Publication date: 22 May 2002

MINUTES OF
MONETARY POLICY COMMITTEE MEETING
8 and 9 May 2002

These are the minutes of the Monetary Policy Committee meeting held on
8 and 9 May 2002

They are also available on the Internet
(http://www.bankofengland.co.uk/mpc/mpc0205.pdf).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 5 and 6 June will be published on 19 June 2002.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 MAY 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; the projections for GDP growth and inflation to be published in the May *Inflation Report*; and other considerations. The Committee had also received a letter from the Chancellor (attached as an Annex) setting out the inflation target at which the Committee should aim in accordance with section 12 of the Bank of England Act 1998.

The world economy

2 In the United States, recent data suggested that output had grown strongly in the first quarter. More than half the 1.4% growth was accounted for by the contribution from inventories, which were now no longer falling, but final sales to domestic purchasers were also growing strongly and had repeated the near 1% growth seen in the fourth quarter of last year. Productivity had increased by 2.1% on the quarter and by more than 4% on the year. All this confirmed that the economy had picked up quite quickly from last year's trough.

3 The question remained, though, to what extent growth would be sustained in the coming quarters. So far, the recovery had not added to employment: indeed, the unemployment rate had increased to 6%. Business confidence had slipped a little, after several months of rapid improvement. There were as yet few signs of a pick-up in investment, and capital goods orders were little changed from the fourth quarter. The resilience of consumption could weaken as household debt burdens increased. There were downside risks to asset prices, which could – if they crystallised – also affect consumption. These risks had increased in the past month, as information had become available to investors about the disjunction between investment bank stock recommendations and analysts' private views, and with more widespread concerns about accounting practices.

4 The Committee's latest projections, which were broadly in line with recent outside forecasts, did not, however, assume that growth would continue at its recent pace, as the boost from the turnaround in the inventory cycle would be only temporary. The benchmark against which to judge the sustainability of the recovery should be that of a more gentle pace of growth for the rest of this year. The recent pick-up in investment in information and communications technology (ICT) was

encouraging and suggested that any investment overhang in the United States might now be quite limited. Market and business concerns about the recovery, reflected in rather weaker equity market prices, could be associated as much with doubts about the extent to which corporate profitability would recover as with doubts about the sustainability of the output recovery itself. Both fiscal and monetary policy in the United States remained supportive.

5 Turning to developments elsewhere in the world economy, the Committee noted that there was little change in the euro area. Confidence had again improved a little and industrial production was somewhat stronger, but it was notable that – despite the slowdown last year – core inflation remained stubbornly persistent and there were signs that this might now be leading to pressure for higher wage settlements. Recent activity data from Germany seemed quite weak, particularly in the light of the sharp US recovery. In Japan, industrial production had increased in the first quarter (the first quarterly increase since the end of 2000) but, as in the euro area, this largely reflected the external stimulus provided by the US recovery. There was little evidence, either in Japan or in the euro area, of any domestic engine for sustained growth. It was, however, encouraging, given the ICT-related origins of the slowdown, that there were a number of signs around the world that high-tech activity was strengthening: electrical machinery production had picked up in a number of Asian economies, notably in South Korea; computer production in the United States was now 6% above its trough; and even in Europe, sales of semiconductors had increased.

Money, credit and asset prices

6 There was little evidence in the monetary data of any slowing in the pace of consumer expenditure growth in the United Kingdom, with notes and coin 8% higher in the year to April. Broad money growth had, however, eased to 5½% on an annual basis in March, and was growing less rapidly than this on an annualised three-month or six-month basis. The main feature of the data for total credit remained the marked difference between the household sector, whose use of credit was some 12% higher than a year ago, and the corporate sector, whose borrowing from the banking system had increased by only 5% in the year to March and was in fact lower in the first quarter than in the fourth quarter of last year. Manufacturers in particular were continuing to repay debt. Overall, therefore, these sectoral differences were increasing.

7 Measures of house prices now uniformly signalled a rapid rate of increase, with both the Halifax and the Nationwide indices increasing at over 15% at an annual rate. Even the DTLR index (which

had shown prices in the fourth quarter up less than 5% on a year earlier) showed an annual increase of over 9% in the first quarter of this year. The preview of the latest survey by the Royal Institution of Chartered Surveyors suggested that the near-term outlook for prices had strengthened, and demand for mortgages was reported by lenders to be rising. With the ratio of house prices to earnings above its historical average, the question was how soon this house price inflation would begin to slow and the speed with which it would do so. It was by no means obvious that the current level of house prices was unsustainable. The central May projection was for a slowdown in house price inflation, although there were risks on either side of this. But the longer house price inflation remained high, the greater the risk of a sharp correction.

8 Several perspectives on these data were discussed. First, the debt-servicing burden arising from current levels of mortgage debt seemed to be sustainable at current levels of interest rates. It was also noted that, by comparison with the late 1980s, interest servicing alone might convey too sanguine a picture of the commitments implied by current levels of indebtedness. However, estimates of debt servicing that included regular principal repayments suggested that it was still below its average since the mid-1980s. Second, much of the pressure on house prices had recently been at the lower end of the market, where there were many potential purchasers who were anxious to enter the market. The record low level of additions to the housing stock, combined with the rising number of households, suggested that upward pressure on the prices of entry-level properties could persist. The binding constraint on these purchasers, however, was typically the size of the loan they could obtain relative to their income, not – as had been the case in the 1980s boom – their ability (at current levels of interest rates) to service it. Provided lenders remained prudent, that might suggest that an increase in interest rates would not of itself create similar servicing difficulties. Third, the combination of mortgage contracts denominated in nominal terms and high nominal interest rates had in the past entailed a front-end loading of real repayments. That had been a constraint on house purchase. Now that nominal rates were lower, it was possible that a higher equilibrium level of prices could be sustained. If, however, purchasers were entering the market under misperceptions of the real burden their borrowing would entail, there would be cause for concern.

9 More generally, it was not house prices themselves which were relevant for policy, but their implications for household consumption (and so, for aggregate demand) and the way it might be affected if debt burdens became less sustainable or house price expectations were not fulfilled. A significant proportion of recent mortgage lending represented withdrawal of equity. But households did not, in aggregate, seem to be converting additional debt into consumption: the saving ratio had

remained broadly stable in the past few years. In addition, mortgage contracts offered more servicing flexibility than had historically been the case. If the economy were to weaken and unemployment to increase, some borrowers might nonetheless find their debt servicing commitments more onerous than they had expected, intensifying the slowdown in consumption.

10 In the foreign exchange markets, the US dollar had fallen by just over 3% against the euro since the Committee's previous meeting, and sterling's effective exchange rate had weakened by about 1%. Though the movements had been relatively small by historical standards, it was notable that the euro had strengthened against the dollar at a time when the US economy appeared to be growing more strongly and against a background of political uncertainties in the euro area. This suggested a possible change in market sentiment.

Demand and output

11 The first estimate of GDP growth in the first quarter, of 0.1%, was lower than expected, with both manufacturing and services weaker than had seemed likely on the basis of survey and other information. Upward revisions to early estimates were not unusual, and recent surveys had been almost universally strong: the CBI measure of business optimism showed the strongest improvement since 1994 and the largest quarterly turnaround for over 25 years; the forward-looking indicators in the surveys carried out by the Chartered Institute of Purchasing and Supply (CIPS) had increased; and monthly output and new orders balances in both manufacturing and services had increased across a range of surveys. Nonetheless, the contrast between the backward-looking official data and the survey information made it hard to determine the current pace of, and near-term outlook for, output growth.

12 In assessing this conflicting evidence, some members noted that the surveys of manufacturing output had not proved to be wholly reliable indicators of the steepness of the slowdown last year and the unexpectedly weak manufacturing production data suggested that the pick-up in surveys this year had not yet been reflected in higher growth. It was also pointed out that, despite the apparent improvement in optimism and in orders, there was little sign even in these surveys that investment plans or employment intentions had strengthened. The surveys could be interpreted as suggesting that growth in the second quarter would be stronger than in the first. In addition, the strongest survey indicators related to April rather than to the first quarter. So it would not become clear until data for more recent months became available whether or not these surveys were misleading. When the Committee had agreed to reduce interest rates by 50 basis points in November, one stated reason had

been that it was thought very unlikely that the surveys would bounce back as they had done in analogous circumstances in late 1998 and early 1999. Of course, the recovery in the surveys in part reflected that decision. But a uniform and substantial improvement of this kind was unusual and should not be ignored. It remained to be seen, however, whether it would be sustained, and whether it would be translated into actual output growth.

13 Consumption growth had slowed to 0.9% in the fourth quarter, from 1.1% in the second and third, and was expected – on the basis of retail sales data and private vehicle registrations – to ease further in the first quarter. But it was unclear whether this trend would continue: the CBI Distributive Trades survey and vehicle registrations in April had been strong, as had household borrowing, consumer confidence and the housing market. All suggested considerable support for continued robust consumption growth.

14 The Committee had discussed extensively the likely demand and output implications of the Chancellor's 17 April Budget announcements in preparing its latest *Inflation Report* projections. Initial outside commentary had suggested that there would be no net effect on demand, as both spending and taxes had been increased with little net effect on the fiscal position. Analysis for the Committee had, however, made it clear that there could be a material impact on activity and on inflation. This would be principally because of the demand implications of a balanced budget fiscal expansion. There might also be effects as a result of the way firms and workers adjusted to the increased levels of employer and employee National Insurance contributions.

15 There were likely to be two main factors which would determine the size of the balanced budget stimulus. The first was the extent to which the import intensity of government spending on goods and services differed from that of private sector spending. This was difficult to judge, since it would depend on the composition of the additional spending. The second was the extent to which increased government spending would be used to increase the wages of existing public sector workers (which would in effect simply be a transfer from those paying the higher taxes). This would reduce the scale of the demand effects. But the Budget still seemed likely, on this analysis, to add to aggregate demand growth once the new spending plans took effect.

16 Other possible consequences of the tax changes were discussed. It was possible that firms might respond to any real wage resistance (which would increase the relative cost of labour) by reducing employment and output. Households might reduce consumption in anticipation of the additional tax

burden, before the tax changes took effect. Evidence was also cited by some members that the effect on demand of a balanced budget increase in government spending was less marked than was embodied in the Committee's central view, with some estimates for other countries even suggesting an effect that might be close to zero. It was agreed that further analysis would be desirable.

The labour market

17 The effects of the increased National Insurance contributions from April 2003 were also important, particularly in assessing the possible consequences for wages and prices. While it was generally accepted that, in the long run, the real burden of the increases to both employer and employee contributions would ultimately fall on employees, there was great uncertainty about how the process of adjustment to this change in taxes would take place and therefore what its consequences for wages, employment and prices might be.

18 In discussing this issue, the Committee had considered various channels through which adjustment might take place. Employers might decide not to pass on in price increases the higher costs implied by their own increased contributions, either because of competitive pressures or because they were confident that the Committee would act to maintain inflation close to target. So they would either need to curtail wage increases or face a squeeze on their margins. If the latter occurred, they would probably initially reduce employment in order to improve average productivity. The resulting increase in unemployment would in due course push down the rate of increase of wages, thus eventually restoring the level of employment. And if employees resisted the increase in their National Insurance contributions by bargaining for higher nominal wages and were able initially to shift the burden to employers, prices might then rise or employment might fall. The consequences for wages and prices therefore depended crucially on the extent to which employees attempted in the short run to resist the necessary slowing in real wage growth and on the nature of any consequent adjustments.

19 Unemployment had fallen in the first quarter, rather than increasing in line with the Committee's February projection. Data on the gross flows of workers between employment and unemployment showed no indications that unemployment was about to increase significantly. This change of view seemed to fit well with the recent data and with survey indications of continued moderate employment growth: despite the lower-than-expected level of unemployment, it was noted that the labour market remained a benign influence on current inflationary pressures. This outcome for unemployment was associated with higher-than-expected inactivity and lower average hours worked. The latter suggested

some spare capacity in the labour market. This could be absorbed as output growth picked up, without the need for substantial increases in employment.

20 The recent marked movements in earnings growth were to a large extent accounted for by the substantial changes in bonus payments compared with a year ago: bonuses had contributed a fall of over 3 percentage points to measured earnings growth in February. This component of earnings growth should diminish in size in the coming months and exert little downward effect in the second half of the year. At the same time, regular pay was also growing less strongly and had eased from about 5% in the second and third quarters of last year to 4.2% in the year to February. Falls in paid overtime hours seemed to account for rather little of this change. But there could be an additional contribution from falls in paid hours more generally, which was hard to quantify.

Prices and costs

21 Annual RPIX inflation had risen a little in March, mainly reflecting slightly higher services price inflation. The level of oil prices in sterling terms had been much the same at the end of April as at the end of March, but the average for April had been about 6% higher than the corresponding figure for March, because of the increases during that month, and was little changed on a year earlier. Oil prices had however fallen by 7% between the April and May meetings. Despite this considerable volatility in oil prices, the price two years ahead implied by futures prices was still around $22. More broadly, there was no evidence of any build-up in price pressures in the supply chain.

22 Survey data too gave little hint of inflationary pressures. While input price measures had been edging up, particularly in the CIPS survey of manufacturing, the survey balances were still at or below their series averages. It was only in the construction sector that the surveys showed any evidence of inflationary pressure.

The May GDP growth and inflation projections

23 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 15 May.

24 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 pick up relatively rapidly in the coming quarters

and to be at above-trend rates from early 2003. The central projection for inflation was for it to slow to about 2% in the near term and then to increase steadily, reaching a little above the 2½% target by the two-year horizon and continuing to rise. In the *Inflation Report* fan charts, the balance of risks to growth was weighted slightly to the downside, reflecting the risks to the world outlook and of the possibility of slower growth in private final domestic demand in the United Kingdom. The risks to inflation were judged to be moderately on the upside, with the risks of a sharper depreciation in sterling and of greater upward pressure on wages and prices from the increase in National Insurance contributions more than offsetting the implications for inflation of the downside risks to output growth.

25 Some members preferred different assumptions for the central projection. Some believed that the projection underestimated the disinflationary impact on UK price setting of the low rate of world export price inflation. Some differed in their assessment of the impact of the Budget spending and tax changes on the economy. As a result, some members thought that the most likely outlook for inflation was a little higher than the central projection and others that it might be up to 1/3 percentage point lower.

Other considerations

26 The Committee noted that there was no expectation, in financial markets or among the economists polled regularly by Reuters, that the repo rate would be changed this month, although there was a widespread consensus that the next change would be to increase the rate. Opinion on the timing of that change was divided. The decision of the Federal Open Markets Committee at its latest meeting to leave US rates unchanged would, it was suggested, have reinforced the UK market view of no change here this month.

The immediate policy decision

27 The Committee agreed that the prospects for the world economy now appeared to be a little less strong than had seemed likely a month ago. The rapid recovery in the United States, associated in large part with the stock cycle, had faltered in the past month and it seemed probable that the pace of the recovery there would now moderate. While it was encouraging that the ICT sector was showing evidence of recovery, not just in the United States but elsewhere in the world, the recent falls in equity prices could signal doubts about future profitability. Such doubts would not encourage the pick-up in investment which would be needed to underpin a more durable recovery. The evidence for recovery

elsewhere in the world, notably in the euro area and in Japan, seemed limited. Those economies were at present dependent for recovery on increased demand from the United States and lacked any obvious domestic engine for sustained growth. Core inflation in the euro area remained persistent.

28 In the United Kingdom, recent data were somewhat less encouraging than the Committee had expected a month ago. In particular, current estimates of GDP growth were below expectations in both the fourth quarter of last year and the first quarter of this, and industrial production remained weak. In contrast, the forward-looking information from recent surveys pointed to a strong pick-up in the second quarter, although it was difficult to know how much weight this survey evidence should be given. Consumption growth might perhaps have eased a little, but consumer borrowing and the housing market remained strong; and early indications were that consumption growth would not ease significantly in the second quarter. Given the weaker-than-previously-expected prospect for world activity, this was not unwelcome. But the immediate issue, of whether UK consumption growth would ease as world demand recovered, or would need to be restrained by policy action, remained much as before.

29 In addition, the implications for demand and for inflation of the changes to taxation and spending announced in the Chancellor's recent Budget now needed to be considered. There were uncertainties about the impact of the Budget on demand, and about the way in which employers and employees would adjust to the higher National Insurance contributions, on which members of the Committee took differing views. Much of the effect would not, however, be felt immediately, given the deferred implementation of these changes, and the Committee agreed that there would be time for further analysis and to watch for early indications of any pass-through of the tax changes to wages and prices.

30 Against the background of the latest *Inflation Report* projections, which showed inflation rising above target by the two-year horizon and pressures continuing to build, members agreed that, in the absence of new information which changed those projections, the repo rate would need to be increased eventually. But members took different views on the future path of inflation and on the speed with which policy would affect it. Those differences had implications for their views both on how soon such an increase would be needed and on how large an increase would be required to continue to meet the inflation target.

31 Some arguments for an immediate increase in the repo rate were identified. For some members, the latest *Inflation Report* projection itself could justify that change. Given the upside balance to the

risks around the central projection, the mean of that projection was for RPIX inflation to reach 2.8% in two years' time and to be increasing. While the effects of the Budget on inflation were assessed to be small in the first two years of the projection, they could be more significant at longer horizons. Starting to increase interest rates now, to offset those future inflationary pressures and to assist in the process of accommodating the planned expansion of government spending, would limit the extent to which interest rates might eventually need to increase. In addition, such action would reinforce the signal given by the projections, that inflationary pressures were soon expected to build. It would also be a clear signal that the Committee would not be prepared to accommodate any inflationary pressures which might result from the way firms and workers adjusted to the tax changes announced in the Budget. Some members also noted the longer-term risks posed by the imbalances between final demand and output in the economy: the longer they were allowed to persist, the larger would be the adjustment which was eventually required and this could also, unhelpfully, be associated with sharp falls in the exchange rate. Concerns were also expressed that current rates of house price inflation were unsustainable. Action now to moderate house price inflation and to check the accumulation of household debt could help to reduce the risks further out.

32 There were, however, a number of arguments – given different weight by different members – for not increasing the repo rate this month. First, it was still not clear that recovery was well-established, either in the United Kingdom or in the world more generally, or how strong it would ultimately prove to be. While it would be wrong wholly to disregard the prospect of a strong pick-up in UK output, as was suggested by recent surveys, the sharp contrast between the surveys and recent outturns suggested that some caution was justified. Second, and related to the weaker tone of recent data, confidence could be fragile. An immediate increase in the repo rate might set it back and delay recovery. Third, while house prices were increasing at a pace which could not continue, their current level did not yet seem to be obviously unsustainable. Fourth, the near-term outlook for inflation was benign and much of the projected inflationary pressure did not become significant until towards the end of the forecast horizon. While recognising the need to be pre-emptive, members noted that some at least of the effect of a change in the repo rate would come through quite quickly and that an increase was not yet justified by the apparent pressures further out. Fifth, there were considerable uncertainties – particularly as to the possible effect of the increases in National Insurance contributions – about some of the factors which were in due course projected to push inflation above target. It was not clear, given the new monetary policy framework, that historical experience would be a good guide to assessing these effects. Those possible sources of inflationary pressure could be monitored and policy could then respond as necessary. Sixth, some members felt that the central projection for inflation was

too high. They did not expect inflation to rise above the target rate within the forecast horizon, and had a more balanced assessment of the risks. Some of the relevant arguments were that the inflation projection underestimated the level and growth rate of potential output; that it overestimated the demand effects of the Budget; and that it made too little allowance for the moderating effect of world prices on UK inflation. For these members, any increase in the repo rate might be some way off.

33 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.

34 Finally, the Governor expressed his appreciation to Ian Plenderleith and to Sushil Wadhwani for the contributions they had made as members of the Committee. The Treasury representative added the Chancellor's own thanks for the way they had discharged their responsibilities.

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 Wadhwani

Gus O'Donnell was present as the Treasury representative.

ANNEX: SUMMARY OF DATA PRESENTED BY BANK STAFF

This Annex summarises the analysis presented by Bank staff to the Monetary Policy Committee on 3 May in advance of its meeting on 8-9 May. 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

A1 US GDP had grown by 1.4% in Q1, according to the advance estimate. The strongest contribution had come from a turnaround in the large inventory correction seen during 2001, adding 0.8 percentage points to quarterly growth. Final domestic demand had grown by 0.9% on a quarter earlier. Consumption growth had eased to 0.9% in Q1, with higher spending on non-durables partly offsetting lower sales of motor vehicles. Investment had been flat over the quarter, with stronger residential investment and ICT spending offsetting lower demand for non-residential structures and other non-ICT durables equipment. Although exports and imports had both risen in Q1, net trade contributed negatively to quarterly growth, subtracting 0.3 percentage points. Non-farm business sector productivity had grown by 2.1% in Q1 compared to the previous quarter.

A2 Manufacturing output had risen by 0.8% in March compared to February. Production of ICT goods had increased by 1.4% over the previous month. The Institute for Supply Management's purchasing managers' index (PMI) for the manufacturing sector fell to 53.9 in April, from 55.6 in the previous month. The PMI for the non-manufacturing sector fell to 55.3 in April, from 57.3 in March. New orders for non-defence capital goods had fallen by 3.0% in March. Both the Conference Board and the University of Michigan measures of consumer confidence had fallen in April: the Conference Board measure had fallen to 108.8, from an upwardly-revised 110.7 in March, and the University of Michigan measure had fallen to 93.0 in April, from 95.7 in the previous month. The unemployment rate had risen to 6.0% in April from 5.7% in March. Non-farm payrolls had risen by 43,000 in April, following a downward revision, from +58,000 to –21,000, to the change in payrolls in March.

A3 Annual consumer price inflation in the United States had risen to 1.5% in March, from 1.1% in February, mainly as a result of higher energy prices. Core consumer price inflation (excluding movements in food and energy prices) had fallen to 2.4%, from 2.6%. Annual producer price inflation had risen to –1.4% in March, from –2.6% in February.

A4 Indicators of euro-area GDP growth suggested that activity would recover during the first half of 2002, unwinding the contraction during the final quarter of 2001. The €COIN indicator published by the Centre for Economic Policy Research had risen in March, following upward revisions for January and February. The European Commission’s GDP indicator in April had suggested quarterly growth of 0.2%-0.5% in 2002 Q1 and 0.5%-0.8% in 2002 Q2, both up 0.1 percentage points from March. In May, the Q1 forecast had been unchanged, but the Q2 growth range had been revised down by 0.1 percentage points. Euro-area industrial production had risen 0.2% during February, after being flat in January. German industrial production excluding construction had fallen by 0.3% in March relative to February. The euro-area purchasing managers’ index (PMI) for manufacturing had risen to 50.7 in April, from 50.0 in March. This was the first time in 13 months that it had been above the ‘no change’ threshold. The euro-area service sector PMI had also risen, to 53.3 in April from 53.1 in March, the fourth consecutive month of expansion. The European Commission’s measure of business confidence was unchanged at –11 in April. The confidence measure in the consumer survey had fallen to –10 in April, from –9 in March. The German IFO index had fallen to 90.5 in April, from 91.5 in March. Euro-area retail sales had risen 0.5% during February after falling 0.4% in January. French consumer spending on manufactured goods had grown by 1.2% in March relative to the previous month.

A5 The euro-area harmonised index of consumer prices (HICP) had risen by 2.5% in the year to March, up slightly from 2.4% in February. Annual core inflation in the euro area had risen to 2.5% in March, 0.1 percentage points higher than in February. The flash estimate had shown annual HICP inflation for the euro area declining to 2.2% in April. German HICP annual inflation had been 1.6% in April, down from 1.9% in March. Producer prices in the euro area had fallen by 0.8% in the year to March, reflecting the decline in energy prices during most of 2001. German producer prices had fallen by 0.2% in the year to March.

A6 In Japan, industrial production had risen by 0.5% in 2002 Q1, the first quarterly increase since 2000 Q4. Production of electrical machinery had risen by 3.2% during the quarter. Export volumes had fallen by 3.2% in the year to March, which had represented a considerable slowing in the pace of decline since the end of 2001. Japanese consumer prices had fallen by 1.2% in the year to March, while core consumer price inflation had fallen by 0.7%. Domestic wholesale prices had fallen by 1.3% in the year to March.

A7 The spot price for Brent crude oil was broadly unchanged since the Committee's previous meeting on April 3. *The Economist* all-item dollar price index had fallen 1.6% since the Committee's previous meeting. The industrial metals prices sub-index had risen 1.6%, whereas the food and non-food agricultural commodities sub-indices had fallen by 3.0% and 1.3% respectively.

A8 Most major international equity indices had fallen since the Committee's previous meeting. In the United States, the Wilshire 5000 index had fallen by 2.2%. In the euro area, the Dow Jones Euro Stoxx index had fallen by 4.8%. The FTSE All-Share index had fallen by 0.6%. In Japan, the Topix index had fallen by 0.2%. The declines had been accounted for mainly by falls in high-technology equity prices.

II Monetary and financial conditions

A9 The twelve-month growth rate of notes and coin had risen to 8.1% in April, from 7.5% in March. The three-month annualised growth rate had fallen to 5.5% in April, from 6.1% in March. The twelve-month growth rate of M4 had fallen to 5.3% in March, compared with 6.3% in February. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 8.0% in March, from 8.5% in February.

A10 The twelve-month growth rate of households' M4 had remained unchanged at 8.2% in March. The twelve-month growth rate of households' Divisia had fallen slightly to 9.0% in 2002 Q1. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had continued to rise in March, to 11.7%. The number of loan approvals for house purchase had fallen in March, to 111,000. Within total lending to individuals, the annual growth rate of secured lending had risen to 10.6% in March, and the annual growth rate of unsecured lending had risen to 15.1%.

A11 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had fallen to 6.5% in March, from 8.2% in February. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had fallen further, to 5.0%, from 5.6% in February. The average monthly flow of total external finance had been £3.4bn in 2002 Q1, similar to the figure in 2001 Q4.

A12 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had fallen to –2.9% in March, from 0.2% in February. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had declined further, to 1.8% in March, the lowest annual growth rate since 1976.

A13 Short-term forward nominal interest rates for the end of 2002 had fallen by up to 36 basis points since the Committee's previous meeting. Interest rate uncertainty three months ahead, as measured by the implied volatility from short-sterling futures, had fallen over the same period. Volatility had been little changed twelve months ahead. Long-term nominal forward rates had been little changed since the Committee's previous meeting. Forward real rates on index-linked gilts had risen since the Committee's previous meeting at maturities beyond five years, although this had partly reflected the influence of the auction of 2½ per cent index-linked Treasury Stock 2020 on 24 April.

A14 Implied forward inflation rates derived from conventional and index-linked gilts had fallen since the Committee's previous meeting at maturities beyond ten years. Inflation expectations of professional forecasters in the HMT monthly survey had remained at 2.3% for 2002 Q4 and 2003 Q4. The monthly Consensus Economics forecast for average inflation in 2002 had risen slightly, to 2.2% in April from 2.1% in March, while the forecast for 2003 had remained unchanged at 2.3%. The twice-yearly Consensus Economics long-term UK inflation forecast had shown that average ten-year expectations had fallen slightly over the past six months. By contrast, breakeven inflation rates, derived from conventional and index-linked gilts, had risen sharply over the same period.

A15 Quoted interest rates had shown little change in April. The effective mortgage rate had continued to fall in March and had now fallen by 13bp since December.

A16 The Merrill Lynch aggregate index of investment-grade sterling corporate bond spreads had changed little since the Committee's previous meeting, but spreads for the telecoms sub-index had widened.

A17 The FTSE All-Share index had fallen slightly since the Committee's previous meeting. The information technology (IT) and non-cyclical-services sectors had experienced the largest falls. The number of profit warnings issued in April had been the same as in March, below the high levels in 2001 and broadly in line with the average of the past five years.

A18 Between 3 April and 8 May, the sterling exchange rate index (ERI) had depreciated by 1.0% to 106.2. That had reflected a 1.5% appreciation of sterling against the US dollar, and a 1.6%

depreciation of sterling against the euro and the yen. The decline in the dollar against the euro and sterling could partly be explained by changes in interest differentials over the same period.

III Demand and output

A19 The ONS' preliminary estimate of quarterly growth of GDP at constant market prices in 2002 Q1 had been 0.1%, following 0.0% in 2001 Q4. Annual GDP growth had slowed to 1.0%, from 1.6% in 2001 Q4. Service sector quarterly output had risen by 0.5% in 2002 Q1, the same growth as in the previous quarter. Within services, output in the distribution, hotels and catering sector was estimated to have risen by 0.4% in Q1.

A20 Retail sales had risen by 0.9% in 2002 Q1, down from 1.3% in 2001 Q4. Annual growth in new private car registrations had also slowed in Q1, falling to 5.3% compared with 25.8% in 2001 Q4. But the CBI Distributive Trades Survey had pointed to strong annual growth in retail sales in April, with the reported sale balance rising to +57 from +31 in March.

A21 The GfK aggregate consumer confidence index had ticked up, to +4.2 in April from +2.8 in March. The index remained around the average seen in the first half of 2001. The component indicators had all improved, with the exception of households' perception of their own financial situation.

A22 The Nationwide house price index had risen by 3.4% in April, and by 4.1% in the three months to April compared with the previous three months. The Halifax house price index had risen by 0.7% in April, and by 3.8% in the three months to April compared with the previous three months. Particulars delivered had risen by 7,000 to 128,000 in February, and were 7.6% higher than a year earlier. The number of loan approvals for house purchase had fallen to 111,000 in March, from 116,000 in February. The March number had, however, been higher than the average for the previous six months.

A23 Annual net rates of return for PNFCs had fallen slightly in 2001 Q4, to 12.0%. For 2001 as a whole, the net rate of return had been 12.2%. Annual net rates of return in the manufacturing sector had edged up to 5.6% in 2001 Q4, from 5.4% in 2001 Q3. In contrast, annual net rates of return had fallen slightly in the service sector, to 13.0% in 2001 Q4, from 13.2% in 2001 Q3.

A24 The British Chambers of Commerce (BCC) survey for 2002 Q1 had reported a rise in service sector investment intentions, with the survey balance rising to +15, from +8 in 2001 Q4. On the other hand, the BCC survey had shown only a marginal recovery in investment intentions in the manufacturing sector, with the survey balance rising to –3, from –5 in 2001 Q4. The April CBI Quarterly Industrial Trends Survey had similarly shown only a small improvement in investment intentions: the balance had risen to –25 in April, from –28 in the January survey. The CBI survey had also shown that the proportion of manufacturing firms working below capacity had fallen to the lowest level since January 1993 and that manufacturers' stocks had been run down in Q1. Further destocking had been expected for Q2.

A25 Volumes of goods exports had fallen by 2.5% in February, and by 5.8% in the three months to February compared with the previous three months. Volumes of goods imports had also fallen in February, by 1.3%, but had been 0.2% higher in the three months to February than in the previous three months.

A26 Survey data for 2002 Q1 on the manufacturing sector had shown an improvement in business confidence. The CBI survey had shown the business optimism balance had risen to +21 in April, from –31 in the January survey. The survey balances for expected output and for orders had also turned positive. The BCC 2002 Q1 survey had shown a rise in domestic sales and orders. The CIPS April manufacturing survey had pointed to orders and output rising for the third consecutive month.

A27 In the service sector, the BCC survey for 2001 Q1 had shown an improvement in both domestic sales and orders. The balance for the former had risen to +26, from +17 in the previous survey. The balance for the latter had risen to +20, from +10 in the 2001 Q4 survey. The CIPS service sector survey for April had shown further improvements in business activity and incoming new business.

IV Labour market

A28 According to the Labour Force Survey (LFS), employment had increased by 30,000 in the three months to February 2002, compared with the previous three months. The working age employment rate had decreased 0.1 percentage points from the previous non-overlapping quarter, to 74.6%, and was 0.2 percentage points lower than a year earlier. Average hours had been unchanged at 32.6 hours per week, after declining during most of 2001.

A29 The CIPS, CBI and BCC employment surveys for April had all suggested continued improvements in the employment picture from 2001 Q4 lows. The CIPS manufacturing and services indices had both ticked up. The index for construction employment had been unchanged, at a positive balance. The CBI and BCC manufacturing and services surveys had indicated stronger employment intentions, and the April REC survey had reported both rising demand for agency staff and a slower rate of increase in staff availability.

A30 The Bank's regional Agents had surveyed a sample of UK employers on their employment intentions. Overall employment had been expected to change little over the rest of the year, with construction and retail contacts expecting some expansion, while manufacturing and other services firms had indicated that employment might decline. Most of the surveyed firms had indicated that they did not intend to adjust average employee hours. The Agents' survey had shown that employers preferred to use paid overtime hours and temporary employees to meet unexpected demand.

A31 The LFS measure of unemployment had fallen by 14,000 in the three months to February, while the rate had been unchanged at 5.1%. Over the same period, claimant-count unemployment had fallen by 3,000 and had fallen by another 6,000 in March. Both inflows and outflows to the claimant count had been little changed, despite the rising redundancies that had been reported in the LFS. Inactivity amongst those aged 16 and older had risen by 51,000 in the fourth quarter and the inactivity rate had increased 0.1 percentage point, to 21.4%.

A32 Headline (three-month average) whole-economy annual earnings growth had been 1.9% in February, 1.0 percentage points lower than in January. Headline annual earnings growth in the private sector had fallen 1.2 percentage points from the January figure, to 1.3%; headline earnings growth in the public sector had fallen by 0.2 percentage points, to 4.7%. Actual whole-economy earnings growth had been 0.9% in the year to February, 1.9 percentage points lower than in November. In private sector services, earnings had been 1.1% lower than a year earlier.

A33 The decline in earnings growth had reflected a sharp reduction in bonus payments. Whole-economy pay excluding bonuses had increased by 4.2% (not seasonally adjusted) in the year to February, 0.1 percentage points higher than the annual growth in January. Overall, bonuses had reduced whole-economy annual earnings growth by 3.2 percentage points (not seasonally adjusted) in February, with a much larger negative effect in the financial intermediation sector.

A34 According to the Bank's settlements database, the twelve-month AEI-weighted mean settlement had been unchanged at 3.3% in March. The difference between average regular pay growth and settlements had been around 1 percentage point. This had been well within the normal range of drift over the past five years.

V Prices

A35 The level of sterling oil prices at the end of April had been broadly unchanged from the level at the start of the month, at around £18 per barrel. However, average oil prices in April had been around 6% higher than their average in March, reflecting increases during March, and had been broadly unchanged from a year earlier. Manufacturing input prices had risen by 2.6% in March, mainly reflecting increases in the prices of crude petroleum products. Together with base effects, this had raised their annual inflation rate to –2.5% in March from –7.1% in February. The CIPS manufacturing survey had suggested that, going forward, input prices would rise further. The input price balance had risen to 51.1 in April, from 43.3 in March, above the no-change level of 50 for the first time in a year.

A36 Manufacturing output prices excluding duties (PPIY) had been unchanged in March, while the annual inflation rate had fallen by 0.3 percentage points to 0.0%. Survey data had suggested that output price inflation would remain subdued. The CBI Quarterly Industrial Trends survey balance of expected output prices had risen to –10 in April, from –16 in March.

A37 Annual RPIX inflation had risen by 0.1 percentage points to 2.3% in March. The rise had mainly reflected slightly higher annual services price inflation, which had risen to 4.6% from 4.5% in February. Annual goods price inflation had been unchanged at 0.1% in March. Annual inflation on the RPIY measure had fallen by 0.2 percentage points to 2.5% in March, but the RPI measure of inflation had risen to 1.3% in March, from 1.0% in February. On the HICP measure, annual inflation had remained at 1.5% in March. In 2002 Q1 as a whole, RPIX inflation had been 2.4%.

VI Reports by the Bank's Agents

A38 The Bank's regional Agents had reported that manufacturing confidence had continued to improve, with many contacts believing that 2001 Q4 had been the bottom of the cycle. Confidence had been supported by improving orders in both domestic and export markets. The upturn in the US economy had been seen as the main driver of growth in exports, but nervousness had remained about how sustained the US recovery would be. Output and orders of some sectors within manufacturing, particularly automotive, had picked up. In contrast, the telecommunications sector had remained depressed, and most aerospace contacts had continued to see falling demand from commercial airlines.

A39 Business services turnover had continued to recover from the low levels recorded at the end of 2001, partly driven by growth in outsourcing. Areas of continued weakness had included mergers and acquisitions activity and advertising. Construction output had recovered following a downturn at the end of last year, with the industry now operating close to capacity in many parts of the country. Demand for housing had remained strong across all regions, but new properties had been in short supply due to a shortage of land with planning permission.

A40 Demand for consumer goods and new cars had remained strong, although there had been some evidence that the rate of growth was slowing. Demand for leisure services, such as health clubs, pubs and restaurants, had generally remained robust.

A41 There had been some evidence that improving confidence was leading to increased investment, particularly in the service sector. The retail and distribution sector had continued to invest strongly. For some contacts, particularly in manufacturing, low profitability had continued to constrain their ability to finance investment. Much investment in new manufacturing capacity had continued to be in overseas locations.

A42 The Budget changes to National Insurance contributions had been seen by employers as a 1% increase to their pay bill. Contacts had also expected that employees would seek increased remuneration to cover their own increased contributions. The increase was not expected to have an immediate effect but would influence staffing and recruitment policies in the medium term. Contacts in some labour-intensive service industries had expected to pass on increased costs in their prices, but many companies had expected to have to absorb the increase in labour costs.

VII Market Intelligence

A43 Between 3 April and 8 May, interest rates implied by short sterling futures contracts expiring up to December 2005 had fallen. Rates implied by the contract for September 2002 had fallen by 35 basis points, and those implied by the contract for March 2003 had fallen by 31 basis points, to 5.32%, reflecting weaker-than-expected data in the United States and United Kingdom and comments by officials. These included UK GDP for 2002 Q1, a Michigan consumer confidence survey and US jobless claims, and speeches by Chairman Greenspan on 17 April and the Governor on 22 April. Rates rose after stronger-than-expected CBI industrial trends and BRC survey data and comments by ECB President Duisenberg on 2 May.

A44 Market participants had generally expected the Committee not to change the Bank's official repo rate in May. Similarly, 27 economists polled by Reuters between 29 April and 1 May had attached a mean probability of 82% to the Committee leaving the repo rate unchanged. The majority of market traders had expected a repo rate of 4.5% or above by December 2002.

A45 The dollar had weakened and the euro and yen had strengthened since the Committee's previous meeting. The dollar had fallen by 2.4% on an effective basis over the period, consistent with falls in US interest rate expectations relative to the euro-area and Japan. Market commentary over the period had suggested a shift in sentiment towards the dollar: the US recovery had been expected to be somewhat slower than previously anticipated, and there had been renewed focus on current and capital account sustainability.

Sir Edward George
Governor
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17 April 2002

REMIT FOR THE MONETARY POLICY COMMITTEE

The Bank of England Act requires that I specify what price stability is taken to consist of and the Government's economic policy objectives at least once in every period of 12 months beginning on the anniversary of the day the Act came into force. I last wrote to you on this matter on 29 April last year.

I hereby re-confirm the target as 2½ per cent for RPIX inflation. In accordance with the Act, I also confirm the economic policy of Her Majesty's Government is to achieve high and stable levels of growth and employment by raising the sustainable growth rate and creating economic and employment opportunities for all.

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

Yours sincerely

GORDON BROWN

REMIT FOR THE MONETARY POLICY COMMITTEE

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

(a) to maintain price stability, and

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

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

Price stability

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

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

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

But if inflation moves away from the target by more than 1 percentage point in either direction I shall expect you to send an open letter to me, following the meeting of the Monetary Policy Committee and referring as necessary to the Bank's Inflation Report, setting out:

— the reasons why inflation has moved away from the target by more than 1 percentage point;

— the policy action which you are taking to deal with it;
— the period within which you expect inflation to return to the target;
— how this approach meets the Government's monetary policy objectives.

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

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

Government's economic policy objectives

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

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

Accountability

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

Restatement of the Remit

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