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MINUTES OF MONETARY POLICY COMMITTEE MEETING

7 and 8 January 1998

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 January 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 5 and 6 February will be published on 11 March 1998.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 7-8 JANUARY 1998

1 The meeting was preceded by a presentation by Bank staff of the most recent data on monetary and economic conditions. The staff presentation is summarised in the Annex to these minutes; it has been updated to incorporate data that subsequently became available to the Monetary Policy Committee before its meeting.

Is the economy slowing in line with the November central projection?

2 The Committee began by discussing recent economic indicators and comparing them with the central projection in the November *Inflation Report*.

3 Members noted tentative signs of deceleration in broad money, and the rather clearer signs of deceleration in credit. The slowdown in credit to ICCs had been particularly clear, even if the most recent figures proved to be erratically low. By contrast unsecured personal credit growth had moderated only slightly and remained strong. The Committee thought that there was not much news in the latest money and credit data.

4 The Committee turned next to domestic demand. The ONS had revised the estimated growth rate of consumer spending in 1997 Q3 downwards from 1.2% to 0.7%. Spending in September had been depressed after the death of Diana, Princess of Wales, but retail sales had bounced back in October and that would support consumer spending in Q4. The Agents' reports suggested that retail sales had been below expectations in the first three weeks of December; and that unwanted stocks had been building up, which could depress retail prices and perhaps output in 1998. Reports of sales since immediately before Christmas suggested that demand had strengthened, however. Consumer confidence had fallen since the summer, though it was still high. In the housing market, activity indicators remained fairly flat. The divergence between the Nationwide and Halifax measures of house price inflation had widened further still in December: the Bank's index, based on Land Registry data which were available only up to 1997 Q3, did not indicate a rising rate of house price increase in Q3. The investment figure for Q3 (a fall of 0.5%) seemed surprisingly weak but the Committee noted that revisions to this estimate were often large.

5 Some other aspects of the third quarter national accounts were difficult to understand - for example the rise of 1.4% in government consumption in Q3 seemed hard to reconcile with the increase of only 0.2% in the output of government and other services.

6 The Committee discussed external trade next. Net exports had increased slightly in 1997 Q3, though the increase was more than accounted for by oil and erratic items. Net exports had changed very little between 1996 Q3 and 1997 Q3. Monthly figures showed a widening of the deficit on trade in goods since September: it was curious, given relative exchange rate movements, that the widening was concentrated in trade with non-EU countries.

7 As to output, GDP growth in Q3, which had been revised down to 0.8%, had been a little lower than the November central projection. The central projection was for an increase in the rate of growth in Q4, followed by a sharp slowdown to below trend growth in 1998 Q1. Members discussed the likely pattern of growth in the light of the latest information. One view was that growth in Q4 would be higher than in Q3, influenced by a rebound in consumer spending following the death of Diana, Princess of Wales. Another was that growth might have reached a peak in 1997 Q2, and that, with none of the major demand components accelerating, the economy had begun to slow down earlier than expected. Some members doubted whether growth would slow down as sharply at the beginning of 1998 as the central projection indicated, citing business surveys which did not suggest that such a sharp slowdown was imminent.

8 The Committee discussed labour market developments. The quantity indicators showed continued tightening, though there were some signs that the pace of tightening had fallen. Surveys suggested that demand for labour was continuing to grow. The welfare-to-work programme was unlikely to enlarge the supply of labour much in 1998 H1. Some members were concerned about the outlook for earnings. They drew attention to the Agents' survey which pointed to higher settlements this year than last; they also suggested that, as the economy slowed down, productivity growth was likely to fall, and unit labour costs to accelerate.

9 A number of other views were expressed. One was that the latest information on pay was consistent with the November central projection, which had incorporated some acceleration in earnings during 1998. A second was that it was not clear that unemployment had yet fallen to the natural rate. Many quantitative labour market indicators, such as hours worked and the activity rate, were still well below the levels they had reached at the previous cyclical peak although it was admitted that those levels had been too high to be compatible with stable inflation. Some members commented that the participation rate was relatively low, suggesting that employment could increase further without inflationary consequences, but others, who thought that unemployment had fallen to a level close to the natural rate, drew attention to the negative short run effects that the expansion of higher education had had on the supply of labour. The much lower regional dispersion of unemployment suggested that the economy might have become more efficient at using labour, and labour market reforms were likely to have led to a fall in the natural rate of unemployment.

10 Members discussed the effect of increases in interest rates on headline RPI inflation and hence on pay bargaining. They recognised that in the short term an increase in interest rates could perversely have a positive effect on pay. Members did not think that effect should affect policy decisions, though interest rates might have to rise further to achieve a given reduction in inflation, thus increasing the transitional cost in foregone output.

11 In sum, there seemed to be some tentative evidence that the economy was slowing down and that it might have grown a little less fast than expected at the time of the November *Inflation Report*.

Why is inflation not falling?

12 The Committee noted that over the last six months or so, inflation outturns had been consistently higher than the short-term forecasts in successive Inflation Reports; there had been no significant moderation in RPIX inflation. As discussed at previous meetings, it appeared that the effects of the exchange rate appreciation on domestic prices thus far had been weaker than expected: pass through had been incomplete in import prices, producer prices and retail prices.

13 This meant that margins had widened, including retail margins, and members discussed why that might have occurred. One possible explanation was that it reflected the strength of consumer demand. If that explanation was correct, margins would be likely to narrow as demand growth slackened. Another possible explanation was price stickiness - ie slowness in adjusting prices in the face of changes in costs in either direction. And another was the extent of competition among retailers, which was perhaps lower than in the United States, where consumer price inflation had recently fallen, despite strong consumer demand. Some members, while recognising that higher margins would have only a temporary direct effect on price inflation, were nevertheless concerned that they might influence labour costs through the effect on the RPI.

14 It was possible that the incompleteness of pass-through was partly explained by a belief that the exchange rate appreciation would not persist. If that belief proved accurate and the exchange rate appreciation were to be partly or fully reversed, prices would not rise as a result. If it proved inaccurate and the current exchange rate level was sustained, then the pass-through would eventually be completed.

15 A gloomier possible interpretation of recent inflation behaviour was that the underlying rate of inflation was well above the inflation target - say in the range 3-4%. On this view, the exchange rate appreciation had been passed through, but its effect had been offset by the upward pressure on inflation resulting from the recovery of output back to or above trend. Members noted that, despite the appreciation of sterling, the UK had the highest inflation rate in the G7, based on national indices. Based on the Harmonised Index of Consumer Prices the UK's inflation rate (2.0% in

November) did not stand out among EU countries, however, even though the UK was at a different phase of the economic cycle.

What is the likely impact of the Asian crisis?

16 The Committee discussed the Asian crisis and its likely effect on the UK. Recent forecasts from the IMF and the OECD suggested that Asian developments might depress GDP in Europe by around ¼% -½% in 1998. Developments since the forecasts were finalised in mid-December (IMF) and mid-November (OECD), suggested that the contractionary effect might turn out to be larger than that.

17 One view expressed in the Committee's discussion was that the degree of weakening in domestic demand which the forecasts had assumed in the Asian countries immediately affected by the crisis was markedly less than that which Mexico had experienced in comparable circumstances in 1995. It would be surprising if demand in the immediately-affected countries grew as fast as the forecasts suggested. Moreover it was easy to imagine that GDP growth in Japan this year might be much weaker than the IMF and OECD forecasts of 1.1% and 1.7% respectively.

18 Members commented that the very large recent depreciations of real exchange rates in the Asian countries most affected by the crisis were unlikely to be sustained: either inflation would rise or nominal exchange rates would recover.

19 The Committee noted that bond yields in industrial countries had fallen over the last month and that UK equity prices had risen sharply. These developments might reflect safe-haven effects, which could include lower discount rates. Financial markets seemed to believe that the Asian crisis, by dampening world demand, would reduce the likelihood of increases in interest rates in industrial countries, and increase the likelihood of decreases.

20 The Committee discussed how developments in Asia might affect the Bank's central projection. It noted that a broader measure of the sterling exchange rate index, incorporating 49 countries accounting for 97% of IMF member countries' total trade, had appreciated since August 1996 by only 1.5% more than the standard measure, which incorporates 20 countries accounting for 83% of IMF members' total trade. The Committee considered whether developments in Asia made it more likely that UK net exports would fall as indicated in the November central projection, or whether they suggested that the fall would be larger or more prolonged than indicated in November. Asian developments would need to be considered carefully in the preparation of the February *Inflation Report*.

21 Members discussed the various risks created by the Asian crisis. Official assistance to Korea had thus far not restored confidence, and the longer a very weak exchange rate and high interest rates persisted, the greater the risk of a flow of bankruptcies and serious economic dislocation. Another risk was that official encouragement for banks to roll over loans to Korea could have the side-effect of inducing banks to reduce lending to other emerging markets: there were signs that that was happening. And there was a risk that increasing net exports from emerging markets could strengthen protectionist sentiment in industrial countries. Overall, the downside risks arising from Asian developments had increased over the last month.

The output gap

22 Members discussed the concept of the output gap, and of its labour market analogue, the difference between unemployment and its natural rate. Its usefulness rested on the belief that if the output gap was positive (ie output greater than potential output) then inflation would rise, other things being equal, but that there were lags in the inflation response. Thus the evolution of the output gap could convey information about future inflation.

23 However estimates of the output gap based on estimates of potential output were very sensitive to the assumptions that had to be made in estimating potential output. For example, plausible reductions in the natural rate of unemployment could be associated with significant increases in the level of potential output which are not necessarily captured by conventional estimation techniques. In the light of these factors, direct indicators of the output gap, such as surveys of capacity utilisation and skill shortages, were clearly of great value, since they did not depend on fragile estimates of potential output.

24 Because of the uncertainty of output gap estimates, it was also important to monitor cost and price indicators closely, even though they are lagging indicators of the output gap.

25 Members noted that the rate of inflation might change in the absence of any change in the output gap, and that it was likely to be particularly sensitive to longer-run inflationary expectations. The current rate of inflation was lower than most measures of inflationary expectations, and this could imply that the output gap was negative.

26 Members discussed recent experience in the United States, where in the past year continued above-trend growth had been accompanied by declining inflation, posing a challenge to the output gap approach. Possible explanations suggested by members included the success of the Federal Reserve in maintaining its credibility and thus restraining inflationary expectations and the weakness of world prices.

Policy conclusions

27 Members agreed that developments in Asia presented serious risks. One view was that it would be possible to respond quickly to financial market contagion if and when the risks crystallised, but another was that even a quick response would not offset an adverse shock to real activity immediately.

28 The Committee discussed whether there was any merit in the idea of reducing UK short-term interest rates (which were the highest in the G7) as a clear signal of concern about the Asian crisis, or, conversely, whether, if there were to be a rise in UK interest rates, it would aggravate the Asian crisis. It was agreed that the UK on its own was too small for the MPC's actions to have a significant global impact, and that in any case the MPC's objectives are domestic in nature.

29 Views about the appropriate level of interest rates ranged across a spectrum. At one end was the view that it was desirable for interest rates to be raised now. Four reasons were advanced for this view. First, doubts had arisen about the forecast for inflation published in the November *Inflation Report*. Inflation outturns in recent months had been above the Bank's central projections, and the central projection contained in the November Report had been significantly below the average of independent forecasts. It seemed likely that the relationship between output growth and inflation over the next two years would be less favourable than had been assumed in the November forecast. The economy was likely to slow down, but not quickly enough to hit the inflation target two years or so ahead. Second, it seemed implausible that any substantial output gap remained to be closed and it was possible that output was already significantly above trend. Third, recent pay settlements and reports of skill shortages were a matter of concern, and suggested that earnings growth might rise to a level incompatible with the inflation target before capacity pressures had eased. An immediate move in interest rates would send a clear and early signal to the labour market of the MPC's determination to achieve the inflation target. Fourth, concerns were expressed about the buoyancy of asset prices.

30 Another view was that, although those arguments had much force, there was still considerable uncertainty about their implications for future inflation and therefore a strong case for waiting another month until a full analysis could be made of the extent of any required rise in interest rates. That analysis would be better carried out in the context of the forecast round for the February *Inflation Report*.

31 A third view was that there was little or no presumption that interest rates should rise. Recent developments in Asia, as well as signs of slowing demand growth at home, suggested the possibility of an earlier turning point in GDP growth than that implied by the central projection in the November *Inflation Report*. It was difficult to measure the size of the output gap and, in any case, its calculated sign did not represent a clear policy signal for an open and slowing economy when its level was low. Moreover, there were clearly risks in both directions. The developments in Asia, in particular, might have significantly more serious downside effects than those projected by either the IMF or the OECD.

32 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be left unchanged this month. On the balance of the arguments set out in paragraphs 29-31, a majority of the Committee (comprising the Governor, David Clementi, DeAnne Julius, Mervyn King and Ian Plenderleith) voted for the proposition, and a minority (comprising Alan Budd, Willem Buiter and Charles Goodhart) voted against, preferring an immediate increase in interest rates. The repo rate was thus left unchanged.

33 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

34 Terry Burns was also present as the Treasury representative.

SUMMARY OF ANALYSIS PRESENTED TO THE MONETARY POLICY COMMITTEE BY BANK STAFF ON 5 JANUARY 1998

A1 This note summarises the analysis presented by Bank staff to the Monetary Policy Committee on 5 January 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 this Annex.

I Monetary conditions

A2 Notes and coin rose sharply by 1% on the month in December and by almost 7% on a year earlier. But the numbers were very difficult to interpret as the seasonal adjustment would not be updated until the effects of Christmas had unwound.

A3 Monthly M4 growth rose in November to 0.9% compared with 0.5% in October. This stronger outturn was partly accounted for by increased repo-market activity. Three-month and six-month growth rates continued to suggest some modest deceleration compared with the first half of the year. Nevertheless, the growth rate of real broad money remained high, at just under 8%, and continued to point to robust real domestic demand growth.

A4 Personal sector M4 continued to grow at an annual rate of around 8%. This had changed little in the past five months, though it had weakened slightly in November after being boosted by windfall deposits in October. More robust estimates of the personal sector's holdings of broad money would be available upon the release of figures for Q4 on 30 January. A breakdown of personal sector M4 between unincorporated businesses and individuals would be available a month after that; individuals' deposits had grown more slowly than total personal sector deposits earlier in the year.

A5 Looking at the split of retail M4 deposits in November, inflows into building society deposits had continued to be strong. As in the recent past, it was understood that the inflows were widely spread across building societies and that the flows were

into share, rather than deposit accounts - only the former qualify for windfall payments upon demutualisation. This lent support to the view that the strong rise in building society deposits was partly due to speculation on the possibility of further demutualisations.

A6 Deposits held by ICCs fell for the second consecutive month in November. The growth of ICCs' deposits had slowed to an annual rate of around 6% in 1997Q3 from 11% in 1996Q3. By contrast, OFIs' holdings of broad money increased in November after a weak October, largely on account of repo activity. Taking October and November together, the average monthly growth of OFIs' deposits was 1.4%, somewhat lower than the average of 2.4% for the rest of 1997. Figures for the third quarter suggested that LAPFs continued to increase their deposits, albeit at a slower rate than in 1996.

A7 M4 lending rose more strongly in November pushing the twelve-month rate up slightly to 7.8%. This followed a period in which the annual rate fell from 9.4% in June to 7.6% in October. The strength reflected a rebound on the month in lending via reverse gilt repo. But taking October and November together, the average monthly growth rate was broadly in line with the average of the previous three months at around 0.6%, compared with 0.9% in the first half of 1997. Overall, it appeared that M4 lending growth had been slower in recent months than in the first half of 1997 and 1996.

A8 The sectoral breakdown showed that the twelve month growth rate of M4 lending to persons was proceeding at a similar rate to the previous four years. Unsecured lending remained robust, partly reflecting a supply effect induced by increased competition in the consumer credit market. Secured lending by banks and building societies continued to grow steadily at an annual rate of 6.2%.

A9 The major contribution to the slowdown in aggregate M4 lending had come from ICCs. In the year to November, ICCs' sterling borrowing from UK banks and building societies rose by 2.9%, the same as in October. Growth in October and November together was 5.8% at an annualised rate. These recent rates of growth

compared with an average annual growth of around 14% in 1996. Net sterling capital issues had also weakened in 1997. Foreign currency capital issues had increased significantly in the first three quarters of the year before weakening in October and November. The earlier strength in foreign currency capital issues represented a small proportion of total ICCs' external finance and appeared to be related to a few large takeovers. Evidence from the Bank's Agents and from surveys was consistent with a picture of weakening credit demand. The overall implications for activity were difficult to assess; internal funds remained stable and had in fact risen during the third quarter, although the effects of dividend payments being brought forward to the second quarter on account of the ACT changes were unclear. Investment intentions also remained firm.

A10 M4 lending to OFIs rose strongly in November (2.1%) after a sharp fall in October (-1.2%). The November rise reflected a rebound in reverse repo activity. The 12-month growth rate of M4 lending to OFIs was 17.0% in November, compared with an average of 19.9% in the first nine months of 1997.

A11 Inflation expectations derived from the gilt market had fallen for the second consecutive month. This appeared to be due to weaker UK data as well as global developments. Estimated short-term real rates had fallen in the early part of the month and the spread between two year and ten year real forward interest rates had narrowed. The fall in short-term real rates might, perhaps, have been in response to the fall in inflation expectations.

A12 The most recent rise in official interest rates had now been passed through by most banks into deposit accounts and standard variable rate mortgages, but typically not by building societies. There had been little pass-through of the official rate rises since May to unsecured lending. This, and the entry of new firms, was consistent with increased competition in the consumer credit market.

A13 The nominal effective exchange rate index had depreciated by 0.8% since the previous MPC, but was 2% higher than the level assumed for the purposes of the projection in the November *Inflation Report*. Yields had fallen in most industrial

countries during the month, perhaps partly in response to developments in Asia. But UK yields had fallen by slightly more, which was consistent with the depreciation of sterling. However the UIP decomposition suggested that only a small part of the recent depreciation was explained by news about monetary policy in the UK relative to that overseas.

II Demand and Output

A14 The ONS had published full national accounts data for 1997 Q3 in December. GDP growth in 1997 Q3 had been revised down to 0.8% (from 0.9%). There had been small but extensive revisions to the data back to the beginning of 1996. And the output and expenditure measures of GDP had begun to diverge.

A15 Domestic demand growth had been revised up to 0.9%, reflecting upward revisions to government consumption, investment and stockbuilding. Strong government consumption growth was difficult to reconcile with the low PSBR numbers and a small rise of 0.2% in government and 'other services' output in the third quarter. Investment data had again been influenced by erratic transport factors; excluding these, investment would have grown by 0.7% in 1997 Q3, rather than falling by 0.5%. Surveys of investment intentions continued to show a reasonably robust picture for both manufacturing and services.

A16 Private consumption had been revised down to 0.7% (from 1.2%). This was in part the result of a weak energy consumption estimate which was difficult to reconcile with strong energy output growth. And it may also have reflected a temporary fall in consumption following the death of Diana, Princess of Wales, which could have depressed consumption by as much as 0.5 percentage points. Retail sales fell by 0.4% in November. Abstracting from September's data, the pace of retail sales growth had moderated, but remained strong.

A17 The Halifax house price index had fallen by 0.2% in December, and the annual rate of house price inflation had fallen to 4.3%. The divergence between the Halifax and Nationwide annual rates of house price inflation had increased to its widest yet:

the Nationwide rate had risen 1 percentage point to 12.6% in the year to December. Housing activity had been fairly stable in 1997 across a range of measures such as lending secured on dwellings and the Royal Institute of Chartered Surveyors (RICS) survey.

A18 The estimated positive contribution of net exports to GDP in the third quarter had been revised down slightly. The underlying picture was of a negative impact from trade in goods and services, but this had been more than offset by a positive effect on GDP from oil and erratic items. On monthly goods data, the non-EU trade balance had been deteriorating. Trade with the EU had remained relatively robust. The OECD and IMF had both forecast a cyclical recovery in domestic demand in the three major European economies during 1998, though the negative effect of sterling's appreciation on the UK trade balance with the EU was yet to come through.

A19 The OECD and IMF had both estimated that the UK output gap was around zero in 1997. Both organisations had also forecast lower growth for the UK in 1998 than the central projection in the November *Inflation Report*. Industrial production and manufacturing output growth had slowed recently, though their annual rates of growth had remained close to their historical averages. The latest monthly surveys from the Chartered Institute of Purchasing and Supply (CIPS) had indicated that manufacturing and services output growth continued to rise. Growth in new manufacturing orders had slowed down in December but in services the rate of incoming new business had increased. The Confederation of British Industry (CBI) monthly trends survey had suggested that manufacturers' optimism about future output and prices remained weak.

A20 The OECD and IMF had both estimated, as a 'central case', that events in Asia would lead to a reduction in EU and North American countries' growth rates of around 1/4 to 1/2 percentage point in 1998, with a rebound in growth in 1999. But the IMF had noted that there were downside risks to their estimate, and the situation in Asia had deteriorated further since these estimates were published.

III Labour Market

A21 There had been a significant increase of 73,000 (0.3%) in the workforce in employment numbers during 1997Q3, according to ONS data published in December. The increase was more than accounted for by employees in employment; the numbers of self-employed fell by 15,000. The largest rise was in the service sector where the number of employees increased by 69,000. The number of manufacturing employees fell by 20,000 in Q3, although monthly data indicated that the number may have risen by 5,000 in October. There had been a further significant rise in the number of employees in 'other' industries of 34,000 after a 47,000 rise in the second quarter. This had largely been in construction, where there had been a switch out of self-employment into employee status, without any net increase in employment. This reflected revised Inland Revenue guidance on the treatment of sub-contractors, which had reduced the attractiveness of self-employment.

A22 The Manpower survey of recruitment intentions into 1998 had been published towards the end of December. It was highly seasonal and so had to be adjusted before interpretation. Subject to that, it suggested that recruitment intentions, although down slightly on the quarter, remained strong; with manufacturing stronger than services. On this last point it contrasted with reports from the Bank's Agents and other surveys, which suggested a stronger employment outlook in services than manufacturing.

A23 The unemployment claimant count fell by 21,000 in November. Although the pace of reduction in recent months was slower than in the summer, the underlying fall remained in line with the Bank staff's benchmark of a decline of some 25,000 - 30,000 a month.

A24 The number of reported vacancies fell by 21,000 in November, after several months of significant increases. But 20,000 of the fall was due to the removal by the Employment Service of an overstatement in the stock. The Employment Service estimated that there remained a residual overstatement in the stock of some 20,000. The gross number of new vacancies notified to job centres, another measure of labour

market demand, was little changed over the past six months.

A25 The dispersion of regional unemployment rates had fallen in the 1990s. Although the unemployment rate, on the claimant count basis, was now below the previous trough in 1990, the rates in the regions with the tightest labour markets remained above their previous lows. Had this lower dispersion affected aggregate wage inflation? There were two cases where it might. One was where national pay rates were determined in a leading region and where that region's unemployment rate had changed relative to the national average. The second was where the regional relationships between unemployment and wage pressure were non-linear, so that wage pressure in each region increased more than proportionately as regional unemployment fell. In this latter case the fall in dispersion would lead to lower wage pressure for a given level of national unemployment.

A26 There appeared to be little empirical support for a 'leading region' hypothesis in the UK. There was some evidence supporting non-linear regional relationships between wages and unemployment, implying that regional dispersion mattered for aggregate wage inflation. But academic research had not found a significant role for regional dispersion in aggregate wage equations.

A27 Whole-economy underlying earnings growth, according to the ONS, remained at 4¼% in October: 4½% in services and 4¼% in manufacturing. But the bonus season was about to begin in earnest, and this could change the picture. Press coverage of a recent survey by a City recruitment firm had suggested that City bonuses could be 20%-30% higher this year than in the previous one. Calculations by Bank staff suggested that a 30% increase in City bonuses could add a quarter percentage point to whole-economy earnings growth on average between November 1997 and April 1998.

A28 There had been some high profile wage settlements in Q4: Fire Service, 4.8%; Rover, 4.5%; and Ford 4.5%. Moreover, the level of settlements had risen in Q4. But there were relatively few settlements at that time of year, and settlements had risen in Q4 in the previous two years. More information would be available when January settlements, which accounted for a quarter of settlements on the Bank database and

around 10% of the workforce, were agreed.

A29 The Bank's Agents reported the results of an informal survey of their contacts, which had asked about pay prospects in 1998. 49% of the sample, which was weighted towards manufacturing, expected to grant a higher basic pay increase in 1998 compared with 1997; only 9% expected a lower settlement. The estimated mean expected settlement was 3.8%. The main reason cited for increasing settlements had been fear of losing staff. Certain types of staff were singled out as requiring higher increases than others: information technology specialists, engineers, construction workers and hotel and catering staff. There was little evidence that other forms of remuneration were increasing by more than basic pay. The modal expected increase in the pay bill per worker was in the 3% to 4% range. It had been too early to see any effect of the phasing out of profit related pay tax allowances, as the reduction in relief applied to profit periods beginning on 1 January 1998.

IV Prices

A30 There had been no signs of any upward price pressures from commodities. Provisional estimates suggested that non-oil commodity prices fell for the fifth consecutive month in November. Oil prices had fallen in December; the price level had been affected recently by news of the possible resumption of Iraqi oil exports.

A31 Manufacturers' input prices had fallen sharply in November to a level 8.3% lower than a year earlier. Imported input prices had fallen by much less than the change in the value of sterling since the start of 1996 would have implied. That could have reflected the predominance of dollar-priced commodities, since sterling has appreciated less against the dollar than other currencies over the past two years. Output price inflation had remained very low in November. Survey evidence suggested a continued subdued outlook for output prices in the short-term: the balance of manufacturing firms expecting to increase prices over the next four months in the December CBI survey had been -1. This was unusually low for the time for the time of the year.

A32 Latest calculations showed that manufacturers' weighted costs continued to fall in November. So despite low output price inflation margins on domestic sales appeared to be still rising. In contrast, margins on export sales were estimated to be falling sharply: export prices fell by 5% in the twelve months to October.

A33 Although UK producer price inflation was lower than in the rest of the G7 economies except the United States, UK consumer price inflation was nevertheless the highest in the G7.

A34 RPIX inflation had been 2.8% in November. Outturns since the start of 1997 had generally been higher than the near term central projections published in successive *Inflation Reports*. That partly reflected the changed timing of Budget measures. But the higher outturns also reflected unexpectedly weak pass-through from the appreciation of sterling since August 1996 to retail prices; for example, in the clothing and footwear sector, which was relatively import intensive.

A35 Monthly changes in retail prices, particularly retail goods prices, were highly seasonal. And for some components the seasonal pattern had been changing; for example, monthly changes in consumer durables' prices had become more volatile during the past ten years. So seasonal adjustment was difficult. It would therefore be difficult to disentangle the seasonal changes in the monthly retail price data at the start of 1998 from any possible delayed pass-through of sterling's appreciation.

V Financial Markets

A36 Trading during December, as usual, had been thin. So care had to be taken in interpreting movements in financial market data during this month. Most major exchange rate movements had not been very large since the previous MPC meeting. The sterling effective exchange rate was 0.8% lower at the time of the January MPC meeting than at the time of the December meeting, having been 2½% lower by mid-December. The dollar effective exchange rate had risen slightly during the month despite the FOMC's decision to leave interest rates unchanged at its mid-December

meeting.

A37 Asian turmoil and concerns about financial fragility had affected exchange rates during December. The Japanese yen had been volatile and during the month had reached its lowest level against the dollar for over five years. The Korean won, too, had been volatile in December. Overall it had depreciated, falling from just under 1200 won to the US dollar to around 1745 on 7 January.

A38 Expectations of a further official interest rate rise in the UK during the next three months seemed to have diminished. Forward interest rates derived from the gilt repo market were now flat at around 7¼%, the current level of the Bank's repo rate. Between 3 December and 7 January, the interest rate implied by the March 1998 sterling future had fallen by more than the current three-month libor, and the former had been below the latter for most of December. Short-term interest rates implied by futures contracts further out had also fallen, both in the UK and in Germany.

A39 The spread between non-collateralised three-month rates (such as interbank rates or certificates of deposit) and general collateral repo rates had risen from around 20 basis points before the financial market turmoil in October to about 35 basis points in December, but had fallen back to 15-20 basis points early in January.

A40 Spot interest rates had fallen between 3 December and 7 January - by about 45 basis points at 3 years and about 30 basis points at 20 years. During the month as a whole, the fall in short-term rates had reflected both lower expected inflation and lower real interest rates.

A41 What information could be gained from financial markets about the likely future impact of the Far East crisis on the UK? UK equity prices were now higher than at the time of the previous MPC meeting, reflecting a continued recovery from the fall at the end of October. Movements in other major economies varied, though the 10% fall in Japanese equities stood out. There had been a large increase in implied stockmarket volatility at the end of October which had been reversed almost completely for the UK and the US, but only partially in Japan. Implied probability distributions for the FTSE

100 showed that the downward skewness had reduced since the turmoil in October, but remained above its five-year average. So the perceived effect of the Asian crisis on the UK economy, as judged by equities, may have dissipated.

An alternative perspective on the impact of the Asian crisis could be gained from an examination of credit spreads. The spread between government ten-year bonds and private sector bonds of similar maturity had increased in October in the UK, and had persisted. That had also happened, to a lesser extent, in the US. There were two possible scenarios that could underlie this. First, increased uncertainty over future firm values could increase the yield on debt with an offsetting effect on the yield on equity. In this case there need not be any net effect on the cost of capital, except possibly for firms with restricted access to equity. But the fact that equity market volatility itself had fallen back since October argued against this explanation. Second, the increase in credit spreads could reflect an increase in risk aversion on the part of investors. In this case, the increase in credit spreads since October (roughly 15 basis points) could reflect higher risk premia which would lead to lower investment. Such a rise in risk premia would also depress the equity market. Although equity prices had not fallen, the second scenario could not be ruled out since other developments might have offset the effect of the rise in risk premia.