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MINUTES OF MONETARY POLICY COMMITTEE MEETING 5 and 6 April 2000

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 April 2000.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0004.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 3 and 4 May will be published on 17 May 2000.



MINUTES OF MONETARY POLICY COMMITTEE MEETING ON 5-6 APRIL 2000

1 Before turning to its immediate policy decision, the Committee discussed the Budget; money and asset prices; demand and output; the labour market; prices and costs; the world economy; and other considerations relevant to its decision.

The Budget

2 Prior to its previous meeting, the Committee had been briefed by Treasury officials on the broad shape of the Budget's macroeconomic projections and the prospects for the public finances. It had agreed that more analysis would be needed once the full details of the Budget were known.

3 Since then the Budget had been finalised. The broad shape of the projections for the public finances was unchanged from the Committee's previous meeting. In 1999/2000 the net borrowing figure was nearly 1% of GDP lower than assumed in the November *Pre-Budget Report* (PBR), with the surplus now put at £11 billion as against £2 billion in November. The net borrowing figures in the Budget for the following two years were also lower than in the PBR, although the difference between the Budget and the PBR numbers was smaller than for 1999/2000. By the third year (2002/2003) net borrowing was higher than in the PBR.

4 The figures for real government consumption and investment over the next two years were higher in the Budget than the assumptions made in the February *Inflation Report*, but little different from those in the November *Inflation Report*. This principally reflected the conventions employed in the Committee's forecasts, not announcements in the Budget. Between November and February the government expenditure deflator had been revised up which, when projected forward, had implied lower public spending in real terms given the government's nominal spending plans. The higher nominal profile for public spending in the Budget would need to be reflected in the May *Inflation Report*, but the February *Inflation Report* had, in effect, already incorporated much of the recorded increase in tax revenue in 1999/2000, and this had influenced the private sector consumption and investment estimates for 1999/2000.

5 There were, as always, uncertainties in the projections of future government revenue and spending, and in assessing the effects of the Budget more generally. The sustained real growth in public spending on goods and services meant that private spending would have to be constrained. However, spending by departments might increase more slowly than projected, as it had done recently, and tax revenues might continue to be above the levels projected by the Treasury, particularly if their past buoyancy reflected structural rather than cyclical factors. But since the reasons for higher tax revenues were not well understood, it was uncertain how far recent trends could safely be extrapolated into the future. It was noted, though, that the Treasury's Budget projections were prepared using what seemed to be prudent assumptions. All in all, most members of the Committee thought that the impact on future activity and inflation from the Budget seemed unlikely to be large over the next two years.

6 The Committee then discussed the effect on the public finances of the spectrum auctions for the Third Generation mobile telephone licences. While the auction receipts would boost the government's cash flow straightaway, the immediate impact on the Public Sector Net Borrowing measure would be much less marked, since for these purposes the revenue would be accrued over the life of the licences, ie until December 2021. On balance, even though the proceeds were likely to be substantially higher than initially expected the macroeconomic effect should not be large, unless any adjustment in taxes or government spending were brought forward rather than accrued over the life of the licences. More immediately, if foreign bidders bought rather than borrowed sterling to pay for the licences there could be a temporary effect on the exchange rate.

Money and asset prices

7 M0 and M4 lending were both increasing at 8%-9% a year, consistent with robust consumption growth. Loan approvals for house purchase had bounced back strongly in February, suggesting that the slowdown around the turn of the year had reflected seasonal effects. Competition in the mortgage market remained intense. House price indicators in March were mixed, with the Halifax index declining while the Nationwide index had risen strongly. Data on site visits and net reservations from the House Builders' Federation pointed to a possible easing in activity later in the year, but it was too early to say whether house price increases would moderate to the extent projected in the February *Inflation Report*.

8 Monetary and financial data, together with recent surveys, suggested a rather stronger outlook for business investment, with capital gearing (as measured by market values) falling as equity prices rose. The financial deficit of the private non-financial corporate sector in 1999, however, was at its highest as a percentage of GDP for almost ten years, although there was little sign that this was holding back planned investment. Much of the deficit had been financed either by foreign currency borrowing or by sterling capital market issuance. Corporate bond spreads over gilts remained wide, perhaps reflecting relative supply, with heavy long-dated corporate bond issuance over the last year.

9 The Committee discussed the implications of the recent movements in global equity prices for the economic outlook. While so-called 'new economy' shares had fallen significantly in price over the month, with the NASDAQ index in the US down around 15%, this had not had a contagious effect on other sectors, and 'old economy' share prices showed a significant rise over the same period. In both cases these moves represented a reversal of the price changes seen earlier in the year, and were not necessarily evidence of increased fragility in the market as a whole, although the extent of recent volatility could alternatively be seen as a sign of a forthcoming downturn, particularly if it should lead to an increase in the equity risk premium.

10 The weakness of the euro continued, although over the month as a whole sterling was little changed despite intra-month volatility. While the decline in the euro might reflect the cyclical strength of the US economy or pessimistic views on structural reform within the euro area, this had not been mirrored in European equity markets, which had risen strongly over recent months. Nor did such hypotheses do much to explain why the euro had fallen by more than 10% against the yen since September.

Demand and output

11 The latest national accounts data for 1999 Q4 included upwards revisions to all of the major components of final domestic demand, which was estimated to have risen by 1.3% in the quarter, and by 4.4% on a year earlier. Stockbuilding was now thought to be lower than earlier estimated, while the contribution of net trade to GDP growth in the quarter was unchanged, at -1.2 percentage points.

12 Industrial production had fallen in February for the third month in succession, although the size of the fall, at -0.6%, had been affected by a sharp decline in energy production, reflecting relatively

mild weather for the time of year. Manufacturing production had also fallen and was now below its August level. When taken together with the net trade figures for Q4, this suggested that the internationally exposed sectors were coming under renewed pressure, reflecting in part the effects of sterling's appreciation against the euro. The fall in output was quite broadly based, with chemicals and engineering (which had contributed significantly to manufacturing output growth in 1999) declining in February.

13 Survey data were not entirely in line with this picture. The purchasing managers' index for manufacturing, produced by the Chartered Institute of Purchasing and Supply (CIPS), had risen slightly in March, and had last been below the neutral level of 50 in April, nearly a year ago; the output index was also higher, while new orders were little changed. In the Engineering Employers' Federation survey, the output balance remained at +9 in Q1, with new orders again little changed. Reports from the Bank's regional Agents had suggested a resumption in manufacturing growth in February. It was possible that in some sectors volumes were being maintained only through a further reduction in margins, and that there would be limits on how much further that process could go.

14 While any slowdown in parts of manufacturing might feed through into the rest of the economy, either directly or through its impact on consumer confidence, at present the services sector appeared to be buoyant. The CIPS services index for business activity had risen to 59.6 in March, its highest level since June 1997. The CIPS construction index also pointed to continuing growth in activity and new orders.

15 The picture for retail sales was mixed. In February volumes had fallen back from their unusually high January levels, but on a three-monthly basis growth was unchanged, at 1.8%. The CBI Distributive Trades Survey had shown quite a marked slowdown in the growth of retail sales volumes and orders placed in March, but expectations for April remained strong. The GfK consumer confidence index was sharply down in March. The evidence suggested that while household spending remained strong, it might no longer be accelerating, although real disposable incomes still seemed to be growing rapidly. But a slowdown in consumption growth was built into the central projection in the February *Inflation Report*, and it was too early to say whether this would materialise.

16 Taking all the evidence together, there was still a sharp contrast between the rapid growth in the services sector, and the less robust performance of manufacturing. On balance it seemed likely that growth in 2000 Q1 would be little different from the central projection in the February *Inflation Report*.

Labour market

17 Whole-economy productivity growth, defined by comparing GDP with the Workforce Jobs measure of employment, had picked up to 1.8% in the year to 1999 Q4, and to 2.7% on an annualised basis between 1999 Q2 and Q4. Figures based on the Labour Force Survey (LFS) employment measure suggested slightly lower figures, at 1.6% and 2.1% respectively. This took annual productivity growth back towards trend, but it was too early to say whether it represented anything more than a normal cyclical response of productivity to a recovery in output growth.

18 The labour market remained tight, with employment growth on the LFS measure up 0.3% in the three months to January. Unemployment had risen on the LFS (but not the claimant-count) measure, reflecting – in an accounting sense – a fall in inactivity, with the LFS unemployment rate unchanged for the past seven months. Survey data were consistent with this picture, and the Recruitment and Employers' Confederation (REC) survey showed a significant strengthening in the demand for staff, in line with the reports of skills shortages from the Bank's regional Agents. It was suggested that the labour market measures in the Budget, when taken together with previously announced reforms, might have a small positive effect on future labour supply.

19 Whole-economy average earnings growth, as measured by the headline rate, had risen to 5.9% in the year to January. Much of the increase seemed to reflect bonus and other payments, in part related to the new millennium. A survey by the Bank's regional Agents suggested that further bonus payments were due to be made in subsequent months, particularly in March, and that this might further complicate the analysis of the data.

20 Some members of the Committee considered that the pricing response by firms to an increase in earnings would depend on whether these took the form of higher settlements or faster 'wage drift', (including bonuses and other payments that might be linked to productivity or profits), with some evidence suggesting that 'wage drift' had a smaller effect on prices. Others believed that the effects

of one-off increases in earnings would tend to feed through into final prices on a smoothed basis, and it was quite unclear whether in the longer term prices reacted differently to increases in earnings stemming from higher settlements, and those reflecting greater wage drift.

21 Data collected by the Bank suggested that on a matched sample basis, settlements in January were if anything lower than a year previously. But the Bank's regional Agents had noted that this was not the case in services, and that pay pressures were building in some areas, with concern about settlements later in the year both in services and some parts of manufacturing.

22 The Committee agreed that the labour market remained tight. While it would be wrong to react to every fluctuation in the average earnings index, given the volatility of that series and the possible distortions resulting from millennium-related factors, it was likely that the starting point for earnings in the Committee's May forecast would be above that in the February *Inflation Report*.

Prices and costs

23 In recent months retail prices had increased by slightly more than had been expected. Part of the reason was the increase in oil prices, but now that OPEC had decided to increase production, and aimed to stabilise oil prices at around \$20-\$25 per barrel, the upside risks to inflation from this source had diminished. The oil price now was no higher than that incorporated into the February *Inflation Report* for Q1. How far earlier price increases had been passed through was difficult to determine, and it was possible that firms would base their pricing decisions on the new (lower) oil price rather than passing on all of the earlier increases.

24 The CBI Monthly Industrial Trends Survey for March showed more respondents now expecting a fall in manufacturing output prices, perhaps reflecting competitive pressures linked to the rise in sterling against the euro. By contrast, higher oil prices had led to an increase in input prices reported in the latest CIPS manufacturing survey. The Bank's regional Agents reported that service price inflation remained relatively high, but variable across sub-sectors.

The world economy

25 Prospects for world economic activity had strengthened further since the February *Inflation Report*, with output in the US accelerating in 1999 Q4 and activity indicators remaining

buoyant in the early part of 2000. The prospects for the euro area had improved, particularly in Germany and France, while East Asia had recovered rapidly from its downturn, and there were also some signs of a recovery in Japan. Official interest rates had risen in the previous month in most OECD economies, and market rates suggested expectations of further increases in official rates later in the year, for instance in the US and the euro area. The prospects for inflation in the global economy would depend not only on the strength of demand growth and the reaction of monetary policy, but also on the size and distribution of world productive capacity relative to demand.

26 The strength of the US economy, and uncertainty about the balance between domestic demand and supply in that country, remained important factors in any assessment of the world economy. The target Federal funds rate had been raised again in March, for the second time this year, and while there had been considerable volatility in the various US equity price indices, on balance these were now not much changed from their levels at the start of the year. To some members this suggested an increased chance of a gradual slowdown in US growth closer to trend.

Other considerations

27 Although a majority of market participants did not expect the Committee to move rates this month, an increase in the Bank's repo rate during Q2 was widely forecast. The Committee had agreed in March, when a change in the repo rate would have been more of a surprise, that this of itself should not be a constraint on the Committee's decision, and that remained the case. The Committee also agreed that, while the *May Inflation Report* provided an opportunity to analyse the latest developments in more detail, and to set out the reasons for any change in official rates at greater length, that also did not preclude a change in rates this month.

28 The Committee discussed a suggestion that it should intervene in the foreign exchange markets. The argument advanced in favour was that this could, if successful, not only be profitable but also improve the balance in the economy between the internationally exposed sectors of the economy and other sectors which were growing very rapidly, reducing the risk that the Committee would need to adjust monetary policy sharply later. Some members were not at all attracted to this view, believing that intervention would be unsuccessful and would cause confusion in the markets about the Committee's reaction function and its priorities. Some others thought that intervention in the foreign exchange market was unlikely to be successful at present, though they did not wish to rule out the

possibility in appropriate circumstances in the future. Sterling's current strength in effective terms reflected a more general weakness of the euro against most other major currencies, and there was little evidence that the present level of sterling was seen as unsustainable or fragile by the market, at least in the short term. On this view, intervention would be effective in current circumstances only if it was accompanied by an easing of monetary policy, which would not be appropriate in the present conjuncture, and to intervene ineffectively could be counterproductive.

The immediate policy decision

29 The Committee discussed the case for leaving rates unchanged, and for increasing the repo rate by 25 basis points. For many members, the choice was finely balanced.

30 Final domestic demand was growing rapidly, although in Q4 this had been offset in part by a large negative contribution from net trade. Some members thought that such an imbalance was not sustainable over the medium term. Although retail sales and consumer confidence had fallen back more recently, consumption still seemed robust, and while there were indications that house prices were no longer accelerating, there was little evidence of a slowdown in the housing market. Business investment growth was moderate but public investment was likely to grow rapidly. Government consumption would also boost total demand for the indefinite future. The net trade picture was more mixed, with the rise in sterling against the euro working in one direction, and stronger world demand in the other. While the services sector remained robust, manufacturing output had fallen in recent months, although survey evidence suggested a rather more resilient picture. The labour market remained tight and, whether or not higher earnings fed through into firms' prices directly, they would add to disposable incomes and hence to demand pressures. While oil prices were now easing back, input costs continued to rise, though there was little evidence of much acceleration in final prices.

31 On one view, it would be better not to raise rates this month. The news over the month as a whole was inconclusive, with falls in manufacturing production, retail sales and consumer confidence, and oil prices, but with the determinants of domestic demand, both private and public, remaining robust. Against that background other factors were also important. First, the extent of price pressures stemming from the labour market required further analysis, not least in disentangling the effects of bonuses and other elements of wage drift from that of settlements. Second, the analysis

undertaken for the *Inflation Report*, and the opportunity this provided to set out the Committee's thinking in detail, were valid reasons not to move this month unless there was a strong case to do so. Third, for some, the volatility in equity markets introduced a possible downside risk which might mean that any increase in rates this month would need to be reversed soon afterwards. Finally, the imbalances in the economy, manifested in another fall in manufacturing production, seemed to have worsened. An increase might exacerbate these imbalances and it was possible that the weakness in some sectors might feed through into the rest of the economy. With inflation running below target, and expected to continue to do so for a while, there was no pressing reason to raise rates straightaway. For these members, no change in the repo rate was needed this month, although for some of them it was more likely than not that there would need to be an increase in rates in due course.

32 On a second view, although the news over the month was mixed, it had on balance pointed to somewhat higher prospective inflation, which was sufficient to tip the balance for some who had been close to voting for higher rates in March. The fog surrounding some of the data around the millennium date change had begun to clear. A rise in rates would no longer come as a big surprise to the market and might not lead to much change either in short-term interest rate expectations or in the exchange rate. To delay moving rates could lead to expectations that more would need to be done later, to rein back the unsustainable growth of domestic demand. While the *Inflation Report* would provide an opportunity to analyse recent developments in more detail, and set out the thinking of the Committee at greater length, this argument was not by itself a conclusive reason for delay. Finally, the Committee had decided in March that the timing of the Budget would not be a constraint on moving rates either that month or this. On balance therefore a rise in the repo rate of 25 basis points was needed this month.

33 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. Six members of the Committee (the Governor, David Clementi, Charles Goodhart, DeAnne Julius, Ian Plenderleith and Sushil Wadhvani) voted for the proposition. Mervyn King, Willem Buiter and John Vickers voted against, preferring a rise in rates of 25 basis points.

34 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

Willem Buiters

Charles Goodhart

DeAnne Julius

Ian Plenderleith

John Vickers

Sushil Wadhvani

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 Bank staff to the Monetary Policy Committee on 31 March, in advance of the meeting on 5-6 April 2000. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in this Annex.

I The international environment

A2 Overall, the world economy had continued to strengthen and industrial production for a wide range of countries had remained strong in January, though there were signs of a slowing in annual growth. Producer and consumer price inflation had risen a little since the end of the year in the United States and the euro area, largely reflecting increased energy costs. OPEC's decision to increase oil production had eased the pressures on oil prices since March, as had evidence of lower compliance with output quotas in the latest quarter. Interest rates had been raised in the United States and the euro area in March, and rates implied by futures contracts had pointed to further tightening in 2000.

A3 Final estimates for US GDP had shown 4.2% growth for 1999 as a whole. US GDP growth had been revised up by 0.1 percentage point in Q4 to 1.8% for the quarter. The revisions had mainly affected net trade, with higher exports and lower imports than in the preliminary profile. However, in January, US export volumes had fallen by 3.4% over the month, partly due to a fall in aircraft sales, and the US trade deficit had widened to a record \$28 billion. US industrial production had slowed slightly in February to 5.6% on a year earlier, largely because of a fall in automobile production. Retail sales, which had grown by 1.1% in February, pointed to strong underlying growth of consumption in Q1, though consumer confidence indicators in March had fallen further from January's record levels. Producer price inflation had been strong in February, rising to 4% over the year, mainly reflecting energy and tobacco price increases. Headline consumer price inflation (CPI) had also risen, to 3.2% in the year to February, and core CPI inflation had risen to 2.1%.

A4 The picture of stronger activity in the euro area in the second half of the year had been confirmed by Q4 results. GDP had grown by 0.9% in Q4 and by 2.2% in 1999. Net trade had made a negative contribution to growth in Q4, but domestic demand had been strong, reflecting the growth

in private consumption, and reported stockbuilding. Industrial production had continued to grow strongly in Q4 and in January was 3.8% higher than a year earlier. Business and consumer confidence had reached the peak levels previously seen in 1998 and so had pointed to a continued strengthening of activity. M3 growth had increased by 6.2% in February, above the January rate of 5.2%. Euro-area PPI inflation had risen again in March. Consumer price inflation was 2.0% in February. As with the United States, energy effects had mainly accounted for the stronger PPI and headline CPI inflation.

A5 The first estimate of Japanese GDP in Q4 had shown a decline of 1.4% on the previous quarter; private consumption had fallen by 1.6%. Investment, mainly non-residential, had contributed positively to growth in Q4. Rising corporate profits and orders had pointed to further investment growth. The March Tankan survey pointed to a slow recovery in output. Japanese workers' household expenditure had increased by 3.9% in the year to February, boosted by the extra day in February 2000, but nonetheless pointed to higher private consumption in Q1. Net trade had been supported by intra-Asian exports and this was also likely to be a strong component in Q1 growth. Exports had increased by 15% in the year to February while import growth had remained above 10%. In February, consumer prices had fallen by 0.6% compared with a year earlier, as the effects of the earlier appreciation of the yen continued to feed through.

II Monetary and financial conditions

A6 The twelve-month growth rate of notes and coin in March had remained strong at 8.4%, the same as in February. Bank staff noted that the velocity of narrow money had fallen in recent years, partly as the result of a gradual adjustment to lower nominal interest rates.

A7 The stock of M4 had risen by £2.2 billion (0.3%) in February leaving the twelve-month growth rate at its historic low of 2.7%. The weak M4 figures had continued to be dominated by other financial corporations' (OFCs') deposits, but private non-financial corporations' (PNFCs') and households' deposits had also been weak in recent months. Aggregate M4 lending (excluding the effects of securitisations) had been stronger in February, rising by £7.5 billion (0.8%) compared with £3.9 billion in January. The twelve-month rate had risen by 0.3 percentage points and remained robust at 8.9%.

A8 Households' M4 deposits had risen by £2 billion (0.4%) in February. But the twelve-month growth rate, at 5.3%, had remained low when compared with rates seen in 1999. Households' M4 lending (excluding the effects of securitisations) had remained robust, increasing by £4.3 billion (0.8%) in February, with the twelve-month rate at 9.7%.

A9 Data on mortgage approvals had pointed to continuing buoyancy in housing market activity. The number and value of mortgage approvals had risen by 11,000 and £0.6 billion respectively in February, reversing the downward trend of the previous two months. This had suggested that secured lending could rise in the coming months. Revised estimates by Bank staff had suggested that mortgage equity withdrawal had been strong in 1999 Q4 at around £2.5 billion, although it had been weaker than provisional estimates, which had put the figure at around £3 billion. Total real lending for consumption (real mortgage equity withdrawal plus real unsecured lending) in 1999 was estimated to have been at its highest level since 1990.

A10 Net bank borrowing (borrowing minus deposits) by PNFCs had risen again in January and February. PNFCs' M4 deposits had fallen by £0.5 billion on average over the first two months of the year whereas PNFCs' M4 lending (excluding the effects of securitisations) had risen by £0.6 billion on average. Non-bank borrowing by PNFCs (and foreign currency capital issues in particular) had been strong in the first two months of the year. In 1999 the PNFCs' financial deficit had stood at £20 billion, which, at 2.4% of GDP, had been at its highest level since 1990. Unlike the previous economic cycle, a relatively small proportion of this debt had been raised via the banking system.

A11 OFCs' M4 had fallen by £1.2 billion (-0.7%) in February, and was 4.5% lower than a year earlier, down from -3.8% in January. OFCs' M4 lending rose by £2.3 billion (1.1%) in February, a 10% increase on a year earlier.

A12 Since the previous MPC meeting, short interest rate expectations around one year out, as measured by the gilt repo curve, had risen by around 5 basis points. Medium-term yields (5-12 years) had risen by around 10-15 basis points.

A13 The February increase in interest rates of 25 basis points had been fully passed through to the average standard variable mortgage rate, but there had been a continued trend for lenders to provide greater discounts for new mortgages. Fixed-rate mortgages had also fallen.

A14 The average of inflation expectations reported in the Treasury survey of independent forecasters had fallen slightly to 2.3% in 2001 Q4. Survey-based measures of inflation expectations for the next two years had also fallen slightly. Trade union expectations had fallen to 2.8% from 2.9% in December 1999. The inflation expectations of the general public had fallen slightly to 4.4%, but these were still well above the inflation target.

A15 Equity prices in the United Kingdom had been relatively volatile since the previous meeting. The FTSE All-Share index had fallen by 2% since the previous MPC meeting, with the IT sector down 29% from its peak in early March. Since October 1999, however, the FTSE IT sector had nearly doubled in value, while the FTSE All-Share had risen by around 8%.

A16 Since the previous MPC meeting, sterling had appreciated by 0.6% against the US dollar (to \$1.5915), but had depreciated by 0.3% against the euro (to 60.67p) and by 1.1% against the yen. The sterling effective exchange rate index (ERI) had depreciated by 0.3% since the previous MPC meeting. This month, movements in sterling against the US dollar had been consistent with 'monetary news', though movements in sterling against the euro had not. The sterling ERI was 0.3% below the February *Inflation Report's* modal projection.

III The Budget

A17 Staff presented a summary of the March 2000 Budget, which had focused on changes in the Treasury's projections compared with the November 1999 *Pre-Budget Report*. The policy changes announced for 2000/01 and 2001/02 had increased discretionary spending in particular, but had been more than offset by non-discretionary changes to spending and revenues. Much of the weaker-than-expected spending and stronger-than-expected revenue outturns in 1999/2000 had been considered to be structural by the Treasury, and were therefore assumed to continue to reduce borrowing over the forecast period.

A18 The net effect of the changes to the projections had been to reduce projected borrowing in 2000/01 and 2001/02. A surplus of around £5 billion was now projected for 2000/01, £4 billion more than in the *Pre-Budget Report*, while a surplus £2 billion higher than in the *Pre-Budget Report* was projected for 2001/02. So in the near term, the Budget represented a modest tightening in the fiscal stance relative to the *Pre-Budget Report*. From 2002/03 onwards, higher borrowing had been

forecast. The Budget projections had been dependent on the Treasury's 2¼% trend growth assumption.

A19 The figures for cyclically adjusted net borrowing had been similar to those for the unadjusted deficit, because an output gap of close to zero had been projected. Very little of the change since the *Pre-Budget Report* had been ascribed by the Treasury to the cycle. Cyclically adjusted net borrowing in the Budget had been estimated at -1.2% of GDP in 1999/2000, and projected at -0.5% in 2000/01, -0.3% in 2001/02, and +0.5% in 2002/03.

A20 The Treasury had expected that the Golden Rule would be met throughout the next five years with a small margin of safety, with the cyclically adjusted surplus on current budget declining to 0.7% in 2004/05 from 1.8% in 1999/2000. The ratio of net debt to GDP had already been below 40%, the Treasury's benchmark, and had been projected to fall to around 33% in 2002/03 and 2003/04.

IV Demand and output

A21 Quarterly GDP growth had been unrevised at 0.8% in Q4 but the level of GDP had been revised up by just under 0.1%. Final domestic demand growth had been revised up to 1.3% in Q4 and the annual growth of final domestic demand had been revised up to 4.4%. Stockbuilding had been revised down; it contributed 0.6 percentage points to GDP growth in Q4, down from the 1 percentage point reported in the previous GDP release. The net trade contribution had been unchanged at -1.2 percentage points. Revisions had brought the expenditure, output, and income measures of GDP closer together.

A22 Household consumption growth in Q4 had been revised up to 1.1%, but there had been some downward revisions to earlier quarters so that the level of consumption in 1999 Q4 was broadly unchanged. Within the total, services had grown by 2.2% on the quarter, and spending on durable goods had risen by 0.3%, while spending on non-durable goods had risen by 0.2%. Cars had contributed little to durables growth in 1999 but spending on other durables had grown by 12.9% in the year to Q4. Real government consumption had been revised up by more than £1 billion by 1999 Q4 with similar-sized revisions to nominal government spending. The estimates of whole-economy investment had been little changed for 1999 Q4 but general government investment had

been revised up and business investment had been revised down. Quarterly manufacturing investment growth had been revised up to 4.3% in Q4, the first positive growth rate since 1998 Q4. Other plant and machinery investment had fallen by 0.4%, which could be consistent with a pause in IT investment around the millennium. Revisions had reduced the volatility of inventories between Q3 and Q4.

A23 There had been upward revisions to the level of both imports and exports during 1999, although the timing of revisions differed. The net trade contribution had been slightly more negative in 1999 H2. The trade deficit had increased to around 2% of GDP in Q4 but this had been more than offset by increases in investment income and so the current account deficit had narrowed to 1.3% of GDP.

A24 The gross operating surplus of all corporations had fallen by 0.9% in Q4 but the level had been revised up by 1.5%. The half-yearly growth rates had been volatile. PNFCs' net borrowing had been little changed in Q4, at 2.4% of GDP. Household compensation of employees had grown strongly, by 1.8% in Q4. The annual household savings ratio had been around 6% over the past two years. It had been low compared with the recent past but did not look so low when compared with the 1960s.

A25 Retail sales had fallen by 1.2% in February following growth of 1.6% in January. The three-month rates had still been strong. The BRC weekly data for March had pointed to further retail sales growth and the Bank's regional Agents had reported little change in the growth rate, although there was a further rise in the dispersion across regions. The CBI distributive trades survey had reported lower sales volume growth in March but a rise in expected growth for April. The GfK measure of consumer confidence had weakened across all categories to -2 in March.

A26 Analysis by Bank staff had shown close links between housing market surveys and housing market activity and prices. Loan approvals and the Royal Institute of Chartered Surveyors (RICS) sales survey had strengthened in February and had suggested stronger activity in the short term. But the House Builders' Federation survey had shown falling growth in site visits and net reservations which pointed to an easing in activity in the summer. House price indicators had been mixed. The Nationwide index had been very strong at 2.3% in March with annual growth rising to 16.2%. By contrast, the Halifax index fell by 0.4% in March and the annual rate of house price inflation eased a

little to 13.5%. The RICS prices data seemed consistent with house price inflation of around 4% per quarter.

A27 Exports had been flat in January and there had been evidence that the upward trend in imports was attenuating slightly. There had been a strengthening in exports to non-EU countries in February.

A28 Industrial output had fallen by 0.6% in February and manufacturing output had fallen by 0.2%, the third month in a row that manufacturing output had declined. Output had fallen across most industries in the latest three months. The weaker-than-expected manufacturing data had led to a fall in the National Institute's projection of GDP growth for the latest three months to 0.5% from 0.8% the previous month. However, surveys had pointed to a rise in manufacturing output in March. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing survey output balance had been 54.1 in March, suggesting a moderate expansion of output in Q1. Though still pointing to an expansion of output, the growth of new orders had moderated to 51.7, with firms citing post-millennium destocking as a factor. CBI Industrial Trends output expectations had been stronger in March at +17; total orders had dipped to -16 but had been broadly flat over the past six months. The Engineering Employers' Federation output balance had been flat at +9 in Q1 and orders had risen slightly. By contrast, the CIPS services survey had risen to 59.6 in March, indicating relatively strong service sector output growth. The CIPS construction trends survey had continued to point to growth of current and future construction activity.

V Labour market

A29 According to the Labour Force Survey (LFS) employment had risen by 83,000 (or 0.3%) in the three months to January compared with the previous three months, a little stronger than the growth rate in each of the previous three releases. Within the total, full-time employment had risen by 88,000 and part-time employment had fallen by 5,000. The 0.3% rise in the number of people in employment in the three months to January had been offset by a 0.3% fall in average hours worked. So total hours worked had been broadly unchanged in the latest quarter.

A30 The number of Workforce Jobs had risen by 70,000 (or 0.3%) in Q4. Within the total, the number of jobs in the production sector had continued to fall, though by less than on average over the past year. There had been a further sharp rise in the number of service sector jobs. The level of

Workforce Jobs in Q3 had been revised, so that the number of jobs was estimated to have fallen by just 1,000 during the third quarter, rather than 51,000 as reported in the previous release of the Labour Market Statistics.

A31 Survey data had been consistent with further increases in employment in Q1. According to the CIPS, the reading on construction sector employment was 60.8 in March, well above the neutral 50 level and the strongest figure since May 1997. Other CIPS surveys suggested a small rise in service sector employment and a small fall in manufacturing employment in March.

A32 There had been a sharp increase in whole-economy productivity growth. One measure, based on the change in the ratio of GDP to Workforce Jobs, had risen from 1.0% in the year to Q3 to 1.8% in the year to Q4. Another measure, based on the change in the ratio of GDP to LFS employment, had risen from 0.8% in the year to Q3 to 1.6% in the year to Q4. Survey data from the Institute of Management Services confirmed the pick-up in productivity growth during the second half of 1999, and suggested that productivity growth had remained firm during the first quarter of this year.

A33 There was little new information on labour shortages. The Recruitment and Employers' Confederation (REC) survey showed a further reduction in the availability of both permanent and temporary staff in March. According to reports from the Bank's regional Agents, skill shortages had remained a serious concern, particularly in southern England.

A34 LFS unemployment had risen by 21,000 in the three months to January compared with the previous three months. Most of the rise had been accounted for by those unemployed for less than six months. The claimant count measure had fallen by 42,000 in the three months to January, and by a further 6,700 in February. Inactivity had fallen by 68,000 in the three months to January compared with the previous three months, reflecting similar reductions in the number who reported that they wanted jobs and those who did not.

A35 There had been a further sharp increase in the headline rate of earnings growth for the whole economy as measured by the Average Earnings Index (AEI), from 5.5% in December to 5.9% in January. The January headline figure was an average of the annual rates for November, December and January. These were 5.1%, 6.2% and 6.4% respectively.

A36 Within the total, annual growth in manufacturing earnings had fallen by 0.2 percentage points to 5.6% in January. At the same time, annual growth in service sector earnings had risen by 0.4 percentage points to 6.7%.

A37 The latest earnings figures had been affected by millennium-related and other bonus payments. These had included overtime payments to police and health sector workers, and on-call allowances in transport, storage and communication and the utilities sectors. Overtime payments were reported to have risen in the manufacturing sector as firms sought to make up lost output after the prolonged holiday season.

A38 The Bank's regional Agents had asked around 160 of their business contacts to comment on any bonus payments which they had made, or planned to make, during the period November 1999 to April 2000. Around 50% of all respondents had stated that the share of bonus payments in the total wage bill would be higher this year than last year. This proportion was slightly higher in the financial services sector than in manufacturing. Looking at those firms that had reported a higher bonus share for this year, the most common explanation was higher productivity and profits, with around 70% citing this as either an 'important' or a 'very important' factor. The need to retain and recruit staff was a close second in most sectors, though not in manufacturing where employment had been falling. The millennium was seen as 'important' or 'very important' by fewer than one third of those firms reporting a higher bonus share this year. On balance, roughly the same proportion of respondents had expected to make significant bonus payments in March as had done so in January, though it looked as if March bonuses would be concentrated in the financial services sector.

A39 Consistent with the AEI, the REC survey showed a sharp pick-up in the growth rate of salaries for permanent staff around the turn of the year. There had been a more moderate increase in the growth rate of pay for temporary (or contract) staff. Wages and salaries per head rose by 5.0% over the year to 1999 Q4, 0.5 percentage points below the headline growth in the AEI for December. Growth in unit wage costs fell from 3.8% in the year to Q3 to 3.2% in the year to Q4, reflecting the sharp increase in productivity growth.

A40 According to the latest available data, the Bank's AEI-weighted twelve-month mean settlement was 3.3% in February, the same as the January figure. On balance, settlements were

turning out lower this year than last year: of the 110 settlements that could be matched 25 were higher, 11 the same and 74 lower in January 2000 than in January 1999.

VI Prices

A41 The Bank oil-inclusive commodity price index had risen by 3.4% in February, taking the annual inflation rate from 18.9% to 22.7%. The monthly increase had reflected price rises in all the major components of the index, except for non-indigenous food. In particular, the price of fuels had risen quite sharply, by 5.1%. This had been mainly due to the 9% rise in crude oil prices in February. Excluding oil, commodity prices had risen by 1.8% in February to give an annual inflation rate of 2.9%.

A42 Seasonally adjusted manufacturing input prices had risen by 3.1% in February, taking the annual inflation rate from 10.8% to 14.5%, the highest since the mid-1980s. This had again mainly reflected the large monthly rise in the price of crude oil. There had also been rises in the prices of imported materials as a whole and of domestically produced food. According to March's CIPS manufacturing survey, the input price index had risen to its highest level since August 1995. Seasonally adjusted total output prices excluding excise duties (PPIY) had risen by 0.1% in February, to give an annual inflation rate of 1.6%, slightly down from 1.7% in the previous month. March's CBI survey output price balance had fallen sharply to -11 from -4.

A43 Prices of imported and exported goods had risen by 1.1% and 0.5% respectively in the three months to January compared with the previous three months. Excluding oil, the price of imported goods had risen by 0.5%, while the price of exported goods had fallen by 0.5% over the same period.

A44 RPIX inflation had risen to 2.2% in February, up from 2.1% in the previous month. RPI inflation had risen to 2.3% in February from 2.0% in January. RPIY inflation had remained unchanged for the second consecutive month in February at 1.8%. Large monthly rises in the prices of clothing, used cars and tobacco had been partly offset by price falls for pharmaceuticals and toiletries, and vehicle insurance. HICP inflation had risen from 0.8% to 1.0% in February. As a result, the difference between HICP and RPIX inflation had narrowed slightly to 1.2% in February from 1.3% in January. Much of this reduction in the difference had been accounted for by a rise in February in the price of new cars, which are not included in RPIX.

A45 The basket and weights of the RPI had been updated, with goods receiving a lower weight and services a higher one. The weights for petrol and depreciation had also risen.

VII Reports by the Bank's Agents

A46 The Bank's regional Agents had reported a continued moderate recovery in manufacturing activity, although significant sectoral differences remained. The outlook for the sector was reported to be heavily dependent on future movements in the exchange rate. Service sector output growth had remained stable at a strong rate, and there had been some evidence of a strengthening in business services growth. Construction output growth had remained broadly stable, although wide regional variations persisted. The Agents suggested that export volumes had been maintained, but that the strength of sterling continued to result in intense pressure on margins. Concerns regarding the strength of import penetration appeared to have increased further.

A47 Agents had reported a slight easing in annual retail sales growth in February, following stronger Christmas/millennium sales, consistent with ONS retail sales data. New car sales had remained unchanged, while there had been further evidence of a pick-up in the used car market.

A48 Manufacturers had continued to find it difficult to pass on increases in input prices. There had been further downward pressure on retail goods prices, while service sector inflation was thought to have remained stable. Contacts had remained concerned about skill shortages in the labour market, and there had been signs that expectations regarding pay settlements later in the year had increased in manufacturing and services.

VIII Market intelligence

A49 Expectations of UK interest rates implied by short sterling futures had risen slightly since the previous MPC meeting. But the unexpected weakness of the February retail sales and manufacturing output data, and the sustained strength of sterling since the previous MPC meeting, had limited expectations of a rise in the official interest rate in April. Ahead of the meeting, the markets had attached a probability of up to a half to a rise in the official rate of 25 basis points. The latest poll of economists' expectations reported by Reuters suggested about a 40% chance of a rate rise, and an expected peak of 6.5% by the third quarter.

A50 In the United States, the FOMC had raised the official rate by 25 basis points on 21 March. This move had been widely anticipated and there had been little market reaction to it. Following the publication of the February FOMC minutes on 23 March, in which a discussion of a 50 basis point rate rise was reported, US interest rate futures had risen sharply, but had since fallen back. The ECB raised their official rate by 25 basis points on 16 March and, following that change, interest rate expectations in the euro area had fallen.

A51 Since the previous Committee meeting there had been some volatility in US equity markets, with a 15% fall in the US NASDAQ index and a 12% rise in the Dow Jones index (the FTSE All-Share index had fallen by 2% over the same period). Market participants had reported that the movements had been caused by a fall in demand for technology stocks and a corresponding rise in demand for 'blue-chip' stocks. In recent days there had been a notable rise in volatility, with the NASDAQ having fallen by 16% between 24 March and 5 April and the Dow Jones having fallen by 0.7% over the same period. Increased volatility had been attributed to uncertainty about the valuation of technology stocks.

A52 Sterling's effective exchange rate index had fallen slightly from 109.3 to 108.9 since the previous Committee meeting, reflecting a small depreciation against the euro and the yen, but a slight appreciation against the US dollar. Risk reversals traded in the foreign exchange market were close to neutral for sterling exchange rates. Since the previous Committee meeting there had been a number of mergers and acquisition deals (both confirmed and rumoured) which had, or were expected to, involve purchases of sterling. That had helped to support sterling, both against the US dollar and the euro.