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# MINUTES OF MONETARY POLICY COMMITTEE MEETING

## 8 and 9 April 1998

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These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 April 1998.

They are also available on the Internet (<http://www.bankofengland.co.uk>).

The Chancellor of the Exchequer announced on 6 May 1997 that the Government was giving the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released no later than 6 weeks after each meeting. Accordingly, the minutes of the Committee meeting held on 6 and 7 May will be published on 10 June 1998.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 8-9 APRIL 1998**

The Committee discussed recent developments with particular emphasis on the continuing rise in equity prices, the recent further appreciation of the exchange rate, the growth rate of consumer demand and the contrast between quantity and price signals in the labour market.

### **Monetary developments and the implications of rising equity markets**

1 Indicators of both broad and narrow money growth had shown signs of slowing down. The twelve-month growth rate of M4 in March had fallen to 9.8% from a recent peak of 11.9% in July 1997 and that of M0 had fallen to 6.8% in March from a peak of 7.2% the previous month. Estimates of Divisia money growth in Q1 would become available during April.

2 M4 lending to Industrial and Commercial Companies (ICCs) had accelerated in January and February. Bank staff had raised the question of whether ICCs demand for credit was being driven by a need for working capital in the face of a slowdown in activity. The Committee concluded that supporting evidence for this hypothesis seemed to be weak as yet, but that it would be worth watching.

3 Taken together, the money growth data over three months were consistent with a slower rate of growth of nominal income in the economy more widely, but were not conclusive. On the other hand, the evidence from share prices clearly went in the opposite direction. Not only had the FT-SE 100 index risen by a further 6% during March, but the upward movement had also been reflected in a wider variety of stocks than during 1997, with similar rises in the FT-SE 250 and FT-SE Small Capitalisation indices. The increase in share prices over the previous twelve months or so had contributed to a significant rise in personal sector net financial wealth. The problem was to gauge the implications for consumption of the increase in wealth held in equities

4 The size of the wealth effect on consumption from rising equity prices would depend, on a number of factors. Although direct share ownership had become more widespread, it was not clear whether this would lead to a weaker impact on consumption (if the large number of individuals with small holdings did not react) or to a stronger impact (if the gains were more widely perceived).

5 The rise in equity markets was clearly a global phenomenon. The strength of UK markets was less marked than in countries such as the United States, Germany, Italy or Spain, although measurement in a common currency boosted the UK market's relative performance. A fall in real interest rates had occurred in most of these countries and probably contributed at least a part of the rise in equity prices. Corporate mergers in the United States may also have been an influence.

6 The Committee concluded that the medium-term implications of the rise in the equity market would have to be addressed in the forecast for the May *Inflation Report*. Meanwhile the direction of the effect this month was to support consumption growth.

### **The further appreciation of sterling**

8 The exchange rate had appreciated over the month but had fallen back on the first day of the Monetary Policy Committee (MPC) meeting leaving a net appreciation of 2% since the previous meeting. The initial appreciation in the month might have been partly a reaction to the Budget - which might have strengthened a perception of sound government policy in the United Kingdom - and partly arising from continuing uncertainty about monetary developments.

9 The Committee debated whether some of the strength in sterling could be due to a re-rating of the UK economy. Market perceptions of the sustainable rate for sterling appeared to have strengthened, perhaps reflecting the United Kingdom's continuing strong economic performance. On one view, as a result, a greater proportion of sterling's appreciation might persist, and this would not necessarily have adverse effects on trade or output.

10 It was also possible that uncertainty surrounding the future monetary policy of the European Central Bank (ECB) was contributing to the strength of sterling. In this case, although some uncertainty might be removed by the announcement of appointments to the executive board of the ECB, it was likely to be fully resolved only as the market learnt about the ECB's approach to setting interest rates from 1999 onwards. The bond markets did not, however, seem to share any concerns about future European monetary policy: bond yields had generally fallen, converging on the lower German level. One possible explanation for different reactions in the foreign exchange and the bond markets was that the stability pact might have given credibility to expectations of tight fiscal policy in Europe – which might be balanced by looser monetary policy.

11 Other influences related to the creation of the single currency could not be ruled out. One was the diversification motive – as the number of currencies was reduced, those seeking to spread their portfolio might be more inclined to buy sterling, along with other non-euro currencies.

12 To the extent that the persistence of a high exchange rate was caused by these EMU-related factors then the short-run effect, via the impact on prices and net trade, would be broadly equivalent to a tightening of monetary conditions. It was therefore possible that downward pressures on inflation had been increased, without a further rise in interest rates.

13 On a further possible view, the variation in sterling was just normal volatility and the most recent movement had been downwards. Such fluctuations were unlikely to have any significant impact.

### **Demand and output**

14 Retail sales fell in February but earlier erratic factors were making it difficult to assess the underlying trend. In particular, the funeral of Diana, Princess of Wales, had affected spending in September and October 1997 and was still affecting estimates of the three-month growth rate. Seasonal adjustments over the Christmas period and record price discounting in January also made assessment difficult. There had been thirteen profit warnings from retailers since January 1998 compared with three in the same period in 1997. The Confederation of British Industry (CBI) Distributive Trades Survey for March showed a marked weakening in retail sales growth, but this survey could have been affected by the timing of Easter this year compared to last.

15 Looking at other components of consumption, private car registrations data were buoyant in Q1 and the CBI Financial Services Survey was strong. Surveys of consumer confidence continued to show positive balances, although well below the historically high levels in mid-1997 associated with the largest building society conversion payouts. Taking all the evidence together, consumption growth seemed likely to have remained robust in Q1, but some of the indicators supported the February *Inflation Report* projection that, after a strong first quarter, consumption would decelerate over the course of 1998.

16 The Office for National Statistics (ONS) revisions to the composition of expenditure in 1997 had brought the numbers more into line with what had been assumed for domestic demand growth for 1997 in the February *Inflation Report*. However, the ONS estimate of the level of GDP in 1997 had

been revised down by 0.3% and the level in Q4 by 0.2%. This left the level of GDP below that assumed as the starting point for the *Inflation Report* projections.

17 The path of GDP growth through 1997 had also altered: it now looked smoother, with less pick-up in H1 and less slowdown in H2. The growth rate in the fourth quarter was now estimated to have been 0.2 percentage points higher than previously, despite the downward revision to the estimated level in that quarter. Evidence on GDP growth in Q1 seemed to be consistent so far with the central projection in the February *Inflation Report*.

18 The output measure of GDP in 1997 H2 had been significantly depressed by the primary sectors - agriculture, energy extraction and supply - and the same might happen in 1998 Q1. The mild winter had led to weak energy demand. A measure of GDP which excluded these volatile sectors (which account for around 6% of GDP) showed growth continuing at above trend rates of around 0.8% per quarter in 1997 H2. It was not obvious how to react to this divergence. Weak production in any sector affected incomes from that sector, and recent weaker earnings data were linked to lower overtime payments for workers in the utility industries. But to the extent that such fluctuations were due to temporary climatic factors, primary sector output was likely to return to normal, boosting GDP growth in due course.

19 According to the ONS data, manufacturing output remained weak and continued to show a weaker picture than the majority of surveys. The monthly CBI and Chartered Industry of Purchasing and Supply (CIPS) manufacturing surveys were stronger, the British Chambers of Commerce (BCC) quarterly survey less so. The CIPS survey even appeared to indicate a strengthening of manufacturing growth.

20 The indicators of service sector output were more uniformly strong, despite the fact that elements of the service sector were exposed to the exchange rate appreciation, either directly through final demand or indirectly via services supplied to manufacturing. Details of the CIPS services survey suggested that the balance remained strong, with increased numbers reporting growth higher and increased numbers reporting a weakening. This suggested that the service sector was subject to diverse demand conditions in different sub-sectors. This more complicated picture was supported by the weaker surveys of retailing.

21 Capacity utilisation measures for both services and manufacturing remained above average and

robust, on both the CBI and BCC surveys. The strength of manufacturing output in the CBI survey seemed consistent with the capacity utilisation measures.

22 Overall, the Committee considered that recent domestic activity data were broadly consistent with the February *Inflation Report*. Despite the remaining data puzzles, it was fairly clear that the externally exposed sectors of the economy were suffering while the less-exposed remained relatively buoyant.

23 International news had shown the European economies continuing to recover slightly faster than previously expected and a robust US outlook, offset by a deteriorating Japanese conjuncture. The concern about a general financial crisis seemed to be receding. Recovery in Asia was now thought likely to take longer than earlier predictions but otherwise was not likely to be any more severe. Overall, there seemed to be little net change in demand conditions in UK export markets, although there was a general concern about the difficulties facing Japan.

### **The corporate sector**

24 The Committee discussed the combined evidence on the position of the corporate sector, which generally reacts to interest rate changes sooner than the household sector. One possible view was that the corporate position was weakening rather sharply. Manufacturing output was falling and exports were flat. M4 growth for ICCs had turned negative in the fourth quarter of 1997, while M4 lending to ICCs had recently risen, which could indicate cash-flow problems. The National Accounts revisions showed a downward adjustment to gross profits of almost £6bn in 1997 and the ICCs' financial balance in 1997 was negative for the first time since 1992. Retailers' margins had started to fall as unit labour costs had picked up and the exchange rate was clearly squeezing manufacturing margins. One side-effect of the Asian crisis would be to reduce income from overseas operations, partly because of lower profits in foreign currency terms and partly because of a lower sterling value of those profits. Overall there were signs of a significant squeeze on the corporate sector, which could have greater knock-on consequences for investment and employment than are currently foreseen in the *Inflation Report* forecast.

25 Counter to this was the continuing strength of the stock market to the extent that, in addition to the fall in real yields, it reflected expectations of strong future dividend growth. Furthermore, analysis of movements in import prices, unit labour costs and retail prices implied that a reduction in

profits would be a necessary consequence of hitting the inflation target unless there were a fall back in unit labour cost growth.

### **The fiscal position**

26 The Committee had been given a short briefing on the provisional net fiscal effect of the Budget at the March MPC meeting, so there was relatively little news to the Committee on the fiscal position. The main issue for the Committee was the implication of the PSBR undershoot in 1997/98 - equivalent to about 1% of GDP on current estimates - for domestic demand. It was not clear how much of the smaller PSBR was due to a higher effective tax rate and how much might indicate stronger than recorded activity in the past. If higher tax revenue was due to the introduction of self-assessment (and not just from the self-employed), some of the improvement was likely to be permanent. The unexpected strength of other components – such as VAT and corporation tax receipts - suggested stronger past expenditure or incomes. The expenditure undershoot in 1997/98 was to be made up in 1998/99 so this was a less important factor.

27 On one view there had been a significant, and partly unanticipated tightening of fiscal policy in 1997/98, which would continue to affect aggregate demand in 1998/99. On another view, the fiscal outturn could be signalling the possibility of higher activity levels than had been recorded in past data.

28 The March PSBR numbers would reveal whether the normal upsurge in government expenditure at the end of the financial year had happened.

### **Quantity versus price signals in the labour market**

29 The labour market data on quantities were signalling a tighter position than the price data. The Committee reviewed each in turn and the conclusions that could be drawn.

30 Manufacturing employment showed a surprising rise of 20,000 in January and employment intentions indicated by the Manpower survey remained well above the long-term average. The BCC survey and the Bank's Agents recorded high and rising skill shortages. The CIPS surveys showed a

flat trend for current manufacturing employment, but continuing strong growth in services employment.

31 The claimant count measure of unemployment had continued to fall in 1998, albeit more slowly than in 1997. The Labour Force Survey (LFS) data due next month would be important additional evidence on this apparent moderation of the fall in unemployment. The LFS data should also help to reconcile the claimant unemployment and employment data.

32 Price indicators gave less sign of a tightening labour market than the quantity data. Underlying average earnings growth for November and December had been revised down from 4  $\frac{3}{4}$ % to 4  $\frac{1}{2}$ % and the rate of earnings growth was estimated to have been stable at 4  $\frac{1}{2}$ % over the four months to January. Although earnings growth remained at a high level, the situation had not deteriorated as might have been expected from the quantity data. Several possible explanations were discussed.

33 On one view it took time for labour market tightening to be reflected in earnings or settlements and recent growth in employment would feed through in due course. The Committee could not afford to wait for earnings to accelerate - that would mean reacting too late. In the late eighties earnings growth had not been an early indicator of the pick-up in inflation. One had to form a judgment about inflationary pressures and that meant forming a view about unobservable variables such as the natural rate of unemployment.

34 On another view, it was significant that settlements had not picked up during the important New Year settlement period when lagged pressures from past labour market tightening might have been expected to be felt.

35 An important question was how much the natural rate of unemployment might have fallen. The short-term unemployment rate was below the level seen during the late-eighties (at the peak of the previous cycle). Current quantity indicators would be extremely worrying if the natural rate had not fallen at all. Although earnings growth over the previous twelve months had been close to the Bank's forecast in the February 1997 *Inflation Report*, unemployment had fallen faster than predicted, suggesting a more benign conjuncture, perhaps consistent with a lower natural rate of unemployment. It seemed likely that the long series of labour market reforms, particularly during the eighties, had led to a fall in the natural rate of unemployment, though it was difficult to identify what particular reforms could have caused it to fall during the last year.



36 There was no reliable estimate of the natural rate of unemployment, but some Committee members placed greater weight on the survey data relating to skill shortages or recruitment difficulties as direct estimates of the balance of supply and demand in the labour market. These indicators suggested that the labour market was already very tight.

37 The Committee went on to discuss a number of other factors which might be influencing the labour market. The appreciation of sterling might have been holding back earnings growth if labour markets were not fully integrated. As profits were squeezed in the externally exposed part of the economy so wage bargainers in those sectors would reflect this in settlements. If sterling's appreciation was expected to persist then this would result both in lower wage increases and in corporate re-structuring to improve labour productivity.

38 Another contributing factor to the restraint of earnings growth might have been the lower settlements rate in the public sector. It was not clear how long this could persist. The competitive pressure raised by contracting out previously public sector work to private sector firms might be a restraining factor on some public sector pay deals. In this case differential growth rates of earnings might be sustained for some time. Contracting out to private companies – with lower levels of earnings but faster growth rates - might widen the recorded gap between private and public sector earnings growth.

39 Shifts in employment patterns might also have contributed to a fall in the natural rate of unemployment. Employment in manufacturing had been flat or falling and there had been a huge shake-out in the privatised utilities. The rise in employment had come in the less unionised parts of the service sector. The move to more part-time and temporary jobs would also have been an influence. There was no longer any sign of large manufacturing companies - such as car manufacturers - setting a pay-round 'norm'. Services settlements tended to be more related to the firm's own profits and, in some cases, could be influenced more by public sector comparisons rather than by manufacturing settlements. And even in manufacturing, unions were now more aware of the competitive pressure on companies and anecdotal evidence reported that this was being reflected in negotiations.

40 In the United States, the benign labour market conditions seemed to have been supported by strong productivity growth, especially in manufacturing. That may have reflected a lagged effect

from new technology – especially Information Technology. In the United Kingdom there was no evidence yet of strong productivity growth. Indeed, weak measured productivity growth during the upswing implied higher unit labour costs.

41 Finally, it was possible that the better-than-expected combination of unemployment and earnings reflected a fall in inflation expectations. This was consistent across various surveys, although the general public's inflation expectations were still significantly above the Bank's inflation target of 2½%.

42 Taken together, the quantity signals appeared to indicate a tightening of the labour market and some surveys suggested that the tightening would continue. The problem was in judging where the natural rate of unemployment lay. On one view, the subdued behaviour of earnings was encouraging evidence that the natural rate of unemployment might be lower than had previously been thought, though this could be affected, as noted at the March MPC meeting, by the prospect of a National Minimum Wage.

## **Prices**

43 The news on prices remained benign. The oil price had fallen further and world commodity prices generally remained weak. UK producer price inflation was flat. Retail prices had been much as expected, showing a bounce back from January's record discounting.

44 Looking forward, changes in petrol duties announced in the Budget and implemented immediately meant that the level of retail prices would be temporarily boosted by as much as 0.3 percentage points. This would remain in the twelve-month inflation figures from April to June, until the previous duty increase dropped out in July. In the interim it was possible that the RPIX inflation rate could reach 3% and the RPI inflation rate 4%. The Committee was clear that it should not try to offset such short-term fluctuations reflecting the timing of indirect tax changes associated with the fact that the 1998 Budget was in March and the 1997 Budget was in July. The MPC's inflation forecasts incorporated the Government's plans for increasing duties on alcohol and tobacco every year in real terms as detailed in previous *Financial Statement and Budget Reports*. The March Budget announcements on excise duties affected the expected timing of tax effects, but did not alter the Committee's views of the inflation rate in two years time.

## **The immediate policy decision**

45 The Committee started its discussions on the policy decision by reviewing the possible impact on financial markets of various choices. The markets were expecting no change this month with a small probability attached to an increase. A decision to leave rates unchanged might therefore have a small effect. It was thought that a rise would be a surprise to the markets but there were differing views as to the impact this would have on the exchange rate. A decision to cut would be regarded as a big surprise given the February *Inflation Report* and would require strong justification to be accepted as being consistent with the inflation target.

46 Moving to the immediate question of whether to change rates this month, the economy appeared to be broadly on track with the central projection published in the February *Inflation Report*. The weakening of the net trade position seemed to be firmly established and the main issue had been the projected path of a slowdown in consumer demand after a robust first quarter. The available information on Q1 seemed to broadly support the projections. Quantity indicators of activity in the labour market and in the money data were also reasonably consistent with the central projection. The main news on the month concerned the continuing rise in share prices, the appreciation of the exchange rate, the implications of the Budget and the slightly better-than-expected earnings data.

47 Given that the February *Inflation Report* suggested that it was more likely than not that interest rates would need to rise in order to hit the inflation target, on one view the arguments for an increase had not diminished. On this view, the economy was still operating at a level above that consistent with hitting the inflation target. Domestic demand was growing too rapidly to achieve the necessary slowdown in activity. Inflation had been temporarily depressed by the appreciation of the exchange rate but it ought to have fallen further. It was most likely that inflation would start rising once the effect of the appreciation wore off. The balance of risks was still on the upside and there remained particular risks from cumulative strong money growth and possible depreciation of the exchange rate.

48 On this view, the news on the month did not significantly alter the case for a rise in rates. The continuing rise in equity prices was likely to support robust consumption growth, even if the precise magnitude of its influence was unclear. The Budget had not contained much news for the Committee and the variation in the exchange rate was no more than usual month-to-month volatility. And to the extent that the rise in the exchange rate reflected an improvement in UK competitiveness

or a shift in demand for UK goods, this would not have the effect of tightening monetary conditions. The quantity data and direct indicators all suggested that the labour market was continuing to tighten. On this view, if one waited for the earnings data to show signs of clear inflationary signals then the appropriate policy response would be delayed too long.

49 Further evidence in favour of a rise in rates was the robust picture of GDP growth excluding the more variable primary sectors. In particular, to the extent that a mild winter had temporarily depressed (seasonally adjusted) energy output, a rebound would boost GDP growth in due course.

50 An alternative view was that the need for a rise in rates had been offset by the news over the month. The further appreciation of the exchange rate could have delivered a tightening, possibly in excess of that yielded by a quarter percentage point rise in interest rates. And some members concluded that the Budget implied a tighter fiscal position - certainly for 1997/98 and possibly spilling over into 1998/99 - than perceived at the time of the February *Inflation Report*.

51 In addition, the weaker-than-expected earnings growth had helped to offset concerns about inflationary pressures in the labour market, although earnings growth remained at a level which was only just consistent with hitting the inflation target. The upside risks to the central projection identified in the February *Inflation Report* had not so far materialised and leading activity indicators suggested that the expected slowing down of the economy was taking place. Furthermore, the level of GDP in 1997 had been revised downwards so that any output gap above trend was less than previously thought.

52 The central projection for inflation in the February Inflation Report had only just been above 2 ½%. On one possible view given subsequent developments, particularly the Budget and the rise in the exchange rate, a case could be made for a cut in interest rates to rebalance the overall policy setting. But the evidence on the pace of the domestic slowdown in demand was not yet sufficiently clear to persuade any members of the Committee to advocate a cut this month.

53 Members discussed the timing of any interest rate move. On one view it was a bad time to raise rates. Sterling was strong, creating an unbalanced economy, and this would be exacerbated by a further move now. Retail prices would show a spike from excise duties in the second quarter and the RPI would be further boosted by a rate rise now. The February *Inflation Report* central projection was for growth in the UK economy to slow during 1998. Against this background and given current

projections, it could be argued that the costs of waiting a few months, in terms of any additional tightening that proved necessary, would be small. Finally, the *May Inflation Report* round was just about to start and that would provide a fresh opportunity to assess medium-term inflationary pressures and the attendant risks.

54 An alternative view in favour of an immediate rise was that the data were broadly confirming the outlook published in the *February Report* and that a failure to move sufficiently rapidly would require a larger correction in due course - perhaps at a time when growth in the economy was already slowing. On this view, the cost of reversing policy, should that prove necessary, would simply be to accelerate the return to a sustainable growth path. It was also possible to argue that a delayed increase could add more to the imbalance in the economy than an immediate move.

55 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be left unchanged this month. Five members of the Committee (the Governor, David Clementi, Charles Goodhart, DeAnne Julius and Ian Plenderleith) voted for the proposition and three (Alan Budd, Willem Buiter and Mervyn King) voted against, preferring an immediate increase in interest rates.

56 The following members of the Committee were present:

Eddie George (Governor)

David Clementi (Deputy Governor)

Alan Budd

Willem Buiter

Charles Goodhart

DeAnne Julius

Mervyn King

Ian Plenderleith

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

## **ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF**

A1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 3 April 1998, in advance of its meeting. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

### **I Monetary conditions**

A2 The annual rate of notes and coin growth had slowed slightly in March to 6.7%. Narrow money had broadly been growing in line with nominal consumption during 1997 and into 1998, at a rate of 6%-7%. This followed a period of negative notes and coin velocity growth.

A3 M4 rose by 0.8% in February, compared with 0.3% in January. This increase reflected a bounceback in repo activity. But the annual rate had nevertheless edged down from around 12% in mid 1997 to less than 10% in February.

A4 Personal sector M4 growth of 0.3% in February was slightly weaker than in previous months. Unusually large income tax payments in January and February, in particular due to the new self-assessment scheme, may have accounted for some of the recent weakness.

A5 ICCs' M4 annual growth rate had fallen further in February, to 5.1%, but the three-month annualised rate (3.5%) and the six-month annualised rate (-1.7%) were both lower. As a result, staff estimates of the liquidity gap in the corporate sector had become more negative in the last quarter of 1997. The sharp fall in ICCs' M4 growth since the autumn of 1997 had been in line with behaviour in previous cycles.

A6 OFIs' M4 had grown strongly in February (by 2.8%), largely as a result of repo activity. Staff estimates of the liquidity overhang for a subset of OFIs - the life assurance and pension fund sector (LAPFS) - remained large and positive in 1997 Q4. But survey evidence suggested that LAPFS had started to run down cash balances relative to their total portfolio during 1998, perhaps providing an upward impetus to asset prices.

A7 M4 lending had risen strongly in February, partly reflecting stronger reverse repo activity. Total personal sector lending growth, at 7%, had been in line with recent months. Since October 1997, growth in secured lending to the personal sector had slowed slightly, in line with a gradual slowing in some indicators of housing market activity (eg the RICS indicator of property sales) and prices. Council of Mortgage Lenders data suggested that remortgaging had picked up slightly in 1997 Q4. Through 1997, remortgagees had switched to fixed-rate mortgages, probably

reflecting the inversion of the yield curve. Total unsecured lending to individuals had risen by 1.2% in February, a little lower than in December and January but broadly in line with the average for 1997. Annual growth remained around 16%. Rates charged on credit cards and in particular on personal loans had fallen relative to official rates during 1997, perhaps reflecting extra supply as new firms entered the market.

A8 ICCs' M4 lending had risen sharply by 1.7% in February. It had been higher in the first two months of 1998 than in 1997 as a whole. One possible explanation was that ICCs' cashflows might have tailed off (which was consistent with survey evidence), prompting an increase in borrowing to finance working capital requirements or maintain planned investment (again, consistent with some recent survey evidence). Other possible explanations included borrowing to pay corporation tax payments, although they had largely been made in January; borrowing to finance merger and acquisition activity, which seemed to have picked up in 1998 but mainly affected financial and overseas firms; and borrowing to repurchase equity.

A9 On price developments, there had been little change on the month in bank savings rates and secured loan rates. Credit card and overdraft rates had also been unchanged, but personal loan rates had fallen slightly on average. In the past year, savings rates and variable mortgage rates had risen broadly in line with the repo rate. But overdraft and personal loan rates had fallen, which, together with the entry of new firms, was consistent with increased competition in the unsecured lending market. Changes to mortgage interest tax relief had increased effective mortgage rates from April 1.

A10 In the money markets, expected three-month interbank rates implied by sterling futures contracts had changed little since the previous MPC meeting. A profile of falling rates remained priced into short sterling futures, with the December 1999 contract implying nominal rates of around 6¼-6½%.

A11 Long-term inflation expectations derived from the gilt-edged market had also changed little from the previous MPC meeting. Inflation expectations had been on a downward trend since May 1997, but appeared to have stabilised at around 2.7% in recent months. Short-term inflation expectations derived from opinion surveys had nudged down in March, and were around 20-30 basis points lower than in December. Evidence from the Consensus survey suggested that inflation expectations of business economists had fallen during 1997, but this fall was less clear in other survey measures and in short-term expectations derived from the gilt-edged market. Recent falls in price expectations of the general public derived from the BASIX and GFK surveys did not show a clear downward trend, and they remained well above those of business economists.

A12 Estimates of short-run real interest rates, derived by combining nominal interest rates with survey estimates of inflation expectations, suggested that real rates had fallen by around 20 basis

points since December, following rises during 1997. Short-run real rates derived from index-linked gilt prices had fallen by a similar amount since December, despite a slight rise since the previous MPC. Australian and Canadian real yields had also fallen. US real yields had not, although the US index-linked market was set up recently and the liquidity premium attached to the initial issue of index-linked debt might now be diminishing.

A13 The sterling ERI had risen by 1.9% since the March MPC meeting, and the broader measure, incorporating exchange rates against 49 foreign currencies, had risen by 1.4%. The forward path of the ERI implied by uncovered interest parity had been broadly unchanged, but was at a higher level than assumed in the February *Inflation Report*. Estimates by Bank staff suggested that the fundamental equilibrium exchange rate had risen slightly between August 1996 and end 1997, but the appreciation in the real effective exchange rate had been considerably larger.

## II Demand and output

A14 The quarterly National Accounts for 1997 Q4 had included a number of revisions as far back as 1996 Q1. The revisions affected the expenditure and income composition of GDP more than the output measure. The main upward revisions to expenditure in 1997 had been to consumption and investment, by £1.5 billion and £1.7 billion respectively. But downward revisions to government consumption and to net trade in goods and services left the level of GDP in 1997 0.3% lower than before. The most notable revisions to income had been to gross trading profits of companies in 1997, which were now £5.7 billion lower. That had resulted in the first annual financial deficit for industrial and commercial companies since 1992, partly reflecting the introduction of the windfall tax in 1997.

A15 The revisions to GDP had reduced the pick-up in activity in 1997 H1 and the subsequent slowdown in the second half of the year. The growth rate of GDP in 1997 Q4 had been revised up from 0.4% to 0.6%, though this still left the level of GDP in 1997 Q4 0.2% lower than previously estimated. The upward revisions to investment had led to a rise in the investment/GDP ratio, though it remained below its historical average. Business investment (around 2/3 of the total) had accelerated in 1997 and was now significantly above its historical share of GDP. Overall, the National Accounts picture was closer to what had been expected at the time of February *Inflation Report*. The data continued to show a clear divergence between external and domestic demand.

A16 The 4.6% rise in consumers' expenditure in 1997 had been the strongest since 1988, and had been similar to the rise in real personal disposable income. Most notably, expenditure on durable goods had risen by 11%.

A17 The 1.2% fall in retail sales volumes in February had supported the view that January's 1.8% rise reflected historically sharp price discounting. Private car registrations had grown very strongly



in the first two months of 1998 Q1, and were 20% higher in the three months to March than in the same period in 1997.

A18 Consumer confidence had slipped further in March, according to the GFK survey, to a balance of 1.8%, above the average in the last few years, but lower than the windfall-boosted balances in mid 1997. But the balance of consumers who thought that it was advantageous to make a major purchase remained high. Net consumer credit was still rising as a proportion of disposable income. The annual rate of increase in both the Halifax and the Nationwide house prices indices had declined in March, and particulars delivered had fallen for the fourth consecutive month.

A19 Total investment grew by 1.0% in 1997 Q4, and was 5.9% higher than a year earlier. Service sector investment continued to grow strongly, but manufacturing investment had fallen by 3.6% on the quarter. By asset, purchases of aircraft had played a significant role in the rise in service sector investment in 1997 as a whole, but property-related investment had also risen strongly.

A20 The current account had remained in surplus throughout 1997, and had recorded the first annual surplus since 1985. But the balance of trade in goods and services had deteriorated sharply in the second half of 1997 in real terms, detracting 0.8 percentage points from GDP growth in 1997 Q4. Excluding oil and erratics, there had been a fall of 2.9% in UK export volumes in January, but import volumes had fallen by 3.5%, implying a positive contribution from net trade. The level of underlying export volumes in January was no higher than in June 1997, despite growth in the UK export markets of more than 4% in 1997 H2.

A21 The deterioration in the UK balance of trade in goods was entirely due to a worsening in the deficit with non-EU countries, with one third accounted for by a widening deficit with East Asia (excluding Japan). Trade balances with EU countries were either stable or had been improving, with a narrowing of the aggregate deficit with the EU countries in the second half of 1997. This was largely accounted for by a fall in import volumes towards the end of 1997 and the beginning of 1998. Notwithstanding concerns about the validity of the EU/non-EU price-volume split, the drop in imports from the EU countries was hard to understand, given the size of the appreciation of sterling against EU currencies and the relative buoyancy of UK domestic demand. The US experience had been similar, showing a slight improvement in its trade balance with the EU countries (excluding the United Kingdom).

A22 Revisions to the 1997 Q4 output data had further increased the split between above-trend growth in service sector output and falling manufacturing output. Manufacturing output had fallen by 0.5% in Q4 and total industrial production fell even more sharply, by 1.1%, reflecting weak energy output. The split had continued in 1998 Q1: manufacturing output had grown slowly in

January and was virtually flat in February, making a second successive quarterly fall likely. That contrasted with the relatively buoyant survey evidence, which had continued to suggest slowing but positive output growth. CBI output expectations had picked up during 1998 Q1, and the Chartered Institute of Purchasing and Supply (CIPS) survey for March had reported the strongest rise in manufacturing output since May 1997. The CIPS survey for the service sector had shown no sign of deceleration in output growth. The British Chambers of Commerce survey also suggested continued strong service sector growth in Q1.

A23 The National Institute of Economic and Social Research had begun to publish a monthly estimate of GDP. That had shown a projection for GDP growth of 0.5% for 1998 Q1. Much of the recent slowdown in GDP had been accounted for by falling energy and agricultural output. Excluding these more volatile primary sectors, there had been very little slowdown in GDP growth in 1997 H2. Construction output rose by 1.4% in 1997 Q4, and rising new orders data suggested that the recovery had continued so far in 1998. That was supported by the results of a new CIPS survey on construction, and reports from the Bank's Agents.

A24 In March, the Agents undertook a special inquiry into investment intentions. The survey covered 128 firms from the manufacturing, services, agricultural and construction sectors. The results showed that investment intentions for 1998 were generally positive. A balance of around 20% of service sector firms said that they intended to increase investment, and a significant proportion had strengthened their intentions in the past six months. Manufacturing firms were less optimistic, though the balance expecting to raise investment in 1998 was (perhaps surprisingly) positive. The need to spend more on training and skills was a key reason given for increasing investment. There was a more mixed emphasis on investment to increase cost efficiency, and noticeably less need for investment in plant and machinery.

A25 There was a short summary of the Budget. Successive forecasts for the PSBR (excluding the windfall tax) in 1997/98 had been revised down from 1.7% of GDP in the July 1997 Budget to 0.6% of GDP in the March 1998 Budget. The largest component of the Budget undershoot for 1997/98 had been higher-than-expected revenue, which contributed £5 billion of the £7 billion undershoot from the November 1997 Pre-Budget Report. Further fiscal tightening was in the pipeline: a structural surplus was expected by 1999/2000; the 'Golden Rule' might be met in 1997/98, and would definitely be met in 1998/99; and the ratio of debt to GDP was falling. The Code for Fiscal Stability had been designed to lock in the gains.

A26 The Budget measures had been broadly neutral in macroeconomic terms. The thrust of the Budget was to improve supply-side performance through microeconomic reforms, with changes to National Insurance; the introduction of the Working Families Tax Credit; abolition of ACT; lower corporation tax; and reforms to Capital Gains Tax.

### III Labour market

A27 Indicators of labour demand had continued to show strong growth. Total employment growth (based on the ONS Workforce in Employment measure) increased by 150,000 (0.6%) in 1997 Q4. And the increase for 1997 Q3 had also been revised up, from 73,000 to 107,000. In the whole year, the employed workforce increased by 438,000 (1.7%). The number of employees in employment rose more quickly than total employment: an increase of 171,000 in 1997 Q4, and 513,000 in the whole of 1997. The fall in self-employment during 1997 was at least partly caused by a change in the employment status of construction workers for tax purposes.

A28 The majority of new jobs had been created in the service industry, where employees in employment had increased by more than 2% (367,000) in 1997, a similar figure to 1996. The number of production sector employees had been virtually unchanged in the past two years. More recent data for manufacturing had shown a large increase (21,000) in the number of employees in January. But this series was erratic and prone to revision. The trend in manufacturing employment was probably flat.

A29 The CIPS survey data suggested that manufacturing employment might have fallen marginally in March. But its service sector survey suggested strong employment growth; the index in March was the highest since August 1997. The CIPS construction report also showed an increase in employment: its March number was the highest since May 1997. This sectoral picture was broadly confirmed by reports from the Bank's Agents.

A30 Recruitment intentions had also remained strong, according to the recruitment company Manpower. Manpower's survey of companies, which looked ahead to the second quarter of 1998, showed that recruitment intentions were at their highest level for nine years. Intentions were particularly strong in consumer-led industries (leisure, retail, transport and other distribution). Perhaps surprisingly, manufacturing intentions had also remained strong.

A31 Claimant unemployment fell by 14,000 in February, to 4.9%. There was a similar fall in January, when the claimant count was thought to have been artificially low owing to an early count date. So it appeared that the pace of decline in the claimant count was slowing.

A32 But there had been clearer signs of a bounceback in the stock of unfilled vacancies, which had been similarly affected by an early count in January. After the sharp decline in January, new notifications of vacancies had increased in February to 224,000, similar to the average level in the second half of 1997. But the increase was probably related to the artificially low January figure, so the trend was probably downwards.

A33 There was a contrast between the strong growth in employment and the falls in the numbers of claimant unemployed. In 1997 Q4, the Workforce in Employment measure had increased by 150,000, but the claimant count had only fallen by 63,000. The apparent paradox had continued into 1998: surveys suggested that employment growth was still strong, but the decline in claimant unemployment had slowed further. Some possible explanations were considered. The increase in the population of working age could account for some 32,000 each quarter of the extra employment. Another possibility was that the Workforce in Employment measure exaggerated employment growth, though this seemed unlikely given that the surveys corroborated the strong numbers. A further possibility was that the claimant count might be underestimating the degree of labour market tightening. If many non-claimant searchers were finding jobs, this would reduce the Labour Force Survey measure of unemployment by more than the claimant count. The new Labour Force Survey data to be released in April would clarify this. The final possibility was that previously inactive people were being encouraged to seek work and taking the additional jobs.

A34 Reports from the Bank's Agents suggested that skill shortages among their contacts had remained high. Other surveys also suggested that skill shortages remained a problem. The Enterprise Barometer, published this month by the investment company 3i, asked firms about their largest problems. From a sample of 450 respondents, skill shortages came top of the list, with 22% of respondents citing it as their biggest problem. More than half the firms responding said they were facing skill shortages, and of these, 61% reported them as a real barrier to growth. CIPS surveys suggested that skill shortages might be intensifying. The service sector survey noted that firms were having difficulties filling low-skilled as well as high-skilled vacancies. And despite the strongest rise in employment for eight months, labour shortages had added to a backlog of work. According to this survey, higher rates of pay were increasingly needed to retain and recruit staff. The CIPS construction survey noted a further fall in the availability and quality of subcontractors in recent months.

A35 Whole-economy underlying earnings growth had been flat at 4½% for the four months to January; November and December having been revised down by a ¼ percentage point since the March MPC meeting. Smoothing the series to allow for the effects of bonuses gave two results. The Kalman Filter method showed earnings growth unchanged at 4.5% between December and January. Adjusting for large sectoral movements, the estimates rose to 4.7% from 4.5%, probably because bonus payments were higher last year.

A36 Bank calculations, based on National Accounts data for 1997 Q4, revealed a sharp pick-up in real product wages; the four-quarter growth rate was faster than that of the real consumption wage, reversing a recent trend. If this were sustained and not revised, it could be a factor pushing up overall real wage pressure, because at a given demand for hours worked there would be lower effective supply. But much of the recent movement in real product and real consumption wages was caused by a marked slowing in the rate of increase of the GDP deflator relative to the Tax and

Price Index. The GDP deflator had recently been revised down significantly, and was prone to further revision.

A37 Productivity growth in the year to 1997 Q4 slowed, as GDP growth fell and employment continued to grow strongly. Slower productivity growth was leading to higher increases in unit wage costs: 3.8% in 1997 Q4, the highest since 1992. Unit wage costs were growing faster than prices, which implied a falling profit share.

A38 The Bank database now included wage settlements for January, covering 80% of employees who normally settle in that month. The level of settlements had been flat in recent months, but was  $\frac{1}{2}$ - $\frac{3}{4}$  percentage point higher than a year ago.

#### IV Prices

A39 The Bank's commodity price index had fallen again in February, largely because of lower oil prices (down by more than 6% in February). Oil prices had subsequently recovered slightly following the OPEC deal to cut production with effect from 1 April. But relative to the RPI, oil prices were around the same as in 1972, before the first oil price shock.

A40 UK input prices had continued to fall in February, reflecting the weakness in commodity prices. And the CIPS survey suggested another fall in March. Output prices remained flat: annual inflation measured by producer prices excluding taxes had been 0.2% in February. And the balance of firms in the CBI Survey expecting to raise prices in the next four months had fallen from -6 in February to -11 in March. Despite falling input prices, Bank estimates of manufacturers' domestic margins had narrowed recently, because of rising unit labour costs. Exporters' margins had fallen for around two years because of lower export prices. But prices of exported goods had risen by 0.5% in January (non-oil, not seasonally adjusted), and the annual deflation rate appeared to be moderating. Import prices had also risen, by 0.3% in January (non-oil, not seasonally adjusted).

A41 RPIX annual inflation had risen to 2.6% in February from 2.5% in the previous month. Goods inflation had picked up to 2% in February as the effects of discounting in the January sales wore off, but service price inflation remained much higher, at 2.8%. Bank estimates of retailers' margins had fallen slightly in 1997 Q4 because of higher unit labour costs. But margins were still estimated to be wider than a year earlier.

A42 There had been a large differential in annual inflation as measured by the retail sales deflator and inflation measured by RPIX goods excluding petrol and cars. The retail sales deflator is constructed using RPI data but is based on 1992 weights, whereas the RPI weights are updated and fixed for each year, which might account for some of the difference. The retail sales deflator

appeared to have placed higher weight on low food prices in 1997.

A43 There was also an increasing differential (around 1½ percentage points in February 1998) between goods inflation as measured by RPIX and by the Harmonised Index of Consumer Prices (HICP). That had been mostly because of the use of a geometric mean for averaging prices in the HICP, whereas RPIX used an arithmetic mean. This effect was probably exaggerated by the variance of prices during the post-Christmas sales. The annual inflation rate of the GDP deflator had been revised down to 1.3% per annum in 1997 Q4, from 2.1%.

A44 Looking ahead, the increase in petrol duties in the recent Budget was likely to add around 0.3 percentage points to RPIX inflation in April. In July, last year's rise in petrol duties would drop out, which was likely to reduce RPIX by a similar amount. And a number of other tax effects on RPIX inflation during the next few months meant that RPIY inflation would be a better indicator of the trend in price changes in this period.

## V Financial markets

### *Foreign exchange*

A45 March was busier than February in the foreign exchange markets. Sterling strengthened by 3% during the month (but against a background of declining volatility until late in the period). By 31 March, the appreciation of sterling had taken it to its highest for ten years in effective terms.

A46 A range of factors had been cited by the market to explain sterling's rise in the month: a perception that the Budget had done little to take pressure off monetary policy; further 'safe-haven' EMU flows; occasional rises in the oil price as OPEC attempted to reach agreement; and the dismissal of the Russian government. Much of the activity in sterling had occurred around the Budget; sterling strengthened sharply during the speech as short-term interest rate expectations were also revised up sharply. The next day, short-term interest rate expectations had fallen in response to weak data, but sterling continued to strengthen. From that point on, there had been more talk of a re-rating of sterling.

A47 Uncertainty measured by implied volatility on sterling currency options had been trending down against both the dollar and the Deutsche Mark until 30 March, after which it picked up slightly. And the implied volatility for a simplified sterling ERI had also been trending down until 30 March. Risk reversals showed that the probability attached to the prospect of future sharp falls in sterling against the Deutsche Mark had fallen relative to the probability of future sharp rises up to a one-month horizon. Meanwhile, the market's 90% confidence band for the £/DM exchange rate one month ahead was now 23 pfennigs, compared with 33 pfennigs when sterling peaked in the summer. The implied correlation between £/\$ and DM/\$ had not changed much during the

past two months but, at 0.65, had recovered a substantial part of the decline during sterling's appreciation from August 1996 to April 1997.

### *Bond and money markets*

A48 Money-market rates were little changed over the month. Par gilt yields had fallen during the month, by about 30 basis points at ten years.

A49 Short-term interest rate expectations derived from futures prices had changed little on the month in the United Kingdom, United States or Germany. In the United Kingdom, much of the news had occurred around the middle of the month at the time of the Budget, when short-rate expectations were revised up by about 10-15 basis points, though much of that was unwound on the following day given weaker-than-expected data and the Chancellor's comments to the effect that the MPC had been told the broad stance of the Budget at its March meeting. The money-market yield curve had remained downward-sloping. Anecdote suggested that many in the market expected rates to be left unchanged through the summer and early autumn, and cut towards the end of the year. The recent flattening of the money-market yield curve had been unexceptional by past standards, but had been more marked than in the United States.

A50 Gilts outperformed most international markets during the month. The continued benign outlook in the United States helped the UK market. Towards the end of the month, continued sterling strength was thought to have supported gilts relative to foreign markets. Real yields on index-linked bonds were little changed during the month, with a slight fall at the longer end.

### *Equity markets*

A51 The UK equity market had tracked the US market closely in local currency terms since the previous MPC meeting. The Nikkei 225 had fallen during the month, with apparent attempts to support the market before the financial year-end proving unsuccessful. Price/earnings ratios were at historically high levels in most of the major equity markets, except Japan.

A52 Since July 1997, the UK equity market had risen by about 27%, while 20-year real spot yields had fallen by about 80 basis points. So much of the rise in the UK equity market might be 'explained' by the fall in the real rate at which future profits were discounted, assuming that everything else was unchanged. In the United States, there had been little change in real yields on index-linked bonds in that period. But in Europe, falling real yields did seem to have been a factor alongside accelerating growth. If a falling real discount rate explained the rise in the UK market since July, then it was possible that the strength of the UK equity market during this period might not be saying much about the strength of the economy. Also, the implication of increased equity

wealth for consumption would be uncertain.

The general retailers' sector of the FT-SE All Share index had fallen by 10% relative to the total index since the start of the year. The underperformance had been accompanied by a number of profit warnings (out of 50 firms in the sector, 13 had issued warnings in the current year, compared with 3 last year) and a bias towards downward revisions in analysts' earnings forecasts for 1998/9 in the past three months. But only five companies cited consumer demand as a reason for their profits warnings; other reasons given included sterling's strength; unseasonal weather; expenditure switching and firm specific factors. Overall, therefore, the underperformance of the retailers' sector could not be clearly linked at this stage to an earlier-than-expected slowdown in consumer demand.