the CML average rate on all new mortgages suggests that initial interest charges faced by borrowers have risen to date by considerably less than official rates since the autumn of 1999. Incomplete pass-through is also apparent in banks' and building societies' deposit rates. Average quoted deposit rates in the Bank's sample of instant access and time deposit accounts have risen by a little over half of the rise in repo rates over the same period.

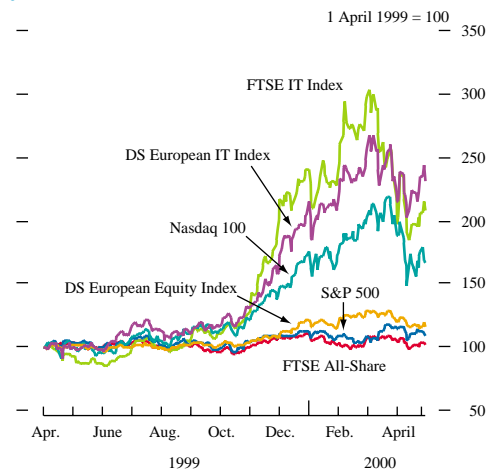
Equity prices

The FTSE All-Share index averaged 2977 in the 15 working days up to and including 3 May, about 1½% below the central projection for May implied in the *February Report*. Over the past three months aggregate equity indices in other countries are generally little changed (see Table 1.C). But within these indices, there have been sharp falls, and increased volatility, in the valuations of companies operating in information technology (IT) sectors (see Chart 1.16). However, over a longer period, IT shares have risen considerably more rapidly than shares of companies in other industries. For example, the valuation of the UK IT sector has more than doubled over the past year, while the FTSE All-Share index is little changed.

Property prices

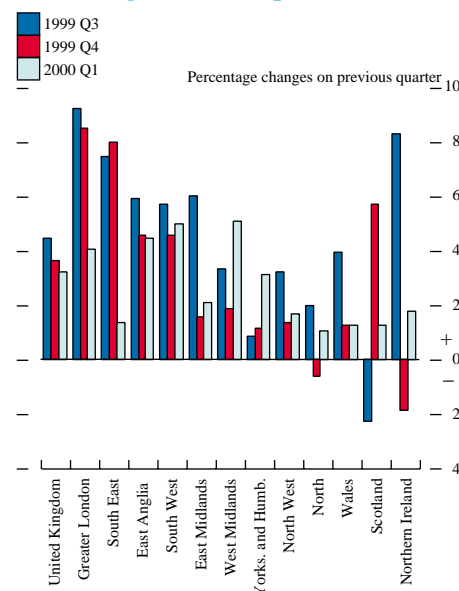
Annual house price inflation remains high. The Halifax index rose by 14.2% in the year to April, while the

Chart 1.16
International equity indices over the past year



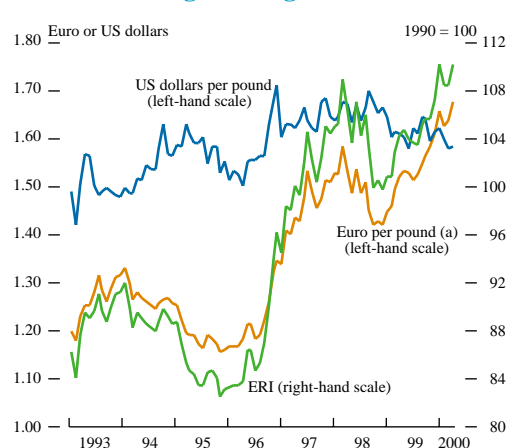
Source: Primark Datastream.

Chart 1.17
Halifax regional house price inflation



Source: Halifax plc.

Chart 1.18
Selected sterling exchange rates



Source: Bank of England.

(a) Rates before 1 January 1999 are calculated as a synthetic euro exchange rate based on a weighted average of the component currencies.

Nationwide index rose by 17.5% over the same period. Nevertheless, there are some tentative signs that annual house price inflation may be moderating. House price data from Halifax plc suggest that quarterly house price inflation has fallen recently, particularly in London and the South East (see Chart 1.17). And although mortgage approvals suggest that current activity remains firm, longer-leading indicators, such as starts and reservations, suggest slower housing market activity later this year.

Exchange rates

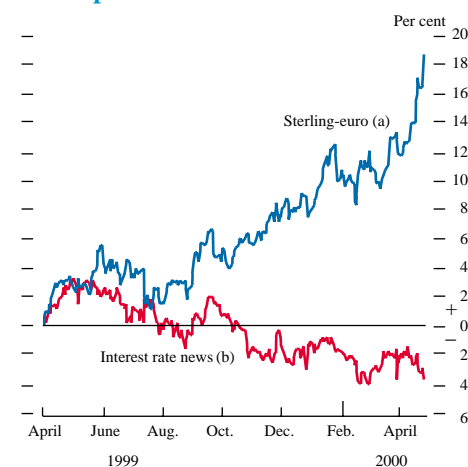
The sterling effective exchange rate index remains close to its highest level since 1985. The 15 working day average of the ERI up to and including 3 May, used as the starting-point for the current projections, is 110.7, around 1½% above the central path assumed in the February Report. As noted in previous Reports, much of the appreciation in the ERI in recent years has reflected a rise in sterling against the euro. By contrast, sterling has fallen somewhat against the US dollar (see Chart 1.18).

Over the past year, the euro has fallen by around 11% against a trade-weighted basket of currencies, including sterling.⁽¹⁾ Persistent euro weakness is hard to explain. Changes in interest rates in the United Kingdom relative to the euro area do not appear to explain the appreciation of sterling against the euro. Chart 1.19 shows that current and future expected interest rates in the euro area have risen relative to interest rates in the United Kingdom over the past year. That would normally suggest a depreciation, rather than an appreciation, of sterling against the euro.

An alternative explanation for the depreciation of the euro is that investors have become more concerned about the risks associated with holding euro assets relative to assets denominated in other currencies, such as sterling. Chart 1.20 indicates that at the time of the February 2000 Consensus Economics exchange rate survey, respondents expected sterling to depreciate at a faster rate against the euro than in March 1999. As noted above, market interest rate expectations rose in the euro area relative to the United Kingdom over this period (see Chart 1.19). To the extent that investors' asset allocations are based on these interest rate expectations and these forecasts of bilateral exchange rate movements, these data perhaps suggest a rise in the risk premium on holding euro assets.

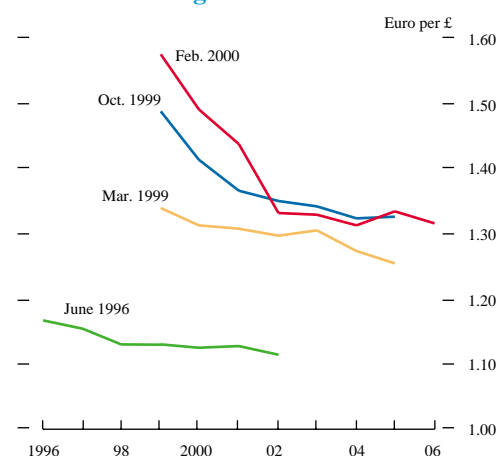
(1) See Crompton, R., 'An effective exchange rate index for the euro area', *Bank of England Quarterly Bulletin*, May 1999, pages 190–94, for a description of how this index is constructed.

Chart 1.19
Cumulative change in sterling-euro exchange rate and relative interest rates since April 1999



(a) Cumulative change in sterling-euro exchange rate.
 (b) Cumulative percentage point change in differentials between UK and euro-area interest rates up to ten years.

Chart 1.20
Consensus survey for the sterling-euro nominal exchange rate



Source: Consensus Economics.

A further potential reason why sterling may have appreciated against the euro in recent years is that the equilibrium exchange rate of the United Kingdom has risen relative to that of the euro area. To date there is little evidence for this in current account or other macroeconomic data. And Chart 1.20 shows that in recent Consensus Economics surveys of long-run nominal exchange rate forecasts, respondents have continued to expect the euro to appreciate to a similar level against sterling in coming years as at the time of the March 1999 survey (see Chart 1.20). However, over the period since 1996, it appears that respondents have come to expect the euro to appreciate to a lower rate against sterling in the medium term, perhaps consistent with an upward revision to the expected equilibrium sterling exchange rate over this period (see Chart 1.20).

1.3

Summary

Narrow money growth has fallen from unusually high levels around the turn of the new millennium, but remains well above nominal spending growth. Annual broad money growth increased in 2000 Q1, owing to higher OFCs' M4 deposits at the end of the quarter. By contrast, growth in other broad money deposits eased slightly. Annual lending growth has strengthened further, consistent with a growing financial deficit of the UK private sector. Equity prices have fallen slightly over the past three months, with particularly large falls in high-technology sector share indices. House price inflation remains rapid but there are some tentative signs that it may be easing.

Sterling remains very high, reflecting persistent euro weakness against a range of currencies including sterling. Estimated UK short real rates have risen over the past year. But short-term nominal interest rate expectations have eased in recent months and long-term interest rates have fallen. The market still expects the repo rate to rise in the near term but now anticipates a lower peak in official interest rates.

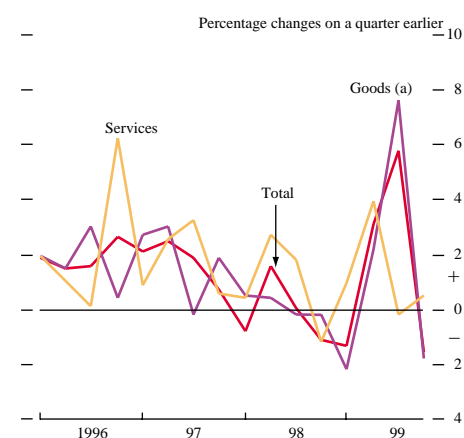
Continued strength in final domestic demand underpinned GDP growth of 0.8% in 1999 Q4, with the expansion of consumption remaining particularly robust. By contrast, the contribution of net trade to GDP growth was sharply negative in Q4. Overseas demand picked up further, but the net trade position was dampened by the strength of the exchange rate and some unwinding of the very sharp rise in exports observed in the previous quarter. Growth in the service sector remains robust, but industrial production has weakened in recent months, and preliminary estimates suggest that overall output growth slowed to 0.4% in 2000 Q1.

2.1 External demand

The outlook for growth in UK export markets has strengthened further since the February *Report*.⁽¹⁾ The pace of expansion in the United States in recent quarters has again been faster than expected, with estimates of GDP growth revised up to 1.8% in 1999 Q4 and growth of 1.3% in 2000 Q1. Output in the United States grew by 4.1% in 1999 as a whole compared with 1998, but domestic demand grew even more strongly and the trade deficit widened further. The MPC's expected profile for US growth has been raised since February, although domestic demand growth is still projected to slow over the next two years. The outlook for demand growth in the euro area has also improved since February. Euro-area GDP rose by 0.9% in 1999 Q4, with domestic demand somewhat stronger than expected, and estimates of growth in the earlier quarters of 1999 were revised up slightly. High levels of consumer and industrial confidence continue to support the outlook for growth in the euro area. Economic activity in emerging market economies has picked up further since February. By contrast, growth in Japan remains muted and uneven. Japanese GDP declined by 1.4% in 1999 Q4, which was weaker than expected at the time of the February *Report*. There are signs of recovery in non-residential investment and industrial production in Japan, but other areas of economic activity remain weak. Overall, the MPC judges that UK export markets will grow faster over the

(1) For a detailed discussion of international economic developments, see 'The international environment' article in the *Bank of England Quarterly Bulletin*, May 2000, pages 135–49.

Chart 2.1
UK export volumes



(a) Excludes oil and erratic components of goods exports, which are included in the series shown for total export volumes.

Chart 2.2
Contributions to quarterly manufactured goods export volume growth

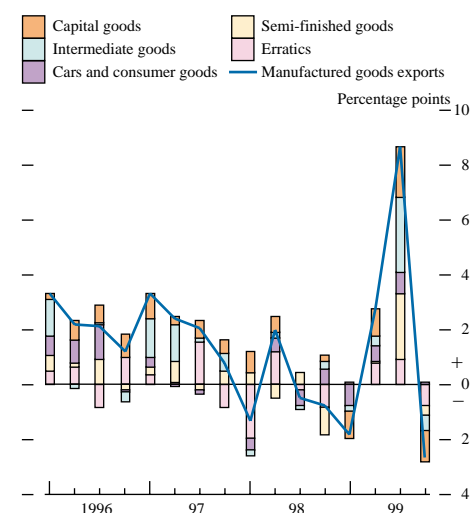
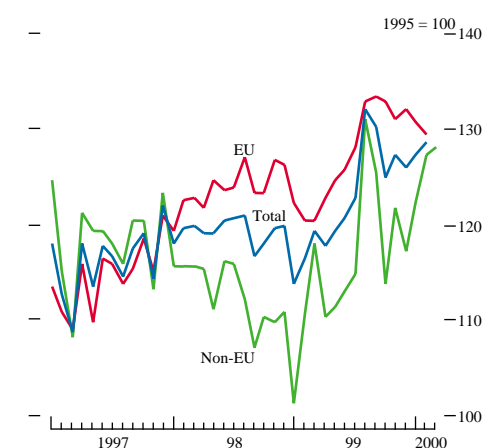


Chart 2.3
Volumes of UK goods exports to EU and non-EU countries^(a)



(a) Excludes oil and erratic components.

forecast period than assumed in February, as world trade continues to expand strongly.

The profile of UK exports over recent quarters has been rather volatile (see Chart 2.1). The jump in export volumes in 1999 Q3 was partly reversed in Q4, when exports fell by 1.5%. That reflected movements in goods export volumes, as the volume of services exports remained relatively steady during the second half of 1999. The decline in exports in Q4, in common with the strength of exports in Q3, was seen in sales of goods to most major geographical regions and was also broadly based across the main product groupings (see Chart 2.2). However, monthly data for this year so far suggest that the underlying trend in exports remains upwards. In particular, exports to non-EU countries—which fell back sharply in Q4—recovered strongly in 2000 Q1 (see Chart 2.3). By contrast, exports to EU countries continued to fall, perhaps owing to the fact that the recent rise in the sterling effective exchange rate has primarily reflected appreciation of sterling against the euro.

Most survey evidence in Q1 suggested continued growth in exports in the near term (see Table 2.A). However, export indicators relating to the manufacturing sector alone were generally weaker than in Q4, and the CIPS index indicated a decline in new manufacturing export orders in April for the first time in a year. Survey responses indicate that manufacturers continue to register considerable concerns about the level of the exchange rate. Consistent with recent official data on export volumes and the particular strength of sterling against the euro, the CIPS survey suggests that the most marked adverse effects of the exchange rate appreciation on manufacturers' competitiveness are being reported in relation to trade with European countries.

Net trade made a negative contribution of 1.2 percentage points to GDP growth in Q4, partly reflecting the weakness of exports compared with Q3. However, it also reflected the fact that import volumes rose by 2.0% in Q4. That was a slower rate of increase than in the previous quarter, but was faster than had been projected in the February *Report*. The continued strength of import growth probably reflects both the rapid pace of growth of domestic demand in Q4 and the effect on import penetration of the appreciation of sterling during 1999. Reports from the Bank's regional Agents suggest that one aspect of this may be that UK firms are increasing the proportion of their inputs that they source from abroad. Growth in imports of intermediate and

Table 2.A
UK export outlook^(a)

	1999				2000
	Q1	Q2	Q3	Q4	Q1
BCC export orders					
<i>Services</i>	+1	+4	+15	+5	+10
<i>Manufacturing</i>	-9	-3	+10	+11	+8
CIPS export orders (b)					
<i>Manufacturing</i>	47.3	50.5	54.7	52.9	52.2
CBI industrial trends					
<i>Optimism about exports</i>	-17	-9	-5	+2	-10
DHL quarterly export indicator					
<i>Export confidence, next three months</i>	+23	+26	+29	+28	+38

Sources: BCC, CIPS, CBI and DHL.

- (a) Numbers reported are survey balances unless otherwise shown. An increase suggests a rise in the proportion of respondents reporting 'higher' relative to 'lower'.
- (b) A reading above 50 suggests expansion, a reading below 50 suggests contraction.

Table 2.B
Composition of UK goods import growth

	1999			
	Q1	Q2	Q3	Q4
Total goods imports, percentage changes on a quarter earlier	0.9	0.4	5.8	1.9
Contributions of: (a)				
Non-manufactured goods	0.3	0.2	0.6	0.2
Manufactured goods	0.6	0.3	5.2	1.7
<i>of which: Intermediate goods</i>	0.5	0.1	1.5	1.2
<i>Capital goods</i>	0.4	0.1	1.1	1.0
<i>Consumer goods</i>	0.3	0.3	0.3	0.4
<i>Semi-finished goods</i>	0.4	0.1	1.9	-0.4
<i>Other</i>	-1.0	-0.4	0.4	-0.4

(a) Contributions may not sum to total because of rounding.

Table 2.C
GDP and expenditure components^(a)

	Percentage changes on a quarter earlier				
	1998 Q4	1999			
	Q1	Q2	Q3	Q4	
Consumption:					
Households (b)	0.5	1.8	0.9	0.6	1.1
Government	0.5	1.9	0.9	0.6	1.2
Investment	1.2	0.6	0.9	0.7	1.6
<i>of which, business investment</i>	2.9	0.3	1.6	-1.0	1.1
Final domestic demand	0.6	1.5	1.0	0.5	1.3
Change in inventories (c)	0.2	-0.2	-1.0	0.3	0.6
<i>excluding alignment adjustment (c)</i>	0.3	-0.6	-0.6	0.6	-0.2
Domestic demand	0.8	1.3	0.0	0.8	1.9
Net trade (c)	-0.8	-0.9	0.7	0.1	-1.2
GDP at market prices	0.0	0.4	0.7	1.0	0.8

- (a) At constant 1995 market prices.
- (b) Includes non profit making institutions serving households.
- (c) Contribution to quarterly growth.

capital goods has indeed been particularly strong in recent quarters (see Table 2.B).

Monthly data suggest that the recent rapid growth in imports may slow somewhat in Q1. However, overall import growth in the next two years is likely to remain strong, owing to the effects of the higher exchange rate and the fact that domestic demand growth is projected to remain above trend. Reflecting the positive outlook for overseas demand, the MPC judges that export growth will be somewhat stronger than previously forecast, though it is expected to remain slower than import growth over the forecast period. The MPC's central assumptions therefore imply that the overall contribution of net trade to GDP growth over the next couple of years will remain negative, as in the February *Report*.

2.2 Domestic demand

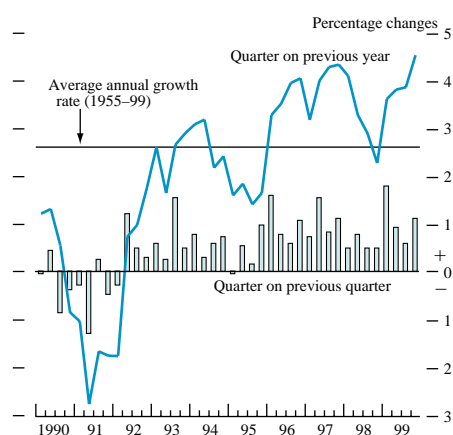
Domestic demand grew by 1.9% in the fourth quarter of 1999, and was 4.1% higher than a year earlier. The strength of domestic demand in Q4 partly reflected a large contribution to growth of 0.6 percentage points from stockbuilding. That in turn was accounted for by an increase in the size of the alignment adjustment, which is used by the ONS to help balance estimates of growth in the income, expenditure and output measures of GDP. But final domestic demand growth—which excludes inventory investment—also picked up strongly. It rose to 1.3% in Q4 from 0.5% in Q3 (see Table 2.C), reflecting an increase in the growth rates of both consumption and investment. Final domestic demand was 4.4% higher than in the same quarter a year earlier.

Consumption

Quarterly growth of consumers' expenditure picked up in 1999 Q4, to 1.1% (see Chart 2.4). The level of consumption in Q4 was 4.4% higher than a year earlier, and was higher than was expected in the February *Report*. The strength of consumer demand in Q4 was concentrated in expenditure on services and on durable goods other than vehicles. These categories of spending rose by 2.2% and 1.7% respectively in Q4 (see Chart 2.5), and have increased by 5.0% and 12.9% over the past year. By contrast, spending on vehicles continued to fall, in line with survey evidence suggesting that consumer demand for cars was depressed because of consumers' expectations about possible future changes in car prices.⁽¹⁾ Growth in non-durables

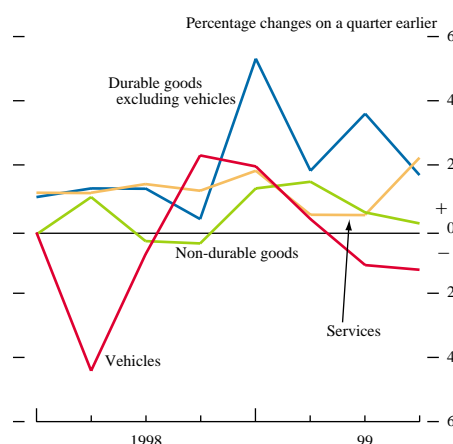
(1) Factors affecting the demand for cars were discussed in the box on pages 16–17 of the February 2000 *Inflation Report*.

Chart 2.4
Household consumption growth^(a)



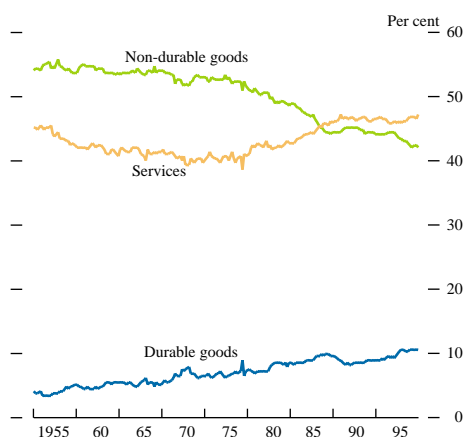
(a) At constant 1995 prices.

Chart 2.5
Categories of consumption growth^(a)



(a) At constant 1995 prices.

Chart 2.6
Share of real household consumption
by type of product



goods spending also remained weak in Q4, slowing to 0.2%.

Part of the relative weakness in spending on non-durables goods in late 1999 was accounted for by lower expenditure on energy, perhaps owing to unusually mild weather. But weaker growth in purchases of non-durables goods than in other categories of spending is typical of most economic upswings. The lower degree of cyclicity in spending on non-durable goods largely reflects the particularly high proportion of this spending accounted for by 'necessities', rather than discretionary purchases. For example, more than one third of spending on non-durable goods is accounted for by food, home fuels, medical goods and cleaning materials, spending which tends to be less sensitive to changes in consumers' income than spending on services and durable goods. These differences in the sensitivity to changes in income also affect the longer-term trends in different types of consumption. As the national income of a country grows over time, the proportion of total household expenditure accounted for by non-durable goods tends to fall while that accounted for by services and durable goods tends to rise. This has been true of the United Kingdom in recent decades (see Chart 2.6).

Although National Accounts data suggest that the volume of food sales fell in 1999 Q4, retail sales data suggest that there was a significant rise in total sales by outlets classified as 'food stores' in December, followed by a sharp decline in these stores' sales in January and February. That may have partly reflected strength in millennium-related sales of non-food items by 'food stores' in December, such as alcoholic beverages. The volume of sales by other retail outlets has also been somewhat erratic in recent months, with a sharp increase in January, a decline in February and a recovery in March. It is possible that this volatility also reflected unusual seasonal factors relating to the millennium. As Chart 2.7 suggests, the underlying trend in overall retail sales volumes since December has remained robust. Sales rose by 1.5% in the three months to March compared with the previous three months, and were 5.2% above their level in the same period a year earlier. The CBI distributive trades survey suggested that retail sales strengthened further in April and that retailers anticipate continued strong growth in May.

Robust consumer spending has been supported by recent trends in income, wealth and household borrowing. Estimated real post-tax income grew markedly in

Chart 2.7
Retail sales volumes

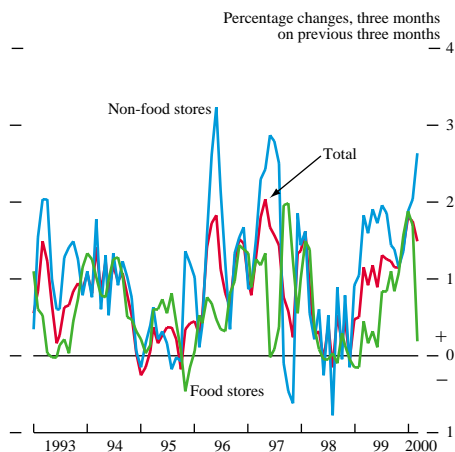
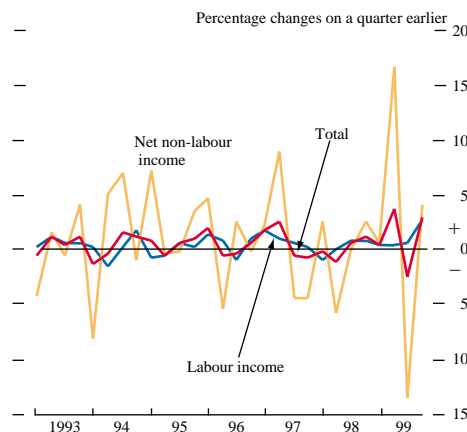
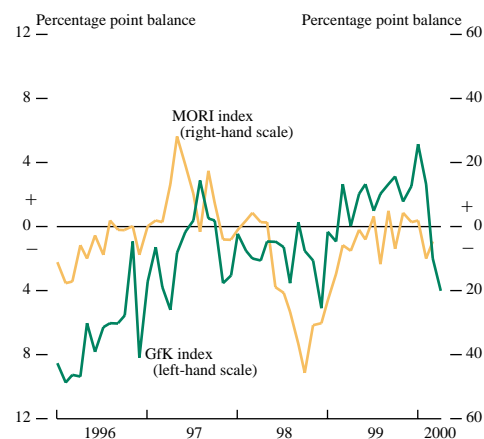


Chart 2.8
Real household post-tax income^(a)



(a) Deflated by the household consumption expenditure deflator. Taxes are deducted from labour income.

Chart 2.9
Consumer confidence



Sources: GfK and MORI.

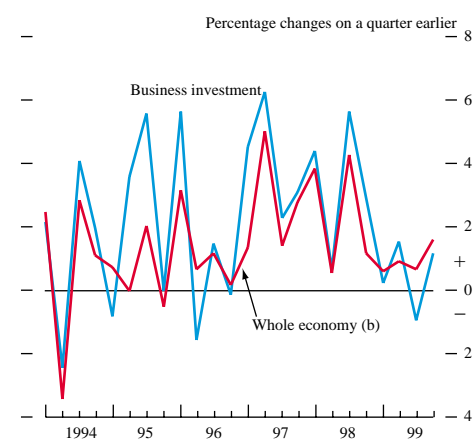
1999 Q4 (see Chart 2.8). It rose by 3.0%, reversing the decline observed in the previous quarter, and was 4.7% higher than a year earlier. Within total disposable income, labour income grew rapidly, but there was also a rebound in non-labour income, reflecting the unwinding of the effects on dividends of the abolition of Advance Corporation Tax (ACT). Estimates of personal sector wealth have been revised down since the February Report and wealth declined in 1999 Q3, as equity prices fell in that quarter. But equity prices recovered strongly in Q4 and real net financial wealth rose by more than 10%, to a level 7.2% higher than a year earlier. Housing wealth also rose markedly in the last quarter of 1999, and significant increases in house prices in 2000 Q1 are likely to have increased it further since then. Annual growth in total lending to individuals also picked up further in Q1, to its highest rate since 1991 Q3, mainly due to faster growth in secured lending.

The Bank of England repo rate has risen by 1.0 percentage points since September 1999. Any change in monetary policy takes time to have its full impact, but prospective consumption growth is likely to be moderated by the recent increases in interest rates. Such changes in monetary policy affect the personal sector through several different channels. Changes in the official interest rate have an impact on the interest rates which individuals face on personal savings and debts. The recent increases in official interest rates have been reflected in higher interest rates on many retail financial products, which would tend to depress households' current consumption by making borrowing more expensive and making saving a more attractive use of household income.⁽¹⁾ Rises in official interest rates may also affect households by dampening the level of those asset prices which affect households' wealth. Higher interest rates are therefore likely to have been one factor depressing consumer confidence in recent months (see Chart 2.9). The GfK index fell in April to its lowest level since December 1998, and declines were also observed in other indices of consumer confidence produced by MORI and the Consumers' Association. The fall in confidence, if sustained, may be an early indicator of slower consumer spending growth in the coming quarters.

On balance, the MPC judges that the level of consumer spending is likely to be slightly higher over the next two years than was projected in February, reflecting recent

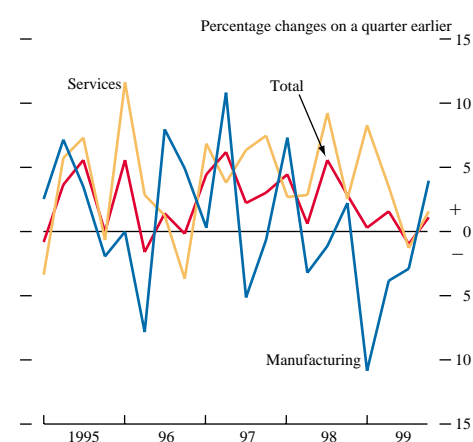
(1) The effects of changes in official interest rates on the economy are discussed in more detail in *The transmission mechanism of monetary policy*, Monetary Policy Committee, 1999, Bank of England.

Chart 2.10
Gross fixed capital formation^(a)



- (a) At constant 1995 prices.
(b) Includes business investment, investment by general government, private dwelling investment and transfer costs.

Chart 2.11
Business investment by sector^(a)



- (a) At constant 1995 prices.

robust growth and the strength of personal income and housing wealth indicators. However, the Committee expects consumption growth to slow from current rates of expansion, reflecting the effects of higher interest rates and the appreciation of the real exchange rate.

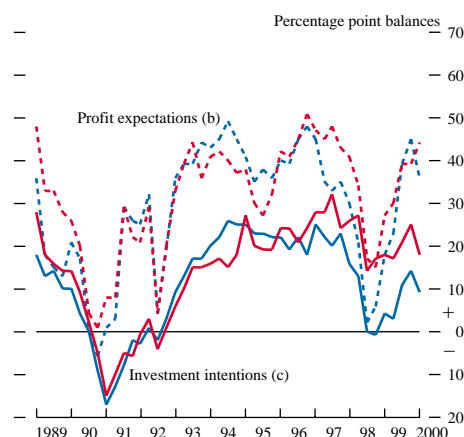
Investment demand

Total investment rose by 1.6% in the fourth quarter of 1999, the strongest increase for five quarters (see Chart 2.10). Government investment rose sharply in Q4 for a second consecutive quarter, but the recovery was also supported by a rebound in investment by private businesses, which accounts for three quarters of total investment. Business investment rose by 1.1% in Q4, following a decline of 1.0% in Q3. Reflecting slow growth in the first three quarters of 1999, business investment in Q4 was only 2.0% higher than a year earlier, and recent revisions to the National Accounts have lowered the estimated level of business investment in 1999. However, the recovery in growth of business investment in the fourth quarter of the year was stronger than had been anticipated in the *February Report*.

The share of service sector investment in total business investment has risen from around a half to more than two thirds over the past decade. Movements in overall investment in recent years have consequently been strongly influenced by trends in the service sector (see Chart 2.11). Service sector investment growth slowed in the first three quarters of 1999, possibly reflecting the lagged effects of slower activity growth in the sector in 1998. Following the pick-up in demand in 1999, service sector investment recovered in 1999 Q4. However, there were also marked movements in investment by other sectors in 1999. Manufacturing sector investment fell sharply throughout most of the year, mirroring earlier movements in manufacturing activity and business confidence, but it rose strongly in Q4 following the recovery in manufacturing output in mid-1999.

Survey data on the outlook for overall investment are consistent with further growth, led primarily by the service sector. Reports from the Bank's regional Agents suggest that more firms have raised investment plans than have lowered them in the past six months, and the majority of firms expect to maintain or increase investment spending over the next two years. A stronger outlook for investment in buildings—which accounts for 40% of business investment—is also suggested by a pick-up in new industrial and commercial construction orders in recent months and by the CIPS construction

Chart 2.12
Investment intentions and profit expectations^(a)



Source: BCC.

- (a) Manufacturing sector responses shown in blue, service sector responses shown in red.
 (b) Balance of responses to the question: 'Do you believe that over the next twelve months profitability will improve/remains the same/worsen?'
 (c) Balance of responses to the question: 'Over the past three months, which changes have you made in your investment plans for plant and machinery: revise upwards/no change/revise downwards?'

survey, which reported a sharp increase in activity in the commercial sector in Q1. The BCC's quarterly economic survey of the manufacturing and services sectors suggests that investment intentions remain well above the low levels recorded before the slowdown in investment growth in 1999. However, indices for both the services and manufacturing sectors fell slightly in 2000 Q1 (see Chart 2.12), and the CBI quarterly survey of the manufacturing sector suggested that investment intentions have weakened substantially over the past three months.

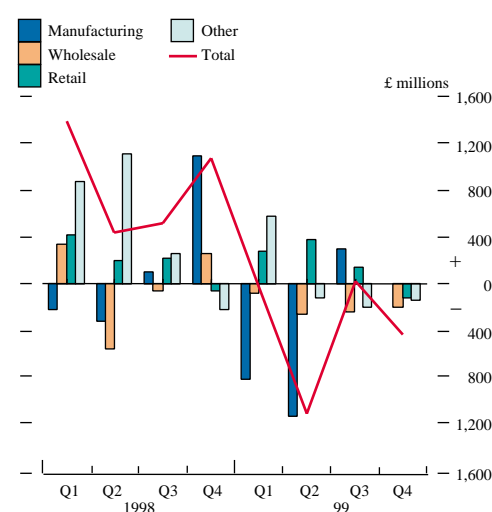
The weakening in some survey measures of investment intentions may have reflected a perception by firms that domestic demand growth will slow, as a result of the rise in official interest rates since September 1999 and the appreciation of the exchange rate. For example, the CBI quarterly industrial survey indicated a marked rise in the proportion of manufacturers reporting that uncertainty about demand would constrain their investment over the coming year. However, as noted above, the underlying outlook for consumption growth remains robust, and prospects for world demand and government spending have strengthened since the February *Report*. The CBI also reported that manufacturing firms view the cost of finance as unlikely to constrain investment over the coming year. That is consistent with the fact that long-term corporate bond yields have not risen in line with short-term interest rates in recent months, and that despite volatility in equity prices over recent quarters, equity issuance in the year to 2000 Q1 was significantly higher than in the previous year. Firms also utilise internal sources of finance for investment such as retained profits. Excluding the alignment adjustment,⁽¹⁾ the gross operating surplus of private non-financial corporations rose for the third consecutive quarter in 1999 Q4, and was 5.2% higher than a year earlier—its fastest annual growth rate since 1997 Q3. Consistent with these indicators and with the stronger outlook for overseas and government demand, the MPC projects a slightly higher profile for investment growth than in the February *Report*.

Inventories

The headline measure of inventory investment in the National Accounts suggests that stockbuilding

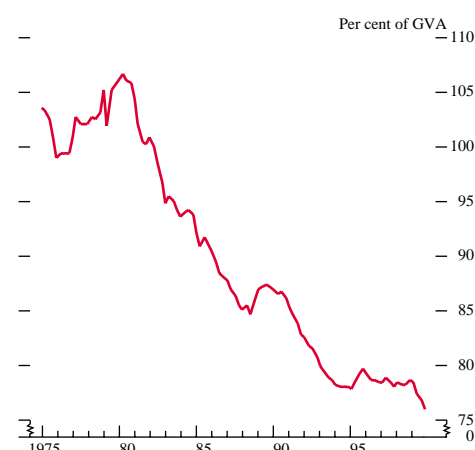
(1) The alignment adjustment is used by the ONS to reconcile any discrepancies in the growth rates of the income, expenditure and output measures of GDP which are published in the National Accounts. In the income measure of GDP, the alignment adjustment is allocated to the gross operating surplus of private non-financial corporations. On the expenditure side of the National Accounts, the alignment adjustment is allocated to the stockbuilding component of demand.

Chart 2.13
Change in inventories^(a)



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

Chart 2.14
Ratio of whole-economy inventories to gross value added (GVA)^(a)



(a) At constant 1995 prices.

contributed 0.6 percentage points to GDP growth in 1999 Q4. However, that was more than accounted for by the statistical alignment adjustment to the National Accounts, which is allocated to stockbuilding.⁽¹⁾ The underlying data on inventories suggest that, following a small increase in 1999 Q3, whole-economy stocks fell in 1999 Q4 (see Chart 2.13), subtracting 0.2 percentage points from quarterly GDP growth. The latest data therefore suggest that rather less stockbuilding took place ahead of the new millennium than suggested by many surveys of business trends around the end of the year. Forward-looking survey evidence suggests that firms expect to reduce stock levels further in the near term. For example, the CBI quarterly industrial trends enquiry in April showed a sharp decline in firms' anticipated stock levels over the coming four months.

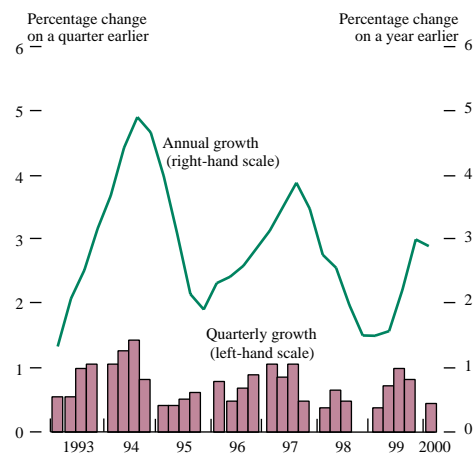
The ratio of stocks to output across the economy has fallen since 1980 (see Chart 2.14). That decline was led primarily by a reduction in manufacturing sector inventories, reflecting both a fall in the sector's stock-output ratio and a contraction in the share of manufacturing in total UK output. The whole-economy stock-output ratio was broadly flat between 1995 and 1998, as an increase in retail stock holdings provided an offset to the trend in the manufacturing sector, but it resumed its downward trend in 1999. Past declines in the stock-output ratio have been associated with changes in production techniques, such as the introduction of 'just-in-time' supply management methods and more integrated production processes. Similar trends have been observed in other industrialised countries such as the United States and Japan. In its central projection the MPC has assumed that the stock-output ratio in the United Kingdom will continue to decline, reflecting further improvements in production and distribution processes. Such improvements may result in part from the increasing use of electronic commerce by UK businesses.

Public sector demand

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 Budget published on 21 March. These projections incorporate faster growth of real government consumption over the next two years than in the *February Report*. However, estimates of effective tax rates have also been revised upward somewhat over the past three months, and the

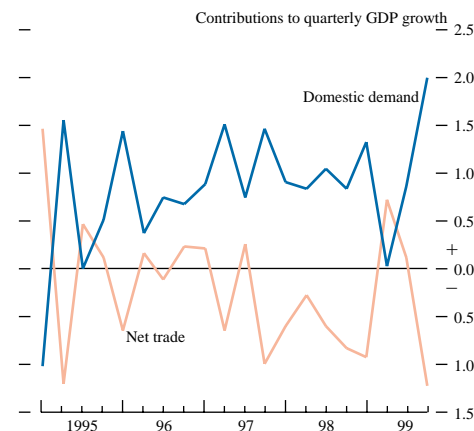
(1) See footnote 1 on page 20.

Chart 2.15
GDP growth^(a)



(a) At constant 1995 market prices.

Chart 2.16
Contributions of domestic demand and net trade to GDP^(a)



(a) At constant 1995 prices.

projection for benefit payments has been lowered. These factors dampen the impact of higher government consumption on overall output growth over the forecast period.

2.3

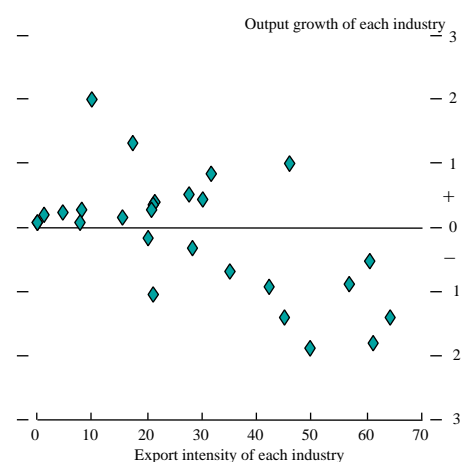
Output

According to preliminary estimates, GDP grew by 0.4% in 2000 Q1, compared with 0.8% in 1999 Q4, and the annual growth rate declined slightly to 2.9% (see Chart 2.15). However, since the *February Report*, revisions to National Accounts data for 1998 and 1999 have raised estimates of the level of GDP in 1999 Q4 by 0.3%. On the expenditure side of the National Accounts, the revisions also raised estimates of the level of domestic demand and depressed the net trade position in 1999, further accentuating the contrast between the strength of domestic demand and the weakness of net trade (see Chart 2.16).

Previous *Reports* have discussed the role of sterling's appreciation since 1996 as a factor explaining the weakness of net trade relative to domestic demand. The impact of the strength of the exchange rate may also be seen at a more disaggregated level. Chart 2.17 suggests that industries which export a high proportion of their output have recently tended to experience rather weaker growth than less export-intensive sectors of the economy. However, the chart also illustrates that the correlation is far from perfect, reflecting the importance of other factors in determining output growth, such as sector-specific influences on demand. The negative relationship between industrial output growth and export intensity is also less marked when considering growth over the past year rather than over the past three months, suggesting the need for caution in interpreting the more recent data.

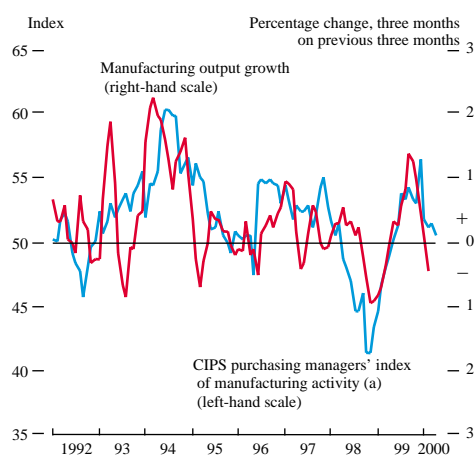
Industrial production fell by 0.8% in the three months to February, in part reflecting weakness in energy-related sectors such as mining and utilities. However, manufacturing output has also weakened since November 1999 (see Chart 2.18). The rebound in manufacturing output between the second and fourth quarters of 1999 left the level of output 1.5% higher in February compared with the same month a year earlier. But manufacturing output fell in each month between December and February, slowing the three-month growth rate to -0.5% in February from 0.4% in Q4 and 1.4% in Q3 (see Chart 2.18). The output of both the chemicals and engineering industries—which had been growing

Chart 2.17
Export intensity and recent output growth
of the main UK industries^{(a)(b)}



- (a) Export intensity is defined as the proportion of each industry's value added that is exported in relation to final demand for its products, as measured by the UK input-output tables. Production and service sector industries are disaggregated to the level of detail available in the ONS Index of Production and National Accounts respectively.
- (b) Output growth rates for production industries refer to growth in the three months to February 2000, compared with the previous three months. Output growth rates in industries within the service, construction and agriculture sectors refer to growth in the three months to December 1999, compared with the previous three months.

Chart 2.18
Manufacturing output



Sources: ONS and CIPS.

- (a) A reading above 50 suggests expansion, a reading below 50 suggests contraction.

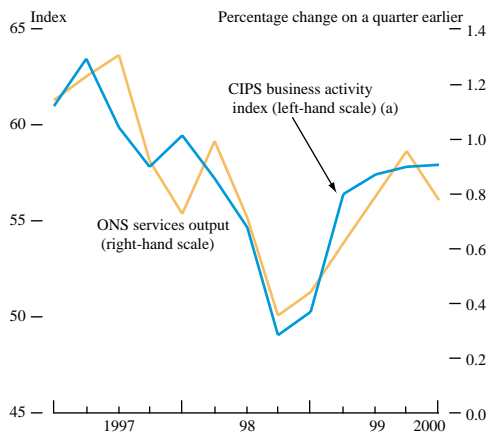
particularly strongly in the second half of 1999—fell by 0.3% in the three months to February.

Survey data indicate that business sentiment in the manufacturing sector has weakened in early 2000 (see Chart 2.18). The CIPS purchasing managers' index fell in April to a point suggesting little growth in manufacturing activity, while the CBI measure of business optimism declined sharply in 2000 Q1, to levels recorded in spring 1999. The CBI and the CIPS have noted that some of the weakness in manufacturing activity in Q1 may have been accentuated by factors relating to the new millennium. In particular, the CIPS has reported that output was depressed in early 2000 owing to some manufacturers' customers running down precautionary holdings of stocks which were built up before the date change. Perhaps consistent with this, and with the continuing strength of domestic demand, the CBI quarterly industrial survey suggests that a small positive balance of respondents continue to expect a rise in the volume of new orders over the coming quarter. However, both surveys have stressed the importance of weaker export orders in depressing business confidence in the manufacturing sector, reflecting the continued appreciation of sterling in recent months.

Service sector output rose by 0.9% in 1999 Q4. The strongest growth remained in the post and telecommunications sector, though rapid expansion was also reported in transport and financial intermediation. Preliminary estimates suggest that service sector output rose by a further 0.8% in 2000 Q1 (see Chart 2.19), to a level 3.2% higher than a year earlier, and survey data indicate that the outlook for service sector output remains firm. The CIPS business activity index for the service sector activity rose in March to its highest level since June 1997, and remained close to that level in April. Consistent with this, the BCC survey suggests that domestic sales and orders in the service sector continued to increase strongly in 2000 Q1, albeit less rapidly than in Q4, while growth in export demand for services picked up in Q1 compared with Q4 despite the higher exchange rate.

National Accounts data suggest that construction output grew by 0.6% in 1999 Q4, following similar growth in Q3, and was 2.1% higher than a year earlier. The outlook for construction remains positive. The volume of new orders in the construction sector strengthened in recent months, rising by 5.8% in the three months to February compared with the previous three months. The

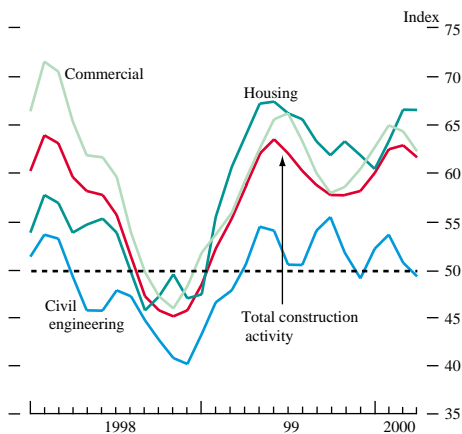
Chart 2.19
Measures of services output



Sources: ONS and CIPS.

(a) A reading above 50 suggests expansion, a reading below 50 suggests contraction.

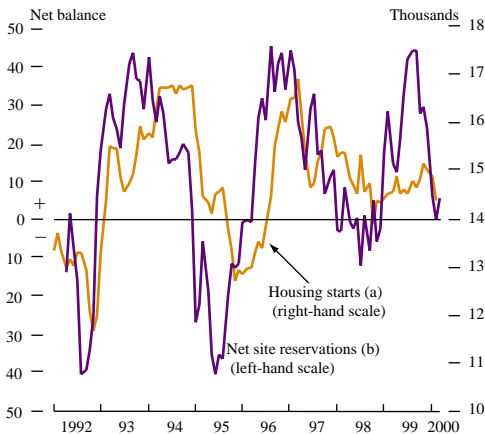
Chart 2.20
CIPS construction survey^(a)



Source: CIPS.

(a) A reading above 50 suggests expansion, a reading below 50 suggests contraction.

Chart 2.21
Housing starts and site reservations



Sources: DETR and House Builders' Federation.

(a) Three-month backward-looking moving average.
(b) Net balance of survey respondents reporting an increase in site reservations compared with a year earlier.

CIPS index of construction activity fell a little in April, but remains at a level consistent with rapid rates of business expansion (see Chart 2.20). The CIPS survey also continues to report widespread expectations of increases in future construction output.

Within the three construction sectors covered by the CIPS survey, the housing sector has tended to record the strongest levels of business sentiment over the past year (see Chart 2.20). But while moderately strong investment indicators would tend to support the outlook for commercial construction work in the near term, there are some signs that activity in the housing market may be slowing. Private housing starts fell by 5.1% in the three months to February compared with the previous three months, and were 1.1% lower than a year earlier. The decline in housing starts is in line with survey evidence from the House Builders' Federation, which has reported falling numbers of site visits and smaller increases in net site reservations in recent months (see Chart 2.21). On the other hand, the loan approvals and lending data reported in Section 1 continue to support a firmer picture.

2.4 Summary

Output growth weakened in the first quarter of 2000, but expenditure indicators are rather stronger and prospects for medium-term GDP growth in the United Kingdom remain favourable. The outlook for consumption in the near term is supported by continued strong growth in wealth, labour income and borrowing. However, consumer confidence has fallen, and consumption growth is likely to slow in the coming quarters. Investment growth remains supported by the strength of prospective domestic and overseas demand growth, which seem stronger than at the time of the previous *Report*. However, the contribution of net trade to GDP growth is expected to remain negative over the next two years, reflecting the likely strength of imports as domestic demand remains above trend, and the continuing influence of the strength of sterling. Reflecting the balance of these considerations, the MPC expects GDP growth to slow moderately in the coming quarters before settling at around or a little above trend.

Labour market conditions remain tight. Employment has continued to grow steadily, and total hours worked have picked up slightly in recent months. Productivity growth has picked up markedly. Claimant count unemployment has fallen further. On the broader LFS measure unemployment has also fallen, reflecting a decline in the number of long-term unemployed. Reported labour shortages remain widespread. Average earnings growth has been significantly stronger than expected in recent months, while settlements have continued to edge down. So growth in components of pay not accounted for by wage settlements has risen further. That may in part reflect high bonuses paid around the turn of the year. Firms may have used these to reward staff for past productivity and profitability gains, or for millennium preparation and working, or to aid staff retention in a tight market.

Chart 3.1
Growth in LFS employment and hours worked

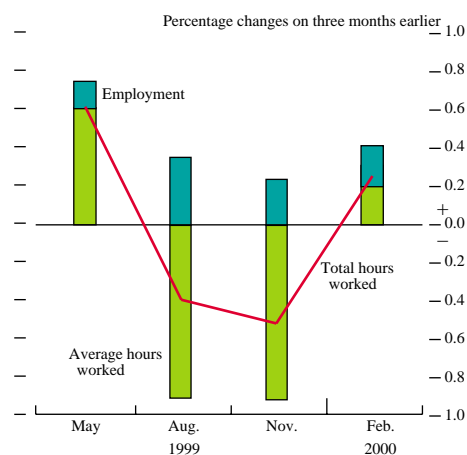
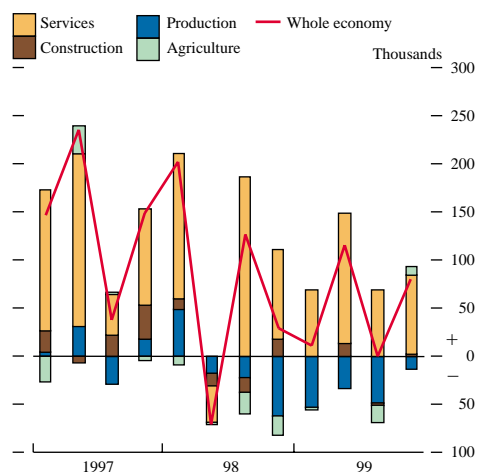


Chart 3.2
Quarterly changes in Workforce Jobs

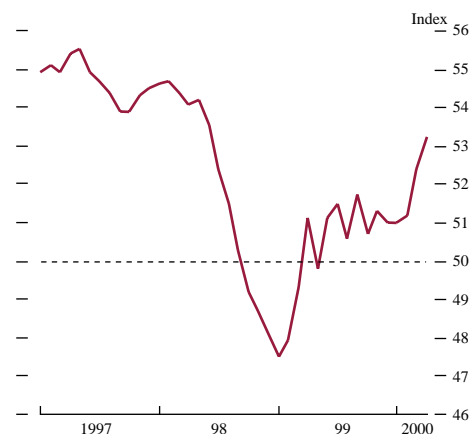


3.1 Employment, labour market tightness and productivity growth

Whole-economy employment has continued to grow steadily. Labour Force Survey (LFS) employment rose by 59,000 (0.2%) in the three months to February, and the Workforce Jobs measure rose by 80,000 (0.3%) in 1999 Q4, and by 207,000 (0.7%) in the year to Q4. Moreover, average hours per head rose in the three months to February (see Chart 3.1), although they fell compared with the same period a year earlier, leaving total hours worked—in principle, a more comprehensive measure of labour usage—unchanged in the year to February.

Employment growth in recent quarters has reflected the continued strength of recruitment in the service sector: in the year to 1999 Q4, the number of service sector jobs rose by 354,000, or 1.7%, according to the Workforce Jobs survey (see Chart 3.2). Employment growth in finance and business services accounted for roughly a third of the rise in service sector jobs over the period. By contrast, the number of jobs in the production industries fell by 148,000, or 3.2%, in the year to Q4. But there are signs that the rate of decline has slowed: the fall in production industry employment in Q4 was less than a third of the average fall in the

Chart 3.3
CIPS survey employment index^(a)



Source: Chartered Institute of Purchasing and Supply.

(a) Weighted index of data on manufacturing, services and construction. A reading of 50 indicates no change on the previous month.

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

Percentage balance of employers planning to recruit in next period (b)

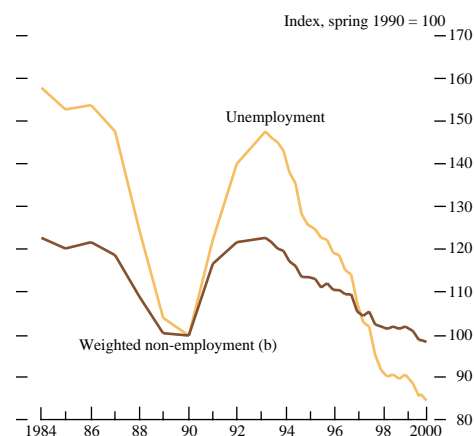
	Series average (c)	1999				2000
		Q1	Q2	Q3	Q4	Q1
Services						
BCC	12	12	16	21	21	25
Manufacturing						
BCC	3	-6	2	6	12	3
CBI	-17	-26	-22	-15	-10	-15

(a) Seasonally adjusted by the Bank.

(b) Next three months for BCC; next four months for CBI.

(c) CBI from 1972; BCC from 1989.

Chart 3.4
Measures of labour market tightness^(a)



Sources: ONS and Bank of England.

(a) Pre-1993 figures based on yearly observations.

(b) The weighted non-employment series is a weighted average of the number of people in each of seven different categories of non-employment. The weights are based on the average proportion in each category who found employment in the next three months, relative to the proportion of the short-term unemployed who found employment in the next three months.

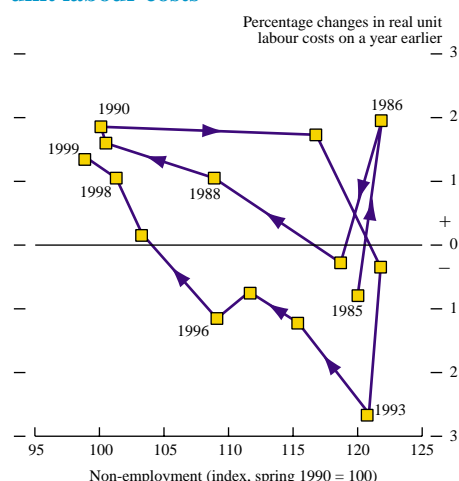
previous three quarters. The number of construction jobs was little changed in Q4 compared with the previous quarter.

More timely or forward-looking indicators of employment growth have continued to suggest further growth in employment. The CIPS employment index has risen since the turn of the year, although it remains below its levels in 1997–98 (see Chart 3.3). And the latest CBI/PricewaterhouseCoopers survey found that employment growth in the financial services sector remained strong in Q1. Turning to forward-looking indicators, the outlook for manufacturing employment has weakened since the turn of the year according to the CBI and BCC surveys and reports from the Bank’s regional Agents. But employment intentions in the service sector—which accounts for a much larger share of total employment—have strengthened further (see Table 3.A), to their highest level since 1997 Q3.

Pay pressures are influenced by both the degree and the rate of change of labour market tightness, reflecting the balance between the demand for, and the supply of, labour. One measure of this balance is the number of people who are searching for, and are available for, work. This is captured by LFS unemployment, which fell by 25,000 in the three months to February compared with the previous three months, having risen slightly in the three months to November. The recent decline was accounted for by a fall in the number of long-term unemployed: there was a small rise in the number unemployed for less than a year. It is possible that recent Government policies, such as the New Deal, have helped some of the long-term unemployed to find work. The claimant count—a narrower measure of unemployment based on the number of people receiving unemployment benefits—fell by 33,400 in the three months to February, and by a further 7,700 in March, to its lowest level since March 1980.

Chart 3.4 compares an index of LFS unemployment with the index of weighted non-employment considered in the February Report, based on the number of individuals in each of seven different categories of non-employment, weighted according to the average rate at which they become employed. The measure has not fallen as far as unemployment relative to the previous trough in 1990, but on this measure too, labour market conditions appear to be tight by recent historical standards.

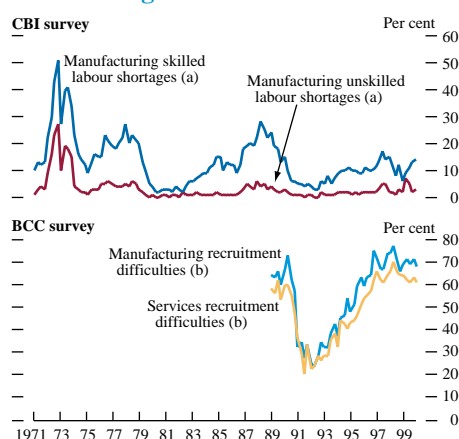
Chart 3.5
Non-employment and the change in real unit labour costs^(a)



Sources: ONS and Bank of England.

(a) The non-employment series is that used in Chart 3.4. Real unit labour costs are defined as the Average Earnings Index adjusted for the employers' tax rate and deflated by the product of the GDP deflator and a productivity measure based on LFS employment data.

Chart 3.6
Skill shortages and recruitment difficulties



Sources: British Chambers of Commerce and Confederation of British Industry.

(a) Question: 'Are shortages of skilled/unskilled labour likely to limit output during the next four months?'.
 (b) Question: 'Did you experience any difficulties over the past three months in finding staff in the following categories: skilled manual, technical/professional, managerial/clerical and un/semi-skilled?'

Chart 3.7
Average duration of Jobcentre vacancies^(a)



(a) Defined as the stock of Jobcentre vacancies divided by monthly outflows.

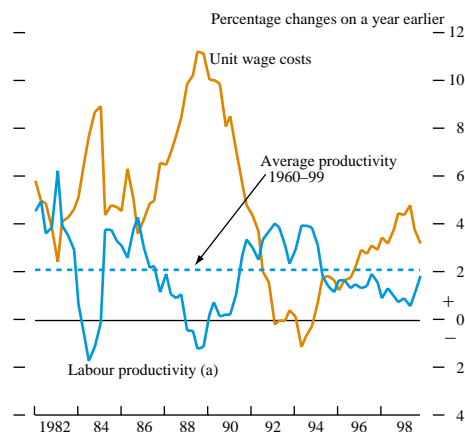
Similar to the pattern for LFS unemployment discussed in the February *Report*, real unit labour costs growth has been weaker in relation to this measure of non-employment in the 1990s' expansion than it was at similar points in the previous cycle (see Chart 3.5). It is possible that this reflects a decline in the equilibrium level of non-employment. This may reflect labour market reforms and structural changes in the economy over the past two decades.

Turning to survey indicators of labour market tightness, the BCC measures of recruitment difficulties are higher than on average during the ten-year lifetime of the survey, although they are lower than their levels in 1997–98. And the CBI measure of skill shortages in manufacturing—for which a longer run of data is available—has continued to rise, though it remains well below the historic peaks of the early 1970s and the mid to late 1980s (see Chart 3.6). The Bank's regional Agents report that skill shortages remain a concern, although they have been little changed in most regions in recent months. The Recruitment and Employment Confederation (REC) survey has been reporting reduced availability of permanent and temporary staff.

Indicators of job vacancies provide another way of assessing the relationship between the supply of, and unsatisfied demand for, labour. New vacancies notified to Jobcentres fell slightly in March, but remain higher than a year ago, and the REC Press Recruitment Advertising Index—a measure of the number of recruitment advertisements in the national press—rose by around 15% in the year to March. The average time taken to fill Jobcentre vacancies remains high by recent historical standards (see Chart 3.7), which may in part reflect the relative tightness of labour market conditions.

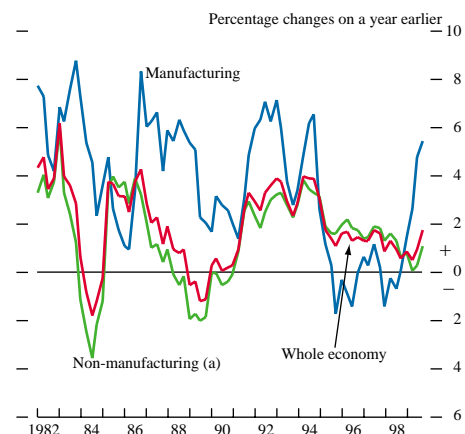
Labour productivity growth has picked up in recent quarters as output growth has outstripped the increase in employment. Annual growth in the official measure of productivity per worker, which is based on the Workforce Jobs measure, rose from 1.0% in 1999 Q3 to 1.8% in Q4 (see Chart 3.8). Whole-economy labour productivity growth in Q4 was close to its long-run average of roughly 2%, having been below this level for several years. Although manufacturing productivity growth has been stable over the past three months, it has risen sharply over the past 18 months as employment has continued to fall when output growth has turned up. Moreover, productivity growth in the rest of the economy picked up in the second half of 1999 (see

Chart 3.8
Growth in labour productivity and unit wage costs



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

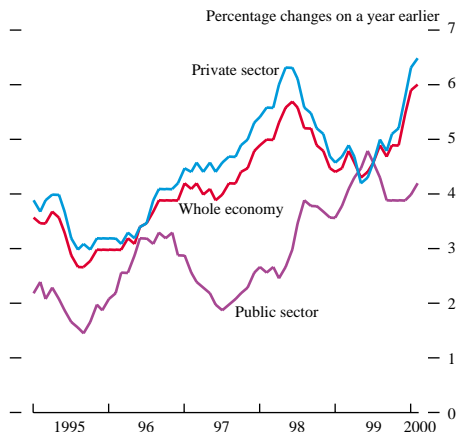
Chart 3.9
Labour productivity growth



Sources: ONS and Bank of England.

(a) Based on official measures of whole-economy and manufacturing labour productivity growth.

Chart 3.10
Headline growth in nominal earnings^(a)



(a) Annual growth in backward-looking three-month average of the AEI.

Chart 3.9). Outside the manufacturing sector, productivity growth appears to have picked up recently in most industries, especially in transport and communications and financial services.

Developments in labour productivity growth have an important influence on the growth in whole-economy supply capacity and on the degree of inflationary pressure in the labour market. Stronger productivity acts to dampen the upward pressure on firms' unit wage costs of a rise in earnings. Given the pick-up in productivity growth, annual growth in unit wage costs fell further in Q4, to 3.2% (see Chart 3.8). In the longer term, real earnings are likely to rise in line with trend productivity growth.

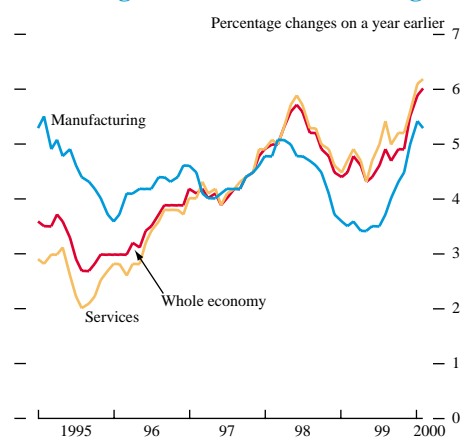
Previous *Reports* have discussed some possible implications of recent Government policies designed to affect the supply of and demand for labour, including the New Deal and the Working Families Tax Credit (WFTC). The March Budget contained a number of further measures, including extensions to the New Deal, designed to help the long-term unemployed and other disadvantaged groups into employment. In forming its latest inflation projection the MPC has decided not to adjust its assumptions, but these will be kept under review as further data and analysis become available.

3.2 Earnings and settlements

Earnings growth, as measured by the Average Earnings Index (AEI), has been significantly stronger in recent months than expected at the time of the February *Report*. The AEI headline rate of annual earnings growth rose to 6.0% in the three months to February, 1.1 percentage points higher than its value in November. Most of the recent increase in headline earnings growth was accounted for by the private sector (see Chart 3.10). Since last summer, earnings growth has risen in both manufacturing and service sector firms (see Chart 3.11). Inferred growth in earnings per hour has exceeded growth in earnings per head recently, reflecting the fall in average hours worked in the year to February.

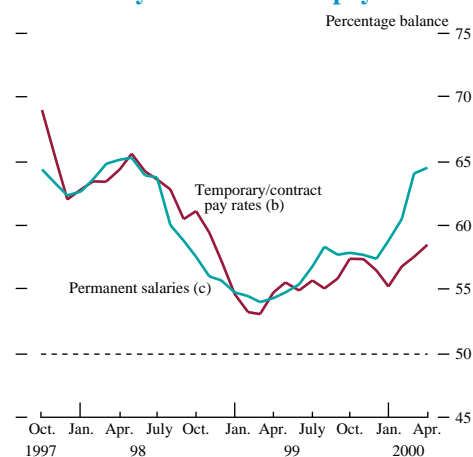
Turning to other indicators of pay, information on wages and salaries paid to the household sector is published quarterly as part of the National Accounts (early estimates of which are based partly on the AEI). At the beginning of last year, earnings growth as measured by wages and salaries per head was a little higher than as measured by the AEI. But in 1999 Q4, annual growth in

Chart 3.11
Headline growth in nominal earnings^(a)



(a) Annual growth in backward-looking three-month average of the AEI.

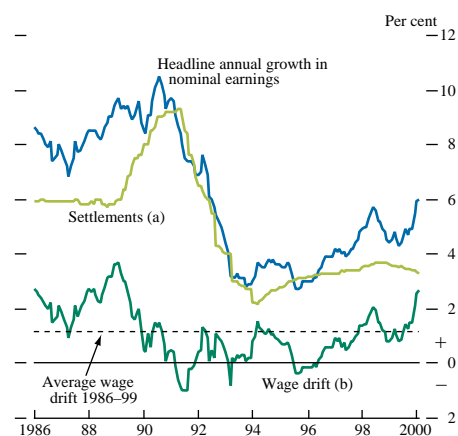
Chart 3.12
REC survey on salaries and pay rates^(a)



Source: Recruitment and Employment Confederation.

- (a) A reading of 50 indicates no change on the previous month.
 (b) Question: 'Are average hourly pay rates for temporary/contract staff higher, the same or lower than one month ago?'.
 (c) Question: 'Are average salaries for permanent staff higher, the same or lower than one month ago?'.

Chart 3.13
Settlements, nominal earnings growth and wage drift



Sources: ONS, Bank of England and Industrial Relations Services (IRS).

- (a) Based on IRS data until 1994, then Bank of England, which draws on information from the CBI, Incomes Data Services, Industrial Relations Services, Labour Research Department and the Bank's regional Agents.
 (b) Difference between earnings growth and settlements.

wages and salaries per head, at 5.0%, was 0.5 percentage points lower than the AEI measure of annual earnings growth. According to the REC survey, which is based on a much smaller sample, salaries for both permanent and temporary/contract staff have picked up further in recent months (see Chart 3.12).

Earnings growth can be expressed as the sum of wage settlements and wage drift. The Bank's estimate of the twelve-month mean settlement has edged down slightly since the beginning of last year. The pick-up in the annual growth of the AEI since the first half of last year is therefore more than accounted for by changes in wage drift. Wage drift includes factors such as bonuses, overtime payments, profit-related pay, individual merit awards, and compositional changes in the workforce. So the pick-up in growth in the AEI over the past nine months reflects changes in some or all of these components. Although the measure of wage drift has risen above its longer-run average recently, it remains below the levels of the late 1980s (see Chart 3.13).

The recent rise in wage drift may in part reflect millennium effects and considerably higher bonuses than a year ago, which makes it difficult to assess the underlying trend in earnings growth. Moreover, following a change in February last year in the scope of the bonus data collected, the contribution of bonuses to annual earnings growth can be assessed for only the most recent month. The official data on bonuses prior to February are not directly comparable with previous years, so their contribution to annual earnings growth cannot be reliably measured. Prior to February last year, firms were asked to report bonuses only when they represented a significant change in the monthly paybill. Since then, they have been asked to report all bonuses paid. This change affects the split of total pay between regular pay and bonuses, but has no effect on the overall level of the AEI.

Moreover, the new sample for the AEI, used by the ONS from October last year, has a substantially higher representation from the service sector as well as of younger firms, making it more representative of the economy. If the previous sample was under or over-representative of the number of firms that paid bonuses, the official data on annual bonus growth may remain an uncertain indicator of the true bonus contribution to annual earnings growth until October.

Measured average earnings grew by 5.5% in the year to February. The ONS has reported that bonuses

contributed around 0.5 percentage points to earnings growth over the period. The contribution of bonuses to whole-economy earnings growth in the year to February was more than accounted for by bonuses in the service sector: bonuses detracted from earnings growth in the manufacturing sector over the period.

There is some qualitative evidence on the type and nature of the recent bonus contribution to annual earnings growth. The ONS has indicated that part of the recent rise in annual earnings growth can be accounted for by larger bonus payments than a year ago in the financial services sector. These bonuses were not generally related to millennium preparation and working. There is also evidence of millennium-related bonus and overtime payments in some other services, including police and health sector workers. The ONS has indicated that annual bonus growth also rose in the manufacturing sector in December and January. There is evidence that some of these bonuses were millennium-related, and were supplemented by increased overtime payments as firms sought to make up lost output after the prolonged holiday period. Consistent with this picture, average weekly overtime hours in the manufacturing sector rose by 5.5% in the three months to February compared with the same period a year earlier.

In March, the Bank's regional Agents asked around 160 of their business contacts to report on any bonus payments that they had made, or planned to make, during the period November 1999 to April 2000. Around half of all respondents expected the share of bonus payments in the total wage bill to be higher in this period than a year earlier. This proportion was slightly higher in the financial services sector than in manufacturing. Of those questioned who expected a higher bonus share this year, the most common explanation was to reward staff for past productivity and profitability gains, followed by the need to retain and recruit staff. Less than a third cited millennium preparation and working as a significant factor. On balance, roughly the same proportion of respondents expected to make significant bonus payments in March as had done so in January, and March appears to be a particularly important month for bonuses in the financial services sector. So the headline rate of annual earnings growth (based on a three-month moving average) may include a significant bonus contribution for some months. In the summer, the contribution of wage drift to annual earnings growth is likely to fall back.

Table 3.B
Survey-based inflation expectations^(a)

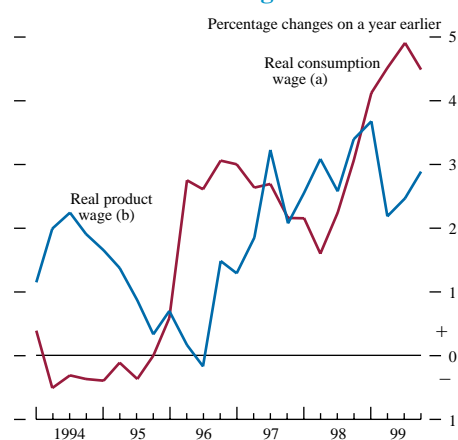
Per cent

	1999				2000
	Q1	Q2	Q3	Q4	Q1
RPI inflation rate one year ahead					
Academic economists	2.3	2.3	2.5	2.2	2.4
Business economists	2.1	2.2	2.4	2.4	2.5
Finance directors	2.3	2.3	2.4	2.3	2.4
Trade unions	2.7	2.5	2.5	2.6	2.4
General public	4.1	4.0	3.7	3.9	3.9

Source: Barclays Basix survey.

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

Chart 3.14
Growth in real earnings



Sources: ONS and Bank of England.

(a) Wages and salaries per head divided by tax and prices index.
 (b) Wages and salaries and employers' social security contributions per head divided by GDP deflator at basic prices.

Although wages are typically agreed in nominal terms, wage bargainers care ultimately about expected real wages, which depend also on expected inflation. In particular, lower inflation expectations tend to result in lower rates of increase in nominal wages. RPI inflation expectations according to the Basix Survey have fallen since 1998—consistent with the fall in wage settlements growth over the same period—although they have picked up slightly for some groups between 1999 Q4 and 2000 Q1 (see Table 3.B). But the inflation expectations of trade unions for the next twelve months have continued to fall.

Employers are concerned about the real product wage, which is their total labour costs per employee relative to the prices of the goods and services they sell. Employees, on the other hand, care about the real consumption wage—a measure of earnings in terms of real purchasing power after taxes have been deducted. The four-quarter growth rate of the real consumption wage has risen over the past year, and has outpaced the real product wage (see Chart 3.14). The relationship between these two real wage series depends on two main factors: the terms of trade, and taxes on employment income and consumers' expenditure. The terms of trade is the ratio of export to import prices. Over the past year, export prices have fallen less rapidly than import prices, which has boosted both the terms of trade and the real consumption wage relative to the real product wage. An increase in the wedge between the real consumption wage and the real product wage should mean, other things being equal, lower overall real wage pressure, because at a given level of demand for hours worked there would be a greater effective supply of labour.

It is difficult to judge the likely effect on prospective inflation of the recent rise in earnings. This depends on the extent to which the rise reflects temporary factors and/or past or expected productivity improvements. Insofar as the rise in earnings reflected unusual productivity gains, there would be less effect on unit wage costs and inflationary pressure. Insofar as the rise is indicative of labour market tightness, the implication would be greater inflationary pressure. The Committee judges that the higher growth in earnings is likely to be temporary, and would put relatively little upward pressure on prices. The implications of the recent rise in earnings for the Committee's judgments on the outlook for inflation are discussed further in Section 6 of this *Report*.

3.3

Summary

Employment has continued to grow. Productivity growth has picked up. Unemployment has fallen on both the claimant count and LFS measures. Survey evidence and Agents' reports suggest that skill shortages remain a concern. Although settlements have continued to edge down, earnings growth is significantly stronger than expected three months ago. So estimated wage drift has risen further. Recent bonus payments appear to have been higher than a year ago, and headline earnings growth may be boosted by bonuses for some months. The effects of the recent rise in earnings on prospective inflation are uncertain. They will depend on the extent to which the rise reflects temporary factors and unusual productivity gains rather than general labour market tightness.

Table 4.A
World oil production and demand

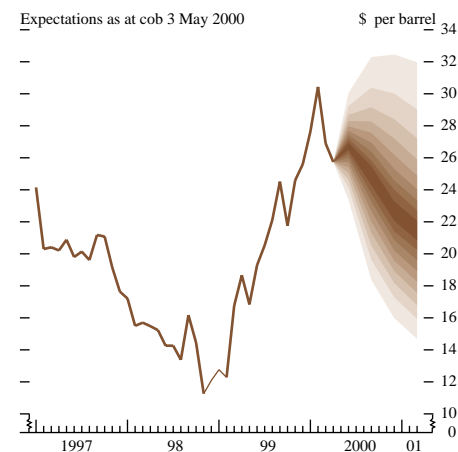
Millions of barrels per day

	1997	1998	1999
Demand			
Total	73.4	74.0	75.3
of which:			
Asia	19.8	19.4	20.3
Production			
Total	74.4	75.5	74.0
of which:			
OPEC	27.2	28.0	26.6
Change in stocks (a)	0.3	0.3	-0.7

Source: International Energy Agency—*Monthly Oil Market Report*.

(a) Reported by OECD countries. This does not equal the difference between estimates of production and demand because it excludes unreported changes in OECD and non-OECD stocks.

Chart 4.1
Implied distribution for oil prices^{(a)(b)}



Sources: NYMEX and Bank of England.

- (a) Derived from option prices for West Texas Intermediate oil (WTI). Prices for WTI tend on average to be around \$ 1 per barrel higher than those for Brent crude oil. But in April the difference was around \$ 3.
- (b) The chart depicts the probability distributions for oil prices, and is rather like a contour map. 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 oil prices. The markets judge that there is a 10% chance of oil prices being within the darkest, central band at any date. Each successive pair of bands covers a further 10% of the distribution until 90% of the distribution is covered. The bands widen as the time horizon is extended, indicating increased uncertainty about oil price outcomes.

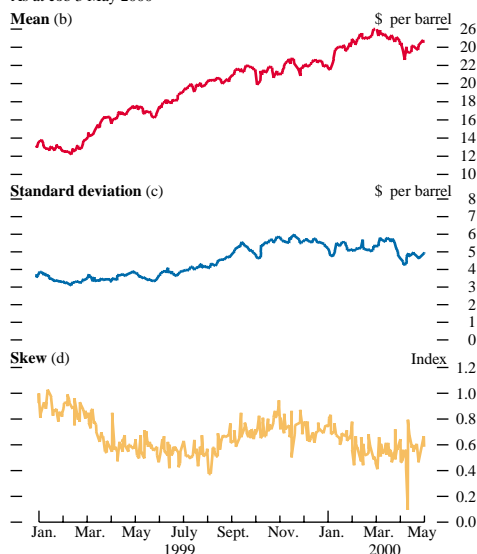
In 2000 Q1 world commodity prices rose by more than expected at the time of the *February Report*. That put further upward pressure on UK manufacturers' input prices. Moreover, manufacturers' unit labour costs are no longer falling. But manufacturers' output price inflation remains subdued, partly reflecting intense competition from imports. The sterling prices of imported manufactures have continued to decline, reflecting the appreciation of the exchange rate over the past year. Retail goods price inflation has fallen below zero. But surveys suggest that inflation in corporate services prices has picked up and retail services price inflation has also increased. As expected, aggregate RPIX inflation has fallen slightly since the *February Report*, and remains below the government's 2½% target.

4.1 Raw materials and commodity prices

According to the International Energy Agency, global final demand for oil increased by 1.7% in 1999, mainly because of an increase in demand from Asian countries (see Table 4.A). By contrast, supply is estimated to have contracted by 2.0% as OPEC reduced production. So reported stocks of oil fell in 1999, and are likely to have declined further in the early months of this year. The increased scarcity of oil was associated with a rise in its price (see Chart 4.1), and in early March the price of Brent crude oil exceeded \$ 30 per barrel for the first time since the Gulf crisis in 1991. But oil prices then fell in anticipation of, and following, an agreement by OPEC to increase production. On 29 March, OPEC members agreed to raise production by 1.45 million barrels per day, equivalent to around 2% of world production in 1999, although quotas have not been strictly adhered to in the past. The average price of oil in 2000 Q1 was close to \$ 27 per barrel, higher than expected at the time of the *February Report*. Prices are currently lower than that; Brent crude averaged around \$ 22 per barrel in April, and, consistent with futures prices, the MPC has continued to assume that the price of oil declines further towards \$ 18 per barrel in two years' time. Market uncertainty, as measured by the standard deviation of the distribution for oil prices implied by futures contracts, has diminished since the OPEC meeting (see Chart 4.2).

Chart 4.2
Information from futures prices about the oil price six months ahead^(a)

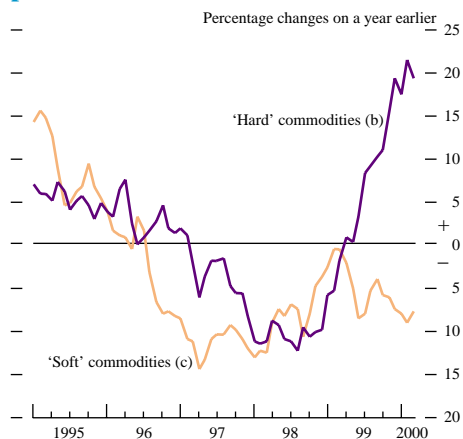
As at cob 3 May 2000



Sources: NYMEX and Bank of England.

- (a) Derived from option prices for West Texas Intermediate oil (WTI). Prices for WTI tend on average to be around \$ 1 per barrel higher than those for Brent crude oil. But in April the difference was around \$ 3.
- (b) The expected price in six months' time.
- (c) The spread of views about the expected price in six months' time.
- (d) Skewness reflects the balance of risks around the central, most likely, path for oil prices. A positive skew indicates that the balance of risks are on the upside.

Chart 4.3
Bank sterling non-oil commodity price index^(a)



- (a) Monthly average of prices of primary commodities, weighted by their shares in UK demand.
- (b) Includes prices of non-oil fuels and metals.
- (c) Includes prices of domestically produced and imported foodstuffs and non-food agricultural products.

But the skew of the distribution suggests that the balance of risks is still judged by the market to be on the upside of the downward sloping central projection.

Non-oil commodity prices in 2000 Q1 were slightly higher than expected at the time of the February *Report*. In the year to March the Bank's sterling non-oil commodity price index rose by 3.0%. Stronger-than-expected prices for hard commodities such as metals have more than offset weaker-than-expected food prices (see Chart 4.3). The link between world industrial production and demand for hard commodities may be weaker than in the past if the prospective increase in manufacturing production is concentrated in high-technology sectors, whose use of commodities is less intensive than traditional manufacturing. Nevertheless, consistent with an upward revision to the prospects for world activity, the MPC has assumed a higher rate of increase in non-oil commodity prices than in its February projections.

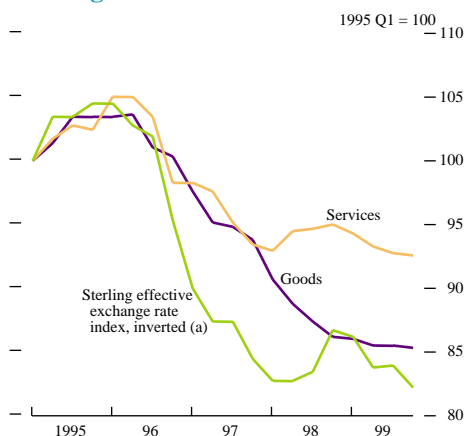
4.2 Import prices and the exchange rate

Sterling import prices of goods and services fell by 0.2% in 1999 Q4 and were 1.4% lower than a year earlier. Within the total, goods import prices were 1.1% lower than a year earlier, whereas services import prices fell by 2.6% over the same period (see Chart 4.4). The main reason why goods import prices have fallen by less than services import prices over the past year is that oil prices have increased (see Chart 4.5).

The impact of oil prices on world prices depends both on the direct effects arising from oil usage in production, and on any indirect effects that arise when oil price changes affect expectations about inflation and hence wages. There are two reasons why the impact of any change in oil prices may be less than in the past. OECD consumption of oil per unit of GDP has fallen by almost a half since 1972, and monetary policy regimes firmly focused on maintaining price stability should limit any further passthrough into wage and price inflation.

Even excluding oil, sterling import prices of goods and services have fallen by less than might have been expected based solely on movements in the sterling effective exchange rate: in the year to 1999 Q4 the sterling price of non-oil imports fell by 2.5% whereas the exchange rate appreciated by 5.3%. That is partly

Chart 4.4
UK sterling import prices and the exchange rate



Sources: ONS and Bank of England.
(a) A fall indicates an appreciation.

Chart 4.5
Contribution to annual changes in sterling goods import prices

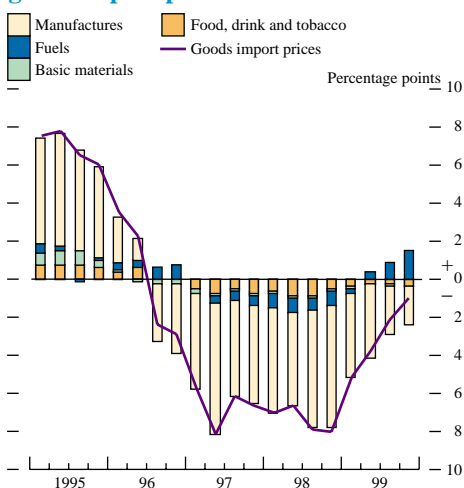
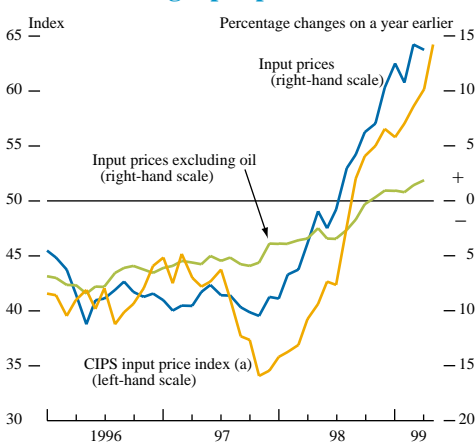


Chart 4.6
Manufacturing input prices



Sources: ONS and CIPS.

(a) Survey responses to question asking how prices compare with the same month a year ago. Readings above 50 suggest that prices are rising, readings below 50 indicate falling prices.

because world prices have risen: in 1999 Q4 UK trade-weighted world export prices rose for the third consecutive quarter, and by more than expected. Looking ahead, the MPC has assumed that world export prices rise more quickly than in the February projection because of stronger world demand and the lagged effects of the rise in oil and other commodity prices.

But even allowing for movements in world export prices, sterling import prices have not declined as much as expected in recent quarters. That may have been because overseas producers raised their relative margins on exports to the United Kingdom, perhaps because they expected the appreciation would be short-lived, and because demand in the United Kingdom was more buoyant than in other markets. But the persistence of the appreciation and competition from other producers may encourage overseas suppliers to reduce their margins in order to increase their UK sales. The MPC have assumed that margins are reduced over the forecast period. Together with the recent further appreciation of sterling, that means that by the end of the forecast period sterling import prices are a little lower than assumed in the February Report, despite the stronger profile for world export prices.

4.3 Costs and prices in manufacturing

Manufacturers' input price inflation has increased since the February Report. The annual rate of inflation was 13.8% in March. That mainly reflects the direct effect of further increases in the price of oil. But even after excluding oil from the index, input price inflation has risen (see Chart 4.6). That partly reflects the use of oil in the production of other inputs: for example the prices of imported plastics rose by 15.6% in the year to March. And, consistent with the increase in commodity prices, imported metals prices in March were 14.7% higher than a year earlier. The CIPS manufacturing survey also indicates that input price pressures have risen.

During much of 1999, manufacturers' unit labour costs declined as rapid productivity growth outpaced earnings growth. But output has fallen in recent months and earnings growth has picked up, putting upward pressure on unit labour costs. With the pick-up in input price inflation, manufacturers' weighted overall costs are estimated to have risen by around 3.4% in the year to February (see Table 4.B).

Table 4.B
Manufacturers' costs and prices

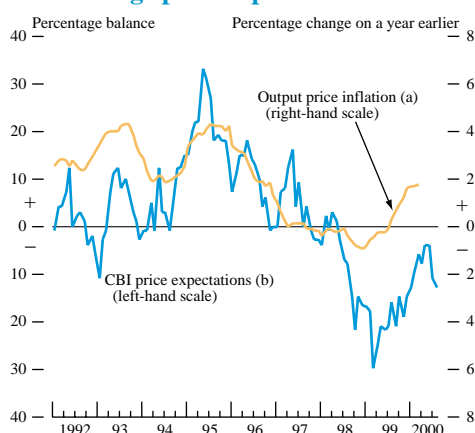
Percentage changes on a year earlier

	1999				2000	
	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.
Weighted costs (a)	1.0	1.5	2.0	3.3	3.0	3.4
Unit labour costs (46.8%)	-1.5	-0.7	-1.2	0.3	0.6	-0.1
Materials and fuels (30.1%) (b)	6.2	7.0	10.2	12.5	10.8	14.2
Imports of finished goods (6.9%)	0.0	-1.1	0.0	0.0	0.0	0.0
Bought-in services (16.2%)	2.3	2.2	2.0	1.9	1.9	1.9
Output prices (excluding duties)	0.7	0.9	1.2	1.6	1.7	1.7

Sources: ONS and Bank of England.

(a) Percentages shown in brackets reflect weights of components, derived from 1989 input-output tables for the United Kingdom.
(b) Includes imports of semi-finished goods.

Chart 4.7
Manufacturing output price inflation and CBI average price expectations



Sources: ONS and CBI.

(a) Excluding excise duties.
(b) Balance of manufacturers expecting to increase prices over the following four months minus those expecting to reduce prices, adjusted for seasonal variation. This series has been advanced by four months, as it relates to producers' expectations of future prices.

Table 4.C
BCC and CIPS surveys of service sector prices

	1999				2000
	Q1	Q2	Q3	Q4	Q1
BCC prices balance (a)	17	11	22	24	26
CIPS input price index (b)	54.9	55.5	54.5	57.9	58.9
CIPS selling price index	49.7	50.9	49.2	52.3	53.3

Sources: CIPS and BCC.

(a) Percentage balance of responses to the question: 'Over the next three months, do you expect the price of your services to increase/remain the same/decrease'.
(b) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices. The CIPS survey is monthly, and the quarterly values shown are averages over the relevant three months.

Manufacturers have in general been unable to pass on this increase in costs to domestic output prices: excluding excise duties the annual rate of output price inflation has remained below 2%. Moreover, the CBI monthly industrial trends survey shows an increase in the balance of firms who expect to reduce their domestic output prices over the next four months (see Chart 4.7). That is likely to reflect competition from the declining sterling price of imported manufactured goods. For manufacturers as a whole, moderate output price inflation but increasing cost pressures suggest that domestic margins have continued to decline.

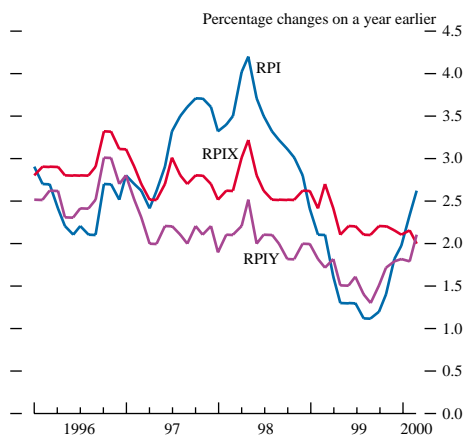
4.4 Costs and prices in the service sector

Unit wage costs in the service sector are estimated to have risen by nearly 4% in the year to 1999 Q4, well above rates of increase in the manufacturing sector. The rate of increase slowed during 1999, as productivity growth picked up, but earnings growth rose sharply around the turn of the year. And the CIPS survey has indicated an increase in service sector input cost pressures in 2000 Q1 (see Table 4.C), with rising staff costs cited as a reason. While firms continued to mention strong competition as a factor limiting increases in prices charged, the survey indicated that upward pressure on output prices had also risen. The ONS is developing an official producer output price index for services, but at present data are only available for certain sectors. Consistent with the CIPS survey, which highlighted an increase in fuel costs, the ONS estimates that output price inflation in the freight road transport sector has increased, to reach 4.0% in 1999 Q4. The picture of service sector output prices rising more quickly is corroborated by the BCC survey, which has shown a rising prices balance since 1999 Q2. Retail services prices are discussed below.

4.5 Retail prices

The rate of retail price inflation excluding mortgage interest payments (RPIX) was 2.1% in 2000 Q1, broadly in line with the February *Inflation Report* projection. In March, annual RPIX inflation was 2.0%, compared with 2.2% in the previous month (see Chart 4.8). That decline reflected last year's increase in tobacco and petrol duties dropping out of the annual calculation: RPIY inflation, which excludes mortgage interest payments and indirect taxes, rose to 2.1% in March from 1.8% in February. All-items RPI inflation rose to 2.6%

Chart 4.8
Retail price inflation



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

Chart 4.9
Goods and services price inflation

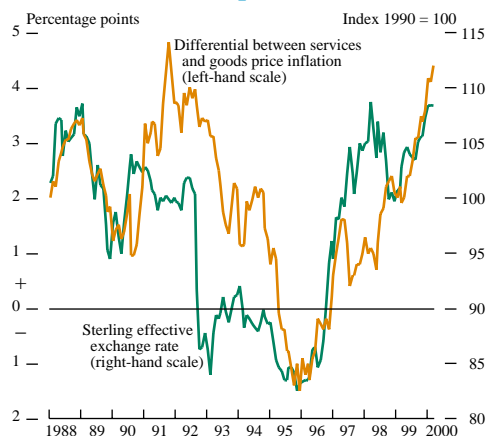
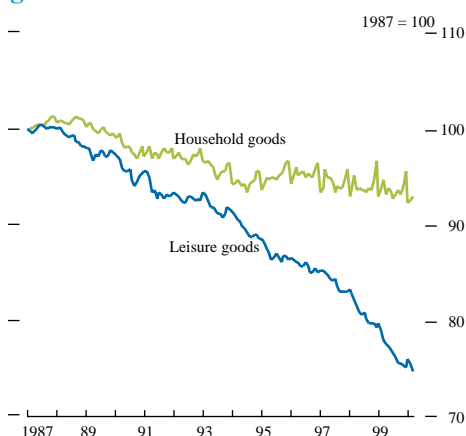


Chart 4.10
Relative price of household and leisure goods^(a)



(a) Prices relative to all RPIX goods prices.

in March, as mortgage rates increased relative to a year earlier.

While RPIX inflation has remained relatively steady, the gap between retail goods and services price inflation has widened further: the differential in 2000 Q1 was 4.3 percentage points. On average the prices of services tend to rise more quickly than the prices of goods. That is because productivity growth is lower on average in the service sector. The average gap between the inflation rates for retail goods and services over the past ten years has been around 2 percentage points. A similar gap is evident in other major economies. The differential is currently much larger than this historical average. That may in part reflect the recent appreciation of the exchange rate, because the goods sector is more exposed to international competition (see Chart 4.9). But it may also indicate an increase in the degree of competition in the goods sector relative to the services sector, over and above that caused by the appreciation.

Retail goods prices fell by 0.1% in the year to 2000 Q1; excluding petrol they fell by 1.5%. The anticipation of greater competition in new car retailing has led to a sharp decline in used-car prices relative to a year ago, and that sector continues to make the largest negative contribution to RPIX inflation (-0.3 percentage points in March). Used car prices have recovered by 1.9% since December, although future developments in car prices will be affected in part by the consequences of the Competition Commission's report into new car retailing. Retail goods prices in other sectors may have been affected by increased use of the Internet. Prices quoted on the Internet were included in the RPIX sample for the first time in February: the ONS incorporated quotes on two leisure goods, books and toys, which were judged more likely than other goods to be bought on the Internet. But the weight attached to Internet prices is currently less than half a part per thousand. Prices charged by traditional retailers may have been affected by competition with Internet retailers. That might be expected to lead to a decline in the relative price of those goods most likely to be bought on the Internet, for example household and leisure goods. But Chart 4.10 shows that recent movements in their relative prices have continued well-established trends.

Reports from the Bank's regional Agents continue to suggest that retail margins are falling. And the February *Report* noted that general retailers' relative share prices had fallen sharply, a trend that has continued in recent

Utility prices

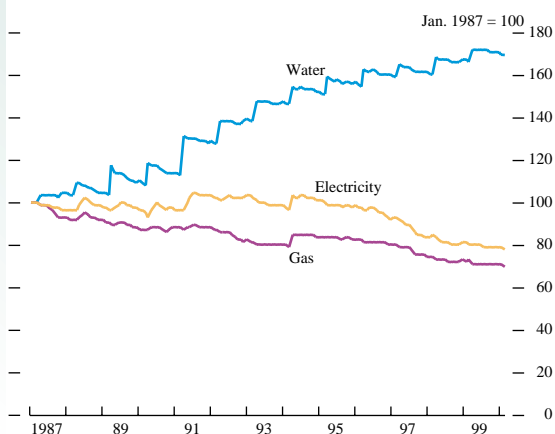
The gas, water, and electricity services were privatised in 1986, 1989, and 1990 respectively. Domestic consumers were then in the situation of being provided services by private monopolies. So to protect consumers and provide incentives for efficiency, systems of regulation were introduced.

These systems of regulation restrict the revenue that the company can make or the prices that can be charged. The transmission of electricity across the National Grid, the distribution of electricity by Public Electricity Suppliers and the transportation of gas by Transco are all subject to revenue control. Revenue controls restrict the rate of annual increase in revenue. In general revenues have been required to fall relative to the RPI. Where they have been allowed to rise more rapidly than the RPI it has been to fund investment deemed necessary by the regulator. That has been the case for the water industry (see Chart A).

The supply of gas to domestic customers by British Gas Trading (owned by Centrica) and the supply of electricity by Public Electricity Suppliers to some domestic customers within the suppliers' area are subject to price control. The price controls restrict the rate of annual price increases to RPI minus an efficiency factor. The controls on revenues and prices are intended to remain in place until sufficient competition has developed.

From 1 April 2000, Ofgem, the regulator for the electricity and gas industries, has removed direct debit customers completely from the scope of the gas supply price controls and from the key elements of

Chart A
Relative prices of services provided by utilities to domestic consumers^(a)



(a) Components of the retail price index relative to the aggregate.

the electricity supply price controls, as competition for these customers is sufficiently developed. Since 1998 for gas and 1999 for electricity, all households in Great Britain have been able to choose their domestic supplier. Ofgem expects the prospective increase in competition to be sufficient to remove all gas customers from the supply price controls from April 2001 and all electricity customers from 2002.

Implementation of the latest price control reviews on 1 April, means that some electricity, gas and water prices will fall. Collectively, expenditure on these services comprises 4.3% of the RPIX basket of goods and services. The new price limits imply that domestic electricity prices should fall, on average, by around 6%. Domestic gas prices should

months. But this information on current and prospective margins relates mainly to the retailing of goods. The strength of demand for services may have enabled margins to increase in that sector. It is the aggregate margin of all firms involved in the supply of goods and services for consumption that is relevant to developments in aggregate retail price inflation. A recent survey by the Bank's Agents asked about trends in profit margins in the retail, non-retail services, manufacturing, and construction sectors. The survey indicated that overall across these sectors there had been a slight narrowing of margins in 2000 Q1. But large majorities of firms in the construction and non-retail services sectors, where demand has been buoyant, had seen an increase in profit margins. Different trends in

fall by around 4%. The regulators anticipate that prices may fall by more because of increased competition. New price limits for the water industry in England and Wales imply a reduction in prices by around 12% on average. This is the first time that prices have fallen on average across the industry since it was privatised.

These price cuts reduce the relative price of energy and water. The relative price of gas and electricity has already been falling for some time, but the prospective decline this year is significantly larger than experienced before. The aggregate rate of inflation in the economy is determined by the balance of nominal demand and supply. For a given level of nominal income, cuts in utility prices will raise the amount of real income that consumers can spend on other goods and services. There may therefore be offsetting price increases for these goods and services, as demand for them increases. But the timing and magnitude of any such adjustment is very uncertain. So the MPC has assumed that these large relative price changes could have a temporary effect on RPIX inflation.

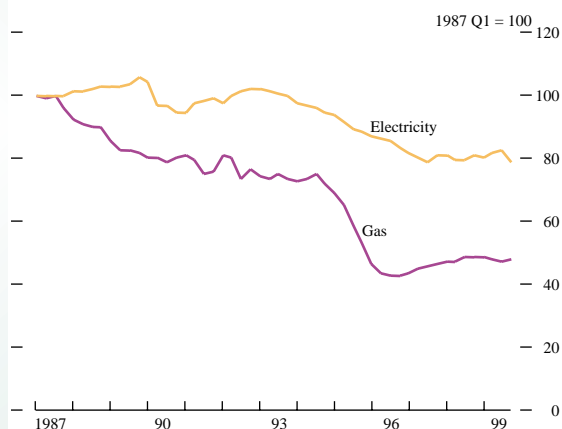
Simply applying the quoted average price cuts to the weights of the respective services in the RPI suggests that the aggregate price level measured by RPIX would be 0.4% lower after 2000 Q2.

Reflecting the possible offsetting effects on other prices, the MPC has assumed a net effect on RPIX inflation of minus 0.2 percentage points over the next year. There is considerable uncertainty about this, both because of the possible adjustment of other prices and the diversity of price controls across different electricity and water suppliers.

Competition in the supply of energy to industrial consumers began earlier: in 1986 and 1990 for large users of gas and electricity respectively. That has helped to reduce the relative price of energy for industry (see Chart B). The supply of energy to businesses is no longer covered by price controls, but there are other regulatory changes that are likely to affect business energy costs. Electricity transmission and distribution costs are set to fall and proposals for new trading arrangements for electricity generation may also reduce prices.

Chart B

Relative prices of energy for industry^(a)



(a) Relative to producer output prices excluding excise duties.

The impact on aggregate RPIX inflation is difficult to judge because the potential adjustment to output prices will vary across industries. The current projection assumes that lower electricity prices for business reduce RPIX inflation by 0.1 percentage points at the end of the forecast period.

the margins of firms providing services rather than goods may explain why it has not been possible to identify from official data a significant structural change in the relationship between retail prices, domestic unit labour costs and import prices, that might be related to increased competition.

Retail services price inflation rose to 4.2% in 2000 Q1 from 3.9% in the previous quarter. Some retail services prices are subject to regulation, for example rent and utility prices. One might therefore get a better gauge of how the balance of supply and demand is affecting services prices by looking at prices in the unregulated sector. As Chart 4.11 shows, the recent increase in retail services price inflation has been mainly in the

Chart 4.11
Services price inflation

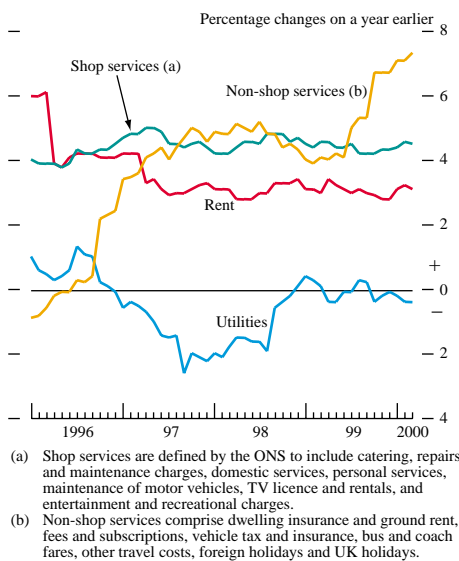
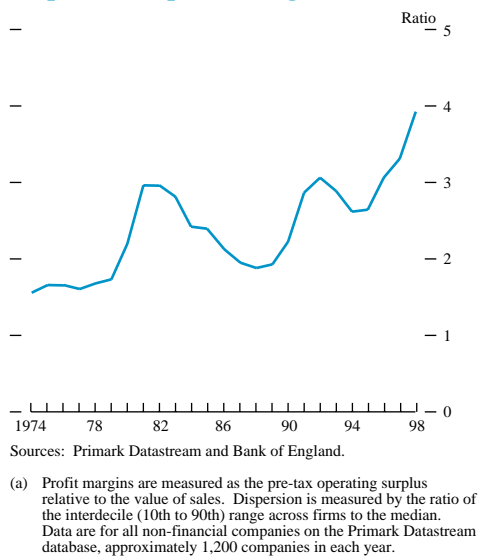


Chart 4.12
Dispersion of profit margins^(a)



unregulated sectors. Some regulated services prices are set to fall significantly, as price cuts announced by utility regulators are implemented (see the box on pages 38–39).

Reports of increased competition in some sectors of the economy may be associated with the normal process of structural change. To try to assess whether the pace of structural change is currently any more rapid than usual, Chart 4.12 looks at how the dispersion of profit margins across individual companies has changed over time. More rapid structural change may lead to greater dispersion between the profit margins of firms in expanding and contracting markets. The chart illustrates that profit margins tend to become more dispersed during recessions. But against this general pattern there has been a sharp increase in dispersion during the current expansion. One hypothesis might be that the increase in dispersion reflects the differential impact that the appreciation of the exchange rate has had on the tradeable and non-tradeable sectors of the economy. But a similar increase in dispersion has occurred within both the manufacturing and service sectors. This is consistent with, but not strong evidence for, some increase in the pace of structural change. But such change need not affect the aggregate relationship between retail prices, domestic unit labour costs and import prices.

While any evidence for a structural shift in aggregate pricing behaviour comes largely from Agents' reports and surveys, rather than econometric relationships based on official data, the MPC has maintained its assumption that the prospective increase in competitive pressures may be different in nature to that experienced in the past. The Committee has therefore assumed that there will be some overall compression of retailers' margins over the forecast period, which will put downward pressure on retail prices. The Committee has also maintained the assumption (detailed in the box on pages 38–39) that reductions in the prices of services provided by the utilities will temporarily lower retail price inflation.

4.6 Other price indices

Retail price inflation can be thought of as a weighted average of domestically generated inflation (DGI) and imported inflation. The appreciation of the exchange rate continues to put downward pressure on imported inflation. But this effect will gradually fade unless the

Chart 4.13
Measures of domestically generated inflation

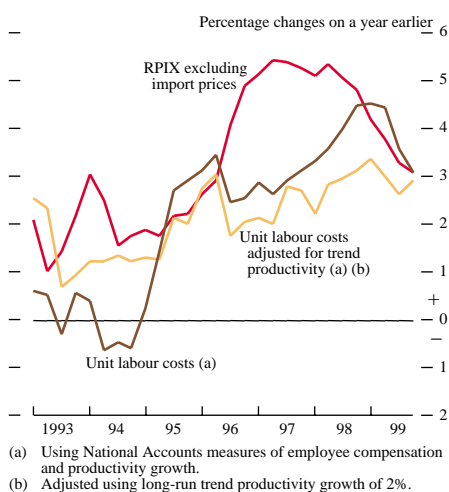
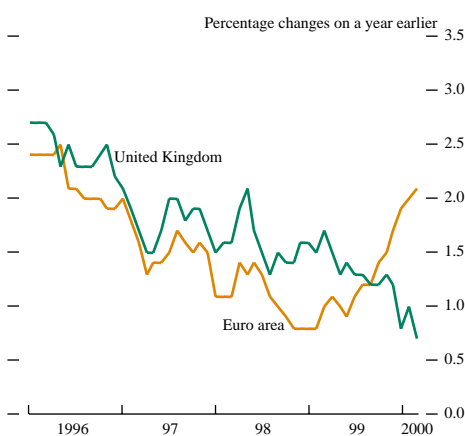


Chart 4.14
HICP inflation



exchange rate strengthens further. So it is important to look at measures of DGI. One measure is calculated by adjusting RPIX inflation for the share of direct and indirect imports in consumption. That measure of DGI declined in 1999 Q4, continuing the trend apparent since 1998 (see Chart 4.13). But it may have been temporarily high following the initial appreciation of sterling if there was some lag between import prices falling and UK retailers adjusting their prices. To avoid the distortions caused by temporary fluctuations in profit margins it may be better to focus on unit labour costs. DGI as measured by actual unit labour costs has also fallen as productivity growth has recovered, and both measures are now around 3%. The measure of DGI that uses unit labour costs adjusted for trend productivity growth has been around 3% since 1998.

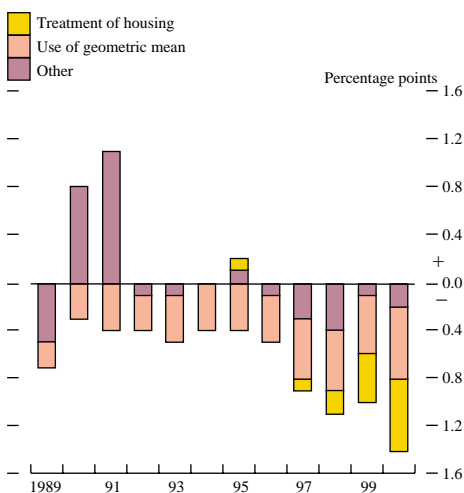
A change in the exchange rate is one cause of relative price fluctuations. But changes in preferences, technology, and other supply shocks, such as an increase in the price of oil, also lead to relative price changes. Large relative price changes may temporarily obscure underlying developments in aggregate inflation. A possible solution is to look at a measure of inflation that removes large relative price changes from the sample. The Bank calculates a measure of inflation that excludes the largest and smallest 15% of weighted price changes in the individual components of the retail price index. This trimmed mean measure of RPIX inflation has remained below the official measure. But theory gives no direct guide to how much of the distribution it is sensible to trim, and there may be circumstances when certain large relative price changes provide useful information about future aggregate inflation.⁽¹⁾

Annual inflation in the Harmonised Index of Consumer Prices (HICP) was 0.7% in March (see Chart 4.14), the lowest rate since the official series began in 1996 and lower than in any country in the euro area. There are several reasons why UK HICP inflation is below RPIX inflation, but most of the difference is attributable to the different treatment of housing and to the different approaches used to weight components of the indices at the lowest level of aggregation.

RPIX includes a measure of part of the cost of owner-occupied housing, termed 'housing depreciation'. This is the notional amount that the owner would need to

(1) For a discussion, see 'To trim or not to trim? An application of a trimmed mean inflation estimator to the United Kingdom', Bakhshi, H and Yates, A, *Bank of England Working Paper*, No 97, July 1999.

Chart 4.15
Reasons for differences between UK HICP
and RPIX inflation^{(a)(b)}



(a) The figure for 2000 relates to March.
 (b) The official UK HICP index starts in 1996. The chart is based on analysis by the ONS contained in 'Harmonised index of consumer prices: historical estimates', O'Donoghue, J, *Economic Trends*, No 541 December 1998.

set aside on a regular basis to maintain their house at a constant quality, and hence provide a constant flow of housing services. It is calculated using an index of house prices. HICP does not currently include an owner-occupied housing component. So the recent rapid rise in house prices has been a factor causing divergence between the two measures of consumer price inflation in the United Kingdom (see Chart 4.15).

RPIX uses an arithmetic mean to average prices at the lowest level of aggregation, whereas the HICP uses a geometric mean. Using a geometric mean results in a lower measure of aggregate inflation because when relative prices change, the geometric method gives more weight to goods and services whose relative price has fallen, whereas the arithmetic method has fixed weights. The contribution of different weighting procedures to the gap between RPIX and HICP inflation has tended to rise over the past ten years: it reached 0.6 percentage points in March, double its level ten years ago. The reasons for this are not wholly clear, but it may be due to increasing dispersion of prices within components of the index.

4.7

Summary

In 2000 Q1 world commodity prices rose by more than expected at the time of the *February Report*. That has put further upward pressure on UK manufacturers' input prices, and manufacturers' unit labour costs are no longer falling. But manufacturers' output price inflation has remained subdued and the CBI industrial trends survey shows an increasing net balance of firms that expect to cut prices. That is likely in part to reflect competition from cheaper imports, which has added to downward pressure on manufacturers' margins. The appreciation of sterling has contributed to the growing divergence between retail goods and services price inflation. Retail goods price inflation has fallen below zero. But surveys suggest that corporate services price inflation has picked up and retail services price inflation has also increased. In contrast to the manufacturing sector, a recent survey by the Bank's regional Agents suggests that margins in the non-retail services sector are increasing. Measures of domestically generated inflation have fallen somewhat, but are around 3%. In aggregate, as expected, inflation has remained below the Government's 2½% target 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 are attached as an Annex to this Report. The Bank of England's repo rate was maintained at 6% in March, April and May.

In the February Report, the MPC's central projection was for annual real GDP growth to rise to 3% in early 2000, before easing to a little below 2½% in 2001 and early 2002. The Committee's best collective judgment of the prospects for RPIX inflation was that it was likely to decline to around 2% during 2000, before rising to the 2½% target level in the second year of the projection. Changes relative to the November projection mainly reflected upward pressure on inflation from a higher path for nominal earnings growth and stronger determinants of consumer demand, and downward pressure from the higher exchange rate path and higher interest rates. The balance of risks to inflation was judged to be slightly on the upside, while the risks to real GDP growth were thought to be broadly balanced. Particular uncertainties were emphasised relating to the future course of the exchange rate and the degree to which technological and competitive developments would be likely to reduce inflation in the medium term. Alternative judgments on these issues led some Committee members to prefer profiles for inflation up to ½% higher or lower at the two-year forecast horizon than the central projection based on the best collective judgment.

At its meeting on 8–9 March, the Committee discussed the potential impact of the forthcoming Budget which, according to Treasury estimates, would involve a somewhat higher path for government consumption but a tighter fiscal stance over the next two years than expected at the time of the November Pre-Budget Report (PBR). The Committee assessed that the impact on future output and inflation of the information on the Budget was likely to be small, though that would depend in part on whether there was any impact on the exchange rate. Further analysis would be conducted once the full details were known.

Revisions to consumption and investment data implied that final domestic demand had increased by 4%–4½%

in the year to 1999 Q4, which was faster than earlier thought, though there were signs that this growth rate was moderating slightly. Total domestic demand growth was also higher in Q4 than expected. There was a greater-than-expected positive contribution from inventory accumulation, but this was offset by a higher-than-expected negative contribution from net trade. Overall, the latest indicators of demand and output provided a mixed picture, with some remaining strong while others had weakened. Industrial production had fallen since November but services output remained strong. Surveys of business optimism were also at high levels.

The broad money stock (M4) was growing at its lowest rate on record. This slow growth no longer reflected just the behaviour of OFCs' deposits, which had been weak for some time, but PNFC and household deposit growth had also recently slowed. By contrast, the growth in lending remained strong. Loans to households secured on housing continued to be robust, while the growth of unsecured credit was still high though well below its peak. Corporate borrowing also remained strong, but there was little evidence to suggest distress borrowing; rather, firms were generally optimistic and investing at high rates. The sterling effective exchange rate had risen slightly since the previous meeting, largely reflecting continuing euro weakness. The Committee noted the rapid rise in new technology stocks, and discussed the potential links between a US stock market correction and a fall in the dollar. House price inflation was running at around 15% per annum in the year to February on both the Halifax and Nationwide indices, but there were some signs that housing market activity might be moderating.

There was little surprising news in UK labour market quantities data since the previous meeting. The latest earnings data, however, had shown a sharp increase. But it was not clear how much weight should be placed on the latest figures owing to special factors relating to year-end bonuses, some of which might be Y2K-related and others which might be the result of higher past profits. At face value, the earnings data were above the path assumed in the February *Inflation Report*, but more information was needed before firm conclusions could be drawn. There appeared to be a marked contrast between UK and US earnings behaviour—UK earnings growth was running ahead of that in the United States, despite the US economy exhibiting greater productivity growth and likely to be equally affected by millennium bonus effects. In contrast to earnings, settlements had fallen slightly. And some companies continued to report

that pay increases were warranted by higher productivity so they were not putting upward pressure on unit costs.

There was a further rise in the price of oil in February, which came on top of increases during the previous twelve months. The oil price was well above the profile that had been assumed in the February *Report*, though there was uncertainty about what action OPEC members might take at their March meeting and it was still possible that the oil price might return to around the forecast path. The rise in input prices would add to pressures on manufacturing prices, but survey measures of output price intentions remained negative, suggesting that margins continued to be squeezed. The downward pressure on margins may have been one of the factors behind the increase in the PNFC sector's financial deficit. RPIX inflation had fallen to 2.1% in January and HICP inflation had fallen to 0.8%. The wedge between these two measures was explained in large part by differing treatment of housing and car prices, together with the methods used for averaging the different prices in the index. There was evidence of a further widening in the divergence between goods price and service price inflation, with retail goods price inflation falling to around zero and retail services price inflation rising to 4.2%.

The Committee also discussed prospects for the euro-area and US economies. GDP growth in the euro area seemed to be strengthening but inflation was also picking up slightly. Faster growth might in due course underpin an appreciation of the euro. US growth data had again been surprisingly strong and there was increased concern about the balance of aggregate demand and supply. It was possible that a further month of strong data had increased the risk of a large change in financial market sentiment at some point.

The Committee discussed the differences between its own February forecast and those of outside forecasters. The main differences appeared to relate to the assumed behaviour of inventories and the projections for earnings and prices. The MPC assumed a continued decline in the stock-output ratio as firms economise further on inventories, while many other forecasters did not. But there was no simple explanation for the differences in price-earnings projections. It seemed that other forecasters assumed a more benign short-term trade-off between growth and inflation. The Committee agreed to return to this issue during the May *Inflation Report* round.

The Committee agreed that the timing of the Budget would not constrain their decision in March or April. They also discussed some of the issues that would arise if there were a rate change in March that had not been expected by the markets.

With regard to the immediate policy decision, there was one view within the Committee that saw the inflation prospects as having deteriorated in the medium term but thought there was a case for waiting before taking further action. The deterioration was associated with evidence that final domestic demand and earnings were growing faster than previously thought. But uncertainty relating to bonuses and the full details of the Budget, combined with the potential effects on the already high exchange rate of an unexpected rate rise, tipped the balance in favour of waiting for more information before any further increase. Another group within the Committee acknowledged that some data were pointing to increased inflationary pressure but noted that there were other indicators, such as the decline in industrial production, pointing in the opposite direction. They were worried that a further rise in sterling might exaggerate the growing external and internal imbalances, risking a later collapse of sterling with adverse inflationary consequences. As interest rates had already risen in four steps by 100 basis points over the previous six months, it would be sensible to wait for the effects of these past changes to work through, especially as the short-term profile for inflation was benign. The Committee voted unanimously to maintain the Bank's repo rate at 6%.

At its meeting on 5–6 April, the Committee started by discussing the Budget. The broad shape of the projection for the public finances was unchanged from the Treasury briefing in advance of the March meeting. Net borrowing was projected to be lower than assumed in the November Pre-Budget Report (PBR) for the next two years but higher than the PBR figure by 2002/03. The implied projections for real government spending and investment over the next two years were higher in the Budget than had been assumed in the February *Inflation Report*, but were about the same as assumed in November. Overall, most members of the Committee took the view that the impact on future activity and inflation of the Budget seemed unlikely to be large over the next two years. The potential effect on the public finances of the third generation mobile telephone licences was also discussed. It was noted that, while government cash flows would be boosted almost

immediately, the macroeconomic effects would probably be small. But there could be some temporary effect on the exchange rate if a foreign bidder needed to buy a significant amount of sterling to pay for its licence.

Narrow money and lending data were consistent with robust spending growth, and loan approvals for house purchase had picked up in February, suggesting that the earlier slowdown had been partly seasonal. It was too early to tell whether house price inflation would moderate at the pace expected at the time of the February *Inflation Report*. Monetary data and surveys suggested a stronger outlook for business investment. The PNFC sector had an increasing financial deficit, but there was little sign that this was holding back investment plans. Equity prices had shown some fall in ‘new economy’ and a recovery in ‘old economy’ stocks. Euro weakness had continued, but the sterling effective exchange rate was little changed on the month.

The National Accounts data had been revised to show final domestic demand growth running at 4.4% in the year to 1999 Q4. Stockbuilding was lower than earlier thought but the net trade contribution was unchanged. Industrial production had fallen for three months in a row. The overall picture suggested renewed competitive pressures on the internationally exposed sectors of the economy, resulting from the strength of sterling against the euro. Survey evidence continued to point to rising manufacturing output, but it was possible that volumes were being maintained at the cost of shrinking margins, a situation that could not continue indefinitely. The service sector remained buoyant, in contrast to manufacturing. It seemed likely that GDP growth in 2000 Q1 would be in line with the February *Inflation Report* projection.

Productivity growth appeared to have picked up but it was too early to say if this was just a normal cyclical recovery. The labour market remained tight, with employment increasing moderately, unemployment stable at low levels, and some reports of widening skill shortages. Earnings growth had risen but the recent rise was thought largely to reflect bonus payments, in part millennium related. Some Committee members took the view that wage drift would have a smaller effect on prices than would settlements, while others were less convinced that the split made a difference to price-setting in the longer term. Bank data suggested that settlements were continuing to ease, but the Bank’s regional Agents detected higher settlements in services and some early indications of higher pay pressure in all sectors later in

the year. It was agreed that, while it would be wrong to react to every fluctuation in the earnings data, it was clear that the earnings profile for the May forecast would probably be above that in the February *Report*.

Retail price inflation had been slightly higher than expected but this largely reflected higher petrol prices, and oil prices had recently fallen to within the range projected in February, so the upside risk to inflation from this source had diminished. Surveys had reported further falls in goods prices but rises in input prices, and the Bank's Agents reported robust services price inflation though with variability between sub-sectors.

Prospects for world economic activity had strengthened further since February, with US growth coming in above expectations in 1999 Q4 and activity indicators remaining buoyant into 2000. Euro-area growth prospects had improved, East Asia had recovered rapidly and there were possibly some signs of an upturn in Japan. Official interest rates had risen in many countries, and market expectations were for further rises. The behaviour of the US economy was important for global prospects and some members thought that there was a good chance of US growth slowing gradually towards trend.

The Committee discussed a suggestion that it might intervene in an attempt to bring down the exchange rate and thereby help to correct the balance between the externally exposed sectors and the rest of the economy. Some members thought that this would be unlikely to work at present but might be considered in future, while others thought it could only be successful if accompanied by monetary policy easing, which would be inappropriate. Ineffective intervention was considered to be counterproductive.

With regard to the immediate policy decision, many members thought that the choice was finely balanced between leaving rates unchanged and a 25 basis point rise. Final domestic demand was growing rapidly—consumption still seemed robust, private sector investment was growing moderately and public sector investment was likely to grow rapidly. The net trade position was mixed, with the strength of sterling working in one direction and the growth of world demand working in the other. The labour market remained tight. The oil price had eased but input prices continued to rise, though there was little sign of any acceleration in final goods prices. On one view it would be better to leave

rates unchanged, as the news over the month was inconclusive. First, the extent of price pressures resulting from labour market tightness required further analysis and this could be undertaken in the context of the May forecast round. Second, the volatility of equity markets provided reasons for caution. Third, an increase in rates might exacerbate the imbalances in the economy and, with inflation expected to be running below target for some time, there was no pressing reason for an immediate rise. Some members who did not want a rate rise at present thought nonetheless that a rise might eventually be needed. A second view was that the balance of evidence had tipped in favour of an immediate rate rise. Much of the millennium fog had begun to clear and a rate rise would no longer come as a big surprise to the markets. A delay might lead to expectations that more would need to be done later. While the *Inflation Report* forecasting round would give an opportunity for further in-depth analysis, this was not in itself any reason to delay. It had also been agreed that the timing of the Budget should not create a constraint on rate movements in March or April. On this view a repo rate rise of 25 basis points was necessary. The Committee voted by six to three to leave the Bank's repo rate unchanged at 6%.

At its meeting on 3–4 May, the Committee voted to leave the Bank's repo rate unchanged at 6%.

6.1 The inflation projection assumptions

This *Report* was approved by the Committee on 5 May. It 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 of GDP growth and RPIX inflation over the next two years, together with the uncertainties surrounding them. These projections are based on the assumption that the Bank's repo rate remains unchanged at 6% during the next two years. Projections based on market interest rate expectations are also shown. The key assumptions conditioning the projections are described below.

The outlook for world activity has strengthened further since February. Momentum in the United States remains rapid, with growth in recent months substantially exceeding earlier expectations. Although higher interest rates and a fading impulse from earlier gains in equity prices are likely to dampen growth in the quarters ahead, the level of output over the next two years is likely to be higher than projected in February. Prospects for output growth in the euro area continue to improve. Rising business and consumer confidence are signalling further strengthening of domestic demand, and external demand should also support activity, partly because of the depreciation in the euro. The recovery in many emerging market economies continues to strengthen, with particularly rapid growth in South East Asia. However, prospects in Japan have altered little over the past three months. A mild recovery in output remains the most likely outcome over the next two years, but self-sustaining growth in private demand is not yet firmly established. Taking these developments together, the most likely prospect is for more rapid growth in world output and trade than assumed in February. Growth in UK-weighted world imports may rise to around 8½% this year, from 6% in 1999. World trade growth may then ease back somewhat in 2001 as demand growth, particularly in the United States, slows in response to tighter policy.

The Committee has raised the central projection for world activity in successive *Reports* as the global

recovery has gathered pace. However, there remain a number of risks to the projection, and the Committee continues to judge that the risks to activity are weighted to the downside. A sharper-than-expected slowdown in the United States, perhaps in response to a marked fall in equity prices, is one such risk. A substantial change in US asset prices might also spill over to other financial markets, including in the United Kingdom.

Commodity prices in the first quarter of the year were higher than projected three months ago. Oil prices rose sharply in January and February as stocks were run down further and the previous restraints on OPEC production were maintained. The price of Brent crude peaked at more than \$ 30 per barrel in early March. More recently, oil prices have fallen back substantially as OPEC announced an easing of supply restrictions. The Committee has maintained the assumption that the Brent price will fall back towards \$ 18 per barrel by early 2002, although the trajectory has been raised a little reflecting the higher starting-position. Industrial commodity prices have risen more quickly than projected three months ago, more than outweighing weaker-than-expected food prices. The stronger profile for world output is likely to lead to somewhat higher non-oil commodity prices over the next two years than assumed in February.

Import prices in the United Kingdom reflect a number of influences: the prices of commodities and of internationally traded goods and services set in world markets; the profit margin on overseas sales to the United Kingdom; and the sterling exchange rate. In local currency terms, export prices of the major overseas countries edged up during 1999, after falling in the second half of 1998. Reflecting the stronger outlook for world activity, the Committee expects overseas export prices to rise a little more quickly than projected in February, although global inflation is likely to remain low. Given the levels of world export prices and the sterling effective exchange rate, import prices have been rather higher in recent quarters than previous relationships would imply. That suggests that foreign suppliers may have widened margins on sales to the United Kingdom. Reviewing the evidence on the relationship between world prices, the exchange rate and UK import prices, the Committee judged that this widening is likely to be temporary. Margins are expected to fall back over the next two years, putting downward pressure on import prices and domestic inflation.

The sterling exchange rate has remained very strong over the past three months. The effective exchange rate index (ERI) averaged 110.7 in the 15 working days up to and including 3 May, consistent with bilateral sterling exchange rates of \$ 1.58 and 59 pence against the euro. This forms the starting-point for the exchange rate profile assumed in the current projection. It is higher than the starting-point of 109.4 in the February *Report* and an implied level of 109.1 for May in the February central projection.

The outlook for the exchange rate remains highly uncertain. In particular, there is a risk of a sharp correction to the sterling-euro exchange rate, although the difficulty of anticipating both the timing and extent of any such correction means that the risk is not reflected in the fan charts. In line with recent *Reports*, the Committee agreed to take the average of a constant nominal rate and a path related to the pattern of market interest rate differentials as the basis for the central projection. Under this approach, and adjusting for the conditioning assumption of constant UK interest rates, the sterling ERI declines to 108.9 by 2002 Q2, consistent with bilateral sterling exchange rates of \$ 1.58 and 61 pence against the euro (equivalent to DM3.35). That is a slightly more gradual decline than in February. If, alternatively, the central projection were based on the assumption that the exchange rate moves fully in line with interest rate differentials, inflation at the two-year horizon would be some 0.2 percentage points higher than in the central projection. Output growth would also be rather stronger. On the other hand, basing the projection on a constant nominal exchange rate would reduce inflation by some 0.2 percentage points at the two-year horizon, and GDP growth would be correspondingly weaker.

Financial wealth is an important influence on household consumption. The ONS has recently made significant downward revisions to estimates of household financial wealth. Over the forecast period, financial wealth is extrapolated from the latest ONS estimate in line with changes in equity prices. Stock markets have been quite volatile over the past three months, but overall have declined only slightly. In the 15 working days to 3 May, the FTSE All-Share index was some 1½% lower than the central path assumed three months ago. The Committee has maintained the central case assumption that equity wealth rises from the current level in line with nominal GDP over the forecast period.

Housing wealth also has a significant influence on consumer spending. House prices nationally have continued to rise swiftly, although there are some tentative signs that the rate of increase may be moderating. The Committee continues to expect house price inflation to ease, partly in response to recent increases in interest rates, but judges that the deceleration in prices may be less pronounced than estimated three months ago. The central assumption is that annual house price inflation will remain in double figures through this year, but will decline to around 8% by the end of 2001.

The fiscal plans announced by the Chancellor in the Budget statement on 21 March have been incorporated into the forecast. The central projection is based on the government's plans for the growth of nominal public spending, and estimates of effective tax rates taken from published HM Treasury projections. The profiles for real government spending and total tax receipts are derived from this base in line with the Committee's assessment of the prospects for inflation and output. In the February *Report*, the Committee had assumed that the likely growth rate for real government spending on goods and services was a little lower than in November because of an upward revision to the relevant deflator. The higher profile for nominal public spending in the Budget has offset this effect. Real government spending and investment are consequently likely to be a little higher over the next two years than assumed in February, but broadly in line with the assumptions embodied in the November projection. Relative to the assumptions in the February *Report*, there is a slight contractionary effect on output and inflation prospects over the next two years from the change to benefit projections in the Budget and the revised estimates of effective tax rates.

Previous projections incorporated assumptions about the effects of labour market reforms introduced by the government. There is no change to these assumptions in the current *Report*.

6.2 The output and inflation projections

According to the preliminary ONS estimate, output growth has weakened around the turn of the year. GDP rose by 0.4% in the first quarter of 2000—compared with an increase of 0.8% in the fourth quarter of last year. A softening of growth was thought likely three months ago, but the preliminary estimate indicates a more marked slowdown than previously expected. By

contrast, survey data on the whole support a rather stronger picture, and recent information on the composition of demand also suggests that the first-quarter outturn may understate the underlying momentum. RPIX inflation edged down to 2.0% in March. A slight decline in inflation was projected in the February *Report*—recent outturns have been broadly in line with earlier expectations. The Committee reassessed the medium-term prospects for output and inflation against this background.

ONS releases published in February and March confirmed that GDP increased by 0.8% in the fourth quarter of 1999—in line with the preliminary estimate incorporated in the February projection—but incorporated an upward revision to the level of output, as growth in previous quarters was revised up. The level of activity in the fourth quarter was around 0.3 percentage points higher than assumed in February, and estimated growth in the year to the fourth quarter was correspondingly raised to 3.0%. The data releases also incorporated revisions to the composition of demand. In particular, final domestic demand growth was revised up. Consumer spending, government consumption and investment all grew rather more quickly during 1999 than thought likely three months ago, and final domestic demand growth in the year to the fourth quarter was almost 4½%. On the other hand, the net trade position weakened markedly. Imports rose more rapidly than projected in February, while exports fell back by more than expected from the strong third-quarter outturn.

The preliminary estimate of GDP growth for 2000 Q1 is primarily derived from output data and no information is yet available on the composition of demand. The weaker-than-expected outturn for GDP growth contrasts with information on demand components from monthly data and surveys. Although final domestic demand growth may have slowed somewhat, indicators of consumer spending suggest a relatively strong picture for the first quarter. Moreover, monthly trade data are consistent with a positive contribution to output growth in the first quarter, even though the underlying trend in net trade remains negative. It is possible that stocks have fallen sharply. That would be consistent with some survey evidence suggesting a rundown of stocks after the millennium, but for this to reconcile the data such a correction would have to be much larger than previously expected. More information on the composition of demand and output in the first quarter will help the Committee to interpret the implications for the medium-term outlook.

Recent output data provide signs of a renewed divergence between the performance of different industrial sectors. In general, growth remains robust in industries where the major market is domestic and where international competition is relatively limited. This applies to parts of the service sector but is not universal: many services are internationally traded, and others depend heavily on the performance of more exposed sectors of the economy. At the aggregate level, however, service sector output is rising quickly and business confidence within the sector remains high. Construction activity is also benefiting from strong growth in domestic demand. On the other hand, output has fallen in many sectors of manufacturing industry in recent months. The recent weakness may partly reflect a desire to run down precautionary stocks built up ahead of the millennium date change, but the strength of sterling against the euro and an associated intensification of international competition are widely cited by manufacturers as major influences on the production trend. Surveys of business confidence in manufacturing have fallen back to the levels of last spring, but appear to be consistent with a flat or slightly rising output trend rather than further falls. Reports from the Bank's regional Agents are consistent with this assessment.

Consumer spending continues to grow robustly. Household spending volumes rose by 4½% in the year to 1999 Q4, a much sharper increase than projected three months ago. In part, the faster-than-expected growth over this period reflects upward revisions to past data, but the fourth-quarter outturn also signalled greater impetus than earlier judged. Monthly indicators suggest that spending growth has remained strong in the early months of 2000. Retail sales volumes rose by 1½% in the first quarter, although the underlying trend may be lower in view of an exceptionally strong outturn for January.

The news on indicators of consumer spending prospects has been mixed. Labour income has risen more quickly than expected in recent months, which will tend to stimulate consumer spending. And house price inflation remains high. Credit indicators and narrow money growth also support a robust picture in the short term. In the opposite direction, indicators of consumer confidence have fallen markedly over recent months. Estimates of financial wealth held by households have been revised down significantly by the ONS, and equity prices have declined somewhat. Balancing these various influences, and taking into account the higher level of consumption at the end of last year, the

Committee has revised up the projection for consumer spending a little relative to the February *Report*. But the Committee continues to expect household expenditure growth to slow through this year, in response to the recent increases in interest rates and the impact of sterling strength on output and employment. Annual growth rates may fall back to around 2½% by early next year.

The outlook for whole-economy investment is a little stronger than expected in the February *Report*. Investment rose more rapidly during 1999 than projected three months ago, as general government investment increased more sharply in the second half-year than judged likely earlier. By contrast, estimates of business investment—around three quarters of the total—were revised down somewhat in the early part of the year, but there were some signs of a recovery around the year-end. Aggregate profitability has strengthened in recent quarters, and although the corporate sector financial deficit has widened significantly over the past year, there are as yet few signs that the corporate financial position is constraining investment. The recovery in business investment is nonetheless expected to be relatively modest, and growth may slow in the second half of this year. Indeed, surveys of investment intentions have weakened over the past three months, consistent with a relatively soft outlook. General government investment is expected to rise in line with the government's commitment to double the proportion of public sector net investment in terms of GDP over the next three years.

Recent data for inventories are clouded by statistical adjustments used by the ONS to help balance the National Accounts. The most recent data including the statistical adjustment point in a different direction to the data excluding the adjustment. The Committee considers that there is relatively little news in the recent data for inventories, although surveys and the limited information available on output and demand components are consistent with a substantial fall in stocks in the first quarter of this year. The Committee has maintained the assumption that inventories will fall further as a proportion of output over the next two years, as firms economise on stock-holding costs. The growth of electronic commerce may reinforce this process.

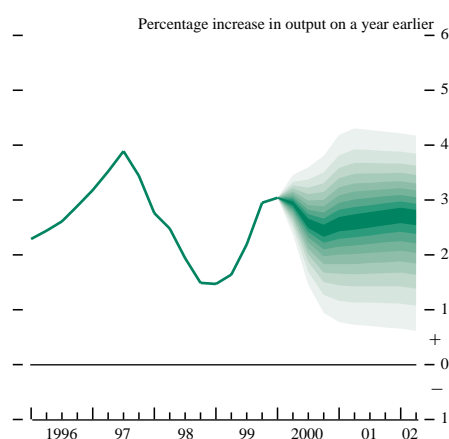
The trend in exports is hard to read given the volatility in the recent data. Export volumes dipped in the fourth quarter of 1999 after the surge in the summer months. Monthly data suggest that there has been renewed

growth in the early part of this year—particularly in exports outside the European Union—although recent survey data suggest that the upward trend remains relatively subdued. Relative to the February *Report*, however, the prospects for export volumes over the next two years have improved a little: the stronger outlook for world demand and trade outweighs the additional downward pressure from the higher real exchange rate.

Import volumes grew more quickly than projected in the fourth quarter. This may be due in part to the faster-than-expected growth in domestic demand, but import penetration also rose by more than previously estimated. Although recent monthly data suggest a more subdued picture in the first quarter of 2000, import growth is likely to remain rapid over the next two years in view of the strength of both domestic demand and sterling.

Taking into account the stronger outlook for world demand and the additional rise in sterling, both exports and imports are likely to rise more quickly than estimated in February. The upward revisions are largely counterbalancing in terms of their impact on domestic output: the deficit on net trade is likely to widen further over the next two years, at a similar pace to that incorporated in the February projection.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 6%



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 outlook for GDP growth over the next two years is presented in Chart 6.1.⁽¹⁾ The central projection for the four-quarter growth rate of GDP at constant market prices reflects the upward revision to growth in 1999. Four-quarter growth has edged up further to 3% around the turn of the year, broadly in line with the February projection. Output growth is expected to slow as domestic demand growth eases and as the net trade position deteriorates. Output growth may settle in the 2¹/₂%–2³/₄% range over the next two years, at or just above the estimated trend rate of output growth. That is a little stronger than the growth profile expected three months ago, reflecting the rather more rapid momentum of domestic spending and the more buoyant prospects for the world economy.

The links between output and inflation remain hard to gauge. As noted in previous *Reports*, activity growth during 1999 recovered surprisingly quickly, but at the same time inflation outturns were rather weaker than expected. In the first quarter of this year, GDP growth has slowed more than expected, but taking into account

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

the upward revisions to growth rates last year, the level of output in the first quarter was in line with expectations in February. RPIX inflation outturns have also been broadly as expected. The Committee reviewed the recent evidence on the various influences affecting the inflation outlook, and reconsidered the assumptions underlying the projection.

Monetary data continue to provide mixed signals. Aggregate broad money growth was particularly weak around the turn of the year, largely on account of swings in deposits held by other financial corporations, although there are signs of rather stronger growth in the latest monthly data. On the other hand, aggregate credit growth has remained robust, supported by buoyant lending to households. Household sector credit is currently rising at around 10% a year—the fastest pace since 1991. The rapid increase in credit is consistent with a strong near-term outlook for consumer spending. This picture is also supported by narrow money growth, which remains firm now that the end-year distortions have unwound. There has been no change in the Bank's repo rate since February, which has been maintained at 6%. Market expectations are that official rates will rise further in the near term, but the peak in rates is now expected to be lower than was judged likely in February.

Pressures on earnings appear to be rather greater than envisaged three months ago. But the extent of the additional pressure is hard to assess. On the one hand, pay settlements suggest little change. Indeed, recent data on settlements continue to follow a slightly declining trend, although there have been some reports from contacts of the Bank's regional Agents suggesting that this pattern could reverse later in the year if the labour market remains tight. On the other hand, nominal earnings growth has picked up sharply in recent months. Headline annual earnings growth on the AEI measure was 6% in the three months to February, some 1 percentage point higher than in the three months to November. The recent data are affected to some degree by special payments paid around the millennium and by high bonuses paid around the turn of the year. Recent headline earnings data are likely to exaggerate the underlying pay trend substantially.

Recent trends in employment and unemployment confirm that the labour market remains tight. Growth in employment continues to run ahead of increases in the working-age population, with the difference accounted for by individuals moving out of unemployment or inactivity. Unemployment on the Labour Force Survey

estimate has fallen to 5.8%, and the claimant count measure has also edged down slightly. The unemployment rate is at a 20-year low. Employment intentions overall remain firm although there has been a widening of the divergence across sectors, with intentions rising further in the service sector and weakening in manufacturing. Survey evidence and Agent's reports suggest that skill shortages remain a concern.

When bargaining over pay, firms and employees care about outcomes in real terms. Employers focus on the implication for costs relative to the price of their firm's output. Employees, on the other hand, are interested in the potential purchasing power of post-tax earnings in terms of goods and services. Inflation expectations consequently play a significant role in determining the outcome in nominal terms: monetary policy can affect nominal pay pressure through this channel. Recent surveys of inflation expectations on balance indicate little change over the past three months. That suggests that the recent increase in pay growth represents a rise in real earnings.

Given the special factors likely to be affecting the recent earnings data and the benign trend in pay settlements, the Committee judges that there is no reason at present to change previous estimates of the relationship between real earnings and labour market pressures. On this view, the higher growth in real earnings around the millennium largely reflects factors that are likely to unwind relatively quickly, and which themselves would put relatively little upward pressure on prices. But there may also be an impact of higher real wages on demand, which could put some upward pressure on prices indirectly. Balancing these forces, the Committee considers that earnings growth is likely to slow markedly once the major bonus months have passed. Nevertheless, the projection for nominal earnings growth is higher than in the February forecast, as the unwinding of faster growth is not immediate, and the slightly stronger demand profile than projected three months ago tends to put upward pressure on prices and in turn on nominal earnings. Some Committee members consider that the recent increases in wage drift are likely to have smaller effects on prices than in the current central projection, judging that the recent increase largely reflects higher profitability or unmeasured productivity growth. They prefer an alternative assumption which would lower RPIX inflation by 0.2 percentage points in the first year and 0.1 percentage points in the second year of the projection.

The impact of higher earnings growth on cost pressures depends on the behaviour of labour productivity. For example, an increase in earnings per employee would not affect the costs of production if the rise in pay were matched fully by a corresponding improvement in productivity. Labour productivity growth strengthened during 1999 as output growth picked up. Whole-economy productivity rose by 1.8% in the year to 1999 Q4, close to the average increase of the past 40 years of 2% per annum, and more than 1 percentage point faster than in the previous year. Estimates of the growth in wages and salaries per employee from the National Accounts changed little during 1999, and as a consequence annual growth of unit wage costs slowed to 3.2% in the fourth quarter, although there may have been a temporary increase early this year given the sharp rise in earnings growth on the AEI measure.

The Committee re-examined the assumption on the long-term productivity trend underlying the projection and decided to maintain the previous judgment that the 40-year average should be used as the guide. On the Committee's central projection, actual productivity growth is likely to be close to this trend over the next two years.

Recent *Inflation Reports* have highlighted the Committee's view that an intensification of competitive pressures is likely to lead to a compression of price-cost margins over the projection period. In a number of sectors, technological advance is facilitating an increase in price transparency which in turn may be stimulating greater competition, for example through the medium of electronic commerce. The Committee has maintained the judgment in the central projection that pressure on margins will build steadily over the next two years, and that as margins are cut there could be a temporary reduction in measured inflation. No change has been made to the size of the adjustments since the previous *Report*. On the best collective judgment, the structural squeeze on margins reduces inflation by around 0.25 percentage points in the first year and by 0.3 percentage points in the second year of the projection. The separate adjustments made previously to take account of the substantial cuts in the prices of utilities announced by regulators have also been preserved.

There are considerable uncertainties surrounding the assumptions on long-term productivity trends and on the adjustments to margins. In the view of some Committee members, improvements in supply-side performance

could place stronger downward pressures on prices than in the central case, reflecting the possibilities of improvements in the rate of technical progress towards US levels, and of a larger adjustment to margins than in the central projection. Improved supply-side performance overall could reduce inflation by up to 0.3 percentage points over the next two years.

Other Committee members supported the assumption on long-term productivity trends in the central projection but took a different view on the magnitude of the special adjustments to margins and the duration of their impact on inflation. These Committee members considered that the adjustments to margins should affect aggregate inflation only for a short period, reflecting the temporary stickiness of prices. They prefer a smaller adjustment on account of margin compression, particularly in the second year of the projection. Taking this view, inflation at the two-year horizon could be up to 0.3 percentage points higher than in the central projection.

Drawing the various influences together, the Committee's best collective projection for the twelve-month RPIX inflation rate—based on the assumption that nominal interest rates are held constant at 6%—is shown in Chart 6.2.⁽¹⁾ It is presented alongside the projection from the *February Report*, which was also based on constant interest rates at 6% (see Chart 6.3).

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 6%

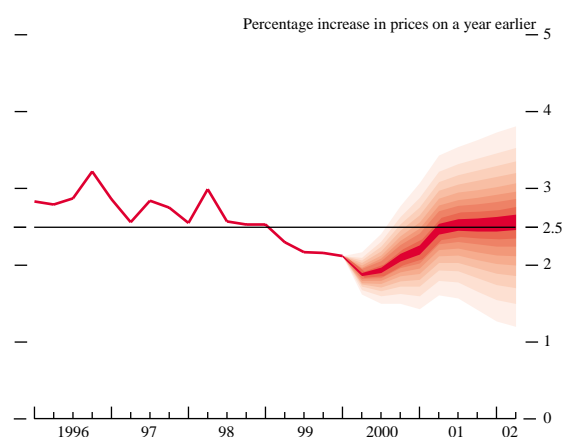
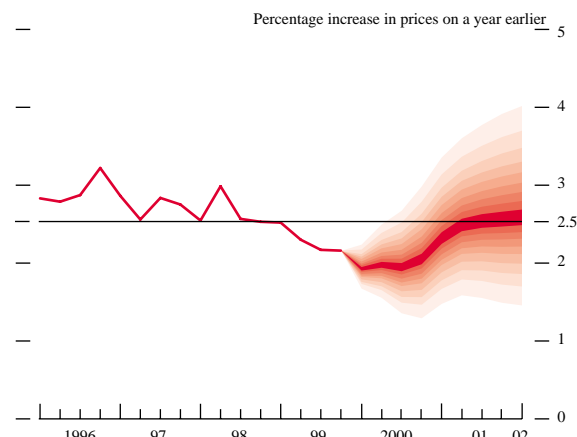


Chart 6.3
RPIX inflation projection in February based on constant nominal interest rates at 6%



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*.

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

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%
2000 Q4	5	32	46	16	1	<1
2001 Q4	6	15	27	28	17	7
2002 Q2	10	16	23	24	17	10

GDP growth

Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
2000 Q4	<1	6	27	43	21	3
2001 Q4	2	8	23	36	25	7
2002 Q2	2	9	24	35	24	6

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

Table 6.B
Possible effects on RPIX inflation and GDP growth of the alternative assumptions

Difference from central projection, percentage points

RPIX inflation

	Constant exchange rate	UIP exchange rate (a)	Weaker pass through from earnings to prices	Improvement in UK supply-side performance	Weaker downward pressure on margins
2001 Q2	-0.1	0.1	-0.2	-0.1	0.1
2002 Q2	-0.2	0.2	-0.1	-0.3	0.3

GDP growth

	Constant exchange rate	UIP exchange rate (a)	Weaker pass through from earnings to prices	Improvement in UK supply-side performance	Weaker downward pressure on margins
2001 Q2	0.0	0.0	0.1	0.0	0.0
2002 Q2	-0.1	0.1	0.1	0.1	-0.1

(a) Assumes the exchange rate moves in line with interest rate differentials (uncovered interest parity), adjusted for the conditioning assumption of constant interest rates in the United Kingdom.

There is little change to the outlook for inflation over the next two years. The broad picture is that inflation is most likely to pick up over the next twelve to eighteen months to around the target level of 2½% and then to remain relatively stable around that level in the first half of 2002. In the near term, the strength of sterling and cuts in margins are pressing down on prices and helping to keep inflation below the target. But inflation is likely to rise gradually as capacity utilisation increases and pressures from the tight labour market build, and as the temporary effects on measured inflation of lower domestic utility prices unwind early next year. The changes in assumptions since the *February Report* have broadly offsetting influences on inflation prospects. A stronger outlook for world demand and prices, a higher short-run profile for earnings, and somewhat faster domestic demand growth are the main upward forces on inflation. But these influences are counterbalanced by the higher exchange rate profile, and the assumption that temporarily high import margins are likely to unwind.

Risks around the central projection for activity are weighted to the downside reflecting the possibility of a weaker world growth outlook, which could also prompt falls in domestic asset prices. This outweighs the risk that final domestic demand growth in the United Kingdom could be stronger.

Inflation risks are slightly upwards in the first year as the possibility of stronger domestic spending outweighs the risk of weaker international demand. But inflation risks in the second year are weighted to the downside, as the likelihood of a weaker outlook for global activity is the dominant influence. Charts 6.4 and 6.5 show the overall balance of risks to inflation at the two-year horizon. Table 6.A provides the Committee's best collective judgment of the probabilities of various outcomes for inflation and GDP growth.

As already emphasised, there remain a number of major uncertainties in the outlook, and for some key judgments, certain Committee members prefer to make different assumptions to those incorporated in the central projection in forming their best estimate of the most likely outcome. These judgments, covering assumptions on the exchange rate profile, earnings, margins, and productivity, are not incorporated explicitly in the fan charts or in Table 6.A, but are shown in Table 6.B, which presents illustrative calibrations of the possible effects of the different assumptions taken individually.

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2002 Q2

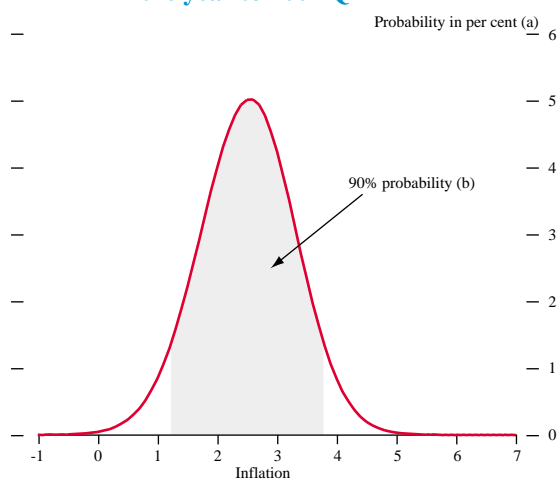
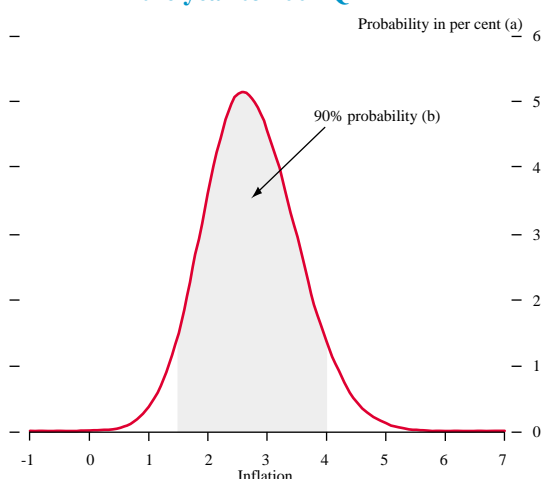


Chart 6.5
February projection for the percentage increase in RPIX in the year to 2002 Q1



Source: Bank of England.

- (a) Probability of inflation being within ± 0.05 percentage points 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 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 *Inflation Report*.

Table 6.C
Market expectations of the Bank's official interest rate^(a)

2000			2001				2002	
Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
6.0	6.3	6.4	6.4	6.4	6.4	6.3	6.2	6.1

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repurchase contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 3 May.

The alternative assumptions presented in the table are regarded by the Committee as a series of separate judgments. The net effect of the alternative assumptions favoured by different Committee members leads to a range of views about inflation prospects, highlighting the uncertainties in forming judgments on the outlook. Based on the alternative assumptions, the inflation profile at the two-year horizon could be up to $\frac{1}{2}\%$ higher or lower than in the central projection portrayed in Chart 6.2.

Financial market expectations of the likely future path of official rates are lower than in February. Drawing on information from the government bond and gilt repo curve, market expectations are for official rates to rise over the next six to nine months to a peak of around $6\frac{1}{2}\%$, before drifting down slightly over the subsequent twelve months (see Table 6.C). The Committee's projections based on the assumption that official rates move in line with inferred market expectations are shown in Charts 6.6 and 6.7. These projections continue to show a lower profile for inflation and output than in the projections based on constant nominal rates. The difference between the projections has narrowed, however, as market interest rate expectations have fallen.

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

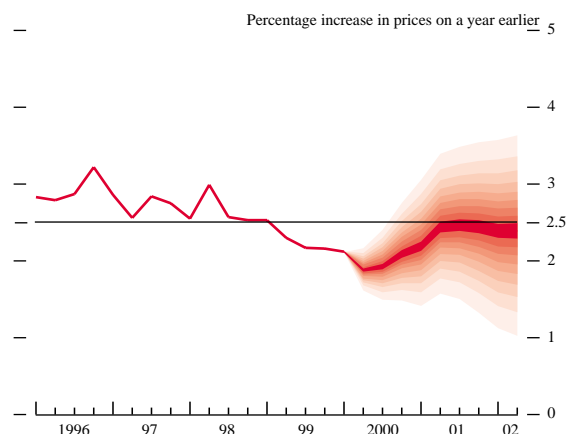


Chart 6.7
Current GDP projection based on market interest rate expectations

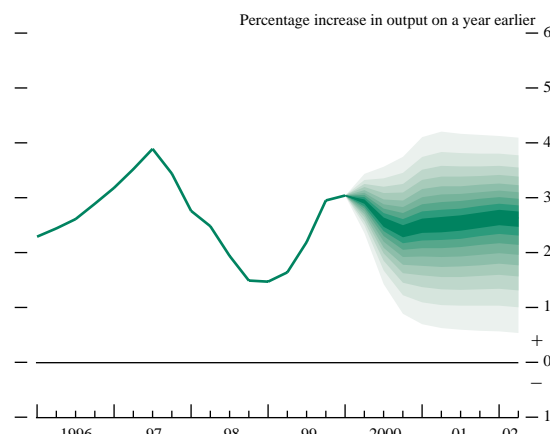
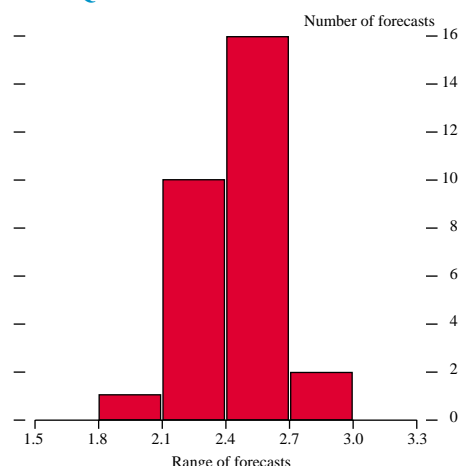


Chart 6.8
Distribution of RPIX inflation forecasts for 2002 Q2



Source: Survey of 29 outside forecasters as of 25 April 2000.

Table 6.D
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%
2000 Q4	14	30	33	16	6	2
2001 Q4	8	17	33	27	10	5
2002 Q2 (b)	8	15	32	28	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%
2000 Q4	1	4	13	39	35	8
2001 Q4	3	9	23	42	19	5
2002 Q2 (b)	4	11	26	39	15	5

(a) 29 outside 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 shows 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 2002 Q2.
(b) 28 forecasters.

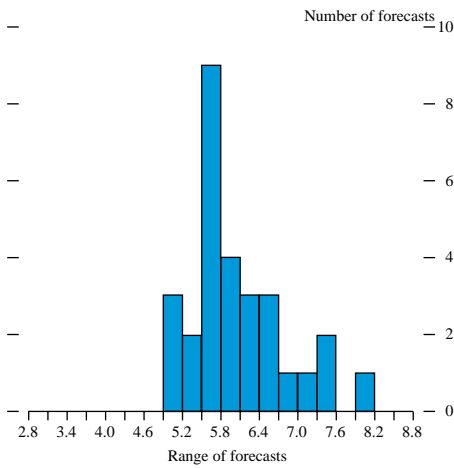
6.3 Other forecasts

In late April, the Bank asked a sample of 29 external forecasters for their latest projections of inflation and output. Based on this survey, the mean forecast for the twelve-month rate of RPIX inflation in 2000 Q4 is 2.1% (with a range of 1.3% to 2.6%), rising to 2.4% in 2001 Q4 (with a range of 1.9% to 2.7%) and remaining at 2.4% in 2002 Q2 (with a range of 1.8% to 2.9%). The distribution of central projections in 2002 Q2 is shown in Chart 6.8. Compared with the survey results in the February *Report*, the average forecast over an eighteen-month to two-year horizon has not changed. On average, external forecasters see a 45% probability of inflation being above 2.5% in 2002 Q2, and a 55% probability of it being below (see Table 6.D). This judgment is similar to that held three months ago.

The forecasters' average projection for four-quarter GDP growth in 2000 Q4 is 3% (with a range of 2¹/₄% to 3³/₄%), up from the 2³/₄% average forecast reported in February. Growth is expected to slow to 2¹/₄% (with a range of 1¹/₂% to 3¹/₂%) by 2002 Q2. That is in line with the February survey.

The mean forecast for the official interest rate in 2000 Q4 is 6¹/₂% (with a range of 6% to 7%), falling to 6% by 2002 Q2 (with a range of 5% to 8%). This is broadly unchanged from the survey results reported in February. The near-term outlook for sterling is rather stronger than in February, but the average forecast for 2002 Q2 is little changed. On average, forecasters

Chart 6.9
Distribution of repo rate forecasts for 2002 Q2

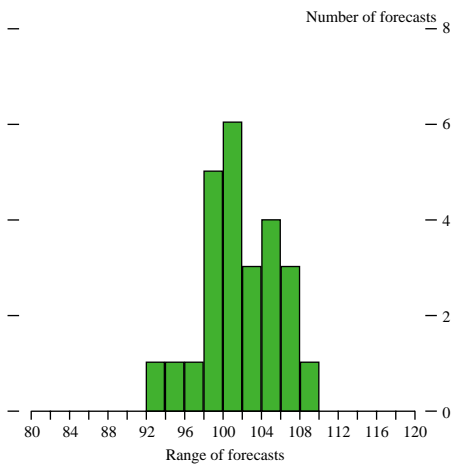


Source: Survey of 29 outside forecasters as of 25 April 2000.

assume that the sterling ERI will fall to 106 by 2000 Q4 (with a range of 98 to 113½) and then decline further to 101½ (with a range of 93 to 108) by 2002 Q2.

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

Chart 6.10
Distribution of sterling ERI forecasts for 2002 Q2



Source: Survey of 25 outside forecasters as of 25 April 2000.

BANK OF ENGLAND

AGENTS' SUMMARY OF BUSINESS CONDITIONS

MAY 2000

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 1,700 businesses in the period between mid-January and mid-April. It provides information on the state of business conditions, from firms across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular firm or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions.

- Manufacturing output continued to grow during the period, but the rate of growth slowed recently in most regions. Looking forward, confidence about the performance of the manufacturing sector in coming months deteriorated in many regions—mostly reflecting the sustained strength of sterling.
- Strong growth in construction activity was maintained in most regions during the period.
- Service sector growth remained strong. Professional and IT services continued to record the fastest growth.
- Retail spending growth was reported to have moderated slightly in most regions, following a pick-up during December and January. Most Agencies reported that sales of new cars remained depressed, although a recovery in the level of used car sales was noted in several regions.
- Export demand continued to increase, though moderately. However, export growth was reported to have been more than offset by growth in imports—both for finished goods and for inputs into manufacturing.
- Investment intentions in the manufacturing sector deteriorated in most regions compared with the previous period, with an increasing number of firms moving capacity overseas. In contrast, service sector investment continued to strengthen. Many plans remain focused on IT development.
- Increases in materials prices continued, but generally remained confined to a few commodities—most notably oil and oil products, metals, pulp and paper. Downward pressure on manufacturing output prices remained, with most firms suggesting that it was still difficult to pass on any increases in costs. There continued to be little change in previous retail prices trends, with flat or falling goods prices and rising service sector prices still being reported. House price growth remained broadly stable.
- Pay pressures in the manufacturing sector remained subdued in most regions, with most settlements similar to or lower than a year ago. Settlements in the service sector were slightly stronger than a year earlier. Agents noted that bonuses and other non-pay rewards (for example share options) have increased as a share of overall remuneration.
- Labour market conditions remained tight (particularly in the southern regions of the United Kingdom). Skill shortages worsened compared with the previous period, although the incidence of shortages stabilised recently. Moderate service sector employment growth continued. Manufacturing sector employment continued to decline in most regions, although the rate of decline was stable in recent months.

(1) The Bank of England has Agencies for Central Southern England, the East Midlands, Greater London, the North East & Cumbria, the North West, Northern Ireland, Scotland, the South East & East Anglia, the South West, Wales, the West Midlands, and Yorkshire & the Humber.

OUTPUT

Agriculture

Activity in the agricultural sector remained depressed during the period. Pig and poultry farming continued to be reported as areas of serious weakness. Incomes in the dairy industry also appeared to be under substantial pressure. Early signs emerged that demand for some agricultural commodities had bottomed out during the period, but most farmers believed that a sustained recovery was unlikely. The pessimistic outlook was attributed to general over-supply in the sector, caused by increased import competition (particularly from continental Europe). Sustained downward pressure on farm incomes was reported to have resulted in an increasing number of business failures in the sector.

Manufacturing

After strengthening in the second half of 1999, most Agencies suggested that the recovery in manufacturing output growth paused over the Christmas/New Year period—mostly reflecting the longer-than-normal shutdown period. More recently, reports suggested that while manufacturing output continued to expand, the rate of growth moderated in most regions. Looking forward, confidence about the performance of the manufacturing sector in coming months deteriorated in many regions—attributed to the sustained strength of sterling.

Reports of the diversity of performance within the manufacturing sector continued. Strong growth persisted in telecommunications and electronics, as well as parts of the chemicals sector (eg pharmaceuticals). But contacts continued to note that textile and clothing output remained in decline, while the automotive components sector was still weak.

Manufacturing contacts' reports of increased volumes being obtained through reduced margins persisted, reflecting increased competitive pressures (see Output prices). Following sustained margin pressure, recent reports from contacts suggest that some firms have preferred to lose orders rather than to supply at lower prices—thus dampening output.

Manufacturing firms reported few capacity constraints, and many sectors cite significant spare capacity. The underlying trend for many sectors (particularly at the lower value-added end) remains weak. The incidence of firms moving production outside the United

Kingdom, particularly those with overseas parent companies, was reported to have intensified noticeably in recent months (for example in the clothing sector).

Construction and housing

While the rate of construction growth varied considerably within and between regions, most Agencies noted that growth had remained broadly stable at a strong rate in recent months. The south and south-east of England remained the areas of strongest activity.

Growth was reported for both residential and commercial activity. Most contacts suggested that recent interest rate increases have yet to have any significant impact on demand. But there are expectations in some regions that residential construction growth will begin to ease in coming months. The limited availability of suitable land and persistent planning delays are expected to constrain output. In most regions, commercial activity continued to be driven by strong growth in retail and leisure sector activity, while in others, increased public spending on education and health boosted non-residential construction. But industrial construction activity was generally more subdued.

Services

Service sector growth was sustained at a strong rate during the period. But the divergence within the service sector appears to have widened, with business services growth reported to have strengthened alongside easing consumer services growth. The strongest growth continued to be recorded in professional services—particularly legal, accountancy and property-related services. Media and advertising firms were also reported to have benefited from the recent sharp growth in 'dot.com' companies. In addition, increased demand for staff from recruitment agencies resulted from the tight labour market. Many contacts confirmed the expected pick-up in IT output, following the pre-millennium pause.

But many Agencies suggested that growth in consumer services had now peaked. For example, slowing demand was reported for UK tourism—mostly attributed to exchange rate effects.

Capacity constraints have become a growing concern for many service sector firms—mostly reflecting difficulties in recruiting suitably skilled staff (see Employment) and constraints of office space (see Investment).

DEMAND

Consumption

Retail sales growth was reported to have moderated slightly in many regions, following stronger Christmas/January sales. But most Agencies suggest that the retail sector was difficult to read in recent months—notably, year-on-year comparisons were more complicated because of the later-than-usual Easter period this year. Similar sectoral trends to those recorded in previous *Agents' Summaries* continued—strong household goods sales (for example audio-visual and telecommunications equipment), combined with continued weak clothing sales. Overall, spending in the leisure sector appears to have continued to grow, but probably at a slower pace.

New car sales to individuals remained depressed during the period, with little evidence of any general improvement in sales. Many contacts suggested that consumers were making increasing use of the Internet to purchase cars from continental Europe. But most Agencies noted clear signs of a recovery in the level of used car sales compared with the previous period.

Exports

The recovery in export demand noted in previous *Agents' Summaries* continued during the period. Demand from the United States remained strong, while reports of improvement continued in East Asia. Reports of European demand were varied but, overall, were slightly more positive. On balance, most Agencies suggest continued moderate export growth during the period.

But the improvement in export performance was reported to have been more than offset by relatively stronger import growth. Import volumes increased both for finished goods and for inputs into manufacturing (as firms stepped up purchases of relatively cheaper overseas materials to alleviate margin pressure). For many firms, the proportion of inputs sourced from overseas suppliers has increased significantly in recent quarters. Competition for final goods from imports (particularly from continental Europe) remains intense and pressures have increased further recently.

Investment

Trends in manufacturing and service sector investment diverged further during the period. Investment intentions in the manufacturing sector deteriorated

noticeably in most regions. Uncertainty regarding the long-term profitability of many UK operations has resulted in a further increase in the number of firms investing in capacity overseas. The outlook is said to remain heavily dependent on future movements in the exchange rate. Investment intentions in the agricultural sector also remained particularly depressed, with little improvement noted.

By contrast, service sector investment strengthened further. Most of the recent strength was related to investment in the retail, leisure and professional services sectors. For example, capacity constraints in many professional services businesses has led to increased demand for commercial office space.

Following the millennium-related pause in IT investment in late 1999, investment in IT resumed strongly in the new year in most sectors—particularly for e-commerce and Internet-related activity.

COSTS AND PRICES

Input prices

Reports of increased materials prices continued during the period. However, as reported in the previous *Agents' Summary*, increases were confined to a few commodities—mostly oil and related products (such as plastics) and also some metals, paper and pulp.

Despite these increases, most firms mitigated their effects. In many cases, the continued strength of sterling has enabled firms to source cheaper materials from abroad. In addition, firms have utilised more effective purchasing techniques, such as centralised purchasing. Overall, firms remained less concerned about material-cost increases than about higher business rates, commercial rents, insurance premiums and regulatory costs (in particular the climate levy).

Pay

Pay trends remained similar to those reported in recent *Agents' Summaries*. However, Agencies stress that the estimation of underlying trends is being made increasingly difficult by 'adjustments' to, and moves away from, conventional settlements. Many contacts report that bonuses and other non-pay rewards (for example share options) are becoming an increasing component of overall remuneration. This is being reflected in increased 'wage drift', with total wage costs per employee increasing much faster than settlements in most sectors.

Manufacturing settlements in recent months have been equal to or slightly lower than a year earlier. By contrast, settlements in the service sector have been slightly stronger overall, although there are wide variations. For example, much higher settlements are said to have occurred in areas of more pronounced skill shortages—particularly in the southern regions of England (see Employment). In addition, some Agencies suggest that skill shortages have resulted in stronger pay pressures in the construction sector.

Output prices

The picture of output prices remained unchanged from the previous *Agents' Summary*. Downward pressure on manufacturing output prices continued, with most contacts still reporting flat or falling prices. Evidence of input price increases being passed up the supply chain remained limited. A notable exception appears to have been oil, where there were clear signs that price increases had been passed on (although not a full pass-through in most cases). In addition, some firms had contractual agreements related to materials costs. Consequently, most firms suggest that manufacturers' margins narrowed further during the period—particularly in export markets.

Although some service sector firms also experienced downward price pressure caused by competition, prices in the service sector, on average, continued to increase. Professional service fees (for example legal and accountancy fees) continued to record some of the strongest price increases.

Retail prices

There was little change to the trend of flat or falling goods prices reported in previous *Agents' Summaries*. The majority of contacts do not foresee any changes to this trend in coming months. Increased competition (such as from new Internet retailers) is reported to have encouraged further discounting during the period. However, retailers switching to cheaper overseas suppliers (for example for clothing) have often alleviated margin pressure. Electronic items (for example computers) continued to record some of the largest declines during the period.

Service sector prices continued to increase during the period. Inflation was reported to have remained broadly unchanged overall, although significant differences were reported in the ability of individual firms to raise prices. Examples of retail service sector increases include motor vehicle insurance and servicing costs, and hairdressing. But further discounting was seen in parts of travel services (for example airfares).

New car prices fell further during the period, with the level of prices said to be well down on a year earlier. Second-hand car prices were reported to have risen slightly in most regions.

Overall, house price growth appears to have remained broadly stable at a strong rate, although a few Agencies reported signs of a moderation recently. As in previous reports, overall growth in particular regions was said to mask significant variations between 'hotspots' of activity and the remainder of the region.

EMPLOYMENT

The labour market picture remained tight during the period. Skill shortages worsened compared with the previous *Agents' Summary*, although conditions appeared to have stabilised more recently. Skill shortages continued to be reported in construction, IT, engineering, managerial and professional positions.

Manufacturing employment levels continued to decline in almost all regions during the period—although the pace of decline appears to have been broadly stable. More recently, the outlook for the sector deteriorated further, with employment expected to fall more rapidly in coming months, as restructuring progresses. Moreover, there have been some reports of an increasing tendency towards employing temporary workers in the sector—perhaps as a precautionary mechanism in case of future cutbacks.

Service sector employment continued to grow moderately in most regions—at a broadly similar pace to the previous period.

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



Minutes of the Monetary Policy Committee meeting on 9–10 February 2000

1 Before turning to its immediate policy decision, the Committee discussed money, credit and asset prices, demand and output, labour market conditions, the world economy, and prices and costs; reviewed the February projections for output and inflation; and considered the implications of sterling's further appreciation and the continuing imbalances in the economy for its policy decision.

Money, credit and asset prices

2 Sterling's effective exchange rate index (ERI) had been volatile, moving in a range of 106.7 to 110.6 in the 15 days up to the meeting. It had risen by about three quarters of a percentage point since the Committee's January meeting, and the 15-day average used as the starting point in the February *Inflation Report* projections was about four percentage points higher than that used in the November projections. This rise in the ERI was accounted for by an appreciation against the euro which could not be explained by changes in interest rate differentials.

3 The Committee discussed whether sterling's strength might be explained by a rise in the medium-to-long run equilibrium real exchange rate against the euro. There might have been such a rise if, for example, UK production had become more competitive relative to the euro area, perhaps on account of greater market flexibility and/or more widespread application of new technologies. But, at least as yet, there was no sign of this from the performance of the trade equations in the medium-term macroeconomic model, and it was difficult to identify news over the past few months suggesting that the long-run equilibrium exchange rate had changed.

4 Another possibility was that there had been a change in the risk premium, with sterling regarded as having become less risky relative to the euro. The change to the UK's monetary framework and/or, for example, uncertainty about structural reform in parts of continental Europe could, in principle, have brought that about. It was, however, highly uncertain whether this was a material part of the explanation of sterling's recent rise.

5 If sterling had risen on account of a change in the risk premium, what would that imply for the path of the exchange rate looking forward? A number of possibilities were identified. First, a reduction in the perceived risk in holding sterling relative to other currencies would mean that holders of sterling-denominated assets would require a lower relative return than otherwise, in which case the market would be expecting sterling to depreciate on a steeper path than otherwise for any given path of interest rate differentials. Second, while a shift in the risk premium in sterling's favour implied an expectation that sterling would depreciate by more than otherwise over the long run, it did not necessarily follow that sterling should be expected to depreciate in the shorter run, including over the forecast horizon. If, as on this view seemed likely, portfolio managers and others were gradually learning about the new UK monetary framework, perceptions of relative risk and credibility would change gradually. In that case, the risk premium might continue to adjust for a while, with holders of sterling earning supernormal returns during a transition period of uncertain length. Yet another possibility for some members was that sterling had risen because of the significant interest differential *vis-à-vis* the euro, and the growing expectation that this difference would not decline in the near future. Some empirical evidence supported the notion that one might earn persistent, supernormal returns from currencies that offered the higher interest rate. Views differed on these possibilities.

6 Committee members differed in their preferred assumptions for the path of sterling's effective exchange rate in the February *Inflation Report* projections. Some preferred to assume a constant nominal exchange rate; some others preferred a depreciation in line with interest rate differentials (and perhaps with the balance of risks to sterling towards a steeper depreciation). The assumption used in the best collective projections was half way between the two. Others noted that an econometric model-based projection for the exchange rate yielded a broadly similar answer.

7 Turning to the monetary data, the Committee noted that the rate of increase in narrow money had fallen sharply during January so that, as earlier thought, December's very rapid growth did seem to be an end-year/end-millennium phenomenon. Nevertheless, the underlying rate of M0 growth appeared to be robust, pointing to strong growth in household spending in the near term. More generally, household M4 growth had picked up; household Divisia growth had risen between Q3 and Q4; and total household borrowing was now rising more quickly than since the early 1990s, with mortgage equity withdrawal increasing. Taken together, this supported the buoyant near-term outlook for consumption suggested by rising incomes, consumer confidence, and wealth.

8 House price inflation had remained high. The Halifax index had risen by 16% in the year to January, up from around 13½% in December, but the significance of this rise was uncertain as the Halifax index had been volatile over the past few months. The Nationwide index, rising at about 13% year-on-year, had been more stable. There were tentative signs in the activity data that pressures in the housing market might be easing, perhaps reflecting tighter monetary conditions. The number of particulars delivered had fallen in December by about 2½%, and the figure for November had been revised down slightly. The volume of transactions was basically flat. The number of loan approvals had fallen slightly at the end of 1999, having previously been stable since the summer. While the Committee assumed in its best collective projection that there would most probably be some moderation in house price inflation over the coming year or so, it was likely to remain quite high. This would tend to support continuing robust consumption growth, with some members seeing upside risks.

Demand and output

9 As already noted, the underlying determinants and forward-looking indicators of consumption had strengthened. For example, consumer confidence, as measured by the GfK index, had risen by a further 6 points in January to +8, its highest level since autumn 1997. Although new car purchases had recently been relatively weak, it seemed probable that this reflected a pause while prospective purchasers waited for the results of the Competition Commission inquiry into the car market.

10 Reports from the Bank's regional Agents suggested that the apparent weakness in business investment in the second half of 1999 might in part be explained by firms having delayed spending with an IT component until the millennium-date change was safely out of the way. If so, any deferred expenditure would tend to support near-term investment growth, as in the view of some Committee members would the possibility of firms stepping up investment related to e-commerce. Tighter monetary conditions and the higher exchange rate would, on the other hand, tend to reduce investment spending. Overall, the Committee concluded that the most likely outlook for investment was slightly weaker than in November, but with some members seeing upside risks.

11 The outlook for net trade was important to the Committee's judgment about the balance of pressures on the economy's productive capacity and, therefore, the prospects for inflation. Export growth had picked up during 1999 with the recovery in world economic activity; Q3 had been unusually strong. Imports had also increased during 1999. Since the November *Report*, however, the trade figures had been weaker and the outlook had changed because of the further appreciation in sterling's exchange rate. It now seemed likely that the contribution of net trade to output growth would be more negative than earlier expected. This had three consequences. First, it would help to offset the effects on GDP growth of the prospective sustained strength of final domestic demand, and so contribute to containing near-term pressures on capacity. Second, it would mean that the imbalances in the economy—in particular between businesses which were externally exposed and those which were not—would be likely to persist, and could even become more pronounced. Third, other things being equal, it would entail a larger current account deficit and accumulating external debt.

12 In the second half of 1999, output had grown at 0.8% per quarter, slightly above trend. There had been some signs in the latter part of 1999 that the sectoral split in activity was becoming somewhat more balanced. Services sector growth had fallen slightly between Q3 and Q4, and manufacturing production as a whole had been picking up. But overall industrial production and manufacturing had fallen in December, and there remained marked differences between industrial sectors. Moreover, the effects of sterling's further appreciation, which would tend to reduce growth in externally-exposed businesses, would not yet be apparent in the activity data.

13 The Committee discussed whether, or not, an accumulating current account deficit would have implications for the exchange rate. On one view, it was questionable whether it was consistent to assume both a growing external deficit and persistent sterling strength. If there had been a change in the equilibrium real exchange rate, sterling might remain high but then the trade deficit—and so the current account deficit—would be smaller than assumed. Alternatively, an accumulating external deficit would lead to a depreciation. The latter seemed, on this view, more likely: to the extent that the divergence between the growth rates of domestic demand and output persisted and widened, the greater the risk to sterling would become. On another view, there was no obvious inconsistency between the projected current account deficit and persistent sterling strength over the forecast horizon. Two reasons for this were suggested. First, in a world of highly mobile capital, there was no direct link between the current account and the exchange rate. Instead, there were links through asset markets. Second, the size of the prospective current account deficit was on this view modest, at 2%–2½% of GDP. Third, while a deficit which continued to grow would over the medium-to-long run entail a depreciation in sterling's real exchange rate, that did not imply that the real, and even less the nominal, exchange rate had to fall during the next two years or so. The UK economy could generate the required surpluses in the future without a sharp near-term nominal depreciation.

Labour market conditions

14 Labour market conditions might have tightened slightly since the Committee's November *Inflation Report*. The evidence since the Committee's January meeting was mixed. While claimant count unemployment had fallen by around 20,000 in December, taking the rate down 0.1 percentage point to 4.0%, the broader-based LFS measure had increased by around 12,000 in the three months from September to November compared with the previous three months. The LFS measure of employment had risen slightly over the same period, with part-time employment falling and full-time employment rising. Total hours worked had fallen slightly. Survey-based indicators of recruitment intentions remained strong in the services sector and had picked up in

manufacturing. The British Chamber of Commerce indicator of recruitment difficulties had been stable, although the Bank's regional Agents were reporting increased skill shortages compared with the previous quarter.

15 On recent developments on pay, some members drew encouragement from public sector settlements, on the grounds that they could have a useful demonstration effect. But there was also concern that the earnings data would be difficult to interpret over the coming months given that financial sector and millennium-related bonuses were expected to be strong.

16 The earnings and settlement data continued to diverge. On the Average Earnings Index (AEI) measure, earnings had grown at an annual rate of 4.9% in the three months to November, and had persistently been higher than had been expected at the time of the Committee's November *Inflation Report*. Wage drift appeared to be increasing as settlements had, on average, been running at around 3½% over recent months, and on most measures were lower in January than a year ago. The regional Agents' survey of the prospect for earnings growth in 2000—summarised in the Annex—also showed a divergent picture: settlements were, on balance, expected to be weaker in 2000, but total pay per employee was on balance expected to rise at a faster rate than in 1999.

17 It was possible that increasing wage drift was a sign of tight labour market conditions. Alternatively, the wedge between settlement and earnings growth might be accounted for by increases in profit-related—or performance-related—pay, which might more closely reflect productivity improvements. In that case it would not necessarily signal increasing pressure on prices. However, while measured productivity growth had recovered in recent quarters, it was now only broadly in line with the past long-run trend. It was difficult to know whether there had been improvements in productivity that were not reflected in the official data. Views differed on this.

18 Members placed different weight on the earnings and settlement numbers. Overall, the Committee concluded that, partly reflecting the recent stronger-than-expected outturns of the AEI, the path for earnings growth would be higher than had been assumed in the November projections.

World economy developments

19 The USA had continued to grow more strongly than earlier expected, and seemed set to continue to do so, although downside risks remained. Recent growth in the euro area had also been stronger than expected in November, and the improvement in business confidence indicators suggested a stronger outlook. Partly against this background, both the Federal Reserve and the ECB had raised interest rates since the Committee's January meeting. This tightening of global monetary conditions had been in line with what had been assumed in the Committee's November projections.

20 Developments in Japan were less clear. Consumption remained very weak and output might even have fallen in the second half of 1999, having done so in Q3. But there were signs of improvement in corporate profitability, which could support investment. That might have contributed to the rise in the Nikkei index over the past few months, although it was noted that price rises had been markedly more pronounced in some stocks than in others. The Committee noted that there were some signs of market concerns about the growth in Japanese government debt which, if fiscal policy were as a result to be constrained, would tend to place more pressure on monetary policy in the absence of a self-sustaining recovery in growth.

Prices and costs

21 Probably reflecting the stronger world economic conjuncture, commodity prices had continued to rise. The annual

rate of increase in the Bank's oil-inclusive index had risen to nearly 22% in December; excluding oil, the rate of growth was slightly over 3½%, the highest rate since January 1996.

22 Although input prices were rising strongly, intermediate prices (as measured for example by producer output prices) were increasing more moderately, and RPIX inflation had remained below the 2½% target.

23 The counterpart to the rapid recent rise in manufacturing productivity had been that the twelve month rate of change in manufacturing unit wage costs had fallen in every month between July and November, when the twelve month fall had been 1.3%. However, there was little evidence that measured economy-wide labour productivity growth had risen above levels implied by the past long-run trend of around 2% per year. It was plausible that the Internet would facilitate an increase in the level of productivity that might be spread over several years.

24 Given that the expected path of aggregate demand was close to estimates of the economy's productive capacity, judgments on the outlook for inflation over the forecast horizon depended to a significant degree, as in November, on views about the implications of developments in technology and in competition. The Committee concluded that, in its best collective projection, the downward adjustments should be slightly larger than in November.

25 Some members preferred a smaller adjustment to price-cost margins, particularly in the second year of the projection. While there were undoubtedly major changes underway in competition and technology, the implications for inflation were not straightforward. There had been major technological changes in the real economy during the 1970s and 1980s—for example, in computing power—but that period had also seen the highest inflation rates in modern British history. Such developments entailed changes in relative prices, but it was unclear how large changes in some relative prices should be translated into a change in the aggregate price level. Some other members preferred larger downward adjustments to price-cost margins in both years than in the best collective assumptions. For example, the effects of the Internet and e-tailing would most likely be greater than assumed, with larger second-round effects on costs and prices. More generally, the supply side innovations did not just entail relative price changes but were characterised by a generalised intensification of product market competition and so were affecting the economy as a whole, with a compression of average margins.

The February output growth and inflation projections

26 The Committee agreed the projections to be published in the *Inflation Report* on Thursday 17 February.

27 On the assumption of an official repo rate of 6.0% over the next two years, the best collective projection was for output growth to rise to about 3% and then fall back to around 2½%—close to most estimates of trend—for most of the forecast period. This was softer than in November, largely reflecting the tightening of monetary policy and sterling's appreciation.

28 On the best collective projection, RPIX inflation fell slightly from its current level of 2.2% to about 2% during 2000, and then rose gradually to around the 2½% target from mid-2001. There was less of a saucer shape (that is, a dip followed by a sharp upturn) than in November, reflecting upward pressures early in the forecast period from higher earnings growth than in the November projection and downward pressures later on in the forecast period from the restraining effects of tighter monetary policy and the higher exchange rate.

29 As already described, there was a range of preferred assumptions for the path of the nominal exchange rate and for price-cost margins; these were presented in Table 6.B on page 57 of the February *Inflation Report*. Different members preferred different combinations of these assumptions, either raising or lowering the inflation projection at the two-year horizon by up to half a percentage point.

Other considerations: implications of the exchange rate and sectoral imbalances

30 Against the background of its latest projections and its analysis of the recent data, the Committee discussed a range of issues before turning to its immediate policy decision. In particular, a number of Committee members were very concerned about the further rise in the exchange rate that had occurred over the past few months; and about the associated imbalances in the economy.

31 The prospects for inflation depended heavily on the path of the exchange rate, which was highly uncertain. If sterling were to depreciate in line with interest rate differentials (or more) then, other things being equal, inflation would most likely be above the 2½% target by the forecast horizon. If, on the other hand, sterling's current strength persisted, inflation would most likely be below target throughout the forecast period.

32 The Committee discussed the implications for monetary policy of domestic sectoral imbalances associated with the continuing strength of sterling.

33 On one view, prospective sectoral imbalances should not of themselves affect the Committee's interest rate decision given its remit. Moreover, imbalances had, if anything, narrowed in recent months. The difference between recent annual rates of growth for services and manufacturing had declined. Regional differences had also narrowed, with for example the balance of new orders recorded in the January CBI Quarterly Trends survey rising in ten out of eleven regions. Moreover, a marked dispersion of growth rates amongst firms within particular sectors was to be expected in a period of technological and structural change; in that sense the imbalances between old and new industries were a symptom of factors that would otherwise be regarded as desirable.

34 On another view, if the exchange rate persisted at its current level, the imbalances in the economy would probably get worse and that was unwelcome. It was already likely that there had been failures amongst businesses which would have been able to survive at a lower—and, on the view of some members, more sustainable—real exchange rate. It was noted that one recent IMF study had estimated that sterling was overvalued by more than 15%, a bigger misalignment than the study estimated for any other industrialised country. It was, therefore, desirable to consider whether official policy could do anything to mitigate this. It was noted in that context that the textbook response would be fiscal policy tightening. But that kind of active use of fiscal policy was forsworn under the current fiscal framework, and it was observed that fiscal policy had in fact tightened over the past few years. As to monetary policy, whether the Committee's remit was in principle consistent with taking these concerns into account depended on whether there were different paths of interest rates which could achieve the inflation target but which might have different implications for the exchange rate. It was noted that an interest rate policy which helped to sustain sterling at current or higher levels ran significant risks with the inflation target at some future point when sterling could fall sharply. In the interests of making it easier to meet the inflation target at all times, an interest rate path now that helped to keep sterling lower would be desirable. On the other hand, an interest rate policy which sought to offset the current strength of sterling would risk fuelling domestic demand, which could have adverse implications for inflation further ahead.

35 It was in any event unclear what, if anything, the Committee could do to address these wider concerns given the current conjuncture of market expectations. The market was firmly expecting a 25 basis point rise in the Bank's repo rate. Some members believed that if that were the Committee's decision, there would be little change in either the exchange rate or in money market rates. Some other members were concerned that a tightening of policy, even though expected, could have the effect of putting further upward pressure on sterling when the *Inflation Report* was released, by making it appear a 'one way bet' in the short run.

36 There was also a range of views on the likely market reaction to a decision to maintain the repo rate at 5.75%. Some members thought that, particularly given the *Inflation Report* projection, it was likely that the market would conclude that a rate rise had simply been deferred, and possibly even that the official rate would end up having to go higher than otherwise. In that case, sterling's exchange rate would be supported and might even rise rather than falling back. Some other members thought that it might be possible to explain a 'no change' decision in a way which avoided that risk and which might create conditions in which sterling eased back. RPIX inflation had been below the 2½% target for nine months and, on current evidence, was set to remain so over the coming year. This profile might make a 'wait and see' policy feasible and could potentially provide a safe background against which to explain publicly that inflation would undershoot the target if both sterling and interest rates remained at their current levels. That might help to dent any 'one way bet' element in sterling's short-run strength. In addition, these members doubted that sterling would rise sustainably on a 'no change' decision, because if it were to do so, the markets would quickly conclude that, other things being equal, a future interest rate rise had become less likely, which would weaken an important source of support for sterling.

37 The Committee debated whether intervention in the foreign exchange markets could usefully be deployed, either with the announcement of the Committee's immediate repo rate decision or subsequently. Those members prepared to contemplate intervention placed some weight on its use as a signal of concerns about the level of the exchange rate—a more powerful signal than words alone—but most of them concluded that it could be an option only if the Committee decided to leave the repo rate unchanged and, even then, would have to depend on market conditions. Other members thought, first, that it was doubtful whether intervention would be effective as there was little evidence that the market consensus which sustained sterling at its current level was fragile; and that a failed attempt to influence the exchange rate via intervention would damage the Committee's credibility. Second, to the extent that sterling's strength mainly reflected euro weakness, the MPC could do very little about it. Third, the Committee's analysis of the exchange rate could be conveyed via the minutes of the meeting and did not need to be demonstrated via intervention.

38 While views differed on the range of options feasibly available to the Committee, there was broader agreement that, subject to the over-riding objective of achieving the inflation target, it would be preferable to have a lower exchange rate and higher interest rates from the point of view of economic conditions and balance more generally.

The immediate policy decision

39 Some members of the Committee preferred forecast assumptions—about the path of the exchange rate and about price-cost margins—which would produce a central projection for inflation at the two-year forecast horizon closer to 3% than 2½%. In the short run, inflation would continue to be below target and would be further restrained by the appreciation in sterling, which would more than offset the increase in oil prices. But it was vital to be forward-looking. Given the medium-term outlook, policy needed to be tighter, and in particular domestic demand growth

needed to be reined back. The choice was, therefore, for an immediate increase in the repo rate of 25 basis points or 50 basis points. Another view accepted the best collective judgment of the central projection, but regarded the balance of risks to inflation as clearly on the upside, on account of the possibility of a faster depreciation in the exchange rate and stronger domestic demand growth than assumed in the central projection. On this view too, the choice was between a 25 basis point and a 50 basis point increase. There was, however, more than one path for interest rates that would enable the Committee to achieve the target. Given that inflation was set to remain below target in the relatively short term, there was time to gather more evidence, in particular about the path of the exchange rate, earnings, price-cost margins, and productivity, all of which were highly uncertain but important to the inflation outlook. There was, thus, no need to take the risk that an immediate 50 basis point increase might put further upward pressure on sterling. An immediate rise of 25 basis points was the best course.

40 For some other members, the immediate choice was between a 25 basis point increase and no change, and for them that choice was very finely balanced. On the one hand, there were risks to the inflation outlook from continued buoyant domestic demand growth and a tight labour market, which implied strong underlying domestically-generated inflation. On the other hand, inflation could remain below target for a protracted period if sterling's strength persisted, as the experience of the past few years suggested it clearly might. While inflation would tend to be higher than expected if sterling fell by more than assumed in the best collective projection, it was arguable that there could be time to raise rates if and when that happened as inflation was otherwise set to remain below target for a further period. Given the immediate benign outlook and the major uncertainties about the more distant prospect, this analysis suggested that either a rise of 25 basis points or no change would be consistent with pursuit of the inflation target and thus with the Committee's remit. However, given the Committee's inflation projection profile, in the view of some there was a risk that leaving rates unchanged would have the perverse effect of putting further upwards pressure on sterling, by leaving the market with the expectation that tighter policy had simply been deferred; and in the view of others, that sterling could not fall much on a no-change decision without engendering expectations of further interest rate rises. Although sterling was substantially overvalued against the euro, it was not clear how monetary policy could in the short run help to produce a better balance between external and internal monetary conditions. In those circumstances, the better course was to continue to restrain domestic demand growth, which remained above trend and so posed an upside risk to the medium-term outlook for inflation unless brought back to a more sustainable rate. On a delicate balance, the better course was therefore to raise rates by 25 basis points. Some members taking this view thought that, subject to any new evidence about the inflation outlook, there might then be an opportunity to wait and see before making any further change, and that this would offer the best chance of achieving the inflation target while enabling sterling to return to a more realistic level.

41 On another view, there was no need for a further increase in the repo rate. Internationally, the tightening of monetary policy elsewhere over the past month would help to contain any inflationary pressures from the stronger world economy. Domestically, there had been little news, and recent labour market data had, if anything, been encouraging. The outlook for domestic demand growth might have strengthened slightly but sterling had continued to appreciate over the month, which would restrain activity and inflation. In terms of the forecast, if sterling remained at its current level and/or the downward pressures on prices from stronger competition and new technology were greater than in the best collective assumption, then inflation would continue to undershoot the target for the next two years. A further increase in the repo rate would increase this undershoot and would also create a short-term risk of adding to sterling's strength.

42 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be increased by 25 basis points to 6.0%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Charles Goodhart, Willem Buiters, Ian Plenderleith, John Vickers and Sushil Wadhvani) voted for the proposition. DeAnne Julius voted against, preferring to maintain interest rates at 5.75%.

43 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
Willem Buiters
Charles Goodhart
DeAnne Julius
Ian Plenderleith
John Vickers
Sushil Wadhvani

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

Annex: Summary of data presented by Bank staff

1 This annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 4 February, in advance of its meeting on 9–10 February 2000. At the start of the Committee meeting itself, members were made aware of subsequent information that had become available, and that information is included in this Annex.

I The international environment

2 Recent data releases confirmed the stronger outlook for the global economy. Growth in the United States had remained robust in 1999 Q4, and leading indicators in the euro area had remained strong. There was also evidence that emerging markets had continued to recover. Japanese growth remained fragile, but had been supported by strengthening exports. Oil prices had increased further since January, as had metals prices. Increased concern about inflationary risks had led to 25 basis point increases in policy rates in the United States and the euro area. The markets continued to expect further increases over the coming months.

3 US GDP had grown by 1.4% in 1999 Q4, the same rate as in Q3. Consumption had continued to grow strongly in Q4. Investment growth had slowed—perhaps partly reflecting a Y2K effect—but growth in government expenditure had increased. Productivity had grown strongly in Q4. Manufacturing productivity had increased particularly rapidly, at an annualised rate of 6.4%, its fastest pace since 1971. New orders had risen strongly in December. Consumer confidence had increased to 144.7 in December, its highest recorded level, and retail sales growth had remained strong in that month, before slowing in January. US headline CPI inflation had picked up to 2.7% in December, but core CPI inflation had decelerated to 1.9%. Final producer price inflation had risen by 3% in December. Growth in the employment cost index had risen slightly in Q4, largely reflecting increases in benefits costs. Employment growth had remained strong in January.

4 The FOMC had raised the Federal funds target rate by 25 basis points to 5.75% on 2 February, with the announcement (using the new format) that ‘the Committee believes the risks are weighted mainly towards conditions that may generate heightened inflationary pressures in the foreseeable future’. This assessment reflected concerns that demand would continue to outstrip growth in potential supply.

5 Annual industrial production growth in France and Germany had continued to accelerate in November (measured on a three-month moving-average basis). Production growth in Germany had remained buoyant in December, and though orders had fallen in that month, the underlying trend remained strong. Euro-area business confidence had improved for the ninth successive month, while consumer confidence had remained stable at a high level. Annual euro-area HICP inflation had accelerated to 1.7% in December, from 1.5% in November. HICP inflation excluding energy, food, alcohol and tobacco had increased by less, to 1.1%, from 1.0% in November, while annual euro-area total producer price inflation had increased to 3.0%, mainly reflecting energy price increases. Annual euro-area labour cost growth had increased slightly in 1999 Q3, to 2.2%, from 2.0% in Q2.

6 The average annual growth rate of euro-area M3 had increased to 6.1% in the three months to December, from 6.0% in the three months to November, still well above the ECB’s reference rate of 4.5%. But a number of special factors had been distorting the annual growth rate of M3, and would continue to do so for several months. The ECB had increased its refinancing rate by 25 basis points to 3.25%, reflecting an increase in the risks of

‘second-round effects’ from oil and non-energy commodity prices, developments in the euro exchange rate, and expectations of higher inflation rates in the next few months.

7 Japanese data on industrial production and the tertiary sector suggested that output growth in 1999 Q4 had increased moderately. There had been minor revisions to the National Accounts data for Q3, but these had left quarterly GDP growth unchanged, at -1.0%. Annual export volume growth had increased in the three months to December. But private demand indicators had remained weak. Annual retail sales growth had remained negative, and the rate of decline of workers’ incomes had increased in December. Annual CPI inflation had remained at -1.1% in December. But, excluding food, annual CPI inflation had been less negative, at -0.1%. And the rate of decline of wholesale prices had slowed, to only -0.5% on a year earlier in January. Annual growth in M2+CDs had fallen to 2.6% in December, from 2.9% in November.

II Monetary and financial conditions

8 Narrow money had grown very strongly in January. After adjustment for seasonality and the introduction of the new 50p and £2 coins, notes and coin had increased by 2.0% on the month, and the twelve-month growth rate had risen to 13.0%. The published growth rate is based on the average levels during the month and this had been distorted upwards by the effects of the millennium persisting into the early weeks of January. The distortion had affected January’s level proportionately more than December’s but had appeared to have largely unwound by the end of January. Data from the end of January and beginning of February had suggested that the underlying annual rate of growth of narrow money had been in the 8%–9% range in January, a similar rate to November.

9 The stock of M4 had risen by £5.1 billion (0.6%) in December. The three-month annualised rate of growth had increased by 3.5 percentage points to 6.6%, the highest rate since May. The twelve-month rate had picked up slightly to 3.6% but remained low, due primarily to the run-down of deposits by other financial corporations (OFCs). Excluding the volatile OFCs sector, the growth rate of M4 had been stable over the past year, at around 6.0%. M4 lending (excluding securitisations) had grown by £9.2 billion (0.9%) in December, and the twelve-month rate had risen to 9.0%, its highest since October 1998. The rapid growth had been broadly based: household borrowing had remained strong and private non-financial corporations’ (PNFCs) and OFCs’ borrowing had strengthened in Q4. Flows of M4 and M4 lending had diverged since mid-1998. In an accounting sense, that reflected the strength of net sterling deposits from non-residents.

10 Households’ deposits at banks had grown by 1.0% in December (rather stronger than the monthly average of 0.7% in Q4); annual growth had been 6.5%. Households’ borrowing had remained robust. The rate of growth in the year to Q4 of 9.5% had been the strongest since 1991 Q2. Net secured lending had increased by £3.6 billion in December despite slight falls in both the value and number of loans approved. Total unsecured lending had increased by 1.1% in December, continuing the robust growth seen throughout 1999.

11 The M4 deposits of PNFCs had fallen by £0.2 billion in December, but strong growth in previous months had resulted in strong growth in the fourth quarter as a whole. In contrast, M4 lending to PNFCs had increased rapidly in December, by £3 billion. But taking the fourth quarter as a whole, both M4 deposits and lending had shown similar strength. PNFCs’ non-bank borrowing had also been strong in the fourth quarter, particularly via equities.

12 Since the previous MPC meeting, short-term interest rate expectations, as measured by the gilt repo curve, had fallen by around 0.2%. There had been virtually no change in longer-term nominal rates since that meeting. Corporate spreads were little changed on a month earlier and the yield on corporate bonds had remained much lower at long maturities than at shorter maturities. PNFCs' bond issuance data had suggested that companies viewed longer-term rates as relatively attractive: throughout the second half of 1999 the proportion of bond issuance with a maturity of greater than fifteen years had increased. There had been almost complete pass-through of the January repo rate increase to standard variable mortgage rates by the beginning of February.

13 There had been little change in RPIX inflation expectations derived from surveys for 2000. Most survey-based measures had fallen by 0.1 percentage points to between 2.1% and 2.3%. Survey estimates of RPIX inflation for 2001 had suggested that people expected inflation to rise to 2.4%.

14 Equity prices had fallen by 3.6% since the January MPC meeting, well below the performance of other stock markets. Equity prices in all sectors other than information technology and non-cyclical services had fallen since the January MPC meeting.

15 Sterling had been volatile at the end of January and beginning of February. By the close of business on 9 February the effective exchange rate index had appreciated by 0.7% from its level at the January MPC meeting to 108.6. Over the month sterling had depreciated markedly against the dollar (2.2%) but had appreciated by 1.5% against the euro.

III Demand and output

16 The preliminary ONS estimate of GDP growth in 1999 Q4 had been 0.8%, unchanged from Q3. The annual growth rate had risen to 2.7%. Service sector output had grown by 0.9% in Q4 and had been 2.9% up on a year earlier. Within services, the distribution, hotels and catering sector had grown by 0.6%. The more recently available industrial production data had shown a rise of 0.3% in Q4 while manufacturing output had risen by 0.7% over the same period.

17 New construction orders had risen by 0.6% in the three months to December. The CIPS index of construction activity had indicated robust growth since February 1999.

18 The deficit on trade in goods had widened slightly, to £2.5 billion in November from £2.3 billion in October. The EU deficit had widened to £0.5 billion but the non-EU goods deficit had narrowed slightly to £2.0 billion. The non-EU goods deficit had widened to £2.3 billion in December. Excluding oil and erratics, the volume of goods exports had risen by 1.2% in the three months to November and the volume of imports had risen by 2.4%. Total goods imports had risen by 0.7% over the same period.

19 Retail sales volumes had risen by 0.6% in December and by 1.3% on a three-monthly basis. Consumer confidence remained strong. The GfK consumer confidence index had risen to +8.0 in January, its highest level for more than two years and above its historical average. The Consumers' Association quarterly survey of confidence had been +41 in January, compared with +34 in October.

20 Private new car registrations in the three months to January had fallen by 12.6% on a year earlier. Total new registrations had fallen by 4.1% over the same period.

21 Both the Halifax and Nationwide house price indices had shown further increases in January, of 2.4% and 0.9% respectively. Annual house price inflation had remained high on these measures, at 16.0% and 13.1% respectively. Particulars delivered had fallen by 2.4% in December and the annual growth rate had declined to

11.7%. The RICS survey had shown weaker sales and instructions in December.

22 The public sector net cash requirement had been £9.2 billion in December.

23 The BCC and CBI surveys had shown a pick-up of manufacturing investment intentions in Q4 compared with levels a year earlier. The CBI intentions balance rose slightly, to -9 in Q4 from -11 in Q3. The BCC had shown an increase in investment intentions (plant and machinery), to +14 in Q4 from +11 in Q3. The BCC survey had also shown an increase in service sector investment intentions, the balance rising to +25 in Q4 from +21 in Q3.

24 The CBI quarterly industrial trends survey had shown fewer firms with more than adequate stocks: however, the stocks of finished goods balance had risen sharply since Q2. The CIPS survey of manufacturing had shown that stocks of finished goods had been built up ahead of the millennium, perhaps consistent with a positive contribution to GDP growth in Q4. The CBI distributive trades survey had reported a build-up of retailers stocks in January.

25 Looking ahead to 2000 Q1, survey evidence suggested continuing growth. The CBI quarterly industrial trends survey had shown a marked improvement in new manufacturing orders in Q4. The BCC survey for Q4 had shown slight improvements in domestic and overseas orders in the manufacturing sector, and declines in the service sector. The CIPS purchasing managers' survey of manufacturing showed a fall in the headline index, to +52.0 in January from +56.3 in December, reflecting the 'millennium effect' as firms adjusted stock positions. The CIPS services measure had fallen by less and construction was broadly flat.

IV The labour market

26 LFS employment had increased by 60,000 (0.2%) in the three months to November, compared with the previous three months. This was considerably slower growth than in the three months to August, but much the same as in the three months to October. The increase had been more than accounted for by a 101,000 (0.5%) rise in full-time employment; part-time employment had fallen by 42,000 (0.6%), so employment growth in full-time equivalent terms had been faster than in heads. The total number of hours worked had fallen by 0.1% in the three months to November, largely reflecting a fall of 0.4% in average hours worked per person.

27 Turning to survey data, the CIPS manufacturing survey for January had suggested that there had been a further decline in manufacturing employment. The same survey had suggested that construction employment had expanded at a more rapid rate than in December, while services employment growth had stabilised. Forward-looking surveys by the BCC and CBI had suggested an upturn in manufacturing employment intentions in 1999 Q4, although the CBI balance had remained negative.

28 New vacancies notified to Jobcentres had risen slightly in December, to 237,800. The CBI industrial trends survey had reported a sharp increase in skill shortages in 1999 Q4, while the net balance of manufacturers reporting shortages of unskilled labour had fallen back towards its historical average. The BCC had reported a slight rise in recruitment difficulties in manufacturing and services. The Recruitment and Employment Confederation (REC) survey had shown that there had been a further deterioration in the availability of agency staff. The latest reports by the Bank's regional Agents had suggested that skill shortages had persisted.

29 The latest unemployment statistics had shown a mixed picture. LFS unemployment had increased by 11,000 in the three

months to November compared with three months earlier, though the rate had remained unchanged at 5.9%. But claimant count unemployment had fallen by 28,700 over the same period and by a further 21,900 in December. The claimant count rate had fallen by 0.1 percentage points to 4.0% in December. The rise in LFS unemployment had been among the very short term unemployed (up to six months) and the long term unemployed (over twelve months).

30 Labour market inactivity had fallen by 36,000 in the three months to November compared with the previous three months. This fall was more than accounted for by a decline in the number of people who reported that they did not want a job. The percentage of the working-age inactive wanting a job had increased by 0.6 percentage points to 30.3%.

31 Whole-economy headline earnings growth, a three-month moving average of the annual monthly rates, had remained unchanged in November, at 4.9%. Both private and public sector headline earnings growth had also remained unchanged. Headline earnings growth in manufacturing had increased to 4.5%, while service sector headline earnings growth had eased slightly to 5.1%. The twelve-month growth rate of earnings had fallen back slightly to 5.0%.

32 Other earnings data had offered contrasting pictures. The Reward index had fallen from 3.5% in November to 3.4% in December. The January REC survey had indicated a sharp rise in earnings growth for permanent staff supplied by job agencies, though growth rates for temporary staff had eased slightly.

33 The Bank's AEI-weighted twelve-month mean measure of whole-economy settlements had been unchanged in December at 3.5%. The three-month whole-economy mean had fallen by 0.4 percentage points to 2.7% in December. This was mostly accounted for by a decline in public sector settlements, which had fallen by 1.0 percentage points to 2.2%. The real value of settlements had fallen back in 1999 Q4, reflecting the rise in RPI inflation.

34 Details of the settlements for NHS workers covered by the NHS Pay Review Body had been announced on 17 January. Overall, the paybill of NHS workers covered by the Review Body was to increase by 3.4%. Details of the settlements for school teachers covered by the School Teachers' Review Body had been announced on 1 February. The paybill of school teachers covered was to rise by 3.3%. Both come into effect on 1 April.

35 The Bank's regional Agents had conducted an informal survey of around 270 firms on the prospects for earnings growth in 2000. Among the contacts sampled that had a company-wide settlement, 21% had expected it to be higher in percentage terms in 2000 than in 1999, while 34% had expected their settlement to fall. But 38% had expected growth in total pay per employee to be higher in 2000 than in 1999, with 26% expecting it to be lower.

36 Respondents had expected that the recruitment and retention of staff, especially in construction, would be the main factor likely to raise earnings growth in 2000. Other notable upward pressures had included productivity and company profitability. The outlook for inflation had been highlighted as the main downward pressure, especially in the retail sector.

V Prices

37 The Bank oil-inclusive commodity price index had risen by 1.9% in December. The annual inflation rate rose from 17.8% in November to 21.8% in December. The monthly rise had partly reflected the rise in crude oil prices in December: the Brent one-month futures price had risen by 4% (in sterling terms). Excluding oil, commodity prices had risen by 1.3% in December to give an annual inflation rate of 3.7%. Metals prices had risen

strongly again, and there were signs that domestic food prices may have reached their trough.

38 Seasonally adjusted manufacturing input prices had risen by 0.7% in December, taking the annual inflation rate from 10.0% to 12.0%, the highest rate since 1985. This largely reflected the recent rise in crude oil prices, but import prices as a whole had also risen sharply on the year. According to the latest CIPS manufacturing survey, the input prices index had risen to +56.3 in January, up from +55.4 in December. Seasonally adjusted total output prices excluding excise duties (PPIY) had risen by 0.2% in December, to give an annual inflation rate of 1.5%, slightly up from 1.2% in the previous month. The latest quarterly BCC output price intentions balance had risen for both the manufacturing and service sectors.

39 Export and import prices had risen by 0.2% and 1.3% in November. Stripping out the oil component, export and import prices had fallen by 2.3% and 0.7% in the previous three months compared with the same period a year earlier.

40 RPIX inflation had remained at 2.2% in December, unchanged since October. The wedge between RPIX services and RPIX goods inflation had widened to its greatest level since September 1992. RPIX service price inflation had remained unchanged at 3.9%. The largest positive contributions had come from leisure and vehicle insurance. RPIX goods price inflation had fallen to 0.3%, the lowest rate on record, mainly reflecting lower tobacco and seasonal food prices.

VI Reports by the Bank's regional Agents

41 The Bank's regional Agents had reported continued widespread, if moderate, recovery in manufacturing output and orders. The improvement in orders had been evenly spread between domestic and external orders. There had been stronger growth in business services mainly related to information technology, corporate restructuring and property. Steady growth was also reported in consumer services. Consistent with the latest CIPS construction survey, construction orders had continued to grow, but had not accelerated.

42 Agents had reported strong retail sales growth over Christmas and the New Year, particularly in household goods. The new car market remained subdued, but there were reports of a slight recovery in the used car market. External demand had continued to pick up. While services investment remained strong, manufacturers were reported to be more hesitant.

43 Manufacturers' input prices had continued to rise. There had been continued downward pressure on manufacturers' output prices, squeezing margins further. In the service sector, input price increases and higher wage costs had remained easier to pass through to consumers. Retail prices were reported to be flat or falling. The labour market had remained tight, with growing shortages of both skilled and unskilled staff leading to sizeable pay pressure in some areas, notably in information technology and accountancy. There had been steady growth in employment in services.

VII Market intelligence

44 The sterling effective exchange rate index had continued to rise over most of the month, reaching 110.3 on 1 February, its highest level since December 1985. However, the index had fallen sharply after 1 February. It ended the period at 108.6, 0.7% above its level at the time of the January MPC meeting.

45 The rise in sterling's trade-weighted index during January had largely reflected the euro's depreciation against all the major currencies. News about relative interest rate differentials had been unable to provide much explanation for exchange rate movements during the month. A number of commentators had concluded that

the euro had been overvalued in 1998 and 1999 and had illustrated this point with reference to the euro area's negative 'basic balance', defined as the sum of the current account balance and net long-term capital flows (direct and portfolio investments). For these commentators, a negative 'basic balance' was consistent with the view that structural factors had made euro-denominated assets unattractive for investors. A second explanation put forward by some commentators for sterling's appreciation had related to mergers and acquisitions involving UK companies—both actual and rumoured.

46 Market expectations of official UK interest rates implied by short sterling futures contracts for 2000 and 2001 had fallen by

10–25 basis points during the month. This had largely been attributed to a fall in interest rate expectations following the publication of the minutes of the January MPC meeting, as well as the effects of some weaker-than-expected economic surveys. Market participants had also cited the continued appreciation of sterling as a factor likely to influence near-term MPC decisions. Beyond 2001, however, interest rates implied by short sterling futures contracts had risen.

47 Market anecdote for the immediate policy decision had been a perceived 75:25 chance of a 25 basis points increase in the Bank's repo rate. This was broadly consistent with the term structure of market interest rates for very short maturity assets.

Minutes of the Monetary Policy Committee meeting on 8–9 March 2000

1 Before considering the implications of the latest data for the immediate policy decision, the Committee discussed the implications of the forthcoming Budget; recent developments in demand and output; money and asset prices; the labour market; prices and costs; the world economy; other forecasts of the UK economy; and other considerations.

The Budget

2 The Committee had been briefed by Treasury officials prior to its meeting on the broad shape of the forthcoming Budget's macroeconomic projections and public finances. The fiscal outcome for 1999/2000 was tighter than had been expected at the time of the Pre-Budget Report, but much of that tightening had already happened and was in the data. Essentially, the broad picture was one of both higher tax revenues and lower public spending. The Treasury's estimates were for the cyclically-adjusted Public Sector Net Borrowing Requirement for 1999/00 to be almost 1% of GDP tighter than thought at the time of the November Pre-Budget Report, and looking forward that it would remain some ¼% to ½% tighter over the next two fiscal years.

3 The Budget's spending profile assumed that the current fiscal year's underspending would be made up in subsequent years, but spending was otherwise broadly unchanged as a share of GDP in aggregate terms since the Pre-Budget Report. There had, however, been some changes within the aggregate. In particular, lower social security spending—lower transfers to the household sector—was offset by higher government consumption spending. Since the marginal propensity to spend out of these transfers was likely to be quite high, the demand-weighted impact of these changes might be broadly offsetting.

4 The Committee discussed the possible implications for inflation. Three factors were discussed. First, much of the tightening was already in the data. So the relationship between, for example, consumption and post-tax income was different from that expected at the time of the Pre-Budget Report, and would need to be re-examined in the next *Inflation Report* forecast round. Second, since the reasons for the rise in tax revenues were not well understood, it was possible that those higher revenues would not persist—statutory tax rates had not been raised. However, it was noted that the fiscal projections were, as usual, produced on the basis of cautious assumptions, for example that the ratio of VAT to consumption would fall somewhat over the period of the projections, albeit from a higher starting point. Third, it was possible that higher tax revenues indicated higher activity than currently recorded in the national accounts, rather than an increase in effective tax rates. The implications of this for inflation depended in part on whether any under-recording of output was matched by a commensurate under-estimate of potential output.

5 Overall, the broad fiscal picture looked somewhat tighter than had seemed probable a month ago. The impact on future activity and inflation seemed to be fairly small, although that would, in part, depend on whether the Budget had any lasting effect on sterling's exchange rate. More analysis would be needed once the full details of the Budget were known.

Demand and output

6 Prior to the recent release of 1999 Q4 output and expenditure data, the picture had been one of a gradual slowing in the annual rate of growth of final domestic demand from around 4½% to around 3%–3½%. The latest data showed that the rate was now

back in the 4%–4½% range at the end of 1999, on account of upward revisions to both consumption and investment. Considered in this way there was less evidence that final domestic demand was slowing to a more sustainable pace. However, it was possible to analyse the data in a variety of different ways. For example, smoothing the data over two quarters still suggested a moderation in the rate of growth during 1999. Furthermore, the growth rate of final domestic demand in the fourth quarter had been in line with the February *Inflation Report* central projection.

7 There was a 1.2 percentage point negative contribution from net trade to GDP growth in Q4, much larger than expected. This, in turn, had been offset by a stronger-than-expected contribution from inventories, so that total domestic demand growth was much stronger than expected. It was possible that these two factors were linked, as the increase in stocks might be import-intensive. In addition, some of the change in net trade on the quarter might be erratic. Nonetheless net trade looked weaker than had been previously thought and possibly reflected quicker or larger effects from the most recent appreciation of sterling, or a delayed response from the past appreciation of sterling. This suggested that even if the overall pace of output growth was as expected, the mix of aggregate demand—between domestic demand and net trade—now looked less benign than it had appeared a few months ago when the net trade contribution had for a while been positive.

8 On inventories, it was possible that the increase might also prove to be erratic. It was still difficult to assess the size of the millennium effects. In addition, the change in manufacturing, wholesale and distribution stocks did not account for much of the aggregate change in inventories over the quarter. The increase was largely accounted for by 'other' industries, which included the quarterly statistical alignment adjustment. The rise in stocks in these industries in Q4 might also be linked to the recent weakness of car registrations. If, for example, the number of car registrations eventually recovered to its former level, then the underlying picture for consumption would have been stronger (and inventories weaker) than recorded. The change in seasonal pattern following the change to new car registration practice last year also made comparisons difficult.

9 Overall the latest indicators of demand and output gave a rather mixed picture, with some remaining strong and others weakening. Many of the strong indicators pointed to continuing buoyancy of domestic demand. In particular, real earnings growth had been strong and wealth continued to rise. The GfK consumer confidence index had fallen on the month, but this was as expected following its surge in January and the index remained close to the level it had been at throughout 1999. The latest CBI Distributive Trades survey pointed to both a strong outcome for February and an expectation of a strong March. However, the Bank's regional Agents had detected a mixed retailing picture in February. In aggregate, retail sales growth had continued at broadly the same pace, but with some regions reporting stronger and others weaker growth.

10 A number of indicators on the output side showed perhaps greater signs of a slowdown in the rate of growth, many reflecting the recent weakness in net trade. Industrial production had been weak in January and there had been small downward revisions to earlier quarters. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing activity index had fallen slightly in February and had therefore remained well below its level in Q4—though it remained above the neutral 50 level. The OECD leading indicator for the UK had also turned lower. It was possible that the recent

weakness in some of the output indicators might slow income growth and, in turn, domestic demand. By way of contrast with weaker industrial production data, the latest CIPS services and construction indices had continued to show strong growth and the 3i survey had shown business optimism to be strong.

Money and asset prices

11 Broad money was growing at the slowest annual rate of growth since July 1983, when the monthly figures had first been published. In addition, the disaggregated data indicated that this month, unlike in recent months, Other Financial Corporations could not account for the reduction in the aggregate M4 growth rate. It was possible that some of the weakness in household and corporate deposits was accounted for by the unusual seasonal timing of tax payments which might prove temporary, and it would therefore be useful to see another month's data before drawing any conclusions. The large financial deficit of the corporate sector was another possible contributing factor.

12 By contrast growth in lending remained strong. Household credit growth, in particular, was breaking records, with annual growth at 10% the highest since the early 1990s. In the housing market, both the number and value of approvals for house purchase had fallen on the month, but there was uncertainty as to whether this was a stronger than normal seasonal effect around the year-end. Corporate borrowing also remained strong. There were few signs of significant financial stress in other indicators. While the latest evidence showed that the corporate sector financial deficit as a percentage of GDP was quite large by historical standards, the special survey conducted by the Bank's regional Agents had found little evidence of distress borrowing, and suggested that companies were borrowing to invest.

13 Exchange rates between the dollar, euro and yen had been volatile over the past month. Although there were further signs of stronger activity in the euro area, there had been continued signs of even stronger activity in the United States, so it was perhaps not too surprising that the euro had remained weak. Some of the recent strength of the yen against the dollar might be related to year-end repatriation effects, which could prove temporary. It was perhaps surprising that sterling had not moved much over this period, despite large movements in other currencies. The sterling effective exchange rate index had risen a little compared with the time of the Committee's previous meeting, but was broadly in line with the assumption underpinning the central projection in the February *Report*. However, during the month sterling had reached its highest-ever level against the euro, and a seven-month low against the dollar. Looking over a longer period the risk premium on sterling relative to the euro might have fallen.

14 If, as the Committee had discussed at a previous meeting, there was a positive correlation between the US stock market, corporate sector profitability and investment, and the dollar, then any fall in the US stock market might be associated with a weakening of the dollar. The Committee noted that while there had been a fall in the Dow Jones stock market index recently, the NASDAQ index had continued to rise, reflecting the weight and differential movement of new technology stocks. The difference between the performance of stocks in new and old sectors was striking, and was apparent in the UK and continental European indices too. The Committee also noted the change in the composition of the FTSE 100, which had led to the inclusion of a number of new IT companies.

15 Regarding house prices, both the Halifax and Nationwide indexes showed growth of 15% in the year to February. The latest Royal Institute of Chartered Surveyors survey indicated that the balance of estate agents reporting rising prices remained strongly positive in January. There were tentative signs that the rate of increase in some of the southern regions of the UK might be slowing slightly, offset by a corresponding rise in the rate of

increase in other regions. As well as the fall in approvals around the turn of the year, there were also signs that the number of site visits and reservations might be falling. But these indicators might have been affected by the millennium, and it was too early to judge whether activity had in fact slowed. The Committee noted that the rate of increase in prices would have to slow substantially from current rates over the next two years if the projection in the February *Inflation Report* was to be met.

The labour market

16 There was little news in the data published on labour market quantities this month. The LFS data for employment were likely to be revised up in April, with revisions spread over a number of years. The implications for other data—such as productivity—were not clear.

17 There had been a sharp rise in earnings growth in December. It was interesting that the rise in earnings growth was not restricted to the private service sector, as there had been a marked increase in manufacturing too. There were two main questions. First, how much weight should be placed on the December number in gauging the underlying growth rate? Second, what did it imply about the underlying determinants driving both costs and prices, and also consumption, and hence affecting the outlook for inflation?

18 Some of the marked rise in annual earnings growth in December probably related to bonuses. But because of the change in the ONS's survey form early last year, it was not yet possible to get a clear view on the contribution from bonuses to the change in the annual rate of earnings growth. If it related to bonuses, it would be sensible to smooth the effects. Since it was possible that part of the bonuses related to millennium preparation and working, it was also possible that significant increases in earnings might be recorded for some months to come, and that consequently the annual rate of growth might not decline and even rise in January. One suggestion was that some of the payments might be millennium-related 'loyalty' bonuses, which were negotiated some time ago when companies feared potentially large effects from the Y2K computer problems. If so, these payments might not be directly related to past profits, as in the case of more traditional bonuses, and hence would represent an additional cost to the firm, albeit a one-off cost. In any event, these bonuses would be paid to the household sector, but it was uncertain whether households would consume only the annuity value of the addition to their wealth. Even if they did, 'saving' through purchases of consumer durables would add to aggregate demand. More information would be needed, but taken at face value the latest earnings data were higher than the starting point for earnings growth assumed in the February *Inflation Report*.

19 The contrast between the level of US and UK nominal (and real) earnings growth was quite marked, especially given that recent rapid productivity growth might warrant higher real earnings growth in the United States, and the fact that the millennium effects on pay might have been expected in the US as well. Although UK productivity growth was rising, it was lower than in the US and seemed unlikely to explain the entire rise in earnings growth over recent months. The increase in UK earnings growth looked less dramatic when an adjustment was made for hours—growth in nominal earnings per hour had been flat, but at a fairly high level of around 5½%, for some time.

20 In contrast to the earnings figures, the three-month AEI-weighted series for pay settlements had fallen slightly over the past month, so the latest settlements data could not account for the rise in earnings growth. The two series implied that there had been a further rise in pay drift, which would be consistent with higher bonuses and/or other factors. This measure of drift had been surprisingly strong over the late 1990s relative to measured productivity growth. Companies continued to report that pay increases were warranted by productivity growth and profits, and

that pay deals were often self-financing with unit costs kept in check.

21 There were a number of ways in which to reconcile the apparent contradictions between what individual companies said and what was recorded in the earnings data. First, one possibility continued to be that both aggregate output and productivity were under-recorded. Although this probably had little implication for the output gap as the data for both supply and demand would be affected, there would be lower unit labour costs than currently recorded. However, for this to be significant the under-recording of the level of productivity would have to be increasing through time, which was unproven, but possible in the light of US experience. Second, it was possible that for some companies the falls in input prices over recent years had financed increases in labour costs. In that case, overall costs would rise or drift would fall (to the extent it was profit related) given that input prices were now rising. Another possibility was that a small increase in labour costs in each individual company had only a small effect on its total costs, since labour costs were generally a small fraction of most companies' total inputs. But this could aggregate to a large increase in costs, once intra-firm transactions were netted out and one looked at value added aggregated across the economy as a whole.

Prices and costs

22 The oil price had risen further since the Committee's previous meeting, and had touched \$30 per barrel. It was well above the profile that had been assumed in the February *Inflation Report* projections, though it was possible that it could still come down broadly in line with the forecast path. There was general uncertainty ahead of the next OPEC meeting in March.

23 Manufacturing input prices were volatile from month-to-month, but seemed to be rising by around 10% at an annual rate. Weighted costs in manufacturing (for example, including labour costs, raw materials and other inputs) now seemed to be rising by around 2½% on an annual basis, and at some point might push up output prices unless a further downward squeeze in profit margins occurred. The current downward pressure on margins might also be leading to an increase in the corporate sector's financial deficit. Forward-looking price indicators of output price pressures—such as the CBI Industrial Trends survey—were still negative.

24 The fall in RPIX inflation to 2.1% in January was also associated with a further fall in HICP inflation to 0.8%, the lowest since the series began and the lowest among all 15 EU countries. A large part of the widening of the wedge between the two series could be explained by differing treatments of housing and of car prices.

25 The CBI Distributive Trades survey balance of prices had recently recorded its lowest level since the survey question began. However, the latest BRC shop price data showed a slight increase in February. Retail goods price inflation continued to fall and was now zero, and there had been a further increase in the rate of decline in the retail sales deflator in January. It was possible that the strong rise in retail sales volumes in January was related to greater discounting. By contrast, the rate of increase of retail services prices had increased to 4.2% in January from 3.9% in December.

26 There was anecdotal evidence that some companies were able to offset some of the rise in input prices by savings made through the use of e-commerce. The recent developments to promote easier and cheaper household access to the Internet might, in the view of some members, lead to quicker and more significant effects from e-commerce than thought likely a month ago. But it was noted that in the US, where there was already low cost access to the Internet by households, the share of retail sales conducted over the Internet was currently only around 0.6%.

The world economy

27 Prospects for activity in the euro area seemed to be improving, and the latest indicators also pointed to slightly higher inflation. But the picture had not changed significantly over the past month. If activity were to strengthen more quickly that might underpin an appreciation of the euro from its current level.

28 The latest US data had again been surprisingly strong. Chairman Greenspan's recent Humphrey-Hawkins testimony, together with the latest data, suggested that there was more concern about the balance of demand relative to potential supply. If this signalled either an earlier and/or a larger move in interest rates than previously expected, then it might increase the chances of a gradual slowing of activity growth. But there were no signs that the testimony had changed market expectations of where US interest rates would go, either in the near-term or further out. It was possible that a further month of strong data had heightened the risks of a bigger change in financial market expectations at some point.

Other forecasts of the UK economy

29 The Committee briefly considered the differences between the February *Inflation Report* projections using market interest rates, and a range of recently published outside forecasts. The main differences seemed to be on inventories and on the price/earnings nexus. On inventories, the MPC's projection assumed a continuing decline in the stock-output ratio. This partly reflected a view that there might be further efficiency gains from the exploitation of information technology. Most other forecasters did not appear to assume a continuation of a downward trend in the stock-output ratio. Differences of view on the cyclical influences on inventories, and the unwinding of any millennium-related adjustments, might account for some of the difference in 2000. There was no simple explanation for the differences that emerged on prices and earnings, which reflected a variety of different judgments. Other forecasts, however, seemed to embody a more benign short term trade-off between growth and inflation. The Committee would return to these issues in the normal course of the quarterly forecast round.

Other considerations

30 The Committee concluded that the timing of the Budget was not a constraint on their decision either this month or next.

31 There had been a widespread expectation that the Committee would not change interest rates this month, although a further rise was still expected by the summer. The Committee agreed that a change in interest rates this month would come as a surprise to the market and would need to be explained carefully. That of itself should not be a constraint on individual members' decisions, but the Committee would need to take into account the prospective effects of any surprise to the markets.

The immediate policy decision

32 A variety of factors were identified which pointed to higher prospective inflation than a month ago, and to which members attached varying weights. First, the underlying pace of demand growth over recent quarters might be even stronger than initially thought, partly because it was against a backdrop of a tighter fiscal position than previously expected for 1999/00. Retail sales volumes in January had also been much stronger than expected and, taken together with some other demand indicators, supported the view that fast demand growth had continued into the first quarter of 2000. In addition, the Committee's projection for domestic demand was below the average of outside forecasts for 2000, albeit largely on account of a highly uncertain contribution from inventories. Second, the latest data implied a higher starting point for earnings growth than thought at the time of the *Inflation Report*. Third, the oil price had risen further and would, unless it reversed, put further upward pressure on world and domestic prices. In addition, there

were significant imbalances in the economy, and these might have implications for aggregate demand and inflation. On net trade, the trend was probably somewhere between the strong Q2/Q3 figures and the weaker Q4 data. Nonetheless, the balance between domestic demand and net trade looked at least as worrying as a month ago. The further deterioration in net trade should at some stage come to an end. But given the upward revisions over the past month to data for consumption and investment in the middle of last year, more might now need to be done to slow the pace of domestic demand growth. A change in asset prices might bring about a re-balancing of the economy. For example, at some point the exchange rate might depreciate, or there could be a fall in the stock market or slower house price inflation. Unless these adjustments occurred, it might be difficult to re-balance the economy. But it was uncertain whether these adjustments would occur smoothly. In the view of some members, that pointed to a greater need to restrain domestic demand growth now.

33 For those members who attached significant weight to these factors, and especially for those whose February central projections for inflation were above target beyond the short-term, there was a case for a further rise in interest rates of 25 basis points. However, there were also reasons for waiting. First, it was possible that after a month some of the fog surrounding some recent data might have cleared. For example, there were tentative signs in some of the housing activity indicators that the market might be turning, although some of the recent weakening might be due to millennium effects. But, given the possibility of stronger bonus-affected earnings data over the next few months, it was not clear that waiting would help to clarify the picture on nominal earnings growth. Second, it was not possible to do a full analysis of the Budget yet, so it might be prudent to wait before drawing a firm conclusion on the implications for inflation. Third, a rise in interest rates this month would come as a surprise to the markets. The market expectation was that interest rates would not move this month, but would still rise by the summer. It was possible that an increase in rates now might be seen as implying a lower path for interest rates in the future. But a rise in interest rates risked pushing up the market's interest rate expectations and hence sterling—which would exacerbate the imbalances in the economy and push inflation further below target in the short run. Overall, the considerations for these members were very finely balanced between raising interest rates by 25 basis points this month and waiting to see more data and analysis. For these members, it was best to keep interest rates unchanged this month.

34 For other members, the recent economic data did not suggest the need to change interest rates this month. Despite attaching

some weight to the stronger economic data discussed above, there were data that pointed the other way. Again, different members placed different weights on these various factors. First, although the mix of stronger domestic demand and weaker net trade looked less benign than a month ago, there were no clear implications for aggregate demand and inflation as these factors were offsetting. Second, the batch of monthly indicators was mixed, and overall it was possible to view them as being mildly weaker rather than mildly stronger for demand and output. For example, some members attached greater weight to the recent weaker industrial production data and the manufacturing CIPS survey, which on this view were consistent with slowing output growth in line with the February central projection. Third, the Budget suggested a tighter fiscal stance than previously anticipated by households and companies. Fourth, there were downside risks to inflation, most notably of a sharp reversal in the recent rise in oil prices or a fall in the US stock market. Fifth, it made sense to wait and try to collect more information on the type and nature of bonuses that were helping to push up average earnings growth. Also, further analysis of the possible differential effects of settlements and drift on prices and consumption was needed. Sixth, a rate rise now, by driving the pound even higher, would aggravate the external imbalance and might increase the probability of a sudden fall in sterling that might thereby jeopardise the inflation target. Seventh, given that interest rates had increased by 100 basis points in four steps over the past six months, it was sensible to wait and see how the economy reacted, particularly, given the short-term profile for inflation.

35 The Governor invited the members of the Committee to vote on the proposition that the Bank's repo rate be maintained at 6.0%. The Committee voted unanimously in favour of the proposition.

36 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
 Willem Buiter
 Charles Goodhart
 DeAnne Julius
 Ian Plenderleith
 John Vickers
 Sushil Wadhvani

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

Annex: Summary of data presented by Bank staff

1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 3 March, in advance of its meeting on 8–9 March 2000. 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 this Annex.

I The international environment

2 The global economy (except Japan) had remained strong. The Purchasing Managers Indices for the United States, France and particularly Germany had all risen in February. Bank estimates had suggested that quarterly growth in UK export markets for goods and services had been 3.6% in Q3, and 2.4% in Q4. Oil prices had remained strong in February, with evidence of greater backwardation (spot price above futures price). There had been increased volatility in oil prices, reflecting falling oil stocks and speculation about OPEC's strategy. Metal prices had risen in January. Markets were expecting further tightening in monetary policy in the United States and the euro area. Market expectations derived from Fed Funds futures had implied a 27 basis points rise in March and a further 15 basis points in May. Three month euribor futures had implied a rate of 4.1% from June.

3 Quarterly US GDP growth for 1999 Q4 had been revised up to 1.7%, from 1.4%. Quarterly labour productivity growth in Q4 had been revised up to 1.5%, the highest rate since 1992 Q4. Industrial production and capacity utilisation had both strengthened in January. The value of retail sales had increased by 0.3% in January, following an upwardly revised increase of 1.7% in December. The drop in retail sales growth in January might have reflected a millennium effect. The monthly growth rates of broad and narrow money had fallen back in January, which appeared to confirm Y2K effects. Consumer confidence had fallen in February from its highest ever level in January, probably reflecting rising oil prices and monetary tightening. There had been little evidence of a secondary effect from rising oil prices on price inflation for other goods. The annual increase in the Personal Consumption Expenditure deflator had remained flat in January at 2%.

4 Preliminary estimates had suggested that GDP had grown in 1999 Q4 by 0.9% and 0.7% in France and Germany respectively. Euro-area industrial production had risen in December. Industrial production in Germany had increased by 0.5% on the month in January. Total manufacturing orders in Germany had fallen by -0.4% in January. There had been a small fall in euro-area employment in 1999 Q3. That was partly explained by the negative effect on German employment of the unwinding of government job programmes. By contrast, French employment had picked up strongly in Q4. The annual growth rate of euro-area M3 in January had been affected by the impact of the introduction of the euro a year previously. There had been a further increase in both total and intermediate annual PPI inflation in the euro area in December. Euro-area HICP inflation had risen to 2% in January. HICP energy price inflation had risen throughout the euro-area. The sharpest rises had been in Germany, probably due to tax effects.

5 Official sources had suggested that the first GDP release for 1999 Q4 in Japan might be negative. That was supported by Japanese household expenditure data (published by the Economic Planning Agency), which had fallen by 2.2% in 1999 Q4. By contrast, output data for both industry and services had been flat and consumer confidence had strengthened over the same period. New construction orders had strengthened in January 2000, almost entirely due to growth in private sector orders. The narrowing of the Japanese trade surplus in January had been largely due to the movement in oil prices. Y2K effects on base money in Japan had

largely disappeared in February. Both core and headline CPI inflation had remained negative in January (with headline inflation of -0.9%), as had final PPI inflation. Raw materials inflation had increased sharply in January, and there had been a small rise in intermediate PPI inflation.

6 Industrial production growth in Latin America had strengthened in December. Growth had fallen back slightly in Asia and the transitional economies, though it had remained strong in emerging markets as a whole. Capacity utilisation in South Korea had risen above pre-crisis levels. CPI inflation in December had fallen in Latin America and had remained flat in Asia.

II Monetary and financial conditions

7 The stock of notes and coin had stabilised in February, following the sharp distortions around the year-end, so longer-term growth rates based on February data could be expected to give a better idea of the underlying picture than those based on either January 2000 or December 1999. The twelve-month growth rate in February had remained strong at 8.4%, in the middle of the 8%–9% range cited for the underlying rate in February's *Inflation Report*.

8 The stock of M4 had fallen by £2.9 billion (-0.4%) in January taking the twelve-month growth rate to 2.6%, the lowest on record. The fall on the month had been accounted for by a rundown in both households' and private non-financial corporations' (PNFCs') deposits. Other financial corporations' (OFCs') M4 deposits had continued to stabilise after the sharp falls earlier in 1999. OFCs' M4 rose by £1.5 billion (0.8%) in January, taking the twelve-month growth rate from -6.2% to -4.0%.

9 Aggregate M4 lending (excluding the effects of securitisations) had also been weaker in January, rising by £3.3 billion (0.3%) compared with £8.8 billion in December. The twelve-month rate had fallen by 0.4 percentage points, but remained robust at 8.4%. Much of the weaker outturn in January had been accounted for by a fall in lending to OFCs of £1.1 billion (-0.5%). There had been a £5.8 billion fall in non seasonally adjusted reverse repo activity, consistent with the possibility that the fall in lending to OFCs had reflected an unwinding of banks' millennium-related collateral holdings.

10 Households' M4 deposits had fallen by £1.5 billion (-0.3%) in January, reducing the twelve-month growth rate to 5.3% from 6.4% in December. Part of the fall in January might have reflected payments delayed from December because of the large number of bank holidays, or millennium-related concerns. Household deposits had probably also been depressed by large payments under the self-assessment tax arrangements.

11 Households' M4 borrowing (excluding the effects of securitisations) had remained robust, increasing by £4.5 billion (0.8%) in January, with the twelve-month rate at 9.6%. Net total secured lending to individuals had increased by £3.4 billion, down by £0.2 billion from December.

12 The number and value of mortgage approvals had fallen in January, for the second month running. Both series were now lower than they had been since early 1999, although some lenders had suggested that the fall in January might have been an exaggerated seasonal effect. That was consistent with the pick up in business they had seen in February.

13 Provisional estimates by Bank staff had suggested that mortgage equity withdrawal had remained strong in 1999 Q4 at around £3 billion, though somewhat lower than in Q3. On this

basis, total real lending for consumption (real mortgage equity withdrawal plus real unsecured lending) was estimated to have been higher in the second half of 1999 than at any time since 1990.

14 Bank borrowing by PNFCs minus PNFCs' M4 deposits had risen again in January, through lower deposits rather than higher lending. PNFCs' M4 deposits had decreased by £2.8 billion in January; PNFCs' M4 lending (excluding the effects of securitisations) had fallen by £0.1 billion. Non-bank borrowing by PNFCs had also been relatively strong in the first two months of the year. Strong net borrowing in recent months had been consistent with higher corporate expenditure relative to internal funds.

15 Since the previous MPC meeting, interest rate expectations about the immediate future as measured by the gilt repo curve had remained unchanged, but expectations at longer maturities had fallen by around 40 basis points. Over the month, long-term UK yields had moved particularly closely with US bonds. UK corporate bond yields had fallen in line with gilt yields providing continued incentives for companies to issue debt. The February rate rise had been fully passed through to the average standard variable mortgage rate, but there had been a continued trend for lenders to provide greater discounts for new mortgages.

16 A fall in real forward interest rates derived from the yield curve had accounted for the fall in nominal forward rates at the long end. At shorter maturities the fall in nominal forward rates had been attributed to a fall in inflation expectations. Survey-based measures of inflation expectations for the next couple of years had remained below 2.5%.

17 The FTSE All-Share index had risen by 3.2% since the previous MPC meeting, while the FTSE Small Cap index had risen by 10.6%. Since October 1999, the FTSE IT sector had more than doubled in value.

18 Since the previous MPC meeting, sterling had appreciated by 1.6% against the euro, but depreciated by 1.7% against the dollar and by 3.8% against the yen. The sterling effective exchange rate index (ERI) had appreciated by 0.6% over the same period. Monetary news had been unable to explain bilateral exchange rate movements. The sterling ERI was 0.1% below the February *Inflation Report's* modal projection.

III Demand and output

19 Quarterly GDP growth at constant market prices had been unrevised at 0.8% in 1999 Q4, though the annual growth rate had been revised up to 2.9% from 2.7%. Quarterly growth in 1999 Q3 had been revised up to 1.0% from 0.8%. Total industrial production had risen by 0.1% in 1999 Q4. Manufacturing output had grown by 0.5% in 1999 Q4, while service sector output had grown by 0.9%, unrevised from the preliminary estimate. Construction output had grown by 0.7% and agriculture had grown by an unusually strong 1.2%.

20 The National Institute of Economic and Social Research had estimated that the three-month on three-month GDP growth rate had been 0.8% in February.

21 The expenditure breakdown of GDP showed that domestic demand had grown by 1.9% in Q4. Final domestic demand had grown by only 0.9%, however, as the change in inventories had contributed 1.0 percentage points to quarterly growth.

22 Private consumption (including that of non-profit institutions serving households) had grown by 0.8% in 1999 Q4. Private consumption had grown by 4.4% in the year to 1999 Q4, the highest growth rate since 1989 Q2. There had been significant upward revisions to consumption growth in the first half of 1999. This had reflected new data on alcohol spending: the level of consumption in 1999 Q3 was 0.5% higher than had previously been

thought. A complete breakdown of consumption for Q4 was not yet available. Government consumption had risen by 0.7% in Q4, unchanged from Q3. Total investment (including acquisitions less disposals of valuables) had grown by 1.7% in 1999 Q4. There had been significant revisions to investment growth in 1999: the revised level of total investment in 1999 Q3 was 1.1% higher than had previously been thought. Business investment had risen by 1.2% in Q4, and was 3.8% higher than a year earlier. Within this, manufacturing investment had fallen by 2.9% in Q4, while service sector investment had risen by 3.0%. Total company profits had fallen by 0.3% in Q4, but were 8.0% higher than a year earlier, and corporation tax data had also suggested that company profits had improved.

23 Inventories had made a positive contribution to GDP growth in 1999 Q4. Including the alignment adjustment, inventories had risen by £0.6 billion in Q4, compared with a fall of £1.3 billion in Q3. The CBI Monthly Trends survey in February had reported that manufacturers still perceived their stocks to be more than adequate, though the balance was below the long-run average. Other surveys had pointed to a drawing down of stocks since the new year.

24 Net trade had contributed -1.2 percentage points to GDP growth in 1999 Q4, the first negative quarterly contribution since 1999 Q1. Total exports of goods and services had fallen by 1.6%, while imports had grown by 1.8%. Exports of goods to non-EU countries had fallen by 5.4% in Q4, partly reversing the increase in Q3.

25 Turning to indicators of Q1 activity, manufacturing output had fallen by 0.4% in January. Retail sales volumes had risen by 1.5% in January, consistent with the British Retail Consortium (BRC) survey. Growth in retail sales volumes had continued to exceed that of retail sales values. The CBI Distributive Trades survey had shown a total balance of +47 retailing respondents reporting higher sales in February compared with a year ago, up from +29 in January, and further growth had been expected in March. The MORI measure of consumer confidence had fallen sharply to -10 in February and the GfK confidence index (which had a bigger sample and had historically been less volatile) had fallen a little to +3.1, though confidence about households' own situation remained firm. Private new car registrations in the three months to February had fallen by 12.4% on a year earlier. Total new registrations had fallen by 5.2% over the same period.

26 The housing data had been mixed in February. The Halifax house price index had fallen by 0.9%, but the Nationwide measure had risen by 2.2%. Annual house price inflation had remained high at 15.0% on both measures. Particulars delivered had increased by 5.4% in January and the annual growth rate had risen to 20.4%. Private housing starts and completions had both risen in January.

27 The public sector net cash requirement had been -£17.2 billion in January (a surplus).

28 Turning to the latest sectoral surveys, the manufacturing output expectations balance in the CBI Monthly Trends survey had remained broadly unchanged at +10 in February. The total orders balance had increased to -11 in February, and the export orders balance had increased to -25.

29 The headline index of the Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey had fallen further to 51.0 in February. The output index had fallen to 52.1. Stocks of finished goods had fallen in February for the fourth consecutive month. The survey had pointed to rather more buoyant export growth than the official data had suggested in recent months. The latest DHL survey had shown a strengthening in exporters' confidence. The headline CIPS services survey balance had risen slightly to 57.3 in February, the twelfth successive month of expansion. The CIPS construction index had also been strong, rising to 62.0 in February. Construction new orders had fallen by

3.9% in the three months to January compared with the previous three months, and were 3.1% below their level a year ago.

IV The labour market

30 Labour Force Survey (LFS) employment had increased by 75,000 (0.3%) in 1999 Q4. The rate of growth had been slower than in Q3, but slightly higher than in the three months to November. The increase had been largely accounted for by a 60,000 (0.3%) rise in full-time employment; part-time employment had risen by 14,000 (0.2%). Employment in full-time equivalent terms had risen broadly in line with heads. The total number of hours worked had risen by 0.2% in Q4, though average hours worked per person had fallen by 0.2%.

31 Turning to survey data, the CIPS manufacturing survey for February had suggested that there had been a further fall in manufacturing employment, but at a slower rate than in January. The same survey had suggested that construction employment had expanded at a more rapid rate than in January, while services employment growth had remained stable.

32 New vacancies notified to Jobcentres had fallen by 7,700 in January, to 228,800. The Recruitment and Employment Confederation (REC) survey for February had suggested that there had been a further decline in the availability of agency staff. The latest reports by the Bank's regional Agents had suggested that skill shortages persisted.

33 LFS unemployment had fallen by 4,000 in Q4, though the rate had remained unchanged at 5.9%. Claimant count unemployment had fallen by 44,700 in Q4, and by a further 9,800 in January. The claimant count rate had fallen in January, to 4.0%.

34 Labour market inactivity had fallen by 36,000 in Q4. The percentage of the working-age inactive wanting a job had remained broadly unchanged.

35 Whole-economy headline earnings growth, a three-month moving average of the annual monthly rates, had increased by 0.6 percentage points in December, to 5.5%. This increase had been accounted for by a rise in private sector headline earnings growth; public sector headline earnings growth had remained unchanged. Headline earnings growth in both manufacturing and services had increased by 0.5 percentage points, to 5.0% and 5.7% respectively. The twelve-month growth rate of whole-economy earnings had risen by 1.1 percentage points to 6.2%. The ONS had suggested that about half of the increase in this month's (non seasonally adjusted) Average Earnings Index (AEI) growth rate was accounted for by the financial services sector, mainly reflecting larger bonus payments than a year ago.

36 Other earnings data had offered a mixed picture. The February REC survey had indicated a rise in earnings growth for both permanent and temporary staff supplied by job agencies. The Reward index had fallen from 3.4% in December to 3.2% in January.

37 The Government had announced that the National Minimum Wage was to be uprated in October 2000. The adult rate was to be raised from £3.60 to £3.70. The youth rate was to be raised from £3.00 to £3.20 in June.

38 The Bank's AEI-weighted twelve-month mean measure of whole-economy settlements had been unchanged in January, at 3.4%. The three-month whole-economy mean had fallen by 0.4 percentage points to 2.4% in January, though this was based on comparatively few new settlements.

39 Details of the settlements for both Armed Forces staff and senior public sector workers had been announced. Overall, the

paybill of both groups was to increase by 3.3%. Both increases would come into effect on 1 April.

V Prices

40 The Bank oil-inclusive commodity price index had fallen by 0.6% in January, taking the annual inflation rate from 21.4% down to 18.4%. The monthly fall had reflected price falls in all the major components of the index, except for metals. In particular, the price of domestic food had fallen quite sharply, suggesting that domestic food prices had not yet reached their trough. Excluding oil, commodity prices had fallen by 1.0% in January to give an annual inflation rate of 1.2%.

41 Manufacturing input prices had fallen by 1.0% in January, taking the annual inflation rate from 12.2% to 10.4%. This had mainly reflected falls in the prices of domestic food and of imported materials. January's fall may have been only a temporary pause in the recent upward trend in input prices, however, as oil prices had risen sharply again in February. According to February's CIPS manufacturing survey, the input price index had risen to its highest level since August 1995. Total output prices excluding excise duties (PPIY) had remained unchanged in January, to give an annual inflation rate of 1.8%, slightly up from 1.6% in the previous month. February's CBI survey output price balance had also remained unchanged at -4, with respondents having continued to report expectations of falling prices.

42 Imported goods price inflation had been broadly unchanged at -0.4% in December, despite a further rise in the contribution from fuels prices to 1.9 percentage points. The contribution from manufactured goods prices had fallen further to -1.8 percentage points from -1.4 percentage points. Total goods export price inflation had risen to 2.6% in December, with a larger positive contribution from fuels prices.

43 RPIX inflation had fallen to 2.1% in January, down from 2.2% in each of the previous three months. HICP inflation had fallen to 0.8% in January, the lowest since the series began in January 1996 and also the lowest in the EU. The difference between HICP and RPIX inflation had widened to 1.3% in January from 1.0% in the previous month. Around 40% of this change in the wedge had been accounted for by higher housing depreciation which is not included in the HICP measure.

44 The gap between RPIX services and RPIX goods price inflation had widened to its highest level since November 1991. RPIX service price inflation had risen to 4.2% in January. The largest positive contributions had come from leisure (0.3 percentage points) and vehicle insurance. RPIX goods price inflation had fallen to 0.0%, the lowest on record. The largest positive contributions to RPIX goods price inflation had come from petrol (0.7 percentage points) and tobacco. The BRC Shop Price Index had risen by 0.9% in February, to give an annual inflation rate of -0.3%. The CBI Distributive Trades Survey retail price expectations balance had fallen to -9 in March, the lowest since the series began in 1983.

VI Reports by the Bank's Agents

45 The Bank's regional Agents had reported a pause in manufacturing output growth as millennium stocks had been run down. There had been stronger growth in business services mainly related to professional services. Consistent with the latest CIPS construction survey, construction orders had continued to grow, particularly from the leisure industry and projects under the Private Finance Initiative.

46 Some Agents had reported a slight easing in retail sales growth since January as many retailers had run down stocks, though the household goods sector had continued to show strong growth. The new car market had remained subdued, but there had

been reports of continued recovery in the used car market. Exporters had remained confident about the strength of overseas demand growth, but margins had been further squeezed owing to the strength of sterling. There had been evidence that import penetration had increased, both at the intermediate and final production levels.

47 In the housing market, prices were reported to be rising, but not accelerating. There had been some evidence that activity had peaked, with the exception of city centre sites. In the labour market, skill shortages had remained a concern. There had been considerable variation in December bonuses across and within both regions and sectors.

48 Manufacturers' input prices had continued to rise. There had been continued downward pressure on manufacturers' output prices, squeezing margins further. In the service sector, input price increases and higher wage costs had remained easier to pass through to consumers.

49 Retail price inflation had been reported to have been broadly negative, and the Agents had reported some concern from their contacts about higher overhead costs.

50 The Bank's regional Agents had conducted a survey of UK firms regarding their investment intentions. Among the contacts sampled, more companies had raised their investment plans than had cut them over the past six months. The construction and non-retail services sectors had recorded the strongest revisions to their investment intentions. Over the next two years, the majority of firms had expected investment spending on IT to be maintained or increased, compared with the previous two years. Almost half of the companies surveyed had claimed not to have made any

significant borrowing in the past six months. But of those companies that had borrowed, financing new domestic investment had been by far the strongest motive.

VII Market intelligence

51 Expectations of UK interest rates implied by short sterling futures had fallen since the MPC meeting, by around 30 basis points for contracts maturing in 2001 and 2002. Expectations of interest rates in the United States and, to a lesser extent, the euro area had also fallen, notwithstanding expectations of increases in official rates in March by the FOMC and ECB. By contrast, there had been little expectation in the market that official rates in the United Kingdom would rise in March. Market participants had commented on the disinflationary effects of a high exchange rate and the possibility that the earnings and retail sales data had been distorted by end-year effects.

52 Sterling's effective exchange rate had appreciated slightly since the previous MPC meeting, with a 1.6% appreciation against the euro (which has a 65% weight in sterling's effective exchange rate) counterbalanced by a depreciation against the dollar. In seeking to explain the continued strength of sterling, market participants had emphasised the impact of the general weakness of the euro. Against the dollar, sterling had been at the bottom of its trading range over the last three years. Risk reversals traded in the foreign exchange options market had suggested that market participants had been paying a premium to protect themselves against the risk of sterling depreciating against the dollar. This was not the case against the euro. Data on market positioning had suggested that most participants' holdings of sterling were close to their benchmarks. Chart-based traders had continued to expect the euro to depreciate against sterling.

Text of Bank of England press notice of 9 March 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

The minutes of the meeting will be published at 9.30 am on Wednesday 22 March.

Minutes of the Monetary Policy Committee meeting on 5–6 April 2000

1 Before turning to its immediate policy decision, the Committee discussed the Budget; money and asset prices; demand and output; the labour market; prices and costs; the world economy; and other considerations relevant to its decision.

The Budget

2 Prior to its previous meeting, the Committee had been briefed by Treasury officials on the broad shape of the Budget's macroeconomic projections and the prospects for the public finances. It had agreed that more analysis would be needed once the full details of the Budget were known.

3 Since then the Budget had been finalised. The broad shape of the projections for the public finances was unchanged from the Committee's previous meeting. In 1999/2000 the net borrowing figure was nearly 1% of GDP lower than assumed in the November *Pre-Budget Report* (PBR), with the surplus now put at £11 billion as against £2 billion in November. The net borrowing figures in the Budget for the following two years were also lower than in the PBR, although the difference between the Budget and the PBR numbers was smaller than for 1999/2000. By the third year (2002/2003) net borrowing was higher than in the PBR.

4 The figures for real government consumption and investment over the next two years were higher in the Budget than the assumptions made in the February *Inflation Report*, but little different from those in the November *Inflation Report*. This principally reflected the conventions employed in the Committee's forecasts, not announcements in the Budget. Between November and February the government expenditure deflator had been revised up which, when projected forward, had implied lower public spending in real terms given the government's nominal spending plans. The higher nominal profile for public spending in the Budget would need to be reflected in the May *Inflation Report*, but the February *Inflation Report* had, in effect, already incorporated much of the recorded increase in tax revenue in 1999/2000, and this had influenced the private sector consumption and investment estimates for 1999/2000.

5 There were, as always, uncertainties in the projections of future government revenue and spending, and in assessing the effects of the Budget more generally. The sustained real growth in public spending on goods and services meant that private spending would have to be constrained. However, spending by departments might increase more slowly than projected, as it had done recently, and tax revenues might continue to be above the levels projected by the Treasury, particularly if their past buoyancy reflected structural rather than cyclical factors. But since the reasons for higher tax revenues were not well understood, it was uncertain how far recent trends could safely be extrapolated into the future. It was noted, though, that the Treasury's Budget projections were prepared using what seemed to be prudent assumptions. All in all, most members of the Committee thought that the impact on future activity and inflation from the Budget seemed unlikely to be large over the next two years.

6 The Committee then discussed the effect on the public finances of the spectrum auctions for the Third Generation mobile telephone licences. While the auction receipts would boost the government's cash flow straightaway, the immediate impact on the Public Sector Net Borrowing measure would be much less marked, since for these purposes the revenue would be accrued over the life of the licences, ie until December 2021. On balance, even though the proceeds were likely to be substantially higher than initially expected the macroeconomic effect should not be large, unless any

adjustment in taxes or government spending were brought forward rather than accrued over the life of the licences. More immediately, if foreign bidders bought rather than borrowed sterling to pay for the licences there could be a temporary effect on the exchange rate.

Money and asset prices

7 M0 and M4 lending were both increasing at 8%–9% a year, consistent with robust consumption growth. Loan approvals for house purchase had bounced back strongly in February, suggesting that the slowdown around the turn of the year had reflected seasonal effects. Competition in the mortgage market remained intense. House price indicators in March were mixed, with the Halifax index declining while the Nationwide index had risen strongly. Data on site visits and net reservations from the House Builders' Federation pointed to a possible easing in activity later in the year, but it was too early to say whether house price increases would moderate to the extent projected in the February *Inflation Report*.

8 Monetary and financial data, together with recent surveys, suggested a rather stronger outlook for business investment, with capital gearing (as measured by market values) falling as equity prices rose. The financial deficit of the private non-financial corporate sector in 1999, however, was at its highest as a percentage of GDP for almost ten years, although there was little sign that this was holding back planned investment. Much of the deficit had been financed either by foreign currency borrowing or by sterling capital market issuance. Corporate bond spreads over gilts remained wide, perhaps reflecting relative supply, with heavy long-dated corporate bond issuance over the last year.

9 The Committee discussed the implications of the recent movements in global equity prices for the economic outlook. While so-called 'new economy' shares had fallen significantly in price over the month, with the NASDAQ index in the US down around 15%, this had not had a contagious effect on other sectors, and 'old economy' share prices showed a significant rise over the same period. In both cases these moves represented a reversal of the price changes seen earlier in the year, and were not necessarily evidence of increased fragility in the market as a whole, although the extent of recent volatility could alternatively be seen as a sign of a forthcoming downturn, particularly if it should lead to an increase in the equity risk premium.

10 The weakness of the euro continued, although over the month as a whole sterling was little changed despite intra-month volatility. While the decline in the euro might reflect the cyclical strength of the US economy or pessimistic views on structural reform within the euro area, this had not been mirrored in European equity markets, which had risen strongly over recent months. Nor did such hypotheses do much to explain why the euro had fallen by more than 10% against the yen since September.

Demand and output

11 The latest national accounts data for 1999 Q4 included upwards revisions to all of the major components of final domestic demand, which was estimated to have risen by 1.3% in the quarter, and by 4.4% on a year earlier. Stockbuilding was now thought to be lower than earlier estimated, while the contribution of net trade to GDP growth in the quarter was unchanged, at -1.2 percentage points.

12 Industrial production had fallen in February for the third month in succession, although the size of the fall, at -0.6%, had

been affected by a sharp decline in energy production, reflecting relatively mild weather for the time of year. Manufacturing production had also fallen and was now below its August level. When taken together with the net trade figures for Q4, this suggested that the internationally exposed sectors were coming under renewed pressure, reflecting in part the effects of sterling's appreciation against the euro. The fall in output was quite broadly based, with chemicals and engineering (which had contributed significantly to manufacturing output growth in 1999) declining in February.

13 Survey data were not entirely in line with this picture. The purchasing managers' index for manufacturing, produced by the Chartered Institute of Purchasing and Supply (CIPS), had risen slightly in March, and had last been below the neutral level of 50 in April, nearly a year ago; the output index was also higher, while new orders were little changed. In the Engineering Employers' Federation survey, the output balance remained at +9 in Q1, with new orders again little changed. Reports from the Bank's regional Agents had suggested a resumption in manufacturing growth in February. It was possible that in some sectors volumes were being maintained only through a further reduction in margins, and that there would be limits on how much further that process could go.

14 While any slowdown in parts of manufacturing might feed through into the rest of the economy, either directly or through its impact on consumer confidence, at present the services sector appeared to be buoyant. The CIPS services index for business activity had risen to 59.6 in March, its highest level since June 1997. The CIPS construction index also pointed to continuing growth in activity and new orders.

15 The picture for retail sales was mixed. In February volumes had fallen back from their unusually high January levels, but on a three-monthly basis growth was unchanged, at 1.8%. The CBI Distributive Trades Survey had shown quite a marked slowdown in the growth of retail sales volumes and orders placed in March, but expectations for April remained strong. The GfK consumer confidence index was sharply down in March. The evidence suggested that while household spending remained strong, it might no longer be accelerating, although real disposable incomes still seemed to be growing rapidly. But a slowdown in consumption growth was built into the central projection in the February *Inflation Report*, and it was too early to say whether this would materialise.

16 Taking all the evidence together, there was still a sharp contrast between the rapid growth in the services sector, and the less robust performance of manufacturing. On balance it seemed likely that growth in 2000 Q1 would be little different from the central projection in the February *Inflation Report*.

Labour market

17 Whole-economy productivity growth, defined by comparing GDP with the Workforce Jobs measure of employment, had picked up to 1.8% in the year to 1999 Q4, and to 2.7% on an annualised basis between 1999 Q2 and Q4. Figures based on the Labour Force Survey (LFS) employment measure suggested slightly lower figures, at 1.6% and 2.1% respectively. This took annual productivity growth back towards trend, but it was too early to say whether it represented anything more than a normal cyclical response of productivity to a recovery in output growth.

18 The labour market remained tight, with employment growth on the LFS measure up 0.3% in the three months to January. Unemployment had risen on the LFS (but not the claimant-count) measure, reflecting—in an accounting sense—a fall in inactivity, with the LFS unemployment rate unchanged for the past seven months. Survey data were consistent with this picture, and the Recruitment and Employers' Confederation (REC) survey showed a significant strengthening in the demand for staff, in line with the

reports of skills shortages from the Bank's regional Agents. It was suggested that the labour market measures in the Budget, when taken together with previously announced reforms, might have a small positive effect on future labour supply.

19 Whole-economy average earnings growth, as measured by the headline rate, had risen to 5.9% in the year to January. Much of the increase seemed to reflect bonus and other payments, in part related to the new millennium. A survey by the Bank's regional Agents suggested that further bonus payments were due to be made in subsequent months, particularly in March, and that this might further complicate the analysis of the data.

20 Some members of the Committee considered that the pricing response by firms to an increase in earnings would depend on whether these took the form of higher settlements or faster 'wage drift', (including bonuses and other payments that might be linked to productivity or profits), with some evidence suggesting that 'wage drift' had a smaller effect on prices. Others believed that the effects of one-off increases in earnings would tend to feed through into final prices on a smoothed basis, and it was quite unclear whether in the longer term prices reacted differently to increases in earnings stemming from higher settlements, and those reflecting greater wage drift.

21 Data collected by the Bank suggested that on a matched sample basis, settlements in January were if anything lower than a year previously. But the Bank's regional Agents had noted that this was not the case in services, and that pay pressures were building in some areas, with concern about settlements later in the year both in services and some parts of manufacturing.

22 The Committee agreed that the labour market remained tight. While it would be wrong to react to every fluctuation in the average earnings index, given the volatility of that series and the possible distortions resulting from millennium-related factors, it was likely that the starting point for earnings in the Committee's May forecast would be above that in the February *Inflation Report*.

Prices and costs

23 In recent months retail prices had increased by slightly more than had been expected. Part of the reason was the increase in oil prices, but now that OPEC had decided to increase production, and aimed to stabilise oil prices at around \$20–\$25 per barrel, the upside risks to inflation from this source had diminished. The oil price now was no higher than that incorporated into the February *Inflation Report* for Q1. How far earlier price increases had been passed through was difficult to determine, and it was possible that firms would base their pricing decisions on the new (lower) oil price rather than passing on all of the earlier increases.

24 The CBI Monthly Industrial Trends Survey for March showed more respondents now expecting a fall in manufacturing output prices, perhaps reflecting competitive pressures linked to the rise in sterling against the euro. By contrast, higher oil prices had led to an increase in input prices reported in the latest CIPS manufacturing survey. The Bank's regional Agents reported that service price inflation remained relatively high, but variable across sub-sectors.

The world economy

25 Prospects for world economic activity had strengthened further since the February *Inflation Report*, with output in the US accelerating in 1999 Q4 and activity indicators remaining buoyant in the early part of 2000. The prospects for the euro area had improved, particularly in Germany and France, while East Asia had recovered rapidly from its downturn, and there were also some signs of a recovery in Japan. Official interest rates had risen in the previous month in most OECD economies, and market rates suggested expectations of further increases in official rates later in

the year, for instance in the US and the euro area. The prospects for inflation in the global economy would depend not only on the strength of demand growth and the reaction of monetary policy, but also on the size and distribution of world productive capacity relative to demand.

26 The strength of the US economy, and uncertainty about the balance between domestic demand and supply in that country, remained important factors in any assessment of the world economy. The target Federal funds rate had been raised again in March, for the second time this year, and while there had been considerable volatility in the various US equity price indices, on balance these were now not much changed from their levels at the start of the year. To some members this suggested an increased chance of a gradual slowdown in US growth closer to trend.

Other considerations

27 Although a majority of market participants did not expect the Committee to move rates this month, an increase in the Bank's repo rate during Q2 was widely forecast. The Committee had agreed in March, when a change in the repo rate would have been more of a surprise, that this of itself should not be a constraint on the Committee's decision, and that remained the case. The Committee also agreed that, while the *May Inflation Report* provided an opportunity to analyse the latest developments in more detail, and to set out the reasons for any change in official rates at greater length, that also did not preclude a change in rates this month.

28 The Committee discussed a suggestion that it should intervene in the foreign exchange markets. The argument advanced in favour was that this could, if successful, not only be profitable but also improve the balance in the economy between the internationally exposed sectors of the economy and other sectors which were growing very rapidly, reducing the risk that the Committee would need to adjust monetary policy sharply later. Some members were not at all attracted to this view, believing that intervention would be unsuccessful and would cause confusion in the markets about the Committee's reaction function and its priorities. Some others thought that intervention in the foreign exchange market was unlikely to be successful at present, though they did not wish to rule out the possibility in appropriate circumstances in the future. Sterling's current strength in effective terms reflected a more general weakness of the euro against most other major currencies, and there was little evidence that the present level of sterling was seen as unsustainable or fragile by the market, at least in the short term. On this view, intervention would be effective in current circumstances only if it was accompanied by an easing of monetary policy, which would not be appropriate in the present conjuncture, and to intervene ineffectively could be counterproductive.

The immediate policy decision

29 The Committee discussed the case for leaving rates unchanged, and for increasing the repo rate by 25 basis points. For many members, the choice was finely balanced.

30 Final domestic demand was growing rapidly, although in Q4 this had been offset in part by a large negative contribution from net trade. Some members thought that such an imbalance was not sustainable over the medium term. Although retail sales and consumer confidence had fallen back more recently, consumption still seemed robust, and while there were indications that house prices were no longer accelerating, there was little evidence of a slowdown in the housing market. Business investment growth was moderate but public investment was likely to grow rapidly. Government consumption would also boost total demand for the indefinite future. The net trade picture was more mixed, with the rise in sterling against the euro working in one direction, and stronger world demand in the other. While the services sector

remained robust, manufacturing output had fallen in recent months, although survey evidence suggested a rather more resilient picture. The labour market remained tight and, whether or not higher earnings fed through into firms' prices directly, they would add to disposable incomes and hence to demand pressures. While oil prices were now easing back, input costs continued to rise, though there was little evidence of much acceleration in final prices.

31 On one view, it would be better not to raise rates this month. The news over the month as a whole was inconclusive, with falls in manufacturing production, retail sales and consumer confidence, and oil prices, but with the determinants of domestic demand, both private and public, remaining robust. Against that background other factors were also important. First, the extent of price pressures stemming from the labour market required further analysis, not least in disentangling the effects of bonuses and other elements of wage drift from that of settlements. Second, the analysis undertaken for the *Inflation Report*, and the opportunity this provided to set out the Committee's thinking in detail, were valid reasons not to move this month unless there was a strong case to do so. Third, for some, the volatility in equity markets introduced a possible downside risk which might mean that any increase in rates this month would need to be reversed soon afterwards. Finally, the imbalances in the economy, manifested in another fall in manufacturing production, seemed to have worsened. An increase might exacerbate these imbalances and it was possible that the weakness in some sectors might feed through into the rest of the economy. With inflation running below target, and expected to continue to do so for a while, there was no pressing reason to raise rates straightaway. For these members, no change in the repo rate was needed this month, although for some of them it was more likely than not that there would need to be an increase in rates in due course.

32 On a second view, although the news over the month was mixed, it had on balance pointed to somewhat higher prospective inflation, which was sufficient to tip the balance for some who had been close to voting for higher rates in March. The fog surrounding some of the data around the millennium date change had begun to clear. A rise in rates would no longer come as a big surprise to the market and might not lead to much change either in short-term interest rate expectations or in the exchange rate. To delay moving rates could lead to expectations that more would need to be done later, to rein back the unsustainable growth of domestic demand. While the *Inflation Report* would provide an opportunity to analyse recent developments in more detail, and set out the thinking of the Committee at greater length, this argument was not by itself a conclusive reason for delay. Finally, the Committee had decided in March that the timing of the Budget would not be a constraint on moving rates either that month or this. On balance therefore a rise in the repo rate of 25 basis points was needed this month.

33 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. Six members of the Committee (the Governor, David Clementi, Charles Goodhart, DeAnne Julius, Ian Plenderleith and Sushil Wadhvani) voted for the proposition. Mervyn King, Willem Buiters and John Vickers voted against, preferring a rise in rates of 25 basis points.

34 The following members of the Committee were present:

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

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

Annex: Summary of data presented by Bank staff

1 This annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 31 March, in advance of the meeting on 5–6 April 2000. 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 this Annex.

I The international environment

2 Overall, the world economy had continued to strengthen and industrial production for a wide range of countries had remained strong in January, though there were signs of a slowing in annual growth. Producer and consumer price inflation had risen a little since the end of the year in the United States and the euro area, largely reflecting increased energy costs. OPEC's decision to increase oil production had eased the pressures on oil prices since March, as had evidence of lower compliance with output quotas in the latest quarter. Interest rates had been raised in the United States and the euro area in March, and rates implied by futures contracts had pointed to further tightening in 2000.

3 Final estimates for US GDP had shown 4.2% growth for 1999 as a whole. US GDP growth had been revised up by 0.1 percentage point in Q4 to 1.8% for the quarter. The revisions had mainly affected net trade, with higher exports and lower imports than in the preliminary profile. However, in January, US export volumes had fallen by 3.4% over the month, partly due to a fall in aircraft sales, and the US trade deficit had widened to a record \$28 billion. US industrial production had slowed slightly in February to 5.6% on a year earlier, largely because of a fall in automobile production. Retail sales, which had grown by 1.1% in February, pointed to strong underlying growth of consumption in Q1, though consumer confidence indicators in March had fallen further from January's record levels. Producer price inflation had been strong in February, rising to 4% over the year, mainly reflecting energy and tobacco price increases. Headline consumer price inflation (CPI) had also risen, to 3.2% in the year to February, and core CPI inflation had risen to 2.1%.

4 The picture of stronger activity in the euro area in the second half of the year had been confirmed by Q4 results. GDP had grown by 0.9% in Q4 and by 2.2% in 1999. Net trade had made a negative contribution to growth in Q4, but domestic demand had been strong, reflecting the growth in private consumption, and reported stockbuilding. Industrial production had continued to grow strongly in Q4 and in January was 3.8% higher than a year earlier. Business and consumer confidence had reached the peak levels previously seen in 1998 and so had pointed to a continued strengthening of activity. M3 growth had increased by 6.2% in February, above the January rate of 5.2%. Euro-area PPI inflation had risen again in March. Consumer price inflation was 2.0% in February. As with the United States, energy effects had mainly accounted for the stronger PPI and headline CPI inflation.

5 The first estimate of Japanese GDP in Q4 had shown a decline of 1.4% on the previous quarter; private consumption had fallen by 1.6%. Investment, mainly non-residential, had contributed positively to growth in Q4. Rising corporate profits and orders had pointed to further investment growth. The March Tankan survey pointed to a slow recovery in output. Japanese workers' household expenditure had increased by 3.9% in the year to February, boosted by the extra day in February 2000, but nonetheless pointed to higher private consumption in Q1. Net trade had been supported by intra-Asian exports and this was also likely to be a strong component in Q1 growth. Exports had increased by

15% in the year to February while import growth had remained above 10%. In February, consumer prices had fallen by 0.6% compared with a year earlier, as the effects of the earlier appreciation of the yen continued to feed through.

II Monetary and financial conditions

6 The twelve-month growth rate of notes and coin in March had remained strong at 8.4%, the same as in February. Bank staff noted that the velocity of narrow money had fallen in recent years, partly as the result of a gradual adjustment to lower nominal interest rates.

7 The stock of M4 had risen by £2.2 billion (0.3%) in February leaving the twelve-month growth rate at its historic low of 2.7%. The weak M4 figures had continued to be dominated by other financial corporations' (OFCs') deposits, but private non-financial corporations' (PNFCs') and households' deposits had also been weak in recent months. Aggregate M4 lending (excluding the effects of securitisations) had been stronger in February, rising by £7.5 billion (0.8%) compared with £3.9 billion in January. The twelve-month rate had risen by 0.3 percentage points and remained robust at 8.9%.

8 Households' M4 deposits had risen by £2 billion (0.4%) in February. But the twelve-month growth rate, at 5.3%, had remained low when compared with rates seen in 1999. Households' M4 lending (excluding the effects of securitisations) had remained robust, increasing by £4.3 billion (0.8%) in February, with the twelve-month rate at 9.7%.

9 Data on mortgage approvals had pointed to continuing buoyancy in housing market activity. The number and value of mortgage approvals had risen by 11,000 and £0.6 billion respectively in February, reversing the downward trend of the previous two months. This had suggested that secured lending could rise in the coming months. Revised estimates by Bank staff had suggested that mortgage equity withdrawal had been strong in 1999 Q4 at around £2.5 billion, although it had been weaker than provisional estimates, which had put the figure at around £3 billion. Total real lending for consumption (real mortgage equity withdrawal plus real unsecured lending) in 1999 was estimated to have been at its highest level since 1990.

10 Net bank borrowing (borrowing minus deposits) by PNFCs had risen again in January and February. PNFCs' M4 deposits had fallen by £0.5 billion on average over the first two months of the year whereas PNFCs' M4 lending (excluding the effects of securitisations) had risen by £0.6 billion on average. Non-bank borrowing by PNFCs (and foreign currency capital issues in particular) had been strong in the first two months of the year. In 1999 the PNFCs' financial deficit had stood at £20 billion, which, at 2.4% of GDP, had been at its highest level since 1990. Unlike the previous economic cycle, a relatively small proportion of this debt had been raised via the banking system.

11 OFCs' M4 had fallen by £1.2 billion (-0.7%) in February, and was 4.5% lower than a year earlier, down from -3.8% in January. OFCs' M4 lending rose by £2.3 billion (1.1%) in February, a 10% increase on a year earlier.

12 Since the previous MPC meeting, short interest rate expectations around one year out, as measured by the gilt repo curve, had risen by around 5 basis points. Medium-term yields (5–12 years) had risen by around 10–15 basis points.

13 The February increase in interest rates of 25 basis points had been fully passed through to the average standard variable mortgage rate, but there had been a continued trend for lenders to provide greater discounts for new mortgages. Fixed-rate mortgages had also fallen.

14 The average of inflation expectations reported in the Treasury survey of independent forecasters had fallen slightly to 2.3% in 2001 Q4. Survey-based measures of inflation expectations for the next two years had also fallen slightly. Trade union expectations had fallen to 2.8% from 2.9% in December 1999. The inflation expectations of the general public had fallen slightly to 4.4%, but these were still well above the inflation target.

15 Equity prices in the United Kingdom had been relatively volatile since the previous meeting. The FTSE All-Share index had fallen by 2% since the previous MPC meeting, with the IT sector down 29% from its peak in early March. Since October 1999, however, the FTSE IT sector had nearly doubled in value, while the FTSE All-Share had risen by around 8%.

16 Since the previous MPC meeting, sterling had appreciated by 0.6% against the US dollar (to \$1.5915), but had depreciated by 0.3% against the euro (to 60.67p) and by 1.1% against the yen. The sterling effective exchange rate index (ERI) had depreciated by 0.3% since the previous MPC meeting. This month, movements in sterling against the US dollar had been consistent with 'monetary news', though movements in sterling against the euro had not. The sterling ERI was 0.3% below the February *Inflation Report's* modal projection.

III The Budget

17 Staff presented a summary of the March 2000 Budget, which had focused on changes in the Treasury's projections compared with the November 1999 *Pre-Budget Report*. The policy changes announced for 2000/01 and 2001/02 had increased discretionary spending in particular, but had been more than offset by non-discretionary changes to spending and revenues. Much of the weaker-than-expected spending and stronger-than-expected revenue outturns in 1999/2000 had been considered to be structural by the Treasury, and were therefore assumed to continue to reduce borrowing over the forecast period.

18 The net effect of the changes to the projections had been to reduce projected borrowing in 2000/01 and 2001/02. A surplus of around £5 billion was now projected for 2000/01, £4 billion more than in the *Pre-Budget Report*, while a surplus £2 billion higher than in the *Pre-Budget Report* was projected for 2001/02. So in the near term, the Budget represented a modest tightening in the fiscal stance relative to the *Pre-Budget Report*. From 2002/03 onwards, higher borrowing had been forecast. The Budget projections had been dependent on the Treasury's 2¼% trend growth assumption.

19 The figures for cyclically adjusted net borrowing had been similar to those for the unadjusted deficit, because an output gap of close to zero had been projected. Very little of the change since the *Pre-Budget Report* had been ascribed by the Treasury to the cycle. Cyclically adjusted net borrowing in the Budget had been estimated at -1.2% of GDP in 1999/2000, and projected at -0.5% in 2000/01, -0.3% in 2001/02, and +0.5% in 2002/03.

20 The Treasury had expected that the Golden Rule would be met throughout the next five years with a small margin of safety, with the cyclically adjusted surplus on current budget declining to 0.7% in 2004/05 from 1.8% in 1999/2000. The ratio of net debt to GDP had already been below 40%, the Treasury's benchmark, and had been projected to fall to around 33% in 2002/03 and 2003/04.

IV Demand and output

21 Quarterly GDP growth had been unrevised at 0.8% in Q4 but the level of GDP had been revised up by just under 0.1%. Final domestic demand growth had been revised up to 1.3% in Q4 and the annual growth of final domestic demand had been revised up to 4.4%. Stockbuilding had been revised down; it contributed 0.6 percentage points to GDP growth in Q4, down from the 1 percentage point reported in the previous GDP release. The net trade contribution had been unchanged at -1.2 percentage points. Revisions had brought the expenditure, output, and income measures of GDP closer together.

22 Household consumption growth in Q4 had been revised up to 1.1%, but there had been some downward revisions to earlier quarters so that the level of consumption in 1999 Q4 was broadly unchanged. Within the total, services had grown by 2.2% on the quarter, and spending on durable goods had risen by 0.3%, while spending on non-durable goods had risen by 0.2%. Cars had contributed little to durables growth in 1999 but spending on other durables had grown by 12.9% in the year to Q4. Real government consumption had been revised up by more than £1 billion by 1999 Q4 with similar-sized revisions to nominal government spending. The estimates of whole-economy investment had been little changed for 1999 Q4 but general government investment had been revised up and business investment had been revised down. Quarterly manufacturing investment growth had been revised up to 4.3% in Q4, the first positive growth rate since 1998 Q4. Other plant and machinery investment had fallen by 0.4%, which could be consistent with a pause in IT investment around the millennium. Revisions had reduced the volatility of inventories between Q3 and Q4.

23 There had been upward revisions to the level of both imports and exports during 1999, although the timing of revisions differed. The net trade contribution had been slightly more negative in 1999 H2. The trade deficit had increased to around 2% of GDP in Q4 but this had been more than offset by increases in investment income and so the current account deficit had narrowed to 1.3% of GDP.

24 The gross operating surplus of all corporations had fallen by 0.9% in Q4 but the level had been revised up by 1.5%. The half-yearly growth rates had been volatile. PNFCS' net borrowing had been little changed in Q4, at 2.4% of GDP. Household compensation of employees had grown strongly, by 1.8% in Q4. The annual household savings ratio had been around 6% over the past two years. It had been low compared with the recent past but did not look so low when compared with the 1960s.

25 Retail sales had fallen by 1.2% in February following growth of 1.6% in January. The three-month rates had still been strong. The BRC weekly data for March had pointed to further retail sales growth and the Bank's regional Agents had reported little change in the growth rate, although there was a further rise in the dispersion across regions. The CBI distributive trades survey had reported lower sales volume growth in March but a rise in expected growth for April. The GfK measure of consumer confidence had weakened across all categories to -2 in March.

26 Analysis by Bank staff had shown close links between housing market surveys and housing market activity and prices. Loan approvals and the Royal Institute of Chartered Surveyors (RICS) sales survey had strengthened in February and had suggested stronger activity in the short term. But the House Builders' Federation survey had shown falling growth in site visits and net reservations which pointed to an easing in activity in the summer. House price indicators had been mixed. The Nationwide index had been very strong at 2.3% in March with annual growth rising to 16.2%. By contrast, the Halifax index fell by 0.4% in March and the annual rate of house price inflation eased a little to

13.5%. The RICS prices data seemed consistent with house price inflation of around 4% per quarter.

27 Exports had been flat in January and there had been evidence that the upward trend in imports was attenuating slightly. There had been a strengthening in exports to non-EU countries in February.

28 Industrial output had fallen by 0.6% in February and manufacturing output had fallen by 0.2%, the third month in a row that manufacturing output had declined. Output had fallen across most industries in the latest three months. The weaker-than-expected manufacturing data had led to a fall in the National Institute's projection of GDP growth for the latest three months to 0.5% from 0.8% the previous month. However, surveys had pointed to a rise in manufacturing output in March. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey output balance had been 54.1 in March, suggesting a moderate expansion of output in Q1. Though still pointing to an expansion of output, the growth of new orders had moderated to 51.7, with firms citing post-millennium destocking as a factor. CBI Industrial Trends output expectations had been stronger in March at +17; total orders had dipped to -16 but had been broadly flat over the past six months. The Engineering Employers' Federation output balance had been flat at +9 in Q1 and orders had risen slightly. By contrast, the CIPS services survey had risen to 59.6 in March, indicating relatively strong service sector output growth. The CIPS construction trends survey had continued to point to growth of current and future construction activity.

V Labour market

29 According to the Labour Force Survey (LFS) employment had risen by 83,000 (or 0.3%) in the three months to January compared with the previous three months, a little stronger than the growth rate in each of the previous three releases. Within the total, full-time employment had risen by 88,000 and part-time employment had fallen by 5,000. The 0.3% rise in the number of people in employment in the three months to January had been offset by a 0.3% fall in average hours worked. So total hours worked had been broadly unchanged in the latest quarter.

30 The number of Workforce Jobs had risen by 70,000 (or 0.3%) in Q4. Within the total, the number of jobs in the production sector had continued to fall, though by less than on average over the past year. There had been a further sharp rise in the number of service sector jobs. The level of Workforce Jobs in Q3 had been revised, so that the number of jobs was estimated to have fallen by just 1,000 during the third quarter, rather than 51,000 as reported in the previous release of the Labour Market Statistics.

31 Survey data had been consistent with further increases in employment in Q1. According to the CIPS, the reading on construction sector employment was 60.8 in March, well above the neutral 50 level and the strongest figure since May 1997. Other CIPS surveys suggested a small rise in service sector employment and a small fall in manufacturing employment in March.

32 There had been a sharp increase in whole-economy productivity growth. One measure, based on the change in the ratio of GDP to Workforce Jobs, had risen from 1.0% in the year to Q3 to 1.8% in the year to Q4. Another measure, based on the change in the ratio of GDP to LFS employment, had risen from 0.8% in the year to Q3 to 1.6% in the year to Q4. Survey data from the Institute of Management Services confirmed the pick-up in productivity growth during the second half of 1999, and suggested that productivity growth had remained firm during the first quarter of this year.

33 There was little new information on labour shortages. The Recruitment and Employers' Confederation (REC) survey showed a

further reduction in the availability of both permanent and temporary staff in March. According to reports from the Bank's regional Agents, skill shortages had remained a serious concern, particularly in southern England.

34 LFS unemployment had risen by 21,000 in the three months to January compared with the previous three months. Most of the rise had been accounted for by those unemployed for less than six months. The claimant count measure had fallen by 42,000 in the three months to January, and by a further 6,700 in February. Inactivity had fallen by 68,000 in the three months to January compared with the previous three months, reflecting similar reductions in the number who reported that they wanted jobs and those who did not.

35 There had been a further sharp increase in the headline rate of earnings growth for the whole economy as measured by the Average Earnings Index (AEI), from 5.5% in December to 5.9% in January. The January headline figure was an average of the annual rates for November, December and January. These were 5.1%, 6.2% and 6.4% respectively.

36 Within the total, annual growth in manufacturing earnings had fallen by 0.2 percentage points to 5.6% in January. At the same time, annual growth in service sector earnings had risen by 0.4 percentage points to 6.7%.

37 The latest earnings figures had been affected by millennium-related and other bonus payments. These had included overtime payments to police and health sector workers, and on-call allowances in transport, storage and communication and the utilities sectors. Overtime payments were reported to have risen in the manufacturing sector as firms sought to make up lost output after the prolonged holiday season.

38 The Bank's regional Agents had asked around 160 of their business contacts to comment on any bonus payments which they had made, or planned to make, during the period November 1999 to April 2000. Around 50% of all respondents had stated that the share of bonus payments in the total wage bill would be higher this year than last year. This proportion was slightly higher in the financial services sector than in manufacturing. Looking at those firms that had reported a higher bonus share for this year, the most common explanation was higher productivity and profits, with around 70% citing this as either an 'important' or a 'very important' factor. The need to retain and recruit staff was a close second in most sectors, though not in manufacturing where employment had been falling. The millennium was seen as 'important' or 'very important' by fewer than one third of those firms reporting a higher bonus share this year. On balance, roughly the same proportion of respondents had expected to make significant bonus payments in March as had done so in January, though it looked as if March bonuses would be concentrated in the financial services sector.

39 Consistent with the AEI, the REC survey showed a sharp pick-up in the growth rate of salaries for permanent staff around the turn of the year. There had been a more moderate increase in the growth rate of pay for temporary (or contract) staff. Wages and salaries per head rose by 5.0% over the year to 1999 Q4, 0.5 percentage points below the headline growth in the AEI for December. Growth in unit wage costs fell from 3.8% in the year to Q3 to 3.2% in the year to Q4, reflecting the sharp increase in productivity growth.

40 According to the latest available data, the Bank's AEI-weighted twelve-month mean settlement was 3.3% in February, the same as the January figure. On balance, settlements were turning out lower this year than last year: of the 110 settlements that could be matched 25 were higher, 11 the same and 74 lower in January 2000 than in January 1999.

VI Prices

41 The Bank oil-inclusive commodity price index had risen by 3.4% in February, taking the annual inflation rate from 18.9% to 22.7%. The monthly increase had reflected price rises in all the major components of the index, except for non-indigenous food. In particular, the price of fuels had risen quite sharply, by 5.1%. This had been mainly due to the 9% rise in crude oil prices in February. Excluding oil, commodity prices had risen by 1.8% in February to give an annual inflation rate of 2.9%.

42 Seasonally adjusted manufacturing input prices had risen by 3.1% in February, taking the annual inflation rate from 10.8% to 14.5%, the highest since the mid-1980s. This had again mainly reflected the large monthly rise in the price of crude oil. There had also been rises in the prices of imported materials as a whole and of domestically produced food. According to March's CIPS manufacturing survey, the input price index had risen to its highest level since August 1995. Seasonally adjusted total output prices excluding excise duties (PPIY) had risen by 0.1% in February, to give an annual inflation rate of 1.6%, slightly down from 1.7% in the previous month. March's CBI survey output price balance had fallen sharply to -11 from -4.

43 Prices of imported and exported goods had risen by 1.1% and 0.5% respectively in the three months to January compared with the previous three months. Excluding oil, the price of imported goods had risen by 0.5%, while the price of exported goods had fallen by 0.5% over the same period.

44 RPIX inflation had risen to 2.2% in February, up from 2.1% in the previous month. RPI inflation had risen to 2.3% in February from 2.0% in January. RPIY inflation had remained unchanged for the second consecutive month in February at 1.8%. Large monthly rises in the prices of clothing, used cars and tobacco had been partly offset by price falls for pharmaceuticals and toiletries, and vehicle insurance. HICP inflation had risen from 0.8% to 1.0% in February. As a result, the difference between HICP and RPIX inflation had narrowed slightly to 1.2% in February from 1.3% in January. Much of this reduction in the difference had been accounted for by a rise in February in the price of new cars, which are not included in RPIX.

45 The basket and weights of the RPI had been updated, with goods receiving a lower weight and services a higher one. The weights for petrol and depreciation had also risen.

VII Reports by the Bank's Agents

46 The Bank's regional Agents had reported a continued moderate recovery in manufacturing activity, although significant sectoral differences remained. The outlook for the sector was reported to be heavily dependent on future movements in the exchange rate. Service sector output growth had remained stable at a strong rate, and there had been some evidence of a strengthening in business services growth. Construction output growth had remained broadly stable, although wide regional variations persisted. The Agents suggested that export volumes had been maintained, but that the strength of sterling continued to result in intense pressure on margins. Concerns regarding the strength of import penetration appeared to have increased further.

47 Agents had reported a slight easing in annual retail sales growth in February, following stronger Christmas/millennium sales, consistent with ONS retail sales data. New car sales had remained unchanged, while there had been further evidence of a pick-up in the used car market.

48 Manufacturers had continued to find it difficult to pass on increases in input prices. There had been further downward pressure on retail goods prices, while service sector inflation was thought to have remained stable. Contacts had remained concerned about skill shortages in the labour market, and there had been signs that expectations regarding pay settlements later in the year had increased in manufacturing and services.

VIII Market intelligence

49 Expectations of UK interest rates implied by short sterling futures had risen slightly since the previous MPC meeting. But the unexpected weakness of the February retail sales and manufacturing output data, and the sustained strength of sterling since the previous MPC meeting, had limited expectations of a rise in the official interest rate in April. Ahead of the meeting, the markets had attached a probability of up to a half to a rise in the official rate of 25 basis points. The latest poll of economists' expectations reported by Reuters suggested about a 40% chance of a rate rise, and an expected peak of 6.5% by the third quarter.

50 In the United States, the FOMC had raised the official rate by 25 basis points on 21 March. This move had been widely anticipated and there had been little market reaction to it. Following the publication of the February FOMC minutes on 23 March, in which a discussion of a 50 basis point rate rise was reported, US interest rate futures had risen sharply, but had since fallen back. The ECB raised their official rate by 25 basis points on 16 March and, following that change, interest rate expectations in the euro area had fallen.

51 Since the previous Committee meeting there had been some volatility in US equity markets, with a 15% fall in the US NASDAQ index and a 12% rise in the Dow Jones index (the FTSE All-Share index had fallen by 2% over the same period). Market participants had reported that the movements had been caused by a fall in demand for technology stocks and a corresponding rise in demand for 'blue-chip' stocks. In recent days there had been a notable rise in volatility, with the NASDAQ having fallen by 16% between 24 March and 5 April and the Dow Jones having fallen by 0.7% over the same period. Increased volatility had been attributed to uncertainty about the valuation of technology stocks.

52 Sterling's effective exchange rate index had fallen slightly from 109.3 to 108.9 since the previous Committee meeting, reflecting a small depreciation against the euro and the yen, but a slight appreciation against the US dollar. Risk reversals traded in the foreign exchange market were close to neutral for sterling exchange rates. Since the previous Committee meeting there had been a number of mergers and acquisition deals (both confirmed and rumoured) which had, or were expected to, involve purchases of sterling. That had helped to support sterling, both against the US dollar and the euro.

Text of Bank of England press notice of 6 April 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

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

Text of Bank of England press notice of 4 May 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

The *Inflation Report* will be published on Wednesday 10 May.

The minutes of the meeting will be published at 9.30 am on Wednesday 17 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, plus all sterling deposits (including certificates of deposit) held at UK banks and building societies by the non-bank, non building society private sector.

M4 lending: sterling lending by UK monetary institutions (MFIs) to all UK residents other than the public sector and MFIs. M4 lending includes loans and advances as well as investments, acceptances and reverse repo transactions.

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

ACT: Advance Corporation Tax.

BCC: British Chambers of Commerce.

CBI: Confederation of British Industry.

CIPS: Chartered Institute of Purchasing and Supply.

CML: Council of Mortgage Lenders.

cob: close of business.

DETR: Department of the Environment, Transport and the Regions.

DMO: Debt Management Office.

DS: Datastream.

ECB: European Central Bank.

EU: European Union.

FTSE: Financial Times Stock Exchange.

GfK: Gesellschaft für Konsum, Great Britain Ltd.

ICPFs: insurance companies and pension funds.

IMF: International Monetary Fund.

IT: information technology.

LAPFs: life assurance and pension funds.

LFS: Labour Force Survey.

MEW: mortgage equity withdrawal.

MORI: Market and Opinion Research International.

MPC: Monetary Policy Committee.

NIESR: National Institute of Economic and Social Research.

OECD: Organisation for Economic Co-operation and Development.

OFCs: other financial corporations.

OFIFAs: other financial institutions and financial auxiliaries.

ONS: Office for National Statistics.

OPEC: Organisation of Petroleum Exporting Countries.

PBR: Pre-Budget Report.

PNFCs: private non-financial corporations.

PSNB: public sector net borrowing.

PSNCR: public sector net cash requirement.

REC: Recruitment and Employment Confederation.

S&P: Standard and Poor's.

UIP: uncovered interest parity.

WFTC: Working Families Tax Credit.

Y2K: Year 2000.

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.