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MINUTES OF MONETARY POLICY COMMITTEE MEETING 9 and 10 April 2003

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 April 2003.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0304.pdf>).

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 7 and 8 May will be published on 21 May 2003.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 APRIL 2003

1 Before turning to its immediate policy decision, the Committee discussed the world economy; money, credit and financial market prices; demand and output; the labour market; prices and costs; and some other considerations. The Committee noted a letter from the Chancellor (attached as an Annex) setting out the remit for the Committee over the following year, in accordance with section 12 of the Bank of England Act 1998.

The world economy

2 Oil prices had dropped sharply over the past month, falling by nearly \$10 per barrel. This had been surprising, as most advance scenarios of the economic consequences of hostilities in Iraq – even those of a short war – had envisaged a pronounced upward spike in oil prices, at least in the initial phase. The price falls probably reflected there being less apparent damage to Iraqi oil fields than feared, increased oil production by OPEC, and better prospects for oil production in Venezuela and Nigeria. In any event, the price reductions unwound the increases since early December and were likely to benefit the United States in particular, given the strong pass-through from crude oil prices to retail gasoline prices there. Most major equity market indices had risen over the month, except in Japan: for example, the Wilshire was up over 4% and the Euro Stoxx up over 8%. Their movement during the month suggested that events in Iraq had played a part, with indices rising as uncertainty about events diminished in the run-up to hostilities, and then temporarily reversing when it looked as if the war might last longer than first thought. Higher equity prices suggested that investors had either revised upwards their assessment of future corporate earnings, or downwards the equity risk premium, or both. Higher short-term interest rates and bond yields also pointed to the same conclusion. Most increases in yields had been due more to increases in real rates than to higher inflation expectations, possibly reflecting portfolio shifts into equities.

3 In contrast to developments in financial markets, news on the month about output, demand, and business and consumer confidence had indicated a weakening of the near-term economic outlook. In

the United States, industrial production had increased by only 0.1% in February. The Institute for Supply Management (ISM) indices for manufacturing and non-manufacturing had fallen sharply in March. In principle, the ISM indices reflected hard evidence about production, new orders, employment, inventories and supplier deliveries, although it was still possible that the responses to the ISM surveys had been coloured by wider worries about the prospect of war in Iraq. Most of the responses had been gathered prior to the outbreak of hostilities and the rise in equity markets. Consumption spending had been weak. The Bureau of Economic Analysis estimate of monthly consumption had fallen 0.4% in February, after a reduction of 0.2% in January, although bad weather on the east coast may have been partly responsible. Weekly data suggested that retail sales had faded in the second half of March, after a pick-up in the first half. Consumer confidence had dropped on both the Conference Board measure (based on responses prior to the start of the war) and the Michigan measure, although there were signs of a rebound in the latter amongst those polled after the commencement of hostilities. Although there was still some scope for more mortgage equity withdrawal via refinancing, mortgage rates had edged up. It seemed less likely than it had in February that consumer spending would sustain US domestic demand until investment began to pick up. Labour market developments reinforced this doubt. Taking February and March together, non-farm payrolls fell by nearly half a million, and claims for unemployment insurance had increased slightly. Only a minority of the decline in non-farm payrolls was accounted for by the call-up of reservists in the armed forces (over 200,000 by mid-March, not all of whom would have been on those payrolls beforehand). According to the Conference Board survey, a higher proportion of households than at any time since 1994 reported that jobs were hard to find. Labour market weakness now seemed more likely to persist. The Consensus forecast for US GDP growth in 2003 had dipped 0.2 percentage points in March, to 2.4%, and the most recent IMF *World Economic Outlook* (WEO) forecast was 2.2%, down from 2.6% last September.

4 The Consensus forecast for euro-area GDP growth in 2003 also fell 0.2 percentage points in March, to 1.1%, the same as the latest WEO forecast. GDP in 2002 Q4, at 0.2% on the first release, had been a little higher than expected, but it had probably been boosted to a greater extent than previously thought by temporary factors such as the impact of tax incentives on investment and the purchase of new cars in Italy, and flood-related construction spending in Germany. As in the United States, the latest indicators of activity had fallen back, with declines in the Purchasing Managers Indices for both manufacturing and services in March: both were now below the 50 level. The European Commission measure of industrial confidence had slipped further. Industrial production

data showed a more mixed picture. There had been an increase of over 1% in January in the euro area as a whole, but the figures may have been exaggerated by seasonal factors; production had fallen sharply the month before. In February, German industrial production had fallen by 0.4%. Retail sales had followed a similar pattern, with euro-area sales bouncing back in January but German sales falling off in February. Euro-area consumer confidence had declined for the sixth month running in March, reflecting concerns about both the general economic situation and individual job prospects; unemployment had risen in February. It remained difficult to identify what would give rise to a recovery in EU domestic demand in the near term, and the appreciation of the euro since the end of 2000 would tend to weaken external demand.

5 The indications from Japan were that the reported 0.5% growth of GDP in 2002 Q4 might indeed have marked some improvement in the Japanese economy. The METI ‘all-activity’ index rose 1.7% in January, more than reversing its December fall. The Consensus forecast for GDP growth in 2003 had risen 0.2 percentage points in March, to 0.6%. The likely economic impact of the emergence of Severe Acute Respiratory Syndrome (SARS) in the rest of East Asia could not yet be assessed, although it was clear that air travel in the region had dropped off sharply.

Money, credit and financial market prices

6 In the United Kingdom, as elsewhere, equity prices had been volatile, but indices had on average risen over the month, with, for example, the FTSE-All Share index up around 7% since the Committee’s March meeting. Short-term movements had been positively correlated with changes in market interest rates, with both seeming to follow day-to-day news about developments in Iraq. There appeared to have been domestic as well as international influences affecting UK interest rates: one-year forward rates had increased significantly more than in the United States and the euro area. In particular, UK interest rates rose on publication of the minutes of the Committee’s March meeting. Market anecdote suggested that the trigger had been the discussion in the minutes of the arguments for an increase in the repo rate, even though no member had supported such a move. That had contrasted with the fall in short-term money market rates that had taken place immediately after the February reduction in the repo rate. Judging by implied forward interest rates, participants now expected the turning point in the repo rate to arrive earlier than previously thought. Nevertheless, transactions volatility suggested that the sterling money market curve in early March might not have been as good a guide to expectations of future interest rates as usual.

7 The greater rise in short-maturity money market interest rates in the United Kingdom than elsewhere might have been expected to have encouraged an appreciation of sterling. But in fact sterling had depreciated further – by around 1% on the effective measure. Last month, the Committee had considered three possible, not mutually exclusive, explanations for sterling’s fall: first, a reassessment by market participants of how the Committee reacted to economic news; second, a downward revision in their estimates of the equilibrium real exchange rate expected in the medium term; and, third, a reduction in confidence due to assessments of the likely consequences of war in Iraq. The further fall in sterling this month, juxtaposed against the rise in UK interest rates relative to those abroad, provided evidence against the first hypothesis. And the increases in equity prices and short-term interest rates weighed against there having been a persistent ‘Iraq’ effect, and therefore against the third hypothesis. An explanation in terms of a lower expected equilibrium real exchange rate seemed more likely. It was suggested that the fall could have been due to a perceived worsening of the outlook for UK domestic demand (relative to other countries). There had indeed recently been more discussion of this possibility, for example in the IMF’s *World Economic Outlook*. Such a shift would mean that a lower real exchange rate was necessary to boost external demand and hence bring total demand back into line with the United Kingdom’s supply capacity, as would be expected in the long run in the absence of further shocks. Another possible reason for a lower equilibrium real exchange rate was that the share of UK domestic demand spent on imports might be increasing faster than ONS statistics reported (putting downward pressure on sterling via the current account); in this context, it was notable that the rest of the EU reported more exports to the United Kingdom than the ONS recorded as UK imports, although it was unclear why any perception that UK imports were being underreported would have affected sterling suddenly in the recent past. Several ways in which an adjustment in the real exchange rate could be brought about were considered. One mechanism was through the adjustment of capital flows. For example, overseas investors might have been anticipating the lower growth of domestic demand and the resulting lower profits (at least in the short run) by reducing direct investment. Or, there might have been an increased demand from the UK for foreign financial assets. Even without a shock to domestic demand, investors might have reduced the desired weight of sterling assets (including direct investment) in their portfolios, perhaps because of a general tendency to repatriate capital at a time of international uncertainty. In any event, the likelihood that the recent depreciation of sterling would persist was probably higher than had been thought last month.

8 The growth rate of broad money had picked up a little in February, as had that of narrow money in March. There had been some signs of a decline in bank borrowing by non-financial firms. Although the annual growth rate of non-financial corporate borrowing had increased, the monthly flow had eased back compared with the average monthly flow in 2002 Q4. It looked likely that total new external finance by companies would be lower in 2003 Q1 than in the previous quarter. That could have reflected some combination of lower costs, lower investment, lower dividends, higher revenues and, conceivably, the impact of tighter borrowing constraints imposed by lenders. Firms had been strengthening their balance sheets and the corporate sector as a whole ran a financial surplus last year. Eventually, stronger balance sheets might encourage investment, but in the near future firms might want to increase their net saving further, for example to offset the widespread increase in deficits in company defined-benefit pension funds, and that might mean further cuts in planned investment, dividends and employment. Companies in declining sectors of the economy had particularly tough challenges in financing defined-benefit pension funds. Outside the oil sector, there had been few signs of an increase in gross trading profits.

9 The monthly flow of new borrowing by households – both secured and unsecured – had also fallen back a little from the average in the fourth quarter last year. But these rates were still high by historical standards. Mortgage equity withdrawal as a proportion of personal disposable income was almost as high at the end of last year as in the housing boom of the late 1980s. Two-year fixed-rate mortgage rates were lower than they had been in February. There were few signs from the borrowing data that consumption growth would be weak. However, the path of total household borrowing was not necessarily a good guide to the path of consumption in the short term, not least because of the heterogeneity of households; for example, borrowing had accelerated in 2002 while consumption growth had fallen slightly. Borrowing could be used to finance the purchase of assets by households as well as consumption of goods and services. Borrowing could also be undertaken to maintain consumption in the face of slower growth in disposable incomes. The Committee's February central projection had indeed envisaged a fall in the household sector's saving ratio in the short run.

10 So far this year, house price inflation had fallen a little more than the Committee had projected at the time of the February *Inflation Report*, with the three-month-on-three-month rates of increase of house prices running at between 4% and 4½% according to the Halifax and Nationwide indices. The Royal Institution of Chartered Surveyors survey indicated that price increases had moderated further

and were likely to decline even more. Indicators of the volume of activity also suggested that a slowdown was under way in the housing market.

Demand and output

11 The estimate of GDP growth in the final quarter of 2002 was unchanged in the latest ONS release. As a result of data revisions, it now looked as if consumption and business investment had been higher than previously thought, and it seemed more likely that investment might have stabilised. The upward revisions to domestic demand were offset by an upward revision to imports.

12 Output in 2003 Q1 was likely to have been lower than expected at the time of the February *Inflation Report*. In March, the CIPS private services activity index had dropped below 50, after several months of falls, and it was likely that private services sector growth had been considerably weaker in the first quarter of this year than in 2002 Q4. The picture for manufacturing was more confused. According to the index of production, manufacturing output growth had held up, increasing by 0.2% in January (largely because of production of computers) and by 0.3% in February (with increases more broadly based across sectors). But both the CIPS and CBI surveys for March suggested that there had been a sharp deterioration subsequently. These surveys asked respondents about output and orders, not business sentiment, so in principle they should not have been biased by any concern about the increase in international political tension unless reflected in reduced or delayed activity. In the past, the CIPS responses had sometimes given a misleading signal about output, but more because of inadequate industry coverage (such as under-representation of expanding ICT firms during the slowdown of the late '90s) than because of bias due to confidence effects.

13 There had been further signs of a slowdown in household spending. Retail sales had fallen by 0.1% in February, suggesting that the reported weakness in January was not due simply to difficulties in applying seasonal adjustment to the data around Christmas. VAT receipts had been unexpectedly low in February. CIPS survey data pointed to a fall in output of manufactured consumption goods in March. The CBI Distributive Trades survey's balance for retail volumes fell sharply in March, although this might to some extent have reflected the fact that Easter falls later this year than last, so that the holiday spending period falls in April instead of March. Private sales of cars were relatively strong in March. Consumer confidence had changed little in March after its decline in recent months, and the weakness continued to reflect concerns about the general economic situation more than

households' own economic circumstances, although the latter had also weakened somewhat. Publicity given to the slowdown in house prices since Christmas may have contributed to the weakness. The impact of the war in Iraq was uncertain. The path of consumption had been little affected by the earlier Gulf War and the Falklands campaign, but it was possible that there was more concern over security, especially in city centres, during the present hostilities. Consistent with this, sales within the M25 appeared to have fallen disproportionately.

14 Overall, it now seemed likely that consumption growth in 2003 Q1 had been considerably lower than envisaged in the February *Inflation Report*, and below its long-run trend. The question was, looking forward, what were the implications of the apparent weakness of consumption in the first quarter? There were three possibilities. First, the weakness might have been erratic, and might quickly reverse as some of the uncertainties about the consequences of the war in Iraq were resolved. Second, consumption had been expected to slow from the second quarter onwards as higher National Insurance contributions and Council Tax reduced disposable income growth. It was possible that the weakness might simply have reflected an earlier-than-predicted arrival of this expected slowdown, as consumers anticipated the imminent reduction in the growth of their disposable income. Third, it could have been the sign of a downward revision to consumers' estimates of their income over the long run for some other reasons, in which case further falls could be expected later when the higher National Insurance contributions and Council Tax affected disposable income. Assessing the outlook for consumption was complicated by the difficulty in forecasting real disposable income due to the divergence between the personal consumption deflator and RPIX.

15 Turning to the other components of demand, the Treasury briefing suggested that the Budget had relatively mild implications for the expected profile of government spending, but a more thorough analysis would be possible during the forthcoming forecast round. A range of measures to raise potential output had also been announced in the Budget, but any effects were likely to be modest over the time horizon relevant to the Committee's decision. Export demand had been significantly weaker than expected in February, especially to non-EU countries. This was consistent with the weak data on demand in the United Kingdom's major trading partners, and perhaps made earlier falls in reported exports more plausible. But it was clear that the puzzles surrounding the trade data remained.

The labour market

16 In general, the labour market appeared to remain reasonably robust. The unemployment rate on the Labour Force Survey measure had fallen to 5.0% in the three months to January, and it was likely that it would turn out to have been lower in the first quarter than assumed in the Committee's central projection in February. Employment had increased by 57,000 in the same period. The CIPS employment survey suggested that there had continued to be net job losses from the private sector in March, but the Workforce Jobs data showed that public sector employment had continued to grow in 2002 Q4. Labour supply also depended on the hours worked by members of the labour force. Total and average hours worked had fallen in Q4. A special survey by the Bank's regional Agents had reported a trend across all sectors for average weekly hours worked to fall, partly because of the impact of legislation, and partly because of pressure from existing and prospective employees. The fall thus did not seem to be a purely cyclical effect, the consequence of firms hoarding labour in the expectation of an early recovery in demand. Hence any shake-out of labour in the event of a protracted period of lower-than-expected growth was likely to be less than might previously have been forecast. The impact on wage costs was unclear; it depended on whether the fall in average hours pushed up average hourly pay (as it would, for example, if weekly pay was not affected) or reduced it (as it would tend to if fewer hours were worked at overtime rates).

17 The growth of pay (excluding bonuses) was much the same in the year to January as in the year to December, and wage settlements, at 2.9% in February, continued to be remarkably stable. The increases in National Insurance contributions came into effect this month, and data on April settlements were likely to help in assessing their impact. So far, there had been little sign of employees trying to compensate for their increased contributions by demanding higher pay settlements. Nor did there seem to have been a reaction to the upward movement in RPI inflation over recent months. That might be because of confidence that the inflation rate would be anchored at around 2½% by monetary policy. There was also a possibility that employers would have agreed higher settlements had it not been for the increase in their National Insurance contributions.

Prices and costs

18 The annual rate of RPIX inflation was 3% in February, a little higher than had been expected by the Committee. The main surprise had been clothing and footwear prices, which had been higher than

expected for a couple of months now. Last month, the increases could be regarded as spurious, the likely result of a change in the collection date for RPI data relative to the timing of post-Christmas sales, but it was now more difficult to dismiss them.

19 As the Committee had noted previously, the profile of RPIX inflation in the near term would be raised by a number of temporary factors. The impact of higher retail petrol prices discussed last month was now likely to be short-lived given that sterling oil prices had fallen by around 25% since the Committee's March meeting. That fall would reduce inflation projections (relative to last month's) by around 0.2 percentage points in the near term, but, because the two-year-ahead futures price of oil had remained unchanged, there was now likely to be a higher mechanical contribution to the annual rate of inflation further out. However, because of sterling depreciation during the first quarter, this year's large Council Tax increases and the temporarily high housing depreciation component, annual RPIX inflation was still likely to increase over the forthcoming quarter. Thereafter, it was likely to fall gradually, as house price increases moderated and the price level effect of the Council Tax fell out of annual comparisons.

20 One of the major uncertainties over the forecast horizon was how large and how long-lasting the impact on retail prices of the 5% depreciation in sterling since the February *Inflation Report* would be. A purely mechanical simulation with the Bank's medium-term macroeconomic model suggested that it could add somewhere between a half and one percentage point to inflation during 2004. But that depended on several factors, including the impact on the wholesale prices of imports, the pass-through from wholesale import prices to retail prices, the effect of any price increases on wage bargainers' and price setters' inflation expectations, and the size of the stimulus to UK net exports. Threshold effects might be important, with little change in prices for moderate falls in sterling. Recent international evidence suggested that the pass-through to retail prices might be less now than in the past. Direct price effects were likely to be the most important factors in the short run, while indirect effects via the impact on aggregate demand and inflation expectations would tend to build up more gradually. The overall effect on the price level might be spread out over a lengthy period.

21 Two other issues relating to price setting were discussed. First, wage bargainers' and price setters' reactions to movements in the components of RPIX might depend on the particular components in question. For example, changes in Council Tax and petrol prices might be more visible and receive greater media coverage than changes in the housing depreciation component of RPI.

Although RPI was widely used as a benchmark for wage negotiations, in practice it was not clear that it was the most relevant index to help explain actual wage settlements; the link had become weaker since the beginning of the 1990s. Second, reactions to changes in inflation also depended on how wage bargainers and price setters thought that the monetary policy authorities would react. In particular, the degree to which the Committee was expected to accommodate apparently temporary shocks to inflation (but permanent shocks to the price level) would be important.

Other considerations

22 The Reuters poll of economists suggested that there were slightly higher expectations of a rate change this month than last, but a mean probability of just over 60% was attached to there being no change in the repo rate. Most expected a reduction in May. Market anecdote was that a reduction this month might be taken as an indication that interest rates would follow a lower path than previously thought. As the Committee's meeting was taking place immediately after the Budget, there was also a possibility that any change in the repo rate would mistakenly be seen as a commentary on the Budget rather than as a response to a wide range of data.

The immediate policy decision

23 Although a gradual recovery in the world economy was still likely in the medium term, the Committee agreed that the global outlook currently seemed somewhat weaker than at the time of the February *Inflation Report*. Economic forecasts of GDP growth in 2003 had been revised down. Surveys of business and consumer confidence had been particularly pessimistic about the near-term outlook. They may have been affected by increased uncertainty due to the situation in Iraq. However, not all the news on the month had been bad for the world outlook. In particular, the drop in oil prices and the increases in equity prices around the world in the second half of the month would tend to stimulate activity. It was not yet clear to what extent there might be a rebound in confidence as a result of the likely early conclusion of the war in Iraq. In the United Kingdom, evidence was accumulating that the anticipated slowdown in consumption growth was under way, although its extent was still uncertain. The question was whether investment, external demand and public sector spending would pick up fast enough to keep aggregate demand broadly in line with potential supply. The depreciation of sterling would help in this regard, as would stronger equities and lower oil prices. In addition, the Committee had to consider a situation in which, for a while, UK inflation was likely to be

above target, albeit as a result of a range of temporary factors likely to unwind in the coming year, and growth might be below trend.

24 In the light of the evidence about global and domestic demand and prices, the Committee considered arguments for reducing the repo rate or maintaining it at the current level. Committee members differed in how persuasive they found each of these to be.

25 There were a number of possible reasons for a reduction. First, the world economy had been weaker than expected and the outlook seemed to have deteriorated. In particular, data from the United States had been weaker. It was difficult to know what weight to put on survey data at the current conjuncture because of the war in Iraq, but, arguably, it was unlikely that the downturn in indicators was all war-related. Demand for euro-area exports, for example, would be affected by the recent past appreciation of the euro for some time. Second, it looked likely that UK output had been lower in the first quarter than expected and the signs were that demand for UK goods and services was slowing. Consumer spending was likely to reflect the weakness of retail sales, the slightly faster-than-expected slowing of house prices, and the fact that the rate of consumer borrowing had apparently passed its peak. Although firms seemed to be strengthening their balance sheets, there was no guarantee that this would be reflected in increased investment in the near term. Reported exports had been repeatedly weaker than expected. In the context of weak global demand, it was not clear that the fall in the exchange rate would boost net trade sufficiently to keep aggregate demand growing broadly in line with potential supply. This news about output and demand contained valuable information about the level of inflation in the future, and it was particularly desirable for the Committee to react promptly. Third, given the likely behaviour of house and oil prices, the contribution of these factors to measured inflation was likely to fall significantly over the next year. Fourth, pay settlements, particularly in the private sector, implied lower increases in real wages. Fifth, the risks to inflation entailed by maintaining an interest rate that was too tight were greater at present than the risks entailed by reducing rates, given the degree of spare capacity in the economy thought to exist by some Committee members.

26 There were also arguments in favour of maintaining the current repo rate and, for most Committee members, these, taken together, were more convincing. First, the news about output and demand was ambiguous. Consumption and business investment had been higher than expected in 2002 Q4, and unemployment had remained low. Manufacturing output had been unexpectedly strong

in February. The export data had been weak but were difficult to reconcile with other sources of information. The fall in the price of oil would tend to stimulate activity. The rise in equity markets would help to sustain consumption, which was not necessarily slowing faster than the Committee had expected: the retail sales position was complicated by the lateness of Easter this year; the deceleration in house prices had been tentative and rates of increase were still high in many regions; and household borrowing was still at historically high levels, supported by further increases in house prices and by the low real interest rates facing consumers. The war in Iraq had increased the difficulty of interpreting survey responses, probably making them unduly pessimistic but to an unknown extent. It looked likely at the moment that the war would be over quickly, so that uncertainty from this source would be less next month; hence, on this occasion, a delay should help clarify the underlying picture for the Committee. Second, the decline in the sterling exchange rate had persisted, despite an increase during the month in UK interest rates relative to the rest of the world, and largely independently of movements in the dollar-euro rate. This would tend to raise prices both directly, even though the speed and degree of pass-through to retail prices was uncertain, and indirectly, via the boost it would give to net external demand. Third, it was important not to let inflation expectations drift upwards away from the target. While there was little sign of this happening at the moment, the expected increase in inflation in the short run, even though it was largely due to transient factors, might affect expectations of inflation further ahead. There was more of a risk that any impact of sterling's depreciation would be amplified by further wage and price adjustments if the credibility of the target were dented. Policy would be less effective if reductions in the repo rate were to trigger rises in inflation expectations and hence rises in the yield curve further out, as might have happened to a limited extent after the February reduction. Fourth, there were a number of issues that would benefit from further analysis in the context of the forecast round leading up to the May *Inflation Report*, such as the probable extent of exchange-rate pass-through, the quality of trade statistics, the impact of the Budget, and the implications of the decline in average hours worked. It was not clear at this stage what the Committee would conclude about these issues, and hence what the consequences would be for the inflation projection.

27 The Governor invited members to vote on the proposition that the repo rate should be maintained at 3.75%. Seven members of the Committee (the Governor, Mervyn King, Andrew Large, Kate Barker, Charles Bean, Stephen Nickell and Paul Tucker) voted in favour. Christopher Allsopp and Marian Bell voted against, preferring a reduction in the repo rate of 25 basis points.

28 The following members of the Committee were present:

Eddie George, Governor

Mervyn King, Deputy Governor responsible for monetary policy

Andrew Large, Deputy Governor responsible for financial stability

Christopher Allsopp

Kate Barker

Charles Bean

Marian Bell

Stephen Nickell

Paul Tucker

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 April 2003, in advance of its meeting on 9-10 April. At the start of the Committee meeting itself, members were made aware of the information that had subsequently become available, and that information is included in this Annex.

I The international environment

A2 According to the final estimate, US GDP had increased by 0.3% on a quarter earlier in 2002 Q4, compared with the preliminary estimate of 0.4%. The estimates of quarterly consumption and investment growth were unchanged, at 0.4% and 1.1% respectively, while estimated quarterly growth in government spending had been revised down from 1.2% to 1.1%. The estimated stockbuilding and net trade contributions had remained unchanged, at 0.1 and -0.4 percentage points respectively. Pre-tax corporate profits (including an adjustment for inventory valuation and capital consumption) had risen by 3.3% in Q4 compared with a quarter earlier. Non-farm business sector labour productivity had risen by 0.2% and unit labour costs had risen by 1.0% over the same period.

A3 Industrial production in the United States had risen by 0.1% in February compared with a month earlier, but manufacturing output had fallen by 0.1%, and total industry capacity utilisation was unchanged at 75.6%. The Institute for Supply Management (ISM) manufacturing index had fallen to 46.2 in March, from 50.5 in February, while the ISM non-manufacturing index had fallen to 47.9, from 53.9. Non-farm payrolls had fallen by 108,000 in March, following a fall of 357,000 in February. The unemployment rate had remained unchanged at 5.8% in March.

A4 Real consumption in the United States had fallen by 0.4% in February compared with a month earlier, following a 0.2% monthly fall in January. Real personal disposable income had fallen by 0.2%, following an increase of 0.2% in January. Nominal retail sales had fallen by 1.6%, following a monthly rise of 0.3% in January. Excluding sales of automobiles, retail sales by value had fallen by 1.0%, following an increase of 1.2% in January. The final release of the University of Michigan measure of consumer confidence had shown a decline to 77.6 in March, from 79.9 in February, and the Conference Board index had declined to 62.5, from 64.8 in February. The falls in both indices had reflected declines in the current conditions and future expectations components. The US trade deficit

had narrowed in January to \$41.1 billion, from \$44.9 billion in December. Export volumes had risen by 1.5% in January compared with a month earlier, and import volumes had fallen by 3.0% over the same period. The current account deficit had widened to 5.2% of GDP in Q4, compared with 4.8% in Q3.

A5 Euro-area GDP had grown by 0.2% on a quarter earlier in 2002 Q4, compared with a quarterly increase of 0.4% in 2002 Q3. Quarterly private consumption growth had remained unchanged, at 0.4%, while quarterly growth in government expenditure had risen to 0.6%, from 0.3% in the previous quarter. Stockbuilding had contributed 0.1 percentage points to quarterly growth and net trade had reduced it by 0.2 percentage points. Industrial production in the euro area had increased by 1.1% in January compared with a month earlier. In Germany and France, industrial production had increased by 2.0% and 1.5% respectively over the same period. German manufacturing orders had fallen by 0.6% in February compared with a month earlier, following a 4.1% increase in January. The volume of retail sales in the euro area had increased by 2.5% on a month earlier in January, after a fall of 0.7% in December. German retail sales had fallen by 1.1% on the month in February, following a 3.3% increase in January. Consumer spending on manufactured goods in France had fallen by 0.5% in February compared with a month earlier, following a 0.6% increase in January. The euro-area unemployment rate (ILO measure) had increased to 8.7% in February, from 8.6% in January, while German and French unemployment rates had increased by 0.1 percentage points, to 8.7% and 9.1% respectively.

A6 The euro-area manufacturing purchasing managers' index (PMI) had fallen to 48.4 in March, from 50.1 in February. In Germany, the manufacturing PMI had fallen to 47.8 in March, from 49.9 in February, while in France it had fallen to 48.1, from 51.5 in February. The euro-area services PMI had fallen to 47.7 in March, from 48.9 in February. The German IFO index had fallen to 88.1 in March, from 88.9 in February; the fall had been attributable to declines in both the current conditions and the future expectations components of the index. The French INSEE measure of manufacturing confidence had fallen to 94 in March, from 97 in February. The European Commission measure of euro-area consumer confidence had fallen by 2 points in March, to -21, while the measure of industrial confidence had decreased by 1 point, to -12.

A7 Japanese worker households' real expenditure had fallen by 1.6% in February compared with a year earlier. Nominal retail sales had risen by 1.9% in February compared with a month earlier.

Industrial production had fallen by 1.7% in February compared with a month earlier. Domestic private sector machinery orders (excluding volatile items) had fallen by 9.6% in February compared with a month earlier, after increasing by 7.0% in January. The Japanese tertiary activity index had risen by 1.8% on the month in January and the all-industry activity index by 1.7%. Export volumes had increased by 10.2% in February compared with a year earlier. Export volumes to the United States had fallen by 5.9% over this period, while export volumes to Asia had increased by 23.8%. Import volumes had risen by 1.6% in February compared with a year earlier. The Bank of Japan's Tankan large manufacturers' diffusion index had fallen by 1 point, to -10, but the large non-manufacturers' diffusion index had increased by 2 points, to -14. Firms' outlook for sales and profits in the financial year 2003 had been more optimistic than their assessment of the financial year 2002. The all-household survey had reported an annual decline of 1.0% in real spending in February, compared with a 1.5% annual decline in January. The unemployment rate had fallen to 5.2% in February, from 5.5% in January.

A8 The price of physical Brent crude oil had fallen to around \$25 per barrel, a decrease of around \$9 per barrel from the price at the time of the Committee's previous meeting. *The Economist* industrial metals dollar price index had fallen by 7.2% since the Committee's previous meeting, while the non-food agricultural commodities index had fallen by 4.1% and the dollar food index by 3.6% over the same period.

A9 In the United States, annual producer price inflation had risen to 3.5% in February, from 2.8% in January. Annual core producer price inflation (excluding food and energy prices) had fallen to 0.1% in February, compared with 0.5% a month earlier. Annual consumer price inflation had increased to 3.0% in February compared with 2.6% in January. Annual core consumer price inflation had fallen to 1.7% in February, from 1.9% in January. The euro-area harmonised index of consumer prices (HICP) had increased by 2.4% in the year to February, compared with a 2.2% increase in the year to January; the flash estimate for the twelve months to March had been 2.4%. The preliminary estimate for the German HICP had been an increase of 1.3% in the year to March. In Japan, consumer prices had fallen by 0.1% in the year to February, compared with a fall of 0.5% in the year to January.

A10 Most major international equity indices had risen since the Committee's March meeting. In local currency terms, the Wilshire 5000 had risen by 4.4%, the Dow Jones Euro Stoxx by 8.5%. The Japanese Topix had fallen by 2.6%.

II Monetary and financial conditions

A11 The twelve-month growth rate of notes and coin had continued to increase, to 6.6% in March from 6.2% in February. Annual growth of M4 had increased slightly to 6.7% in February, from 6.5% in January. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had increased to 11.0% in February, from 10.4% in January.

A12 The twelve-month growth rate of households' M4 had fallen slightly, to 8.6% in February from 8.7% in January. The twelve-month growth rate of households' M4 borrowing (excluding the effects of securitisations) had been unchanged at 14.5% in February. Annual growth of total net lending to individuals, a broader measure, had also been unchanged, at 13.7%. But the three-month annualised growth rate had fallen slightly further, to 13.8% in February from 13.9% in January, having peaked at 14.6% in October 2002. Within total lending to individuals, the annual growth rate of secured lending had risen to 13.6% in February, from 13.5% in January. The annual growth rate of unsecured lending to individuals had fallen to 14.2% in February, from 14.6% in January.

A13 The number of loan approvals for house purchase, after adjusting for the number of working days in the month, had been unchanged at 108,000 in February. The number of particulars delivered had fallen to 124,000 in February, from 127,000 in January. The House Builders Federation's monthly survey had shown that the balance of members reporting an increase in net reservations in February compared with a year earlier had increased after a sharp drop (to -34) in January, but had remained negative, at -18. And the Royal Institution of Chartered Surveyors (RICS) survey had shown that the balance of respondents expecting an increase in sales over the next three months had fallen from +1 in January to -19 in February, the lowest since the start of the series in 1998.

A14 Mortgage equity withdrawal (MEW) had risen to £13.3 billion in 2002 Q4, or 7.2% of personal disposable income (PDI), compared with £10.7 billion, or 5.9% of PDI, in 2002 Q3. Total unsecured lending to individuals had fallen to 2.7% of PDI in 2002 Q4, from 3.2% of PDI in 2002 Q3. Overall, therefore, total lending for consumption had been 9.9% of PDI in 2002 Q4, compared with 9.1% in 2002 Q3.

A15 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had recovered slightly to 4.7% in February, partly reversing the sharp fall to 4.1% in January.

The twelve-month growth rate of PNFCs' M4 borrowing (excluding the effects of securitisations) had increased further, to 8.5% in February from 7.5% in January. PNFCs had raised £2.1 billion of total external finance (excluding the effects of securitisations) in February, compared with an average monthly flow of £4.6 billion over the previous six months. Within external finance other than M4 borrowing, moderate sterling bond and equity issuance had been more than offset by net repayments of foreign currency bank borrowing and net redemption of securities in foreign currency.

A16 Data from the major British banking groups (MBBG) on the breakdown of sterling lending had shown that the twelve-month growth rate of their lending to manufacturing companies had become slightly less negative in February. The annual growth rate of borrowing by construction companies had risen sharply, while that of other sectors' borrowing had changed little on the month.

A17 The annual growth rate of M4 deposits of other financial corporations (OFCs) had increased, to 2.6% in February from 2.2% in January. The twelve-month growth rate of OFCs' M4 borrowing (excluding the effects of securitisations) had bounced back, to 4.2% in February from 2.9% in January.

A18 The FTSE 100 index had risen by 8.4% between 5 March and 9 April. The FTSE All-Share index had risen by 7.5% over the same period, but the FTSE Small Cap had fallen by 0.3%. All sectoral indices within the FTSE had risen, apart from Information Technology, which had declined by 4.0%. Uncertainty about the future level of the FTSE 100, as measured by the volatility implied by options prices, had fallen over the month, although it had remained above its average over the past ten years. But the skew to expectations for the index, an indicator of perceptions of the balance of risk, had become less negative. The number of downward profit warnings by UK companies in March 2003 had been slightly higher than in March 2002.

A19 Nominal forward rates had risen at all horizons between 5 March and 9 April, by 57 basis points at two years and 20 basis points at 15 years. The standard deviation of six-month sterling interest rate expectations, a measure of uncertainty, had risen over the month. This rise had been larger than in the euro area and the United States. Real forward rates had risen by 40 basis points at two years and 20 basis points at ten years. They had, however, fallen at maturities beyond 19 years, by 9 basis points at 25 years. Ten-year real spot rates had risen internationally.

A20 Between 5 March and 9 April, forward implied inflation expectations had been broadly unchanged at horizons between five and ten years, but had risen at longer horizons: by 12 basis points at 15 years, and 23 basis points at 25 years. Mean RPIX inflation expectations in HM Treasury's survey for 2003 Q4 had risen, to 2.6% in March from 2.4% in February; and in the Consensus Economics survey, mean RPIX inflation expectations for 2003 as a whole had also risen, to 2.7% in March, from 2.6% in February, 2.5% in January and 2.4% in December 2002. Mean RPIX inflation expectations in both HM Treasury's survey for 2004 Q4 and the Consensus forecast for 2004 as a whole had been unchanged at 2.4% in March.

A21 The average two-year discounted mortgage rate quoted for new customers had increased by 1 basis point in March. But the average standard variable mortgage rate (SVR) quoted for existing borrowers had fallen by 13 basis points, while the average two-year fixed mortgage rate had fallen by 16 basis points in March. Quoted rates on household savings deposits had also fallen in March.

A22 The sterling effective exchange rate index (ERI) had depreciated further since the Committee's previous meeting. It stood at 99.7 on 9 April, compared with 100.4 on 5 March. Sterling had depreciated by 2.9% against the dollar and by 0.3% against the euro. While movements in sterling exchange rates since the Committee's February meeting could not be accounted for by changes in relative interest rates, there had been some evidence of a rise in the risk premium and lower two-year expectations for sterling's ERI up to 10 March, the day of the latest Consensus Economics survey. Consensus forecasts had continued to point to a fall in the sterling ERI, with an expected depreciation of sterling against both the euro and the dollar.

III Demand and output

A23 In the Q4 National Accounts release, the estimate of quarterly GDP growth at constant market prices in 2002 Q4 had been unrevised, at 0.4%. Estimated annual growth had been revised up, by 0.1 percentage points, to 2.2%. The release had included revisions to estimated GDP for 2001 and 2002 (as well as small revisions to income data from 1999). The net impact of these revisions had been to raise the estimated level of GDP at market prices in 2002 Q4 by 0.4%.

A24 On the output measure, estimated quarterly GDP growth at basic prices had been unrevised from the previous release, at 0.3% in 2002 Q4. Within this, estimated service sector growth had been

unrevised at 0.5%, estimated manufacturing output growth had been revised down by 0.1 percentage points, to -1.0%, and estimated construction output growth had been revised up, to 1.9%, from 1.1% in the previous release.

A25 On the expenditure measure, estimated quarterly final domestic demand growth in the fourth quarter had been revised up, to 0.9%, from 0.6% in the previous release. Estimated household consumption growth (including non-profit institutions serving households) had also been revised up, to 1.1%, from 1.0% in the previous release. Within this, consumption of retail goods and of services had been the main contributors to overall consumption growth. Estimated whole-economy investment growth (including valuables) in 2002 Q4 had been revised up, to -0.2%, from -1.3% in the previous release. Within this, estimated business investment growth had been revised up, to 0.4%, from -1.1% in the previous release. Government investment also rose in 2002 Q4, by 3.4%.

A26 The estimated contribution of inventories to GDP growth in 2002 Q4 had been revised up, to 0.8 percentage points, from 0.7 percentage points in the previous release. Excluding the alignment adjustment, inventories had contributed 0.2 percentage points to GDP growth. The Q4 alignment adjustment had been the largest positive adjustment since adjustments of this type had been introduced in 1983. The ONS had suggested that this had reflected issues relating to the consistency of data on domestic output and demand and overseas trade. Estimated domestic demand growth had been revised up, to 1.6% in 2002 Q4, from 1.3% in the previous release.

A27 Estimated export growth in 2002 Q4 had been revised down a little, to -3.6%, from -3.4% in the previous release. Estimated import growth had been revised up, to 0.2%, from -0.3% in the previous release. Within exports, there had been a 5.8% fall in goods exports, which had been partially offset by a 2.7% rise in services exports. The estimated contribution of net trade to quarterly GDP growth in 2002 Q4 had been revised down, to -1.3 percentage points, from -1.0 percentage point in the previous release.

A28 On the income side of the accounts, households' real post-tax income had risen by 0.9% in 2002 Q4. This had reflected increases in both households' real post-tax labour income (which excludes dividends and other non-labour income), which had risen by 0.6%, and non-labour income, which had risen by 2.2%. The saving ratio had fallen by 0.2 percentage points, to 4.9% in 2002 Q4.

The estimate of households' net financial balance for Q3 had been revised down in Q3, with the deficit widening to -0.7% of GDP in Q4, marking the fourth consecutive quarter of financial deficit.

A29 The gross operating surplus of private corporations (excluding the alignment adjustment) had risen by 0.8% in 2002 Q4, following a fall of 0.7% in Q3. Private corporations' financial balance (excluding the alignment adjustment) had been in surplus for the fourth consecutive quarter in 2002 Q4. This had broadly offset the financial deficit of households, such that the private sector as a whole had been close to financial balance in 2002 Q4. The public sector net financial deficit had widened in 2002 Q4.

A30 The current account deficit had widened to £3.1 billion in 2002 Q4, following a deficit of £1.1 billion in Q3. The widening had been driven primarily by an increase in the trade deficit.

A31 Turning to indicators of expenditure in 2003 Q1, retail sales volumes had fallen by 0.1% in February, following a 1.0% fall in January. The March CBI Distributive Trades survey had pointed to a sharp fall in annual retail sales volumes growth, with the reported sales balance falling to -13 , from $+2$ in February. According to data supplied by the Society of Motor Manufacturers and Traders (SMMT), new car registrations had been 3.4% higher than a year earlier in March. In Q1 as a whole, total new registrations had fallen by 1.4% on the same period a year earlier. The Nationwide house price index had risen by 1.9% , and the Halifax index by 1.1% on the month in March; their respective annual growth rates had also risen slightly, to 26.2% and 23.8% respectively. The GfK consumer confidence aggregate indicator had fallen to -10 in March, from -9 in February. The constituent balances had remained broadly unchanged in March, with both forward- and backward-looking balances relating to the general economic situation remaining significantly negative.

A32 Overseas trade data in February had indicated that goods export volumes had fallen by 5.6% on the month, reversing the 5.2% increase in January. Exports to non-EU countries had fallen particularly sharply. Goods import volumes had also fallen, by 1.7% in February, following a rise of 4.3% in January. The trade in goods deficit had widened to £3.7 billion, whereas the trade in services surplus had narrowed slightly, to £1.2 billion. Overall, the total deficit in goods and services had widened to £2.4 billion in February, from £1.8 billion in January.

A33 On the output side, the CIPS services survey activity index had fallen, to 49.0 in March, from 50.2 in February. This had been the lowest activity balance since December 2001. The incoming new business index had also fallen, to 48.8 in March, from 49.9 in February. Manufacturing output had been estimated to have risen by 0.3% in February, and by 0.2% in January. However, the CIPS manufacturing survey output index had fallen sharply in March, to 45.6, from 49.7 in February, and the new orders index had also fallen, to 44.9 in March, from 48.5 in February. These balances had been at their lowest levels since December and September 2001 respectively. The CBI Monthly Trends survey total orders balance had been broadly unchanged at -30 in March.

IV The labour market

A34 According to the Labour Force Survey (LFS), employment had increased by 57,000 in the three months to January, compared with the previous three months. This had followed a rise of 150,000 in 2002 Q4, and a 106,000 rise in the previous non-overlapping quarter. The rise in employment in the three months to January had been more than accounted for by full-timers (up by 121,000). The working-age employment rate had increased by 0.1 percentage points on the previous quarter, and by 0.3 percentage points on the year, to 74.6%. Workforce Jobs had increased by 47,000 in 2002 Q4, with the biggest source of employment growth in public administration, education and health.

A35 Total hours worked in the three months to January had fallen by 0.2% compared with the previous non-overlapping quarter. Average hours had declined by 0.4% in the three months to January, reflecting a 0.6% fall in average hours for full-time workers to below levels seen at the time of the Golden Jubilee last year.

A36 The Bank's regional Agents had conducted an informal survey of 194 firms (covering around 280,000 employees) on the prospects for average hours over the medium term. Overall, the survey responses had suggested that average hours had been likely to continue to decline. But the large number of respondents expecting no change in average hours had implied that the downward trend had been unlikely to increase. A number of factors had been identified as being behind the decline in average hours, including legislation (mainly the Working Time Directive) and pressure from both existing and prospective employees.

A37 The overall CIPS employment index for March had been broadly unchanged on the previous month, and had remained below the ‘no-change’ level of 50. The rate of implied job losses in manufacturing had slowed slightly, but had risen in services. Recent surveys of employment intentions had been consistent with some moderate growth in employment in 2003 Q2. The Recruitment and Employment Confederation (REC) survey had shown that availability of both temporary and permanent staff had increased more rapidly in March, and the latest CBI services sector survey had shown some evidence of labour shortages easing in some sectors.

A38 LFS unemployment had fallen by 73,000 in the three months to January and had been 28,000 lower than a year earlier. The unemployment rate had fallen by 0.2 percentage points to 5.0%. The claimant count had risen by 2,600 in February after a (revised) increase of 700 in January. Working-age inactivity had risen by 57,000 in the three months to January. This had been more than accounted for by the 119,000 increase in those who did not want a job. The working-age inactivity rate had increased by 0.1 percentage points to 21.4%.

A39 Annual productivity on the official ONS measure had grown by 2.1% in 2002 Q4, 0.1 percentage points higher than annual growth in the previous quarter. Productivity growth calculated using LFS heads employment had, however, fallen back by 0.3 percentage points, to 1.0%. Annual growth in the official ONS measure of whole-economy unit wage costs had ticked up 0.2 percentage points, to 1.9%, in 2002 Q4.

A40 Headline (three-month average) whole-economy annual average earnings growth had eased by 0.1 percentage points, to 3.6% in January. Headline earnings growth in the public sector had picked up by 0.4 percentage points, to 5.0%, and headline earnings growth in the private sector had fallen by 0.3 percentage points, to 3.2%. Actual whole-economy earnings growth had fallen by 0.1 percentage points, to 3.3%, in January. Whole-economy regular pay growth (not seasonally adjusted) had fallen by 0.1 percentage points, to 4.0%, in January. Bonuses had made a negative contribution to overall earnings growth of 0.7 percentage points.

A41 The Bank’s twelve-month, Average Earnings Index weighted, whole-economy mean measure of pay settlements had remained unchanged, at 2.9% in February.

V Prices

A42 Sterling oil prices had fallen by around 23% since the March MPC meeting, but were slightly higher on average in March than had been expected at the time of the February *Inflation Report*.

A43 Manufacturing input prices had risen by 1.4% in February, and the annual inflation rate had risen to 5.9% in February, from 4.6% in January. The March CIPS manufacturing survey had pointed to further increases in input prices, with the input price balance rising to 61.9 in March, from 55.2 in February.

A44 Manufacturing output prices excluding duties (PPIY) had risen by 0.2% in February, while the annual inflation rate had risen to 1.4%, from 1.3% in January. Looking ahead, survey data had continued to point to downward pressure on output prices. The expected output price balance from the CBI Monthly Trends survey had fallen to –19 in March, from –14 in February.

A45 The GDP deflator at factor cost had risen by 0.9% in 2002 Q4, and the annual inflation rate had fallen to 3.0%, from 4.0% in 2002 Q3. Within this, the household consumption deflator had risen by 0.3% in 2002 Q4 and the government consumption deflator by 0.6%. The exports deflator had risen by 1.1% in 2002 Q4, while the imports deflator had fallen by 1.3%. Consequently, the terms of trade had risen by 2.4% in Q4, to a level which had been high by historical standards.

A46 Annual RPIX inflation had risen by 0.3 percentage points to 3.0% in February. Within this, annual goods price inflation had risen by 0.4 percentage points to 0.1% in February, while annual services price inflation had fallen by 0.1 percentage points to 4.5% in February. Annual RPI and RPIY inflation had both risen in February, to 3.2% and 3.1% respectively. Annual HICP inflation had risen by 0.2 percentage points, to 1.6%, in February.

VI Reports by the Bank's Agents

A47 The Bank's regional Agents reported that the outbreak of war had exacerbated a weakening in corporate confidence. Contacts had reported lower business expenditure on services, including advertising, consultancy and business relocation services, and lead times had shortened as customers had deferred decisions. Many professional firms, including recruitment and property consultants, had become increasingly dependent on public sector clients.

A48 Demand for international air travel had fallen sharply on the outbreak of war. Airline contacts had reported that passengers had begun to make reservations very close to the time of travel. Overseas holiday bookings had been weak in previous months and bookings had fallen further since the war had started.

A49 Weaker consumer confidence had been reflected in lower growth in retail sales in all regions. New car sales had also slowed, despite increased use of incentives to boost sales when the new registration plates had come out. Consumer services activity had been more positive, although contacts had reported that discretionary spending in bars and restaurants had been cut back. Concerns over foreign travel had been expected to boost domestic tourism, but some companies would be adversely affected by the expected continued low number of visitors from North America.

A50 Average increases in house prices had slowed across most regions. More properties had been on the market and they had been taking longer to sell. House builders had continued to report that the volume of output had remained constrained by shortages of land with planning permission. But there had also been reports of a lower number of site visits since the start of 2003.

A51 Contacts had reported that the forthcoming increase in employee National Insurance contributions had not generally been an issue in pay negotiations. The increase in employer contributions had been viewed by many in the same way as any other additional costs. Pensions had remained a more serious issue for many companies.

VII Market intelligence

A52 Changes in asset prices, interest rates and major exchange rates had been closely correlated across markets and countries during the period: market contacts had suggested that the prospect, and subsequently the progress, of the war in Iraq had been the main determining factor. Rapid unwinding of risk positions may have contributed to the sharpness of some of those moves.

A53 On 9 April, interest rates implied by short sterling futures contracts had been significantly higher than on 5 March. The rate implied by the June 2003 contract had been 12 basis points higher at 3.47%, and that implied by the June 2004 contract 49 basis points higher, at 3.91%. Geopolitical

developments had been the main influence on interest rate expectations, although UK implied rates had risen by more than international implied rates following the publication of the minutes of the March MPC meeting. Market participants had generally expected the Committee not to change the Bank's official repo rate at its April meeting. Economists polled by Reuters between 1 and 3 April had attached a mean probability of 62% to no change in the Bank's repo rate at the April meeting, and a mean probability of 36% to a decrease of 25 basis points. The mean expectation for the level of the repo rate at end-2003 had fallen by 19 basis points since the previous poll, to 3.55%.

A54 Between 5 March and 9 April, sterling's effective exchange rate had fallen by 0.7%, reflecting depreciations of 2.9% against the dollar and 0.3% against the euro. Market participants had suggested a number of UK-specific factors that may have weakened sterling independently during the period: UK participation in the Iraq war; reported comments by MPC members about the UK conjuncture and the exchange rate; and a perceived weakening of consumption growth.



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

April 2003

**The Rt Hon Sir Edward George
Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH**

Ben Elde

REMIT FOR THE MONETARY POLICY COMMITTEE

The Bank of England Act (1998) 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 17 April last year.

I hereby re-confirm the target as 2½ per cent for RPIX inflation. In accordance with the Act, I 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, which has one amendment to clarify the timing of the open letter procedure, for ease of reference.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Gordon Brown'.

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, normally on the same day as the publication of the RPIX data 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.