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MINUTES OF MONETARY POLICY COMMITTEE MEETING 9 and 10 February 2000

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 February 2000.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0002.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 8 and 9 March will be published on 22 March 2000.



MINUTES OF THE MEETING OF THE MONETARY POLICY COMMITTEE HELD ON 9-10 FEBRUARY 2000

1 Before turning to its immediate policy decision, the Committee discussed money, credit and asset prices, demand and output, labour market conditions, the world economy, and prices and costs; reviewed the February projections for output and inflation; and considered the implications of sterling's further appreciation and the continuing imbalances in the economy for its policy decision.

Money, credit and asset prices

2 Sterling's effective exchange rate index (ERI) had been volatile, moving in a range of 106.7 to 110.6 in the 15 days up to the meeting. It had risen by about three quarters of a percentage point since the Committee's January meeting, and the 15-day average used as the starting point in the February *Inflation Report* projections was about four percentage points higher than that used in the November projections. This rise in the ERI was accounted for by an appreciation against the euro which could not be explained by changes in interest rate differentials.

3 The Committee discussed whether sterling's strength might be explained by a rise in the medium-to-long run equilibrium real exchange rate against the euro. There might have been such a rise if, for example, UK production had become more competitive relative to the euro area, perhaps on account of greater market flexibility and/or more widespread application of new technologies. But, at least as yet, there was no sign of this from the performance of the trade equations in the medium-term macroeconomic model, and it was difficult to identify news over the past few months suggesting that the long-run equilibrium exchange rate had changed.

4 Another possibility was that there had been a change in the risk premium, with sterling regarded as having become less risky relative to the euro. The change to the UK's monetary framework and/or, for example, uncertainty about structural reform in parts of continental Europe could, in principle, have brought that about. It was, however, highly uncertain whether this was a material part of the explanation of sterling's recent rise.

5 If sterling had risen on account of a change in the risk premium, what would that imply for the path of the exchange rate looking forward? A number of possibilities were identified. First, a reduction

in the perceived risk in holding sterling relative to other currencies would mean that holders of sterling-denominated assets would require a lower relative return than otherwise, in which case the market would be expecting sterling to depreciate on a steeper path than otherwise for any given path of interest rate differentials. Second, while a shift in the risk premium in sterling's favour implied an expectation that sterling would depreciate by more than otherwise over the long run, it did not necessarily follow that sterling should be expected to depreciate in the shorter run, including over the forecast horizon. If, as on this view seemed likely, portfolio managers and others were gradually learning about the new UK monetary framework, perceptions of relative risk and credibility would change gradually. In that case, the risk premium might continue to adjust for a while, with holders of sterling earning supernormal returns during a transition period of uncertain length. Yet another possibility for some members was that sterling had risen because of the significant interest differential vis-à-vis the euro, and the growing expectation that this difference would not decline in the near future. Some empirical evidence supported the notion that one might earn persistent, supernormal returns from currencies that offered the higher interest rate. Views differed on these possibilities.

6 Committee members differed in their preferred assumptions for the path of sterling's effective exchange rate in the February *Inflation Report* projections. Some preferred to assume a constant nominal exchange rate; some others preferred a depreciation in line with interest rate differentials (and perhaps with the balance of risks to sterling towards a steeper depreciation). The assumption used in the best collective projections was half way between the two. Others noted that an econometric model-based projection for the exchange rate yielded a broadly similar answer.

7 Turning to the monetary data, the Committee noted that the rate of increase in narrow money had fallen sharply during January so that, as earlier thought, December's very rapid growth did seem to be an end-year/end-millennium phenomenon. Nevertheless, the underlying rate of M0 growth appeared to be robust, pointing to strong growth in household spending in the near term. More generally, household M4 growth had picked up; household Divisia growth had risen between Q3 and Q4; and total household borrowing was now rising more quickly than since the early 1990s, with mortgage equity withdrawal increasing. Taken together, this supported the buoyant near-term outlook for consumption suggested by rising incomes, consumer confidence, and wealth.

8 House price inflation had remained high. The Halifax index had risen by 16% in the year to January, up from around 13½% in December, but the significance of this rise was uncertain as the Halifax index had been volatile over the past few months. The Nationwide index, rising at about 13%

year-on-year, had been more stable. There were tentative signs in the activity data that pressures in the housing market might be easing, perhaps reflecting tighter monetary conditions. The number of particulars delivered had fallen in December by about 2½%, and the figure for November had been revised down slightly. The volume of transactions was basically flat. The number of loan approvals had fallen slightly at the end of 1999, having previously been stable since the summer. While the Committee assumed in its best collective projection that there would most probably be some moderation in house price inflation over the coming year or so, it was likely to remain quite high. This would tend to support continuing robust consumption growth, with some members seeing upside risks.

Demand and output

9 As already noted, the underlying determinants and forward-looking indicators of consumption had strengthened. For example, consumer confidence, as measured by the GfK index, had risen by a further 6 points in January to +8, its highest level since autumn 1997. Although new car purchases had recently been relatively weak, it seemed probable that this reflected a pause while prospective purchasers waited for the results of the Competition Commission inquiry into the car market.

10 Reports from the Bank's regional Agents suggested that the apparent weakness in business investment in the second half of 1999 might in part be explained by firms having delayed spending with an IT component until the millennium-date change was safely out of the way. If so, any deferred expenditure would tend to support near-term investment growth, as in the view of some Committee members would the possibility of firms stepping up investment related to e-commerce. Tighter monetary conditions and the higher exchange rate would, on the other hand, tend to reduce investment spending. Overall, the Committee concluded that the most likely outlook for investment was slightly weaker than in November, but with some members seeing upside risks.

11 The outlook for net trade was important to the Committee's judgment about the balance of pressures on the economy's productive capacity and, therefore, the prospects for inflation. Export growth had picked up during 1999 with the recovery in world economic activity; Q3 had been unusually strong. Imports had also increased during 1999. Since the November *Report*, however, the trade figures had been weaker and the outlook had changed because of the further appreciation in sterling's exchange rate. It now seemed likely that the contribution of net trade to output growth would be more negative than earlier expected. This had three consequences. First, it would help to offset the effects on GDP growth of the prospective sustained strength of final domestic demand, and so contribute to containing near-term pressures on capacity. Second, it would mean that the imbalances in

the economy – in particular between businesses which were externally exposed and those which were not – would be likely to persist, and could even become more pronounced. Third, other things being equal, it would entail a larger current account deficit and accumulating external debt.

12 In the second half of 1999, output had grown at 0.8% per quarter, slightly above trend. There had been some signs in the latter part of 1999 that the sectoral split in activity was becoming somewhat more balanced. Services sector growth had fallen slightly between Q3 and Q4, and manufacturing production as a whole had been picking up. But overall industrial production and manufacturing had fallen in December, and there remained marked differences between industrial sectors. Moreover, the effects of sterling's further appreciation, which would tend to reduce growth in externally-exposed businesses, would not yet be apparent in the activity data.

13 The Committee discussed whether, or not, an accumulating current account deficit would have implications for the exchange rate. On one view, it was questionable whether it was consistent to assume both a growing external deficit and persistent sterling strength. If there had been a change in the equilibrium real exchange rate, sterling might remain high but then the trade deficit – and so the current account deficit – would be smaller than assumed. Alternatively, an accumulating external deficit would lead to a depreciation. The latter seemed, on this view, more likely: to the extent that the divergence between the growth rates of domestic demand and output persisted and widened, the greater the risk to sterling would become. On another view, there was no obvious inconsistency between the projected current account deficit and persistent sterling strength over the forecast horizon. Two reasons for this were suggested. First, in a world of highly mobile capital, there was no direct link between the current account and the exchange rate. Instead, there were links through asset markets. Second, the size of the prospective current account deficit was on this view modest, at 2%-2½% of GDP. Third, while a deficit which continued to grow would over the medium-to-long run entail a depreciation in sterling's real exchange rate, that did not imply that the real, and even less the nominal, exchange rate had to fall during the next two years or so. The UK economy could generate the required surpluses in the future without a sharp near-term nominal depreciation.

Labour market conditions

14 Labour market conditions might have tightened slightly since the Committee's November *Inflation Report*. The evidence since the Committee's January meeting was mixed. While claimant count unemployment had fallen by around 20,000 in December, taking the rate down 0.1 percentage point to 4.0%, the broader-based LFS measure had increased by around 12,000 in the three months from

September to November compared with the previous three months. The LFS measure of employment had risen slightly over the same period, with part-time employment falling and full-time employment rising. Total hours worked had fallen slightly. Survey-based indicators of recruitment intentions remained strong in the services sector and had picked up in manufacturing. The British Chamber of Commerce indicator of recruitment difficulties had been stable, although the Bank's regional Agents were reporting increased skill shortages compared with the previous quarter.

15 On recent developments on pay, some members drew encouragement from public sector settlements, on the grounds that they could have a useful demonstration effect. But there was also concern that the earnings data would be difficult to interpret over the coming months given that financial sector and millennium-related bonuses were expected to be strong.

16 The earnings and settlement data continued to diverge. On the Average Earnings Index (AEI) measure, earnings had grown at an annual rate of 4.9% in the three months to November, and had persistently been higher than had been expected at the time of the Committee's November *Inflation Report*. Wage drift appeared to be increasing as settlements had, on average, been running at around 3½% over recent months, and on most measures were lower in January than a year ago. The regional Agents' survey of the prospect for earnings growth in 2000 – summarised in the Annex – also showed a divergent picture: settlements were, on balance, expected to be weaker in 2000, but total pay per employee was on balance expected to rise at a faster rate than in 1999.

17 It was possible that increasing wage drift was a sign of tight labour market conditions. Alternatively, the wedge between settlement and earnings growth might be accounted for by increases in profit-related – or performance-related – pay, which might more closely reflect productivity improvements. In that case it would not necessarily signal increasing pressure on prices. However, while measured productivity growth had recovered in recent quarters, it was now only broadly in line with the past long-run trend. It was difficult to know whether there had been improvements in productivity that were not reflected in the official data. Views differed on this.

18 Members placed different weight on the earnings and settlement numbers. Overall, the Committee concluded that, partly reflecting the recent stronger-than-expected outturns of the AEI, the path for earnings growth would be higher than had been assumed in the November projections.

World economy developments

19 The USA had continued to grow more strongly than earlier expected, and seemed set to continue to do so, although downside risks remained. Recent growth in the euro area had also been stronger than expected in November, and the improvement in business confidence indicators suggested a stronger outlook. Partly against this background, both the Federal Reserve and the ECB had raised interest rates since the Committee's January meeting. This tightening of global monetary conditions had been in line with what had been assumed in the Committee's November projections.

20 Developments in Japan were less clear. Consumption remained very weak and output might even have fallen in the second half of 1999, having done so in Q3. But there were signs of improvement in corporate profitability, which could support investment. That might have contributed to the rise in the Nikkei index over the past few months, although it was noted that price rises had been markedly more pronounced in some stocks than in others. The Committee noted that there were some signs of market concerns about the growth in Japanese government debt which, if fiscal policy were as a result to be constrained, would tend to place more pressure on monetary policy in the absence of a self-sustaining recovery in growth.

Prices and costs

21 Probably reflecting the stronger world economic conjuncture, commodity prices had continued to rise. The annual rate of increase in the Bank's oil-inclusive index had risen to nearly 22% in December; excluding oil, the rate of growth was slightly over 3½%, the highest rate since January 1996.

22 Although input prices were rising strongly, intermediate prices (as measured for example by producer output prices) were increasing more moderately, and RPIX inflation had remained below the 2½% target.

23 The counterpart to the rapid recent rise in manufacturing productivity had been that the twelve month rate of change in manufacturing unit wage costs had fallen in every month between July and November, when the twelve month fall had been 1.3%. However, there was little evidence that measured economy-wide labour productivity growth had risen above levels implied by the past long-run trend of around 2% per year. It was plausible that the Internet would facilitate an increase in the level of productivity that might be spread over several years.

24 Given that the expected path of aggregate demand was close to estimates of the economy's productive capacity, judgments on the outlook for inflation over the forecast horizon depended to a significant degree, as in November, on views about the implications of developments in technology and in competition. The Committee concluded that, in its best collective projection, the downward adjustments should be slightly larger than in November.

25 Some members preferred a smaller adjustment to price-cost margins, particularly in the second year of the projection. While there were undoubtedly major changes underway in competition and technology, the implications for inflation were not straightforward. There had been major technological changes in the real economy during the 1970s and 1980s – for example, in computing power – but that period had also seen the highest inflation rates in modern British history. Such developments entailed changes in relative prices, but it was unclear how large changes in some relative prices should be translated into a change in the aggregate price level. Some other members preferred larger downward adjustments to price-cost margins in both years than in the best collective assumptions. For example, the effects of the Internet and e-tailing would most likely be greater than assumed, with larger second-round effects on costs and prices. More generally, the supply side innovations did not just entail relative price changes but were characterised by a generalised intensification of product market competition and so were affecting the economy as a whole, with a compression of average margins.

The February output growth and inflation projections

26 The Committee agreed the projections to be published in the *Inflation Report* on Thursday 17 February.

27 On the assumption of an official repo rate of 6.0% over the next two years, the best collective projection was for output growth to rise to about 3% and then fall back to around 2½% – close to most estimates of trend – for most of the forecast period. This was softer than in November, largely reflecting the tightening of monetary policy and sterling's appreciation.

28 On the best collective projection, RPIX inflation fell slightly from its current level of 2.2% to about 2% during 2000, and then rose gradually to around the 2½% target from mid-2001. There was less of a saucer shape (that is, a dip followed by a sharp upturn) than in November, reflecting upward pressures early in the forecast period from higher earnings growth than in the November projection and downward pressures later on in the forecast period from the restraining effects of tighter monetary policy and the higher exchange rate.

29 As already described, there was a range of preferred assumptions for the path of the nominal exchange rate and for price-cost margins; these were presented in Table 6.B on page 57 of the February *Inflation Report*. Different members preferred different combinations of these assumptions, either raising or lowering the inflation projection at the two-year horizon by up to half a percentage point.

Other considerations: implications of the exchange rate and sectoral imbalances

30 Against the background of its latest projections and its analysis of the recent data, the Committee discussed a range of issues before turning to its immediate policy decision. In particular, a number of Committee members were very concerned about the further rise in the exchange rate that had occurred over the past few months; and about the associated imbalances in the economy.

31 The prospects for inflation depended heavily on the path of the exchange rate, which was highly uncertain. If sterling were to depreciate in line with interest rate differentials (or more) then, other things being equal, inflation would most likely be above the 2½% target by the forecast horizon. If, on the other hand, sterling's current strength persisted, inflation would most likely be below target throughout the forecast period.

32 The Committee discussed the implications for monetary policy of domestic sectoral imbalances associated with the continuing strength of sterling.

33 On one view, prospective sectoral imbalances should not of themselves affect the Committee's interest rate decision given its remit. Moreover, imbalances had, if anything, narrowed in recent months. The difference between recent annual rates of growth for services and manufacturing had declined. Regional differences had also narrowed, with for example the balance of new orders recorded in the January CBI Quarterly Trends survey rising in ten out of eleven regions. Moreover, a marked dispersion of growth rates amongst firms within particular sectors was to be expected in a period of technological and structural change; in that sense the imbalances between old and new industries were a symptom of factors that would otherwise be regarded as desirable.

34 On another view, if the exchange rate persisted at its current level, the imbalances in the economy would probably get worse and that was unwelcome. It was already likely that there had been failures amongst businesses which would have been able to survive at a lower – and, on the view of some members, more sustainable – real exchange rate. It was noted that one recent IMF study had estimated that sterling was overvalued by more than 15%, a bigger misalignment than the study

estimated for any other industrialised country. It was, therefore, desirable to consider whether official policy could do anything to mitigate this. It was noted in that context that the textbook response would be fiscal policy tightening. But that kind of active use of fiscal policy was forsworn under the current fiscal framework, and it was observed that fiscal policy had in fact tightened over the past few years. As to monetary policy, whether the Committee's remit was in principle consistent with taking these concerns into account depended on whether there were different paths of interest rates which could achieve the inflation target but which might have different implications for the exchange rate. It was noted that an interest rate policy which helped to sustain sterling at current or higher levels ran significant risks with the inflation target at some future point when sterling could fall sharply. In the interests of making it easier to meet the inflation target at all times, an interest rate path now that helped to keep sterling lower would be desirable. On the other hand, an interest rate policy which sought to offset the current strength of sterling would risk fuelling domestic demand, which could have adverse implications for inflation further ahead.

35 It was in any event unclear what, if anything, the Committee could do to address these wider concerns given the current conjuncture of market expectations. The market was firmly expecting a 25 basis point rise in the Bank's repo rate. Some members believed that if that were the Committee's decision, there would be little change in either the exchange rate or in money market rates. Some other members were concerned that a tightening of policy, even though expected, could have the effect of putting further upward pressure on sterling when the *Inflation Report* was released, by making it appear a 'one way bet' in the short run.

36 There was also a range of views on the likely market reaction to a decision to maintain the repo rate at 5.75%. Some members thought that, particularly given the *Inflation Report* projection, it was likely that the market would conclude that a rate rise had simply been deferred, and possibly even that the official rate would end up having to go higher than otherwise. In that case, sterling's exchange rate would be supported and might even rise rather than falling back. Some other members thought that it might be possible to explain a 'no change' decision in a way which avoided that risk and which might create conditions in which sterling eased back. RPIX inflation had been below the 2½% target for nine months and, on current evidence, was set to remain so over the coming year. This profile might make a 'wait and see' policy feasible and could potentially provide a safe background against which to explain publicly that inflation would undershoot the target if both sterling and interest rates remained at their current levels. That might help to dent any 'one way bet' element in sterling's short-run strength. In addition, these members doubted that sterling would rise sustainably on a 'no change' decision, because

if it were to do so, the markets would quickly conclude that, other things being equal, a future interest rate rise had become less likely, which would weaken an important source of support for sterling.

37 The Committee debated whether intervention in the foreign exchange markets could usefully be deployed, either with the announcement of the Committee's immediate repo rate decision or subsequently. Those members prepared to contemplate intervention placed some weight on its use as a signal of concerns about the level of the exchange rate – a more powerful signal than words alone – but most of them concluded that it could be an option only if the Committee decided to leave the repo rate unchanged and, even then, would have to depend on market conditions. Other members thought, first, that it was doubtful whether intervention would be effective as there was little evidence that the market consensus which sustained sterling at its current level was fragile; and that a failed attempt to influence the exchange rate via intervention would damage the Committee's credibility. Second, to the extent that sterling's strength mainly reflected euro weakness, the MPC could do very little about it. Third, the Committee's analysis of the exchange rate could be conveyed via the minutes of the meeting and did not need to be demonstrated via intervention.

38 While views differed on the range of options feasibly available to the Committee, there was broader agreement that, subject to the over-riding objective of achieving the inflation target, it would be preferable to have a lower exchange rate and higher interest rates from the point of view of economic conditions and balance more generally.

The immediate policy decision

39 Some members of the Committee preferred forecast assumptions – about the path of the exchange rate and about price-cost margins – which would produce a central projection for inflation at the two-year forecast horizon closer to 3% than 2½%. In the short run, inflation would continue to be below target and would be further restrained by the appreciation in sterling, which would more than offset the increase in oil prices. But it was vital to be forward-looking. Given the medium-term outlook, policy needed to be tighter, and in particular domestic demand growth needed to be reined back. The choice was, therefore, for an immediate increase in the repo rate of 25 basis points or 50 basis points. Another view accepted the best collective judgment of the central projection, but regarded the balance of risks to inflation as clearly on the upside, on account of the possibility of a faster depreciation in the exchange rate and stronger domestic demand growth than assumed in the central projection. On this view too, the choice was between a 25 basis point and a 50 basis point increase. There was, however, more than one path for interest rates that would enable the Committee to achieve

the target. Given that inflation was set to remain below target in the relatively short term, there was time to gather more evidence, in particular about the path of the exchange rate, earnings, price-cost margins, and productivity, all of which were highly uncertain but important to the inflation outlook. There was, thus, no need to take the risk that an immediate 50 basis point increase might put further upward pressure on sterling. An immediate rise of 25 basis points was the best course.

40 For some other members, the immediate choice was between a 25 basis point increase and no change, and for them that choice was very finely balanced. On the one hand, there were risks to the inflation outlook from continued buoyant domestic demand growth and a tight labour market, which implied strong underlying domestically-generated inflation. On the other hand, inflation could remain below target for a protracted period if sterling's strength persisted, as the experience of the past few years suggested it clearly might. While inflation would tend to be higher than expected if sterling fell by more than assumed in the best collective projection, it was arguable that there could be time to raise rates if and when that happened as inflation was otherwise set to remain below target for a further period. Given the immediate benign outlook and the major uncertainties about the more distant prospect, this analysis suggested that either a rise of 25 basis points or no change would be consistent with pursuit of the inflation target and thus with the Committee's remit. However, given the Committee's inflation projection profile, in the view of some there was a risk that leaving rates unchanged would have the perverse effect of putting further upwards pressure on sterling, by leaving the market with the expectation that tighter policy had simply been deferred; and in the view of others, that sterling could not fall much on a no-change decision without engendering expectations of further interest rate rises. Although sterling was substantially overvalued against the euro, it was not clear how monetary policy could in the short run help to produce a better balance between external and internal monetary conditions. In those circumstances, the better course was to continue to restrain domestic demand growth, which remained above trend and so posed an upside risk to the medium-term outlook for inflation unless brought back to a more sustainable rate. On a delicate balance, the better course was therefore to raise rates by 25 basis points. Some members taking this view thought that, subject to any new evidence about the inflation outlook, there might then be an opportunity to wait and see before making any further change, and that this would offer the best chance of achieving the inflation target while enabling sterling to return to a more realistic level.

41 On another view, there was no need for a further increase in the repo rate. Internationally, the tightening of monetary policy elsewhere over the past month would help to contain any inflationary pressures from the stronger world economy. Domestically, there had been little news, and recent labour

market data had, if anything, been encouraging. The outlook for domestic demand growth might have strengthened slightly but sterling had continued to appreciate over the month, which would restrain activity and inflation. In terms of the forecast, if sterling remained at its current level and/or the downward pressures on prices from stronger competition and new technology were greater than in the best collective assumption, then inflation would continue to undershoot the target for the next two years. A further increase in the repo rate would increase this undershoot and would also create a short-term risk of adding to sterling's strength.

42 The Governor invited members of the Committee to vote on the proposition that the Bank's repo rate be increased by 25 basis points to 6.0%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Charles Goodhart, Willem Buiter, Ian Plenderleith, John Vickers and Sushil Wadhvani) voted for the proposition. DeAnne Julius voted against, preferring to maintain interest rates at 5.75%.

43 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 Buiter
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 the Bank staff to the Monetary Policy Committee on 4 February, in advance of its meeting on 9-10 February 2000. At the start of the Committee meeting itself, members were made aware of subsequent information that had become available, and that information is included in this Annex.

I The international environment

A2 Recent data releases confirmed the stronger outlook for the global economy. Growth in the United States had remained robust in 1999 Q4, and leading indicators in the euro area had remained strong. There was also evidence that emerging markets had continued to recover. Japanese growth remained fragile, but had been supported by strengthening exports. Oil prices had increased further since January, as had metals prices. Increased concern about inflationary risks had led to 25 basis point increases in policy rates in the United States and the euro area. The markets continued to expect further increases over the coming months.

A3 US GDP had grown by 1.4% in 1999 Q4, the same rate as in Q3. Consumption had continued to grow strongly in Q4. Investment growth had slowed – perhaps partly reflecting a Y2K effect – but growth in government expenditure had increased. Productivity had grown strongly in Q4. Manufacturing productivity had increased particularly rapidly, at an annualised rate of 6.4%, its fastest pace since 1971. New orders had risen strongly in December. Consumer confidence had increased to 144.7 in December, its highest recorded level, and retail sales growth had remained strong in that month, before slowing in January. US headline CPI inflation had picked up to 2.7% in December, but core CPI inflation had decelerated to 1.9%. Final producer price inflation had risen by 3% in December. Growth in the employment cost index had risen slightly in Q4, largely reflecting increases in benefits costs. Employment growth had remained strong in January.

A4 The FOMC had raised the Federal funds target rate by 25 basis points to 5.75% on 2 February, with the announcement (using the new format) that ‘the Committee believes the risks are weighted mainly towards conditions that may generate heightened inflationary pressures in the foreseeable future’. This assessment reflected concerns that demand would continue to outstrip growth in potential supply.

A5 Annual industrial production growth in France and Germany had continued to accelerate in November (measured on a three-month moving-average basis). Production growth in Germany had remained buoyant in December, and though orders had fallen in that month, the underlying trend remained strong. Euro-area business confidence had improved for the ninth successive month, while consumer confidence had remained stable at a high level. Annual euro-area HICP inflation had accelerated to 1.7% in December, from 1.5% in November. HICP inflation excluding energy, food, alcohol and tobacco had increased by less, to 1.1%, from 1.0% in November, while annual euro-area total producer price inflation had increased to 3.0%, mainly reflecting energy price increases. Annual euro-area labour cost growth had increased slightly in 1999 Q3, to 2.2%, from 2.0% in Q2.

A6 The average annual growth rate of euro-area M3 had increased to 6.1% in the three months to December, from 6.0% in the three months to November, still well above the ECB's reference rate of 4.5%. But a number of special factors had been distorting the annual growth rate of M3, and would continue to do so for several months. The ECB had increased its refinancing rate by 25 basis points to 3.25%, reflecting an increase in the risks of 'second-round effects' from oil and non-energy commodity prices, developments in the euro exchange rate, and expectations of higher inflation rates in the next few months.

A7 Japanese data on industrial production and the tertiary sector suggested that output growth in 1999 Q4 had increased moderately. There had been minor revisions to the National Accounts data for Q3, but these had left quarterly GDP growth unchanged, at -1.0%. Annual export volume growth had increased in the three months to December. But private demand indicators had remained weak. Annual retail sales growth had remained negative, and the rate of decline of workers' incomes had increased in December. Annual CPI inflation had remained at -1.1% in December. But, excluding food, annual CPI inflation had been less negative, at -0.1%. And the rate of decline of wholesale prices had slowed, to only -0.5% on a year earlier in January. Annual growth in M2+CDs had fallen to 2.6% in December, from 2.9% in November.

II Monetary and financial conditions

A8 Narrow money had grown very strongly in January. After adjustment for seasonality and the introduction of the new 50p and £2 coins, notes and coin had increased by 2.0% on the month, and the twelve-month growth rate had risen to 13.0%. The published growth rate is based on the average levels during the month and this had been distorted upwards by the effects of the millennium persisting into the early weeks of January. The distortion had affected January's level proportionately more than

December's but had appeared to have largely unwound by the end of January. Data from the end of January and beginning of February had suggested that the underlying annual rate of growth of narrow money had been in the 8%-9% range in January, a similar rate to November.

A9 The stock of M4 had risen by £5.1 billion (0.6%) in December. The three-month annualised rate of growth had increased by 3.5 percentage points to 6.6%, the highest rate since May. The twelve-month rate had picked up slightly to 3.6% but remained low, due primarily to the run-down of deposits by other financial corporations (OFCs). Excluding the volatile OFCs sector, the growth rate of M4 had been stable over the past year, at around 6.0%. M4 lending (excluding securitisations) had grown by £9.2 billion (0.9%) in December, and the twelve-month rate had risen to 9.0%, its highest since October 1998. The rapid growth had been broadly based: household borrowing had remained strong and private non-financial corporations' (PNFCs) and OFCs' borrowing had strengthened in Q4. Flows of M4 and M4 lending had diverged since mid-1998. In an accounting sense, that reflected the strength of net sterling deposits from non-residents.

A10 Households' deposits at banks had grown by 1.0% in December (rather stronger than the monthly average of 0.7% in Q4); annual growth had been 6.5%. Households' borrowing had remained robust. The rate of growth in the year to Q4 of 9.5% had been the strongest since 1991 Q2. Net secured lending had increased by £3.6 billion in December despite slight falls in both the value and number of loans approved. Total unsecured lending had increased by 1.1% in December, continuing the robust growth seen throughout 1999.

A11 The M4 deposits of PNFCs had fallen by £0.2 billion in December, but strong growth in previous months had resulted in strong growth in the fourth quarter as a whole. In contrast, M4 lending to PNFCs had increased rapidly in December, by £3 billion. But taking the fourth quarter as a whole, both M4 deposits and lending had shown similar strength. PNFCs' non-bank borrowing had also been strong in the fourth quarter, particularly via equities.

A12 Since the previous MPC meeting, short-term interest rate expectations, as measured by the gilt repo curve, had fallen by around 0.2%. There had been virtually no change in longer-term nominal rates since that meeting. Corporate spreads were little changed on a month earlier and the yield on corporate bonds had remained much lower at long maturities than at shorter maturities. PNFCs' bond issuance data had suggested that companies viewed longer-term rates as relatively attractive: throughout the second half of 1999 the proportion of bond issuance with a maturity of greater than fifteen years had

increased. There had been almost complete pass-through of the January repo rate increase to standard variable mortgage rates by the beginning of February.

A13 There had been little change in RPIX inflation expectations derived from surveys for 2000. Most survey-based measures had fallen by 0.1 percentage points to between 2.1% and 2.3%. Survey estimates of RPIX inflation for 2001 had suggested that people expected inflation to rise to 2.4%.

A14 Equity prices had fallen by 3.6% since the January MPC meeting, well below the performance of other stock markets. Equity prices in all sectors other than information technology and non-cyclical services had fallen since the January MPC meeting.

A15 Sterling had been volatile at the end of January and beginning of February. By the close of business on 9 February the effective exchange rate index had appreciated by 0.7% from its level at the January MPC meeting to 108.6. Over the month sterling had depreciated markedly against the dollar (2.2%) but had appreciated by 1.5% against the euro.

III Demand and output

A16 The preliminary ONS estimate of GDP growth in 1999 Q4 had been 0.8%, unchanged from Q3. The annual growth rate had risen to 2.7%. Service sector output had grown by 0.9% in Q4 and had been 2.9% up on a year earlier. Within services, the distribution, hotels and catering sector had grown by 0.6%. The more recently available industrial production data had shown a rise of 0.3% in Q4 while manufacturing output had risen by 0.7% over the same period.

A17 New construction orders had risen by 0.6% in the three months to December. The CIPS index of construction activity had indicated robust growth since February 1999.

A18 The deficit on trade in goods had widened slightly, to £2.5 billion in November from £2.3 billion in October. The EU deficit had widened to £0.5 billion but the non-EU goods deficit had narrowed slightly to £2.0 billion. The non-EU goods deficit had widened to £2.3 billion in December. Excluding oil and erratics, the volume of goods exports had risen by 1.2% in the three months to November and the volume of imports had risen by 2.4%. Total goods imports had risen by 0.7% over the same period.

A19 Retail sales volumes had risen by 0.6% in December and by 1.3% on a three-monthly basis. Consumer confidence remained strong. The GfK consumer confidence index had risen to +8.0 in

January, its highest level for more than two years and above its historical average. The Consumers' Association quarterly survey of confidence had been +41 in January, compared with +34 in October.

A20 Private new car registrations in the three months to January had fallen by 12.6% on a year earlier. Total new registrations had fallen by 4.1% over the same period.

A21 Both the Halifax and Nationwide house price indices had shown further increases in January, of 2.4% and 0.9% respectively. Annual house price inflation had remained high on these measures, at 16.0% and 13.1% respectively. Particulars delivered had fallen by 2.4% in December and the annual growth rate had declined to 11.7%. The RICS survey had shown weaker sales and instructions in December.

A22 The public sector net cash requirement had been £9.2 billion in December.

A23 The BCC and CBI surveys had shown a pick-up of manufacturing investment intentions in Q4 compared with levels a year earlier. The CBI intentions balance rose slightly, to -9 in Q4 from -11 in Q3. The BCC had shown an increase in investment intentions (plant and machinery), to +14 in Q4 from +11 in Q3. The BCC survey had also shown an increase in service sector investment intentions, the balance rising to +25 in Q4 from +21 in Q3.

A24 The CBI quarterly industrial trends survey had shown fewer firms with more than adequate stocks: however, the stocks of finished goods balance had risen sharply since Q2. The CIPS survey of manufacturing had shown that stocks of finished goods had been built up ahead of the millennium, perhaps consistent with a positive contribution to GDP growth in Q4. The CBI distributive trades survey had reported a build-up of retailers stocks in January.

A25 Looking ahead to 2000 Q1, survey evidence suggested continuing growth. The CBI quarterly industrial trends survey had shown a marked improvement in new manufacturing orders in Q4. The BCC survey for Q4 had shown slight improvements in domestic and overseas orders in the manufacturing sector, and declines in the service sector. The CIPS purchasing managers' survey of manufacturing showed a fall in the headline index, to +52.0 in January from +56.3 in December, reflecting the 'millennium effect' as firms adjusted stock positions. The CIPS services measure had fallen by less and construction was broadly flat.

IV The labour market

A26 LFS employment had increased by 60,000 (0.2%) in the three months to November, compared with the previous three months. This was considerably slower growth than in the three months to August, but much the same as in the three months to October. The increase had been more than accounted for by a 101,000 (0.5%) rise in full-time employment; part-time employment had fallen by 42,000 (0.6%), so employment growth in full-time equivalent terms had been faster than in heads. The total number of hours worked had fallen by 0.1% in the three months to November, largely reflecting a fall of 0.4% in average hours worked per person.

A27 Turning to survey data, the CIPS manufacturing survey for January had suggested that there had been a further decline in manufacturing employment. The same survey had suggested that construction employment had expanded at a more rapid rate than in December, while services employment growth had stabilised. Forward-looking surveys by the BCC and CBI had suggested an upturn in manufacturing employment intentions in 1999 Q4, although the CBI balance had remained negative.

A28 New vacancies notified to Jobcentres had risen slightly in December, to 237,800. The CBI industrial trends survey had reported a sharp increase in skill shortages in 1999 Q4, while the net balance of manufacturers reporting shortages of unskilled labour had fallen back towards its historical average. The BCC had reported a slight rise in recruitment difficulties in manufacturing and services. The Recruitment and Employment Confederation (REC) survey had shown that there had been a further deterioration in the availability of agency staff. The latest reports by the Bank's regional Agents had suggested that skill shortages had persisted.

A29 The latest unemployment statistics had shown a mixed picture. LFS unemployment had increased by 11,000 in the three months to November compared with three months earlier, though the rate had remained unchanged at 5.9%. But claimant count unemployment had fallen by 28,700 over the same period and by a further 21,900 in December. The claimant count rate had fallen by 0.1 percentage points to 4.0% in December. The rise in LFS unemployment had been among the very short term unemployed (up to six months) and the long term unemployed (over twelve months).

A30 Labour market inactivity had fallen by 36,000 in the three months to November compared with the previous three months. This fall was more than accounted for by a decline in the number of people who reported that they did not want a job. The percentage of the working-age inactive wanting a job had increased by 0.6 percentage points to 30.3%.

A31 Whole-economy headline earnings growth, a three-month moving average of the annual monthly rates, had remained unchanged in November, at 4.9%. Both private and public sector headline earnings growth had also remained unchanged. Headline earnings growth in manufacturing had increased to 4.5%, while service sector headline earnings growth had eased slightly to 5.1%. The twelve-month growth rate of earnings had fallen back slightly to 5.0%.

A32 Other earnings data had offered contrasting pictures. The Reward index had fallen from 3.5% in November to 3.4% in December. The January REC survey had indicated a sharp rise in earnings growth for permanent staff supplied by job agencies, though growth rates for temporary staff had eased slightly.

A33 The Bank's AEI-weighted twelve-month mean measure of whole-economy settlements had been unchanged in December at 3.5%. The three-month whole-economy mean had fallen by 0.4 percentage points to 2.7% in December. This was mostly accounted for by a decline in public sector settlements, which had fallen by 1.0 percentage points to 2.2%. The real value of settlements had fallen back in 1999 Q4, reflecting the rise in RPI inflation.

A34 Details of the settlements for NHS workers covered by the NHS Pay Review Body had been announced on 17 January. Overall, the paybill of NHS workers covered by the Review Body was to increase by 3.4%. Details of the settlements for school teachers covered by the School Teachers' Review Body had been announced on 1 February. The paybill of school teachers covered was to rise by 3.3%. Both come into effect on 1 April.

A35 The Bank's regional Agents had conducted an informal survey of around 270 firms on the prospects for earnings growth in 2000. Among the contacts sampled that had a company-wide settlement, 21% had expected it to be higher in percentage terms in 2000 than in 1999, while 34% had expected their settlement to fall. But 38% had expected growth in total pay per employee to be higher in 2000 than in 1999, with 26% expecting it to be lower.

A36 Respondents had expected that the recruitment and retention of staff, especially in construction, would be the main factor likely to raise earnings growth in 2000. Other notable upward pressures had included productivity and company profitability. The outlook for inflation had been highlighted as the main downward pressure, especially in the retail sector.

V Prices

A37 The Bank oil-inclusive commodity price index had risen by 1.9% in December. The annual inflation rate rose from 17.8% in November to 21.8% in December. The monthly rise had partly reflected the rise in crude oil prices in December: the Brent one-month futures price had risen by 4% (in sterling terms). Excluding oil, commodity prices had risen by 1.3% in December to give an annual inflation rate of 3.7%. Metals prices had risen strongly again, and there were signs that domestic food prices may have reached their trough.

A38 Seasonally adjusted manufacturing input prices had risen by 0.7% in December, taking the annual inflation rate from 10.0% to 12.0%, the highest rate since 1985. This largely reflected the recent rise in crude oil prices, but import prices as a whole had also risen sharply on the year. According to the latest CIPS manufacturing survey, the input prices index had risen to +56.3 in January, up from +55.4 in December. Seasonally adjusted total output prices excluding excise duties (PPIY) had risen by 0.2% in December, to give an annual inflation rate of 1.5%, slightly up from 1.2% in the previous month. The latest quarterly BCC output price intentions balance had risen for both the manufacturing and service sectors.

A39 Export and import prices had risen by 0.2% and 1.3% in November. Stripping out the oil component, export and import prices had fallen by 2.3% and 0.7% in the previous three months compared with the same period a year earlier.

A40 RPIX inflation had remained at 2.2% in December, unchanged since October. The wedge between RPIX services and RPIX goods inflation had widened to its greatest level since September 1992. RPIX service price inflation had remained unchanged at 3.9%. The largest positive contributions had come from leisure and vehicle insurance. RPIX goods price inflation had fallen to 0.3%, the lowest rate on record, mainly reflecting lower tobacco and seasonal food prices.

VI Reports by the Bank's regional Agents

A41 The Bank's regional Agents had reported continued widespread, if moderate, recovery in manufacturing output and orders. The improvement in orders had been evenly spread between domestic and external orders. There had been stronger growth in business services mainly related to information technology, corporate restructuring and property. Steady growth was also reported in consumer

services. Consistent with the latest CIPS construction survey, construction orders had continued to grow, but had not accelerated.

A42 Agents had reported strong retail sales growth over Christmas and the New Year, particularly in household goods. The new car market remained subdued, but there were reports of a slight recovery in the used car market. External demand had continued to pick up. While services investment remained strong, manufacturers were reported to be more hesitant.

A43 Manufacturers' input prices had continued to rise. There had been continued downward pressure on manufacturers' output prices, squeezing margins further. In the service sector, input price increases and higher wage costs had remained easier to pass through to consumers. Retail prices were reported to be flat or falling. The labour market had remained tight, with growing shortages of both skilled and unskilled staff leading to sizeable pay pressure in some areas, notably in information technology and accountancy. There had been steady growth in employment in services.

VII Market intelligence

A44 The sterling effective exchange rate index had continued to rise over most of the month, reaching 110.3 on 1 February, its highest level since December 1985. However, the index had fallen sharply after 1 February. It ended the period at 108.6, 0.7% above its level at the time of the January MPC meeting.

A45 The rise in sterling's trade-weighted index during January had largely reflected the euro's depreciation against all the major currencies. News about relative interest rate differentials had been unable to provide much explanation for exchange rate movements during the month. A number of commentators had concluded that the euro had been overvalued in 1998 and 1999 and had illustrated this point with reference to the euro area's negative 'basic balance', defined as the sum of the current account balance and net long-term capital flows (direct and portfolio investments). For these commentators, a negative 'basic balance' was consistent with the view that structural factors had made euro-denominated assets unattractive for investors. A second explanation put forward by some commentators for sterling's appreciation had related to mergers and acquisitions involving UK companies—both actual and rumoured.

A46 Market expectations of official UK interest rates implied by short sterling futures contracts for 2000 and 2001 had fallen by 10-25 basis points during the month. This had largely been attributed to a

fall in interest rate expectations following the publication of the minutes of the January MPC meeting, as well as the effects of some weaker-than-expected economic surveys. Market participants had also cited the continued appreciation of sterling as a factor likely to influence near-term MPC decisions. Beyond 2001, however, interest rates implied by short sterling futures contracts had risen.

A47 Market anecdote for the immediate policy decision had been a perceived 75:25 chance of a 25 basis points increase in the Bank's repo rate. This was broadly consistent with the term structure of market interest rates for very short maturity assets.