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MINUTES OF MONETARY POLICY COMMITTEE MEETING 10 and 11 January 2001

These are the minutes of the Monetary Policy Committee meeting held on 10 and 11 January 2001

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0101.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 February will be published on 21 February 2001.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 10-11 JANUARY 2001

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

The world economy

2 The Committee considered the slowdown in the US economy and the recent monetary policy action by the Federal Open Market Committee (FOMC). Some slowing of growth in the United States, to bring it down to a more sustainable rate, had been necessary for some time and it was welcome that the data confirmed that that was happening. The consensus was now for the US economy to grow by between 2% and 3% this year. That was lower than the Committee's November *Inflation Report* projection. But if the strong productivity performance of the US economy in recent years were to persist, a speedy return to sustainable growth remained plausible. Furthermore, expectations that monetary policy would respond to the prospect of a prolonged downturn made such a downturn less likely than some commentators feared. Some fiscal stimulus also seemed likely, later in the year, and that too would support recovery.

3 The Committee also discussed an alternative scenario, that overcapacity in the US economy might lead to a more pronounced and sustained downturn. The US investment boom of the last few years had been predicated on expectations of continued rapid growth of demand and a very low cost of capital, especially for equity-financed firms in the high-tech sector. Those two supports for investment had now disappeared, and investment growth had fallen sharply. It was possible that overcapacity was not confined to the automobile industry but was quite widespread. On that view, the investment pause could be prolonged, with consequences for asset prices, wealth and confidence which would further reduce consumption and in turn compound the overcapacity problem. New orders for high-tech goods were now falling, having until recently grown at 40% a year, and the frequency of profit warnings suggested that trading conditions were still deteriorating. By no means all the recent investment could be justified by underlying improvements in the productivity

performance of the economy: there had been evidence of over-optimism and misperceptions of likely returns. Equity values in some sectors still seemed hard to reconcile with business prospects, despite the downward adjustment in prices that had already taken place. On this view, it was unlikely that growth would pick up quickly and it would not be easy to deal with this by monetary action. But it was also possible that any problem of overcapacity in the information, computers and telecommunications (ICT) sector was likely to be transitory, not least because ICT capital depreciated quickly and would need to be renewed. In addition, the current level of nominal interest rates was low by historical standards. So despite high levels of indebtedness, debt servicing burdens were not as onerous as in previous cyclical downturns and were therefore less likely to prompt a generalised sharp contraction in the availability of credit.

4 Related to the risks from possible overcapacity, there was also a risk that business and consumer confidence might weaken further, with a widespread loss of confidence that recent productivity gains would persist. If that were to occur, a self-reinforcing downturn in sentiment could set in. For some members, this was a downside risk to which they attached a rather higher probability than others and which would be associated with a substantially worse outcome. Others noted that sentiment could on the other hand stabilise, helped by the FOMC action.

5 Turning to conditions in the rest of the world, the recovery in the Japanese economy was now looking less robust and growth in some Asian economies had also slowed. But the cut in US interest rates had been welcome to a number of countries and the substantial softening of the price of oil, which had fallen 13% in dollar terms since the Monetary Policy Committee's December meeting, would help to offset the effects of lower demand from the United States. The recovery in the value of the euro, combined with the fall in oil prices, had improved confidence within the euro area and would ease inflationary pressures there.

6 The key question however was the extent to which the slowdown in world activity would affect the United Kingdom. The direct effects through trade were unlikely to be very large. But other channels such as direct investment and linkages through financial markets could be important. The broader US and UK equity price indices had been highly correlated

over the past twelve months. Financial fragility in the United States could lead directly to lower UK equity prices, reduced income from direct investments in the United States and slower growth in the UK financial and business services sector (which had contributed on average 0.8 percentage points per annum to UK growth through the 1990s and could be disproportionately affected by a US slowdown). Were these risks to materialise, they could together have a substantial effect on UK growth.

Demand and output

7 Taken as a whole, there was little news in the recent UK GDP data release: growth in the third quarter had been 0.7%, giving growth on the year of 3.0%, and the level of GDP had been revised up by 0.3%. Nominal demand growth was being supported by rapid expansion of money and credit, which was growing much faster than in the early part of 2000 and did not suggest an imminent slowdown in the pace of output growth. However, final domestic demand had increased by only 0.8% in the third quarter, somewhat less than had been projected in the November *Inflation Report*.

8 The information on the composition of growth in the third quarter was perhaps more significant. Consumption growth was more buoyant than had previously been expected, at 1.1% in the third quarter, and was underpinned by high levels of borrowing. This was presumably supported by the gains in housing wealth over the past few years and by expectations of future wage income growth, rather than by equity wealth, and by the greater ease with which financial markets now enabled households to borrow against housing wealth. Household consumption growth still showed no obvious signs of slowing: growth in the fourth quarter now seemed likely to be somewhat faster than previously expected and possibly above that recorded in the third quarter, retail sales were growing at an annual rate of around 4% on the three-month comparison and car registrations had increased sharply on a year earlier in each month of the fourth quarter. Car sales might not make as large a contribution to overall growth in the fourth quarter as they would to consumption, because they were likely to be met in part by reductions in the level of stocks.

9 By contrast, investment growth had again been slower than had been projected and (excluding “valuables”) investment was now recorded as having fallen in the third quarter. This was puzzling, as corporate finances remained sound overall and profitability (which included that of oil companies) had increased in the third quarter. In addition, surveys and reports from the Bank’s regional Agents showed no obvious weakening in investment intentions. Survey indicators did not however present a consistently strong picture: recent information on consumer services and on business/professional services suggested some signs of weakening over the past three quarters. It would be a while before such surveys fully reflected the effects of recent news from the United States.

10 Three possible explanations were suggested for the unexpectedly subdued pace of investment growth. First, that investment was being restricted by the supply of investment goods (this related particularly to those elements of investment which depended on construction, which had been badly affected by wet weather through the Autumn). Second, that difficulties in hiring labour had led firms to postpone planned investment for a while. In the longer term, they would either succeed in attracting the labour they wanted or would begin to substitute capital for labour. In either case, investment growth could be expected to recover. A further possibility was over-capacity, of which there was some evidence both in manufacturing and in parts of the service sector, notably in leisure-related businesses.

11 Part of the puzzle presented by these consumption and investment data might relate to mismeasurement. The consumption deflator, for example, had increased more slowly than retail price inflation in recent quarters and it was therefore possible that the growth rate of real consumption was being overstated. It was plausible too that investment was being understated, because of insufficient allowance for the effects of quality improvements in the deflators used for ICT capital goods.

12 Of the other components of aggregate demand, stockbuilding had been revised down in the third quarter and the ratio of stocks to output was below trend. It therefore seemed unlikely that there would be a substantial effect on overall growth from a turnaround in stockbuilding. Data revisions showed that net trade was making a less negative contribution to demand than had previously been recorded and the Bank’s Agents reported that exports

were growing strongly, though the contribution from trade would be vulnerable to a slowdown in world trade growth.

13 Government consumption had been revised up, though both Annually Managed and Departmental Expenditures still seemed likely to be lower than planned. It was not easy directly to compare these fiscal numbers with those for government consumption. As with the consumption deflator, the government deflator was surprisingly low for the first two quarters of the current fiscal year and might be revised upwards. This, together with due allowance for the accruals adjustments included in the National Accounts and possible changes to the seasonal pattern of government spending, could reconcile the likely fiscal outturn with the currently recorded contribution of government spending to GDP. Any underspend could however result in a larger carry-forward of the amounts available to Departments to spend in future years.

Money, credit and asset prices

14 Growth of the main credit aggregates remained strong, with the twelve-month growth rate of M4 lending at 12.9% in November and the annual growth of household credit at 9.8% - only a little below its recent peak, of 10.2% in June. Net secured lending to individuals had risen strongly in November.

15 Despite weaker data on particulars delivered, leading indicators such as mortgage approvals data pointed to relatively stable conditions in the housing market. Recent price data had been mixed, but at this time of year were based on a very small sample. The rapid slowing in annual house price inflation now seemed to have ended. Current rates of house price inflation were broadly in line with the projection made at the time of the November *Inflation Report* and were not inconsistent with recent information on household consumption. Any renewed downturn in the housing market would probably not occur unless there were to be a loss of confidence associated with concerns about job security and employment prospects.

16 In the UK equities market, recent movements had been concentrated on a limited range of companies and could be associated with special factors. The market as a whole did not seem to be expecting a substantial slowdown in UK growth. But equity values could fall further, following falls in the United States.

17 Sterling's effective exchange rate had fallen some 2½% below the level implied by the starting point of the November *Inflation Report* projection. It had fallen by only 0.4% in effective terms since the Committee's previous meeting, despite the euro having appreciated by over 6% against the dollar. Sterling had in fact risen in that period by nearly 4% against the dollar and over 9% against the yen, but had fallen 2½% against the euro.

The labour market

18 Recent labour market data suggested that there had been no further tightening in the market, but it was not yet clear that it was starting to loosen. The Workforce Jobs measure of employment showed a fall of 38,000 jobs in the third quarter, to a level a little below that at the end of 1999, and the Labour Force Survey (LFS) measure showed an increase of those in employment of only 2,000 in the three months to October, once the data were adjusted for the effects of new population estimates. It had been projected at the time of the November *Inflation Report* that unemployment would begin to increase towards the end of 2000, and on the LFS basis it had now begun to do so (though the claimant count continued to fall). There was, however, some uncertainty about underlying trends because of the possibility that the petrol supply disruption and more general travel difficulties had affected the data from September. The sharp fall in self-employment in the most recent data release was also possibly erratic. Surveys of employment and employment intentions continued to look rather stronger than the official data.

19 There was little news either on earnings or on settlements. The subdued growth in earnings recorded in the corrected New Earnings Survey for the year to April 2000 was well below the comparable data from the Average Earnings Index (AEI). To some members this suggested that it was unlikely that the AEI had been understating the pace of earnings growth. The three-month average of pay settlements had moved up steadily, but no faster than might

have been expected given the rapid rise in RPI inflation from the low point reached towards the end of 1999. Settlements therefore did not seem to be reacting significantly to reported labour shortages and, with RPI inflation likely to begin to fall back into line with RPIX inflation in the coming months, might stabilise at not much above current levels and, some thought, might even fall later in the year. The latest reports from the Bank's regional Agents were that firms were on the whole comfortable with the likely pace of pay growth in the coming months.

Prices and costs

20 The sterling price of oil was over 20% lower than at the time of the November *Inflation Report* - its lowest level since May 2000 - and the futures curve suggested that the dollar price of oil would be somewhat lower at the two-year horizon than it had been in that projection. The volatility in oil prices had contributed to the recent volatility in RPIX inflation, and some members thought that a measure of RPIX which excluded oil-related products would have undershot the target by significantly more than the headline measure. They pointed out that inflation had now been below target for nearly two years and that it was likely to be lower in the fourth quarter of 2000 than projected in the November *Inflation Report*, so that there was a risk that the target would be significantly undershot this year. It was encouraging that the rise in output prices had been so muted, despite the earlier sharp rise in the price of oil: that suggested to these members that there was little inflationary pressure still to feed through from earlier increases in the price of oil. Other members were less confident that this was the case, and found it odd to isolate the effects of petrol prices and to ignore other factors, including the earlier unexpected rise in sterling; they therefore drew less comfort from it.

21 The GDP deflator had increased only 0.7% in the third quarter, and its annual rate of inflation had been revised down from 1.9% to 1.6%. That was significantly lower than in the November *Inflation Report* projection. Similarly, import price inflation had also been revised downwards and was lower than had then been projected. It was possible that the GDP deflator might have been mismeasured. If it were in due course to be revised upwards, output growth might correspondingly turn out to have been slower than it currently appeared, though

this was not necessarily true. But if the data were correct, that might suggest that the pace at which the economy could grow without giving rise to inflationary pressures had increased.

The immediate policy decision

22 For some members, taking the international and domestic outlooks together, the right course would be to leave interest rates unchanged this month. The main news from overseas concerned the US slowdown. The most likely outcome was, as emphasised by the Federal Reserve, a sharp slowing in growth from a previously unsustainable rate to a level which, after a bumpy quarter or two, would remain positive. There were certainly risks to this outlook. But a prolonged slowdown in the United States was likely only if business and consumer confidence fell to such an extent that the notion of a rise in productivity growth was rejected altogether. Though that was plainly a downside risk, it was not, on the basis of information currently available, the most likely outcome. Apart from inflationary pressures being contained, the factors cited by the FOMC as justifying their recent cut in interest rates (further weakening of sales and production, tight conditions in some segments of financial markets in the context of lower consumer confidence, high energy prices sapping purchasing power) did not have obvious counterparts in the United Kingdom. In addition, the UK equity markets did not seem to be as vulnerable as the US markets had become: they had risen less steeply, and so had less far to fall should a more fundamental reappraisal of prospects take hold.

23 At the same time, for these members, the UK economy remained more robust than expected. Consumption continued to grow strongly and showed little sign of the slowdown that would be needed to accommodate the Government's spending plans without straining the productive capacity of the economy and so putting upward pressure on inflation. Money and credit growth remained strong. Although employment had shown little recent growth and there was no sign for the moment that market tightness was being reflected in the pace of earnings growth, there remained risks of inflationary pressures from the labour market. The immediate pressures on RPIX inflation had also lessened somewhat, particularly because of the recent falls in the price of oil, but it was less clear that there had been much change in the

outlook for inflation over the medium term.

24 Against this background, there were several arguments for not changing the repo rate this month. Some members attached particular weight to the uncertain extent to which the weaker US and world outlook would impact on RPIX inflation, and felt that it would be right to await the full assessment of these linkages that would be made in the context of the forthcoming *Inflation Report* forecast. There was no pressing need to change the repo rate now. Circumstances in the UK were significantly different from those which had prompted the FOMC to lower interest rates in the United States and to cut the repo rate today would send a misleading signal: indeed, it might damage confidence here rather than improve it, by giving unwarranted credence to the view that the circumstances were comparable. In any case, some monetary easing had already occurred, as loan rates (particularly those faced by house purchasers) and the exchange rate had fallen in recent months. It would be sensible to wait for clearer evidence that the labour market and the pace of consumption growth were easing, before relaxing the stance of policy. On balance, these members judged that it was not necessary to cut rates this month in order to achieve the inflation target.

25 For some other members, while this analysis of the most likely outcome was broadly correct, the balance of risks had shifted sufficiently to the downside to justify a cut in the repo rate this month. Uncertainty in the United States could begin to affect business confidence in the United Kingdom, and delay a recovery in investment growth here. Admittedly, a cut in rates could better be explained in the context of the new forecast next month and, if made now, might wrongly be interpreted as merely a reaction to the cut in rates in the United States. It was possible also that, should confidence remain strong, an immediate cut in the repo rate would turn out to have been unnecessary. A purely reactive approach would not suggest that a cut was needed now. But it was important to anticipate what might occur in the absence of a cut, with the possibility that confidence might weaken and then be harder to restore. With RPIX inflation below target, there was sufficient scope to cut rates this month by 25 basis points as insurance against the risk of a worse outcome without putting achievement of the target over the medium term in doubt.

26 For some other members, the implications of recent developments in the United States and in the world economy more generally were more disinflationary for the United Kingdom and the risks to the world outlook more acute. There was evidence of significant overcapacity, not just in the United States but also elsewhere in the world, which could take some time to correct. Equity prices in the United States had risen by far more than could be justified by productivity improvements and asset prices remained vulnerable. The recent loss of confidence there had come as a surprise and its speedy recovery was by no means assured. Although it was quite likely that growth in the United States would match the consensus of between 2% and 3% and although it was also quite plausible that expectations of monetary easing there would underpin confidence, this could not be relied upon. The outlook in Japan seemed to have worsened again and the consensus view on prospects for the euro area could be a little complacent. The likely effects on the United Kingdom were not confined to trade and price channels: financial and confidence channels could be at least as important. Commodity prices (oil and base metals) had also fallen significantly over the month, in part due to expectations of a slowing in the international economy.

27 Given that the Committee's remit was inflation, not demand, management, these members noted that the GDP deflator and other indicators of domestically generated inflation were all below 2½% and the outturn for RPIX inflation in the fourth quarter was below the November *Inflation Report* projection. RPIX inflation had been below target since April 1999 and recent developments were likely to push it further below. There was in their view little prospect of returning to target unless action were taken soon. On this view too, not cutting rates this month also ran some risk of a fall in confidence that might prove difficult to reverse, so it was better to be pre-emptive and reduce the repo rate by 25 basis points this month.

28 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 6.0%. Five members of the Committee (the Governor, Mervyn King, David Clementi, Stephen Nickell and Ian Plenderleith) voted for the proposition. Christopher Allsopp, Charles Bean, DeAnne Julius and Sushil Wadhvani voted against, preferring a reduction in the repo rate of 25 basis points.

29 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 5 January in advance of its meeting on 10-11 January 2001. 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 US industrial production had increased by 0.2% in November. New orders for goods, corrected for erratic components (ie defence, aircraft, and aircraft parts) had decreased by 1.0% in November, the second consecutive month of decline. Hi-tech goods orders had fallen by 0.3%. There had been evidence of a pick-up in inventory accumulation through 2000, and stronger stockbuilding in durable goods. The overall ratio of inventories to sales had become only slightly higher, but the NAPM inventories index suggested destocking to come. Real consumption and income had both increased by 0.1% in November. Retail sales had fallen by 0.4% in November, although excluding sales of automobiles they had increased. Consumer confidence had fallen in December, and initial unemployment insurance claims had increased for the previous three months.

A3 There had been a small increase in corporate bond spreads in December, but high-yield spreads had risen by less over the past month than in November. Expectations of growth in earnings per share for 2001 had fallen in December, according to the Merrill Lynch fund managers' survey. There had been an increase of 0.1% in US commercial and industrial lending by commercial banks in November, compared with an average monthly growth rate of 1.0% in the first half of 2000.

A4 Euro-area GDP had grown by 0.7% in Q3. The contribution of consumption had fallen to 0.2 percentage points, and net trade had made a negative contribution of 0.2 percentage points. The IFO index for Western Germany had fallen for the sixth consecutive month, but euro-area capacity utilisation had been at its highest level in almost a decade. French consumption spending had recovered slightly in Q4.

A5 On a revised and rebased basis, Japanese GDP had risen by 0.2% in Q3. Investment had made the only positive contribution to growth, of 1.2 percentage points. Household income and retail sales had continued to recover very gradually in November. Industrial production had fallen by 0.8% in November, while tertiary activity had increased by 0.1% in October. The Tankan survey showed that business confidence had increased slightly in the three months to December. The annual growth rate of export and import volumes had slowed in November. The slowdown of exports had been broadly based across regions.

A6 The spot price for Brent crude oil had fallen by about \$2.80 per barrel since the previous meeting to around \$24.60, and futures prices had fallen markedly. There had been little change in the futures prices of other commodities.

A7 In the United States the headline annual growth rate of producer prices had increased from 3.6% in October to 3.7% in November. The annual growth rate of headline consumer prices had fallen slightly from 3.5% in October to 3.4% in November, while the annual growth rate of core consumer prices had increased from 2.5% in October to 2.6%, partly accounted for by increases in tobacco prices. The annual growth rate of hourly compensation in the United States had risen to 4.2% in December from 4.1% in November. In the euro area, annual producer price in inflation had fallen from 6.5% in October to 6.3% in November, while the harmonised index of consumer prices had increased by 2.9% in the year to November: a new peak. The annual growth rate of core inflation had remained steady at 1.5% in November. Japanese domestic wholesale prices had fallen by 0.1% in the year to November, while core consumer prices there had fallen by 0.5%.

A8 Market expectations of the official interest rate in the United States had eased following the Federal Open Market Committee (FOMC) decision to reduce the Federal funds target rate to 6.0%. Further cuts of about 120 basis points were expected by the end of 2001 H1. Expectations of euro-area official interest rates had pointed to a decline of around 20 basis points by the end of 2001 H1.

A9 In the emerging market economies, the growth rate of industrial production had slowed in November, especially in Asia. Asian export volume growth had also declined.

II Monetary and financial conditions

A10 The twelve-month growth rate of notes and coin had fallen from 7.1% to 4.8% in December. But the latest figures had been distorted by the high growth in December 1999 associated with millennium effects. Taking account of this, and other factors such as the payment of winter fuel allowances, the underlying annual growth rate had probably increased in December.

A11 Twelve-month growth rates of both M4 and M4 lending (excluding securitisations) had remained strong in November at 8.3% and 12.9% respectively. Annual growth rates of these aggregates excluding other financial corporations (OFCs) had been 6.7% and 11.1% respectively in November.

A12 The twelve-month growth rate of households' deposits had been 6% in November, well within the range of 4%-7% seen during the previous two years. Annual growth in household credit had been 9.8%, 0.4 percentage points below its peak of 10.2% in June.

A13 Net secured lending to individuals had risen strongly in November: the one-month flow of £4.1 billion had been the highest since the monthly series began in 1993. The flow of unsecured lending had been £1.2 billion in November, £0.4 billion lower than in October. The Bank's estimate of mortgage equity withdrawal in 2000 Q3 was £2.4 billion; the Q2 figure had been revised down by £0.5 billion to £3.0 billion.

A14 Although particulars delivered had fallen in November, mortgage approvals had risen by 4,000 to 103,000. Together with an increase in the stock of mortgage approvals during recent months, this was indicative of stable, or perhaps even rising, future housing market activity.

A15 The one-month flows of private non-financial corporations' (PNFCs') M4 and M4 lending (excluding securitisations) had both been negative in November. Twelve-month deposit growth had fallen from a peak of 14.7% in August to 9.4% in November, with some of this slowdown explained by the build-up, and subsequent run-down, of short-term deposits by a small number of large companies. PNFCs' borrowing from UK monetary and financial institutions had also fallen, from a peak of 16.6% in September to 14.7% in November. The flow of total external finance had fallen in October and November, averaging £3.9 billion per month, compared with £6 billion in 2000 Q3.

A16 Twelve-month growth rates of OFCs' M4 and M4 lending (excluding securitisations) remained strong in November at 14% and 19% respectively.

A17 Since the previous MPC meeting, interest rate expectations, as measured by the two-week gilt repo curve, had fallen at the short end. Further along the yield curve, nominal interest rates had remained largely unchanged during the month and had risen slightly at long maturities. Swap and corporate bond yields had been unchanged over the same period. Non-government sterling corporate bond issuance had remained robust in Q4, but much of this reflected issuance by supra-national bodies.

A18 A range of survey-based inflation expectations for the year 2001 had been little changed in the previous twelve months, suggesting that recent falls in short-term nominal interest rates had reflected movements in real yields. One year ahead inflation expectations had fallen back in Q4, after an increase in Q3.

A19 There had been some small falls in retail rates during November - notably in the standard variable mortgage rate. Two-year fixed mortgage rates had also fallen in December, but a substantial decline in swap rates at the end of November had suggested a further fall in borrowing costs in the future.

A20 The FTSE All-Share index had declined by 3% since the previous MPC meeting, as had the Small Cap index. The IT sector and non-cyclical services (mainly telecommunications) had fallen most sharply, by 19% and 10% respectively during the same

period. The number of profit warnings made by UK firms in December had been higher than in the same month in 1999, and the proportion of warnings made by IT companies had risen sharply.

A21 Since the previous MPC meeting, the sterling ERI had fallen by 0.4%. Sterling had risen strongly against the dollar and yen, but had fallen against the euro. About 1.5 percentage points of sterling's 3.7% rise against the dollar could be explained by 'monetary news'; but the fall against the euro could not be explained by movements in the yield curve during the month.

III Demand and output

A22 In the National Accounts, quarterly real GDP growth had been unrevised at 0.7% in Q3. However, annual growth had been revised up slightly to 3.0% from 2.9%. In addition, revisions back to the beginning of 1999 had resulted in the level of GDP being 0.3% higher in Q3. The revisions had had the effect of amplifying the movements in GDP around the millennium. The surge in growth in 1999 Q3 and Q4 had been more pronounced than previously thought, as had the slowing in the first quarter of last year. There had been considerable differences between the output-based measure of growth and the expenditure and income-based measures, particularly during 2000 Q1.

A23 On the expenditure side of the accounts, quarterly final domestic demand growth had been unrevised at 0.8% in Q3, though the composition of demand had been revised. Household consumption growth in Q3 had been revised up, to 1.1% from 1.0%, and investment growth had been revised down. Within consumption, all of the major components of consumption had recorded robust growth. But within durables, spending on motor vehicles had declined by 0.4% during the quarter.

A24 Government consumption growth in Q3 had been revised up slightly, to 0.7% from 0.6%. In addition, there had been significant upward revisions to the level of government consumption back to the beginning of 1999. Growth in whole-economy investment (including the net acquisition of valuables) had been revised down in Q3 to zero from 0.5%.

Excluding valuables, total investment had fallen by 0.5% in Q3. Investment in dwellings had risen on the quarter, but business and general government investment had both fallen.

A25 In Q3, the contribution to GDP growth from stockbuilding had been revised down to 0.2 percentage points from 0.4 percentage points, partly reflecting revisions to the alignment adjustment. Correspondingly, the annual contribution of stockbuilding to GDP growth in Q3 had also been revised down (to 0.6 percentage points from 1.1 percentage points).

A26 Export growth in Q3 had been revised down to 1.4%, compared with a previous estimate of 1.7%. Import growth had been revised down more sharply - from 3.0% to 2.0%. These revisions had resulted in the net trade contribution to GDP growth being revised to -0.3 percentage points from -0.6 percentage points in the previous release.

A27 Turning to the outlook for Q4, retail sales had risen by 0.7% in November, which had increased the three-month growth rate by 0.1 percentage points to 1.4%. Further ahead, the CBI Distributive Trades Survey had suggested a further rise in annual retail sales growth in December, with the balance on reported sales rising to +16 from +13. Data on private vehicle registrations had strengthened further in the three months to December, rising by 27% on a year earlier. The GfK measure of consumer confidence had risen marginally in December, to 0 from -2 in the previous month.

A28 Indicators in the housing market had been mixed. The Nationwide house price index had risen by 1.2% on the month in December, and by 1.9% on a three-month basis. By contrast, the Halifax index had fallen by 1.1% in December, and the three-month growth rate had fallen to 1%. The annual rates of inflation of the two indices had diverged further. On the activity side, particulars delivered had fallen by 4,000 to 109,000 in November, their lowest level since November 1998. But the leading indicators of housing market transactions had been stronger. In addition to the pick-up in loan approvals, the House Builders Federation (HBF) net reservations balance had risen to +4 in November from -12 in the previous month. Similarly, the HBF site visits balance had risen on the month and the CIPS housing construction activity balance had risen to 52.1 in December.

A29 According to monthly trade data, exports of goods (excluding oil and erratics) had risen by 2.4% in October, raising the three-month growth rate to 3.7%. Exports to the non-EU had been particularly strong and had risen by 8.5% in October, with a further 0.8% increase in November. Imports of goods (excluding oil and erratics) had risen by 0.1% in October, and by 3% in the three months to October.

A30 The Purchasing Managers Index for manufacturing output in Q4 had remained at 51.3 in December. The CIPS services survey had suggested that activity had strengthened in December, with the index rising to 57.6 from 57.0 in the previous month. The CIPS construction activity index had been 55.5 in December, up from 54.3 in November. Though this had indicated a faster pace of construction growth on the month, it remained well below its levels earlier in the year.

IV The labour market

A31 According to the Labour Force Survey (LFS), there had been an increase in employment of 18,000, or 0.1 percentage point, in the three months to October on the previous quarter. However, LFS figures, adjusted for the effect of grossing to new population estimates indicated that employment had grown by only 2,000. Bank staff estimated that total employees had increased by around 65,000 in this period, while temporary employees had decreased by around 70,000. Workforce Jobs had fallen by 38,000 in Q3 to a level just below that reached in the fourth quarter of 1999. Most of this decline had been accounted for by lower employment in manufacturing and construction.

A32 Survey evidence suggested that employment growth had remained strong in the fourth quarter, while skill shortages had intensified. The CIPS employment surveys had shown a slight easing in the overall pace of employment growth in December. According to the CBI/Deloitte & Touche business and consumer service sector survey, shortages of professional consumer services staff and clerical staff across this sector had increased in the quarter to November. The Bank's regional Agents had also continued to report widespread skill shortages in the service sector.

A33 Average full-time hours had fallen by 0.7% in the three months to October compared with the previous three months. Bank staff estimated that total hours worked had declined by 0.6% in the three months to October but had increased by 0.3% compared with a year ago, when adjusted for new population estimates.

A34 LFS unemployment had increased by 36,000, with the unemployment rate rising by 0.1 percentage points to 5.5%, in the three months to October compared with the previous three months. This rise in the LFS unemployment rate had been accounted for by an increase in unemployment among those aged below 25. Claimant count unemployment had fallen by 5,300 in November, with the rate unchanged at 3.6%. The working-age inactivity rate had been 21.0% in the three months to October. This was unchanged from the previous quarter.

A35 The official National Statistics measure of annual productivity growth, based on Workforce Jobs, had eased to 2.6% in Q3 from 2.9% in Q2. The annual growth rate of an alternative measure based on LFS employment had also fallen by 0.3 percentage points, to 1.9%, over the same period.

A36 Headline annual earnings growth, as measured by the Average Earnings Index (AEI), had increased to 4.2% in October from 4.1% in September. This had been the third consecutive month that the headline rate had increased. This rise had been largely accounted for by a 0.2 percentage point increase in private sector services earnings growth. Public sector earnings growth had been unchanged at 3.4%. Actual earnings growth had fallen slightly to 4.1% in October. This had reflected a larger negative contribution of bonuses to earnings growth. The Recruitment and Employment Confederation (REC) survey had indicated a slight easing in the rate of growth of agency salaries in December.

A37 The annual growth rate of wages and salaries per head, calculated from National Accounts data, had increased from 3.8% in Q2 to 4.1% in Q3. Largely reflecting this rise in the growth of wages and salaries, the annual rate of whole-economy unit labour costs had edged up slightly in Q3. The annual growth of the real product wage had fallen in Q3 and had exceeded that of the real consumption wage for the second consecutive quarter. However, the

gap had narrowed slightly. The labour share of income had declined by 0.8 percentage points in Q3.

A38 The Bank's AEI-weighted measure of twelve-month whole-economy mean wage settlements had remained unchanged at 3.0% in November, for the fifth consecutive month. The three-month whole-economy mean wage settlement had fallen by 0.1 percentage points to 3.2% in November, as higher public sector settlements early in the third quarter had dropped out of the calculation.

A39 Details of the 2001-02 settlements for NHS workers covered by the NHS Pay Review Body had been announced on 18 December. The average settlement for doctors and dentists had been an increase of 3.9% in 2001-02 compared with 3.3% last year. The average settlement for nurses and allied professions had risen to 3.7% compared with 3.4% last year. Both settlements were to take effect on 1 April.

V Prices

A40 The Bank's oil-inclusive commodity price index had risen by 1.2% in November, but due to base effects the annual inflation rate had fallen to 16.9% in November from 19.5% in October. The monthly increase had mainly reflected rises in the price of fuels, which had largely been accounted for by the rise of around 4.5% in the sterling oil price. In contrast, the average sterling oil price in December had fallen by more than 20% compared with November, taking it to its lowest level since May 2000. This was likely to affect the commodity price index in December. The Bank's oil-exclusive commodity price index had risen by 0.5% in November but the annual inflation rate had eased to 5.8% in November from 7.4% in October.

A41 Manufacturing input prices had risen by 0.5% in November, but the annual inflation rate had fallen to 10.8% in November from 12.9% in October. The monthly increase had mainly reflected the increase in the average sterling oil price during November. Input prices excluding food, beverages, tobacco and petroleum industries had fallen by 0.2% in November. The annual inflation rate had fallen to 3.1% in November from 4.6% in October.

Looking ahead, the sharp fall in the sterling oil price in December was likely to affect input prices in December. The CIPS manufacturing survey input price index had fallen to 53.3 in December from 55.1 in November. Output prices excluding excise duties (PPIY) had risen by 0.1% in November. The annual inflation rate had eased slightly to 1.8% in November from 1.9% in October. Looking forward, the latest CBI manufacturing output price expectation balance had strengthened to -4 in December from -13 in November.

A42 The quarterly change in the GDP deflator at market prices for 2000 Q3 had been revised down to 0.7% from 0.9%. The annual inflation rate in 2000 Q3 had also been revised down, to 1.6% from 1.9%. The annual inflation rate of the household consumption deflator had also been revised down, to 0.6% from 1.0%, while the annual inflation rate of the export price deflator had been revised up, to 1.5% from 1.2%. The change in the import price deflator in 2000 Q3 had been revised to a rise of 0.1% from a fall of 0.3%, but revisions further back meant that the annual inflation rate of the import price deflator in 2000 Q3 had been revised down, to 0.6% from 0.8%.

A43 RPIX inflation had risen by 0.2 percentage points to 2.2% in November. This rise largely reflected increases in the contributions from petrol and, to a lesser extent, seasonal food prices. Annual goods price inflation had increased to 0.8% in November from 0.5% in October, while annual services price inflation had been unchanged at 3.1% in November. RPI inflation had risen from 3.1% to 3.2% in November. RPIY inflation had risen to 1.8% in November, while HICP inflation had been unchanged at 1.0%. Consequently, the gap between RPIX and HICP inflation had widened to 1.2 percentage points.

VI Reports by the Bank's Agents

A44 The Agents had reported that annual retail sales growth in December had remained strong, particularly during the week prior to Christmas. Electronic goods, such as TVs and mobile phones, had continued to record the strongest growth. New Year sales had been adversely affected by snowfalls in many areas, but underlying demand was reported to have remained strong. Many retail contacts had reported that pre-Christmas discounting had been

less evident than in the previous year. But significant discounting had been reported in the early post-Christmas sales, most notably for clothing.

A45 Contacts had reported that heavy rainfall in recent months had affected construction output significantly. However, activity was likely to recover considerably in the spring, reflecting strong consumer demand and increased public spending. The bad weather had also adversely affected agricultural output - particularly root crops. It was expected that this would result in higher prices for many items, although this was likely to be mitigated somewhat by higher imports of these products.

A46 Manufacturing output growth had recently picked up a little further. The recovery had continued to be driven mostly by stronger export demand. While export volumes had continued to grow, most firms had suggested that this continued to be at the expense of margins. However, some contacts had suggested that the fall in sterling against the euro would assist exporters' margins in coming months. Asia and Eastern Europe had been reported as the most dynamic markets. But there had been early signs of slowing demand from the United States.

A47 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 increasing in recent months. The rate of pay settlements had been broadly maintained, although upward drift had occurred for some specific skills.

VII Market intelligence

A48 Expectations of official interest rates implied by short sterling futures and the gilt forward curve had fallen over the month, by as much as 25 basis points at short maturities. Part of this movement had occurred on 20 December, following the publication of the minutes of the December MPC meeting and the statement by the FOMC that the risks in the United States were 'weighted mainly toward conditions that may generate economic weakness in the foreseeable future'. UK market interest rates had also fallen after the FOMC's 50 basis point reduction in the Fed funds target rate on 3 January, although over the period since the

previous MPC meeting the fall in expected UK interest rates was smaller than for US or euro-area rates. A 25 basis point reduction in the Bank's repo rate was now priced into market rates by February. A majority of market participants did not expect a reduction this month: in the most recent survey of private sector economists conducted by Reuters in early January, the mean probability attached to a 25 basis point cut in the Bank repo rate in January was 25%.

A49 The sterling effective exchange rate index (ERI) was little changed from its level at the December MPC meeting. However, there had been sharp movements in sterling bilateral exchange rates, including a 3.7% appreciation against the dollar and a 2.4% depreciation against the euro, which has a 65% weight in the sterling ERI. Implied correlations derived from one-month foreign exchange option prices had shown that the degree of co-movement expected between sterling and the dollar was similar to that expected between sterling and the euro.

A50 The main feature in the foreign exchange market since the December meeting had been the continuation of the euro's broadly based appreciation. One of the factors that had contributed to this movement was further evidence of slowing growth in the United States, following the release of weaker-than-expected US third quarter GDP in late October. This had been reflected in US interest rates, which had fallen by more than those in the euro area. There were also indications that capital outflows from the euro area and into the United States, related to mergers and acquisitions, had slowed. Market forecasts for 2001 were, on average, for the euro to appreciate against the dollar by almost 12%; much of this had already happened, and the magnitude of the expected appreciation was similar to that predicted for 2000, over the course of which the euro had in fact depreciated.