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MINUTES OF MONETARY POLICY COMMITTEE MEETING 9 and 10 May 2001

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 May 2001

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0105.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 5 and 6 June will be published on 20 June 2001.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 MAY 2001

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed the world economy; money and credit; demand and output; the labour market; prices and costs; and possible tactical considerations. Prior to the meeting, the Committee had also received a letter from the Chancellor (attached as an annex) setting out the inflation target at which the Committee should aim in accordance with section 12 of the Bank of England Act 1998.

The world economy

2 Developments in the United States over the month presented a contrasting picture. Amongst forward-looking indicators, while most forecasts of output growth over the next year or so had been revised down, the equity market had recovered somewhat and medium-to-long maturity bond yields had risen. The backward-looking data were also mixed. Output growth in Q1 had, at 0.5% on Q4, been stronger than expected, supported in particular by robust household spending. There had been a big negative contribution from stocks, as the corporate sector rapidly adjusted to the changing outlook. This probably helped to explain the fall in import growth, and thus the larger-than-expected contribution to quarterly output growth from net trade. There were suggestions that the inventory adjustment was more advanced in parts of the 'old economy' than in the information and communications technology (ICT) sector and capacity utilisation appeared still to be falling, so that there might be significant adjustment to come in the economy as a whole.

3 There was also now more evidence of weakness in investment. While total investment had held up reasonably well in Q1, there had been a sharp fall in investment in ICT – the principal driver of the investment boom of the past few years. The other major news had been the substantial fall in employment in March. Employment (as measured by non-farm payrolls) had fallen in services as well as manufacturing, and temporary employment had dropped sharply. It was possible that, having for a while held on to labour against the prospect of a rapid recovery, US firms were now expecting – and preparing for – a more protracted slowdown. Developments in labour market conditions would be important, via effects on incomes and consumer confidence, for the path of household spending, and in

particular would affect whether households saved more in order to strengthen balance sheets after several years of heavy borrowing.

4 The Committee debated the outlook for the US economy against this background. Some members were pessimistic about investment. A number of outside forecasters believed that there was an investment overhang and so material spare capacity in the economy. While ICT equipment was depreciated rapidly in company accounts, the equipment and software would not in fact necessarily become obsolete and so would not have to be replaced so quickly, unless suppliers developed new applications which users considered essential. Orders for durable goods had fallen sharply in recent months, and this was likely to be a leading indicator of weak investment. Although the recent rise in the equity market was not easy to square with GDP forecasts being lowered, the equity market had been highly volatile and not much weight should be placed on its recent movements.

5 For some other members, the outlook could be characterised as bi-modal. On the one hand, against a background of continued aggressive monetary policy easing by the Federal Reserve, credit conditions had eased since the early part of the year and equity markets had recovered somewhat since the Committee's April meeting, although they were still lower than at the time of the February *Inflation Report*. A plan for tax cuts had now been agreed by Congress. For the United States as a whole, the housing market apparently remained healthy; perhaps unusually, house prices had been steady or rising notwithstanding the fall in equity market prices over the past year or so. That would tend to support consumption. Developments in the labour market and corporate sector failures were not obviously out of line with what would be expected if there were a cyclical slowdown in growth. On the other hand, the underlying imbalances – reflected in high aggregate household indebtedness, parts of the corporate sector being highly geared, and the sizable external indebtedness which was the counterpart to cumulative current account deficits – could seriously impede recovery and prolong the cyclical downturn. But that was still not the most likely scenario.

6 Related to this, expectations of the medium-to-long-term outlook for productivity growth were crucial. The recovery in the equity market over the past month might be reflecting relative optimism on that front. The data for Q1 showed a fall in productivity growth, but that was typical in a cyclical slowdown and so did not provide evidence either way about the underlying trend. In support of a positive medium-term outlook, some commentators and academic work had suggested that the benefits

of the new technology were still spreading through the economy and that, in consequence, there remained substantial scope for further productivity gains. There was scientific evidence that the rate of technical progress in ICT could remain rapid, which was important since falling prices for semiconductors and other key technological building blocks had driven the ICT investment boom.

7 Overall the Committee concluded that the outlook for the United States had, on balance, weakened over the past month. It was clearly weaker than at the time of the February *Inflation Report*, and the risks were on the downside. There were various views amongst members about the most likely prospect and the probability of the downside risks crystallising.

8 It was unlikely that growth would pick up elsewhere in the world sufficiently to offset the effect of the US slowdown on the world economic outlook. In fact, growth in the euro area seemed to be moderating. For example, business confidence had weakened and the Purchasing Managers Index had fallen below 50 in April. The picture varied, however, across the single currency area: in particular, Germany was slowing while France remained relatively strong. There had been sizeable tax cuts in both countries, which would help to support consumption. Household confidence remained high in the euro area as a whole. There had not been good economic news about Japan over the past month, and prospects there were weak. The problem of how to stimulate Japanese consumer demand remained, and it was not yet clear whether structural reform would help or hinder that in the short-to-medium term, even though it was important in the longer term. Both Japan and various emerging market economies in Asia were being adversely affected by the global shock to ICT demand.

Money and credit

9 In the United Kingdom, narrow money growth had fallen slightly in April, but the level of cash and demand-deposit money holdings relative to economic activity remained a puzzle, given that much of the adjustment in households' money holdings to a low inflation environment should already have occurred.

10 More significantly, although the twelve-month growth rates of broad money and lending had fallen slightly over the most recent month (March), they remained quite high at around 8½% and 12% respectively. Household M4 and M4 lending growth were around 7½% and 9½%. Taken together with the rise in the twelve month growth rate of Divisia money between 2000 Q4 and 2001 Q1, the

household money and credit data were consistent with a robust outlook for consumption growth and the housing market.

11 The picture for the non-financial corporate sector was less clear. Deposit growth had fallen in recent months – most noticeably as measured by the three-month and six-month annualised rates of growth – after rising rapidly during most of 2000. On the lending side, there seemed to be contrasts between sectors. The manufacturing sector had made net repayments to the banking sector in 2000 Q4 and again in 2001 Q1, while lending to the services sector had remained robust and lending to the real estate and construction sectors had been rising rapidly. Recent regular discussions with the banks suggested that there had so far been little distress borrowing, although they were monitoring the position in the light of the economic slowdown and the foot and mouth epidemic. Competitive conditions in the market for lending to medium-sized corporates were said to be intense.

12 The FTSE All-Share equity index had risen by around 7% since the Committee's April meeting, compared with a rise of about 15% in the US Wilshire index; these indices were respectively about 5% and 6% below their levels at the time of the February *Inflation Report*. The sterling Exchange Rate Index was up about 0.5% on the month.

Demand and output

13 The data on demand and output in 2000 Q4 and 2001 Q1 were hard to interpret. Current data suggested that output growth in Q4 had been much lower than final domestic demand growth. In order to help balance the National Accounts, the ONS had employed their standard approach of making an adjustment to the data on inventories, which are relatively poorly measured. As a result, the ONS effectively assumed substantial destocking in Q4, but that did not square well with the survey evidence, and it would be odd if a major correction to inventories had occurred in the United Kingdom a quarter before the United States. Overall, as more information became available, revisions to the other components of demand or to output could not be ruled out. The provisional estimate for the quarter-on-quarter growth rate in Q1 had, at 0.3%, also been lower than expected. Expenditure data were not yet available, but both retail sales and new private car registrations had been strong. This implied robust consumption growth, but it was also possible that spending in shops was substituting for spending in other areas, such as leisure services, curtailed by transport disruptions and the restrictions to stop the

spread of foot and mouth disease. It was likely that strong consumption would partly be reconciled with slower output growth by a significant negative contribution from net trade, reflecting weaker demand in the United States, lower global demand for ICT goods, higher imports of cars, and the continuing strength of sterling's exchange rate. But it was too early to be confident about that. There had been a variety of special factors in the past two quarters, which would distort the data: retail transport problems, bad weather and floods, and more recently the foot and mouth epidemic. In each case these would have had some effect on supply as well as demand conditions, so slower output growth would not necessarily have translated fully into reduced pressure on the economy's productive capacity. Alternatively, it was possible that the Q1 output data were signalling weaker underlying demand. Whereas Q4 output growth outside the energy sector had been significantly higher than the aggregate number, that was not so for Q1; and the global demand slowdown had become more pronounced during the quarter.

14 Looking forward, the latest surveys, although mixed, were generally consistent with slowing growth. The April Chartered Institute of Purchasing and Supply (CIPS) surveys for both manufacturing and services had been significantly weaker. The CBI Quarterly Industrial Trends measure of optimism had fallen, although a less gloomy picture was presented by responses to other questions in the survey. The British Chambers of Commerce (BCC) survey for Q1 was less weak than the CBI and CIPS surveys, but it had been compiled earlier. Construction orders were buoyant according to the CIPS survey. On the household side, while consumer confidence was weak as measured by MORI, it was steady according to GfK, to which Committee members tended to give more weight. It was suggested that more weight should be placed on the business confidence measures than on the consumer confidence measures as forward-looking indicators, because household spending would react more quickly to the factors affecting confidence whereas, by contrast, there would be delay between changes in business confidence and the consequent changes to investment and other business spending.

15 It was difficult to detect an obvious effect from the foot and mouth outbreak in most surveys, but the sharp falls in the CIPS services indicators were most marked in the hotels and leisure sectors, which were likely to be indirectly affected by foot and mouth. The Bank's regional Agents had reported a material adverse impact on the tourism and leisure industries in the affected areas, as well as on agriculture. It was too soon to form a view on the overall economic effects of the epidemic, but they

might persist into Q2 and Q3 if tourist bookings for the summer had been significantly diverted to other countries.

Labour market conditions

16 On the Labour Force Survey (LFS) measure, employment had increased quite strongly in the three months to end-February, but taking the past six months together now seemed to be rising rather more slowly and broadly in line with the population of working age. Unemployment had fallen on both the LFS and, in March, claimant-count measures. The survey evidence on labour market conditions was mixed. While the BCC and Recruitment and Employment Confederation (REC) surveys might imply a small tightening, the CBI Industrial Trends survey pointed to an easing in the manufacturing sector and the CIPS services survey suggested a recent sharp slowing in employment growth in services. The Bank's regional Agents had reported some signs of easing in skill shortages.

17 The sharp rise in earnings growth in February largely reflected some financial firms paying bonuses a month earlier than in 2000, and so was probably erratic. Regular pay growth had been at around 4% in the year to January, but this was probably affected by strong pay growth around the time of the millennium date change dropping out of the twelve-month data, and so might understate the underlying trend. The April REC survey had for the second month running reported a drop in the rate of increase in salaries earned by workers placed in permanent jobs by employment agencies. The Bank's regional Agents were seeing few upward pressures on pay.

18 Overall, it seemed that labour market conditions were stable, and might perhaps be set to ease slightly as the economy slowed.

Prices and costs

19 Having ticked up for a period as the effects of sterling's earlier appreciation wore off and as oil prices rose, manufacturing input price inflation had fallen back in March, to under 4% on the twelve-month measure, the lowest rate for two years. Output price inflation was subdued. RPIX inflation had been a touch below 2% in March, and was expected to remain around that level in April.

20 Over the past year or so, there had been a narrowing in the divergence between goods inflation and services inflation, as measured by RPIY as well as RPIX, which had opened up from 1997 as a consequence of sterling's appreciation. In particular, services inflation had fallen from around 4½% in early 2000 to just under 3% in March. It was suggested that this would be consistent with continuing pressure on margins; some members noted that the recent Euler survey had suggested that competitive pressures were more intense than at any time since the survey began in 1993. Goods inflation, which was still slightly negative on the RPIY measure, would prospectively be kept low by a slowing world economy.

The May GDP growth and inflation projections

21 The Committee took its policy decision in the light of the preparation of the projections to be published in the *Inflation Report* on Wednesday 16 May.

22 On the assumption of an official repo rate of 5.5% over the next two years, the central projection would be for RPIX inflation to be clearly below the target throughout the forecast period. On an alternative assumption of an official repo rate of 5.25% over the next two years, the central projection was for GDP growth to be at or a little below trend for most of the forecast period – a slightly lower path than in the Committee's February projection, due to a weaker world economic outlook and slower growth in domestic consumption. The central projection for RPIX inflation, assuming a 5.25% repo rate, was for it to remain around, or a little below, 2% during 2001 and then to rise towards the 2½% target by the end of the two-year forecast horizon. For growth, the balance of risks in the published fan charts was on the downside in the first year of the projection, and for inflation it was on the downside throughout the forecast period, in both cases mainly on account of the clear downside risks to the US outlook over the coming year or so. The Committee emphasised the uncertainty around its projections.

23 Some members had different views of the most likely outlook for inflation, reflecting different assumptions about the path of the international economic slowdown and the sensitivity of UK inflation to international influences and about the UK economy's supply-side performance. The main differences were recorded in Table 6.B of the *Inflation Report*. In combination, these alternative assumptions could reduce the inflation profile at the two-year forecast horizon by up to ½ percentage point.

Possible tactical considerations

24 The clear majority expectation in the financial markets was for a 25 basis point cut in the Bank's repo rate, with a small probability ascribed to a 50 basis point cut.

25 The Committee noted that the timing of the general election was irrelevant to its decisions, which would as usual be made on the basis of what was judged necessary to achieve the 2½% target for RPIX inflation over the medium term.

The immediate policy decision

26 For most members, the most likely outlook for output growth and inflation was as published in the *Inflation Report* fan charts. There was uncertainty about how best to interpret the recent weak UK output numbers given the apparent robustness of final domestic demand and the various temporary factors affecting activity in Q4 and Q1. Output growth was, nevertheless, likely to be at or below trend for a while given the slowdown in the world economy. Business confidence had most probably fallen but the scale of that fall was as yet unclear. Slowing consumption growth and an increasing negative contribution to GDP growth from net trade were expected more than to offset the effects of rising public spending. The labour market was still quite tight but was no longer obviously tightening, and underlying pay pressures appeared stable. Price and cost pressures remained subdued. For these members, the news on the month was on balance in the direction of weaker growth and so warranted a further small cut in the Bank's repo rate. For some of these members, not much, if any, downside news had been needed since the Committee's April meeting to justify a further easing. Various arguments were identified for not cutting by more than 25 basis points, to which members gave various weights. First, recent data on retail sales, car registrations, the housing market, and household money and credit growth pointed to consumption growth remaining fairly strong, albeit slowing. Clearer evidence of its slowing would be needed to justify a larger cut in interest rates. Second, a cut of 50 basis points would run a material risk of being misinterpreted as implying that the Committee thought the prospect was bleaker than was in fact the case, and so could perversely damage confidence. Third, since there had been relatively little domestic news on the month and the implications for the United Kingdom of the international news were not clear, the better course was to move in small steps, cutting again if either domestic or international news were to justify that in due course. Fourth, while a large cut would be

warranted if RPIX inflation were ‘stuck’ at around 2%, there were not compelling reasons to believe that it was. Inflation outturns of around 2% should, in fact, be regarded as close to the 2½% target, given the unavoidable margins of error in setting policy produced by the lags in the transmission mechanism and the incidence of shocks. With the economy set to grow at or close to trend, a labour market which was still tight, and the earlier dampening effects on inflation of sterling’s appreciation wearing off, inflation was most likely to rise gradually over the coming two years or so. It was not, therefore, necessary or prudent to cut by more than 25 basis points now.

27 In varying degrees, these members emphasised risks to the outlook. A deeper or more prolonged-than-expected downturn in the United States, perhaps triggered by adjustment in private sector balance sheets, could trigger a further deterioration in UK net trade, potentially creating serious problems for the tradeables sector and leading to lower-than-projected inflation outturns. So far, asset prices, and in particular the recent recovery in equities, provided some comfort on that front. A second risk stemmed from imbalances in the UK economy. Domestic demand was set to continue growing materially faster than the rate of growth of the economy’s supply capacity, having already done so for four years; indeed, the reduction in interest rates in April and a further cut now were designed to support domestic demand growth given the prospective increasing negative contribution to GDP growth from net trade as the world economy slowed. This created a risk that the resulting current account deficits would trigger a sharp depreciation in sterling’s exchange rate, causing inflation to rise by more than projected. The Consensus projections for the sterling Exchange Rate Index showed a steeper depreciation than assumed in the Committee’s central projection. But a sharp depreciation was far from certain; in some circumstances an economy could run current account deficits indefinitely, although they could not widen indefinitely. In respect of both of these risks, these members concluded that such ‘worst case’ scenarios should not affect policy now; the Committee could react to them if they were to crystallise in the light of economic conditions more generally at the time. On the basis of the current outlook, a 25 basis point reduction was the best immediate course.

28 For some other members, the most likely outlook for output growth and inflation was, in varying degrees, somewhat weaker than reflected in the published fan charts and the downside risks somewhat greater.

29 On one such view, a 50 basis point reduction had been needed in April, so no further news had been required to warrant a 25 basis point cut in the repo rate this month. In fact, the news on the month had been mostly on the downside, so there was a real question of whether there should be an immediate cut of 50 basis points. Domestically, while the Q4 and Q1 output numbers might be revised upwards, that was not the most likely prospect; and the fall in business confidence pointed to a slowing economy. External demand was weakening, and world price inflation was falling. On the basis of estimates of the neutral real interest rate, policy remained contractionary; and it was striking that, on current inflation outturns, the United Kingdom now had the highest real short-term interest rates in the G7. The level of UK rates needed to be lower to reach the inflation target in the medium term. But there was a difficult and important question about timing. Three arguments pointed to making an immediate cut of only 25 basis points, with a clear prospect of further cuts later. First, a series of small cuts would have greater announcement effects and so would be more effective in supporting household confidence, when that became necessary, than a single large cut. Second, there was considerable uncertainty about the international outlook, and it would be useful to wait to see how the slowdown in the United States and elsewhere developed. Third, as the market was still learning about how the Committee reacted to news, it was preferable to keep to the Committee's recent practice of small changes in the repo rate rather than aggressive moves that might have to be followed by quick reversals. The gradualist approach the Committee had been adopting made it easier to explain policy and so influence behaviour in the economy.

30 On another view, the published central projection for RPIX inflation was about ½ percentage point too high. This was for four main reasons. First, the outlook for both the United States and the euro area was weaker than assumed. Second, against a background of a protracted US downturn and the global shock to ICT demand, business investment would be weaker than projected. Third, the supply capacity of the economy was greater and the sustainable rate of unemployment was lower than had been built into the projection, perhaps because of a mismeasurement of capital. Fourth, the recovery in profit margins embodied in the projections was implausible given the direct survey evidence, falling capacity utilisation and the likely fall in the world inflation rate. Since the Committee's April meeting, the news had been clearly on the downside. Domestically, there had been a marked deterioration in the forward-looking surveys, which implied that output growth would again be weak in Q2; and while consumption remained strong, it was to be expected that the slowdown would be seen first in the corporate sector and so in investment, with consumption slowing later. Internationally, the German data pointed to a further

slowdown, and forecasts for the euro area were already being revised down. The US data were more mixed, but the most likely prospect was now clearly for an extended ‘U’-shaped path for growth, as firms were shedding labour – itself a sign that they were giving up on a more rapid ‘V’-shaped recovery – which would dent household confidence and spending. The equity price rise over the previous month was positive news, but the market was still well below the levels prevailing at the time of the February *Inflation Report*, and it had recently been too volatile for the recovery to be given much weight. Additional downside news over the month was not needed to justify a cut in the Bank’s repo rate, as it needed to be lower in order to prevent a persistent undershooting of the 2½% inflation target. The question was how quickly to move. Since the gradualist approach of cuts of 25 basis points had not prevented a significant fall in business confidence, a bolder approach of an immediate cut of 50 basis points was warranted.

31 The Governor invited members to vote on the proposition that the Bank’s repo rate should be reduced by 25 basis points to 5.25%. Eight members of the Committee (the Governor, Mervyn King, David Clementi, Christopher Allsopp, Charles Bean, DeAnne Julius, Stephen Nickell and Ian Plenderleith) voted for the proposition. Sushil Wadhvani voted against, preferring a reduction in the repo rate of 50 basis points.

32 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 4 May, in advance of its meeting on 9-10 May 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 World industrial production growth had slowed to 2.8% in the year to February, from 4.1% in January. In the G3, industrial production had slowed: in the United States to +0.8% in the year to March, from +1.1% in February; in Japan to -1.5% in the year to March, from +1.8% in February; and in the euro area to +3.8% in the year to February, from +5.4% in January. Consensus growth forecasts for 2001 had been revised down for the United States and Japan and to a lesser extent for the euro area.

A3 The spot price for Brent crude had risen to just over \$27 per barrel, \$3 higher than at the time of the April MPC meeting. Gasoline prices in the United States had risen as stocks had fallen, reflecting low crude oil stocks, refinery disruptions and previous low refinery capacity investment. Since the April MPC meeting, the Economist Industrial Commodity Index had risen by 4.2%, led by non-food agricultural commodities, but the Economist Food Index had fallen by 2.6%.

A4 In the United States, GDP had risen by 0.5% in Q1 compared with the previous quarter. Consumption had contributed 0.5 percentage points to growth and private fixed investment had contributed 0.1 percentage points. Investment in information and communications technology (ICT) equipment had fallen for the first time since 1991, but this had been offset by strong growth in investment in other machinery and equipment, and structures. Growth in new orders for capital goods (excluding erratic items) had continued to slow in March. Inventory growth had slowed sharply in Q1, contributing -0.7 percentage points to growth, but this had been partly offset by a positive contribution to growth of 0.4 percentage points from net trade. Labour productivity had been unchanged in Q1 compared to the previous quarter, and the annual rate of growth had slowed from 3.4% in Q4 to 2.8% in Q1.

A5 Manufacturing output in the United States had risen in March for the first time in six months, which had reflected a strong recovery in motor vehicle output. The National Association of Purchasing Managers' (NAPM) index had risen from 43.1 to 43.2 in April, reflecting a pick-up in the new orders component but weaker employment and inventory indices. Non-farm payrolls had fallen by 223,000 in April, and manufacturing payrolls had fallen by 104,000. The unemployment rate had risen to 4.5% in April, from 4.3% in March, and initial claims for unemployment insurance had continued to rise.

A6 Real consumption in the United States had risen by 0.2% in March compared with the previous month. Consumer confidence had fallen in April: the Conference Board measure had fallen from 116.9 to 109.2. Headline CPI inflation had fallen from 3.5% to 2.9% in March, largely due to the lower energy price inflation. The core rate, excluding food and energy, had remained unchanged at 2.7%. The Employment Cost Index had risen by 1.1% in Q1 compared with the previous quarter.

A7 There had been a recovery in US equities, and the S&P500 had risen by 7.7% in April. High-yield credit spreads had been broadly unchanged, with the exception of the telecoms sector in which spreads had narrowed. That had been consistent with the rise in telecoms equity prices in April.

A8 The slowdown in industrial production in the largest euro-area countries had been moderate up to February, but the European Commission industrial conference survey in April had pointed to a sharper slowdown to come. German industrial production had increased by 1.4% in the year to March, compared with a rise of 4.8% in the year to February. Consumer confidence had remained at high levels in April. Consumer confidence for the euro area had been unchanged for the third consecutive month.

A9 In the euro area, the annual rate of growth of M3 had increased to 5.0% in March from 4.7% in February. Euro-area PPI inflation had fallen to 4.1% in the year to March from 4.5% in February, and the April price expectations survey had pointed to further falls in the coming months. Headline HICP inflation had remained unchanged at 2.6% in the year to March but core inflation (HICP excluding energy, food, alcohol and tobacco) had increased to 1.8%. Non-energy industrial goods inflation had increased to 1.3% in March from 1.2% in February.

A10 Japanese industrial production had fallen by 1.5% on the year in March. This had been driven mainly by the electrical machinery sector. Services activity, however, had increased by 4.5% in the

year to February. Export volumes had fallen again in March, by 3.1% on the year, while import volumes had increased by 4.3% in the year to March. Consumer prices had declined by 0.4% in the year to March. Retail sales had increased by 1.6% in the year to March. Machinery orders had increased by 6% in the year to February. However, the growth rate of IT-related machinery orders had been on a declining trend, contributing 0.4 percentage points to annual growth.

II Monetary and financial conditions

A11 The twelve-month growth rate of notes and coin had fallen in April to 7.8%, down 0.4 percentage points on March, with the three-month annualised growth rate (at 4.3% in April) emphasising the deceleration in notes and coin growth in recent months.

A12 The twelve-month growth rate of M4 had fallen in March to 8.4%, the decrease due to a marked slowing in other financial corporations' (OFCs') M4 growth. (Excluding OFCs, M4 growth had increased slightly to 7.7%.) The twelve-month growth rate of aggregate M4 lending (excluding the effects of securitisation) had fallen to 11.9%, while excluding OFCs it had decreased to 10.3%. One-month flows of both M4 and M4 lending were robust.

A13 The twelve-month growth rate of household M4 had increased in March to 7.6%, the highest figure since February 1998. Households' Divisia – the aggregate with the closest statistical relationship with consumption – had grown in 2001 Q1 at an annual rate of 7.7%. Households' M4 lending growth had slightly decelerated to 9.4% in March. Secured lending growth had been steady, while unsecured lending had slowed. The number of housing loan approvals had increased by 3,000. The stock of outstanding approvals had also risen strongly in March.

A14 Private non-financial corporations' (PNFCs') M4 growth in March, at 8.1%, had been virtually unchanged, but shorter-term growth rates had suggested a rapid slowing since last summer. The twelve-month growth rate of PNFCs' M4 lending (excluding securitisation) had fallen in March to 12.5%, although the one-month flow remained robust. The rise in bank borrowing had coincided with a decline in other external finance. OFCs' M4 growth had fallen in March to 10.8%. The contribution of institutional investors to overall OFCs' M4 growth had decreased in 2001 Q1 with respect to the previous quarter. Insurance corporations' and pension funds' holdings of cash, as a fraction of their overall financial assets, had apparently stabilised at a lower level than in the recent past. OFCs' M4 lending growth had decreased in March to 17.6%.

A15 PNFs' net recourse to the banking system had increased in 2001 Q1 with respect to the previous quarter. Manufacturers were continuing to repay debt, while services and construction borrowing had rebounded strongly, notably in the transport and telecommunications, and wholesale and retail trade, sectors. There had been no net flow to agriculture.

A16 Short-term interest rates had been unchanged. The market had been expecting rates to fall in the near term, but expectations had been higher further out. Longer yields had continued to move away from an inverted shape. For the first time since July 1999, the two-year rate had been below the ten-year rate.

A17 Survey-based measures of short-term inflation expectations had been broadly unchanged over the month. Both the Consensus Economics and Treasury surveys for RPIX inflation in 2001 had been unchanged at 1.9%, the lowest level since 1997. General public inflation expectations (measured by the Barclays Basix survey) had apparently remained at the high level prevailing in March. Inflation expectations inferred from the gilt market had risen about 20 basis points at the short end, were unchanged at medium maturities and had fallen by 10-20 basis points at the long end. The rise in long nominal yields had therefore apparently been a reflection of a rise in real yields, consistent with an improvement in market views of prospects for economic growth.

A18 Interest rates for AAA and A-rated corporate borrowers had moved up slightly over the past month, broadly in line with comparable gilts. Non-gilt issuance, which had been low in March, had returned in April to a level close to the average from October to February.

A19 Savings rates for depositors had substantially reflected the reduction in repo rates in February, with the expectation that the reduction in April would come through in May. Unsecured loan rates had not fully reflected the reduction in repo rates in February.

A20 Standard variable mortgage rate (SVR) mortgage rates had already fallen by more than 50 basis points this year, and a further fall of 20 basis points had been expected in May following the reduction in repo rates in April. Effective mortgage rates in March had fallen by 16 basis points, broadly in line with what would have been expected given the reduction in repo rates in February, suggesting no net impact yet from the SVR cuts. Fixed-rate mortgage rates had evidently stabilised after last year's fall, and differentials over swap rates had widened since the turn of the year.

A21 The FTSE All-Share index had risen since the last MPC meeting. The recovery since mid-March had occurred despite the rise in real interest rates, suggesting either that expectations of earnings growth had picked up, or that the equity risk premium had fallen. The rebound in equity prices had been quite broadly based, but the information technology sector had been outperforming other sectors. Profit warnings had still been higher than for the corresponding period last year, but were lower than in recent months.

A22 Since the previous MPC meeting, there had been little change in sterling in nominal terms (it had appreciated 0.5% since the previous Committee meeting). Two-year-ahead expectations for sterling from the Consensus Economics survey had risen, roughly in line with changes in spot rates in the month to early April. Similar survey evidence for the dollar had suggested that it continued to enjoy a risk premium, even though the US economy had not been expected to outperform the euro area over the next two years.

III Demand and output

A23 The preliminary estimate of GDP growth in 2001 Q1 had shown growth easing to 0.3% from 0.4% in 2000 Q4. Service sector growth had been 0.7% in 2001 Q1, unchanged from 2000 Q4. Within services, the distribution, hotels and catering sector had grown by 0.4%, down from 0.8% in 2000 Q4. Both manufacturing output and industrial production had fallen by 0.7% in Q1.

A24 Retail sales had grown by 0.1% in March and by 1.5% in 2001 Q1. The retail sales balance in the Confederation of British Industry (CBI) survey of distributive trades had risen slightly to +32 in April from +30 in March. The GfK consumer confidence index had been broadly stable in April (+1.9 compared to +3.2 in March). The MORI index had risen to -22 in April, from -29 in March.

A25 The Nationwide house price index had risen by 0.8% in April and by 2.4% in the three months to April compared with the three months to January. The Halifax index had risen by 1.7% on the month in April and had also risen by 2.4% on a three-month basis. The House Builders' Federation (HBF) house price survey balance had fallen to +21 in March from +32 in February. HBF net reservations had fallen to +7 in March, from +12 in February. Particulars delivered were unchanged in March at 117,000.

A26 Public sector net borrowing in March had been £3.1 billion, compared with £1.1 billion in March 2000. Net borrowing had been -£16.5 billion in the financial year 2000/2001, compared to -£15.5 billion in the financial year 1999/2000.

A27 Survey evidence on stocks in 2001 Q1 had been mixed: the April CBI industrial trends survey had indicated rising stock balances, but the CBI distributive trades survey had indicated falling stocks.

A28 The total deficit on trade in goods and services had narrowed slightly in February to £1.5 billion from £1.6 billion in January. In the three months to February, total goods export volumes had grown by 2.4%, and total goods import volumes by 2.8%. Total non-EU goods export volumes had fallen by 8.5% in March, and total non-EU goods import volumes had risen by 1.2%.

A29 Business confidence measures had been mixed. The British Chambers of Commerce (BCC) survey had reported broadly unchanged confidence about both profitability and turnover in the first quarter of 2001 for both the manufacturing and the service sectors. However, the CBI April Industrial Trends survey had shown a sharp fall in general business optimism, the balance falling from -3 in January to -29 in April, the lowest for two years. The Institute of Directors survey had also shown a fall in general business optimism.

A30 Survey data on services output were generally weaker than last month. The Chartered Institute of Purchasing and Supply (CIPS) services activity index had fallen to a two-year low in April, and the BCC survey had reported a fall in orders to the service sector. BCC survey data for the service sector had shown that the balance of investment intentions had fallen slightly to +21 in 2001 Q1 from +24 in 2000 Q4.

A31 Both the CBI and BCC surveys had shown a fall in manufacturing orders in Q1. In addition, the CIPS manufacturing activity index had fallen to a two-year low in April. The BCC survey had shown a fall in manufacturing investment intentions in Q1, but the CBI quarterly survey had shown a slight pick-up.

IV The labour market

A32 According to the Labour Force Survey (LFS), employment had risen by 113,000 (0.4%) in the December to February period compared with the previous three months. This relatively rapid rate of

growth had been consistent with recovery from the effects of those temporary factors that had caused employment to fall last autumn. The working-age employment rate had been broadly unchanged over the past six months.

A33 The CIPS employment index suggested that employment growth in services had slowed sharply in April, while employment in manufacturing had fallen more rapidly. Employment growth in construction had risen slightly. The overall index had been close to the neutral 50 level, consistent with unchanged employment. The Recruitment and Employment Confederation (REC) survey had shown a further slowing in the growth of demand for both permanent and temporary staff in April. The BCC and CBI surveys had both been consistent with weaker employment growth during the second quarter.

A34 No new data on the other main measure of heads employment, Workforce Jobs, had become available since the previous meeting, but the existing data had been revised following the introduction of the new Annual Business Inquiry. The level of Workforce Jobs had been revised up by almost 1 million, more or less uniformly across the whole of the sample from June 1959. That had meant that the number of jobs implied by the Workforce Jobs survey was now much closer to the number of jobs implied by the LFS. Nevertheless, there remained a gap between the recent growth rates of the two series. After adjusting for the effects of grossing to new population estimates, the LFS estimate of jobs had risen by 1.1% during the year to November to January. Workforce Jobs had risen by only 0.2% during the year to December.

A35 Average hours had risen by 0.7% in the December to February period compared with the previous three months. They were also 0.7% higher than a year earlier.

A36 LFS unemployment had fallen by 42,000 in the December to February period compared with the previous three months. That had taken the rate down to 5.2%. The claimant count had fallen by 31,100 during the same period, and by a further 13,000 in March. Working-age inactivity had fallen by 24,000 in the December to February period, compared with the previous three months. But the working-age inactivity rate, at 21.2%, remained higher than a year earlier.

A37 There had been mixed evidence on skill shortages. The BCC survey had shown a small increase in recruitment difficulties in both services and manufacturing in Q1. The REC survey had shown a small deterioration in the availability of agency staff in April compared with March. And

according to the CBI/PricewaterhouseCoopers survey, labour shortages reported by financial services firms had remained high. But the CBI Industrial Trends survey had shown a slight easing of skilled labour shortages in manufacturing. And the Bank's regional Agents had reported that, in some parts of the country, and in some sectors of the economy, skill shortages had begun to ease.

A38 Headline annual earnings growth had risen by 0.5 percentage points to 5.0% in February. The annual rates of growth in December, January and February had been 4.8%, 4.3% and 5.9% respectively.

A39 Most of the pick-up in annual earnings growth in February had been accounted for by bonus payments. The contribution of bonus payments to annual earnings growth in February had been 1.9 percentage points (not seasonally adjusted). 1.5 percentage points (not seasonally adjusted) of the whole-economy bonus effect in February had reflected large bonus payments by a small number of firms who last year had made bonus payments in March. This timing change meant that much of the February bonus effect might be matched by a weaker bonus effect in March.

A40 Regular pay growth (not seasonally adjusted) had slowed sharply, from 4.6% in December to 3.8% in January, consistent with large millennium-related payments made last year dropping out of the twelve-month comparison. Regular pay growth had recovered to 4.1% in February, but had remained below rates seen at the end of last year. This weakness in pay per head growth might have been related to the strong growth in average hours.

A41 The Bank's twelve-month AEI-weighted mean pay settlement had been unchanged at 3.1% in March. Across that subset of firms recorded in the Bank database as making a settlement in Q1 of this year and in Q1 of last year the average settlement had risen by 0.5 percentage points. During the period 1999 Q4 to 2000 Q4, RPI inflation had risen by 1.6 percentage points while RPIX inflation had fallen by 0.1 percentage points. According to the latest data from Incomes Data Services (IDS), there had been some indications that settlements in April were turning out slightly weaker than in January, perhaps reflecting recent falls in RPI inflation.

A42 Revisions associated with the switch to the Annual Business Inquiry had meant that annual growth in manufacturing productivity through last year had been revised up by around one percentage point. Annual growth in manufacturing unit wage costs had been revised down by a similar amount.

V Prices

A43 The annual inflation rate of the Bank's oil-inclusive commodity price index had fallen to 2.1% in March from 6.3% in February. This had mainly reflected falls in sterling oil prices. Both the rise in commodity price inflation in 1999 and the recent falls had been related to movements in the prices of fuels. Average sterling oil prices had risen by around 4.5% in April compared with the average price in March.

A44 Annual input price inflation had been 3.6% in March, the lowest rate for 18 months. The CIPS manufacturing survey input price balance had been 50.4 in April, broadly consistent with no change in input prices in April. Output prices excluding excise duties had risen by 0.2% in March, which had left the annual inflation rate unchanged at 0.8%. The CBI survey expected output price balance had been -14 in April, broadly unchanged from the balance in March (-13).

A45 The Climate Change Levy – a levy on energy use and a reduction in employers' National Insurance Contributions – had been introduced on 1 April. This had been intended to be revenue-neutral at an economy-wide level. Due to difficulties in collecting data from energy suppliers, the ONS had stated that they would not publish an input price series including the effects of the Climate Change Levy in April. However, they intended to publish an estimate of the effect of the levy in April and to publish an input price index including the effects of the levy in due course.

A46 Annual RPIX inflation had been 1.9% in March, unchanged from the previous month. On a quarterly basis, RPIX inflation in Q1 had been 1.9%. RPI inflation had fallen to 2.3% in March from 2.7% in February, reflecting both recent reductions in mortgage rates, and the March 2000 rise in mortgage rates dropping out of the annual comparison. RPIY inflation had risen to 1.8% in March from 1.6% in February, while HICP inflation had also increased, to 1% in March.

VI Report by the Bank's Agents

A47 Agents had reported that overall manufacturing activity had weakened further recently. Firms in the ICT sector had continued to record the most significant downturn. Elsewhere in the sector, activity had remained fairly firm. However, deteriorating confidence about future activity had become more widespread across all parts of manufacturing in recent weeks. In particular, contacts had become more concerned about the adverse impact of the US slowdown.

A48 Contacts had reported a further pick-up in construction activity in recent weeks, as firms sought to reduce backlogs caused by earlier weather-related delays. Most Agencies continued to suggest that underlying demand had remained robust in most areas of construction, and had even strengthened in some regions (notably in parts of Southern England). In particular, growth in residential construction had picked up in recent weeks.

A49 Service sector growth had slowed further recently – in both consumer and business services. Within business services, contacts in ICT and financial services had reported the most noticeable slowdown in activity. Demand for other professional services activity had generally remained robust. Consumer services had also slowed, largely as a result of recent adverse effects of foot and mouth disease. This had resulted in significantly lower demand for tourism and related services (eg restaurants) in rural areas. It had been noted, however, that there had been some substitution towards retail goods spending in urban areas.

A50 The Agents had undertaken a survey of around 180 firms regarding their expectations of consumer spending growth in 2001. The responses had shown that a small majority of firms had revised their expectations of sales value growth in 2001 down slightly since the beginning of the year. It was noted that foot and mouth disease had been a significant negative influence on confidence in some industries – particularly in parts of the service sector. Nevertheless, a significant majority expected value growth to be slightly higher than in 2000. Moreover, growth in volumes in 2001 had also been expected to pick up, to a broadly similar extent. Respondents had also been asked about their expectations for retail prices. The results had indicated some slight upward pressure on retail prices in 2001, most notably in retail services.

A51 There had been early signs that the labour market had softened somewhat recently. Manufacturing employment had continued to decline steadily, while employment growth in some parts of the service sector had slowed – particularly in IT and financial services. There had also been reports of cutbacks in employment in agriculture and tourism-related services on account of foot and mouth disease. Some Agencies (particularly in southern regions of England) had noted further signs of an easing in skill shortages in some sectors. Most Agencies suggested that pay growth had remained subdued. Moreover, some had reported early indications that pay pressures in parts of the service sector had eased somewhat in recent weeks (eg IT services). A notable exception had been the construction sector where, if anything, pay pressures had increased recently.

VII Market intelligence

A52 Near-term expectations for the Bank's repo rate out to the end of 2001, derived from sterling money market instruments, had ended the period broadly unchanged from their position on 4 April. In the first half of the month, interest rate expectations had increased in response to the stronger-than-expected average earnings data for February and rising equity prices. However, these effects had then been largely reversed after Easter following the FOMC's unexpected 50 basis point reduction in the Federal funds target rate, weaker-than-expected UK retail sales and GDP data. After allowing for these offsetting influences, forward rates derived from sterling money market instruments had continued to suggest a strong expectation that the MPC would reduce the Bank's official repo rate by 25 basis points at its May meeting. Similarly, economists polled by Reuters on 3 May had attached a 70% mean probability to a reduction in the Bank repo rate on 10 May.

A53 In contrast, interest rate expectations for 2002 and 2003 had increased by around 20-25 basis points over the month. Market commentators noted that this development had largely reflected somewhat less pessimistic assessments about the outlook for US and UK growth in 2002 and beyond. The divergent performances of near-term interest rate expectations, on the one hand, and expectations for 2002 and 2003 on the other, had begun around mid-March and had coincided with a more general rise in equity markets and government bond yields in the United States, the euro area and the United Kingdom. Factors that had been cited by market participants to explain this change in sentiment had included the unexpected resilience of consumption and housing market activity in the United States, some better-than-feared corporate results in both the United States and Europe, and the FOMC's actions to reduce the Federal funds target rate by 2 percentage points since the start of the year.

A54 The sterling ERI had been broadly stable since the Committee's previous meeting, rising by 0.5% to 105.5. Movements in sterling during April had largely been driven by developments in the euro area and the United States, rather than by domestic considerations. Market participants had noted a few signs from risk reversal statistics, market positioning data and surveys of market participants' attitudes that sentiment towards the euro might have improved over the month. However, most market-makers had remained uncertain about the strength of this evidence and had continued to recommend to their clients that they maintain neutral short-term positions in the euro. Nevertheless, looking further ahead, most market commentators continued to believe that the dollar would depreciate against the euro and that, as a consequence, sterling would also depreciate against the euro.



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Sir Edward George
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29 April 2001

Dear Ed,

REMIT FOR THE MONETARY POLICY COMMITTEE

The Bank of England Act requires that I specify what price stability is taken to consist of and the Government's economic policy objectives at least once in every period of 12 months beginning on the anniversary of the day the Act came into force. I last wrote to you on this matter on 25 May last year.

I hereby re-confirm the target of 2 ½ per cent for RPIX inflation. In accordance with the Act, I also confirm that the economic policy of the government is to achieve high and stable levels of growth and employment by raising the sustainable growth rate and creating economic and employment opportunities for all.

I attach a copy of the remit, as first set out in 1998 (after the Act came into force), for ease of reference.

*Yours sincerely
Gordon*

GORDON BROWN

REMIT FOR THE MONETARY POLICY COMMITTEE

The Bank of England Act came into effect on 1 June 1998. The Act states that in relation to monetary policy, the objectives of the Bank of England shall be:

- (a) to maintain price stability, and
- (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

In order to comply with the Act, this remit sets out what price stability shall be taken to consist of and what the economic policy of the Government shall be taken to be.

Price stability

I confirm that the operational target for monetary policy remains an underlying inflation rate (measured by the 12-month increase in the RPI excluding mortgage interest payments) of 2½ per cent. The inflation target is 2½ per cent at all times: that is the rate which the MPC is required to achieve and for which it is accountable.

My intention is to lock into our policy making system a commitment to consistently low inflation in the long term. The real stability that we need will be achieved not when we meet the inflation target one or two months in succession but when we can confidently expect inflation to remain low and stable for a long period of time.

The framework takes into account that any economy at some point can suffer from external events or temporary difficulties, often beyond its control. The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output.

But if inflation moves away from the target by more than 1 percentage point in either direction I shall expect you to send an open letter to me, following the meeting of the Monetary Policy

Committee and referring as necessary to the Bank's Inflation Report, setting out:

- the reasons why inflation has moved away from the target by more than 1 percentage point;
- the policy action which you are taking to deal with it;
- the period within which you expect inflation to return to the target;
- how this approach meets the Government's monetary policy objectives.

You would send a further letter after three months if inflation remained more than 1 percentage point above or below the target. In responding to your letter, I shall, of course, have regard to the circumstances prevailing at the time.

The thresholds do not define a target range. Their function is to define the points at which I shall expect an explanatory letter from you because the actual inflation rate is appreciably away from its target.

Government's economic policy objectives

The Government's central economic policy objective is to achieve high and stable levels of growth and employment. Price stability is a precondition for these high and stable levels of growth and employment, which will in turn help to create the conditions for price stability on a sustainable basis. In the recent past, instability has contributed to the UK's poor growth performance, not least by holding back the long-term investment that is the foundation for a successful economy.

The monetary policy objectives of the Bank of England are to maintain price stability and subject to that, to support the Government's economic policy, including its objectives for growth and employment.

Accountability

The Monetary Policy Committee is accountable to the Government for the remit set out in this letter. The Committee's performance

and procedures will be reviewed by the Court on an ongoing basis (with particular regard to ensuring the Bank is collecting proper regional and sectoral information). The Bank will be accountable to Parliament through regular reports and evidence given to the Treasury Select Committee. Finally, through the publication of the minutes of the Monetary Policy Committee meetings and the Inflation Report, the Bank will be accountable to the public at large.

Restatement of the Remit

The inflation target will be confirmed in each Budget. There is a value in continuity and I will have proper regard to that. But I will also need to consider the case for a revised target at these times on its merits. Any changes to this remit will be set out in the Budget. The Budget will also contain a statement of the Government's economic policy objectives.