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MINUTES OF MONETARY POLICY COMMITTEE MEETING

7 and 8 February 2001

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 February 2001

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0102.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 7 and 8 March will be published on 21 March 2001.



MINUTES OF THE MEETING OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 FEBRUARY 2001

1 Before turning to its immediate policy decision, the Committee discussed the world economy; demand and output; money and credit; the labour market; prices and costs; and possible tactical considerations; and reviewed the February projections for output and inflation.

The world economy

2 The biggest change since the Committee's November projections had been the extent of the slowdown in the United States, and the Federal Reserve's 100 basis point easing of monetary policy. Members debated whether a 'V' or a more extended 'U' shaped path for US growth was most likely, and the nature and scale of various downside risks.

3 One broad scenario was that there would be a sharp but short-lived slowdown in the United States, driven by adjustment of inventory holdings. Supported by underlying strength in productivity growth, an increased ability of firms to adjust stocks quickly and the Federal Reserve's interest rate cuts, growth would, on this scenario, begin to recover quite soon. A second broad scenario was that there could be a more prolonged or deeper slowdown, brought about by interactions between weakened business and consumer confidence, underlying economic imbalances, and the possibility of further sharp corrections in asset prices. In particular, against a background of a very large private sector net financial deficit and persistent large current account deficits, households and corporates might try to repair their balance sheets quickly, especially if expectations of sustainable productivity growth, and hence future income growth, were to be revised down.

4 Some members judged that the first broad scenario was the most likely outlook, and was therefore most relevant to its immediate policy decision. They were fortified in this view by recent developments in US financial markets. Since early January, US equity markets had risen; corporate bond spreads had fallen back and some high-yield issuance had resumed; and the dollar had stabilised. It was unlikely that that would have been the picture if markets were expecting a 'hard landing', which would imply a lower level of equity prices and a weaker dollar. For these members, recovery from about the middle of the year was most likely, which was also the view of the Federal Reserve and the IMF.

5 Some other members thought the slowdown could well be prolonged by the weakness of confidence in the real economy. Households and firms were likely to adjust less quickly than Wall Street to the Federal Reserve's policy easing. Leading indicators were not yet turning up, and surveys suggested that investment growth would remain weak for a while, possibly reflecting overcapacity after years of exceptionally strong investment growth. Even without the worst downside risks crystallising, underlying imbalances would be a drag on the economy. Taken together, this pointed to a 'U' rather more than to a 'V', with growth most likely to recover slowly over the next year rather than more quickly from the second half of this year.

6 There was a range of views on the downside risks. Some felt that a more prolonged slowdown would of itself exacerbate the possibility of further risks crystallising. Those members took less comfort from the recent performance of financial markets. There were instances of serious economic problems in the past – for example, in the UK, Scandinavia, and Japan – where asset prices had fallen sharply some time after output growth had begun to slow. Others argued that, while it was possible to paint all sorts of 'disaster' scenarios, such developments had in the past typically been associated with serious mistakes in macroeconomic policy. There was no particular reason to expect that now; and there was room for both monetary and fiscal policy easing in the United States if that were to prove necessary.

7 The Committee noted the various channels, discussed in the February *Inflation Report*, through which the UK outlook might be affected by weaker world growth, including via overseas trade and investment returns, asset prices and exchange rates, confidence, and lower world prices. So far, UK consumer and business confidence had held up well, although it was possible that the effects on domestic confidence of the US slowdown would be delayed. Some members thought that lower world export prices would have a direct, disinflationary impact on UK prices greater than was built in to the published projections. Those members also thought that the published projections might underestimate the impact of a US slowdown on the United Kingdom via the effect on the employment and investment decisions of UK firms with US affiliates. In addition, some members thought that there could be an impact on foreign direct investment in the United Kingdom by the many US firms with affiliates here whose home profitability and cash flows would be under pressure. Alternatively, foreign direct investment might conceivably be supported if, for a while, the United Kingdom and the euro area grew faster than the United States. It was agreed that this area merited further study,

including whether there had been corresponding positive effects on the United Kingdom during recent years when US growth and profits had been very strong.

8 An important influence on the UK economy would be developments elsewhere in the world. After faster growth in world output and trade than for over a decade, some slowdown was both inevitable and desirable, at least in the United States. The US's closest neighbours – Mexico and Canada – were generally forecast to slow down, following a period of rapid growth. In the euro area, reasonably steady growth was likely to be maintained, supported by still high consumer and business confidence. Japan appeared to be weakening again, but output might be supported somewhat by the fall in the yen.

9 Another important influence on the United Kingdom would be sterling's exchange rate. The ERI had fallen by just over 1% since the Committee's previous meeting and by about 3½% relative to the path projected in the November *Inflation Report*. If the US economy proved weaker than built into the central projection, the dollar might well fall further, and sterling's effective exchange rate might fall to some extent too, mitigating to some degree the pass-through from weaker world demand into UK growth and inflation.

Demand and output

10 The Committee discussed how much news there was in the preliminary estimate of UK Q4 GDP growth, which at 0.3% (quarter-on-quarter) had been a lot weaker than Q3 (0.7%) and than expected. Four-quarter GDP growth had fallen from 3.5% in Q2 2000 to 2.4% on the preliminary Q4 estimate.

11 Part of the slowdown was most likely related to bad weather and transport disruptions. Growth in GDP excluding energy was somewhat stronger. The GDP data were volatile from quarter to quarter. These considerations pointed to some bounceback in Q1.

12 That was not certain, however. Members generally thought that there was news in the slowdown in services growth. This might be associated with the global economy slowing and in particular with consequently lower demand for business and financial services. It was, though, possible that services had been adversely affected by the weather and transport problems in Q4.

13 An expenditure breakdown of Q4 growth was not yet available. Various indicators suggested that consumption had again been robust. Retail sales growth had continued at 1.3% in Q4, and private vehicle registrations had been very strong, following publication of the Competition Commission report.

14 Measures of consumer confidence had remained strong, and on some measures business confidence had risen in recent months. The Committee discussed what might explain this given the sharp slowdown, and much weaker confidence, in the United States. Possible explanations, suggested by contacts, included firms basing their responses to surveys on their latest hard data on orders; increased confidence, following the events of 1998, that monetary policy would respond appropriately to an external shock; and sterling's depreciation against the euro over recent months reducing competitive pressures on some business sectors.

15 Another possible explanation was simply that the effects of US events on UK confidence were lagged. The Committee recalled that, during the 1997-98 emerging market economy crises, UK firms had not reported falling orders until the spring of 1998, although confidence had fallen more promptly after the mid-1998 problems in Russia and at Long Term Capital Management. It was perhaps noteworthy that the number of profit warnings had recently been increasing, particularly in cyclical services.

Money and credit

16 Broad money and credit growth had both slowed slightly, but remained high: about 8% and 12½% respectively in the twelve months to December. Household credit growth was still close to 10%, and the number of mortgage approvals had increased slightly in December. Growth in bank borrowing by the non-financial corporate sector had fallen back somewhat.

17 Some members drew a degree of comfort from the signs of deceleration in broad money and credit, which would be consistent with slowing private sector demand growth, but were concerned that the rate of money and credit growth was still high. In the absence of a compelling explanation of why the velocity of circulation should have changed, arguably there were upside risks from the possible monetary 'overhang' implied by persistently strong growth. Other members put little or no weight on these data.

The labour market

18 The Committee discussed whether conditions in the labour market might be easing. Adjusting for revised estimates of the size of the working population, employment as measured by the Labour Force Survey (LFS) had fallen by nearly 50,000 in the three months to November. On the same basis, the working age population had increased by about 60,000 over the same period. But those data needed to be looked at alongside the data for unemployment and inactivity. On the LFS measure, unemployment had risen by about 10,000, whereas claimant count unemployment had fallen by about 25,000. The difference between employment and unemployment on the LFS data was accounted for by a sharp rise (about 100,000) in inactivity, and in particular in the ‘inactive’ who reported that they did not want a job. While some people in this category did actually find jobs, fewer generally did so over any period than the unemployed. Taken together, recent data did not, therefore, imply easier labour market conditions.

19 Other indicators suggested that conditions remained tight. In particular, according to surveys, recruitment intentions were still strong, and skill shortages and vacancies were still high.

20 But this had still not spilled over into rapidly accelerating wages. On most measures average earnings growth had been drifting upwards in recent months, and the latest data suggested that settlements were a little higher than a year ago. An important question was whether they would now stabilise or continue to rise. In the short run, earnings growth was likely to fall back if bonuses were lower than a year ago, when there had been large millennium-related payments. The Industrial Relations Services survey had implied that settlements would peak around now. It was possible that this reflected a lagged effect of the rise in RPI inflation; relative to RPIX, RPI inflation would fall going forward as rises in mortgage interest rates a year ago dropped out of the index. Most members nevertheless judged that there were upside risks to inflation from earnings.

Prices and costs

21 Manufacturing productivity growth had risen in recent months by more than earnings growth, and whole-economy unit labour cost growth had fallen over the past year.

22 Energy-related costs had recently been volatile. Although still well below the levels expected when the November projection had been finalised, oil prices had risen again in recent weeks, possibly reflecting cold weather in the United States and developments in the Middle East. Futures markets still pointed to a gradual decline. Wholesale gas prices had risen by around 200% since mid-1999. Given that world gas reserves were abundant, however, it seemed likely that persistently high wholesale gas prices would eventually bring forth increased supply, so that the implications for inflation at the two-year horizon of the Committee's projections were not likely to be material.

23 Looking ahead, with the possibly important exception of the Chartered Institute of Purchasing and Supply survey of the services sector, all the main surveys had recently pointed to rising output prices. For manufacturing, it was possible that this reflected sterling's depreciation against the euro, which would tend to reduce the intensity of price competition from foreign firms.

24 The British Retail Consortium had reported that January sales discounting had been deeper than a year earlier. The Bank's regional Agents had, however, reported the opposite. It was in any case likely that, in the short run, RPIX inflation outturns could be quite volatile. The January outturn was expected to be below December's 2.0%.

25 Survey-based measures of inflation expectations had all fallen slightly over the month. It did now seem that the autumn rise in the general public's inflation expectations had been caused by the petrol price rises.

The February GDP growth and inflation projections

26 The Committee agreed the projections to be published in the *Inflation Report* on Wednesday 14 February.

27 On the assumption of an official repo rate of 6.0% over the next two years, the central projection would be for RPIX inflation to be below the target throughout the forecast period. On an alternative assumption of an official repo rate of 5.75% over the next two years, the central projection would be for GDP growth to be a little below trend during most of 2001, rising to around or a little above trend during 2002; and for RPIX inflation to fall a bit further during 2001, before rising back to around the

target at the two-year horizon. For both growth and inflation, the balance of risks in the published fan charts was clearly on the downside, principally reflecting risks to the US outlook.

28 Some members had different views of the most likely outlook for inflation, reflecting different assumptions about the economy's supply-side performance and about the implications of the international environment. The main differences were recorded in Table 6.B of the *Inflation Report*; some combinations of alternative assumptions could reduce the inflation profile at the two-year horizon by up to ½ percentage point. Some members judged the downside risks to be larger than reflected in the published fan charts; for some other members there were larger upside risks to inflation than reflected in the published fan charts, so that upside and downside risks should be more or less balanced in the second year of the projections.

Possible tactical considerations

29 The financial markets were firmly expecting a cut in the Bank's repo rate of 25 basis points. Both a 'no change' decision and a larger cut would come as a surprise.

30 The Committee noted that there was some discussion amongst commentators of whether its interest rate decisions would be influenced by the timing of the Budget or of a general election. Members agreed that there was nothing they could do about this kind of speculation other than to keep on setting the policy they thought was necessary to achieve the inflation target, in the light of all the available information, month by month.

31 Similarly, the Committee underlined that the objective it had been set by the Government was to achieve the 2.5% inflation target, which was symmetric. The parameters triggering a letter to the Chancellor about divergences from that target were part of the apparatus for accountability, not any part of the target.

The immediate policy decision

32 Taken together, recent news implied that UK price and cost pressures remained benign, with inflation most likely to continue below the 2.5% target for quite a while. Private sector final demand still needed to slow down to accommodate the planned increases in public spending. So far,

consumption still seemed to be robust, as were confidence and the money and credit indicators. Investment growth was weak, however, and net trade was likely to continue to make a negative contribution to output growth over the next two years. While there were temporary factors affecting the Q4 output numbers, it did seem that service sector output growth might well be moderating. Although the labour market remained tight, creating an upside risk to inflation in the view of most members, earnings growth had continued to be moderate, and unit labour cost growth had fallen reflecting the rise in productivity growth. Rather more clearly than any of the domestic developments, the world economic outlook had become distinctly softer over recent months. This was desirable after a period in which the growth in world output and trade had been stronger than for a decade, but it altered the outlook. The most likely prospect was that US growth would recover after a pause in the first half of the year, but a deeper or more prolonged downturn could not be ruled out.

33 Against this background and in the light of its latest projections, members agreed that an immediate easing of policy was appropriate. For some, a modest reduction would be a prudent precautionary step in the light of recent developments. The outlook had weakened somewhat, and RPIX inflation was set to remain below target for a while. Not altering the policy stance could endanger confidence, which might be fragile. The risks around the central projection were, though, significant on both sides, and needed to be monitored carefully. Domestically, the labour market remained tight, and consumption growth needed to slow. With household debt having risen relative to income and net trade having made a negative contribution to GDP growth for five years, there were underlying imbalances in the economy which created a risk of sterling falling at some point. There would be important information about domestic conditions from the Q4 expenditure breakdown, labour market data, and the Budget. So far as international influences were concerned, the risks were on the downside, but it was not appropriate for policy to seek to anticipate possible, but on current information not especially likely, scenarios about global economic developments.

34 For some other members – some of whom had preferred a cut of 25 basis points in January – the news on the month posed a real question of whether the repo rate should be cut by 50 basis points now. The supply side of the UK economy was, on this view, stronger than built into the best collective projections, so that demand could recover during the second year without inflation rising to the extent projected. There were tentative signs that labour market conditions were beginning to ease; the long-running risk of a marked acceleration in earnings had not materialised. While reported skill shortages were high, that might well be a structural rather than a cyclical phenomenon.

Internationally, the US slowdown was likely to last somewhat longer than assumed; the downside risks there were, moreover, serious. Importantly, even if the US economy were to recover quickly, it was likely that the published projections had understated the disinflationary impact on the United Kingdom of the US slowing. RPIX inflation had undershot the target for some while and was set to continue doing so. A mechanical link to policy from a forecast adjusted for these considerations, and taking account of the downside risks, could easily be consistent with a 50 basis point cut. But it was not in fact necessary to move by more than 25 basis points now, since it was not optimal to respond mechanically to a two-year ahead inflation projection. First, in such an uncertain environment, a gradualist approach was better. Second and related to that, a larger cut might perversely damage confidence by leading financial markets, households and firms to reach mistaken conclusions about the Committee's assessment of the outlook. Third, sterling was likely to weaken in effective terms if, as some members expected, US growth slowed by more than was built into market prices. A gradual depreciation of sterling would of itself contribute to bringing inflation back towards the 2.5% target; interest rates did not have to do all of the work. Fourth, it was prudent to wait and see how consumer and business confidence in the United States reacted to the Federal Reserve's 100 basis point cuts, and how UK confidence was affected by US developments. There was time to wait, as the lags between policy changes and confidence were probably somewhat shorter than other elements of the transmission mechanism. The possible need for further cuts could be kept under review in the light of developments.

35 The Governor invited members to vote on the proposition that the Bank's repo rate should be reduced by 25 basis points to 5.75%. The Committee voted unanimously in favour of the proposition.

36 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
 Christopher Allsopp
 Charles Bean
 DeAnne Julius
 Stephen Nickell
 Ian Plenderleith
 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 2 February 2001 in advance of its meeting on 7-8 February 2001. At the start of the meeting itself, members were made aware of information that had subsequently become available. That information is included in this Annex.

I The international environment

A2 The downturn in world industrial production had continued on the latest available figures for November. The projected out-turn from Consensus Forecasts for GDP growth in 2001 had fallen in January compared to the December survey: from 3.0% to 2.6% for the US; from 2% to 1.8% for Japan; and from 3% to 2.9% for the euro area.

A3 The NASDAQ index had risen by over 3.3%, while the Wilshire index had risen by 2.6%. US corporate bond yields had fallen back across all the main credit quality classes since the Federal Reserve rate cut on 3 January. Debt issuance had increased in the US, including of high yield bonds. The overall rise in emerging market equity prices had been 9.5% and had been driven by a 15% increase in Asian equities. Emerging market bond yields and bond yield spreads had both fallen, reflecting greater optimism about the Argentinian and Turkish economies, and as a result of the US interest rate cut on 3 January.

A4 The year-end spike in US commercial paper spreads had been more pronounced than in previous years and, after a dip, spreads had risen sharply again on 16 January but had fallen back in early February. US commercial and industrial lending by commercial banks had risen. This might have indicated an increase in distress borrowing as well as an increase in the funding of excess inventories. Anecdotal market reports had also indicated net outflows by foreign investors from US equities in January.

A5 US GDP growth in 2000 Q4 had slowed to 0.3%, the lowest quarterly growth rate since 1995 Q2. A further slowdown in investment growth, to -0.4%, had accounted for much of the

slowdown in domestic demand. Consumption growth had also slowed, to 0.7% in Q4 from 1.1% in Q3. There had been some evidence of de-stocking. The large fall in the National Association of Purchasing Managers Index in January had been largely accounted for by falls in the production and new orders components; the employment measure had fallen by less. Manufacturing output had fallen by 0.3% in Q4, the first quarterly decline since 1991. The data for US manufacturing employment had suggested that so far most of the reduction in labour input had taken place in hours worked rather than in employment. Non-farm payrolls had risen by 268,000 in January, following a (downwardly revised) increase of 19,000 in December. Construction and public sector workers had accounted for most of the increase. Labour productivity on an hourly basis in the non-farm business sector had risen by 0.6% in Q4, following a 0.7% increase in Q3. ICT production growth had slowed in December to 1.3% month on month, but had remained healthy compared to other manufacturing. Motor vehicle production in particular had seen large falls (-6.8% quarter on quarter in Q4). Capital goods orders (excluding erratics) fell 3.0% month on month in December. Consumer confidence had fallen sharply in January, although both the Michigan and Conference Board measures had remained above 1990/91 levels. The expectations component of the Conference Board measure had seen the largest one month fall since October 1990. Weekly indicators had suggested that US retail sales had recovered in January. Average hourly earnings growth had slowed in January to 3.9% year on year from 4.3% in December.

A6 Euro area industrial production had risen by 4.4% year-on-year in November from 3.8% in October. Euro area retail sales had risen by 1.2% year-on-year in November. The euro area purchasing managers survey had declined slightly, but remained at a high level. Euro area consumer confidence had fallen by 1 point in January after the strong rebound in December. Euro area industrial confidence had fallen 3 points compared to November. Japanese industrial production had risen by 1.5% month-on-month in December. Forward-looking indicators of investment had remained reasonably robust and machinery orders had risen by 13% year on year. Japanese import volumes had remained relatively strong, particularly for high-tech industrial equipment. However, external demand had declined and export volumes had risen by 1.4% year on year in December.

A7 Price pressures in the United States had remained muted and core CPI inflation had been 2.6% in the year to December. Headline HICP inflation for the euro area had fallen to 2.6% in December from 2.9% in November. Euro area producer price inflation had fallen to 5.4% in December from 6.3% in November. Japanese consumer price inflation had risen to -0.2% in December. Japanese wholesale price inflation had been 1.2% in January. Import price inflation in December had risen in Japan, but fallen in the US and Germany.

A8 The oil price had risen to around \$30pb, but there had been little change in the profile of the oil futures curve. The cut in OPEC production of 1.5 million barrels per day had been in line with market expectations. There had been slight falls in non-oil industrial commodity prices, but food commodity prices had risen.

A9 The depreciation in the dollar exchange rate index (ERI) had been reversed following the Federal Open Market Committee (FOMC) rate cut on 3 January, and the dollar ERI had been only 3% off its November peak at the beginning of February. The euro ERI had been largely unchanged for most of the month before depreciating in early February.

A10 FOMC policy rates implied by Fed Funds swaps on February 7 had indicated that the markets expected a 50bp reduction by the FOMC in March. Markets had expected a slight easing in euro area policy rates by the summer.

II Money and financial conditions

A11 The twelve-month growth rate of notes and coin had fallen to 4.4% in January. But the latest figures had been distorted by the high growth in December 1999 and January 2000 associated with millennium effects. Taking account of this, and other factors such as the method of payment of winter fuel allowances, the underlying annual growth rate had probably increased further in January.

A12 There had been continued evidence of a slowdown in lending and deposit growth, with twelve-month growth rates of both M4 and M4 lending falling to 8.0% and 12.5% respectively. However, lending growth remained strong compared with recent years. Annual growth rates of

these aggregates excluding Other Financial Corporations (OFCs) had been the same in December as in November, at 6.7% and 10.7% respectively. Annual growth in both M4 deposits and lending, with or without OFCs, appeared to have peaked in 2000 Q3.

A13 The twelve-month growth rate of households' deposits had been 6.2% in December, the same as in November. Annual growth in both households' M4 and households' Divisia had fallen in Q4 taken as a whole. Annual growth in household credit had been 9.7%, 0.5 percentage points down from its peak of 10.2% in June. Growth in net lending to individuals had remained strong in December, at 8.2% for secured lending and had fallen slightly, to 12.5%, for unsecured lending. As a proportion of income, total borrowing by individuals was now clearly below the 1999 peak.

A14 The number of mortgage approvals in December had been above the 2000 H2 average, suggesting stable or mildly positive prospects for housing activity.

A15 There had been a sharp fall in private non-financial corporations' (PNFCs') M4 and M4 lending growth in December, down to 9.0% and 13.3% respectively. M4 growth had fallen from a peak of 14.7% in August. PNFC borrowing from UK monetary and financial institutions had also fallen, from a peak of 16.6% in September, but borrowing growth still remained stronger than for most of the last three years. Total external finance-raising (TEF) had risen sharply to £7.2bn in Q4.

A16 Twelve-month growth rates of OFCs' M4 and M4 lending had remained strong in December at 12.3% and 18.7% respectively, though M4 growth had fallen from the October peak of 16.1%. The fall in annual M4 growth in Q4 had reflected a lower contribution from securities dealers and other specialist firms. The contribution from institutional investors had remained strong.

A17 Since the previous MPC meeting, interest rate expectations, as measured by the two-week gilt repo curve, had been virtually unchanged at the short end. Implied volatilities on short sterling contracts had fallen, suggesting markets were less uncertain about the immediate future. Longer nominal interest rates had changed little since the January MPC meeting, though they had risen since the FOMC decision to reduce the federal funds rate by 0.5 percentage points on 3

January. Since the February 2000 MPC meeting, there had however been a significant disinversion in the yield curve and fall in nominal yields. Swap and corporate bond yields had hardly changed in the past month, and had moved broadly in line with gilt yields. Non-government sterling corporate bond issuance had remained strong in January, with more medium term issuance than usual.

A18 Survey-based inflation expectations for the year 2001 had fallen on the month. The first survey of inflation expectations for 2002 was now available. These had shown that there was some expectation of a rise back to the target from the lower levels observed for 2001.

A19 Retail rates had shown no change in the standard variable mortgage rate, though fixed mortgage rates had fallen at all regularly used maturities in January. Re-mortgaging had been rising, as a percentage of gross lending, over the last year. This could have been consistent with individuals shopping around for the best deals.

A20 UK equities in all capitalisation groups had risen since the Committee's January meeting. The FTSE All-Share index had risen by 2.8%, and the Small Cap index by 4.3%. The resources and cyclical consumption goods sectors had risen most, by 10.9% and 5.4% respectively, during the same period. The IT sector had also risen by 3.7%, in tandem with the rise on NASDAQ. The number of profit warnings made by UK firms in January had been higher than in the same month in 2000, and the proportion of warnings made by IT and cyclical services companies had risen sharply. Most of these warnings had been made by non-FTSE 350 companies.

A21 Since the Committee's previous meeting, the sterling ERI had fallen by 1.2%. Sterling had fallen against all the main bilateral exchange rates. About 1.0 percentage points of sterling's 1.9% fall against the dollar could be accounted for by 'interest rate news', as could virtually all of the euro's 0.9% fall against the dollar. 'Monetary news' could account for 0.6 percentage points of sterling's 1.1% fall against the euro.

III Demand and output

A22 The preliminary National Statistics estimate of GDP growth in 2000 Q4 had shown growth easing to 0.3% from 0.7% in Q3. Annual GDP growth had slowed to 2.4%. Service

sector output had grown by 0.7% in Q4, down from 0.9% in Q3. Within services, Distribution, Hotels and Catering had increased by 1.3% in Q4, at about the same rate as in the previous quarter.

A23 Industrial production had fallen by 0.6% in Q4. This had been accounted for by the weakness in mining output. Manufacturing output growth had been 0.5% over the same period.

A24 Retail sales had grown by 0.1% in December and by 1.3% in Q4, the same rate as in Q3. Looking ahead, the reported retail sales balance of the CBI survey of Distributive Trades had picked up markedly, from +16 in December to +36 in January. Private vehicle registrations had been 27% higher in Q4 than a year earlier. Increased vehicle demand might have been partly met by running down stocks, thereby limiting the effect on GDP.

A25 The Nationwide house price index had risen by 2.5% in January and by 3.3% in the three months to January compared with the three months to October. By contrast, the Halifax house price index had risen by only 0.1% on the month in January and prices on a three month basis had been broadly unchanged. Regional house price dispersion between the South-East (including London) and the rest of the UK had remained high in Q4. Particulars delivered had increased by 4,000 to 113,000 in December. Loan approvals pointed to some rise in the level of particulars delivered in early 2001.

A26 Investment intentions of British Chambers of Commerce service sector firms had picked up further in Q4: the balance for plant and machinery investment had risen from +21 in Q3 to +24. By contrast, the BCC's balance on similar investment intentions in the manufacturing sector had fallen from +16 to +11 in Q3.

A27 Outturns for Central Government Other Current Expenditure in Q2 to Q4 had suggested that little further growth was required in 2001 Q1 to meet the *Pre-Budget Report* forecast for government consumption for the fiscal year 2000/01 as a whole. By contrast, a large rise in Central Government Gross Investment spending seemed necessary in 2001 Q1 for the forecast to be met.

A28 Export and import volume growth for goods had weakened in November: goods exports had risen by 1.0% and goods imports by 0.5% in the three months to November compared with the previous three months. In Q4, exports to the non-EU had risen by 6.9% on the previous quarter, up from -1.9% in Q3.

A29 The GfK consumer confidence index had risen to +5.4 in January, its highest level for a year. On business confidence, the CBI Quarterly Industrial Trends business optimism balance had increased in January to -3 from -9 in October.

A30 Forward looking survey data on services output had been mixed. The BCC service sector home order balance had risen in Q4 to +31 from +23 in Q3. But the expected sales balance as recorded by the Dun and Bradstreet survey had dropped back in January to +45 from +58 three months ago. And the Chartered Institute of Purchasing and Supply (CIPS) services incoming new business balance had weakened in January to 56.3 from 57.6 in December.

A31 On manufacturing, the CBI Quarterly Industrial Trends survey had indicated a strengthening in orders: the expected CBI total order balance had risen to +9 in January, up from +2 in October. The BCC home order balance had also increased slightly to +12 in Q4 from +11 in Q3. The Dun and Bradstreet survey had shown that the expected sales balance had fallen to +34 in January from +38 three months ago.

IV Labour market

A32 According to the Labour Force Survey (LFS), employment had fallen by 49,000 (0.2%) in the three months to November, compared with the previous three months (these figures include an adjustment for the effects of grossing to new population estimates. Unless noted otherwise, all LFS data subsequently quoted have been similarly adjusted). That had been the first reduction, on a non-overlapping basis, since the three months to May 1993. It had been accounted for by lower female, rather than by lower male, employment. Estimates by Bank staff suggested that

the number of temporary employees had fallen by 42,000. The number of permanent employees had continued to increase, though by less than in the previous quarter.

A33 National Statistics had recently made available longitudinal datasets constructed from matching the responses of individuals to successive LFS interviews. These data allowed for the identification of changes in the economic status of an individual from one quarter to the next. It appeared that the number of people entering employment had changed little during the three months to November. By contrast, the number of people leaving employment, notably to inactivity rather than to unemployment, had picked up sharply. This had probably accounted for much of the recent turnaround in employment growth.

A34 The available evidence suggested that the demand for labour remained high. The ratio of Jobcentre vacancies to claimant count unemployment remained close to historic peaks. According to the BCC survey, the balance of service sector employers planning to recruit staff had actually risen slightly in the fourth quarter. According to the BCC and the CBI surveys, the balance of manufacturing sector employers planning to recruit staff had fallen, but these balances remained substantially above average. The Bank's regional Agents reported that skill shortages remained widespread, though had probably not intensified. The CBI survey had shown that shortages of skilled labour in manufacturing had been more acute than at any time since 1988.

A35 LFS unemployment had increased by 10,000 in the three months to November. This rise had been accounted for by increased unemployment among those aged under 25. Claimant count unemployment had fallen by 25,900 in the three months to November, compared with the previous three months, and by a further 2,600 in December. The slower rate of fall in the claimant count had been accounted for mainly by a fall in the number of people leaving the count, rather than by an increase in the number of people joining it. In the past, it had been increases in the number of people joining the count that had tended to precede sustained rises in claimant count unemployment. LFS inactivity had risen by 98,000 during the three months to November. This had been more than accounted for by a rise in the number of people not wanting a job.

A36 Headline earnings growth, as measured by the Average Earnings Index (AEI), had remained at 4.2% in November. Actual earnings growth had risen from 4.1% in the year to October to 4.4% in the year to November. That had been due, in part, to a slightly less negative contribution from bonuses. But regular pay growth had also increased, from 4.4% in the year to October, to 4.6% in the year to November. Falling overtime hours, notably in manufacturing, had continued to depress annual earnings growth.

A37 The Bank's twelve-month AEI-weighted mean measure of settlements, which draws on information from a variety of sources, was 3.0% in December, unchanged for the sixth consecutive month. The three-month measure had fallen by 0.2 percentage points to 3.2% as a higher service sector deal agreed in September had dropped out of the comparison.

A38 The final three months of each year, and in particular December, were usually the quietest for settlements. January was traditionally a more important month. On the basis of information available at the time of the meeting, it appeared that settlements had continued to rise in January. They had been a little higher than equivalent settlements one year previously.

A39 Unit wage costs in manufacturing had risen by 0.9% in the year to November. Throughout most of last year, manufacturing productivity and manufacturing earnings had grown at broadly similar rates, so that growth in unit wage costs had been moderate.

V Prices

A40 The Bank oil-inclusive commodity price index had fallen by 8.2% in December, the largest monthly fall since the start of the series in 1990. This had taken the annual inflation rate sharply down from 18.5% in November to 7.1%, the lowest rate since July 1999. The large monthly decline had reflected significant falls in the prices of all the components of the index except domestic food. The fuels component of the index had fallen by 14.2%, largely accounted for by the fall of over 20% (in sterling terms) in the average oil price in December. The average Brent oil price had since fallen by a further 1.3% (in sterling terms) in January. The Bank oil-

exclusive commodity price index had fallen by 1.9% in January, and had been 4.8% higher than a year earlier.

A41 Mirroring the movement in the Bank's commodity price index, manufacturing input prices had fallen by 3.5% in December, taking the annual inflation rate sharply lower from 11.0% in November to 5.7%, its lowest since September 1999. The large monthly fall had mainly reflected the sharp drop in the price of oil in December. There had also been falls in the prices of metals and of other imported materials. Following its fall in December, the CIPS manufacturing survey input price index had risen from 53.4 to 58.6 in January, the highest since July 2000. Output prices excluding excise duties (PPIY) had been unchanged in December. Despite this, the annual inflation rate had fallen to 1.6% in December from 1.8% in the previous month, as last December's rise had dropped out of the annual comparison. The expected output price balance in the January CBI Quarterly Industrial Trends survey had risen sharply to 4 from -12 in the previous quarter.

A42 RPIX inflation had fallen to 2.0% in December, down from 2.2% in November. This had largely reflected a lower contribution to annual RPIX inflation from petrol prices. RPI inflation had declined from 3.2% in November to 2.9% in December. RPIY inflation had fallen to 1.7% in December from 1.8% in the previous month, while HICP inflation had fallen from 1.0% to 0.9% over the same period.

VI Reports by the Bank's Agents

A43 The Bank's regional Agents had reported that manufacturing output growth had picked up slightly in recent months. The recovery had continued to be driven mostly by stronger export demand. There had been some reports of an easing in orders as a result of the recent slowdown in the US economy. However, in most cases, concerns about a slowing in demand from the United States had been offset by improved prospects in other export markets. In addition, the recent weakening of sterling against the euro, if maintained, was expected to assist the competitiveness of UK manufacturers in coming quarters.

A44 Contacts had continued to report little recovery in construction output, following the weather-affected downturn experienced in earlier months. However, the Agents had stressed that underlying confidence and expectations regarding future construction activity had remained strong. In particular, many construction firms expected a strong pick-up in public sector demand, although there had been some caution regarding the exact timing of the spending. In addition, most Agencies had suggested that commercial and dwelling construction was also likely to strengthen. However, many contacts had suggested that the pick-up was not likely to be noticeable until the spring.

A45 The Agents had reported that recent strong annual retail sales growth had been maintained into January. There had been reports that discounting in the seasonal sales had been less deep than last year, reflecting strong volumes. There had been widespread reports of a considerable improvement in year-on-year private new car sales in December and January.

A46 Skill shortages had remained a major issue for many firms, although they had not intensified recently. There had been little sign of labour cost pressures intensifying in recent months.

A47 Inflation in materials prices had eased in recent weeks as the effect of lower oil prices had fed through. There had been further reports that output price pressures were rising. In most cases, manufacturing output prices were now flat, although a number of contacts reported that price increases had been achieved.

VII Market intelligence

A48 Interest rate expectations implied by short sterling futures contracts had fallen slightly over the month, largely in response to announcements of weaker-than-expected domestic GDP and retail sales data, as well as the release of the weak US GDP data for Q4. Partly offsetting these movements, however, rate expectations had increased following the announcements of a few stronger-than-expected surveys of domestic business conditions and some better-than-expected corporate profit announcements which had helped to increase UK and overseas equity

prices. While there had been little change in the markets' views about the likely path of interest rates in the first half of 2001, implied interest rates for the second half of the year and the first half of 2002 had declined by around 7 to 15 basis points since 10 January.

A49 Measures of interest rate uncertainty derived from options on interest rate futures contracts suggested that market participants had become considerably more uncertain about the short-term outlook for US interest rates in December and January. In contrast, however, uncertainty about the outlook for sterling interest rates over three and six-month horizons had increased by a much smaller amount and had fallen back again to relatively low levels in late January. Forward rates derived from most sterling money market instruments implied a central expectation that the Bank's repo rate would be reduced to around 5.25% by the summer. Information derived from interest rate options contracts suggested that a majority of market participants had seen greater downside than upside risks to this mean expectation. Turning to expectations for the forthcoming Committee meeting, a Reuters poll conducted on 1 February had found that City economists had attached a 65% chance to the Committee reducing the Bank's repo rate by 25 basis points.

A50 Developments in the foreign exchange markets had been fairly quiet over the month: sterling had depreciated by 1.9% and 1.1% against the dollar and euro respectively. Foreign exchange flows related to mergers and acquisitions activity had had little effect on sterling's exchange rate movements during the period. Sterling's movements had therefore been largely related to broader changes in sentiment towards the dollar and euro. Looking ahead, correlations derived from the implied volatilities on one-month options contracts suggested that sterling was likely to continue to be influenced by such considerations.