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MINUTES OF MONETARY POLICY COMMITTEE MEETING

2 and 3 March 1999

These are the minutes of the Monetary Policy Committee meeting held on 2 and 3 March 1999.

They are also available on the Internet (<http://www.bankofengland.co.uk/mpc9903.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 7 and 8 April will be published on 21 April 1999.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 2-3 MARCH 1999

1 The Committee discussed the prospects for the world economy; money and financial markets; demand and output; the implications of the Budget projections for the macroeconomic outlook; the labour market; prices; and other considerations bearing on the decision this month, before turning to its immediate policy decision.

The world economy

2 Activity in the United States economy had again been stronger than expected over the past month. Indeed, provisional estimates suggested it had contributed around half of the increase in world demand in 1998, well in excess of its 20% share of world output. The National Association of Purchasing Managers (NAPM) index had strengthened – partly reflecting an improvement in export orders. This was surprising given recent weakness in the world economy and the strength of the US dollar. There were, perhaps, some parallels with the UK survey data. However, the prospects for the US economy as a whole still seemed to be for slowing growth over coming quarters. On balance, prospects for growth in the euro area had weakened over the month, but with considerable inter-regional variation. The weak Q4 output data in Germany and Italy had more than counterbalanced some stronger than expected French data. In Japan, there were now signs that financial restructuring was taking place but, in the short run, this might exacerbate the weakness in credit conditions. The immediate prospects for activity there did not seem to have changed much over the past month. Overall, there seemed to be little change in the prospects for UK export demand from developments in other major industrial economies.

3 The situation outside the OECD had not changed much over the past month. There had been renewed difficulties in Brazil, and the real had weakened. There was still a risk of contagion, but other major countries in South America were not obviously under pressure. The lower oil price had already led to lower imports by the oil exporting countries and this could be seen in UK exports, but otherwise developments over the month were much as expected overall.

Money and financial markets

4 Narrow money growth continued to be quite strong, and was possibly being influenced by the past reductions in interest rates. Broad money growth was continuing to ease, and it was noticeable that the shorter three and six-month annualised growth rates were below the twelve-month growth rate. The risks from past rapid growth in broad money had diminished.

5 The sterling effective exchange rate was currently over 2% higher than the 15 day average used as the starting-point for the February *Inflation Report* projections. The FT-SE All-Share index had risen by 2% since the February *Report*. The rise in share prices was broadly based, with both the FT-SE 100 and Small Capitalisation indexes rising over the period. This was in contrast with earlier periods when the FT-SE 100 had grown faster than the Small Capitalisation index.

6 The rise in the sterling effective exchange rate reflected the balance of two offsetting bilateral movements; sterling had depreciated against the US dollar but had appreciated against the euro. The implications for UK inflation would depend on the reasons for the changes. Political and economic developments in the euro area probably accounted for some of the depreciation of the euro against the dollar and sterling over the past month. It was possible that the weakening euro reflected the market's expectation that prospects for euro-area demand and output growth were weaker than for the United States, and perhaps for the United Kingdom as well given the possibility of faster growth here in late 1999 and 2000. There was evidence that the movement in interest rate differentials could account for some of the rise in sterling.

7 The rise in the exchange rate and in equity prices would have opposite effects on the central projection for inflation, but the movement in the exchange rate was thought to be the more significant of the two. To the extent that sterling's strength persisted it would increase the imbalance between the traded and non-traded sectors of the economy, and would require a strengthening of domestic demand if inflation were not to fall below target.

Demand and output

8 The level of GDP in 1998 Q4 had been revised down by ¼% since the preliminary output estimate available at the time of the February *Inflation Report*. The expenditure composition had also been published, and this showed slightly weaker final domestic demand than assumed in the central projection. The rise in inventories had also been stronger than expected, leaving domestic demand growth a little stronger overall. But faster domestic demand growth had been offset by a larger negative contribution from net trade (primarily weaker exports), and so GDP

growth in the fourth quarter was, at 0.2%, unchanged from the time of the February *Report*. The statistical discrepancy between the expenditure and average measure of GDP was 0.6% in 1998 Q4. But due to the suspension of the Average Earnings Index there was no income measure of GDP available for Q4. Within the output breakdown, the fall in construction output for the third successive quarter seemed surprising given recent orders and survey data.

9 Consumption growth had been revised down in 1998 Q3, but the level in Q4 was not materially different from that expected at the time of the *Report*. Hence, the puzzle as to why consumption growth had weakened so much through 1997-8 remained. Retail sales (around 40% of consumption) had recovered in January, but the underlying picture remained fairly weak. Consumer confidence in January had risen for the third successive month on the GfK measure. It was likely that the five reductions in interest rates since the autumn had played a material role in stabilising confidence, but it was difficult to be sure how robust the recent recovery was. More work was needed to understand how consumer confidence was affected by changes in interest rates. There were also some signs of a pick-up in the housing market, particularly in the indicators which are at the start of the house buying process, such as House Builders Federation site visits and reservations. There seemed little news in the latest house price figures.

10 The build-up in inventories appeared a little puzzling as it was not apparent in either the official manufacturing or retail distribution figures, where any signs of weaker than expected demand might be expected. The rise in stocks in the fourth quarter - and for 1998 as a whole - had been concentrated in the 'other industries' sector, which included the quarterly alignment adjustment (between the expenditure and output measures of GDP). It was possible that this rise in stocks could partly reflect a change in the pattern of car registrations this year, which would not as yet be accounted for in the usual seasonal adjustment.

11 The news in the national accounts and recent surveys could be interpreted in several ways. First, the lower level of GDP than in previous estimates, coupled with the build up of inventories, might point to a weaker picture for demand than previously thought. In particular, the weaker outturn for exports in Q4, and the sharp fall in the volatile non-EU exports figure in January, might point to some of the downside risks to external demand coming through. But the changes in the composition and revisions to the level of GDP were not particularly large.

12 Second, the lower level of GDP, coupled with the latest survey data, raised the question of whether the low point in output growth might have come a little earlier than previously expected.

13 Third, the surveys, though generally remaining weak, had all been stronger over the past month. That uniformity was somewhat surprising, and might indicate a slightly better picture than previously thought. Some of the survey indicators were recovering towards levels recorded last summer, before the sharp deterioration occurred. Of particular note had been the improvement in export orders in both the CBI and CIPS surveys over the past month. So to the extent that the surveys had for a while been painting a weaker picture for exports than the ONS data, that gap now appeared to be closing.

14 Overall, the data did not significantly change the picture for demand and output. The improvement in survey data might prove significant, but had yet to be seen in the official data.

The forthcoming Budget

15 Prior to the meeting, the Committee was briefed by Treasury officials about the forthcoming Budget's expenditure and revenue projections and macroeconomic forecasts, but not the detailed measures. The overall fiscal position was reported to remain stable, and was in line with the assumptions in the February *Inflation Report*.

16 At the MPC meeting, the Committee briefly discussed the lower than planned Net Departmental Outlays seen in the first ten months of the 1998/99 fiscal year. This was primarily related to social security rather than other government departments' spending on goods and services. But since the control framework was new this year, it was not known what would happen to spending at the end of the year: departments had less of an incentive to spend their budgets in the final weeks of the fiscal year as they could carry spending forward to future years, which could have timing consequences for the pattern of real demand.

Labour market

17 The Committee had been briefed by Mr King and by Bank staff before the meeting on the review of the Average Earnings Index, which was published on 2 March. Earnings growth was now estimated to have reached a peak of 5.7% in May 1998, before falling back to 4.5% in November on the headline measure. Preliminary estimates of unit wage costs produced by Bank staff using the revised Average Earnings Index suggested a stronger picture for the first half of 1998 than previously thought, and a weaker picture in the second half of the year with the rate of change flat at around 3¾%.

18 The general pattern of earnings growth through 1998 was broadly consistent with the assumptions that had been made at the time of the February *Inflation Report*. That gave the

Committee members somewhat greater confidence in the starting assumptions for earnings growth than they had felt at the time of the *Report*. However, the pace of slowdown in earnings growth was more marked than had been assumed: starting from a higher level and ending a little below the February assumption. The level of earnings at the end of 1998 was close to that assumed in the projections. A preliminary analysis suggested that after making a rough adjustment for hours worked, the profile of the growth of earnings per hour through the second half of the year was broadly flat. Hence the rise and fall in the headline measure through 1998 was, perhaps, consistent with a higher, then lower, contribution from overtime. More analysis of the new figures was needed, for example of the contribution of bonuses to earnings growth. The fall in earnings growth through 1998 would need to be reconciled with the rise in employment and fall in unemployment over this period. One possible explanation was the fall in inflation expectations discussed at previous meetings. Among the recommendations made in the review of the AEI were a number of further improvements to the way the series was compiled to bring it up to best practice. Hence the Committee concluded that it should not, as yet, place great weight on the index.

19 The Bank's settlements series showed some signs that the peak might have been passed on the twelve-month employment weighted mean measure. The Reward index had declined on a broadly similar path to the revised Average Earnings Index over 1998.

20 The Committee noted that its central projection for earnings growth remained towards the top end of the range of other forecasts, despite a broadly similar projection for inflation in these forecasts. The Committee had discussed this during the February *Inflation Report* round in the context of recent movements in productivity. It would be necessary to look at the reasons for the differences in projections of real earnings growth, and hence implied profit margins, in the light of the new earnings data.

21 The latest data continued to show rising employment and falling unemployment, though total hours worked had fallen in December. The rise in employment was partly accounted for by an increase in the number of women in part-time employment. Both the stock of vacancies and number of new vacancies seemed surprisingly high and seemed to bear out the picture in the employment and unemployment data, suggesting a still tight labour market. But the latest Federation of Recruitment and Employment Services (FRES) survey showed that the job market index was at its lowest level since 1992. The three CIPS surveys for manufacturing, construction and services all pointed to falling employment. It seemed likely that a turning point would soon be seen in the official data.

Prices

22 Non-oil commodity prices had risen in January in sterling terms. There were tentative signs that the deflation might be coming to an end. The level of commodity prices was still much lower than a year ago, but they would have to keep falling to lower the central projection for inflation compared with February.

23 Contacts of the Bank's regional Agents were increasingly mentioning that consumers were more 'price sensitive' than previously. The Committee discussed possible explanations for this. The comment might simply reflect inflation illusion. Lower inflation over recent years may have made it easier for people to distinguish movements in relative prices from general price inflation. It seemed likely that the comments also reflected continuing structural changes in the retail industry, for example through a greater use of discount stores, which might be lowering margins.

24 The Committee also noted the rise in inflation expectations at longer maturities over the past month, as measured by the difference between implied forward interest rates on nominal and index linked bonds. It was too early to place much weight on this movement, which was in any event small by historical standards. There had not been much movement in shorter-term survey-based measures of inflation expectations over the past month.

25 Inflation had turned out a little higher than expected in January, but this reflected movement in the highly volatile seasonal food component. It was possible that better weather in February would lower some seasonal food prices. This had no implications for inflation two years or so ahead. The Committee noted that the timing of the Budget would mean that annual changes in fuel duties – from the previously announced 'escalator' – would be included in the March RPI figure this year, rather than in April as had been the case in 1998. This would mean a temporary rise in RPIX inflation in March, all other things being equal. The Committee noted that inflation outturns had been at, or above, 2½% since the introduction of the new policy framework in 1997. These outturns were more surprising given the mainly dampening shocks to world demand and prices. It would be important to consider whether there were any lessons from this.

26 The GDP deflator had risen 2.8% in the year to 1998 Q4, and was the highest for some time. However, the increase in the annual rate partly reflected a low figure in 1997 Q4 dropping out of the comparison, as well as some terms of trade effects. The rise in the household expenditure deflator was still below 2% in the year to Q4.

Other considerations bearing on the decision this month

27 Before turning to the immediate policy decision, the Committee discussed a number of other considerations. First, should the Committee seek to offset the projected weak GDP growth in the first half of 1999? Even if demand and output were turning out weaker than expected, the lags in the operation of monetary policy had previously been assumed to be such that only a limited effect on activity would be possible. However it was possible that there were signs, for example in the confidence surveys, of a more rapid response to changes in interest rates than had been the case in the past. One possible explanation was that the new monetary policy regime provided greater confidence in the commitment to the inflation target which was consistent with the fall in inflation expectations, and might help to explain the moderation of earnings growth since mid 1998.

28 Second, the exchange rate had risen, especially in recent days, to a level above that implied by the central projection in the February *Inflation Report*, despite the 50 basis point reduction in interest rates at the previous meeting. By itself this would tend to reduce import prices and retail prices, and might justify a reduction in interest rates. But it was too soon to judge whether the rise would persist, and what reaction there would be to a further reduction in rates. In any case, it would not be sensible for policy to react to high frequency movements in the exchange rate, as this could lead to a volatile path for interest rates from month to month, and might make it more difficult for others to understand the motives for interest rate changes.

29 Third, the Committee considered whether there was any particular significance in changing interest rates so soon after an *Inflation Report* round. Some members felt that clear news was needed for rates to change so shortly after the last forecast; otherwise, it would appear to downgrade the value and role of the projections.

The immediate policy decision

30 There were four key developments over the month. First, the revised earnings data had been published. Second, the effective exchange rate had strengthened. Third, if anything, the GDP figures were weaker than expected, particularly if weight were placed on the rise in inventories and/or the sharper than expected fall in exports. Finally, there had been a uniform strengthening of survey measures, albeit from a low level. On balance, these four factors suggested slightly lower prospective inflation than thought at the time of the February *Inflation Report*.

31 Some possible reasons for a further reduction in interest rates were identified. If, for example, it was expected that the rise in sterling would be maintained, there might be a case for a 25 basis point reduction in interest rates this month. Second, maintaining rates at their current level this month might be interpreted as a signal that a floor in rates had been reached, which might stall - or even reverse - the recovery in business and consumer sentiment.

32 One view was that the news on the month did not, as yet, amount to a sufficient case for a further reduction in interest rates. It would be better to see more evidence, in particular whether the strength in the surveys was maintained and whether it began to feed through to the official data. There would also be a benefit in undertaking more analysis of the revised earnings data. On this view, the repo rate should be maintained at 5.5%. Among those members holding this view, some felt that it was now slightly more likely than a month ago that there would be a further reduction.

33 The Committee discussed whether, even though there was not a compelling case for an immediate 25 basis point reduction in rates, there might be a case for a smaller reduction. There could be a case for moving in smaller steps than 25 basis points if the data warranted it. However, since the Committee had not previously made changes in anything other than multiples of 25 basis points, there would be a risk of providing a confusing signal to markets. Some members also thought it would imply a degree of fine-tuning beyond what was sensible.

34 Another view was that interest rates should be close to or possibly below the 'neutral' level at this point in the economic cycle. On that view, the reduction in rates of 50 basis points at the February meeting had brought the level of interest rates into its probable neutral range. The news over the past month reinforced the view that interest rates might need to be reduced further. But we had only started to see the effects of previous interest rate reductions, and nominal long and short-term interest rates were now close to their lowest level for many years. The reactions of firms and households – both savers and borrowers – to such historically unusual levels were difficult to predict with much confidence. Although the direction of interest rates was still more likely than not to be down, there was no urgency this month and it was best to observe how the economy reacted to the earlier interest rate reductions. On this view, therefore, the repo rate should be maintained at 5.5%.

35 Another view in February had been that a reduction in rates of 75-100 basis points was required. That view had been predicated on the assumption that first, the central projection in the *Inflation Report* was around 0.2 percentage points too high; and second, that it was possible to ease with a view to supporting activity in the near term without endangering achievement of the inflation target. This was especially true if the transmission mechanism was faster than

had, on average, been the case in the past. The news on the month suggested that both activity and inflation might be a little lower than expected, and could justify a reduction in interest rates over and above what had been thought necessary a month ago. On this view, a reduction of 25-50 basis points was now required.

36 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be maintained at 5.5%. 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 Buiter voted against, preferring a reduction of 0.4%.

37 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 Buiter

Charles Goodhart

DeAnne Julius

Ian Plenderleith

John Vickers

Gus O'Donnell 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 26 February, in advance of its meeting on 2-3 March 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 Monetary conditions

A2 Growth of notes and coin had picked up in February. After adjusting for the effects of the introduction of the new 50 pence and £2 coins, the three-month growth rate was 7.0%, compared with 6.7% in January, and the six-month growth rate was 6.2%, compared with 5.9% in January. The one-month growth rate was 0.5%, the same as in January and a little higher than the average figure for 1998. A small increase in these growth rates might have been expected following interest rate cuts in the second half of 1998, which reduced the opportunity cost of holding notes and coin.

A3 The stock of M4 had fallen by £10 million in January. The twelve-month growth rate had fallen to 7.3%, the lowest since June 1995.

A4 Within M4, the balances of other financial corporations (OFCs) had fallen by £2.6 billion in January, making it less likely that December's modest increase was a purely temporary effect associated with the end of the financial year. The twelve-month growth rate, at 11.0%, had more than halved over the past year.

A5 Following the introduction of self-assessment, January had become a more important month for payment of income tax. It seemed unlikely that this had yet had its full effect on the estimated seasonal component, which may in turn explain why the strong flow into household sector M4 in December (+£5.5 billion) had been followed by a much weaker January (+£1.7 billion). Looking at the average flow over these two months, the gradual pick-up in household sector M4 towards the end of last year appeared to have continued.

A6 Private non financial corporations (PNFCs') holdings of M4 had risen by £0.9 billion in January, largely reversing a £1.0 billion fall in December. Payments of corporation tax in January had been significantly lower than in recent years. Hence there was a risk that the process of seasonally adjusting the monetary aggregates, which looks at the past behaviour of each series, had artificially lowered PNFCs' M4 in December 1998 and artificially boosted it in January 1999. Averaging over these two months, the flow was close to zero.

A7 Sterling lending by M4 institutions had grown by 0.5% in January, the same rate as in December. But the three, six and twelve-month growth rates had all fallen, and remained below rates during the first half of 1998.

A8 M4 lending to OFCs had fallen by £0.3 billion in January. This was smaller than the fall in their M4 deposits, so OFCs' net recourse to banks had increased. During the fourth quarter of 1998, lending to OFCs had been underpinned by lending to financial leasing companies. According to less comprehensive data from the Major British Banking Group, the contribution of lending to financial leasing companies in January was again strong (up by 1.0%).

A9 M4 lending to the household sector had risen by 0.6% in January. Total lending to individuals (excluding lending to unincorporated businesses, but including lending by a number of non-M4 institutions) had also risen by 0.6%. The twelve-month growth rate was 7.7%. Lending secured on dwellings had risen by 0.5% in January, as in each month since August 1998. There had been a small rise in the rate of unsecured credit growth, from 0.7% in December to 1.4% in January. The three and six-month annualised growth rates were 14.3% and 15.6% respectively, below those during the first half of last year.

A10 Turning to price indicators of monetary conditions, more than half the institutions sampled by the Bank had not passed on in full the most recent cut in official rates to their standard variable mortgage rates. For the time being, this was probably of limited significance; since September 1998, standard variable mortgage rates had fallen by 198 basis points, only 2 basis points less than the fall in official rates over the same period.

A11 Since the February MPC meeting, there had been some rise in medium to long-term inflation expectations (as derived from a comparison of the yield on nominal and index-linked gilts). Much of the rise, particularly at the ten-year horizon, occurred on 4 February, the day when official rates were reduced by 50 basis points. By contrast, there had been little change in survey measures of inflation expectations for end 1999 and end 2000. These remained at around 2.2% to 2.3%.

II Demand and output

A12 GDP at constant market prices had grown by 0.2% in 1998 Q4, but the annual rate had been revised down to 1.3% from 1.6%. The expenditure breakdown had shown domestic demand growing by 1.2% in Q4, reflecting a sharp increase in investment and inventories. Net trade had made a negative contribution to GDP growth of -1.1%. The shortfall of the expenditure measure of GDP relative to the average measure was 0.6% of GDP in Q4.

A13 Growth in household spending had increased to 0.4% from 0.1% in Q3. Bank staff had not expected total household spending growth in Q4 to be as weak as had been suggested by retail sales volumes. The level of spending in Q3 had been revised down by 0.1 percentage points, but there had been upward revisions in the first half of 1998.

A14 Investment had grown by 2.0% in Q4. Growth had also been revised up in Q3 to 1.8% from 1.1%. The strength in Q4 was partly because of erratic factors. Nevertheless, sectoral growth rates had been broadly consistent with survey evidence on investment intentions: service sector investment growth had remained strong at 5.2%, and manufacturing investment had declined by 3.1%. The annual growth of whole-economy investment had slowed during 1998.

A15 Inventories had risen sharply by £1.9 billion in Q4, but the level had been revised down by a cumulative £215 million in the first three quarters of 1998. Stock building in 'other industries' had accounted for £1.6 billion of the rise. This category includes the quarterly alignment, which was constrained to sum to zero in the year as a whole. Unless there had been very large revisions to the alignment adjustment — and stocks data had not supported this — it could explain only a part of the overall increase in other industries' stocks. 'Other industries' included car dealers, for whom stocks may have been boosted by the switch to twice-yearly registration periods starting in March. Stocks in the manufacturing and retail sector had made a negative contribution to GDP growth. Manufacturers' stocks of finished goods had risen by £113 million, less than half the increase in Q3. But survey evidence had indicated a continued stock overhang. The CBI monthly trends survey had recorded a small increase in the balance on excess stocks of finished goods to +24 in February from +23 in January, and the balance had remained well above its long-run average.

A16 In Q4, exports had declined sharply by 2.4%, and imports had increased by 0.9%. In 1998, there had been tentative signs that the slowdown in final demand had reduced import growth. Looking ahead, the CBI survey shows exporters increasingly less pessimistic about prospects, with the balance on optimism rising to -18 in January from -41 in October. But the CBI export orders balance had remained negative. Monthly trade data had shown that the decline in exports to non-EU countries had continued in January, with goods exports, excluding oil and erratic items, declining by 6.8%.

A17 Manufacturing output had fallen by 1.3% in Q4. Service sector output had increased by 0.6%, compared with 0.8% in Q3. Within the service sector, output had continued to grow strongly in the transport/communications and finance/business sectors. Output had been

unchanged in the distribution, hotels and catering sector, consistent with weak retail sales in Q4. Construction output had declined for the third quarter in a row, by 0.2%.

A18 The gross operating surplus of corporations had declined by 0.2% in Q4.

A19 Retail sales volumes had risen by 1.1% in January, more than reversing the decline in December. But the underlying trend had been unchanged, with sales volumes in the three months to January 1.5% higher than a year earlier. Sales of clothing, footwear and household goods had grown particularly strongly, partly because of sharp price-discounting. A survey by the Bank's regional Agents covering 108 retailers had supported the view that spending was weak. A majority of respondents had reported declining sales values in December and January relative to a year earlier. Consumer confidence was cited as a key reason. This had implied a sharper slowdown than indicated by the official data.

A20 House price inflation had slowed. The Bank's house price index based on Land Registry data had risen 5.9% in the year to Q4 (down from 7.9% in Q3) and the Halifax house price index had risen by 3.7% in the year to February (down from 4.4% in January). There had been preliminary signs that activity might have turned up. The House Builders' Federation survey in January had shown the first positive balances in seven months on visitors to sites and on net reservations compared with a year earlier. These had been leading indicators of housing transactions in the past. Particulars delivered had risen in February for the second month running. But the recovery was from a low level, and transactions had been 3% lower than a year earlier. The firming-up in housing activity had been consistent with some recovery in consumer confidence. The GfK confidence indicator had risen to -0.6% in February from a trough of -8.2% in October.

A21 Survey evidence had continued to indicate declining manufacturing output in the first two months of 1999 Q1. The output balance of the CBI Trends survey was -10 in February compared with -13 in January. The CIPS survey output balance had remained below 50 in February, for the eleventh month running. But there had been continued signs of an easing in the rate of decline of new orders, mainly because of a bottoming-out in export orders. In the service sector, the CIPS business activity index had remained below 50 for the fourth successive month, indicating contracting output, although the rate of decline had eased.

III International environment

A22 US GDP had risen by 1.5% in the fourth quarter, according to the preliminary estimate. Industrial production was flat in January, and had been growing at around 1.7% on a year earlier for the past three months. Although monthly data had suggested some stabilisation in the trade balance, further falls in net exports were expected in 1999, reflecting slowing growth in the euro area and Latin America. Retail sales growth had slowed in January but this may have simply reflected one-off factors. Consumer confidence had risen again in February, most notably in the 'current conditions' index. Industrial confidence, as measured by the National Association of Purchasing Managers Index, had also risen in February. Manufacturing employment had continued to fall, but service sector job growth remained robust, so that overall employment growth remained above that of the labour force. Despite strong monetary growth and robust real GDP growth, annual inflation remained subdued and was unchanged in January at 1.6%.

A23 In the euro area, imbalances between the consumer and producer sectors had persisted. Euro-area GDP had risen by 2.7% on a year earlier in the third quarter. French GDP had risen by 0.7% in the fourth quarter. In Germany, GDP had fallen by 0.4% in the fourth quarter. The contribution from net trade to quarterly German growth was -0.8 percentage points, the largest quarterly negative contribution since 1993 Q2. German services output had grown by 1.0% in the fourth quarter, compared with 1.1% in the previous quarter. The French survey of service sector output had tracked the official measure of output fairly closely in recent years, and pointed to a moderate slowdown in service sector growth in 1999 Q1. Euro-area industrial production growth had fallen by 0.4% in the year to December, compared with 3.2% in the year to October. Euro-area industrial confidence had stabilised in January, close to its historical average. Euro-area consumer confidence had risen to zero in January from -1 in December; this compared with -9 in January 1998. Inflation in the euro area on the harmonised measure fell to 0.8% on a year earlier in December, from 0.9% in November. In January, the three-month moving average of the twelve-month growth rate of M3 increased to 4.9%, compared with the reference rate of 4.5% set by the European Central Bank.

A24 The Bank of Japan had lowered the overnight discount rate to a range below 15 basis points on 12 February. The Ministry of Finance had also partially reversed its position on Trust Fund Bureau purchases of Japanese government bonds (JGBs), allowing the Bureau to resume outright purchases of JGBs in the secondary market. The yen had subsequently weakened further and 10 year bond yields had fallen back below 2%. Retail sales had remained weak in January, falling by 4.5% on a year earlier. Industrial production had risen by 0.8% in January, but it was still down by 7.5% over the past twelve months. Industrial production had fallen by 6.9% in 1998 as a whole. The inventory index was at its lowest level since February 1995. The Japanese trade surplus had widened in January to 760 billion yen, compared with 386 billion yen in January 1998. The growth in the surplus had reflected the weak state of Japanese

private demand in 1998. It had also reflected the fall in commodity prices which, alongside more recent strength in the yen, had lowered the value of imports. The Consensus Economics average of forecasts for GDP growth in 1999 was unchanged at -1.1% in February.

IV The labour market

A25 Employment had continued to grow strongly at the end of 1998. According to the Labour Force Survey (LFS), employment in Q4 was 122,000 (0.4%) higher than in Q3, and 305,000 (1.1%) higher than in 1997 Q4. The main contribution to the rise in Q4 had come from growth in the number of employees, but the number of self-employed people had also risen, reversing the recent downward trend. A full sectoral breakdown was not yet available, but monthly data had showed that manufacturing jobs had fallen by some 2% in the year to Q4. The February manufacturing survey from the Chartered Institute of Purchasing and Supply (CIPS) had suggested that employment in the sector had continued to fall in early 1999, though at a slightly slower rate. The CIPS surveys on services and construction, and the report on jobs from the Federation of Recruitment and Employment Services (FRES), had pointed to declines in employment, as they had for some time.

A26 Though employment had continued to rise in 1998, hours worked had been broadly flat. Total hours worked had fallen by 0.2% in Q4, and average hours per worker were 0.6% lower. About half of the fall in average hours worked had reflected a rise in the number of part-time jobs. The other half had reflected a fall in average hours worked by full-time workers, consistent with a reduction in overtime working.

A27 The number of jobs advertised in national newspapers had fallen in January, according to the Press Recruitment Advertising Index. The stock of unfilled Job-centre vacancies had also fallen, by 2,200 in January. But new vacancy notifications had remained at a high level, rising by 9,300 in January after falls in November and December. Overall, the Bank's regional Agents had reported a broadly unchanged level of skills shortages. But significant sectoral differences had persisted. Skills shortages were declining in the financial sector, according to the most recent CBI/Price Waterhouse Coopers survey, and were flat to falling in the small business sector, according to the Small Business Research Trust. But shortages in the construction sector were reported to be back at their 1997 peaks by the Federation of Master Builders.

A28 The rise in employment in Q4 had been accompanied by further falls in both inactivity and unemployment. The LFS measure of unemployment had fallen by 15,000 in Q4, and the claimant count had fallen by 5,700 in January. But unemployment rates had been unchanged, at 6.2% and 4.6% respectively. There was still no evidence of the reported rise in redundancies

in the inflows to the claimant count, which fell by a further 6,500 in January. Exit rates had remained at historically high levels. Unemployment of six months or more among 18 to 24 year olds had been falling by around 6,000 a month. Some of this probably reflected the impact of the Government's New Deal for young people. But, in net terms, all of the rise in employment in Q4 had been accounted for by workers aged 35 or over.

A29 The Average Earnings Index had been reinstated on 2 March, following the conclusion of an independent review commissioned by the Chancellor. The headline earnings measure had been available up to July 1998 under the suspended series. According to the new series, headline whole-economy annual average earnings growth had fallen from 5.1% in August to 4.5% in November, reflecting a decline in the growth of both regular and irregular pay. There had also been extensive revisions to the back data, reflecting a number of changes in the method of calculation. In contrast to the suspended series — which had been relatively volatile — the new series showed headline earnings growth rising steadily from a trough of around 2½% in 1995 to a peak of 5.7% in May 1998.

A30 Other data had also suggested a more subdued outlook for settlements and earnings in recent months. The Reward index of annual earnings growth had continued to fall, from a peak of 5.4% in June 1998 to 4.6% in January. The Bank's employment-weighted twelve-month mean measure of whole-economy settlements had remained at 3.7% in January, but the private sector measure had fallen by 0.1 percentage points to 3.9%. In a matched sample of firms from the Bank's settlements database, 86% of employees settling in January had received a lower settlement in 1999 than they had in 1998. The employment-weighted mean for this sample had fallen from 3.8% in 1998 to 3.2% in 1999. The three-month settlements measures from the CBI, Industrial Relations Services and Engineering Employers' Federation had also all fallen in January. And the Bank's regional Agents reported that falling profits and subdued business optimism had led to an easing in pay pressures in manufacturing. But it was possible that there would be some rise in whole-economy settlements in April, when the National Minimum Wage and the settlement agreed by the Public Sector Review Bodies both came into effect.

V Prices

A31 Commodity price deflation had continued to moderate; in January the Bank's (provisional) index, excluding oil, had fallen by 5.2% on a year earlier, compared with -7.4% in December. Natural disasters and sterling's depreciation had increased the sterling price of imported commodities in January; the (provisional) index had risen by 1.1%. Food price deflation had moderated following the unwinding of the downward shocks experienced since

mid-1996. Annual inflation had been zero in December. But forthcoming potential reforms to the Common Agricultural Policy looked likely to decrease prices. The Ministry of Agriculture, Fisheries and Food was estimating a direct effect of up to -0.3 percentage points on the RPI in the year following implementation, assuming full pass-through of the cuts to retail prices.

A32 The one-month futures price of Brent crude oil had averaged \$10.50 in February, down from \$11.09 in January — the effects of a report of falling inventories and cold weather in the United States in January had been short-lived. Manufacturers' material input prices had risen by 0.4% in January, reflecting the rise in oil prices, but there had been no clear change in the downward trend. Annual inflation had remained negative at -6.7%.

A33 Manufacturers' output price inflation had remained at historically low levels. Excluding excise duties, prices had fallen for the seventh consecutive month in January, by 0.2%, leaving them 0.8% below their level a year ago. Total output prices had been flat year on year. The CBI industrial trends survey had pointed to further price falls.

A34 Trade prices for goods had continued to decline in December. Total import prices of goods had fallen by 6.4% in the year to December; total export prices of goods had fallen by 3.8%. In contrast, national accounts data showed that services export prices had risen by 1.4% and import prices by 0.1% in Q4. The annual rate of increase of the GDP deflator had risen to 2.8% in Q4 1998, from 2.0% in Q3. The sharp rise was partly explained by the volatile path of quarterly inflation in 1997, and by increased contributions from government, trade and inventories prices. The household expenditure deflator, at 1.9%, had remained below RPIX inflation. That rise had led to a 0.8 percentage point rise in the GDP deflator based measure of domestically generated inflation, to 3.2%. The RPI-based measure had remained unchanged at 4.9%.

A35 RPIX inflation had remained at 2.6% in January. RPIY inflation had been 2.0%. RPIX services inflation had fallen by 0.1 percentage points to 3.4%, and RPIX goods inflation had remained at 1.4%. Total food price inflation had risen above RPIX inflation.

A36 HICP inflation had increased by 0.1 percentage points in January for the third consecutive month, to 1.6%. The difference between HICP and RPIX inflation had fallen by 0.1 percentage points to 1.0 percentage points, of which 0.5 percentage points was due to the method of calculation and 0.4 percentage points to the exclusion of various owner-occupied housing costs.

VI Agents' national summary

A37 The Bank's regional Agents reported on their assessment of the economy drawn from their discussions with contacts over the past month. Overall, the recent decline in manufacturing activity appeared to have eased significantly, and destocking was well under way. Nonetheless, performance had remained dependent on sector. For example, railway and aerospace demand had been strong, while textiles, ceramics and electrical components manufacturers had continued to suffer from intense import competition. There had been few reports of any increases in output. One exception had been exports to Europe, where some contacts had won back orders as sterling had depreciated. But demand from France and Germany had begun to decline by the end of the period. Construction sector activity had remained buoyant, but enquiries and orders had begun to decline. Demand for commercial developments had been weaker in the north of the United Kingdom than in the south east. Housing market activity had increased since January, especially at the higher-quality end of the market. Increased investment in city-centre property had been reported. Growth in output of business services had declined, reflecting weak manufacturing activity. For example, hauliers had reported falling demand, and corporate travel suppliers had noted trading-down to less expensive travel options. But demand for financial services and telecommunications had remained strong. Retail sales growth had been weak in February; as yet, retailers had reported little increase in consumer demand following the recent interest cuts. Consumer demand for leisure services, such as gymnasiums, overseas holidays and restaurants had remained strong.

A38 In the manufacturing sector, employment had fallen and the decline was expected to continue. That had increased concern about employment prospects, and had reduced wage demands. Declining activity had lowered overtime and bonus payments. Growth in service sector pay settlements had remained above manufacturing but had continued to fall, reflecting a decline in activity. Skill shortages had persisted (heavy goods vehicle drivers, precision engineers, accountants and lawyers, for example), but not worsened. Raw materials, intermediate and finished goods prices had continued to fall. Retailers had continued to cut prices in order to reduce high stock levels. Investment intentions had declined across the board. Manufacturers had continued to invest to improve productivity, rather than to expand capacity. And an increasing number of service sector contacts had postponed expansion plans.

VII Information from financial markets

Foreign exchange

A39 The US dollar had continued to strengthen since the previous meeting, and now stood about 7% higher against both the yen and the euro compared with the beginning of the year. The yen had weakened following a cut in interest rates, and there had been statements by the

Japanese authorities indicating that they were more comfortable with a weaker yen. The euro had weakened following the release of weaker-than-expected economic data for the euro area.

A40 Sterling had appreciated in effective terms, although it was now at an 18-month low against the stronger dollar. Sterling's implied volatility had risen since the previous MPC meeting, but was still lower than at the beginning of the year. Options data suggested that the probability of a large sterling fall against the euro had declined.

Government bond and money markets

A41 Expectations for UK interest rates in 1999 had fallen, but had risen looking two years or more forward. The market's reaction to the minutes of the previous MPC meeting had been a major reason for this. Three-month Libor rates were now expected to rise after falling to a level of 5%. In the United States, rates expected for next year and beyond had risen by around 50 basis points, primarily because of Fed Chairman Greenspan's Humphrey-Hawkins testimony. Near-term euribor rates had remained broadly unchanged. The gilt yield curve had flattened, with yields rising most for maturities between five and ten years. In general, bond prices abroad had also weakened since the previous meeting, with the exception of Japan.

Equity and corporate debt markets

A42 The UK stock market had risen, and the FT-SE 100 index had touched an all-time high. In contrast, the US market had fallen since the previous MPC meeting, driven by the Humphrey-Hawkins testimony. The other main international indices had remained broadly unchanged.

A43 In the United States, credit spreads for the most highly rated firms had fallen by 8 basis points, but spreads for lower-credit firms had risen by 5 basis points. In the United Kingdom, credit spreads for highly rated firms had fallen by about 15 basis points, and by more than 30 basis points for lower-credit firms. Swap spreads in the United States had risen slightly, but had fallen at all maturities in the United Kingdom.

A44 Analysts' and fund managers' forecasts of corporate earnings in 2000 had been revised up slightly since the previous MPC meeting. Profit warnings had declined in February compared with the previous three months, and for the first time in several months the level was below that recorded a year ago. Compared with February 1998, there had been a sharp decline in the proportion of firms citing the strength of sterling or problems in emerging markets as the reason for their worsened performance.

