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MINUTES OF MONETARY POLICY COMMITTEE MEETING

3 and 4 May 2000

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 May 2000.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0005.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 6 and 7 June will be published on 21 June 2000.



MINUTES OF THE MEETING OF THE MONETARY POLICY COMMITTEE HELD ON 3-4 MAY 2000

1 Before turning to its immediate policy decision, the Committee discussed the world economic outlook; exchange rates; money and asset prices; demand and output; labour market conditions; and prices and costs; reviewed the May projections for output and inflation; and considered the implications for policy of robust domestic inflationary pressures versus the disinflationary effects of sterling's appreciation against the euro.

The world economic outlook

2 The most significant news concerned the US, where recent output growth had again been surprisingly strong: 1.3% in 2000 Q1 after 1.8% in 1999 Q4. Final domestic demand growth had risen to 2.1%, with negative contributions to GDP from net trade and stockbuilding. There had also been more marked signs that the strength of demand was feeding through to prices and costs. Quarterly growth in employment costs had been 1.4% in Q1, up from 1.0% in 1999 Q4; the month-on-month rate of increase in the CPI had risen from 0.2% in January to 0.5% in February and to 0.7% in March; core CPI inflation had risen too, above expectations. The market was firmly expecting the FOMC to raise interest rates at its 16 May meeting, with some looking for an increase of 50 basis points.

3 Equity markets in the US, and perhaps in consequence elsewhere, had been highly volatile over the month. The NASDAQ was now substantially off the levels reached early in the year. Whereas the possibility of a large and disorderly equity price fall remained one of the key risks to the world economy, the equity market had risen so far over the past few years that an orderly correction need not give rise to concerns about the macroeconomic outlook; some correction was welcome, and indeed could usefully contribute to restraining US domestic demand growth.

4 If a further correction were to occur, which was far from certain, the implications for output and inflation would depend on the nature of the underlying shock. There would be an important difference between, on the one hand, a greater-than-expected tightening of US monetary policy in response to excess demand but with the story of significantly improved supply-side performance basically intact; and, on the other hand, news that the economy's prospective supply capacity had

not improved by as much as seemed to be built into current equity valuations and borrowing decisions. In the latter case, output growth could potentially fall back as prices accelerated. It was not possible to be confident about which, if either, of an aggregate demand or an aggregate supply shock was the more likely.

5 Against this background, the Committee incorporated in its central projections an assumption that the outlook for world economic growth had again strengthened, but with the balance of risks on the downside.

Exchange rates

6 The euro had fallen by around 5% on its effective exchange rate index over the month; and by 6% against sterling, including 2% in the days immediately before the Committee's meeting. Given the significance of sterling's further appreciation for the UK economic outlook, the Committee debated a series of possible reasons for euro weakness that were being canvassed in the markets.

7 One possible explanation was the gap between US and euro-area supply-side performance. If US trend productivity growth had risen relative to that of the euro area, it was to be expected that investment capital would flow to the US, accompanied by an adjustment in the real exchange rate. There was some support for that view in capital account data for the past few years. However, it was difficult to see how relative supply-side performance could explain the euro's sharp depreciation over recent months, particularly as there had been some positive news about structural reform in euro-area economies. Moreover, this story was not easily reconciled with the strength of euro-area equity markets.

8 A second possible explanation was the suggestion that some market participants felt that the ECB was 'behind the curve'. But looking at, for example, unemployment levels in the euro area as a whole, it was also possible to argue that policy was 'ahead of the curve'. Overall, given the news about the outlook and the ECB's objectives, policy seemed to be within the range which would generally be expected. Consistent with that, bond yields had not risen in a way that suggested that medium-to-long run inflation expectations were out of line with the ECB's goals, and so did not suggest that ECB policy lacked credibility. There had, though, been some market comment about

the recent pace of money (and credit) growth, which was now well above the ECB's quantitative reference value. It was conceivable that the market was uncertain about the relative importance of this factor in the ECB's broader strategy of medium-term price stability. But it was not easy to see how this could explain such a large and persistent fall in the external value of the euro.

9 A third possible explanation was that some market participants were concerned about the diverse range of official commentary on euro-area monetary policy, from finance ministries, national central banks and the ECB. Related to that, it was conceivable that there were concerns that communication – and perhaps even the formulation – of ECB policy would become still more complicated as membership of the euro area expanded. More broadly, the market had apparently been concerned about recent political developments in some euro-area countries.

10 The Committee could not identify a compelling economic explanation for the recent euro weakness. Some members were inclined to believe that the recent falls had reflected momentum, or what might be called 'psychological factors'. There was anecdote suggesting that some large trades had had a more persistent impact than usual.

11 The Committee concluded that the current levels of the euro-dollar and euro-sterling exchange rates were unlikely to be sustained. But while sterling was expected to fall at some point against the euro, it was impossible to predict the timing or size of any such adjustment. A likely trigger could be a large fall in global equity markets, led by the US; that could prompt a fall in the dollar against the euro, and possibly therefore in the sterling-euro rate. Alternatively, it was possible that sterling might decouple from the dollar in the event of greater market awareness of differences in the relative cyclical positions and in supply-side prospects for the US and the UK.

12 The Committee decided to assume in the central projection that sterling's path over the next two years would lie halfway between a constant nominal rate and a depreciation in line with interest rate differentials. Although some members preferred the former and some the latter, a majority preferred an average between the two.

13 The Committee's projections used as the starting point a 15 working-day average of sterling's exchange rate index, which was 110.7, around 1½% higher than on the path assumed in the February

Inflation Report. By the time of the Committee's meeting, sterling had risen further, to around 113½ and so was materially above the starting point assumed in the *Report* projections.

Money and asset prices

(i) Household and corporate sector borrowing

14 M0 had grown by 8.2% in the year to April and, adjusting for millennium-related effects, had now been in a 8%-9% range for the past six months or so. Household credit growth had again been strong, at 9.9% in March – the fastest rate since 1991. Net secured lending had risen quite sharply, following an earlier pick up in mortgage loan approvals. The approvals data had also risen in the latest month. The household money and credit data therefore presented a contrasting picture to the recent survey evidence of a fall in consumer confidence.

15 Private non-financial corporate sector (PNFC) borrowing – from banks and from capital markets – had also been robust. In 2000 Q1 PNFC total external finance had been stronger than at any time since 1989 Q3 (adjusting for the boost to borrowing in 1999 Q2 caused by changes to Advance Corporation Tax). There was little evidence of distress borrowing. Sectoral data showed that the manufacturing sector had been repaying bank borrowing in Q1. The Bank's regional Agents had earlier suggested that recent borrowing was largely for investment; over a slightly longer period, it had also financed merger and acquisition activity.

16 Overall, the money and credit data presented a different picture from the weaker-than-expected outturn for GDP growth in Q1. Taking the monetary data at face value might suggest that either output would pick up again or that the Q1 figure could be revised up.

(ii) The housing market

17 Recent data on the housing market were somewhat mixed. The Nationwide price index had risen by 1.6% in April, compared with 2.3% in March, and the twelve-month rate had risen from 16.2% to 17.5%. The Halifax index had risen by 0.8% in April, having fallen by 0.4% and 0.9% in March and February respectively. The twelve month rate was 14.2% in April. A quite different

picture was presented, though, by a preview of the April Royal Institute of Chartered Surveyors' measure of house price pressure. The number of particulars delivered had fallen slightly in March, but were still well up on a year ago. The House Builders' Federation site visits balance had fallen slightly over the month, but the net reservation balance had risen slightly.

18 Put together with the lending data and with anecdote of financing terms being eased over recent months in the face of intense competitive conditions, the overall evidence of the housing market having peaked was perhaps slightly weaker than in the previous month. It was possible, however, that the regional pattern was changing, with slightly slower growth in London and the South East than a few months ago. Looking further ahead, the Committee judged that house prices rises would moderate, but by slightly less than assumed in its February central projection.

Demand and output

19 The Q1 GDP data presented an important puzzle. Growth was recorded at 0.4%, which was below the Committee's February central assumption. Official data suggested that output growth might have been accounted for entirely by net trade, which had apparently bounced back: in particular, exports to non-EU countries had grown by 7.1% over the quarter. If so, domestic demand growth had been zero. But growth in retail sales had clearly been positive, and other indicators also pointed to continued consumption growth. If so, other components of domestic demand must have fallen quite sharply.

20 While business investment intentions had recently weakened, this survey evidence was about periods beyond Q1. Earlier surveys, which were more relevant to Q1, had suggested positive business investment growth. Recent survey evidence might be consistent with a fall in stockbuilding in Q1, perhaps reflecting an unwind of a millennium-related build up, but this did not sit comfortably with the robust corporate sector borrowing data. There was clearer evidence that government consumption had been weak in Q1. Another possible factor was that energy production had been weak during the quarter. Bank staff estimates suggested that, excluding energy, GDP growth had been somewhat stronger than 0.4%. If so, it was possible on the expenditure side that the energy-related component of consumption had been weak.

21 Overall it would probably be some time before the picture was clearer. The Committee thought that the Q1 GDP data contained limited information about the future path of output, but agreed that it would be a mistake to give them no weight in the immediate policy decision. Looking back over a longer period, it did now seem that output growth had peaked in 1999 Q3.

22 Recent forward-looking survey data contained mixed signals. Survey evidence did not seem to point to a fall in manufacturing output, although the outlook had clearly weakened given sterling's strength; and indicators of service sector and construction activity, while slightly weaker, were still clearly pointing to growth. Other surveys implied that export orders had fallen, as had business optimism and, in particular, consumer confidence.

23 There seemed to be somewhat clearer news on the fiscal position. The 1999/00 surplus had been even larger than the Government had forecast at the time of its March Budget, with both weaker-than-expected departmental spending and higher-than-expected revenues. On spending, it seemed that departments were making greater-than-anticipated use of their ability to roll over unspent amounts into the next fiscal year. It was therefore an important question whether that would continue in future years or whether, as the Committee assumed, annual nominal spending would rise to the budgeted amount in the current year. On the revenue side, the question was whether output had been stronger than measured or whether the effective tax yield had risen, so that there had in effect been a further unanticipated tightening of fiscal policy.

Labour market conditions

24 The wedge between the earnings and settlement data remained. The increase in the headline Average Earnings Index had risen to 6.0% in the three months to February, the fastest since July 1992. This figure was affected by millennium-related payments, and so was judged to overstate underlying earnings growth. The twelve month rate of earnings growth in February was 5.5%. There was a major difference between earnings growth and settlements: settlements over the same period had been 3.3%. Members differed in their interpretation of these data. Some, noting that on any reasonable assumptions earnings growth in the UK was well above the rate of productivity growth, were concerned about consequent upward pressures on prices. The recent very strong earnings increases would most likely have some impact on prices, including via the effect on demand of

higher incomes: that was assumed in the central projection. Others believed that settlements had a bigger impact than earnings growth on prices, and that unmeasured productivity improvements would help to offset rapid earnings growth. They preferred an assumption that the recent spike up in earnings growth would have a smaller effect on prices than had been assumed in the central projection.

25 The Labour Force Survey measure of employment had increased by 59,000 (0.2%) in the three months to February, in line with recent quarters. The number of people unemployed had fallen slightly. Evidence from surveys and the Bank's regional Agents suggested that skill shortages remained a concern, but had perhaps stabilised.

26 Overall the labour market remained tight. While it was not obviously tightening further, there was not much evidence of conditions easing.

Prices and costs

27 RPIX inflation was 2.0% in March, with the fall of 0.2 percentage points on the month being slightly larger than expected. There continued to be a large divergence between goods price inflation, which at -0.2% was the lowest on record; and services inflation, which had remained at 4.2%.

28 Some members did not think that the size of the sectoral divergence was significant for the overall inflation outlook, although it was an unwelcome sign of imbalances in the economy. Overall, the Committee agreed that there was little if any news in the latest data relevant to the outlook.

29 In terms of the outlook for prices, an important consideration was the impact of any supply side changes in the economy. The Committee decided to retain in its central projection February's assumptions about structural pressures on domestic margins (and the latest projections had also incorporated a downward adjustment to margins on imports). Also as in February, some members preferred to assume a smaller effect, and some preferred a larger effect. In addition, some members preferred to assume that trend productivity in the UK would rise towards the levels achieved in the US, which would reduce the rate of increase in prices for any given rate of earnings growth.

The May output growth and inflation projections

30 The Committee agreed the projections to be published in the *Inflation Report* on Wednesday 10 May.

31 On the assumption of an official repo rate of 6.0% over the next two years, the central projection was for output growth to slow slightly from 3% to a rate at or a little above trend. The profile was slightly stronger than in the February *Report*. The balance of risks was on the downside, principally on account of the possibility of a setback to world economic growth.

32 On the central projection, RPIX inflation rose to around the 2½% target over the coming year or so and then stabilised at around that level. The profile was much the same as in the February *Report*, with the effects of sterling's appreciation broadly offsetting those of slightly stronger world and domestic demand and a higher profile for earnings growth. The balance of risks was slightly on the upside in the first year and on the downside in the second year.

33 The fan chart projections did not incorporate a risk of a sharp fall in sterling's exchange rate against the euro, since the timing and size of any such correction were both extremely uncertain. Nor did the projections reflect a risk, seen by some members, of earnings growth being higher than assumed.

34 As described above, there was a range of preferred assumptions for the path of the nominal exchange rate, price-cost margins, trend productivity, and the impact on prices of the unwinding of the recent rise in earnings growth; these were presented in Table 6.B on page 62 of the May *Inflation Report*. Different members preferred different combinations of these assumptions, with the effect of either reducing or raising the inflation projection at the two-year horizon by up to half a percentage point.

The implications for policy of strong domestic inflationary pressures versus the disinflationary effects of sterling's further appreciation

35 The Committee discussed the challenges which monetary policy faced on account of, on the one hand, the domestic inflationary pressures generated by strong final domestic demand growth and a tight labour market; and, on the other hand, the downward pressures on inflation from the prospective effects on net trade and import prices of sterling's further appreciation against the euro. There seemed to be material risks to the outlook whatever the Committee's immediate policy decision.

36 A risk if interest rates were raised was that inflation could fall further below target if, for example, the Q1 GDP estimate turned out to be an accurate guide to underlying developments and output growth continued to slow. Moreover, in the view of some members, a policy tightening could put further upwards pressure on sterling, which could aggravate the downward pressures on inflation and output. As well as materially undershooting the inflation target for a while, some viable businesses might be unnecessarily damaged. In addition, a further rise in sterling could increase the risk of sterling falling sharply later. Hence, tightening now could increase the deviation of inflation from target, both in the short run and further out.

37 If, however, interest rates were maintained at 6%, there was a risk that policy might prove to be too easy if, for example, tight labour market conditions were to lead to persistently high earnings growth. That could end up being a classic case of acting too late to head off accumulating inflationary pressures, and that too could damage the real economy. In addition, it was likely that sterling would fall back at some point, given that its rate against the euro in particular seemed unsustainable. If domestically-generated inflation had not been checked by then, policy might need to be tightened quite sharply in order to bring about a material slowdown in output growth. This was not certain, however. For example, if a fall in sterling were prompted by a global equity market correction, which on one view was the most likely trigger, there might be partly offsetting influences on the inflation outlook, although the inflationary effects of a depreciation would tend to come through rather more quickly than the disinflationary effects of a fall in wealth.

38 Views differed on the relative risks depending on assessments of the current conjuncture and individual members' preferred central projection assumptions. There was, however, agreement that it was relevant that inflation was currently below the inflation target, and that sterling was materially higher at the time of the meeting than the 15 working day average used as the assumed starting point in the *Inflation Report* projections. The actual exchange rate at the time of the meeting was judged to be more relevant to the immediate policy decision.

Tactical issues

39 The Committee discussed two tactical issues.

40 First, the Federal Open Markets Committee (FOMC) was expected by the market to increase the Fed funds target by at least 25 basis points, perhaps by 50 basis points, on 16 May. Assuming that the FOMC did tighten, it was conceivable that sterling might decouple somewhat from the dollar, and so perhaps fall slightly against the euro, if UK rates had not been raised again this month, since that might help to signal that the US and UK did not face the same conjunctural issues.

41 Second, the Committee discussed a suggestion that, if the repo rate were maintained at 6%, the Bank should intervene in the foreign exchange markets, ideally as part of concerted intervention to strengthen the euro. A majority of members did not want to contemplate intervention in the current circumstances.

The immediate policy decision

42 A variety of arguments were identified for maintaining interest rates at 6%. The central projection for inflation was broadly in line with the target in the second year of the forecast period, with the level of output around most estimates of trend. While some members had preferred assumptions producing a somewhat higher inflation projection, this was offset by the fact that sterling was, at the time of the meeting, nearly 3% above the starting point assumed in the May projections. For those members who had favoured a tightening of policy in the previous month, the balance of argument had shifted to leaving rates unchanged this month. This was partly because of the Q1 GDP figure, but it was also on account of sterling's sharp appreciation since then and the

implications which these developments, if they persisted, would have for the inflation outlook. On the economic analysis there was no need to change rates this month, and as a matter of tactics doing so might compound the problem of sterling's appreciation.

43 There was, however, a wider range of views on the underlying picture. Some members remained very concerned about the strength of domestically-generated inflationary pressures, reflecting the tight labour market and still-buoyant final domestic demand growth. There were upside risks to inflation from earnings and the possibility of a decline in sterling's exchange rate. Sterling's level against the euro was unlikely to be sustainable; the most likely resolution of this was a rise in the euro's nominal exchange rate against sterling, but the timing was extremely uncertain. Taking these things together, there was a general need to restrain domestic demand growth. This would also guard against having to tighten policy more aggressively later if, for example, sterling fell sharply. While it was therefore more likely than not that policy would need to be tightened again in due course, a tightening was not needed this month; the immediate outlook provided time to see more evidence on output and expenditure and on exchange market developments. Some members taking this view were concerned that economic agents and commentators may have concluded from the recent macroeconomic performance that the Committee could, as a general matter, achieve the inflation target and stabilise the path of output with a series of fairly small changes in interest rates. That was by no means assured. The uncomfortable current combination of internal and external conditions suggested that the operation of policy in the period ahead might easily be considerably more difficult than over the past three years.

44 While agreeing that the conjuncture was particularly challenging, other members did not agree that, other things being equal, policy was more likely than not to be tightened further. First, taken at face value the Q1 GDP numbers and the fall in several survey indicators might suggest that the earlier interest rate increases had had a faster and larger effect than expected. Second, to tighten policy would tend to put further upwards pressure on sterling, compounding the problem of economic imbalances. Attempting to slow domestic demand growth below trend by tightening now in anticipation of a fall in sterling would run the risk both of increasing the degree of undershoot of inflation relative to the target in the short run, and of increasing the size of any inflation overshoot later, by exacerbating the size of sterling's overvaluation now. Third, sterling was most likely to fall in response to a global equity market correction, which would tend to reduce domestic demand and

so help to offset upward pressures on inflation from depreciation. In such circumstances, policy might not need to be tightened aggressively. Fourth, inflation was still materially below target, and was set to remain so for a while, which provided a cushion against a short-term inflationary shock from a fall in sterling. Fifth, to the extent that movements in sterling proved to be erratic, they had no necessary implications for policy. Sixth, some members placed greater weight on downward price pressures from changes in the supply-side of the economy, which would interact with and at least partly offset the inflationary pressures from strong domestic demand.

45 The Governor invited members to vote on the proposition that the Bank's repo rate be maintained at 6.0%. The Committee voted unanimously in favour of the proposition.

46 Finally, on behalf of the Committee the Governor expressed his profound thanks to Willem Buiter and Charles Goodhart for their enormous contributions to establishing the MPC process and for the open-minded way in which they had participated in the Committee's discussions and decisions. On behalf of the Chancellor of the Exchequer, the Treasury representative expressed warm thanks for the contribution they had both made to establishing the credibility of the UK's new institutional framework for monetary policy.

47 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 Bank staff to the Monetary Policy Committee on 28 April in advance of its meeting on 3-4 May 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 The advance estimate of US GDP had risen by 1.3% in Q1, with growth continuing to be driven by consumer spending. Investment had also increased strongly, probably partly reflecting the effect of preparations for the century date change on the profile of investment spending in recent quarters. Industrial confidence had fallen further in April, but was still robust. Non-farm payrolls had risen by 416,000 in March, boosted by temporary hiring for the US 2000 Census, the end of the Boeing strike, and a five week March survey period. Employment costs had picked up in Q1, rising by 1.4% on the quarter. Benefit costs had risen by 2%, possibly reflecting bonus payments associated with the century date change, as well as higher healthcare costs.

A3 In the euro area, industrial production had risen by 1.2% in February, and industrial confidence had increased again in March. Although the western German IFO survey of business confidence had fallen in March, this had reflected a decline in sentiment in the retail and wholesale sectors, since manufacturing sector confidence had risen. German data had also shown strong industrial orders growth in recent months, especially in the external sector. Euro-area consumer confidence had remained unchanged in March. Annual euro-area M3 growth had risen to 6.5% in March, from 5.9% in February.

A4 Japanese industrial production had risen by 2.8% in the first quarter, boosted partly by the effect of the leap year. Machinery orders had strengthened in recent months, as had construction orders, particularly in the private sector. Workers' expenditure rose by 0.7% in Q1, though it remained 1.4% below its level a year earlier. The unemployment rate had remained at 4.9% in March, and new job offers had risen by 6.4% in the first quarter.

A5 The one-month Brent crude oil futures price had risen slightly since the previous meeting, to around \$25 per barrel. Other industrial commodity prices had declined, however. Earlier rises in oil prices had boosted both US CPI and euro-area Harmonised Index of Consumer Prices (HICP) inflation, to 3.7% and 2.1% respectively in March. US core CPI inflation (excluding energy and food) had risen to 2.4%. In the euro area, however, core HICP inflation had remained flat at 1.1% in

March, and preliminary estimates of German CPI inflation had shown a 0.4 percentage point fall in April. The rate of consumer price deflation in Japan had continued to moderate.

A6 The ECB had increased the official interest rate by 25 basis points on 27 April. Interest rates implied by futures contracts had risen on the month for both the United States and euro-area. US bond yield volatility had increased, perhaps because of the effects of US Treasury repurchases. In equity markets, the volatility of the major technology indexes had increased markedly, though index levels had partly recovered after large falls earlier in the month (the largest fall was in the US-based Nasdaq, down by around 11% since the April meeting). Both the volatilities and levels of broader stock market indices had changed by much less on the month; for example the Wilshire 5000, a broader measure of US stocks, had fallen by about 4%.

II Monetary and financial conditions

A7 The twelve-month growth rate of notes and coin had fallen slightly from 8.4% in March to 8.2% in April, still within the underlying (excluding Y2K effects) range of 8%-9% observed over the past 6 months.

A8 The stock of M4 had risen by £13.8 billion (1.7%) in March. The exceptional strength of M4 had been concentrated mainly in the other financial corporations (OFC) sector, though non-OFC M4 growth had ticked up as well, primarily because of the household sector component. Aggregate M4 lending (excluding the effects of securitisations) had also been very strong in March, rising by £18.3 billion (1.9%). Much of the increase on the month had reflected activity in the OFC sector, although borrowing by the non-OFC sectors had also risen. In fact, the annual growth rate in Q1 of M4L, excluding OFCs, was at its highest level since 1991 Q1, at 9.0%.

A9 Households' M4 deposits had risen by £4.6 billion (0.9%) in March. M4 lending to households (excluding the effects of securitisations) had remained robust, increasing by £5.2 billion (0.9%) in March. The annual growth rate in Q1 was at its highest level since 1991 Q2, at 10.1%.

A10 Within total lending to individuals, net secured lending to individuals had increased sharply in March by £4.1 billion (0.8%). The value of loan approvals had also risen further to £10.5 billion. Both loan approvals (numbers and values) and secured lending were above their peak levels reached in 1999.

A11 Net M4 borrowing (borrowing less M4 deposits) by private non-financial corporations (PNFCs) had risen substantially in 2000 Q1, largely reflecting an increase in PNFCs' bank borrowing, which had grown by £7.4 billion (3.7%) on the quarter. A broader measure of PNFCs' external borrowing (which included capital issues and foreign currency borrowing) had also risen strongly on the quarter (up by £15.8 billion).

A12 OFCs' M4 and M4 borrowing had risen exceptionally strongly in March, by £9.0 billion (5.0%) and £8.6 billion (4.0%) respectively on the month. But much of this rise had reflected matched financial transactions between securities dealers and the banking sector which had been outstanding over the month end.

A13 Since the previous MPC meeting, short interest rate expectations, as measured by the two-week gilt repo curve, had fallen slightly at the short end (one year out), but had risen 2-3 years out. Longer nominal interest rates (15-25 years) had also risen slightly, in line with yields in international government bond markets.

A14 Within retail interest rates, there had been little change in secured rates or in savings rates. However there had been significant increases in unsecured rates, though these rates had still registered a net fall since August 1999 – a period over which the official repo rate had risen by 100 basis points.

A15 Surveys of expected inflation in 2000 and 2001 had remained below target. Longer-term Consensus forecasts of inflation over the next ten years had risen slightly. Survey measures of ten-year real interest rates had fallen marginally between October and April.

A16 Since the previous MPC meeting, sterling had appreciated by 6.3% against the euro, but had depreciated by 1.8% against the dollar. The sterling effective exchange rate index (ERI) had risen by 4.3% over the same period to 113.6, taking the index to its highest level since November 1985.

III Demand and output

A17 The preliminary Office of National Statistics (ONS) estimate of GDP growth in 2000 Q1 had shown growth slowing to 0.4% from 0.8% in Q4. The annual growth rate had fallen slightly to 2.9%. Service sector output had grown by 0.8% in Q1 and had been 3.2% up on a year earlier. Within services, the distribution, hotels and catering sector had grown by 0.5%. The ONS had said that growth in the transport and communications sectors was strong and that growth in business services

had been more moderate. Industrial production had fallen by 0.8% on a three-month basis in February, and manufacturing output had fallen by 0.5% over the same period.

A18 Although there had been no new national accounts data, the ONS had reported that construction output had risen at a similar rate to that in earlier quarters. New construction orders had risen by 5.8% in the three months to February. And the Chartered Institute of Purchasing and Supply (CIPS) index of construction activity had risen to 63.9 in March, its highest level since early 1998.

A19 The deficit on trade in goods and services had narrowed slightly to £1.4 billion in February from £1.7 billion in January. The EU goods deficit had widened to £0.6 billion but the non-EU goods deficit had narrowed to £1.8 billion. The non-EU goods deficit had narrowed to £1.5 billion in March. Excluding oil and erratics, the volume of goods exports had fallen by 0.2% in the three months to February compared with the previous three months, and imports had risen by 1.6%. Total import volumes had risen by 1.7% over the same period.

A20 Retail sales volumes had risen by 0.5% in March and by 1.5% on a three-month basis. The GfK consumer confidence index had fallen to -3.8 in April, its lowest level since December 1998 and below its historical average. The quarterly Consumers' Association survey of confidence had been +33 in April compared with +41 in January.

A21 Private car registrations in the three months to March had fallen by 3.8% on a year earlier. Total registrations had risen by 3.9% over the same period.

A22 House prices had risen by 1.6% in April according to the Nationwide measure, and annual house price inflation rose to 17.5%. The Halifax price index had risen by 0.8% in April, and annual inflation had fallen to 14.2%. Particulars delivered had fallen by 0.8% in March. The Royal Institute of Chartered Surveyors (RICS) survey had shown continuing strength in sales in March.

A23 The public sector net borrowing requirement had been -£1.5 billion in March. For financial year 1999-2000 as a whole, it was -£15.0 billion, compared with the Budget projection of -£11.0 billion.

A24 The Confederation of British Industry (CBI) and the British Chamber of Commerce (BCC) quarterly surveys had shown a fall in their indices of manufacturing investment intentions in Q1. The CBI investment intentions balance fell to -21 in 2000 Q2 from -9 in Q1, the lowest since 1999 Q2. The BCC had shown a deterioration in manufacturing investment intentions (plant and machinery) to

9 in Q1 from 14 in Q4. The BCC survey had also shown a fall in service sector investment intentions back to mid-1999 levels, the balance falling to 18 from 25 in Q4.

A25 The CBI Industrial Quarterly Trends stock balance had risen to +3 in Q2 from -10 in Q1. The CIPS survey of manufacturing had shown that stocks of finished goods had been gently eroded through Q1 and into April. The CBI Distributive Trades Survey had reported a rise in retailers' stocks in April.

A26 Looking ahead to 2000 Q2, survey evidence suggested slower GDP growth than in Q1. The CBI Industrial Quarterly Trends Survey had shown a notable fall in manufacturing sector new orders in Q1. The BCC survey for Q1 had shown declines in domestic orders in both the manufacturing and service sectors, and overseas orders in manufacturing had also fallen, but had increased in the service sector. The CIPS purchasing managers' survey of manufacturing showed a fall in the headline index to 50.6 in April from 51.4 in March. The CIPS services measure had been broadly flat, while construction had fallen slightly.

A27 Other surveys such as those by the Institute of Directors, Euler Trade Indemnity and Dun & Bradstreet had suggested continued strength in sales and optimism in 2000 Q2.

A28 The Bank's regional Agents had conducted a survey of UK firms regarding business growth and profit margins in 2000 Q1. Output growth was reported to have been widespread in Q1, but there were notable sectoral differences. Construction and non-retail services had shown the strongest growth. Domestic demand was cited as the main driver of non-retail services growth, but price competition was reported to have held back manufacturing and retail growth. Overall, profit margins had narrowed slightly in Q1, but there were substantial sectoral differences. Construction and non-retail services firms had reported wider margins, while manufacturers' margins had narrowed considerably. Retail margins had narrowed slightly.

IV The labour market

A29 Employment had continued to grow steadily. Labour Force Survey (LFS) employment had increased by 59,000 (0.2%) in December to February, compared with the three previous months. The increase had been more than accounted for by higher part-time employment, which had risen by 75,000. So employment growth had been lower in full-time equivalent terms. Despite the shift towards part-time work, average hours worked had increased by 0.2%. As a result, total hours worked had risen by 0.3% in December-February compared with the previous three months, although they were unchanged compared with the same period last year.

A30 Survey-based evidence had indicated that employment conditions continued to differ between the manufacturing and service sectors. The CIPS survey in April had indicated faster employment growth in the service sector than in March, slightly slower growth in construction, and a continued decline in manufacturing employment. Both the BCC Quarterly Economic Survey and the CBI Industrial Trends Survey had indicated that employment intentions in the service sector had remained strong in Q1, but had weakened in manufacturing.

A31 The latest data suggested that labour shortages persisted. The CBI survey had reported that shortages of both skilled and unskilled staff had increased slightly in Q1. According to the BCC survey, recruitment difficulties had also remained high. The Recruitment and Employment Confederation (REC) survey in April had shown a deterioration in the availability of permanent and temporary agency staff. The Bank's regional Agents had reported that skill shortages remained a concern, though overall they might have lessened slightly.

A32 Unemployment had fallen on both the LFS and claimant count bases. LFS unemployment had fallen by 25,000 in three months to February compared with the previous three months, with the rate falling 0.1 percentage points to 5.8%. Claimant count unemployment had fallen by 7,700 in March compared with the previous month, with the rate unchanged at 4.0%. The fall in LFS unemployment had been more than accounted for by lower long-term unemployment.

A33 Inactivity had been broadly flat, rising by only 3,000 in three months to February compared with the previous three months. An increase of 36,000 in male inactivity had more than offset a fall of 34,000 in female inactivity.

A34 All LFS data from autumn 1993 onwards had been revised to incorporate more up-to-date population estimates. Estimates of the population aged sixteen and above had been revised up by 0.5% by autumn 1999. However, quarterly growth rates, participation, employment and unemployment rates had been little changed.

A35 Earnings growth had remained strong. Whole-economy headline earnings growth had risen by 0.1 percentage points in February to 6.0%, with higher growth in both the private sector (up by 0.2 percentage points to 6.5%) and the public sector (up by 0.2 percentage points to 4.2%). Earnings growth in the private services sector (a newly published series) had risen by 0.1 percentage points in February to 6.9%. Manufacturing earnings growth had fallen by 0.1 percentage points, to 5.3%. Data on the bonus contribution to earnings growth that were not distorted by the change to the Average Earnings Index (AEI) questionnaire in February 1999 had become available for the first time. Bonuses had contributed around 0.5 percentage points to whole-economy earnings growth in

February. Earnings growth, excluding bonuses, had been 5.1%. However, interpreting recent earnings data had remained problematic, since it was difficult to estimate the impact of millennium-related payments.

A36 Settlements had stopped falling and were now broadly flat. The Bank's twelve-month AEI-weighted mean had been 3.3% in March, unchanged since January. Public and private sector means were also unchanged. A majority of settlements in Q1 had been lower than during the same period last year: of the 138 settlements that could be matched, 28 had been higher, 16 had been the same and 94 had been lower. In real terms, however, settlements had continued to grow. Wage drift, the difference between annual earnings growth and pay settlements, had continued to rise in March, though it had remained below the levels seen in the late 1980s.

V Prices

A37 The Bank's oil-inclusive commodity price index had risen by 1.8% in March, taking the annual inflation rate from 22.6% down to 20.7%. The effects of last year's rise in oil prices had largely accounted for the fall in the annual rate. So given the sharp rise in oil prices between March 1999 and February 2000, annual commodity price inflation may thus have peaked in February.

A38 Seasonally adjusted manufacturing input prices had risen by 0.8% in March, taking the annual inflation rate from 14.2% to 13.8%. Again, the decline in the annual rate of change reflected the sharp fall in the annual inflation rate of oil prices. The annual rate of change of seasonally adjusted total output prices excluding excise duties (PPIY) had risen slightly to 1.8% from 1.7% in February. The latest CBI expected output price balance for Q2 had weakened to -13 from -4.

A39 Prices of total imported goods had risen by 1.0% in the three months to February compared with the previous three months. Excluding oil and erratics, prices of imported goods had risen by only 0.3%. Total export prices had remained broadly flat over the same period.

A40 Annual RPIX inflation had fallen by 0.2 percentage points to 2.0% in March, largely owing to last year's rise in tobacco and petrol duties dropping out of the annual comparison and a smaller rise in household goods prices than in March 1999. Service price inflation had continued at an annual rate of 4.2% in March.

VI Reports by the Bank's Agents

A41 The Bank's regional Agents had reported that manufacturing growth, although continuing, had moderated recently. The exchange rate had been reported as a greater concern and the outlook for orders had weakened in most regions. Service sector output growth had remained strong, and there had been some evidence of a strengthening in business services growth. The demand for housing had remained strong, but was not accelerating, and growth had eased in some regions. Agents had reported broadly unchanged annual retail sales growth in April, although the retail sector remained difficult to read in many regions. The Agents had noted that moderate export growth was continuing. Import growth was reported to have strengthened again, and import penetration was expected to rise further in coming months. Investment in the retail and leisure sectors had remained strong, but manufacturing investment intentions had weakened with an increased number of firms cancelling investment plans or switching to overseas locations.

A42 With the exception of some pass-through from higher oil prices, 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, although most Agents suggested that concerns were no worse than in recent months. Some contacts had reported expectations of increasing pressure on pay in some sectors in 2000 H2.

VII Market intelligence

A43 Expectations of short-term interest rates implied by short sterling futures and gilt repo yields had fallen slightly over the month, notwithstanding volatility within the period. Over the second half of the month, the appreciation of sterling against the euro had led some market participants, who had previously expected the MPC to increase official rates in May, no longer to expect such an increase. Market participants subscribing to this view had also noted that there were signs that the rate of increase in domestic asset prices had stabilised. Expectations of interest rates implied by futures contracts and derived from SONIA swaps had suggested that a majority of market participants did not expect an increase in official rates. However, a poll of economists conducted by Reuters had found that a majority expected an interest rate increase in May. Those participants who expected an increase in official interest rates had attached importance to the robustness of domestic demand and labour market indicators over the period since the MPC last increased interest rates in February.

A44 Since last October the broad US and UK equity indices had risen and then fallen, but these fluctuations had been more restrained than those in high-tech stocks, and had not been unusual. Volatility and uncertainty had increased to unprecedented levels for the Nasdaq, but did not look out of the ordinary for either the FTSE or S&P. There had also been an inverse relationship between the level of the Nasdaq and both implied volatility and skewness. The further the Nasdaq had fallen, the more uncertain investors had become, but also the less inclined they had been to believe that subsequent price movements would be downward rather than upward.

A45 Although the high-tech indices had fallen, their contribution to the fall in the broader indices had been small; in terms of market capitalisation they remain a small part of the broader indices. A more important contributor to the fall in the FTSE All-Share index than the IT sector (4.8% weight) had been non-cyclical services (20.5% weight). This had mostly reflected a fall in telecoms, which had perhaps been influenced by the same factors as IT, but it was possible that the recent UK spectrum auctions had also played a role.

A46 Sterling had strengthened by 4.3% over the month in effective terms, with a 1.8% depreciation of sterling's exchange rate against the dollar outweighed by a 6.3% appreciation against the euro. The euro's weakness over the month had been broadly based: it had also depreciated against the yen and dollar, and in effective terms. Expected correlations between exchange rate pairs implied by options prices suggested that the exchange rates for the euro against both the dollar and sterling were expected to move together, but that the exchange rates for sterling against the dollar and the euro were not expected to move together. Over the month, the euro had depreciated notwithstanding an increase in market interest rates relative to those outside the euro-area. Market participants had suggested that euro-area political and economic developments had been a factor behind the depreciation of the currency. Another influence was the stability of the dollar in response to large falls on certain days in the Nasdaq and Dow indices, contrary to the expectation of many market participants who had believed that the dollar would depreciate against the euro following falls in US equity markets. Surveys had suggested that forecasters continued to expect the euro to appreciate against sterling over the next twelve months.

A47 The government's prospective receipts from the auction of third-generation mobile phone licences had not had any observable impact in the money or gilt markets. It was possible that the spread between secured and unsecured money might widen, at least temporarily, depending on how quickly liquid collateral could be mobilised. In the foreign exchange markets, some participants expected sterling to be supported in the short term by inflows related to payment for the licences.