

Publication date: 19 February 2003

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# MINUTES OF MONETARY POLICY COMMITTEE MEETING

## 5 and 6 February 2003

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These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 February 2003.

They are also available on the Internet  
(<http://www.bankofengland.co.uk/mpc/mpc0302.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 March will be published on 19 March 2003.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 FEBRUARY 2003**

1 Before turning to its immediate policy decision, and against the background of its latest projections for output growth and inflation, the Committee discussed some underlying issues; the world economy; money, credit and asset prices; demand and output; the labour market; and prices and costs.

### **Underlying issues**

2 The Committee reviewed two long-standing issues crucial to the assessment of the risks to the outlook for the UK economy: first, the relationship between net external demand, output growth and the exchange rate; second, the relationship between consumption growth, asset prices, household borrowing and debt. An important feature in both cases was the changes in relative prices (including the terms of trade – the price of exports relative to imports, in sterling terms) that had taken place over recent years. The sustainability of the outlook depended in part on whether or not those changes would persist.

3 The external position did not seem to be an immediate cause for concern, at least in nominal terms. The current account deficit was not unusually large – it was close to its forty-year average – and was not increasing at all rapidly. However, the trade balance, and the contribution of net trade to GDP growth (measured at constant prices), had deteriorated markedly. The key question was the extent to which the improvement in the terms of trade in the past few years, which helped reconcile these two perspectives, would be sustained.

4 The current account position could be sustainable so long as those sectors with tradable outputs could maintain their share of export markets, despite in some cases doing so at low margins, and, over time, rebuild their margins by cutting costs and improving productivity. Further exit of firms from the UK production of manufactured goods might, however, worsen the current account and increase the risk of a depreciation in sterling's exchange rate. An alternative assessment was that the manufacturing sector in the United Kingdom had been shrinking since the mid-1960s, and rates of

return in manufacturing had been lower in the 1970s and 1980s than they were today. The higher levels of profitability in the mid-1990s had, on this assessment, been atypical and, even then, the profitability of manufacturing had been lower than that of services. The exit of firms from unprofitable sectors did not necessarily imply that the current account position would worsen: other, more profitable, activities for which there was external demand could be expected to develop in their place. The share of output accounted for by manufacturing remained higher in the United Kingdom than it was in, for example, the United States and the displacement of low value-added activities to countries with lower labour costs was not confined to the United Kingdom. So the weak profitability of manufacturing could be interpreted as a symptom of a long-term shift in comparative advantage, to which the economy was slowly adjusting, rather than of a short-term imbalance which would at some point become unsustainable. On this analysis, the exchange rate need not fall over the medium term. And, even if it did, there remained a question about whether the terms of trade would also deteriorate; that is, whether import prices would rise relative to export prices. There was some evidence that there had been a structural improvement in the United Kingdom's terms of trade; and, as in other countries, changes in the exchange rate now seemed to pass through less readily than in the past to domestic producer and retail prices. Committee members agreed that there were elements of truth in both analyses of the United Kingdom's current account position, although they differed somewhat in the relative weight they attached to them.

5 The household sector's position was to some extent linked to the factors driving the external balance: consumption could probably not have grown so rapidly, had the terms of trade not improved and, by doing so, boosted real incomes. Households could in effect have based their consumption decisions over this period on a belief that the recent improvement in the terms of trade would be maintained. If so, it was natural to expect a period of relatively rapid consumption growth, financed in part by higher levels of borrowing and a consequent accumulation of debt, as consumers adjusted to the higher level of consumption that they now expected to be able to sustain. This might plausibly be accompanied by additional spending on durable goods, and so should be followed by a period of somewhat slower consumption growth once that adjustment to the stock of durables was complete. A reversal of the terms of trade improvement could precipitate a sharp change in consumer behaviour; it could, alternatively, lead to a similarly extended period of rather slower consumption growth.

6 As with the external balance, and partly reflecting the terms of trade improvement, the household sector's position and its implications looked different, depending on whether it was assessed at

constant or current prices. The increase in the share of consumption in total GDP was less marked in current prices, as relative prices had moved in consumers' favour. Household sector financial flows were close to balance; and the saving ratio was above its long-term average in inflation-adjusted terms. Both these facts supported a relatively benign interpretation of the household sector's financial position, as did the rise in net housing equity. Aggregate household borrowing and indebtedness had, however, increased markedly in relation to income and financial wealth. This was a greater cause for concern. Although households had in aggregate acquired additional financial assets at a rate which broadly matched their increasing liabilities, the falls in equity market prices had at the same time eroded the value of their existing financial asset holdings. Households' indebtedness had also increased markedly relative to the value of their liquid assets. This increased the risks of abrupt balance sheet adjustment, should households' economic position deteriorate.

7 These were clearly complex issues, which the Committee would need to revisit.

### **The world economy**

8 The Committee reviewed the uncertainties, for the world economic outlook and for the United Kingdom, engendered by current geopolitical concerns and the possibility of war in Iraq. The sharp falls in consumer confidence might be associated with such worries, as it was consumers' concerns about the general economic situation, rather than about their own financial position, that seemed to have been most affected. That was consistent with movements in the price of gold, which had risen not only in dollar, but also in euro, terms (and so was not simply a reflection of recent dollar weakness). Recent falls in business confidence, and perhaps also in equity markets, might also reflect those concerns. But it was difficult to distinguish between the effect of these influences and unrelated concerns that there might be about the longer-term economic outlook, which would manifest themselves in similar ways. Even short-lived changes in sentiment could nonetheless affect behaviour, notably by delaying firms' planned investment, at least until the present uncertainties were resolved.

9 The Committee's latest projections assumed by convention that equity prices would rise from their current level in line with nominal GDP, and that the effects on activity and prices of their recent fall would be typical of past experience. The variance of the projections had been increased, however, to recognise the added uncertainties in the general outlook. No assumptions had been made in the

central projection about what the economic effects of a conflict might be, as those depended on its extent, duration and outcome – all of which were highly uncertain.

10 The latest data on the United States were mixed, and somewhat weaker than had been embodied in the Committee's November projections. GDP was estimated to have grown by only 0.2% in the fourth quarter of 2002 and consumption growth had slowed. Consumer confidence had weakened, probably in part associated with worries about possible conflict in Iraq, although the continuing fall in employment could also be a factor. The pick-up in investment – the first for two years – was, however, encouraging. The non-manufacturing sector business activity index in the ISM survey had strengthened in January, and the headline manufacturing sector index, while slightly lower on the month, remained strong. On balance, the prospect for the United States, though somewhat fragile and a little weaker in the near term than had seemed likely three months ago, remained one of moderate sustained recovery.

11 Recent news from the euro area was disappointing and activity there continued to fall short of expectations. The further appreciation of the euro exchange rate had weakened the outlook for euro-area net trade, and final domestic demand growth remained very sluggish. Data from Germany, notably on unemployment, had been weak and did not suggest that recovery there was imminent. In Japan, too, the data had been disappointing and it seemed possible that the apparent recovery earlier in 2002 might falter. Elsewhere in Asia, however, the signs were more positive: China in particular was performing strongly – as indeed were a number of other emerging market countries.

12 There had been substantial falls in many of the major international equity indices since the Committee's previous meeting: the Wilshire 5000 had fallen by nearly 7%, the FTSE All Share by over 6% and the Dow Jones Euro Stoxx by around 8%. The uniformity of these falls, in local currency terms, pointed to a common cause. The lack of substantial economic or corporate news over that period suggested that geopolitical concerns were largely responsible. But the dollar had fallen by about 4%, and sterling by over 1%, against the euro, so there was less uniformity in these equity price movements in common currency terms. To the extent that prices in each market were determined by international investors with a diversified portfolio of holdings and no 'home market' bias, this suggested that there might be other factors at work. The UK market, for example, might have been adversely affected by equity divestment by life companies and by market fears of future tax increases.

## **Money, credit and asset prices**

13 The annual growth rate of notes and coin had eased in recent months and again in January, as had that of household M4 and household Divisia since the summer. This was consistent with some slowing in the pace of nominal consumption growth. Household credit continued to accelerate on an annual basis, although households' borrowing for consumption, as a proportion of their disposable income, had probably stabilised in the fourth quarter (but at a high level). Mortgage equity withdrawal as a share of personal disposable income seemed likely to have increased further in the fourth quarter, but this had been partially offset by a smaller flow of (new) unsecured borrowing than in the previous quarter. House prices continued to increase strongly, but the increases in annual house price inflation obscured the fact that there were a number of indicators suggesting that the monthly rate of increase was now slowing. Latest outturns were consistent with the short-term profile embodied in the Committee's latest projections. There was some evidence, for example in early indications of the price expectations balance in the Royal Institution of Chartered Surveyors' housing market survey and in the number of mortgage loan approvals, that housing market activity was also beginning to ease, though this was not conclusive.

14 The corporate sector now seemed to be increasing its borrowing from banks quite strongly and its overall external borrowing had increased since the first half of the year. The implications for business investment were, in current circumstances, particularly hard to read.

## **Demand and output**

15 The ONS's preliminary estimate for GDP growth in the fourth quarter was 0.4%, a little below the Committee's expectations. The prospect for GDP growth in 2003 as a whole, embodied in the projections to be published in the February *Inflation Report*, was around half a percentage point lower than in the November projections.

16 The data on production and manufacturing output in December, which were available to the Committee at its meeting, showed a fall on the month in both cases. Whereas manufacturing output had appeared to be broadly flat last summer, once due account was taken of the effects of the Jubilee holidays on the monthly pattern of output, the underlying trend now seemed to be downwards. A further fall was embodied in the projection for the first quarter of 2003. Survey information about the

immediate outlook was mixed. The latest surveys by the Chartered Institute of Purchasing and Supply (CIPS) indicated that output and orders were weaker than in late summer, in both manufacturing and services. Surveys by the CBI and the BCC were, in contrast, more positive: both showed balances for manufacturers' new orders and expected output which were around their long-run averages, and the BCC survey pointed to improved demand growth in the services sector. The net trade position in the fourth quarter was, however, much weaker than expected. Exports of goods had, on current ONS estimates, fallen sharply in October and November. This was hard to explain in terms of their usual determinants or to reconcile with other data sources and with survey information. It was possible that data revisions would tend to reduce this apparent weakness, as had often been the case with such large movements in the past, and that there would be some offsetting pick-up in the coming months. Even so, it was unlikely that all this weakness in exports would prove to be temporary.

17 Retail sales volumes had increased by just over 1% in December and by nearly 2% in the fourth quarter as a whole, more than double the growth in the third quarter. While this suggested robust consumption growth, it was widely reported that these volume increases had been associated with heavy price discounting: the growth in the value of sales had eased. But the substantial seasonal variation in sales at this time of year made the underlying trends particularly uncertain. Monetary indicators were, arguably, more consistent with a modest easing in nominal consumption growth. The falls in consumer confidence in the past two months had mainly been in the 'general conditions' indicator and so were probably linked to gloomy economic commentary and to worries about the possibility of military conflict in Iraq. Even so, it was possible that consumer behaviour could be affected.

### **The labour market**

18 Employment, as measured by the Labour Force Survey (LFS), had increased quite strongly in the three months to November, with a much larger share accounted for by full-time workers than for some months. Much of the increase in employment was accounted for by a corresponding fall in inactivity, so unemployment had fallen only slightly, on both the LFS measure and the claimant count. The fall in LFS unemployment had been more than accounted for by short-term unemployment, and the rate of inflows to the claimant count was little changed. Taken together, these data suggested a broadly stable labour market picture.

19 Though earnings growth in the public sector had picked up again, largely reflecting the delayed local authority pay settlement, private sector earnings growth continued to ease. The outlook for pay settlements in the coming months, in which the majority of annual deals take effect, remained benign. The Treasury representative outlined the broad terms of the Pay Review Body awards that would be announced soon after the Committee's meeting and covered employees representing about 20% of the public sector payroll. The awards for these groups were on average for increases of about half a percentage point less than those made last year. A special survey by Bank's Agents had confirmed the results of other recent surveys of private sector pay prospects in suggesting that settlements would be only modestly above those of last year. This was despite the higher rate of RPI inflation (often a benchmark for pay deals) and the imminent increase in employee National Insurance contributions. The Agents' survey had at the same time suggested a rather larger increase in overall labour costs. That probably reflected firms' concerns about the cost of pension provision and the increase in employers' National Insurance costs, which should not affect firms' longer-term employment decisions but would nonetheless make them more resistant to pressures to increase rates of pay.

### **Prices and costs**

20 Following the increases towards the end of last year, sterling spot oil prices had increased by about 3% since the Committee's previous meeting and had been 7% higher on average in January than in December. Oil futures prices had also increased, albeit more modestly. This increase in spot prices was surprisingly small, if it was a result of concerns about conflict in the Middle East and the consequent risks to oil supplies, and it seemed to be inconsistent with the extent to which equity prices and business and consumer sentiment appeared to have been affected. It might be that any short-term impact associated with current supply conditions and the possibility of conflict in Iraq was being offset by changes in views about the level at which the price of oil would settle in the longer term, once production in Venezuela had been restored to normal levels.

21 RPIX inflation was 2.7% in December and had increased by 0.6 percentage points since September, the latest data available at the time of the November *Inflation Report*. This increase, though substantial, was in line with the Committee's expectation, and reflected the marked increase in the contributions from housing depreciation and from petrol prices (which had been temporarily weak a year earlier). The Committee's expectation of RPIX outturns over the next few months was a little above what it had been in November. The main additional near-term uncertainty was about the extent



of temporary price discounting. The pronounced volatility of annual RPIX inflation during 2002, which had in part reflected the unwinding of the previous year's price shocks, was unlikely to be repeated in 2003.

### **The February GDP growth and inflation projections**

22 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 12 February.

23 On the assumption of an unchanged official repo rate of 4.0% over the next two years, the central projection would have been for a gradual easing of inflationary pressure in the medium term with RPIX inflation slightly below the 2½% target by the two-year horizon and continuing to fall.

24 On an alternative assumption of an official repo rate of 3.75% over the next two years, the central projection was for GDP growth to edge up to around trend during the first half of this year but to slow a little thereafter. The central projection for RPIX inflation was for it to rise further above target in the near term but to fall back towards the end of this year and during 2004, settling at around the target by the two-year forecast horizon. The Committee judged that the range of possible outcomes was particularly large at present, given the additional uncertainties surrounding the prospect of military conflict in Iraq, and this was reflected in the variance of the projections. Most of the major risks were, taken together, broadly balanced around the central projection. In the *Inflation Report* fan charts, however, the overall balance of risks to the central projection for GDP was weighted marginally on the downside, and that to the RPIX inflation projection slightly to the upside. This reflected the possibility that the central projection might understate the effect of the previously announced increase in National Insurance contributions which would be implemented in April.

25 Bearing in mind the major uncertainties, Committee members held a range of views on the central projection, particularly regarding the speed with which inflation would moderate in the second year of the projection, and on the overall balance of risks. The range of opinion was nevertheless relatively narrow.

## **The immediate policy decision**

26 The outlook for world activity was weaker than it had been three months ago, though the deterioration on the month had been more modest. A moderate recovery remained the most likely prospect in the United States, but domestic demand growth in the euro area remained sluggish and the prospects there were less encouraging. In the United Kingdom, final demand was now expected to grow more slowly – partly reflecting the weaker world outlook, partly the effect of lower equity prices and the less favourable outlook for investment and, to a lesser extent, consumption. The impact of these demand-side influences on inflation was, however, offset – in the short term at least – by the fall in sterling's exchange rate and by higher oil and house prices. But the main news on the month was the weaker GDP outturns in the United States and the United Kingdom, the further falls in equity prices and the weakening in business and consumer sentiment, both in the United Kingdom and abroad. It was unclear whether this simply reflected increased nervousness about the prospect of military conflict in Iraq, and so might prove temporary, or more deep-seated economic weakness; and, even if it did prove temporary, whether it would nevertheless bring forward the expected slowing in consumption growth.

27 There were various arguments for maintaining the repo rate at 4.0% this month, given different weight by different members. First, the projections based on a constant repo rate of 4%, with inflation above target for most of the period and only very slightly below it at the two year horizon, were consistent with either no change in the rate or with a reduction of 25 basis points. Second, consumption growth and house price inflation were projected to slow quite quickly. Given it was not yet clear that that slowdown was well-established, a reduction in interest rates at this meeting could delay it. Related to that, borrowing had in any case become more attractive over the past year even without changes in official interest rates: spreads had fallen, banks were keen to lend and there was significant competitive pressure to do so. A modest reduction in the repo rate was unlikely to have much impact on business investment or output. But any signal of an easier interest rate environment could prompt further, unsustainable, accumulation of debt by households, potentially exacerbating the subsequent adjustment and complicating the operation of monetary policy. Third, the dip in business and consumer sentiment could prove to be temporary, and might not in fact signal that the economic fundamentals had weakened. If this change in sentiment were indeed a reflection of uncertainties about the prospect and economic implications of military action, it was possible that it might not in fact affect behaviour as much as was embodied in the projections; nor was it clear that a reduction in

interest rates would be effective in offsetting such effects. Fourth, there was a risk that inflation expectations could become less firmly anchored to the 2½% level at which they appeared, encouragingly, to have settled. RPIX inflation was already above target and was expected to remain so for some months. A further upward shock to the oil price could push inflation above 3%. That might then cast doubt on whether the inflation target would be met in the medium term. Fifth, the markets were not expecting a reduction in the repo rate at this month's meeting and it would be unwise to lead market expectations down. An unexpected reduction could in current circumstances suggest that the outlook was worse than market participants currently believed and so could, perversely, reinforce the gloomy mood. Finally, without a change in official rates, money market rates and bond yields had already fallen substantially in recent months, easing credit conditions. It was not clear to some members that this (for example, the fall in the medium-to-longer rates relevant for fixed-rate mortgages) was fully reflected in the Committee's projections. It would in their view offset to some extent the adverse news about demand. Some members concluded that, weighing these various arguments, there was no pressing need to reduce official rates this month. There was time to wait, to see whether consumption was in fact slowing as projected, and whether the recent changes in sentiment would unwind as news emerged about the possibility of military action and its economic effects. Maintaining the repo rate at 4% preserved the maximum scope for action.

28 There were also various arguments for a reduction in interest rates this month, which most members felt were on balance decisive but to which they gave different weights. First, for some members, the forecast itself suggested that a reduction in interest rates was necessary. Although RPIX inflation was expected to increase in the coming months, this was largely the result of temporary factors which would unwind and which were not related to underlying inflationary pressures in the economy. In this context, it was also appropriate, in some members' view, to accommodate the direct first-round effects on the price level of the recent fall in the exchange rate. Output growth was projected to be noticeably weaker than in November and there had, in the view of some members, been significant downside news on the month. Output was falling below supply potential during the second year of the projection, and domestically generated inflationary pressures were muted. Some members felt that inflationary pressures might be weaker than embodied in the projection; it was possible that the near-term pick-up in inflation would not be as persistent as was projected, or feed through substantially to wage settlements. Looking ahead to the second year of the projection and beyond justified pre-emptive action now, to offset the prospective weakness in demand and so to keep inflation close to target in the medium term. Second, output – especially in manufacturing – was weaker than

expected and recent export data might be more representative of underlying external demand than the projections allowed. Equity prices had fallen and business sentiment was weaker. While a small reduction in interest rates might not boost investment spending significantly, nor lower the exchange rate (and thereby improve the net trade position), it would reduce producers' costs. At a time when those costs were increasing, not least because of the imminent increase in National Insurance contributions, that would provide some relief for profit margins and lessen the risk that firms in the tradable sectors and with good longer-term prospects might be forced out of business. Third, there were now some indications that consumption growth was slowing and that house price inflation was beginning to ease. A small reduction in interest rates seemed unlikely to increase the upside risks to inflation materially. Some members argued that the current rapid pace of house price inflation was in any case being driven more by the general expectation of a stable and growing economy than by the level of interest rates. Finally, some members doubted that the recent falls in equity prices and in business and consumer sentiment would quickly be reversed, even if the current geopolitical uncertainties were resolved favourably.

29 The Governor invited members to vote on the proposition that the repo rate should be reduced by 25 basis points to 3.75%. Seven members of the Committee (the Governor, Mervyn King, Christopher Allsopp, Kate Barker, Charles Bean, Marian Bell and Stephen Nickell) voted in favour. Andrew Large and Paul Tucker voted against, preferring to maintain the repo rate at 4.0%.

30 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 31 January, in advance of its meeting on 5-6 February. 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 advance estimate, US GDP in 2002 Q4 had grown by 0.2% on a quarter earlier and 2.8% on a year earlier. After growing by 1.0% in the previous quarter, consumption had risen in Q4 by 0.2% on a quarter earlier, with a fall in spending on motor vehicles offset by growth in other components. Investment had risen by 0.8% compared with a quarter earlier, with spending on machinery and equipment having grown by 1.2% on a quarter earlier. Government spending had risen by 1.1% on the quarter. Inventories had detracted 0.1 percentage points from overall quarterly GDP growth in Q4, while net trade had detracted 0.2 percentage points. Manufacturing output had fallen by 0.3% on a month earlier in December, while production of information, communications and technology goods (ICT) had grown by 0.5%. New orders for non-defence capital goods had risen by 2.8% on a month earlier in December. The Institute for Supply Management (ISM) manufacturing index had fallen to 53.9 in January, from 55.2 in December. The headline business activity index for the non-manufacturing ISM survey had risen to 54.5 in January, from 54.2 in December.

A3 US retail sales (excluding motor vehicles) had been unchanged in value in December compared with November, while the value of motor vehicle sales had risen by 5.0% over the same period. The Conference Board measure of US consumer confidence had fallen to 79.0 in January, from 80.7 in December. The University of Michigan headline index of consumer confidence for January had fallen to 82.4 on the final measure, compared with 86.7 in December.

A4 US headline consumer price inflation had risen to 2.4% in the year to December, from 2.2% in the year to November, according to the consumer price index (CPI). Core CPI (excluding food and energy) had risen by 1.9%, compared with 2.0% in November. US producer prices had risen by 1.2%. US non-farm payrolls had fallen by 101,000 in December, following a fall of 88,000 in November.

The unemployment rate had remained unchanged at 6.0%. Average hourly earnings had increased by 0.3% on a month earlier.

A5 Euro-area industrial production had risen by 1.0% on the previous month in November, after increasing by 0.2% in October. German manufacturing orders had increased by 1.7%, after an increase of 1.1% in October. The rise had been mainly due to higher foreign orders. German GDP was estimated to have grown by 0.2% in 2002 compared with 2001, with positive contributions of 1.5 percentage points from net trade and 0.3 percentage points from government consumption outweighing negative contributions of 0.3 percentage points from consumption and 1.3 percentage points from investment.

A6 The German IFO index had risen to 87.4 in January, from 87.3 in December. The rise had been attributable to small increases in both the current conditions and the future expectations components. Euro-area retail sales had decreased by 0.5% in November on a month earlier, after increasing by 0.9% in October. French consumer expenditure on manufactured goods had increased by 1.6% in December compared with the previous month. Euro-area unemployment on the seasonally adjusted International Labour Organisation (ILO) measure had been unchanged at 8.5% in December.

A7 The euro-area harmonised index of consumer prices (HICP) had increased by 2.3% in the year to December, after an increase of 2.2% in November. Annual core inflation in the euro area had fallen to 2.2% in December, from 2.3% in November. The flash Eurostat estimate for euro-area HICP inflation had indicated a rate of 2.1% in the year to January. Producer prices had increased by 1.5% in the euro area in the year to December 2002.

A8 In Japan, industrial production had fallen by 0.9% in 2002 Q4 relative to a quarter earlier, compared with a rise of 2.2% in 2002 Q3. The index of tertiary activity had fallen by 0.7% in November compared with a month earlier, while the all-activity index had fallen by 0.8%. Export volumes had risen by 13.7% in the year to December, while import volumes had increased by 9.4%. The unemployment rate had increased to 5.5% in December, from 5.3% in November.

A9 Since the Committee's previous meeting, the spot price of Brent crude oil had risen from around \$30 per barrel to around \$31.50 per barrel. *The Economist* dollar non-oil commodity price index had risen by 2.2%. Most major international equity indices had fallen since the Committee's January

meeting – the Wilshire 5000 by 6.8%, the FTSE All-Share by 6.2%, and the Dow Jones Euro Stoxx by 8.1% – while the Japanese Topix had risen by 0.7%.

## **II Monetary and financial conditions**

A10 The twelve-month growth rate of notes and coin had fallen to 5.1% in January, compared with 5.4% in December. Annual growth of M4 had risen strongly, to 7.0% in December from 5.8% in November. But, after excluding the deposits of other financial corporations (OFCs), the increase in the annual M4 growth rate had been less pronounced. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had also risen, to 10.7% in December from 10.4% in November. M4 lending, excluding borrowing by OFCs, had risen substantially.

A11 The twelve-month growth rate of households' M4 had risen slightly, to 7.8% in December from 7.7% in November, although the one-month flow had been relatively weak. The twelve-month growth rate of households' Divisia had been 8.6% in Q4, slightly below the 8.9% figure in Q3. The twelve-month growth rate of households' M4 borrowing (excluding the effects of securitisations) had risen to 14.3% in December, from 14.1% in November. Annual growth of total net lending to individuals, a broader measure, had also risen slightly, to 13.6% in December from 13.5% in November. Within this figure for total net lending to individuals, the annual growth rate of secured lending had risen, to 13.3% in December from 13.0% in November. The annual growth rate of unsecured lending to individuals had fallen, to 15.1% in December from 15.4% in November.

A12 The number of loan approvals for house purchase, after adjusting for the number of working days in the month, had fallen to 115,000 in December compared with 121,000 in November. The House Builders Federation monthly survey had shown that the net balance of members reporting an increase in net reservations over the corresponding month a year earlier had fallen in December compared with November, after allowing for seasonal factors. The number of particulars delivered had risen to 130,000 in December, from 128,000 in November.

A13 The annual rate of growth of private non-financial corporations' (PNFCs') M4 deposits had increased by 0.7 percentage points to 6.6% in December. The twelve-month growth rate of PNFCs' M4 borrowing (excluding the effects of securitisations) had increased strongly, to 7.3% in December

from 5.6% in November. PNFCs had raised a monthly average of £5.2 billion of total external finance in Q4 compared with an average of £4.4 billion in the preceding six months.

A14 Data on the breakdown of sterling lending by all banks had shown that the twelve-month growth rate of borrowing had risen in 2002 Q4 for all the main categories of corporates.

A15 The annual growth rate of M4 deposits of other financial corporations (OFCs) had risen sharply, to 4.9%, in December, up from 0.6% in November. The twelve-month growth rate of OFCs' M4 borrowing (excluding the effects of securitisations) had fallen to 4.6% in December, compared with 5.6% in November.

A16 The FTSE All-Share index had fallen by 6.2% since the Committee's previous meeting, and all sector indices had fallen. Uncertainty in the FTSE 100, as measured by the volatility implied by options prices, had risen. The number of UK profit warnings in January had been slightly higher than in January 2002.

A17 Short-term nominal forward rates had fallen and suggested that the markets saw some possibility of a reduction in official rates by the summer. The skew on six-month short sterling interest rates, an indicator of perceptions of the balance of risk, had become slightly negative since the Committee's previous meeting. But the standard deviation of interest rate expectations, a measure of uncertainty, had fallen slightly over the month. Over longer maturities, nominal forward rates had also fallen, by 14 basis points at ten years and by about 20 basis points at twenty years. Real forward rates derived from index-linked gilts had fallen over the month, particularly at shorter maturities. Real spot rates had fallen internationally and were at low levels.

A18 Since the Committee's previous meeting, inflation expectations inferred from the gilts market had risen at shorter horizons, by about 20 basis points at two years, to 2.2%. Mean inflation expectations in HM Treasury's survey for 2003 Q4 had risen to 2.4% in January, from 2.3% in December. In the Consensus Economics survey, expected inflation for 2003 as a whole had also risen, to 2.5%. But both surveys put expectations for 2004 slightly below target.



A19 The Merrill Lynch index of investment-grade sterling corporate spreads (over government bonds) had risen only slightly despite the rise in the implied volatility of equities. Corporate yields had fallen by around ten basis points.

A20 There had been little change in interest rates quoted by banks and building societies since the previous meeting. The largest changes were falls in personal loan rates and fixed-rate mortgage rates. Data from the Council of Mortgage Lenders (CML) had shown that the share of fixed-rate mortgages in gross new lending was estimated to have increased by 5 percentage points, to 38%, in December.

A21 The sterling effective exchange rate index (ERI) had fallen by 0.2%, to 104.5, since 8 January. Sterling had appreciated by 2.9% against the dollar and had depreciated by 1.3% against the euro. The movements in sterling exchange rates could not be accounted for by changes in relative interest rates. Since January 2002, the sterling ERI had remained relatively stable, despite an appreciation of the euro by more than 20% against the dollar. Forecasts in the Consensus Economics survey had continued to point to dollar depreciation against the euro, even though relative interest rates would have been consistent with dollar appreciation.

### **III Demand and output**

A22 The ONS's preliminary estimate for quarterly growth of GDP at market prices in 2002 Q4 had been 0.4%, following 0.9% growth in Q3. Annual GDP growth had picked up slightly to 2.2% in Q4, from 2.1% in Q3.

A23 The preliminary estimate for quarterly growth in service sector output in 2002 Q4 had been 0.6%, following growth of 0.9% in Q3. Within services, quarterly output growth in the distribution, hotels and catering sector had risen slightly, to 0.8%, up from 0.7% in Q3.

A24 Manufacturing output had risen by 0.4% in November, following a fall of 0.6% in October. Overall industrial production had fallen by 0.5% in November.

A25 Retail sales had risen by 1.1% in December in volume terms, on a seasonally adjusted basis (on an unadjusted basis, retail sales in December had been 19.9% higher than in November). Quarterly growth in retail sales in 2002 Q4 had been 1.8%, compared with 0.8% in Q3. Private new car

registrations in the year to December had been 8.0% higher than a year earlier, though in Q4 as a whole registrations had been 6.8% lower than a year earlier.

A26 The Nationwide house price index had risen by a further 1.7% in January and the Halifax index by 1.5%. The Halifax and Nationwide data for Q4 had both suggested that house price inflation in London and the South East had risen in Q4.

A27 The headline GfK consumer confidence balance had picked up slightly in January, to -3.3, from -3.7 in December. But after allowing for seasonal factors, the balance had fallen quite sharply. This fall had been driven by a sharp lowering of consumers' expectations about the outlook for the general economy. By contrast, the fall in households' confidence about their own financial situation had been far more muted.

A28 Goods export volumes had been very weak in November, having fallen by 3.7% over the month, after a 3.0% fall in October. Goods import volumes had fallen by 2.0%, reversing half the 3.9% increase in October. The total deficit in goods and services in November had widened to £2.8 billion, from £2.5 billion in October.

A29 Recent surveys had suggested that business confidence in both the services and manufacturing sectors appeared to have eased slightly in Q4. According to these surveys, confidence in both sectors had been a little below their long-run averages.

A30 The British Chambers of Commerce (BCC) survey had pointed to an improvement in demand growth in the service sector. The balance for domestic orders had risen to +19 in Q4, from +12 in Q3 (although this had remained below the long-run average). But the quarterly average index of the CIPS survey of services business activity had fallen to 54.6 in Q4, from 55.1 in Q3. The monthly Chartered Institute of Purchasing and Supply (CIPS) service sector activity balance had fallen to 52.3 in January, from 53.2 in December.

A31 The Confederation of British Industry (CBI) and BCC survey balances for manufacturers' new orders and expected output had been around their long-run averages. The monthly CIPS manufacturing survey had indicated that manufacturing output had fallen in January for the second successive month.

#### **IV The labour market**

A32 According to the Labour Force Survey (LFS), employment had risen by 107,000 in the three months to November, compared with the previous three months. This had followed a 12,000 rise in the previous non-overlapping quarter and a rise of 105,000 in the three months to October. The rise in employment had been mainly accounted for by full-timers (up 93,000), in contrast to recent months in which part-timers had been the largest component. The working-age employment rate had increased on the quarter, and on the year, by 0.2 percentage points, to 74.6%. Average hours had risen by 0.5% in the three months to November but had been 0.7% lower than a year earlier.

A33 The overall CIPS employment index for January had been unchanged and had remained below the 'no-change' level of 50. According to the quarterly BCC survey, the proportion of firms trying to recruit staff had remained broadly stable, while recruitment difficulties had picked up a little.

A34 LFS unemployment had fallen by 5,000 in the three months to November but had nevertheless been 28,000 higher than a year earlier. The unemployment rate had remained at 5.2%. Claimant count unemployment had fallen by 9,700 in the three months to November, and by a further 5,800 in December. Working-age inactivity had decreased by 49,000, and the working-age inactivity rate had fallen, by 0.2 percentage points on the quarter and on the year, to 21.3%.

A35 Headline (three-month average) whole-economy average earnings growth had been 3.8% in the year to November, up 0.1 percentage points from the previous month. Headline earnings growth in the private sector had slowed by 0.1 percentage points, to 3.6%, and in the public sector had increased by 0.6 percentage points, to 4.3%. Actual whole-economy earnings growth in the year to November had been 3.9%, up 0.2 percentage points from the October figure. Whole-economy annual regular pay growth (not seasonally adjusted) had increased from 4.1% in October to 4.3% in November. This increase had mainly reflected arrears payments (which are excluded from the actual and headline figures) in the public sector, largely associated with the delayed pay settlement for local authority employees. Bonuses had made a 0.1 percentage point contribution to average earnings growth.

A36 The Bank's twelve-month whole-economy mean measure of pay settlements, weighted to match the average earnings index, had been 2.9% in December.

A37 The Bank's regional Agents had conducted an informal survey of 315 firms on the prospects for earnings growth in 2003. Of the firms sampled that had a company-wide settlement, a net balance of +12% had expected their pay settlements to be higher this year than last year. When the settlements were weighted by employment, however, a small balance had expected settlements to be lower, reflecting a weaker outlook among a handful of financial sector companies. A balance of +13% of companies weighted by employment had expected stronger total pay growth per employee this year compared with last year, while a balance of +76% expected the growth of total labour costs to be higher. National Insurance contributions, pension costs and recruitment difficulties had all been cited as exerting upward pressure on the expected increase in total labour costs during 2003.

## V Prices

A38 Sterling oil prices had risen by 2.5% since the January MPC meeting, and had been around 7% higher on average in January than in December.

A39 Manufacturing input prices had risen by 2.8% in December. This rise had mainly reflected an increase in the price of crude oil. Annual input price inflation had risen in December, to 2.7%, from -0.3% in November. Looking forward, the CIPS manufacturing survey had suggested that input prices would continue to pick up. The input price balance had fallen a little, to 51.2, in January, from 51.7 in December, but remained above the 'no-change' level of 50.

A40 Manufacturing output prices excluding duties (PPIY) had risen by 0.1% in December, while the annual inflation rate had remained unchanged at 1.1%. Survey data had continued to point to downward pressure on output prices going forward. The expected output price balance from the CBI *Quarterly Industrial Trends* survey had remained at -12 in January.

A41 Annual RPIX inflation had fallen by 0.1 percentage points, to 2.7%, in December. Within this, annual goods price inflation had fallen to -0.4%, from -0.1% in November, and annual services price inflation had been unchanged at 4.8%. Annual RPIY inflation had been unchanged at 2.9%, annual RPI inflation had risen by 0.3 percentage points, to 2.9%, and annual HICP inflation had risen by 0.1 percentage points, to 1.7%.

## **VI Reports by the Bank's Agents**

A42 Since mid-2002, the Bank's regional Agents had lowered their estimates of growth in retail sales values. But for most regions, growth in January had been only modestly lower than in January 2002. Although retailers had reported strong trading in the weeks immediately before and after Christmas, spending had tailed off thereafter – quite quickly in some regions. Pre-Christmas price discounting by clothing retailers had been more widespread and post-Christmas discounting heavier than the previous year. But the timing and depth of discounting of non-clothing goods prices had been similar to a year earlier.

A43 Consumer services growth had slowed slightly, with reports of weaker bookings for continental and long-haul summer holidays. Hotel and other leisure providers had reported continued buoyancy in their markets. But the strongest growth had been in personal credit, mortgage and property services.

A44 This strength in mortgage services had reflected continued strength in the housing market. Demand from first-time buyers had remained strong and buy-to-let purchases had remained popular with investors. Lenders had reported strong growth in demand for finance, much of which had been remortgaging. Estate agents in most regions had reported an increased supply of properties to the market compared with a year earlier, and price inflation had been less rapid. Prices at the top end of the market had been static or falling across most of the country.

A45 Since October 2002, Agents had indicated that manufacturing output for export had declined. Ports and cargo handling facilities had reported a modest build-up in stocks for export, but this had not been widespread and had not tallied with the sharp fall recorded in official data on goods exports. Manufacturing contacts had reported particular weakness in demand in the euro area, especially Germany. Some exporters had benefited from an improvement in margins as a result of exchange rate movements.

## **VII Market intelligence**

A46 On 5 February, interest rates implied by short sterling futures contracts were lower than they had been on 8 January. The rate implied by the June 2003 contract was 10 basis points lower at 3.71%,

and that implied by the June 2004 contract was 40 basis points lower, at 3.99%. Implied rates for contracts maturing in 2003 and 2004 had fallen for much of the period, partly in response to international developments (continuing concerns over a possible conflict in the Middle East and falls in equity markets), and partly due to some weaker-than-expected US economic data including non-farm payrolls.

A47 Market participants had generally expected the Committee not to change the Bank's official repo rate at its February meeting. Economists polled by Reuters between 28 and 30 January had attached a mean probability of 79% to no change in the Bank's repo rate at the February meeting, and a mean probability of 20% to a decrease of 25 basis points. The mean expectation for the repo rate for end-2003 had fallen by 0.08 percentage points since the previous poll, to 4.17%.

A48 As in December, the dominant change in foreign exchange rates over the period had been the appreciation of the euro against the dollar, by 4.3%. The main themes in market participants' commentaries had continued to be concerns over the size of the US current account deficit and concerns over a potential war with Iraq.