

Publication date: 21 April 1999

MINUTES OF MONETARY POLICY COMMITTEE MEETING

7 and 8 April 1999

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 April 1999.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9904.pdf>).

The Bank of England Act 1998 gives 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 on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 5 and 6 May will be published on 19 May 1999.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 7-8 APRIL 1999

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

The world economy

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

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

4 There were some signs that commodity prices had begun to bottom out, and oil prices had risen sharply as a result of agreed cutbacks in supply. While it was too soon to judge whether these increases would persist, the cutbacks appeared to have greater credibility in the market than had

sometimes been the case. The downward pressure on world prices from oil and other commodities might therefore be less than in the recent past. But with most economies outside the United States below productive capacity, the scope for a generalised pick-up in inflation was limited.

The exchange rate, money and credit

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

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

Demand and output

7 The Committee discussed the revisions made to the estimates of the level and composition of GDP for 1997 and 1998. Since the February *Inflation Report*, the estimated level of GDP at market prices in 1998 Q4 had been reduced by ½ %, although by only ¼ % when measured at basic prices. This had consequences for measures of the output gap and labour productivity. The implications for future price developments were unclear. On one interpretation, this implied that there was less pressure on capacity and that, given the lags involved, the effects of slower GDP growth had yet to feed through fully into lower inflation. On an alternative view, it suggested a less favourable short-run trade-off between activity and inflation; inflation was unchanged and either capacity utilisation was lower, core inflation higher or estimates of capacity had been reduced. But the size of the changes had not been large, and it was not clear on either view how much significance should be attached to this.

8 Estimates for the growth of GDP in 1998 Q4 had also been revised downwards, to 0.1% over the previous quarter. Within this total, the weakest demand components had been government

consumption and net trade. In contrast private consumption and investment had been revised up, significantly so in the case of business investment. At the same time, the downwards revision to inventories suggested that the risks of a significant stock cycle in 1999 had diminished, particularly since stocks held by manufacturers and retailers appeared under control. This interpretation was in line with earlier survey evidence for these sectors. But because of the downwards revision to the level of GDP, the estimated stock-output ratio was little changed.

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

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

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

12 Forward-looking survey evidence continued to suggest an improvement (from a low base) in business confidence in all sectors of the economy. But official data and that from surveys indicated

that manufacturing output was still declining, and information from the Bank's regional Agents suggested that in this sector in particular, confidence remained fragile. By contrast, the CIPS index for services output had risen above 50, indicating growth rather than contraction, for the first time since October. The sharp fall seen in the second half of 1998 might have been partly in response to events in financial markets at that time. A recovery in confidence had therefore been expected, with the readings now consistent with the central projection for output in 1999 contained in the February *Inflation Report*. The CIPS survey for construction had also strengthened, in line with other indicators for that sector.

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

The housing market

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

The labour market

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

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

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

Prices

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

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

20 The most recent figure for RPIX inflation - at 2.4% - had been below the target for the first time since the Committee had been established. This had been despite some strength in the price of seasonal foods, which might unwind in coming months. But the difference from the 2.5% target was very small, and of little relevance to the prospects for inflation two years ahead. Next month it was very likely that RPIX inflation would be above target as a result of the timing of Budget measures,

which would affect petrol prices in March as compared with April last year. But this effect would last for only a month, and should have no implications for inflation in two years' time.

Tactical considerations

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

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

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

The immediate policy decision

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

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

26 The Committee considered various developments which could have suggested leaving rates unchanged this month. The prospects for activity were much as expected, with some signs that past reductions in interest rates were beginning to sustain activity. The changes to the composition of

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

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

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

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

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

31 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be reduced by 25 basis points to 5.25%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Alan Budd, Charles Goodhart, DeAnne Julius, Ian Plenderleith and John Vickers) voted for the proposition. Willem Buiters voted against, preferring a reduction of 50 basis points.

32 The following members of the Committee were present.

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

Andrew Turnbull was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

A1 This Annex summarises the analysis presented by the Bank staff to the Monetary Policy Committee on 1 April, in advance of its meeting on 7-8 April 1999. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in the Annex.

I The international economy

A2 In the United States the final estimate of GDP in 1998 Q4 had been 1.5%, in line with the preliminary estimate. Some special factors which may have supported robust growth in Q4, such as the seasonality of trade data, had possibly begun to unwind in Q1. The trade deficit had widened to \$17.0 billion in January from \$14.1 billion in December. However, other factors supporting rapid growth in Q4 had persisted in early 1999. The outlook for consumption had been little changed: retail sales growth had remained rapid in the first two months of the year and consumer confidence had risen again in March. The NAPM index of industrial sentiment had risen further in March. The sharpness of the rise in the NAPM index in recent months had suggested at least that the slowdown in industrial production growth might have bottomed out. Employment growth had been strong in February, but had weakened in March. This month-to-month volatility may have reflected some weather-related erratic influences. The unemployment rate had fallen to 4.2% in March. Annual growth in average hourly earnings had continued to ease, falling to 3.6% in March, and consumer price inflation had remained muted. Since the March MPC meeting, market expectations of interest rates in the United States had declined, while equity prices in mid-1999 were expected by the market to be slightly higher.

A3 Within the euro area, Italian GDP had declined by 0.3% in 1998 Q4. This decline had been exaggerated by the smaller number of working days in the quarter compared with Q3, though the data had still revealed unexpected weakness in domestic demand growth. In the euro area as a whole, industrial sentiment had weakened slightly in February. The western German Ifo index had fallen in February to its lowest level since August 1996. Yet consumer confidence had remained buoyant. French retail sales had fallen in February but underlying growth had remained robust. The three-month centred moving average of annual broad money growth in the euro area had risen to 5.1% in January from 4.9% in December. Monthly data showed that year on year growth had slowed to 5.2% in February from 5.6% in January, partly reflecting weaker growth of overnight deposits. Annual growth in the euro-area HICP had remained at 0.8% in February, and there had been little sign of inflationary pressure from intermediate prices. Since the previous MPC meeting, the euro had depreciated against the dollar and market expectations of short-term

interest rates had declined. In its spring forecast, the European Commission had revised down its projections for GDP growth in the euro area in 1999 and 2000, to 2.2% and 2.7% respectively.

A4 Japanese GDP had fallen by 0.8% in 1998 Q4. There had been evidence of earlier fiscal stimulus in the data on government investment, which had contributed 0.9 percentage points to growth in that quarter. But all other major components of GDP had remained weak in Q4. In February, the unemployment rate had risen to a record high of 4.6% and inactivity had increased. Employment had continued to fall. In February, personal incomes had continued to decline. Real consumption had fallen by 3.8% in the year to February. The March *Tankan* survey of industrial sentiment had recorded a slight improvement in business confidence, owing primarily to an easing of financial conditions. But other indicators within the *Tankan* had remained weak. Since the March MPC meeting, ten-year government bond yields had continued to fall, by around 25 basis points. Market expectations of Japanese short-term interest rates had remained relatively stable, as had the yen.

A5 Spreads on government bonds in emerging markets over US Treasuries had narrowed over the month, although they remained higher in Latin America than in Asian countries. Agreement on a new IMF financial package for Brazil had been reflected in the appreciation of the Brazilian real since the previous MPC meeting. But available data for the first two months of this year had shown that capital flows to emerging markets were unlikely to be markedly larger in Q1 than in Q4.

II Monetary and financial conditions

A6 Growth of notes and coin had remained stable in March. After adjusting for the effects of the new 50 pence and £2 coins, the one-month growth rate had remained at 0.5%, as in January and February. The annualised three-month growth rate had fallen to 6.0% in March from 6.9% in February.

A7 The stock of M4 had increased by £4.2 billion in February compared with £1.2 billion in January. The February figure included a £3.9 billion rise in repos (not seasonally adjusted). The slowdown in annual M4 growth had continued in February: the twelve-month growth rate of M4 had fallen to 7.4%, from 7.7% in January.

A8 The growth of M4 lending had been relatively weak in February at £3.6 billion, despite strong reverse repo activity, partly reflecting a substantial securitisation. The twelve-month growth rate of M4 lending had been 6.9% in February compared with 7.8% in January (after adjustment for the securitisation, the twelve-month growth rate was 7.1%). This slowdown had partly reflected strong February 1998 figures dropping out of the calculation.

A9 Private non-financial corporations' (PNFCs') holdings of M4 had grown by 1.6% in

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

A10 Households' holdings of M4 had increased by £2.0 billion in February, compared with an increase of £1.9 billion in January. The weak figure for January had been attributed, in part, to the effects of concentrated income tax payments following the introduction of self-assessment. While it was possible that these effects had also been present in the February data, the new information might imply a more general slowdown. Households' M4 borrowing had remained steady at £3.2 billion in February. Total lending to individuals had increased by 0.6% in February, much the same as the average since February 1998. Within individuals' lending, secured lending had increased by 0.5% in February. Again this was broadly in line with one-month changes since February 1998. But the one-month growth rate of unsecured lending had fallen from 1.3% in January to 0.9% in February.

A11 The stock of M4 held by other financial corporations (OFCs) had increased by £0.3 billion in February compared with a fall of £1.8 billion in January. The twelve-month growth rate in OFCs' M4 had fallen to its lowest level since 1995Q1. M4 lending to OFCs had increased to £1.7 billion in February from £0.3 billion in January.

A12 Turning to price indicators of monetary conditions, sterling interest rate expectations had fallen since the March MPC decision. Short-term interest rates had implied that financial market participants expected the repo rate to fall to around 5% during 1999. Longer-term nominal interest rates had also fallen: three-year forward rates had fallen by around 20 basis points since the March MPC meeting. The falls had been concentrated at the short end of the yield curve.

A13 Measures of short-term inflation expectations from monthly surveys had remained broadly unchanged at 2.2% to 2.3%. Measures of two-year inflation expectations from quarterly surveys had shown falls for almost all groups surveyed: for example, the Barclays Basix survey had reported that trade unions' average RPI inflation expectations for the next two years had fallen by 40 basis points since the 1998 Q4 survey. Inflation forward rates, derived from index-linked bond yields, had shown little change since the March MPC meeting. Since the February *Inflation Report*, however, inflation forward rates at all maturities had risen from a range of 2.5% to 2.9% to around 3%. One explanation offered by Bank staff was that nominal yields may have been artificially depressed earlier this year as a result of institutional investors' demand to hold liquid instruments.

A14 The FT-SE 100 index had risen by 6.8% since the March MPC meeting. Implied volatility had fallen further, and to below the levels seen before the Russian debt crisis. The FTSE SmallCap index had risen more than the rest of the market, reflecting in part the strength of the General industrials sector over the period. The Resources sector had also performed very strongly alongside the rise in oil prices.

A15 The effective exchange rate had fallen in recent days, after an earlier appreciation, to stand 0.3% lower than at the March MPC meeting. Sterling had changed little against the euro and had depreciated slightly against the US dollar.

III The Budget

A16 Staff presented a short summary of the Chancellor's recent Budget. HM Treasury's forecast of PSNB (including the windfall tax) for 1998/99 had been revised up slightly. Lower receipts had more than off-set lower spending. The Budget had announced measures that would increase borrowing by £1 billion in 1999/00, £1.4 billion in 2000/01 and £3.6 billion in 2001/02. However, other changes to HM Treasury's forecasts for spending and receipts over these years had led to lower projected borrowing over the same period. Lower forecasts for social security payments and debt interest payments had more than offset lower projected receipts.

A17 Overall, the outlook for the fiscal stance was little changed since the Pre-Budget Report: a small deficit had still been projected in 1999/00 and 2000/01 but this was cyclical in nature; the structural deficit had been projected to be broadly balanced. The 'Golden Rule' was expected to be met with a small margin of safety over the next three years. The net debt to GDP ratio had been projected to fall well below 40 per cent by 2001/02.

A18 The Budget measures had been aimed at targeting help on families with children, improving work incentives and promoting enterprise through microeconomic reform. These had included reductions in personal income tax rates; changes to National Insurance contributions; measures to reduce taxation for small businesses; and the introduction of a Children's Tax Credit along with increases in existing benefits to families with children.

IV Demand and output

A19 The 1998 Q4 National Accounts release had included revisions back to 1997 Q1. The level of GDP at constant market prices in 1998 Q4 had been 0.3 percentage points lower than the February estimate, and 0.5 percentage points lower than the preliminary estimate. Revisions to GDP at constant basic prices had been more limited. Downward revisions to the level of the income and output based measures of GDP had reduced the shortfall of expenditure relative to the average measure. In 1998 as a whole, GDP had grown by 2.1% (revised from 2.3%) compared with 3.5% (unrevised) in 1997. The quarterly growth rate of GDP at constant market prices in Q4 had been revised down to 0.1% from 0.2%. Within the expenditure measure of GDP, upward revisions to consumption and investment growth and the contribution of net trade had been matched by a large downward revision to changes in inventories.

A20 Household spending growth in Q4 had been revised up to 0.6% from 0.4%, following an outturn of 0.1% in Q3. Spending on vehicles and energy had been particularly volatile in Q3 and Q4. Household spending growth had slowed overall in 1998: the annualised rate of growth had eased to 1.2% in 1998 H2 from 3.0% in H1. Despite strong consumption growth, the household saving ratio in Q4 had risen to 7.4% from 6.3%. This had reflected a sharp decline in tax payments which had led to an increase of 1.8% in post-tax income. Compensation of employees had risen by 1.5% in nominal terms in Q4. The erratic path of tax payments and household income during 1998 had partly been related to the introduction of self-assessment. The level of tax payments made by households had risen sharply in 1998 by 17%, leading to virtually no growth in real post-tax household income.

A21 Whole economy investment growth in Q4 had been revised upwards to 2.9% from 2.0%. Business investment had grown by 5.5%. The ratio of business investment to GDP had increased sharply in recent years - in line with the ratio in the US - to exceed its previous peak in 1989 Q3. But the increase in the capital stock to output ratio had been more moderate. In both the UK and the US part of the recent strength in business investment was due to IT spending.

A22 Changes in inventories in Q4 had been revised downwards to £0.9 billion from £1.9 billion. If alignment adjustments are excluded, stockbuilding had increased by less in Q4 than in Q3. The revisions had been concentrated in 'other industries' and manufacturing. Manufacturers and retailers had destocked in Q4, consistent with earlier survey evidence. But lower stockbuilding had been to some extent offset by a downward revision to output so that the stock-output ratio had been little changed. The March CBI monthly Industrial Trends survey had continued to indicate that stocks were more than adequate: the balance had been +20, above its average of +13 since 1985.

A23 The contribution of net trade to GDP growth in Q4 had been revised to -0.9 percentage

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

A24 Service sector output growth in Q4 had been revised down to 0.5% from 0.6%. Manufacturing output had declined by an unrevised 1.3% in Q4. Construction output growth had been revised up to 0.1%. On the income side of the accounts, the main news had been the decline in financial company profits in Q4.

A25 Retail sales volumes had declined by 0.3% in February, following January's strong rise. Though the three month annual growth rate declined further to 1.0%, the CBI Distributive Trades survey had suggested that the decline in sales volumes growth might have reached a trough. The balance on reported sales in March had risen to +14 - the highest since September 1998 - and the orders balance had risen for the second month running. New car registrations had fallen sharply in January and February relative to a year ago, but had been difficult to interpret because of changing seasonal patterns following the change in registration practices.

A26 Industrial production had declined by 0.5% in January - because of a sharp fall in output in the energy extraction and supply industries - but had risen by 0.1% in February because of a rise in energy-related output. Manufacturing output had shown a small increase of 0.1% in January, following five successive monthly declines, but had fallen by 0.1% in February. Growth in industrial production over the three months to February compared with the previous three months had been -1.0% (-0.9% in January); and for manufacturing output it had been -0.8% (-1.0% in January). The CBI and CIPS surveys had indicated another decline in manufacturing output in 1999 Q1, though it appeared that this would be less than in 1998 Q4.

A27 The CIPS Report on Services had reported a rise in all indices in March: the output index had risen from 49.5 to 53, the first positive reading since October 1998; the incoming new business index had also risen above 50 to 53.9, the highest level since June 1998 and above the average for 1998 as whole; and the business expectations index had risen to 76.4 from 72.1 in February.

A28 The Nationwide house price index had increased by 1.5% in March - the largest monthly rise since June 1997 - and had been 7.6% higher than a year earlier; the Halifax index had increased by 1.2% in March and had been 4.5% higher than a year earlier. The RICS survey had suggested price rises across all regions in February. The HBF survey balances on site visitors and net reservations had continued to indicate an increase in housing transactions in coming months. Particulars delivered had increased for a third consecutive month, to stand 4.5% higher in the three months to February compared with the previous three months. The GfK consumer confidence indicator had risen for the third month running.

V Labour Market

A29 LFS employment had grown by 119,000 (0.4%) in the three months to January, compared with the previous three months, somewhat stronger than the Workforce Jobs figure of 69,000 in the three months to December. The difference between the two measures, probably due to timing and the coverage of the surveys, was accounted for by the larger rise in employees in the LFS, driven by a large increase in part-time jobs. Total hours worked had fallen by 0.2% in the three months to January, and average hours per worker had been 0.7% lower. The fall in average hours worked had reflected the large rise in part-time employment and a 0.7% fall in average hours worked by full-time workers, consistent with a reduction in overtime working.

A30 The strong increases in employment had contrasted with survey evidence. The CIPS surveys for March had suggested that employment was continuing to fall in the manufacturing and construction sectors, though there had been a small increase in employment in the service sector. Forward-looking surveys had suggested that this pattern might persist. The Manpower survey for Q1 had shown the weakest job prospects since 1993, for the second quarter in succession. The outlook in manufacturing had worsened, while employment intentions in the service sector had been little changed.

A31 The stock of unfilled job-centre vacancies had edged down by 3,500 in February and the number of jobs advertised in national newspapers had fallen, according to the Press Recruitment Advertising Index. But the number of permanent placements by job agencies had increased in March for the first time in six months, according to the FRES survey on the demand for staff.

A32 LFS unemployment had risen by 37,000 in the three months to January, taking the rate to 6.3%. This had been the first rise in the rate, in non-overlapping periods, since early 1993. The number of people unemployed for more than one year had fallen by 17,000 in the three months to January, offset by a rise in short-term unemployment. Claimant unemployment had risen by 4,300, but the rate had remained unchanged at 4.6%. Inflows into unemployment had been

broadly flat, and the exit rate from unemployment had fallen, but remained at a high level. The rise in employment had been associated with a fall in inactivity of 117,000. In net terms, all of the rise in employment had been concentrated among workers more than 25 years old, which had been roughly matched by falls in inactivity.

A33 Headline whole-economy annual average earnings growth had fallen to 4.3% in December, reflecting a decline in the growth of irregular pay. The slowdown in headline earnings growth since the peak in May had been sharp, but this measure referred to growth in earnings per head. It was likely that the growth in earnings per hour had fallen less rapidly, reflecting the reduction in average hours worked over this period. The Reward index of annual earnings growth had continued to fall, from a peak of 5.4% in June 1998 to 4.5% in February. The growth of wages and salaries had been broadly flat since mid-1997. The rise in 1998 Q4, which had contrasted with the fall in growth measured by the Average Earnings Index over the same period, could be explained by volatility in pension contributions and balancing adjustments between different measures of GDP.

A34 The Bank's employment-weighted twelve-month measure of whole economy settlements had remained at 3.7% in February, but the three-month measure had fallen by 0.3 percentage points to 3.3%. In a matched sample of firms from the Bank's settlements database, mean settlements in January and February had fallen to 3.3% in 1999, from 4% in 1998. The proportion of employees in this sample who had received a lower settlement in 1999 had been 78%. The three-month measure from Industrial Relations Services had also fallen in February.

A35 Annual productivity growth had fallen from 1.1% in Q3 to 0.7% in Q4, the lowest rate since 1991. The revisions to Workforce Jobs, announced in December, had caused a generally downward revision to productivity growth. Because the growth of wages and salaries per head had increased and productivity growth had fallen in Q4, the growth of unit wage costs had continued to rise.

A36 The Bank's regional Agents had conducted a survey of their contacts about employment prospects and the adequacy and quality of their labour force. They had asked whether contacts had expected employment to change over the next 6 months: 36% of respondents had reported that the level of employment was expected to be unchanged, whereas the number of companies who had been planning to increase staff had been the same as the number planning to shed labour (32% each). Over 50% of manufacturers had reported that employment levels were expected to be lower whereas in the service sector over 40% of respondents expected higher employment. There had also been some differences across regions, but most had presented a picture consistent with the overall results.

A37 The Agents had also asked about the adequacy of the existing labour force in relation to

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

A38 The Agents also asked whether the quality of recruits had changed in the last 12 months. Around two-thirds of their contacts had reported that the quality of recruits had been the same recently. There had been little evidence of lower quality recruits overall. However, in the service sector, especially retail, there had been more dissatisfaction with the recent quality of recruits than in manufacturing.

VI Prices

A39 Oil prices had risen by over 20% in March in response to an agreement to new OPEC production cuts. The effect on RPIX inflation and GDP if oil prices were to remain at these levels was likely to be limited. The Bank's index of commodity prices excluding oil had fallen by 0.4% in February, and 1.2% including oil prices. The trend in both measures had continued to be one of moderating deflation. The measures to reform the Common Agricultural Policy (CAP), which had been agreed at the Berlin summit in March, included smaller and later price cuts than in the original proposals. The 0.3% (upper-limit) effect on the RPI which had been estimated by MAFF on the basis of the original proposals was likely to be smaller in light of the agreement. Producer price inflation had remained weak in February: input prices fell by 0.1% - as in January, the movement had been largely accounted for by the oil price (10% of the index); output prices excluding excise duties had risen by 0.2%, to a level 0.6% lower than a year earlier. The CIPS and CBI surveys had continued to suggest further falls.

A40 Import prices had fallen by 0.6% in January whereas export prices had risen by 0.6%. The difference between the annual rates of export and import price inflation had reached 1.5 percentage points in January, the largest difference since June 1997 - though both had remained sharply negative (imports -4.9%, exports -3.4%). The GDP (market prices) deflator in the year to the fourth quarter of 1998 had grown by 2.6%, revised down from 2.8%. The equivalent measure for the implied household consumption deflator had been revised up by

0.4 percentage points to 2.3% - close to the annual rate of RPIX inflation in the fourth quarter (2.5%). The unit labour costs based measure of domestically generated inflation had become available again, and had continued to rise in the fourth quarter of 1998.

A41 RPIX inflation had fallen by 0.2 percentage points to 2.4% in February; both RPIY and RPI inflation had also fallen, to 1.8% and 2.1% respectively. The fall had been largely due to goods price inflation falling by 0.3 percentage points to 1.1%. The HICP inflation rate had also fallen, by 0.1 percentage points to 1.5%, for the same reasons as RPIX. Annual RPIX inflation was likely to increase temporarily in March - largely due to the difference of timing of the budgets in 1998 and 1999 - and fall in April.

VII Reports by the Bank's Agents

A42 The Agents had reported on their general discussions with contacts. Firms in the service sector had tended to report slower growth. But conditions had remained fairly positive overall, particularly in leisure, finance and business services. Growth in the retail sector had continued to be relatively weak, though there had been an increasing polarisation in performance between stores reporting quite strong growth and those reporting no growth or even falling sales volumes. Service firms with an exposure to the manufacturing sector - such as road hauliers - had experienced adverse trading conditions. But Agents had felt that the rate of deterioration in manufacturing activity may have eased. Stock corrections that had started in 1998 Q4 had largely been completed. But competition in the domestic market from imports had been increasing, particularly from European-based firms as European markets had remained relatively weak. The exchange rate had remained a concern for UK exporters and was considered an obstacle to recovery. Demand from the United States had continued to be strong and some East Asian markets had seen a rise in trade enquiries.

A43 Construction sector activity had remained buoyant and this was expected to continue into next year. Housing market activity had shown signs of improvement although it had remained fairly subdued in many areas. But there was less construction work available beyond mid-2000. Firms had suggested that public sector work was likely to be an important factor next year. The outlook for investment more generally had remained positive, though still cautious, and the focus of spending had continued to be on improved efficiency and product development. Investment in some sectors - such as oil and steel - had been reduced or moved overseas.

A44 The service sector had continued to be the main provider of new jobs, though tighter control on numbers and increased flexibility had been evident. More firms had been introducing annualised hours contracts and making more use of part-time and temporary contract staff. There

had been evidence that some firms were reluctant to shed staff as demand slowed because of likely recruitment difficulties in any upturn. Natural wastage had been employed to reduce staff numbers by small amounts. Pay awards had moderated in both the manufacturing and service sectors, more so in manufacturing where there had also been a rise in the number of zero or deferred awards.

VIII Market intelligence

A45 There had been a broad market consensus that interest rates would be lowered in April, based on the improving inflation picture, with some also expecting an ECB rate cut. Survey and asset price evidence had suggested a wider divergence of views on UK rates over the next year or two, based on alternative forecasts for growth and inflation up to 2000. Long-term rates had fallen slightly over the past month. Sterling had appreciated during 1999 versus the euro, and had appeared little affected by domestic factors in the month. Some of the factors influencing sterling - such as demand related to merger and acquisition business - were thought to have been temporary, and there had been some evidence that the market saw downside risks over the next year.