

Publication date: 20 February 2002

MINUTES OF MONETARY POLICY COMMITTEE MEETING

6 and 7 February 2002

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 February 2002

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0202.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 6 and 7 March will be published on 20 March 2002.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 FEBRUARY 2002

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, credit and asset prices; demand and output; labour market conditions; prices and costs; and some possible tactical considerations.

The world economy

2 The latest US indicators suggested some further improvement relative to expectations a few months ago. After falling by 0.3 percentage points in 2001 Q3, output was estimated to have grown very slightly in Q4. Consumption had been stronger than expected, largely reflecting spending on cars encouraged by heavy price discounting. A substantial part of this demand had, however, been met by running down inventories, reducing its net contribution to output growth. Investment in information and communication technology had in Q4 risen for the first time in over a year. While employment had fallen in December, the rate of unemployment had also dropped, implying that some people had moved out of the workforce. Looking forward, most of the recent US survey evidence was positive. Measures of consumer confidence had continued to rise, and were now well above post-11 September troughs. The Institute for Supply Management's manufacturing purchasing managers' index had risen again, to 49.9. The non-manufacturing index had fallen only slightly on the month – from 50.1 to 49.6 – but by rather more when compared with the original estimate for December of 54.1. It was still, though, considerably higher than immediately after 11 September.

3 In the euro area – probably the most important region for assessing the impact of global conditions on the UK economy – there was a disjunction between the backward-looking data and more forward-looking surveys. Demand and output growth had remained weak – somewhat more so than had been built into the Committee's November projections. But business confidence measures were stronger, and purchasing manager indices had risen for the third consecutive month for both manufacturing and services. Consumer confidence indices had been broadly flat on the month. Compared with the November *Inflation Report* assumptions, however, the immediate outlook for euro-area activity was somewhat weaker. There was also a downside risk to domestic demand, but compared with the United States the euro area was not particularly exposed to risks stemming from

imbalances. It was conceivable that the current debate about the Stability and Growth Pact would cause fiscal policy to be tightened relative to current plans, but that seemed unlikely.

4 Conditions continued to be difficult in Japan. Industrial production had fallen sharply over the past year. Deflation persisted. Looking forward, there were downside risks associated with the problems in the financial sector and uncertainty about their resolution. The significance of this for the overall world economic outlook was, however, unclear as Japan's difficulties seemed not to have had a big impact on global conditions over recent years; for example, world trade growth had been very strong in 2000.

5 Against this background, the Committee discussed the risks to the US economic outlook since that was the source of greatest uncertainty affecting global prospects. The underlying position in the United States might be less strong than would perhaps appear from a near-term recovery in growth associated with firms completing their inventory corrections and a rebound from the dip in demand immediately after 11 September. What would matter more in the period ahead was the strength of final domestic demand. While business surveys suggested that investment would not continue falling, they did not yet point to a sustained pick up. There might still be an investment overhang, in which case company spending would be weaker than otherwise. Perhaps more significantly, there were downside risks to consumption from the build up of household debt. Even at low official interest rates, the debt servicing burden was historically high relative to income. If saving were to rise sharply, there might also be a fall in the dollar's exchange rate, which would in turn tend to reduce the real spending power of household incomes. Separately, the Enron case seemed to be affecting the equity market's valuation of other companies. Increased uncertainty about the integrity of published earnings might perhaps be causing a rise in the risk premium; and looking forward, more conservative accounting practices might reduce future growth in published earnings. However, the impact seemed so far to be localised rather than across company share prices generally; and the effect on wealth and demand would plausibly be smaller than would be the case if, say, the expected rate of return on capital generally were revised down.

6 To the extent that weight was given to these possible downside risks, an important question was how well monetary authorities would be able to respond if any of them crystallised. On the one hand, while US headline inflation had fallen, reflecting lower oil prices, measures of 'core' inflation (which stripped out food and energy prices) had gradually edged up from around 2% to nearly 3% over the past two years, perhaps prospectively reducing the scope for further policy easing. On the other hand,

it was suggested that it was not unusual, given the lags in the economy, for core inflation to continue rising during a slowdown in output growth and then to fall back as the economy recovered, so that there was little reason to think that interest rates could not be cut further if the recovery stalled.

7 Overall, the Committee concluded that the international news on the month was positive. The outlook was for world economic growth to recover during this year, but with somewhat weaker activity in the near term than had been built into its November *Inflation Report* projections. The balance of risks was modestly on the downside.

Money, credit and asset prices

8 The global conjuncture implied considerable uncertainty about the sustainability of the current constellation of exchange rates. The US dollar had strengthened again over the past month and, on an effective rate basis, was at a 15-year high. But the internal and external imbalances in the US economy, associated with the build up of debt, posed downside risks. It was difficult to envisage recovery in the Japanese economy without some further yen weakness. The euro had weakened again, and might be restrained by the subdued outlook for euro-area growth and by public commentary on possible tensions between monetary and fiscal policy. But obviously not all of these major currencies could fall at the same time.

9 Compared with the three main currency blocs, sterling's exchange rate was relatively more important for domestic monetary policy given that the United Kingdom was a smaller, more open economy. In effective terms, sterling was broadly unchanged over the month, having fallen against the US dollar and risen against the euro. On balance the Committee judged that the risks to sterling were weighted on the downside, although some members found that difficult to square with the possibility of a more general realignment of bilateral exchange rates given the international conjuncture.

10 Recent UK monetary, credit and housing market data had been robust. The annual rate of broad money (M4) growth had slowed slightly, to just under 7%, in December. But the household measures were generally strong. Notes and coin had risen by 10% on an annualised basis in the latest three months. Household Divisia money – a broader measure of transactions balances – had grown by over 9% in the year to end-December. Total household borrowing growth remained very strong: around 11% in the year to December. Secured borrowing growth had been over 10%. House prices were up nearly 12% on a year ago on the Nationwide measure; and over 16½% on the Halifax measure, which

had risen by 1.6% in January. According to the Royal Institution of Chartered Surveyors, the balance of estate agents across the country expecting house prices to rise had increased from +29 in December to +48 in January.

11 The Committee discussed some of the possible implications of a substantial cumulative rise in household debt relative to income and of the position of household finances more generally. Capital gearing had also risen, but was still below the levels prevailing through much of the 1990s. Income gearing was low at current interest rates by historical standards; other things being equal, interest rates would have to rise substantially for income gearing to reach early-1990s levels.

12 It was not clear, however, whether the early 1990s provided a sensible benchmark of sustainability. On the one hand, in an environment of greater macroeconomic stability, households might be able to sustain higher levels of debt relative to income than in the past. They might simply be making that adjustment; the debt-to-income ratio in the United Kingdom was not out of line with that in many other developed economies. Official interest rates had risen by seven percentage points, from 8% to 15%, over a short period in the late-1980s/early-1990s. A similar absolute rise was now unlikely. 'Affordability' measures of housing – for example, the interest cost of servicing a mortgage relative to income – were, it was suggested, reassuring. Nor was the level of household saving directly comparable with past episodes; it was stronger than implied by the headline numbers. Measures of the household saving ratio which adjusted for inflation were not markedly below the long-term average; and adjusting for spending on durables – on the grounds that they yield a flow of services over time – would, other things being equal, increase the ratio. Furthermore, it was not clear that policy would need to be tightened sharply to restrain demand if rapid borrowing growth continued. Other things being equal, higher debt – as well as the abolition of mortgage interest tax relief – might mean that, compared with the past, smaller changes in official interest rates would be required for a given desired effect on spending and saving decisions.

13 On the other hand, the high levels of debt in the late 1980s had made households vulnerable, compounding the subsequent downturn. Was it clear that borrowers and lenders remembered the lessons of that episode? The more stable monetary environment did not point unambiguously in the direction of more debt being safe. The unexpected rise in inflation in the late 1980s had eroded the real burden of household debt; that was also now less likely. In addition, the lower nominal interest rates implied by lower medium-term inflation expectations meant that the real burden of servicing and repaying debt was now spread more evenly over the life of a loan than during the higher-inflation late-

1980s, when it had been concentrated in the early years of a loan. Related to that, measures of income gearing based only on interest payments might, by ignoring principal repayments, underestimate the household sector's overall debt burden, although some members thought that the quantitative significance of this adjustment for most housing-related loans was likely to be small. Finally, it was possible that the effect on household behaviour of any increase in interest rates would also depend on the proportional change rather than just on the absolute change.

14 Persistently rising debt levels potentially increased the probability that any adjustment to household balance sheets would be abrupt rather than smooth, with an attendant risk of a fall in asset prices and, thus, in the value of collateral. In those circumstances, there might also be implications for financial sector behaviour and associated constraints on household credit availability, which could feed back into spending and so somewhat amplify the effect on aggregate demand. In the view of some members, therefore, rising debt levels risked increasing the volatility of output and so of inflation in the medium term, potentially making future inflation outturns more uncertain. Other members placed little or no weight on this.

Demand and output

15 The imbalances in the economy had for some time been reflected in quite different outturns for manufacturing and services sector output, and for consumption and investment. Manufacturing output had fallen by 1.7% in Q4, and was 5.6% below the level of a year earlier. Services output had, by contrast, risen by 0.9%, and was up 3.6% on twelve months before. The gap between the annual growth rates had not been as big since 1981.

16 Retail sales had risen by 1.3% in Q4 and by 6.2% on 2000 Q4. The implications of the data for December itself were, however, unclear. On an unadjusted basis, sales had grown by 23.5% in December. But the seasonal adjustment factor was a massive -23.8%. On a seasonally adjusted basis, retail spending had, therefore, fallen by 0.3%. Since there was unavoidable uncertainty about the precise size of so large a seasonal adjustment, it would be premature to give much weight to this month's data.

17 Consumption growth, while remaining strong, seemed likely, on the basis of available information, to have eased back in Q4: from an average quarterly rate of around 1% in the first three quarters of 2001 to, perhaps, around $\frac{3}{4}\%$. This seemed to reflect weaker spending on services, which

might in part reflect temporary 11 September effects. Looking ahead, it was possible that durables spending would slow. As a share of total consumption, it had reached historical highs during 2001, but had typically declined relatively quickly during previous economic slowdowns. Given the recovery in consumer confidence, the buoyancy of the housing market and the robust household money and credit numbers, there was not yet conclusive evidence that consumption growth would continue to slow in the near term. The Committee still expected it to slow further ahead, reflecting earlier falls in wealth and the prospect of weaker real income growth.

18 The outlook for investment would be affected by corporate profitability, amongst other factors. Manufacturing profitability (as measured by the annual post-tax rate of return on capital) had been only around 4¼% in Q3, the latest period for which there were data: the lowest rate since early 1992. Services sector profitability remained much higher, but had now declined from a peak of around 18% in 1998 to about 12½% in 2001 Q3.

19 According to the British Chambers of Commerce's Q4 survey, investment intentions in both manufacturing and services were weak. But more generally, recent business surveys had been more encouraging. For example, the Chartered Institute of Purchasing Supply services business activity index had risen; and for manufacturing, the CBI Quarterly Industrial Trends survey was slightly stronger than three months ago. More optimism in the corporate sector might improve investment prospects in due course.

20 Overall, the Committee expected investment gradually to recover in line with aggregate demand and output. But the immediate outlook was weak. In the view of some members, while in the short run the balance of risks to consumption was on the upside, it was on the downside for investment. Further ahead, the balance of risks to aggregate private sector spending was on the downside.

Labour market conditions

21 Although employment, on the Labour Force Survey measure, had increased by 0.2% in the three months to November, hours worked had fallen by 0.6%, largely due to less overtime work. Unemployment had risen slightly. It seemed, therefore, that firms were still hiring workers, coping with shifts in demand by adjusting hours worked. The implications of this looking forward were uncertain. On the one hand, if output growth remained reasonably robust, overtime and hours worked might rise again, without further increases in employment; alternatively, firms might hire more

workers, unwinding the recent rise in unemployment and leading to a re-tightening of labour market conditions. In that case, consumption might not soften as much as expected. If, on the other hand, hours worked recovered to earlier levels but growth stalled, unemployment might rise quite sharply. The path of earnings growth could differ considerably between these scenarios.

22 Earnings growth had eased back slightly in the three months to November compared with the previous three months. Regular pay growth had also slowed; on a non-seasonally-adjusted basis, the twelve month rate had fallen back from 5.0% to 4.6%. Given that overtime pay rates were typically higher than pay for normal hours, the fall might be explained by lower overtime. Bonuses remained significantly lower than last year. Together with uncertainty about the timing of bonuses at some firms over the next few months, this could make the earnings data difficult to interpret.

23 The survey data on employment intentions suggested that demand for labour had recently fallen in services as well as manufacturing. Intelligence from the Bank's regional Agents was consistent with this, and also suggested that on balance their contacts expected pay settlements and, to a lesser extent, earnings growth to be lower in 2002 than in 2001.

Prices and costs

24 At a little over \$19 per barrel, oil prices had been fairly stable over the month and, indeed, since the Committee's November *Inflation Report*. While some other commodity prices had risen, world price pressures remained weak. It was noted that consumer prices had been falling in each of China, Japan, Singapore and Hong Kong, which together accounted for approaching one fifth of world GDP weighted at purchasing power parity exchange rates.

25 During its meeting, the Committee received the ONS's preliminary estimate of January RPIX inflation. At 2.6%, this was much higher than expected. It would represent a sharp rise from 1.9% in December, and was well above the increase which could be accounted for by the unwinding of low petrol prices a year ago. Some of the unexpected increase reflected seasonal food prices, but on a first reading some of the other contributory factors were not so obviously erratic. The Committee agreed that a full analysis of the data would be needed before its March meeting. The data underlined the volatility of annual RPIX inflation from month to month. The short-term risks to RPIX inflation appeared to lie on the upside in Q1 and on the downside in Q2.

The February GDP growth and inflation projections

26 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 13 February.

27 On the assumption of an unchanged official repo rate of 4% over the next two years, the central projection was for the annual rate of GDP growth to ease back slightly during the first half of 2002, before recovering to around trend. The central projection for inflation was below target over the next year or so, after which it rose back towards the 2½% target by the two-year horizon, when it was still slightly below the target but rising. In the *Inflation Report* fan charts, the balance of risks to growth was on the downside, reflecting the risks to the world economic outlook and to private sector domestic demand. The risks to inflation were weighted slightly to the upside, largely due to the effect on import prices of a possible sterling depreciation.

28 Some members preferred different assumptions for both the central projections and risks. Some thought that the most likely outlook for inflation was a little higher. Others thought that it could be up to a quarter of a percentage point lower – a smaller difference than in recent quarters – reflecting views that there would be a greater-than-assumed disinflationary effect from weak world price inflation and that the economy's supply potential was higher than assumed; this was shown in Table 6.B of the *Inflation Report*. On risks, some members placed greater weight on upside risks to both output and inflation. Others judged that the overall balance of risks around the central projection was weighted to the downside for both output and inflation, and in particular did not place much weight on the possibility of a sterling depreciation or on its estimated effect on inflation.

Possible tactical considerations

29 The Committee noted that there was a firm expectation, in financial markets and amongst commentators, that the repo rate would be unchanged this month.

30 The Committee noted that some commentators had advocated intervention in the foreign exchange markets in an attempt to moderate the strength of sterling's exchange rate. The Committee was clearly of the view that intervention was not likely, on its own, to be effective in the present circumstances.

31 The Committee reviewed a range of possible general considerations bearing on the relationship between its fan chart projections and its policy decisions. First, it was important to place weight not just on the central (modal) projection but also on the risks, and – just as important – on the economic factors and analysis behind the fan charts. Second, the fan charts sometimes reflected some low probability, high impact events, which there was no need for policy to anticipate because the Committee could respond to them if and when they crystallised. Third, there were some eventualities (for example, an oil price rise) for which, if they occurred, the appropriate course might be for the Committee to accommodate the first round effects on the price level (and so measured inflation), depending on the economic circumstances prevailing. Fourth, the weight placed on the projection of inflation at the two-year horizon should reflect the nature of the economic influences underlying that projection and whether, in consequence, inflation was projected to be stable, rising or falling then. Fifth, the Committee might sometimes give weight to the expected variability of output and inflation; for example, to whether there were factors which might affect the risks of missing the inflation target, in either direction, by a material amount in the medium term. How much weight should properly be given to these different considerations would vary with the circumstances. The constant factor was the need, under the Government's remit, to set policy in order to achieve the inflation target. The Committee's projections were, therefore, a vital input to its decisions since they were forward looking.

The immediate policy decision

32 Various arguments – given different weights by different members – were identified for leaving the repo rate unchanged. First, with the central projection for inflation at the two year horizon only slightly below the 2½% target and rising, for some members the Committee's projections were in principle consistent with leaving the repo rate unchanged, cutting it slightly or even with raising it slightly. As things currently stood, the outlook was sufficiently close to target that the forecast did not help inform the choice between marginally different policy settings, as a range of interest rate paths could be consistent with achieving the inflation target over the medium term. But in the current conjuncture, cutting rates would undesirably stimulate an already buoyant household sector; and with price pressures currently so benign, a rate increase would be premature. The best course was to leave rates unchanged. Second, some members emphasised the prospect that inflation would be rising at the two year horizon. There would be a risk to the effectiveness of policy if the Committee were to cut rates now only to have to increase them quite shortly afterwards even in the absence of news. It was preferable for the Committee to build and maintain a reputation for making policy settings which

would persist unless economic circumstances changed. That way, repo rate changes would tend to have a bigger impact on longer-term interest rates, the exchange rate and other asset prices, aiding the effectiveness of policy. Third, some members placed weight on upside risks to the inflation outlook. Two main risks to inflation were emphasised: from the possibility of a depreciation of sterling's exchange rate and from the possibility that consumption would not slow as much as projected. These risks were connected, given the imbalances in the economy. There was evidence that the exchange rate was overvalued. The skew to the exchange rate built into the published fan charts was reasonable: it was, for example, fairly close to the profile which would be implied by uncovered-interest-rate parity, which was a conditioning assumption in some outside forecasts. Other members placed less weight on the exchange rate risk in the published fan charts – either because they thought the probability of a depreciation was low or because the pass through to prices would be small or because policy could react if and when sterling fell. But they shared a concern about over-stimulating household spending. A fourth reason identified for maintaining the Bank's repo rate at 4% arose, therefore, from the possibility, suggested by recent outturns, that consumption growth now responded more strongly and more quickly to interest rate changes than in the past. Since consumption growth was not expected to moderate until the second half of the year, cutting interest rates now would stimulate household spending too much in the short run. A preferable course would be to leave rates unchanged for now, cutting them if necessary later in the year as and when domestic demand growth slowed and when the path of the international economy was clearer. Fifth, some members placed weight on risks to the future variance of inflation from high and rising levels of household debt. A cut in rates would encourage further borrowing, increasing the risk of a subsequent abrupt downward adjustment in household spending – and perhaps in asset prices – at some point, which in turn would increase the volatility of inflation around the target. Finally, the news that the January RPIX inflation outturn was expected to be 2.6% raised the possibility that inflationary pressures might not, in fact, be as benign as had been thought. The data would need to be analysed carefully in order to form a judgment on how erratic they were.

33 Various arguments – again given different weights by different members – were also identified for cutting the repo rate. First, the central projection for inflation was below the 2½% target throughout the two-year forecast period. That created a prima facie case for a rate cut, especially given the need for symmetry in policy reactions. Second, it was possible that the US economy might not recover steadily this year given the possibility of a continuing investment overhang, of households and firms repairing balance sheets stretched by the build up of debt, and of a further equity market correction. Third, there were signs – for example, from the Enron fallout, the just-announced Allied

Irish Bank losses, and from Japan – of somewhat greater financial fragility, which might dampen asset prices, reducing wealth and increasing the cost of capital. Fourth, for some members the central projections for output and inflation were too high, as reported in Table 6.B of the *Inflation Report*; and the balance of risks for both was clearly on the downside. There was too much uncertainty for weight to be given to the implied projection beyond two years and thus to the slope of the projection at the two-year horizon. The arguments for delay did not appear convincing given that, despite the buoyancy of consumption, GDP was expected in the short term to remain growing at below trend and that the main risk to consumption further out was on the downside. The upside risk to inflation from a possible sterling depreciation built into the published fan charts was not relevant to the immediate policy decision. The risks to sterling might not even be on the downside and the associated inflationary implications had almost certainly been overestimated. Moreover, if sterling did fall, there would be time to assess and react to the potential medium-term inflationary implications. The implications of imbalances for policy were not clear-cut. For example, not cutting rates because of concerns about growing household indebtedness might imply a higher exchange rate than otherwise, which could increase future inflation volatility. It would, therefore, be a mistake to keep interest rates higher because of the imbalances, as there was no compelling, commonly agreed reason to do so, and there was, therefore, a risk of compromising the transparency and predictability of policy. On that view, a further modest cut was, therefore, needed now in order to meet the inflation target, and there were no good tactical reasons for delay.

34 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4%. Seven members of the Committee (the Governor, Mervyn King, David Clementi, Kate Barker, Charles Bean, Stephen Nickell and Ian Plenderleith) voted in favour. Christopher Allsopp and Sushil Wadhvani voted against, preferring a reduction in the repo rate of 25 basis points.

35 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
 Kate Barker
 Charles Bean
 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 1 February 2002, in advance of its meeting on 6-7 February. 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 According to the advance estimate, US GDP in 2001 Q4 had grown by 0.1% on a quarter earlier, following a fall of 0.3% in Q3. Consumption had grown by 1.3% on a quarter earlier, with sales of motor vehicles having risen by 16%. Investment had fallen by 2.9% in Q4, though investment in information and communications technology (ICT) goods had risen by 0.1% on a quarter earlier, the first increase for four quarters. Declining inventories had made a further negative contribution to GDP growth, of -0.6 percentage points. Both imports and exports had continued to fall, with net trade contributing -0.2 percentage points to GDP growth in Q4. Non-farm business sector productivity had grown by 0.9% on the previous quarter.

A3 The Conference Board and University of Michigan measures of US consumer confidence had risen in January. The Conference Board measure had risen to 97.3, from 94.6 in December, while the Michigan measure had risen to 93.0, from 88.8. Both rises had been accounted for by increases in the future expectations components of the indices. New orders for non-defence capital goods had increased for the third consecutive month in December, by 0.9% on a month earlier. The Institute for Supply Management (ISM) manufacturing sector purchasing managers' index had also increased, to 49.9 in January from 48.2 in December. The headline business activity index for the non-manufacturing ISM survey had fallen to 49.6 in January, from 50.1 in December. Non-farm payrolls had fallen by 89,000 in January, following a 130,000 fall in December. The unemployment rate had fallen to 5.6% in January from 5.8% in December. Initial unemployment insurance claims had declined again in January.

A4 The Federal Statistics Office in Germany had released an initial (working-day adjusted) estimate for GDP growth in 2001 of 0.8%, down from 3.2% in 2000. The Bank of France had released an estimate for French GDP growth of 2.1% in 2001. In the euro area, industrial production had fallen

in November by 0.8% on a month earlier. Euro-area retail sales had increased by 1.2% in the same month, reversing the 1.0% fall that had occurred in October.

A5 The euro-area purchasing managers' index (PMI) for the manufacturing sector had risen to 46.2 in January from 44.1 in December, the third consecutive monthly increase. The service sector PMI had also increased, to 51.0 in January from 49.2 in December. The confidence indicator in the European Commission business survey had risen in January, to -14 from -17 in December. The confidence indicator in the consumer survey had weakened slightly over the same period. In France, the National Institute of Statistics and Economic Studies (INSEE) manufacturers' confidence index had increased in January, due to an improvement in the expectations of future conditions sub-index. The Italian Institute of Economic Studies (ISAE) business confidence index had also improved in December. In Germany, the IFO index of business confidence in western Germany had increased to 86.3 in January from 85.8 in December, with the increase concentrated in the manufacturing sector. The Centre for European Economic Research (ZEW) index of economic sentiment had risen to 35.9 in January from 25.8 in December. The German unemployment rate had increased in January to 9.6%, from 9.5% in December.

A6 In Japan, industrial production had increased by 2.1% in December on a month earlier. The level of industrial production in 2001 Q4 had been 2.4% below that in Q3. Inventories had also declined in Q4, by 3.4%. Electrical machinery production had increased in December by 3.5% on a month earlier, the first monthly rise since December 2000. Electrical machinery inventories had continued to decline, falling by 4.4% in December. Export volumes had declined by 15.3% in the year to December. Real retail sales (deflated by the consumer price index) had fallen by 1.9% in 2001 Q4.

A7 South Korean industrial production had grown in December by 3.3% on a year earlier, while the rate of decline in industrial production in Taiwan had continued to slow. The Consensus Economics survey of GDP growth forecasts for South Korea, Taiwan, Singapore and Malaysia in 2002 had been revised up in January. The 2002 Consensus forecast for China had remained unchanged between December and January, at 7.2%. Industrial production in Argentina had fallen in December by 18.3% on a year earlier. The Consensus forecast for growth in 2002 in Argentina had been revised down to -8.2% in January from -3.3% in December, while the forecast for Brazil had remained unchanged at 2.1%.

A8 The spot price for Brent crude oil had remained little changed from the time of the Committee's previous meeting, at around \$20 per barrel. The *Economist* all-item dollar price index had also been little changed from the Committee's previous meeting. The industrial metals index had fallen by 4% over the same period, but remained 10% above its mid-November level. The *Economist* non-food agricultural commodities price index had risen by 6%; the food commodity index had fallen by 1%. The price of computer memory chips had fallen since the Committee's previous meeting, but remained substantially above the low point in prices reached in the autumn.

A9 In the United States, producer prices had fallen by 1.8% in the year to December, following a 1.1% fall in the year to November. The fall had been largely attributable to weaker energy prices. Core producer prices, excluding food and energy, had risen by 0.7% in the year to December. Annual consumer price inflation in the United States had fallen to 1.6% in December from 1.9% in November, which had again been attributable to the decline in energy prices. Annual core consumer price inflation had fallen to 2.7% in December from 2.8% in November. Producer prices in the euro area had fallen by 1.3% in the year to November and by 1.1% in the year to December. German producer prices had risen by 0.1% in the year to December. The euro-area harmonised index of consumer prices (HICP) had risen by 2.1% in the year to December, unchanged from November. The preliminary estimate for annual euro-area HICP inflation in January suggested a rise to 2.5%. Preliminary annual German HICP inflation had been 2.2% in January, up from 1.5% in December. The rise had been attributable to increases in indirect taxes and seasonal food prices.

A10 Major international equity indices had fallen since 9 January. In the United States, the S&P 500 had fallen by 6.2%; in the euro area, the Dow Jones Euro Stoxx index had fallen by 5.7%; and, in Japan, the Topix had fallen by 10.0%. Spreads over government bonds in the Merrill Lynch aggregate indices of investment-grade corporate bonds had risen for dollar and euro issuance.

II Monetary and financial conditions

A11 The twelve-month growth rate of notes and coin had fallen slightly to 8.0% in January from (a revised) 8.2% in December. The three-month annualised growth rate had risen to 10.1% in January, compared with 8.6% in December. The twelve-month growth rate of M4 had fallen substantially, to 6.7% in December compared with 8.0% in November. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 8.9% in December.

A12 The twelve-month growth rate of households' M4 had fallen to 8.0% in December. The twelve-month growth rate of households' Divisia had remained above that of households' M4 growth, at 9.2% in 2001 Q4. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen to 11.0% in December.

A13 Within total lending to individuals, annual growth of secured lending had risen to 10.2% in December. The number of loan approvals for house purchases had risen slightly, and the annual growth rate of unsecured lending had risen to 14.0% in December.

A14 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 6.8% in December. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had fallen to 8.5%. The average monthly flow of total external corporate finance had fallen to £3.3 billion in 2001 Q4. Growth of sterling lending to the manufacturing sector had contracted rapidly in 2001 Q4, although growth of lending to the real estate, construction and services sectors had remained strong. Corporates' net recourse (calculated using M4 lending adjusted for the effects of securitisations) was positive in 2001 Q4 at £0.5 billion.

A15 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had fallen sharply in December, to 3.4%. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had also fallen sharply in December, to 4.1%.

A16 Short-term nominal interest rates had fallen at all but the very shortest maturities since the Committee's previous meeting. The general collateral repo two-week forward rate had fallen by around 35 basis points six months ahead. The rate one year ahead had fallen since the Committee's previous meeting, but remained much higher than the official repo rate and higher than it had been in November. The spread between this forward rate and the official repo rate had been close to 1 percentage point for most of the period since late December – close to the peaks seen in 1996 and 1999/2000, but below the peak of 1994. The high spread had been consistent with market expectations of a rise in the repo rate and a pick-up in GDP growth even though, on average in the past, actual official repo rates had tended to be lower than the rates suggested by earlier forward rates. Longer-term nominal forward rates at all maturities had also fallen over the month. Real yields had risen at

maturities beyond ten years. This may partly have reflected the impact of the index-linked gilt auction on 24 January.

A17 Inflation expectations derived from gilts at all maturities had fallen since the Committee's previous meeting. The size of the falls may have been exaggerated to the extent that there had been any effect on real yields from the index-linked gilt auction. Monthly inflation expectations of participants in HMT's survey for 2002 Q4 had remained unchanged at 2.1%, while the Consensus Economics year-average forecast for 2002 had fallen to 2.0% in January. Inflation expectations for 2003 from these surveys had been a Q4 value of 2.4% from the HMT survey and a year-average of 2.3% from the Consensus Economics survey.

A18 Quoted credit card rates had fallen by 27 basis points in January. The standard variable rate for mortgages had remained unchanged in January. The two-year discounted rate had fallen by 1 basis point. The two-year fixed mortgage rate had risen by 19 basis points, and the spread over two-year swaps had narrowed.

A19 Spreads over gilts of investment-grade corporate bonds issued in sterling in the Merrill Lynch aggregate index had fallen since the Committee's previous meeting. Non-gilt sterling bond issuance had been less strong in January than in December. Retail lending rates to PNFCs had continued to fall in December.

A20 The FTSE All-Share and FTSE 100 indices had fallen by 3.4% and 3.0% respectively since the Committee's previous meeting, but were little changed since the end of October. The FTSE Small Cap and FTSE 250 indices had fallen by 6.2% and 5.3% respectively over the same period. The information technology and non-cyclical services sectors had been particularly weak. The number of profit warnings issued in January had fallen slightly compared with December, and had been less than in January 2001. A decomposition of changes in the FTSE 100 had suggested that, over the previous six months, the fall of around 5% had been accounted for primarily by weaker reported and prospective profits. There was little change in the estimate of the equity risk premium over this period as a whole. The picture was similar for the S&P 500 in the United States.

A21 Since 9 January, the sterling exchange rate index (ERI) had fallen by 0.1% to 106.8. This reflected a 1.7% depreciation of sterling against the US dollar and a 0.5% appreciation of sterling

against the euro. Relative movements in nominal yields at shorter maturities would have suggested a larger depreciation in effective terms, concentrated against the euro.

III Demand and output

A22 The preliminary ONS estimate of GDP growth in 2001 Q4 had shown quarterly growth easing to 0.2%, from 0.5% in Q3. Annual GDP growth had slowed to 1.9% in 2001 Q4 from 2.2% in Q3. Service sector output had risen by 0.9% in Q4, compared with growth of 0.6% in Q3. Within services, output in the distribution, hotels and catering sector had increased by 0.4% in Q4, down from 1.3% in Q3.

A23 The December industrial production data had been made available to the Committee in time for its meeting. Manufacturing output had fallen by 0.5% in December, and by 1.7% in 2001 Q4. The quarterly fall mainly reflected a sharp fall in the output of the electrical and optical equipment, and basic metal and metal products, industries.

A24 Retail sales had declined by 0.3% in December. They had risen by 1.3% in 2001 Q4, and by 6.2% in Q4 compared with a year earlier. Looking forward, the Confederation of British Industry (CBI) survey of distributive trades had suggested that retail sales would continue to be strong over coming months: the expected sales balance had risen to +25 in February from +19 in January. New private car registrations had been 25.8% higher in 2001 Q4 than a year earlier, and were 5.1% higher in January than a year earlier.

A25 The GfK consumer confidence index had risen to +6.4 in January from -0.6 in December. The MORI measure of consumer confidence had risen to -20 in January from -29 in November. On business confidence, the CBI Quarterly Industrial Trends business optimism balance had increased from -54 in October to -31 in January.

A26 The Nationwide house price index had risen by 0.2% in January, and by 2.7% in the three months to January compared with the three months to October. The Halifax house price index had risen by 1.6% on the month in January and prices on a three-month basis had been 4.6% higher. The Royal Institution of Chartered Surveyors' (RICS) balance of estate agents reporting increased prices over the previous three months had risen from +29 in December to +46 in January. Particulars

delivered had fallen by 6,000 to 125,000 in December but were 11.6% higher than a year ago. Loan approvals had risen slightly to 111,000 in December from 110,000 in the previous month.

A27 Annual net rates of return for PNFCs were broadly unchanged at 12.2% in Q3. Within these, annual net rates of return for the manufacturing and services sectors were 4.3% and 12.5% respectively in 2001 Q3. Investment intentions in the British Chambers of Commerce (BCC) Q4 survey for both service sector and manufacturing firms had continued to decline and had been around the lowest since the early 1990s. The CBI Quarterly Industrial Trends Survey for 2001 Q4 had indicated that investment intentions had not bounced back after 11 September: the balance of firms expecting to increase investment in plant and machinery was unchanged at -28 in the January survey compared with October.

A28 Export and import volume growth for goods had fallen in November: goods exports had fallen by 4.4% and goods imports by 3.5% in the three months to November compared with the previous three months. In 2001 Q4, exports of goods to the non-EU had risen by 1.7% on the previous quarter whilst imports of goods from the non-EU had fallen by 0.1%.

A29 Forward-looking survey data on the service sector had been mixed. The BCC service sector orders balances had fallen in 2001 Q4: home orders had decreased to +10 from +14 in Q3, whilst export orders had fallen to -8 from +1 over the same period. The headline Chartered Institute of Purchasing and Supply (CIPS) services index had risen to 51.4 in December, from 49.4 in November. The CIPS services incoming new business balance had increased to 51.9 in January from 50.5 in December.

A30 In manufacturing, the CIPS manufacturing survey in January had shown signs of improvement in both output and new orders, although both indices had remained below 50. The CBI Quarterly Industrial Trends survey had indicated an improvement in orders compared with three months ago: the expected balance had risen to -12 in January from -25 in October. The BCC home order balance had also shown an improvement: the balance had increased to -6 in 2001 Q4 from -12 in Q3. The CIPS construction index had risen to 54.0 in January from 52.9 in December.

IV Labour market

A31 Labour Force Survey (LFS) employment had increased by 65,000 (0.2%) in the three months to November 2001, compared with the previous three months. This had reflected rises in both female employment (37,000) and part-time employment (43,000). At 74.6%, the working-age employment rate had remained unchanged on the quarter, but had been 0.1 percentage points higher than a year ago.

A32 Despite the growth in employment, the total number of hours worked had fallen by 0.6% in the September to November period, compared with three months before. Average weekly hours worked per person employed had fallen by 0.7% in the latest quarter. The fall in hours had largely reflected lower overtime working.

A33 The CIPS employment surveys for January had suggested that overall employment had continued to decline at the same pace as in December. This had reflected continued employment falls in both manufacturing and services, while employment in construction had continued to rise, although at a slower pace than in December. Forward-looking surveys by the BCC and CBI had suggested a further weakening of employment intentions in manufacturing and services.

A34 Survey evidence on skill shortages had suggested a mixed picture. The CBI Industrial Trends survey had reported a sharp fall in manufacturing skill shortages in 2001 Q4, to below its long-run average. On the other hand, the CBI/PwC survey had suggested that shortages of professionals in financial services intensified in December and the BCC survey had indicated that the proportion of firms who faced recruitment difficulties remained high. The latest reports by the Bank's regional Agents had suggested that skill shortages had been unchanged.

A35 The LFS measure of unemployment had increased by 15,000 in the three months to November compared with three months earlier, though the rate had remained unchanged at 5.1%. Claimant count unemployment had been broadly flat over the same period but had risen by 3,200 in December. The claimant rate had remained unchanged at 3.2%. Claimant outflows had picked up a little in December, while inflows had remained flat.

A36 Inactivity amongst those of working age had fallen by 15,000 (0.2%) in the three months to November, compared with the previous three months.

A37 Whole-economy headline earnings growth, a three-month moving average of the annual monthly rates, had been 4.2% in November, down 0.1 percentage points from October. This easing in the headline rate had largely reflected slower headline pay growth in the public (-0.3 percentage points) and manufacturing (-0.7 percentage points) sectors which had offset higher earnings growth in private sector services (+0.2 percentage points). The twelve-month growth rate of earnings had fallen back to 3.9% from 4.4% in October. Whole-economy regular pay growth (not seasonally adjusted) had also fallen, from 5% in October to 4.6% in November. The contribution of bonuses reduced whole-economy earnings growth by 0.9 percentage points (not seasonally adjusted) in November.

A38 The Bank's AEI-weighted twelve-month mean measure of whole-economy settlements had been unchanged in December at 3.3%. It had been unchanged since April. On the basis of information available at the time of the meeting, it had appeared that settlements for January were turning out to be a little lower than the December figures.

A39 Details of the 2002-03 settlement for teachers in England and Wales covered by the School Teachers' Review Body had been announced on 23 January. The average settlement had been an increase of 3.5% in 2002-03 compared with 3.7% last year. The settlement for those members of the Armed Forces covered by the Armed Forces Pay Review Board had been announced on 29 January. The average settlement had been an increase of 3.7%, the same as last year. Both settlements were due to take effect on 1 April.

V Prices

A40 The Bank's sterling commodity price index had risen by 0.8% between November and December. Prices of metals had fallen by 4.6% in December but this had been more than offset by a 1.2% rise in the prices of domestic food and a 1.0% rise in the price of fuels. The annual inflation rate of the commodity price index had picked up to -6.8% in December from -11.8% in November.

A41 Oil prices had been volatile over recent months, but had remained at low levels following the sharp fall at the end of September 2001. In January, average sterling oil prices had been about 6% higher than their average level in December.

A42 Manufacturing input prices had fallen by 0.7% in December, as a 4.7% fall in crude oil prices had more than offset a 1.2% rise in domestic food prices. Annual input price deflation had eased sharply because of base effects, but prices were still 6.6% lower than a year earlier. Looking ahead, the CIPS manufacturing survey had continued to point to falling input prices. The input price balance had fallen to 39.3 in January, from 40.8 in December.

A43 Manufacturing output prices both including and excluding duties (PPIY) had been unchanged between November and December. The annual inflation rate of total output prices had risen to -1.2% and that of PPIY had been unchanged at -0.4% in December.

A44 Output prices had risen by less than manufacturers' total weighted costs since mid-1997. In 2001, weighted costs growth had eased significantly as falls in input prices had been offset by rises in unit labour costs. The CBI Quarterly Trends survey had shown that both average unit costs and output prices were expected to fall in 2002 Q1 – the balances had been -11 and -23 respectively.

A45 The CIPS service sector survey had shown a rise in the average prices charged index to 51.1 in January from 49.8 in December, and a rise in the average input prices to 53.7 in January from 51.1 in December.

A46 Annual RPIX inflation had risen by 0.1 percentage points to 1.9% in December. The rise had mainly reflected rises of 0.2 percentage points in annual goods price inflation to -0.3%, and 0.1 percentage points in annual services price inflation, to 4.1%. There were no major changes in the contributions of any of the individual components. Annual RPI inflation had fallen by 0.2 percentage points to 0.7% in December. Annual RPIY inflation had risen to 2.3% in December from 2.2% in November, while annual HICP inflation had risen by 0.2 percentage points to 1.0% in December.

VI Reports by the Bank's Agents

A47 The Bank's regional Agents had reported that manufacturing output and orders had continued to fall, and that there had been no clear sign of any slowing in the rate of decline. Aerospace output had fallen further and there had been no signs of recovery in the ICT sector. Manufacturers supplying to

the consumer market had continued to report modest growth in output. The trend to moving production away from the United Kingdom had intensified.

A48 Overall, there had been an improvement in activity in the service sector. Growth in consumer services output had remained robust. There had been a recovery in overseas holiday bookings, except to the United States. Contacts had also reported an increase in demand for domestic holidays. There had been a slight recovery in output growth in the business services sector, following a particularly sharp decline in growth after 11 September.

A49 Construction output growth had stabilised at a high level. Within this, there had been an easing in commercial and industrial construction. But demand for retail construction had remained robust, and there had been continued strong growth in demand from the public sector. The housing market had remained strong, although house price inflation had begun to ease for properties at the top end of the market.

A50 Growth in retail sales had continued to increase. Contacts had reported that spending immediately before Christmas and in the 'sales' afterwards had been higher than during the same period in 2000. Sales of new and used cars had remained very strong.

A51 Raw materials costs had continued to fall, offsetting increases in the price of non-material costs, particularly insurance. Falls in raw material prices had generally fed through to manufacturers' output prices. Retail prices had been stable. There were reports that January discounting had been on a narrower range of stock in 2002 than in 2001, due to better stock control by retailers.

A52 The Bank's regional Agents had conducted an informal survey of around 280 firms on the prospects for earnings growth in 2002. Of the firms sampled that had a company-wide settlement, 15% had expected it to be higher in percentage terms in 2002 than in 2001, while 33% had expected their settlement to be lower. Growth in total pay per employee in 2002 compared with 2001 had been expected to be higher by 28% of the respondents, while 34% had expected it to be lower. The outlook for inflation had been highlighted as the main downward pressure on pay growth in 2002. The main source of upward pressures cited was the recruitment and retention of staff, especially in the retail and construction sectors.

A53 In reports outside the survey, Agents had noted falls in manufacturing employment and a further easing in service sector employment. But recruitment had remained strong in the public sector and in the leisure services and construction industries.

VII Market intelligence

A54 Since the previous Committee meeting, rates implied by short sterling futures contracts had fallen. Rates implied by the contract expiring in March 2002 had fallen by 16 basis points over the period, and those by the December 2002 contract by 48 basis points, to 5.03%. These falls partly reflected lower-than-expected retail sales data, and also perhaps some reversal of technical factors after the year-end. In common with rates implied by eurodollar and euribor contracts, implied rates had fallen following Chairman Greenspan's comments on 11 January. Following Chairman Greenspan's comments on 24 January and higher-than-expected UK GDP data on 25 January, some of the fall in implied rates had been reversed. Towards the end of the period, implied rates had fallen in response to falls in world equity prices, and weaker-than-expected non-farm payrolls and ISM data.

A55 Market participants had generally expected the Committee not to change the Bank's official repo rate in February. Similarly, economists polled by Reuters between 29 and 31 January had attached a mean probability of only 22% to a reduction in the Bank's official repo rate. In line with information from short sterling futures contracts, a majority of traders had expected the official rate to increase before the end of 2002.

A56 The US dollar had appreciated in effective terms by 1.3% since the Committee's previous meeting and had reached a new 15-year high of 124.9 on 25 January. Market participants had attributed the dollar's rise to an improved outlook for the US economy in comparison with other areas. Sterling had depreciated by 0.1% in effective terms and had traded in the top half of its range for last year of 104 to 108; it had risen by 0.5% against the euro but had fallen by 1.7% against the dollar. Sterling's movements had appeared to be influenced mainly by external factors, as there had been relatively little reaction from the foreign exchange market to UK domestic news.