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MINUTES OF MONETARY POLICY COMMITTEE MEETING 9 and 10 January 2002

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 January 2002

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0201.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 February will be published on 20 February 2002.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 JANUARY 2002

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

The world economy

2 The news on the world economy was on balance positive. In the United States, there were early signs that economic recovery in the second half of 2002 might be in prospect. Non-farm payrolls had fallen by 124,000 in December, a much smaller fall than in November. The Institute of Supply Managers' (ISM) (formerly NAPM) non-manufacturing survey index had increased to 54.2 in December, the highest level since December 2000, from 51.3 in November, and the corresponding manufacturing survey index was also higher. Business confidence indicators had recovered to above the pre-September 11 level, while consumer confidence had also picked up. The rate of decline of activity in the information and communications technology (ICT) sector had eased over recent months. Most outside forecasters were beginning to raise their forecasts for US GDP growth in 2002, and were coming closer to the Committee's own projection at the time of the November *Inflation Report*.

3 There were still considerable uncertainties associated with this outlook. It was possible that the shock in September had bought forward some redundancies which were already planned. In that case it might be too early to interpret the smaller fall in payrolls in December than in October and November as signifying an end to the labour market slowdown which had started earlier in the year. While the inventory correction was probably nearly complete, it was less clear that surplus productive capacity had been eliminated and so that the investment slowdown had ended. And the longer-term imbalances in the economy had not been corrected: the saving ratio remained low; the current account was in substantial deficit; and the profit expectations implicit in equity values still appeared to be high. US market interest rates had reacted sharply to the more positive economic indicators, and this in itself might restrain the recovery: for example, it might reduce the potential for further remortgaging at lower interest rates which had up to now probably helped to sustain consumption, and it would increase the cost of finance to business.

4 In the euro area, the picture was mixed. Industrial production and retail sales had both fallen in October, the latest month for which area-wide data were available. More recently, the euro-area Purchasing Managers' Index (PMI) for the service sector, and the European Commission measures for business and consumer confidence, had all risen in December, although they were still low in levels terms. There was some evidence that activity in Germany was weaker than in the rest of the euro area. Most outside forecasts for euro-area activity in 2002 were below the November *Inflation Report* projection. However, the decline in inflation, reinforced by the recent weakness of oil prices, would work to support real incomes and therefore consumption.

5 The Japanese economy remained weak, and the December Tankan survey showed a further fall in business confidence since September. With this in mind, the Committee considered the possible implications of the planned reduction at end-March 2002 of the current comprehensive guarantee for bank deposits. Interbank deposits would effectively no longer be protected. If individual banks ran into difficulties, public support might be required. It was suggested that this could entail an increase in government bond issuance and a sharp rise in bond yields which could be exacerbated by a fall in the yen, which on balance might further weaken Japanese activity. However, deposit insurance would remain in place, so there was no reason to expect a widespread withdrawal from the banking system.

6 It was encouraging that there had so far been little contagion from the recent developments in Argentina. Several of the emerging market economies in Asia were now showing signs of recovery, helped by the improving prospects for the ICT sector in the United States. Growth in China, however, may have begun to slow towards the end of 2001.

Money, credit and asset prices

7 There had been a significant rise, of some 60 basis points at a one-year maturity, in short-term UK market interest rates since the Committee's previous meeting. The central expectation implied by short-term interest rates was that the Bank's repo rate would not be reduced further. Market participants had apparently interpreted some key indicators, in the United Kingdom and abroad, as suggesting stronger-than-expected prospects for demand, and had given these indicators more weight than the continuing evidence of weak current inflationary pressure. By contrast, survey evidence suggested a lower profile for the Bank's repo rate over the next year than was implied by market rates. The latest Reuters' survey of economists indicated a unanimous expectation that there would be no

change in the Bank's repo rate this month.

8 Sterling's effective exchange rate was about 2% higher than at the time of the Committee's previous meeting, reflecting rises of over 1% against the dollar, 1½% against the euro and 8% against the yen. Renewed speculation regarding a move towards EMU entry might otherwise have weakened sterling, so the rise on the month suggested that it was well-supported at the present level.

9 The annual rate of growth of households' deposits had increased in November to over 9%, and households' borrowing to nearly 11%; both rates were at ten-year highs. Mortgage equity withdrawal had risen from 2.3% of total household post-tax income in the first quarter of 2001 to 4.1% in the third quarter.

10 The rate of increase in house prices had risen in December, and the rates recorded (15½% on the Halifax index and 14% on the Nationwide) for 2001 as a whole were the highest rates in any single year since 1988. The rate of increase was consistent with the growth of households' deposits and borrowing, but the renewed acceleration was surprising. One possible explanation was that some households were induced to increase their borrowing by low current nominal rates of interest – the proportionate reduction in mortgage servicing costs associated with the reduction in the repo rate from 6% to 4% had been very large – and were ignoring the fact that the real burden of the loan would no longer be eroded to the same extent by inflation as in the past. If that were the case, adjustment to this misperception might take some time. Alternatively, strong demand for housing might reflect the low returns available on other investments, given that equity returns had been negative and retail deposit rates were low.

Demand and Output

11 Anecdotal evidence, supported by reports from the Bank's regional Agents, the CBI Distributive Trades survey and the latest GfK consumer confidence survey, suggested that strong growth in retail sales had been maintained over the Christmas period. Although consumption had itself grown by 4% in real terms over the year to the third quarter, and by 1% in that quarter, the difference between retail sales and consumption growth was at its largest for 20 years. It was possible that consumption of services not captured in the retail sales data, such as travel and tourism, had been adversely affected, first by the foot-and-mouth epidemic and then by fears about the safety of international travel.

Households' expenditure on durables had risen by over 13% in the year to 2001 Q3.

12 Several factors might have influenced the rise in consumption and the associated continuing low level of the saving ratio. First, the rise in durables expenditure could in degree represent a decision by households to invest in real rather than financial assets, given the low returns available on the latter. Second, the rise in house prices had facilitated an increase in mortgage equity withdrawal. It was possible that this increase in the availability of credit at relatively low interest rates meant that the economy was going through a transitional period in which the rate of growth of debt was temporarily higher while consumers adjusted towards a higher desired ratio of consumption to income. That could imply a relatively gradual slowdown in consumption growth as the new equilibrium level was approached. Third, against the background of strong recent increases in post-tax real income, households might be basing their consumption decisions on an assumption of future income growth which might be unsustainably high. In that case, consumption could be vulnerable to shocks to income or unemployment that led to a downward revision to expected income growth, while higher household indebtedness implied that an increase in interest rates would also have a greater impact than in the past.

13 Given the continuing strength of consumption, it was perhaps surprising that import growth had recently been modest, but the weakness of investment in machinery and equipment, which had a high import content, had been an offsetting influence.

14 The revisions in the latest National Accounts data had been relatively modest. The level of output in 2001 Q3 was slightly higher than previously thought. The level of consumption had been revised down, while the levels of whole economy investment and government consumption had been revised up. Consumption growth in the third quarter was less strong, and investment growth less weak, than earlier reported. The recent weakness of industrial production had lowered estimates of likely GDP growth in 2001 Q4.

15 The latest survey evidence presented a mixed picture. The December Chartered Institute of Purchasing and Supply (CIPS) survey of manufacturing had shown a fall in output, though the rate of contraction of new orders had eased. The survey for 2001 Q4 by the Engineering Employers' Federation had been very weak. The CIPS services survey had shown a rise in all components of the index, while the Agents reported that the decline in stocks was nearing an end.

The labour market

16 Data over the past month suggested that labour market conditions had continued to ease, but perhaps less rapidly than expected. LFS unemployment had risen each month from July to October, and claimant count unemployment had risen slightly in both October and November. Inflows to unemployment were rising, as would be expected in an economic slowdown, but the rate of outflows from unemployment was still high, so that many of those losing their jobs might still be confident of getting another one.

17 Average earnings growth had changed little since July. The contribution from bonuses was still strongly negative, and it was likely that this component could give rise to large month-to-month movements over the next few months, during which bonus payments were concentrated. Weak profitability in several parts of the financial services sector could continue to depress bonuses, although the need to retain staff might mean that the effects of lower profits would not feed through fully.

18 Whole economy productivity had increased by 1.3% in the year to 2001 Q3, a fall of 0.2 percentage points from the Q2 figure. Since mid-1995, productivity growth had been below its long-run annual average rate of around 2% in some 20 out of 25 quarters. Other things equal, lower productivity growth implied upward pressure on unit wage costs. It was uncertain how rapidly productivity growth would rise in the coming quarters as employment growth slowed.

Prices and costs

19 Other pressures on inflation were unusually weak. The oil price had risen to around \$20 per barrel, an increase of about \$1 per barrel since the Committee's previous meeting but still below the level at the time of the November *Inflation Report*. The Economist index of commodity prices had fallen by 9% in sterling terms in the year to December. The UK import price deflator showed a fall of over 2% in 2001 Q3, reflecting declines in a range of different trade categories. Manufacturing input prices had fallen by 11% in the year to November, and manufacturing output prices had fallen by 1%, which was the lowest figure since comparable records began in 1958, in the same period. This in part reflected the particular weakness of the manufacturing sector. Prices of retail services were more buoyant, although the CIPS services survey showed the balance of prices charged below 50 for the

third consecutive month.

Other considerations

20 The Committee considered again the possible implications for policy of the growing imbalances in the economy: on the demand side, the strength in consumption compared with investment, and of domestic relative to external demand, and, associated with that, the growth in the stock of household indebtedness and the growing and accumulating current account deficit; and on the output side, the gap between growth in the internationally tradable and non-tradable sectors. Monetary policy over the past year had been set so as to compensate for weaker external demand by reducing interest rates to support domestic demand. This strategy had so far achieved its aim of keeping inflation close to the target rate by maintaining aggregate demand growth close to potential supply, but necessarily at the cost of widening the imbalances further.

21 It was possible that consumer demand would moderate at the same time as external demand strengthened. The Committee nevertheless reviewed the medium-term risks to maintaining that policy stance if external demand remained weak. Various scenarios were suggested. First, the growing current account deficit could imply a future risk of a large fall in the exchange rate and therefore of higher inflation, although the timing and extent of such a shock, and its effect on inflation, were uncertain. Second, the growth of household indebtedness increased the risk of an abrupt adjustment to consumption at some point, and in those circumstances it might be more difficult to sustain demand with further interest rate reductions. Third, if the business sector came to believe that the level of household indebtedness, and consequently the rate of consumption growth, were becoming unsustainable, investment could be inhibited and might not respond positively to reductions in interest rates. More generally, the greater the imbalances, the more uncertain would be the future path of inflation. Furthermore, the impact of monetary policy on inflation might also be less predictable than otherwise. Under these scenarios, in order to deter households from accumulating unsustainable levels of debt and so reduce the risk of larger deviations (on either the upside or the downside) of inflation from the target further ahead, it might be necessary to accept inflation remaining a little below target over the two-year horizon.

22 The risks from such a policy were discussed. First, if the amount by which inflation was allowed to undershoot the target were to be substantial, there would be a risk that a downside shock to activity

or prices could cause deflation, in which case it might be difficult to ease monetary policy by enough to restore inflation to target. Second, maintaining interest rates at a level at which inflation was expected to undershoot the target two years out risked lowering investment and productive capacity below where it would otherwise have been. While income would also be lower, the imbalances between demand and supply might be worse, so tending to raise inflation in the longer-term future. Third, there would be a risk of some loss of public understanding, so the reasons for the policy would have to be explained particularly carefully. Fourth, if interest rates were higher than they would otherwise be, the imbalances would be exacerbated if the exchange rate were also higher.

The immediate policy decision

23 Over the month, there had been a number of unexpectedly positive indicators from the United States, and the revival of confidence suggested that the effects on demand of the terrorist attacks had been temporary. Euro-area indicators were mixed and the Japanese economy remained weak. It was possible that international financial markets had overreacted to the early signs of prospective US recovery: the likelihood was that the first half of 2002 would see continued weak global activity, and rapid recovery later in the year was not yet assured. In the United Kingdom, retail sales, household borrowing and house prices were stronger than had been expected two months ago, and imbalances in the economy had widened. RPIX inflation was a little below target, and inflationary pressures were weak.

24 Against this background, the Committee agreed that interest rates should remain unchanged this month. There would be a case for a further reduction in interest rates if it was thought likely that consumption would slow before the world economy revived. This might happen as a reaction to rising unemployment and mounting indebtedness. Alternatively, with some positive signs in the past month from the United States allied to continued robust consumer spending over the Christmas period, it was possible that consumption would not slow soon enough, or sharply enough. In that case, a rise in interest rates would be required to keep inflation on track.

25 On balance, and given the available information, there was a reasonable prospect that consumption would slow naturally at broadly the same time that the world economy recovered, allowing the United Kingdom to maintain a growth rate close to trend and inflation close to target. Nor was it clear which sets of risks to this central path, those associated with a more rapid slowdown

or with higher inflation, were more likely to occur. A decision to leave interest rates unchanged was therefore consistent with meeting the inflation target going forward. There were, in addition, particular advantages in making no change in rates now. More information on the progress of the next annual wage round would become available over the next month. Moreover, the Committee would be able to make a fuller quantitative assessment of all the recent economic developments in preparing the February *Inflation Report* projections.

26 For some members, the worsening imbalances posed a particular threat. Real domestic demand growth had exceeded real output growth by 5.7% over the past five years (compared to a peak of 6.1% in the late 1980s). This was unsustainable, and at some stage there could be a sharp correction to the exchange rate in response to a widening current account deficit or to domestic demand as consumers retrenched in the face of rising indebtedness. Although inflationary pressures were subdued at present, a further stimulus to domestic demand at this stage through another cut in interest rates would worsen the imbalances and could make it more difficult to keep inflation close to target in the medium term.

27 For some other members, the choice between a further reduction of 25 basis points in repo rate and leaving the rate unchanged was finely balanced. Recent *Inflation Report* projections for inflation had been too high, and the impact of global disinflation had been underestimated. The rate of unemployment below which UK inflation would start to pick up which was implicit in those projections also appeared too high. While the balance of news on the world economy in the past month had been on the upside, the strength and robustness of the recovery were uncertain. The upturn in global equity markets did not appear fully justified by the prospects for growth and profitability and so was fragile. The possibility of further weakness in Japan, perhaps associated with the prospective reduction in deposit insurance, also posed a downside risk. On balance, consumption growth could be expected to slow, as employment and earnings growth slowed, and as the transition of consumption to a higher equilibrium level consistent with lower interest rates and output volatility was completed. The lower headline rate of inflation and some rise in unemployment might lead to a moderation in pay settlements. Overall, output growth was likely to remain below trend for some time, and inflation consequently to remain below target. Arguments that had been discussed for accepting an undershoot of the inflation target over the two-year horizon did not appear compelling in the current conjuncture. While there were upside risks to inflation from a possible fall in sterling, it was also conceivable that sterling might strengthen further, if the United Kingdom was seen as relatively strong among the major economies. Accordingly, it seemed likely that a further cut in interest rates would be needed soon to

bring inflation back to target. However, in the light of the news over the latest month, there were arguments for delay, in particular to gain more information on global economic prospects and on the current UK wage round, and to take all the relevant information into account in the February *Inflation Report* projections. On balance, therefore, it was preferable to make no change in the repo rate this month.

28 The Governor invited members to vote on the proposition that the Bank's repo rate should be maintained at 4.0%. The Committee voted unanimously in favour of the proposition.

29 The following members of the Committee were present:

Eddie George, Governor
Mervyn King, Deputy Governor responsible for monetary policy
David Clementi, Deputy Governor responsible for financial stability
Christopher Allsopp
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 4 January 2002, in advance of its meeting on 9-10 January. 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 Manufacturing output in the United States had fallen by 0.2% in November compared with a month earlier, and output in the information and communications technology (ICT) sector had fallen by 0.6%. The Institute for Supply Management (ISM) manufacturing index (formerly known as the National Association of Purchasing Managers (NAPM) index) had increased again in December, to 48.2 from 44.5 in November. The non-manufacturing ISM had also risen, to 54.2 in December from 51.3 in November. New non-defence capital goods orders had increased by 4.8% in November, following a rise of 5.9% in October, and a fall of 13.0% in September. Stock adjustment had continued at a relatively rapid pace, and the business sector stock to sales ratio had fallen sharply in October to 1.39, from 1.45 in September. Non-farm payrolls had fallen by 124,000 in December, following a fall of 371,000 in November. The four-week moving average of initial unemployment insurance claims had declined again in December.

A3 Real consumption had fallen by 0.6% in November compared with a month earlier, reversing some of the 2.3% rise in October. Sales of automobiles had fallen by 12.8% in November compared with a month earlier, partly unwinding the 31.1% rise in October. Spending on durable goods had risen by 8.3% compared with September. Both the Conference Board and the University of Michigan measures of consumer confidence had increased in December. The Conference Board index had risen to 93.7 from 84.9 in November, while the final release of the University of Michigan measure had increased to 88.8 in December from 83.9 in November. The increase in both had been attributable to a rise in the expectations component of the index.

A4 Industrial production in October had fallen by 0.6% in France and by 0.2% in Italy compared with a month earlier. German industrial production had declined by 1.8% in November compared with a month earlier, following a revised 1.2% fall in October. The euro-area Purchasing Managers' Index

(PMI) for manufacturing had risen to 44.1 in December from 43.6 in November: the French and Italian indices had increased while the German index had continued to fall. The euro-area service sector PMI had also increased in December, to 49.2 from 46.9 in November. The West German IFO index had increased to 84.9 in November, from 84.7 in October. The rise had been attributable to an increase in the expectations component. The French Investment Intentions Survey had indicated a fall in investment growth in 2001 and this had been expected to continue into 2002. The French manufacturing confidence index had remained weak in December, but the expectations component had improved somewhat: a similar pattern had been evident in a number of other euro-area business surveys conducted in December. The euro-area consumer confidence balance had risen to -10 in December from -12 in November, while the business confidence balance had increased to -17, from -18 in November. Euro-area retail sales had fallen by 1.1% in October compared with a month earlier. French consumer spending on manufactured goods had grown by 0.2% in November, the same (revised) monthly growth rate as in October.

A5 In Japan, the first estimate of GDP in Q3 had been a 0.5% decline compared with Q2. There had been significant revisions to previous GDP data: growth in 2001 Q1 had been revised up to 1.0% from 0.1%, while in Q2 the fall in GDP had been revised down to -1.2% from -0.7%. The revisions had been largely attributable to stronger investment and weaker consumption. Retail sales had fallen by 2.7% in November compared with a year earlier. Industrial production had fallen by 14.3% in the year to November: electrical machinery production had declined by 29.6%. However, the inventory correction had continued in November and inventories had reached their lowest level in fourteen months. Electrical machinery inventories had fallen by 10.5% in the year to November and had reached their lowest level in six years. Machinery orders had fallen by 10.1% in October compared with a month earlier, following a 5.7% fall in 2001 Q3. Export volumes had fallen by 11.4% in the year to November. While this had been a sharp fall, there had been some evidence that the rate of decline had been slowing compared with the 12%-14% declines evident since June.

A6 Consensus Economics forecasts for growth in South East Asia in 2002 had begun to stabilise. South East Asian export values had begun to increase from August. Korean industrial production had risen by 4.9% in November compared with a year earlier; electrical machinery production had increased 9.3% in the year to November. The rates of decline in electrical machinery production in Malaysia and Taiwan had also shown signs of slowing.

A7 The spot price for Brent crude oil had risen to around \$20 per barrel, an increase of around \$1 from the price at the time of the Committee's previous meeting. The *Economist* all-items commodity price index had fallen by 1% since the Committee's previous meeting, while the industrial metals index had fallen by 2% over the same period, reversing some of the 11% increase in November. The *Economist* non-food agricultural commodities index had risen by 2%; the price of foods had fallen by 1%. The Baltic Dry Index of Freight Transport Costs had indicated that transport costs had risen by around 10% following the terrorist attacks on the US, but had since fallen back to near their pre-September 11 levels. There had been evidence that at least some types of computer memory chip prices had risen sharply, and had more than doubled since their low point in the autumn.

A8 In the United States, producer prices had fallen by 1.1% in the year to November, compared with a 0.4% fall in the year to October. As last month, this had been largely attributable to falling energy prices. Annual consumer price inflation had fallen again in November to reach 1.9% compared with 2.1% in October, which had again been attributable to the decline in energy prices. Core consumer price inflation (which excludes energy and food prices), however, had risen to 2.8% in November compared with 2.6% in October. Euro-area producer prices had fallen by 0.7% in the year to October and 1.3% in the year to November: in both months, the falls reflected declining energy prices. German producer prices had risen by 0.1% in the year to November following a 0.6% increase in October. The euro-area harmonised index of consumer prices (HICP) had risen by 2.1% in the year to November, compared with a 2.4% increase in October; the preliminary estimate for December was 2.0% year-on-year. Preliminary German HICP inflation in December had been 1.6% year-on-year, compared with 1.5% in November; in Italy it had been 2.3%, the same as in November. In Japan, annual consumer prices had fallen -1.0% in November, compared with -0.8% in October.

A9 The shorter maturity interest rates in the United States implied by futures contracts and government bond yields had been little changed, but longer maturity rates had risen. Equity indices had increased in the United States (the Wilshire 5000 had risen by 1.8%) and the euro area (the Dow Jones Euro Stoxx index had risen by 1.6%) since the Committee's previous meeting. In Japan, the Topix had fallen by 0.3%: this fiscal year, it had declined by around 22%, and the banking stocks in Topix had declined by almost 40%. In Japan, spreads for lower-rated corporates had also widened and some bank prime lending rates had risen. US dollar-denominated sovereign bond spreads in most Latin American markets had narrowed slightly during the month, but spreads in Argentina had again widened sharply.

II Monetary and financial conditions

A10 The twelve-month growth rate of notes and coin had risen to 8.7% in December, compared with 8.2% in November. The twelve-month growth rate of M4 had remained unchanged in November, at 8.2%. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 9.7% in November, below 10% for the first time since February 2000.

A11 The twelve-month growth rate of households' M4 deposits had remained at 9.1% in November. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen, to 10.8%. Those growth rates had been the highest in nominal terms since 1991 Q2 and 1991 Q1 respectively.

A12 Within total lending to individuals, annual growth of secured lending had risen to 10% in November. The number of loan approvals for house purchase had risen, and the annual growth rate of unsecured lending had risen to 13.1% in November. Total lending for consumption had risen sharply in Q3, within which mortgage equity withdrawal had been strong at £7.0 billion. The household debt to income ratio had continued to rise in Q3, while household income gearing had fallen slightly.

A13 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen to 5.4% in November. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had risen to 9.3%. The flow of total external corporate finance had been £4.5 billion in November, compared to £3.8 billion in October.

A14 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had fallen to 7.6% in November. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had slowed, to 7.1% in November, and had reached its lowest level since October 1999.

A15 Short-term nominal interest rates had risen at all maturities since the Committee's previous meeting. The general collateral repo two-week forward rate had risen by some 60 basis points around one year ahead. Uncertainty about interest rates three and six months ahead, as measured by the volatility implied by options on short sterling futures, had fallen on the month by just under 5 percentage points. Longer-term nominal forward rates had also risen over the month. This rise out to

about 10 years had been partly associated with a rise in real yields, which had risen at all maturities. Ten-year real yields had risen since the low point observed in November by less in the United Kingdom than in the United States but by more than in France.

A16 Inflation expectations derived from gilts at maturities of up to ten years had risen since the Committee's previous meeting, with increases of up to 20 basis points between three and five year maturities. Beyond ten years, these expectations had remained broadly unchanged. Monthly inflation expectations of participants in HMT's survey for 2002 Q4 and the Consensus Economics year average forecast for 2002 had both fallen in December, to 2.1% and 2.2% respectively.

A17 Quoted unsecured lending rates for personal loans and overdrafts had remained unchanged in December. Credit card rates had fallen by 41 basis points. Between January and November 2001, effective personal loan rates (calculated as interest flows as a percentage of average daily balances) had fallen by 117 basis points, while quoted rates for personal loans had risen by 35 basis points. The standard variable rate (SVR) for mortgages had fallen by 45 basis points in response to the November rate cut. The two-year discounted rate had remained unchanged. The two-year fixed mortgage rate had fallen by 13 basis points, but the spread over two-year swaps had continued to widen.

A18 Spreads over gilts in the Merrill Lynch aggregate index of investment grade corporate bonds had fallen slightly across all the main sectors since the Committee's previous meeting. Non-gilt sterling bond issuance had continued to be strong in December. Banks' average interest rates on loans to PNFCs had continued to fall in November, taking the total fall since January 2001 to 144 basis points.

A19 The FTSE All-Share and FTSE 100 indices had remained broadly unchanged since the Committee's previous meeting, while the FTSE 250 and FTSE Small Cap had risen by 3.7% and 2.1% respectively. A decomposition of the sources of changes in the FTSE 100 into changes in real interest rates and in expected profits had suggested that the fall in the market over the year had been driven primarily by weaker profit prospects. The number of profit warnings issued in December had fallen compared with the previous month, but had been greater than in December 2000.

A20 Since 4 December, the sterling exchange rate index (ERI) had risen by 1.8% to 106.9. This reflected a 1.2% appreciation of sterling against the US dollar, a 1.5% appreciation of sterling against the euro, and an 8.1% appreciation of sterling against the yen. Relative movements in nominal yields

at shorter maturities were consistent with a small appreciation. The December Consensus Economics forecast of the short-term ERI profile had been similar to most of those forecast in the previous few months.

III Demand and output

A21 In the National Accounts, quarterly real GDP growth at market prices had been unrevised from the previous release, at 0.5% in Q3. Annual growth had been revised up slightly, to 2.2% from 2.1%. GDP at factor cost had grown less rapidly in Q3 than GDP at market prices, at 0.3%. The National Accounts included revisions to GDP and its components from 2000 onwards. The net impact of those revisions had been to raise the level of GDP at market prices in 2001 Q3 by 0.3%.

A22 On the output measure, GDP growth at basic prices had been revised down to 0.3% in Q3 from 0.4% in the previous release. But this revision had been more than offset by upward revisions to earlier data, so that the level of GDP in 2001 Q3 was 0.3% higher than had been estimated previously. Service sector output growth in Q3 had been unrevised at 0.6%. The decline in manufacturing output had been revised, from -0.8% to -1.1%.

A23 On the expenditure measure, quarterly final domestic demand growth in Q3 had been unrevised at 0.5%. Revisions to past consumption data had caused the level of consumption in 2001 Q3 to be over 0.5% lower than had previously been estimated. Those revisions had been concentrated in the first three quarters of 2001. In Q3 itself, consumption growth had been revised down to 1.0% from 1.3%, but this had been offset by an upward revision to whole economy investment growth to -1.6% from -2.6%. Domestic demand growth had been revised up to 0.6% from 0.5%.

A24 The revision to whole economy investment growth in Q3 had been accounted for by an upward revision to business investment growth, from -4.1% to -1.6%. Within that, manufacturing investment had been estimated to have fallen by 11.1% in Q3. This had been the sharpest decline since 1969. Service sector investment had fallen by 1.7%.

A25 Real government consumption growth in Q3 had been unrevised at 0.7%. But there had been upward revisions to earlier data, such that the level of real government consumption had been revised

up by 1.0%.

A26 The contribution to GDP growth from stockbuilding in 2001 Q3 had been revised up to 0.1 percentage points from the previous estimate of a zero contribution. Within stockbuilding, underlying stocks had made a positive contribution of 0.2 percentage points to GDP growth, while the alignment adjustment had contributed -0.1 percentage points.

A27 Total exports of goods and services had fallen by 3.6% and imports had fallen by 2.7% in Q3. Recent falls in UK imports of goods had been dominated by ICT goods, but the fall in exports had been more broadly based. The contribution of net trade to GDP growth had been revised down to -0.2 from -0.1 percentage points.

A28 On the income measure, households' real post-tax labour income had risen by 0.2% in Q3. In contrast, households' real post-tax total income had fallen by 0.8%, driven by a sharp fall in net property income. The saving ratio had fallen to 4.2% in Q3 from 5.9% in Q2. The household financial balance had fallen back into deficit, at -1.0% of GDP in Q3, from a small surplus in the first half of 2001.

A29 The gross operating surplus of public and private corporations had risen by 4.3% in Q3, which had been the strongest growth rate since June 1999. The increase had been driven primarily by financial corporations, whose gross operating surpluses had grown very sharply. There had also been a sharp reduction in the corporate sector's net financial deficit in Q3. The movements in the household and corporate sector financial balances had been broadly offsetting, such that the total private sector net financial deficit had narrowed only slightly in Q3.

A30 The current account deficit had narrowed sharply in Q3, to £2.0 billion, from £4.6 billion in Q2. The trade deficit had been broadly unchanged at £5.4 billion.

A31 Turning to Q4, retail sales had risen by 1.3% in November, from an upwardly revised 0.1% in October. The December CBI Distributive Trades survey had reported that sales had been the highest for the time of year since December 1986. The British Retail Consortium (BRC) Retail Sales Monitor had reported that retail sales had grown by 8.1% on the year to December, compared with 8.2% in November. Vehicle consumption had remained strong in November. The Society of Motor

Manufacturers and Traders (SMMT) new car registration figures for December showed a 17.3% rise compared to December 2000. The total number of new registrations for 2001 was 10.7% higher than the figure for 2000.

A32 The GfK measure of consumer confidence had improved in December, to -1 from -3 in November. This had reflected an improvement in consumers' expectations of both their own financial situation and the general economy.

A33 The Halifax and Nationwide house price indices had risen by 2.9% and 1.9% respectively in December. In the three months to December compared with the previous three months, the Halifax index had grown by 2.9% and the Nationwide index by 2.8%. Particulars delivered had risen by 8,000 to 131,000 in November, which had been the highest level of housing market activity since the beginning of 2000.

A34 Manufacturing output had fallen by 0.3% in October. This fall had continued to be accounted for primarily by falls in the output of electrical and optical equipment industries and, to a lesser extent, by falls in the production of transport equipment. There had been signs that the rate of decline in output of the electrical and optical equipment sector had eased in recent months. But new orders to this sector had remained weak. The Chartered Institute of Purchasing and Supply (CIPS) manufacturing activity index for December had shown a sharp fall in manufacturing output. The Engineering Employers' Federation (EEF) Engineering Outlook Survey for Q4 had shown a further fall in output and new orders in the engineering sector.

A35 The CIPS services activity index for December had shown signs of an improvement, although it had remained below 50. The latest CBI/PricewaterhouseCoopers Financial Services survey showed a stabilisation in business confidence, despite reported falls in business volumes and profitability.

IV Labour market

A36 According to the Labour Force Survey (LFS), employment had increased by 24,000 in the three months to October compared to the previous three months. This had been more than accounted for by increases in employees (22,000) and the self-employed (36,000), which had been offset by a 32,000 fall in people on government-supported training and employment programmes. The working age

employment rate had remained flat at 74.6% in the three months to October compared to the previous three months. Although employment in heads had risen, total hours worked had fallen by 0.3% in the three months to October, reflecting a 0.5% fall in average hours.

A37 The number of Workforce Jobs had fallen by 54,000 in Q3, but were 116,000 higher than a year earlier. The largest falls had been in production and agriculture. The change in employee jobs in Q3 was broadly similar to the fall implied by an equivalent LFS-based estimate. The Workforce Jobs series had been rebench to the December 2000 Annual Business Inquiry. This had resulted in a 238,000 upward revision to the level of Workforce Jobs in 2001 Q3.

A38 The CIPS employment index for the manufacturing sector had shown a further deterioration in December. But the overall index had remained unchanged, as the construction and services indices had ticked up slightly. The Recruitment and Employment Confederation survey indices of demand for permanent and temporary agency staff had risen slightly, although both were still below the level indicating no change in demand.

A39 The LFS measure of unemployment had risen by 29,000 in the three months to October, compared with the previous three months. The rate had risen by 0.1 percentage points to 5.1%. Over the same period, claimant-count unemployment had fallen by 14,100, but it had increased by 7,500 in October and 4,800 in November. Inflows into the claimant count had continued to rise. In the past, increases in inflows tended to precede upturns in the level of the claimant count.

A40 Inactivity among those of working age had fallen by 1,000 in the three months to October, leaving the rate unchanged at 21.3%.

A41 Headline (three-month average basis) whole-economy annual earnings growth had risen by 0.1 percentage points to 4.4% in the year to October. Headline earnings growth in the private sector had been unchanged from September at 4.0%; headline earnings growth in the public sector had fallen by 0.1 percentage point to 5.7%. Actual whole-economy earnings growth had been 4.4% in the year to October.

A42 Whole-economy regular pay growth (not seasonally adjusted) had remained at 5.0% in the year to October. Bonuses had contributed -0.6 percentage points to earnings growth. The level of bonuses

was significantly lower than a year earlier.

A43 According to the Bank's settlements database, the twelve-month AEI-weighted mean settlement had remained unchanged at 3.3% in November. The Bank had so far received information on 40 agreements effective in November, covering 130,000 employees.

A44 Annual growth in productivity, on the official National Statistics measure, based on Workforce Jobs, had declined by 0.2 percentage points to 1.3% in Q3. On a total hours basis, productivity had increased by 0.9% per hour on a year earlier. Annual growth in unit wage costs had fallen by 0.7 percentage points to 3.1% in the year to Q3.

V Prices

A45 The Bank's sterling commodity price index had fallen by 0.7% in November. Further falls in oil prices had outweighed increases in the prices of domestic food and gas. The annual change in the index had fallen for the sixth consecutive month in November to -11.9%, the lowest rate since October 1998.

A46 Oil prices had been quite volatile in December. Average sterling oil prices had been around 2.5% lower in December than their average level in November, and approximately 25% lower than a year earlier, but spot prices were around 4% higher than at the time of the December MPC meeting.

A47 Manufacturers' input prices had fallen by 1.0% in November. This had mainly reflected further falls in the prices of crude petroleum products and of several imported components. Annual input price inflation had fallen for the seventh consecutive month to -11.1% in November, from -9.1% in October, the lowest annual rate since April 1997. Looking ahead, the CIPS manufacturing survey had indicated that input prices had fallen further in December, albeit at a slightly slower rate: the CIPS input price index had risen slightly to 40.9 in December from 40.4 in November, but had remained significantly below the 50 no-change level.

A48 Manufacturers' output prices excluding duties (PPIY) had fallen by 0.1% in November. The annual inflation rate had fallen to -0.2%, the lowest rate since June 1999. The annual inflation rate of total output prices had fallen again in November to -1.0%, the lowest since the comparable series

began in 1958. Survey data had continued to point to weak output price inflation going forward. The CBI Monthly Trends survey expected output price balance had remained at historically low levels, rising slightly to -29 in December from -30 in November.

A49 The annual inflation rate of the GDP deflator at market prices had risen to 2.4% in 2001 Q3 from 2.3% in 2001 Q2. Within this, the annual inflation rates of the household consumption and the government consumption deflators had been 1.9% and 3.1% respectively in 2001 Q3. The annual inflation rate of the imports deflator had fallen sharply from 1.9% in 2001 Q2 to -0.7% in 2001 Q3.

A50 Annual RPIX inflation had fallen by 0.5 percentage points in November to 1.8%. This had been driven by a sharp fall of 0.9 percentage points in annual goods price inflation in November to -0.5%. Annual services price inflation had been unchanged at 4.0% in November. On the RPI measure, annual inflation had fallen by 0.7 percentage points to 0.9% in November. Annual RPIY inflation had fallen in November to 2.2% from 2.8% in October, while annual HICP inflation had fallen to 0.8%, down from 1.2% in the previous month.

VI Reports by the Bank's Agents

A51 The Bank's regional Agents had reported that manufacturing output and orders had continued to fall, but that the rate of decline had probably slowed. Output from the healthcare, food and niche engineering sectors had remained strong. However, the outlook for civilian aerospace had worsened, and orders for ICT were not expected to recover until the second half of 2002. The shift of manufacturing offshore had continued at a steady pace, and export prospects had generally remained weak. Subsidiaries of foreign-owned companies had seen further cuts in investment budgets. Investment in the retail sector, infrastructure and public sector construction, however, had remained strong.

A52 Consumer services turnover had continued to grow at a steady pace. Most leisure services had seen strong growth in turnover, other than transatlantic holidays and hotels dependent on overseas visitors. Turnover in business services had flattened out as companies had continued to economise on travel, information technology, professional services and advertising. There had been some limited signs, such as a pick-up in conference bookings, that growth in business services might recover in 2002 Q1. Employment in services had continued to grow, albeit slowly, but this had been more than

offset by continued falls in manufacturing employment.

A53 The Agencies had spoken to retailing contacts on 2 January about pre- and post-Christmas trading. Overall, sales had exceeded last year's levels, and turnover had been higher than most retailers' expectations. Growth in sales of luxury foods and big-ticket items, such as games machines, DVD players and jewellery, had been strong. Sales via the Internet had also been stronger than retailers had expected. There had been less pre-Christmas discounting than in previous years due to the strength of demand, and this, combined with better stock control, had resulted in a lower volume of stock in the January sales. Northern and western regions had reported stronger growth in sales than London and the south, whereas sales in London and the south had been relatively stronger during Christmas 2000.

VII Market intelligence

A54 Since 4 December, implied rates from short sterling futures contracts had risen and the curve had steepened. Rates implied by the contract expiring in March 2002 had risen by some 30 basis points over the period, partly in response to better-than-expected non-manufacturing ISM data in the United States on 5 December and better-than-expected UK retail sales data on 13 December. Comments about the strength of consumer spending had also prompted a rise in short-term interest rate expectations. The curve steepness, as measured by the difference between rates implied by those contracts expiring in December 2003 and those expiring in March 2002, had widened further to about 180 basis points on 9 January from around 160 on 4 December. The steepening of the yield curve might have partly reflected technical factors, including low liquidity ahead of the year-end and changes in term premia. Consequently, the steepness of the short sterling curve might have exaggerated the extent to which official interest rates were expected to rise in 2002.

A55 Market participants had generally expected the Committee not to change the Bank's official repo rate in January. Similarly, economists polled by Reuters between 2 and 4 January had attached a mean probability of only 23% to a reduction in the Bank's official repo rate. A majority of traders had expected a rate rise in the second half of 2002.

A56 Sterling had appreciated by 1.8% in effective terms since the Committee's previous meeting. Sterling's rise in effective terms included a gradual appreciation to a high of 108.2 at the end of December, in part reflecting the fact that short term interest rates in the UK had risen by more than

overseas, and in part reflecting a number of temporary supportive influences in thin holiday markets. However, the ERI had fallen sharply on 2 January when sterling recorded its largest one-day fall against the euro since the single currency was introduced in January 1999. Market participants attributed the depreciation of sterling in part to the general strength of the single currency in the aftermath of the introduction of euro notes and coin on 1 January, and also to the unwinding of some of the transitory factors that had contributed to sterling's appreciation during December.