

Publication date: 15 April 1998

MINUTES OF MONETARY POLICY COMMITTEE MEETING

4 and 5 March 1998

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 March 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 8 and 9 April will be published on 13 May 1998.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 4-5 MARCH 1998

1. The Committee discussed the implications of the slowdown in broad monetary growth; puzzles regarding domestic demand, net trade and output; fiscal developments; the tightness of the labour market; recent international developments; and indicators of cost pressures, before turning to what general considerations should bear on the preferred path of interest rates to achieve the inflation target. The Committee were also given a short briefing by the Treasury representative outside its formal meeting on the provisional net fiscal effect of the Budget.

Monetary and financial developments

2. The Committee agreed that the signs of a deceleration in broad money were now apparent. The three- and six-month annualised growth rates were both around 8%, bringing the twelve-month growth rate down to around 10% from 11-12% in mid-1997.

3. The sectoral data were, however, telling diverse stories. On the one hand, personal sector M4 growth seemed, if anything, to have been picking up slightly. Together with a slight rebound in M0 growth, to around 7%, and continuing strong consumer credit growth, this suggested that personal sector demand growth might have remained strong. That was consistent with the apparent recent strength in retail sales.

4. By contrast, the position in the ICC sector seemed very different. The level of money holdings was barely changed over five months, and bank lending growth to ICCs had been weak. It was possible that this reflected the downturn in the externally exposed sectors of the economy. If so, the money and credit numbers were illustrating the different pressures on different parts of the economy. Staff analysis suggested that the effects of a monetary tightening were typically seen in the ICC sector before the personal sector.

5. On another view, the money numbers did not provide much information. Given the inflation target of 2½% and trend real GDP growth of about 2¼%, M4 growth above 5% or so needed to be accompanied by falling velocity. Velocity trends were, however, very difficult to explain or predict. The slowdown in broad money growth was in the right direction, and was implied by the central projection in the February Inflation Report, but the money numbers could not confirm whether the degree of policy tightening was

sufficient to hit the inflation target. Slower money growth was to be expected given the interest rate increases during 1997, especially in M0 and in deposit accounts which paid no or low rates of interest, although it was noted that the slowdown was not in fact in zero or low interest bearing money (M0 and personal sector M4) and so was apparently not based on agents substituting out of money because the Bank had increased the cost of holding it.

6. A further view, while agreeing that money growth should be expected to fall as the economy slowed, also placed weight on cumulative past rapid money growth, and the possibility that there remained a liquidity overhang in the OFI sector which could sustain asset price inflation.

7. This led to a discussion of asset markets. Some members were concerned that, as in some previous cycles, cumulative rapid broad money growth might be associated with unsustainable asset price appreciation and domestic demand growth. Others were less sure. There was uncertainty about the degree to which asset price changes affected the demand for goods and services. The connection between money growth and asset prices was also unclear, not just in the UK but even more so in the US.

8. Overall, the Committee agreed that the recent money and credit numbers suggested a slowing economy, but there was a range of views about how much weight to attach to them.

9. Another aspect of monetary conditions debated by the Committee was the information potentially available from the yield curve. It was possible that the current inverted conventional gilt yield curve (with long maturity nominal rates below short maturity nominal rates) indicated an impending slowdown; the role of the yield curve slope as a leading indicator was supported by some (mostly US) academic research. On the other hand, the results in the literature could be explained by the influence on activity coming from movements in real rates. In particular the gap between short-term real interest rates, as effectively set by the central bank given sticky prices, and the equilibrium real rate should be the better leading indicator of activity. Indeed the nominal yield curve slope could be misleading, because it might change on account of developments in the monetary regime, as had occurred over the past year; the emergence of an inverted nominal yield curve might have been associated with the announcement of operational independence for the Bank, since this had caused a fall in long-run inflation expectations and thus in long-maturity nominal rates relative to short-maturity nominal rates. On this view, there was in principle no additional forward-looking information available from the slope of the conventional yield curve beyond that available from short-term real interest rates. But it was argued that, even if this were true, the conventional yield curve slope might be of some practical assistance given the technical

difficulties associated with estimating the ex ante short real rate and the equilibrium real rate, neither of which could be observed directly.

10. The Committee noted that, although there had been no change in the Bank's repo rate, the short end of the yield curve had risen by about 20bp since its previous meeting, apparently in response to the Inflation Report. And sterling had strengthened in the immediate run-up to the current MPC meeting. While it was possible that an immediate rise in the Bank's repo rate would be accompanied by an offsetting fall in market expectations of future interest rates, the Committee took the view that it would be more likely than not to prompt a further appreciation in sterling.

Real side puzzles

11. The Committee recalled its assessment at earlier meetings that the short-to-medium run path for output and inflation, would in the absence of shocks be determined largely by the balance of influence of domestic demand and net trade. There was a series of puzzles in the data, making it difficult to assess this balance.

(a) Consumption

12. The trend in consumption growth was difficult to identify due to the distortions caused by the funeral of Diana, Princess of Wales. Smoothing over the third and fourth quarters suggested a gradual slowdown in consumption growth. But recent data on car registrations and retail sales suggested that strong personal sector demand growth had in fact continued into 1998. Consumer confidence, as measured in surveys, had fallen, but from exceptionally high levels in mid-1997 associated with the windfall payments, so that the balances were still high compared with past cycles. Income from employment continued to grow strongly; house prices were up, on the Bank's estimate based on Land Registry data, by 9% in Q4 over the previous year, although other indicators suggested that the rate of increase was slowing; and financial asset prices had continued to rise rapidly, as already discussed. The background was therefore suggestive of a continuing impetus to robust consumption growth (and strong imports). Arguably this was apparent in the January retail sales figures, which taken together with December, recorded the strongest Christmas/New Year period growth since 1989.

13. Interpretation was not, however, straightforward. This was always the case for the Christmas/New Year period, given the strength of the seasonal pattern - spending was much higher in December than in

January on an unadjusted basis. In addition, in this particular year, a pre-Christmas BRC survey had indicated that consumers had waited to make some major purchases out of windfall gains until the Christmas/New Year period, and that this had been planned last summer, so that the recent data should not be a surprise. January's strength had also been accompanied by aggressive discounting by stores, which some commentators attributed to retailers carrying higher-than-expected inventories at the end of 1997. Reports from the Bank's regional Agents and surveys suggested that while buoyant retail business had continued into early February, it had since slowed. Finally, there had been profit warnings from some retail companies, perhaps suggesting that the underlying position was not as strong as the sales volume numbers implied.

(b) Net trade

14. The GDP figures for Q4 implied a sharp fall in the trade balance. However, the monthly trade data recorded a small increase between Q3 and Q4 in export volumes of goods excluding oil and erratics, suggesting that the net trade weakness stemmed more from strong import growth than falling exports.

15. The Committee discussed the significance of the growth of gross imports and exports compared with that of the overall trade balance. Net trade was not exogenous. Part of the explanation was related to relative income growth in the UK and overseas. Import volumes would be affected by the strength of domestic demand and exports would be affected by external demand, while both would reflect any domestic capacity constraints. Less comfort could be taken for the inflation outlook if the contribution of net trade to slowing aggregate demand growth came from rises in imports, since this might signal that domestic demand was not slowing fast enough.

16. Another part of the explanation for strong import growth was the greater price competitiveness of imported goods and services caused by the strength of sterling. With this effect, import demand would be expected to be strong even in the face of slowing domestic demand, as home producers lost market share to importers. This effect put direct downward pressure on retail price inflation and indirectly added to the slowdown in domestic demand as home producers were forced either to cut costs or output. To the extent that import growth was a result of such price, rather than income, effects it did not signal the need to tighten monetary policy further.

17. A declining trade balance could help to subdue inflationary pressures when domestic demand was above trend, since the economy could in effect borrow capacity from overseas. Domestic demand growth

could then be reduced more gradually. There would be longer run effects since the current account deficits entailed would reduce the UK's net external assets and thus future levels of consumption. It was noted, however, that in the past strong domestic demand growth sucking in imports had been an indicator of masked inflationary pressures; that had been so in the mid-to-late 1980s, when taking comfort from the ability of the external deficit to accommodate strong domestic demand had led to delays in taking necessary domestic policy action.

(c) Output growth

18. The divergence between the ONS data and surveys of manufacturing had become more pronounced. The ONS data recorded a fall of 0.4% in manufacturing output in Q4 over Q3. Surveys, however, indicated positive, albeit weakening, growth; Bank staff estimated that the CBI survey responses implied above trend manufacturing growth in Q4.

19. There was a range of views on whether the official statistics or surveys should be given greater weight. On one view, the ONS's first estimate of GDP growth should, as a general rule, be given very little weight given the size of revisions. It would be better to treat the early ONS releases as forecasts rather than hard data.

20. Another view was that the surveys did not track the finally revised official output numbers very well, and thus greater weight should be placed on the ONS data and in particular on the direction of revisions. The output growth data for Q4 had been revised down by 0.1 of a percentage point; this was news since the general expectation had been that there would be upward revisions.

21. The Committee agreed that recent developments in activity were unclear. It was possible that the path of future output, and inflation, was more uncertain in the short run than suggested in the Bank's fan charts since the considerable uncertainty about recent past data - and hence the starting point - was not reflected. It was agreed that this issue should be investigated further for the May Inflation Report.

22. There was also a range of views on the implications of the contrast between the manufacturing and service sectors. On one view, the slowdown in manufacturing growth was likely to have knock-on effects for services, directly through the dependence of business services on the production industries, and indirectly via slower personal sector income growth if wage growth and employment fell in

manufacturing. On the other hand, it was argued that continued buoyancy in the services sector could help to sustain the demand for UK manufactures.

Fiscal developments

23. The Committee noted the strong PSDR in January, which some commentators had attributed to higher than expected Inland Revenue receipts from personal tax self assessment, for the tax years 1995/96 and 1996/97. When more data were available it would be important to assess whether this was likely to mean that measures of past national income - and so past output levels - would be revised upwards. It would also be necessary to assess whether the effect was cyclical, on account of the cyclical-sensitivity of income from investment and self-employment.

24. Preliminary analysis by Bank staff suggested, however, that in terms of the current year's fiscal position, any extra revenue in January and possibly February from the introduction of self assessment was less material than the PSBR shortfall which had accumulated over previous months. The Committee noted that the July 1997 Budget had expected to tighten fiscal policy, on a cyclically adjusted basis, by around 1% of GDP. The PSBR numbers since the Budget suggested that that might prove to be an underestimate, but it was too early to judge whether or not any difference was significant. If it were, the key question was whether any extra revenue was being generated by an increase in the tax base or the effective tax yield (or both). The former seemed unlikely judging by the GDP numbers published so far, but the National Accounts might be revised if any unexpected strength in tax revenues suggested that income or expenditure was stronger than previously thought. On the other hand, if the explanation lay in the effective tax yield, fiscal policy would be exerting a stronger future contractionary effect than expected. These were potentially important questions, to which the Committee agreed it would need to return as more information became available.

Labour market developments

25. Unemployment had fallen again in January. This too was difficult to interpret. On the one hand, the twelve thousand fall in the claimant count was significantly below the average monthly fall during 1997, suggesting that the pace of labour market tightening might be moderating. On the other hand, the Department of Employment thought the true fall might be greater as their statistics had been collected unusually early in the month, and very soon after the Christmas/New Year holidays.

26. Other indicators were mixed. Whole economy underlying average earnings growth was unchanged at 4 3/4%. Wage settlements were still rising faster than a year ago; the three-month employment-weighted median was +3.6% compared with +3.0% in January 1997, and the three-month employment-weighted mean had risen from +3.3% to +4.0% over the same period.

27. Wage and earnings data were, however, backward-looking indicators of tightness. As in earlier months the Committee therefore discussed survey measures of tightness. Skilled labour shortages were apparently still increasing, as were recruitment intentions. The one exception was the CBI's measure of shortages of skilled labour in the manufacturing sector, which was consistent with other indicators of a slowdown in manufacturing growth.

28. There was a range of views of what the latest data implied. One interpretation was that, although labour market conditions were still tightening, there were few signs that this was feeding into wages and earnings; after the upturn last summer, growth in settlements had been broadly flat. Since there was now evidence that the economy was slowing, the risks of continued earnings acceleration had diminished.

29. Another interpretation recalled the advice of Bank staff last summer that great weight should not be put on the upturn in settlements that had been recorded then as there were relatively few settlements during the summer. In that case, there was news in the recent data since it covered a period when there were many settlements, and the best comparison was with the position a year ago.

30. The Committee discussed the possible implications of the planned introduction of the Minimum Wage in April 1999, observing that on its own it would be an adverse supply shock at the aggregate level, which would increase the natural rate of unemployment. It noted recent accounts that some employers were awarding wage increases to the low paid in anticipation of the Minimum Wage. The Bank's regional Agents were reporting various reasons why this might be so. One was that some firms making annual payment settlements that spanned the minimum wage's introduction preferred to increase pay now rather than go through a second pay round once the Government had responded to the Low Pay Commission report due in May. A second reason being aired was that some firms felt there would be a stigma attached to having to raise pay once the Minimum Wage was a formal requirement. A third possible explanation was that some firms were simultaneously increasing pay and trying to raise the quality/skills of their employees, with the goal of reducing employment levels. A fourth was that employers were consolidating other parts of remuneration into basic pay so as to minimise the effect of the minimum wage on the total wage bill.

31. The Committee concluded that it was not yet in a position to judge whether these effects, if true, would be significant. The important thing at this stage were the signs that the Minimum Wage might be

affecting labour market conditions earlier than had been expected. The Committee agreed that this needed to be analysed carefully in time for its May Inflation Report.

International developments

32. Recalling its earlier discussions of the Asian situation, the Committee agreed that there had been relatively few developments since its 4-5 February meeting. Indonesia looked worse, but other countries in Asia appeared to be making progress with their IMF programmes. The risks to activity had, however, possibly increased slightly, partly on account of the perception that the Japanese position was not improving. But this might be offset by a marginally better outlook for activity in the EU and USA. The Committee agreed that recent data were broadly in line with its expectations at the time of the February Inflation Report.

Cost pressures

33. The Committee agreed that developments in Asia had contributed to very benign cost pressures. In particular, commodity prices were down 13% on a year ago. Manufacturing output prices (excluding excise duties) had also registered their first ever fall over a twelve-month period (on data constructed back to 1974).

34. On one view this was encouraging for the inflation outlook; it took time for lower input prices to feed through to retail prices. The current cost picture could therefore help to sustain low inflation for some time to come. Another view emphasised that, notwithstanding falling commodity prices and sterling's appreciation, inflation had remained above the target for most of the past year. Strong domestic demand conditions had largely offset favourable cost developments. Looking forwards, there was no reason to expect that commodity prices would continue to fall, or that sterling would continue to appreciate, making the accumulated underlying domestic inflationary pressures more important to the medium-term outlook.

What has changed since the February Inflation Report?

35. Drawing together its discussion of recent developments, the Committee reviewed what had changed since it finalised its February Inflation Report.

36. That broad money growth had slowed now seemed reasonably clear and offered some reassurance, but the sectoral differences were striking. Unchanged personal sector M4 growth combined with 7% M0 growth and continued strong growth in consumer credit contrasted markedly with weak ICC deposit and bank lending growth. Financial asset price growth had persisted, and the exchange rate had appreciated

rather than depreciating in line with expectations. Money market conditions had also tightened, with the money market yield curve about 20-25bp higher out to 1999.

37. In the labour market, developments had not so far been as bad as some had feared. But pay settlements had now been quite high for a prolonged period, and earnings growth was only just consistent with the inflation target. Other cost pressures and price developments were more benign than expected. Given the PSBR numbers, the current fiscal position might be tighter than earlier expected.

38. But little had happened to help clarify the outlook for demand and output. Domestic demand and the productive capacity of the economy remained the key issues. Given past monetary and fiscal tightenings, sterling's level, and the fading effect of windfall gains, Members agreed domestic demand was likely to slow. But the pace and extent of the slowdown remained highly uncertain.

General considerations bearing on interest rate setting

39. Given that the Committee's assessment of the economic outlook and appropriate policy stance was finely balanced, the Committee reviewed some of the general considerations bearing on its choices before turning to its immediate policy decision.

40. First, in any given circumstances, a variety of different interest rate paths could in principle achieve the inflation target. What factors were relevant to the preferred profile of rates? One element of this was the role that the projected path of output should play. There was a broad consensus that the Committee should in principle be concerned about deviations of the level of output from capacity. If the economy operated below capacity, productive resources would be underutilised and inflation would be tending to fall; on the other hand, attempting to operate the economy at above capacity levels of output would be unsustainable and lead to increasing inflation. The desirable rate of growth of output was itself affected by whether the economy was running at or below capacity. In circumstances where the actual level of output was above its capacity level, actual growth would need to be below the growth rate of capacity output for a period in order to bring the economy back to equilibrium. While the Committee agreed that in principle it should be concerned about minimising deviations from capacity rather than smoothing growth rates per se, the practical difficulty was that the trend rate of growth could not be observed with sufficient precision for estimated deviations from capacity output to serve as a clear guide to policy.

41. The Committee considered the way in which uncertainty entered into the forecast, and the implications of that for the determination of interest rates. Three distinct issues were discussed. The first concerned the meaning of the fan charts published in the Inflation Report. The MPC is committed to publishing forecasts in the form of fan charts because they emphasise the fact that forecasts are statements about probabilities of different outcomes. The charts seek to represent the quantifiable uncertainties about the future paths of inflation and output. The bands in the charts reflect the Committee's judgment

about the risks to the central projection, and can encompass minor differences of view about those risks. But there might be circumstances where the differences among the Committee members about the nature and magnitude of the risks were more significant. In such circumstances, it would be necessary to publish fan charts corresponding to more than one forecast.

42. A second issue was the relationship between the forecast for inflation over the next two years or so and the decision on the current level of short-term interest rates. Although the fan chart sought to capture all the relevant issues, it could not be used as a mechanical determinant of the policy decision. Since the fan charts were conditioned on particular paths for interest rates over the next two years (for example, constant rates or the path of rates implied by futures markets), the fan charts could indicate no more than the prospects for inflation were one of those paths to be followed. They could imply the need for policy action, but did not in themselves dictate mechanically precisely by how much or when official interest rates should change.

43. The third issue was whether the existence of uncertainty, or the nature of the uncertainty surrounding inflation, was a reason for delay in taking action that might otherwise seem warranted. Two views were expressed on this. The first was that policy should reflect the latest news and that uncertainty in itself was no reason for delay. The second was that there might be particular cases, where the implied need was for only a small interest rate change, when the cost of a short delay would be small and new information might give more confidence about the need for the change, or not. In those circumstances a delay could be warranted to reduce the risk of unnecessary reversals of policy.

44. A further issue was the optimal frequency of changes in interest rates. In particular, members discussed whether there were costs to rapid reversals of policy; eg cutting rates very shortly after having raised them. On one view such reversals could be misunderstood, creating uncertainty both in financial markets and in the wider economy and damaging the credibility of the MPC process. An alternative view was that this position was irrational. So long as any policy reversals could be properly explained by new developments or improved analysis of the outlook, they need not create confusion about policy goals or the MPC's approach. On that view, there were no benefits in delaying changes in rates to reduce the risk of reversals, and it was better to make changes as soon as they appeared necessary. Also, the desire to minimise the risk of policy reversals was likely to mean that interest rate changes would, on average, be made too late.

The immediate policy decision

45. The Committee discussed its immediate decision about interest rates. Against the background of the Committee's assessment that there had been only a modest amount of news since it finalised the February Inflation Report, the considerations were broadly the same as at its 4-5 February meeting.

46. A number of arguments were advanced for an interest rate increase now. First, on one view it was more likely than not that the level of output was above trend, and the level of unemployment below the natural rate. While earnings growth was still just about consistent with the inflation target, earnings were a lagging indicator of tightness. It was necessary - however difficult - to take a view on where the economy was in relation to trend. Personal sector demand seemed to remain robust, so there was little sign of the level of output returning to trend quickly. On the view that the level of activity was above its capacity level, steps therefore needed to be taken to reduce output growth below trend for a period. The current policy setting should bring output back in line with trend over a period but the slowdown was unlikely to be sufficient to avoid inflation rising above the target in two years time.

47. If output were above trend, there were greater risks involved in delaying a rate increase than in acting early. If policy were tightened now but this was later reversed on account of news that the slowdown was sharper than currently expected, the net effect would be that output had been brought back to trend earlier than expected. But this needed to happen anyway, so it would simply have accelerated the process. On the other hand, if policy action was delayed but growth continued in line with the central projection, the gap between the level of actual output and trend output would increase. The Committee would then have to tighten policy more sharply in due course, perhaps at a time when output growth was already falling, increasing the risk of aggravating the slowdown. Thus, on the view that the level of output was above trend, the risks run by acting early were small and certainly lower than the risks run by delaying.

48. Second, surveys strongly suggested that the general public's expectations of inflation over the next couple of years were materially above the inflation target, even after adjusting for the fact that most surveys covered the RPI rather than the targeted RPIX. It was the public's expectations that were relevant to wage bargaining. Early policy tightening was needed to bring core inflation, as measured by the public's expectations, into line with the target. This would require below-trend growth for a period.

49. Third, as indicated in the February Inflation Report, the risks were clearly on the upside, with the mean inflation rate two or so years ahead materially above the 2½% target, and a 30% chance of being above 3½% in Q1 2000, on the assumption that the Bank's repo rate remained at 7.25%.

50. A number of arguments were advanced against a rise in rates, at least immediately. First, arguments for an immediate tightening placed great weight on the level of output having been above trend since last summer, but this was a highly uncertain judgment. There were major uncertainties about both trend output and the current actual level of output. These uncertainties about the current position of the economy - and in particular about short term downside risks to output - were perhaps not fully captured in the February Inflation Report.

51. Second, the central projection was below the target until the latter part of the forecast horizon. This partly reflected the assumption of constant interest rates throughout the forecast period. Both these arguments pointed to avoiding using the forecast fan chart mechanically.

52. Third, even assuming that a tightening would be needed at some point to achieve the target, the best profile over time might involve a delay in raising interest rates. The economy was projected to slow from the effects on net trade of sterling's appreciation and the Asian developments. A later tightening might affect domestic demand when the dampening effects of sterling's appreciation and Asia were wearing off. This could potentially avoid exacerbating the incipient slowdown in activity while nevertheless achieving the inflation target.

53. Fourth, while there were clear upside risks to inflation, how to react to some of them - such as sterling depreciating more rapidly than implied by uncovered interest parity - was better assessed if and when the risk started to emerge. It was also possible that the downside risks - for example, from Asia - had increased somewhat.

54. Taking these four arguments together, the benefits of waiting to gather information to help resolve the particular uncertainty about the current position of the economy could outweigh the costs. Responding immediately also ran the risk of having to incur what some members saw as the costs entailed by a quick reversal of policy.

55. Members of the Committee agreed, however, that the gap between the differing points of view had probably narrowed slightly since the February meeting. On the one hand, although the Christmas period seasonal adjustments were difficult to interpret, the most recent data did not offer much support for an immediate slowdown in consumption. On the other hand, monetary growth had started to slow, the fiscal position might be tighter than earlier expected, the labour market position had not deteriorated at the rate feared by some, and sterling had not fallen in line with the assumption in central projection. The Committee agreed that the development of the labour market data over the next few months would be especially important to assessing the position of the economy and the inflation outlook.

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

The following members of the Committee were present:

Eddie George (Governor)

David Clementi (Deputy Governor)

Alan Budd

Willem Buitter

Charles Goodhart

DeAnne Julius

Mervyn King

Ian Plenderleith

Gus O'Donnell was also present as the Treasury representative

SUMMARY OF DATA PRESENTED TO THE MONETARY POLICY COMMITTEE BY BANK STAFF

A1 This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 27 February 1998, in advance of its meeting. It has been updated to incorporate data that subsequently became available to the Committee.

I Monetary conditions

A2 Notes and coin grew by 0.6% on the month in January, and preliminary estimates suggested that growth in February was 0.4%. The twelve-month growth rate rose to 7.1% in February, although the introduction of the new 50p coin was still adding 0.2 percentage points to this figure. The Royal Mint had reported that around 20% of the old 50p coins were still outstanding. This meant that the upward distortion to the twelve-month rate would continue beyond February.

A3 The one-month and period growth rates were now indicating a slowdown in M4 growth. M4 rose by 0.2% in January, while three-month and six-month annualised rates fell to 7.8% and 8.1% respectively, down from rates in the 11%-12% range in mid 1997. The slowdown had become more apparent after revisions to the 1997 data, reflecting the normal re-estimation of the seasonal adjustments. Real M4 grew by just under 8% in the year to January, but the six-month annualised rate had fallen below 6%.

A4 The slowdown in M4 growth appeared to be largely accounted for by wholesale deposits. Although still high, the six-month annualised growth rate of wholesale money had fallen to 12.1% in January, down from rates in excess of 20% in the first half of 1997. This was consistent with a 'liability management' description of banks' recent behaviour, with the slowdown in M4 lending requiring banks to bid for fewer deposits.

A5 The sectoral data for January showed the twelve-month growth of personal sector money holdings remaining steady at 8.1%. Revisions to the data had also brought individuals' M4 growth more into line with that for the personal sector. By contrast, ICCs' deposits fell for the fourth time in five months. The twelve-month growth rate came down to 5% in January, continuing the steady fall in this rate recorded through 1997. There were signs that the growth of OFIs' M4 holdings might be slowing as well; the twelve-month growth rate fell to 20.7% in January, down from rates above 25% in mid 1997. However, the fall in January's annual figure reflected the large rebound in repo transactions between banks and the M4 private sector that occurred in January 1997 dropping out of the twelve-month calculation.

A6 Previous analysis by Bank staff had suggested that, within the OFI sector, life assurance and pension funds (LAPFs) were holding excess money balances. While money holdings would be expected to rise rapidly with increases in portfolio values, industry surveys suggested holdings of 'cash' had been higher than normal during 1997. It was possible that the accumulation of money balances could have been reinforced by the practice in parts of the fund management industry of reaching asset allocation decisions on the basis of the desired position relative to a 'benchmark' based on average asset holdings. This might have contributed to the growth in OFI money holdings. In fact, ex post returns from asset markets had for a while been greater than returns from money. There had recently been reports of 'cash-rich' funds underperforming the median. A recent Merrill Lynch survey of funds' asset allocation intentions had indicated plans to move out of money holdings into, among other things, UK equities.

A7 M4 lending growth continued to show signs of slowing. In January it rose by 0.4% and by 6.3% at a six-month annualised rate. Lending to persons remained steady at 6.9% in the year to January. Including lending by institutions other than banks and building societies, the three-month annualised growth of secured lending slowed slightly to 5.5%, but unsecured lending growth continued to rise quickly, by 18.9%. Unsecured credit comprised about 17% of total personal sector credit, but had been growing in importance. Mortgage equity withdrawal had turned positive again in recent quarters, although it was still much lower than in the late 1980s.

A8 Lending to ICCs was strong in January, rising by 0.8% on the month. The flow of £1.4 bn compared with a monthly average of £0.2 bn during the second half of 1997. A fall in the six-month annualised growth rate of lending to OFIs provided tentative evidence that a slowdown was underway in that sector's money holdings.

A9 January's higher-than-expected public sector debt repayment made it more likely that the Government would be overfinanced in fiscal year 1997. The effect would be to depress M4 growth during FY 1997.

A10 Longer-term RPI inflation expectations, as derived from nominal and index-linked gilts, were broadly unchanged since the previous MPC meeting, standing at 2.8% and 2.9% at the five and ten-year horizons respectively. This was only slightly above the measure of long-run inflation expectations taken from the Consensus Economics survey.

A11 The sterling effective exchange rate index had risen by 0.2% between 4 February and 4 March. There had been little movement in the UK forward interest rate curve relative to the rest of the G7, suggesting that there had not been much monetary 'news' during the period.

II Demand and output

A12 GDP growth was revised down from 0.5% to 0.4% in 1997 Q4 to stand 3.0% higher than a year earlier. There were other revisions back to the first quarter of 1997 but the estimated level of GDP in Q3 was unchanged. The first expenditure breakdown of GDP in 1997 Q4 showed a growing divergence between domestic and external demand. Net trade made a -1.1 percentage point contribution to GDP growth in Q4. Domestic demand grew strongly, at 1.3% slightly more than expected in the February *Inflation Report*. Private consumption also grew by 1.3% in Q4, a little less than expected in the February *Inflation Report*. The increase in growth of consumption in Q4 was consistent with an unwinding of the effect from Princess Diana's funeral, but it was difficult to know what would have happened otherwise, and thus to determine the underlying strength of spending.

A13 Retail sales were strong at the beginning of 1998 Q1, growing by 1.8% in January, and taking annual growth to 6.9% - its highest since June 1988. The less volatile three-month annual rate was 5.7% in the three months to January compared with 5.6% to December. Car registrations also continued to grow strongly in January - 11.6% up on a year earlier - particularly by the personal sector. Both retail spending and car sales growth may reflect some further "windfall" spending. But equally, some of the recorded strength in January's retail sales numbers may simply have been substitution from spending in December which showed no growth on November's level after seasonal adjustment. Sales were likely to have been boosted by the extent of price discounting in January as retailers cleared excess stocks (especially in clothing and footwear). Seasonal adjustment in the period is always substantial; nonetheless, seasonally adjusted growth in December and January, taken together, was the strongest since 1989/90. The Bank's Agents suggested that there had been a fall back in growth in the first few weeks of February.

A14 Consumer confidence - as measured by the GFK survey - fell in February to +3.6% (+4.5% in January). It remained at lower levels than mid 1997, but was still historically high. The balance of consumers thinking that there is an advantage in making major purchases at this time - at 19.6% - was not too different from the balance over the summer months when many "windfall" payments were made. There were signs that growth in housing market activity might be moderating. Particulars delivered fell again in January and the RICS survey pointed to a further fall in the number of properties sold over the previous three months compared with 1997 levels. Alongside this possible easing in activity, house price inflation was still moderating according to the Halifax index : the annual rate of increase was 5.1% in February, compared to 12.9% for the Nationwide index. Bank estimates of house price inflation, based on Land Registry data, grew at 9% in the year to 1997 Q4, similar to the previous two quarters.

A15 Total investment grew by 0.8% in 1997 Q4, to be 2.9% higher than a year earlier. Data on investment spending showed a sharp fall of -9.2% in manufacturing investment in Q4 compared with Q3. Surveys of investment intentions suggest this weakness will continue. Given the overall rise in investment in Q4, service sector investment probably increased significantly.

A16 Stockbuilding contributed 0.3 percentage points to GDP growth in Q4, with stocks rising by £1006 million at 1990 prices. But disaggregated stocks data implied that much of the overall increase reflected a positive quarterly alignment adjustment (measured expenditure rose by less than measured output). Retailers ran down stocks in Q4 (and revisions show less of a build-up through 1997) resulting in a fall in the retail stock to sales ratio to its lowest level since 1995 Q2.

A17 There was large public sector debt repayment of £10.4 billion in January, partly due to higher than expected receipts under the new self-assessment tax system. Although there are always uncertainties about expenditure at the year end, the full-year PSBR seemed likely to undershoot the Government's November 1997/98 forecast. The cumulative effects of higher receipts and lower expenditure over a number of months was likely to be a larger effect in determining the 97/98 undershoot than the effects of self-assessment tax system.

A18 Trade data for goods showed a sharp deterioration in the trade balance in 1997 Q4, despite a rebound in exports in December. This deterioration resulted entirely from non-EU trade, partly reflecting an impact from East Asia. Revisions also resulted in a larger deficit through 1997, which has not yet been reflected in the GDP data. It is not clear yet what the implications will be for GDP growth in Q4. The monthly data are consistent with a -0.7 percentage point contribution from trade in goods in Q4, compared to an overall net trade contribution of -1.1 percentage points in the latest GDP expenditure breakdown.

A19 On the output side, the contrast between domestic demand and net trade is reflected in continued strong growth in services output (+1.1%) and a fall in manufacturing output (-0.4%) in Q4, the largest quarterly fall since 1991 Q4. Total industrial production fell even more sharply, by 1.1%, reflecting falling energy output. Manufacturing output was some 1% lower in December than its peak in the summer of 1997 and had fallen in each of the previous three months. The recent weakness was widespread but most noticeable in investment and intermediate goods.

A20 Falling manufacturing output contrasted with survey evidence and Agents' reports that, while growth was slowing, it remained positive. This was true across a range of surveys. But the surveys did point to a worsening outlook for manufacturing: output expectations balances have fallen back in the CBI Industrial Trends survey (+9 in January) and the CIPS survey suggested orders growth was almost zero (index of 50.7 in January). But there remained a large discrepancy between ONS and survey data about whether this future deterioration would follow a period when

output had been rising or falling.

A21 Recent data relating to the situation in Asia were considered. The effects of the crisis were beginning to be evident. Exports to the region had been falling sharply, though imports from the region had been less responsive. G7 trade balances with East Asia were deteriorating (Japan, Germany, France, UK). The Agents undertook a special inquiry in February into the effects of the Asia crisis on UK companies. Recent Agents' reports had mentioned export difficulties amongst some companies, worries about dumping and the impact on inward direct investment. The survey was focused on firms which were expected to be sensitive to the East Asia situation, three quarters of whom were manufacturers. Around 60% said that the situation had already had an impact, two thirds in terms of lost export orders, and a half mentioned some reduction in export prices. Around a quarter had seen a rise in imports from the region; and around a third are benefiting from a fall in their import costs. But around one half had seen a fall in the price of competing imports. Some mentioned the likely wider impact on world commodity prices. Of those who had not yet seen an impact, over three quarters did not expect that to change. In general, a number of respondents and Agents felt it was still too soon to gauge the overall effect on UK business.

III The labour market

A22 Service sector demand for labour remained quite strong: the CIPS survey for January showed the largest increase in employment since August, and there was only a marginal slowdown in February. Information from the Bank's Agents supported the broad picture, although there were some indications employment growth was beginning to fall. There was mixed evidence on manufacturing. ONS data indicated a fall of 17,000 in manufacturing employees in employment in December after two small increases in October and November; the monthly data were, however, quite volatile and were often revised when the quarterly Workforce in Employment survey was released. In contrast, the CIPS survey was consistent with a small increase in employment levels in each of the six months to February. The Agents were reporting a flat position overall with small rises in some regions and small falls in others; this was a slightly weaker position than in the autumn. A broadly flat position was the best assessment of the short-term trend.

A23 Claimant unemployment fell by just over 12,000 in January, leaving the rate unchanged at 5%. The decline was less than in previous months. But the small fall could at least partly reflect the early date for the count: the Employment Service had less time than usual in the New Year to close down the claims of those who had found work. There was a small rise in claimant unemployment in the North East, Scotland and Northern Ireland in January. But looking back over the past six months, the fall in unemployment across the regions had been remarkably uniform outside Northern Ireland.

A24 The stock of vacancies fell by 12,400 in January and was back to the level of early 1997. In contrast to November and December, the decline was not due to the removal of the statistical overcount. But the early count date might have had an influence. Notifications of new vacancies were very weak and were thought to have been affected more than the outflow. A bounce-back in February was quite likely.

A25 There was mixed evidence on skill shortages. The February Reed survey reported that 71% of firms were reporting shortages of suitably skilled applicants, down 6 percentage points from the previous survey. Skill shortages were more prevalent in the service sector and indeed had increased since the previous survey; the easing of shortages in manufacturing was sufficient to pull down the overall average. The Reed data suggesting fewer shortages in manufacturing was in line with the CBI quarterly survey reported in the previous month. But the most recent BCC survey had reported increased recruitment difficulties in both services and manufacturing and the February CIPS survey reported that skill shortages had contributed to a further rise in work outstanding in the service sector. Construction firms were reporting increasing difficulty in attracting suitable applicants. The Agents reported high levels of shortages across a range of skills, but no further intensification in the most recent month.

A26 Whole-economy underlying average earnings growth was unchanged at 4¾% in December. Earnings in manufacturing and services were both rising at this rate; the rise in the private sector remained above 5%. High bonuses had pushed earnings growth up; earnings in the financial intermediation sector were 9.6% higher than in December 1996. But there had also been a modest pick-up in recent months in the earnings measures which smoothed out the effect of bonus payments: the Kalman filter estimate was up 4.7% in the year to December and the estimate which smoothed erratic movements at the industrial level had increased to 4.55%.

A27 Further information confirmed that wage settlements had increased in January, though by a smaller amount than the provisional estimate known at the time of the February *Inflation Report*. Based on 125 settlements covering 74% of the employees expected to settle in January, the three month employment-weighted median settlement in the Bank's database was 3.6% in January, up from 3% a year earlier. The twelve-month mean settlement had risen to 3.4% in January from 3.3%, and in the private sector had increased to 3.8%. The one-month weighted median was 0.5% points higher than in January 1997. Longitudinal analysis of companies settling in January in both years confirmed the general trend but also revealed some exceptions: just under a quarter of firms had achieved a lower settlement in 1998 than in 1997.

A28 The staff presented an analysis of wage drift - the difference between earnings growth and settlements. Previous Bank analysis had suggested that settlements do not necessarily lead wage drift; if anything the reverse tends to be the case. But the rise in performance-related pay systems

meant that there was a risk of a permanent gap emerging between basic pay settlements and total earnings. This might have been offset in recent years by the structural decline in more traditional forms of non-basic pay such as overtime and piece-work. But in the short term such payments might rise as a result of labour market tightness. Several special factors such as the phasing out of tax relief on PRP and the prospect of a national minimum wage might also be affecting settlements.

A29 Although higher settlements would underpin the basic component of pay in 1998, the outlook for earnings would also depend on the various factors affecting the different components of wage drift. The pace and extent of the slowdown in activity would also be a major element.

IV Prices

A30 The latest data showed a further fall in commodity prices in January. The Bank index fell provisionally by 1.7%, largely accounted for by falling oil and metal prices, taking the annual rate to -13.3% (-8.2% excluding oil). Domestic agricultural prices - assumed flat in the provisional estimate - were likely to have fallen again in January, based on producer price data covering food manufacturing materials. UK agricultural prices fell by 14.5% over the year to December 1997.

A31 Oil prices fell further in February - the fourth consecutive monthly fall - to below \$14pb by the end of the month. Higher OPEC quotas and the UN/Iraq deal, alongside lower demand due to a relatively mild northern hemisphere winter, had resulted in rising stocks and falling prices.

A32 Manufacturers' input prices fell by 0.9% in January - taking the annual rate to -9.7% - reflecting falls in oil, food and imported material prices. The CIPS PMI survey for February indicated further falls in material prices. Manufacturers output price inflation remained low. Output prices excluding excise duties (PPIY) fell by 0.2% in January reflecting falling petroleum product prices. Annual PPIY inflation was negative (0.1%) for the first time since 1974 (the start of the series). The CBI Industrial Trends survey suggested a continuation of the recent trend - the balance of firms expecting to raise prices over the next four months remained negative (-7) in January. Overall, UK producer output price inflation was the lowest of the main European economies. But it was above US producer price inflation (-1.9%) which, like the United Kingdom, had been influenced by currency appreciation.

A33 Corporate service sector price indices published by the ONS, covering services such as road freight transport and industrial cleaning, suggested that inflation in the business service sector was higher than in the manufacturing sector (measured by producer price indices). Survey evidence and the Bank's Agents suggested a similar contrast between the different sectors.

A34 Trade prices fell further in December. Export prices fell by 0.5% (excluding oil and seasonally unadjusted); and import prices by 0.2%. Annual rates stood at -4.2% and -4.3% respectively (excluding oil). Revisions to trade prices meant import prices had fallen a little more since the start of the appreciation than previously recorded. But the overall fall remained only a little more than half that expected on the basis of past behaviour.

A35 A number of factors may have accounted for the sluggish response of import prices to sterling's appreciation in 1997. In sterling terms, export prices in the major six overseas economies had deviated significantly from UK import prices since the appreciation. But other factors were more in line with the behaviour of import prices so far. Expectations in 1997 that the appreciation would be temporary and reversed may have delayed the response of prices. And strong relative demand in the United Kingdom may also have enabled import prices to remain above world prices in the short term. Furthermore, the dollar - against which sterling has appreciated by considerably less than the ERI as a whole - may account for a greater volume of UK trade than is implied by its ERI weight (16%). Developing countries and particular sectors - for example commodities and aerospace - traded world-wide in dollars. Evidence suggests that this may increase the dollar's significance in UK trade to around 20-25%. So using the ERI to estimate the expected fall in import prices may underweight the dollar's influence, at least on shorter-run import price movements.

A36 The implications of the analysis were that the factors which might have accounted for the slow response of import prices in 1997 were unlikely to persist. While some depreciation of sterling was still anticipated, market exchange rate expectations were now much closer to current levels. And relatively strong demand growth in the United Kingdom was likely to moderate as the economy slowed this year. The dollar effect was unlikely to persist as competitive pressures require firms to adjust dollar prices. So further downward pressure on import prices - and in turn retail prices - seemed likely in 1998, as was assumed in the February *Inflation Report* forecast.

A37 Retail price inflation fell in January. RPIX fell to 2.5% from 2.7% in December. The fall was consistent with the central projection in the February *Inflation Report*. RPIX goods price inflation was lower in January, falling to 1.7% from 2.1%. RPIX services price inflation fell to 2.8% from 2.9%. The sharp fall in goods inflation reflected record discounting in the January sales and lower food prices. In both cases, it is not clear whether these effects will persist. Typically the larger the discounts in January, the larger the subsequent price increases in February. So it was not clear whether some of the fall in goods price inflation in January reflected further pass-through from lower import prices. February and March would be important months to note this effect in the post "sales" period. The fall in services inflation was due mainly to a smaller rise in repair and maintenance charges than last year, and falling gas prices. Car insurance premiums increased in January and a range of services prices were still rising at an annual rate of over 4%. The

differential between goods and services inflation was 1.1% on an RPIX basis, but over 2% on a RPIY basis.

A38 Other inflation measures also moderated. HARP and THARP inflation rates were closer to RPIX inflation as house price inflation moderated. And the UK EU harmonised price index rose by 1.5% in the year to January (1.8% in December) compared to the EU average rate of 1.6% (December).

A39 The short-term outlook for RPIX inflation would depend significantly on the scale and timing of any Budget changes to excise duties.

V Financial markets

A40 On the whole it had been a quiet month in the foreign exchange markets, despite quite a lot of news (eg from the Gulf and the G7 meeting). Sterling and the US dollar had traded in narrow ranges. The Deutsche Mark had also been stable. Of the major currencies, the yen had been the most volatile. Early in the month it had rallied on the prospect of a meaningful fiscal package and some abatement of concerns in Asia, but it weakened subsequently as hopes of a fiscal stimulus proved unfounded with the announcement of no new tax cuts either before or at the G7 meeting. With renewed weakness in the Nikkei in the second half of the month and downgrades of three more Japanese banks, the yen was 1.9% lower against the dollar and 1.4% lower against the DM compared with the position at the previous month's MPC meeting. Elsewhere in Asia conditions had been a little more stable.

A41 Over the month as a whole, the sterling effective exchange rate had risen very slightly. Using a simplified definition of the ERI based on the Deutsche Mark, US dollar and yen and implied volatilities from options on bilateral exchange rates, it appeared that one-month and twelve-month uncertainty on sterling had declined since the previous MPC meeting, though longer-term uncertainty remained greater than short-term uncertainty.

A42 In Europe spot exchange rates were, in general, approaching their ERM parities. In the case of forward exchange rates, the apparent divergence with central rates was smaller. The implied twelve-month correlation between the DM and the French franc remained very close to unity and correlations between the DM and the Spanish peseta and between the DM and the Italian lira were at or above 0.98.

A43 Short-term UK interest rate expectations were higher than a month ago. The interest rates implied by the June, September and December 1998 sterling futures contracts this year had risen by around 20 basis points, but a downward trend in the level of rates was still foreseen later in the

year. Market participants who believed the MPC would not raise rates at its 4-5 March meeting pointed to doubts about the strength of retail sales, the weak international outlook, the lower-than-expected RPI figures and the imminence of the Budget. Those who expected a rise pointed to the finely balanced January MPC vote, the warning in the *Inflation Report* over the need for a further rate rise and continuing wage pressures. There appeared to be a spread of views on the strong Public Sector Debt Repayment figures announced during the month; some in the market suggesting it was a negative windfall for the personal sector and others thinking it a backward-looking reflection of strong economic growth.

A44 The yield curve had become slightly more inverted. Zero coupon gilt yields had fallen over the first part of the month, by close to 20 basis points from ten years out. The peak had come on the day that the unexpectedly large PSDR was announced, opening up the prospect of reduced gilt supply, but over half of these gains had subsequently been lost.

A45 Zero coupon yields on indexed gilts had fallen again in February, by around 10 basis points at 10 years and by more at shorter maturities. Part of the parallel fall in redemption yields appeared to have been a statistical artefact, reflecting the fact that the month-on-month RPI inflation number was different from the 3% annual assumption the market conventionally uses in calculating IG yields. But this was not an explanation for the fall in real yields over the year as a whole, where annualised RPI outturns had been reasonably close to the 3% assumption. Long-dated real redemption yields in the United Kingdom had fallen by some 60 basis points since the start of September, while US real redemption yields had risen by 10 around basis points. There were three possible reasons why UK long-term real redemption rates had fallen over this period. One possibility was that it might reflect microeconomic changes associated with the Minimum Funding Requirement (MFR), introduced as part of the Pensions Act, which meant that pension fund managers were willing to accept a lower real return on index-linked debt. Another possible cause was the impact of the Asia crisis, which could have led investors to expect a looser monetary stance and possibly increased the relative attractiveness of index-linked bonds against riskier equities and conventionals. However, it was not clear why this should affect the United Kingdom more than the United States. The third possibility was that the fall in real yields reflected the increased probability of the United Kingdom joining EMU, since EMU membership would imply convergence in nominal yields but not necessarily initially in inflation performance. While the EMU story did not have any implications for risk or scarcity premia on index-linked debt, the MFR explanation might do so; to the extent that this was material, the Bank's measures of implied inflation rates from the bond market might be biased upwards.

A46 The All Share Index had risen 3% since the previous month's MPC meeting. Industry sectors continued to diverge. Relative to the All Share Index, General Industrials - the closest match to the manufacturing sector - had performed poorly since last year, perhaps reflecting the

weakness of manufacturing output, but there had been no further deterioration since the Committee's February meeting. By contrast, Financials had continued to outperform. The negative skew (measured by the difference between mean and mode) in the probabilities attached to future levels of the FT-SE 100, which had worsened dramatically with the outbreak of the Asian crisis, had returned to its five year average level over the month. One possible explanation was that this reflected reduced concern over Asia, since the fall had in part coincided with a decline in spreads on Korean corporate debt.