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MINUTES OF MONETARY POLICY COMMITTEE MEETING 8 and 9 January 2003

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 January 2003.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0301.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 February will be published on 19 February 2003.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 JANUARY 2003

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

The world economy

2 News on the world economy had not pointed consistently in one direction. There was nevertheless a clear difference between developments in the United States and the euro area. In the United States, although recent indicators had been mixed, the pace of economic growth seemed broadly consistent with what had been envisaged at the time of the November *Inflation Report*. Overall, a mixed pattern of indicators such as this was typical of an economy in the early stages of recovery. Some evidence suggested strength: manufacturing production had risen in November, and there had been an unexpectedly large rise in the survey indicator of confidence in manufacturing from the Institute for Supply Management (ISM) in December, with new orders picking up sharply. Sales of cars in the fourth quarter were likely to have been stronger than had been expected in November, but this appeared to have reflected an increase in incentives to consumers, which might have brought forward spending from 2003 rather than creating additional demand. Other evidence suggested less buoyancy: the labour market data for November had shown a fall in non-farm payrolls (although this implied that robust productivity growth had continued); and the ISM indicator of non-manufacturing confidence had weakened in December, although its level was still pointing to expansion in that sector. Consumer confidence indicators were giving mixed signals, but it appeared that consumers' concerns about the general economic situation had increased, possibly reflecting the weaker labour market and perhaps also the geopolitical situation. Mortgage refinancing activity was still strong, although less so than in the summer and autumn of 2002, and it was thought that there was still a stock of mortgages which could be refinanced. Personal sector income gearing had still been historically high in the third quarter, because the increase in indebtedness had offset lower servicing costs. There were only limited signs of a pick-up in investment growth. Non-defence capital goods orders fell in November, and it

was unlikely that investment would contribute strongly to the economic recovery in the near future.

3 The recently announced US fiscal package would tend to support domestic demand there if it were passed broadly as proposed. Although a further fiscal stimulus had been seen as a possibility for some time, the measures announced were somewhat larger than most commentators had expected. The impact of some of the measures proposed was uncertain: for example, a rise in equity prices might have been expected in response to the proposed elimination of taxation on dividends received by investors, although it was not clear what would have happened to equity prices in the absence of the proposal. But it was likely that the package would result in an increase in personal disposable income, and so encourage consumption. This might add to one manifestation of the imbalances in the US economy. One counterpart to the rise in the government sector deficit might be a fall in the financial deficit of the household sector and an associated rise in household saving or a fall in their borrowing. Moreover, the recent fall in the dollar, if sustained, would tend to counteract any increase in the current account deficit resulting from additional domestic demand.

4 In the euro area, by contrast, the data published since the November *Inflation Report* had on balance been more subdued than expected, reflecting, in particular, weaker economic performance and confidence in Germany. Industrial production had fallen in October in the euro area in aggregate, and by more than 1% in Germany. The manufacturing PMI survey had fallen in December, again with Germany falling by more than average, while the euro-area services survey had shown little change. Although the European Commission's measure of industrial confidence had risen in December, consumer confidence had fallen, mainly reflecting the public perception of the general economic position rather than their own finances. In the euro area outside Germany, the data were mixed. For example, French consumption had increased in 2002 Q3, and French business and consumer confidence had improved in December, but consumer confidence had deteriorated sharply in Italy in that month. It was noted that the economic indicators for the euro area as a whole would probably not reflect the effect of the recent monetary policy easing by the ECB for a while. Overall, developments in the euro area outside Germany were broadly consistent with the projections embodied in the November *Inflation Report*. But the weakness in Germany implied below-trend growth for the euro area in aggregate in 2003; and the *Inflation Report* projections for 2003 now lay above both the most recent European Commission forecast and the centre of the range forecast by the ECB.

5 Both economic data and confidence surveys had recently been weaker in Germany than for the euro area as a whole. The Committee noted that it was likely that the high levels of prices and unit labour costs in Germany relative to its partner countries were adversely affecting its competitive position and domestic profitability. The likelihood that taxes would be increased may have affected confidence about future income growth.

6 Estimates of Japanese GDP growth for the first two quarters of 2002 had recently been revised downwards, although there was still thought to have been an improved growth performance in the second and third quarters. Expenditure by households was estimated to have risen in 2002 Q3, but had subsequently been much weaker. Japanese exports to other Asian countries had been growing robustly during 2002, reflecting the recovery elsewhere in Asia, and the December Tankan report had shown some improvement in industrial sentiment.

7 There had been some notable movements in international financial markets. The euro had appreciated against the dollar by around 4% since the Committee's December meeting, and in overall effective terms by about 2%. Although this would dampen external demand in the euro area, there could be some short-run positive influence on domestic demand if inflation were reduced, temporarily increasing real disposable income and facilitating lower interest rates than would otherwise have prevailed. Equity indices in most of the major economies were little changed or somewhat lower on the month, but the German DAX index had fallen by about 10%. Market interest rates had fallen in all the major markets, particularly at short and medium maturities. Other things being equal, this would tend to support activity.

8 The extent and timing of the change in the dollar-euro exchange rate had been surprising, given that it had coincided with expansionary fiscal measures in the United States and the increasing likelihood that some euro-area countries would take action to reduce their fiscal deficits. The movement also appeared to contradict the perception that currencies' strength reflected relative growth performance and prospects: the news about the outlook for the US economy in 2003 seemed to have been more robust than that for the euro-area economy. There were various possible explanations. First, the US current account deficit, which was running at well over 4% of GDP, might now be viewed with more concern by financial market participants. Second, although recent US economic data had on balance been broadly consistent with the outlook envisaged in the November *Inflation Report*, some market participants might have anticipated a more rapid recovery, and may therefore

have been disappointed by these data. Third, markets might have changed their view of the likely reaction of the Federal Reserve. The US yield curve had fallen sharply at about a year ahead, suggesting a delay to the time at which the market expected the Fed to begin raising rates towards a neutral level. The relative movement in interest rates between the United States and the euro area had, however, been far smaller because the euro-area yield curve had also moved sharply downwards over the past month. Finally, there was some evidence that international political and military uncertainty had had an adverse impact on the dollar, and had affected other markets. The Swiss franc, gold and spot oil prices had all risen. But the evidence was not conclusive: if there had been a general rise in risk aversion, higher corporate bond spreads might also have been expected.

Money, credit and asset prices

9 The effective exchange rate for sterling had fallen by about 1½% since the Committee's December meeting, leaving it a similar amount below the level envisaged at the time of the November *Inflation Report*. This was apparently related to the large move in the dollar-euro rate: sterling had appreciated by about 2% against the dollar and depreciated similarly against the euro, but the euro has greater weight in the sterling effective index. On a longer perspective, the current level of the index was still inside a range within which sterling had traded for several years. The Committee considered whether the UK external position might have had an independent influence on the fall in sterling. The latest estimates for the current account deficit suggested that it would be around 1% of GDP in 2002, which was close to its average for the past forty years. However, the trade deficit had widened rapidly since early 2000. The growing difference between these two deficits reflected the higher UK net investment income, but it was not clear that this was sustainable. The Committee also noted the uncertainty attached to estimates of trade deficits.

10 As in other major economies, UK short-term nominal and real market interest rates had fallen, implying support for domestic demand. But the FTSE All-Share index had fallen by around 3% during the month and was now some 3% below the level envisaged in the November *Inflation Report* projections. A reduction in the repo rate was perceived by market participants as unlikely at this meeting, but the repo rate was now expected to remain at its current level for longer than previously expected.

11 The annual growth rate of borrowing from banks and building societies by the household sector had been increasing continuously for a year and a half, and had been over 14% in November. Borrowing for consumption was estimated to have risen to around 10% of personal disposable income in 2002 Q3, and was likely to represent a similar proportion in the fourth quarter. Household debt was at historical highs as a percentage of income. However, the inflation-adjusted household saving ratio was close to its average level for the past 20 years, and the personal sector's net financial deficit had been estimated at around zero in recent quarters. That implied that households had in aggregate been acquiring financial assets at the same rate as debt. It was difficult to assess from this information how great was the risk that the personal sector in aggregate might need to reduce its borrowing and consumption abruptly if there were an adverse shock. With nominal interest rates low, households' debt servicing was also low and seemed unlikely to be a source of serious problems unless there was a material adverse shock affecting interest rates or income prospects. Moreover, the aggregate financial balance data suggested that the risk of a sharp change to consumption was less than might be thought on the basis of the aggregate borrowing figures alone. But that risk depended on the balance sheet position of the household sector, and that in turn required an assessment of disaggregated data, for example whether the most indebted households also held substantial assets, and how liquid those assets were.

12 The annual growth rate of bank lending to private non-financial corporations had recently increased, to over 5½% in November. And data from the major British banking groups suggested that the rate of decline of bank lending to manufacturing companies was moderating. These data, together with the decline in yields on corporate bonds, suggested an easing in corporate credit conditions which might to some extent have offset the rise in the cost of capital implied by the most recent falls in equity prices.

Demand and output

13 The National Accounts data released in December showed that UK GDP had grown by 0.9% in 2002 Q3, representing an upward revision of 0.1 percentage point from the original estimate. Taking account of revisions to earlier data, the estimated level of GDP in Q3 was around 0.4% above the level expected at the time of the November *Inflation Report*. However, various indicators suggested that output growth might have slowed in Q4: manufacturing output had fallen in October; and the December manufacturing surveys by the CBI and the Chartered Institute of Purchasing and Supply

(CIPS) and the CIPS services survey, taken together, pointed to a slowing in output growth. On balance, the degree of pressure on supply capacity by the end of 2002 looked likely to have been broadly in line with what had been expected at the time of the November *Inflation Report*. The revisions to past GDP data resolved some earlier puzzles; for example, the slightly stronger profile for growth during the winter of 2001-2 implied that the extent of labour hoarding, which the Committee had found surprising at the time, had been less than thought. The Committee considered whether the revisions to GDP and the latest data on tax revenues implied a change to the average tax rate, and concluded that it was too early to tell.

14 The latest estimate for whole economy investment in 2002 Q3 was that it had been little changed on the previous quarter, having previously been estimated to have fallen sharply. However, business investment had fallen. The latest revisions to past data offered less evidence that business investment had weakened as sharply in the immediate aftermath of the terrorist attacks in September 2001 as previously thought; rather, it appeared that investment had weakened steadily throughout the past two years. The Committee noted that as the relative price of investment goods had been falling for many years, it was likely that the equilibrium constant price investment-output ratio would continue to rise, implying a recovery in investment at some stage. But, despite the recent weakness of investment, it was not clear that this could be expected soon. Indeed, the January CIPS manufacturing survey suggested that prospects remained subdued: the index of new orders for investment goods was lower than those for intermediate or consumer goods.

15 Consumption growth was unrevised at 0.8% in 2002 Q3. But its level had been revised downwards, because of revisions to data for earlier quarters. There were some tentative signs in the fourth quarter that consumption growth might be moderating. The November retail sales data showed only a slight increase over October. The growth of notes and coin in circulation had fallen in November and December. Reports from the Bank's regional Agents and survey evidence from the British Retail Consortium (BRC) suggested that there had been a sluggish start to the Christmas season, but that sales had picked up close to and immediately after Christmas. Reports from individual retailers were mixed. However, experience suggested that data for December needed to be reviewed together with those for January to assess the underlying trends in retail sales, given the large seasonal swings. Moreover, retail sales could be an erratic guide to overall consumption. It was possible that data on consumer services expenditure would show some strength, and borrowing for consumption was likely to be at least as high as a proportion of personal disposable income in Q4 as it had been in

Q3, so it was not yet certain that there had been any material slowdown in consumption growth.

16 Consumption growth had for some time been supported by accelerating household borrowing, in turn associated with the strength of the housing market. There were some signs that the rate of increase of house prices might be beginning to moderate. Judging by the change in the three months to December over the previous three months, house price inflation appeared to have eased a little. Reports from the Bank's Agents were also consistent with a less buoyant market, and house prices in London and the South East, which tended to lead housing market trends in other parts of the country, were more clearly slowing, at least for higher-value properties. Nevertheless, house prices had probably increased by more in 2002 Q4 than had been envisaged in the November *Inflation Report* and so the house price-earnings ratio might have moved further above its longer-run equilibrium level. This implied that house prices would need to grow more slowly than previously expected at some point in the future, although the equilibrium level depended on a range of longer-term demand and supply factors and was itself highly uncertain.

The labour market

17 Demand and supply conditions in the labour market had remained broadly stable. Employment had grown by 105,000 in the three months to October, although much of this reflected an increase in part-time employment. However, the rate of unemployment, at 5.2% on the Labour Force Survey (LFS) measure, had been little changed during 2002. Inactivity had fallen in recent months, and over a longer perspective the rise in employment had been broadly in line with population growth, suggesting no material change in the pressure on labour supply. Surveys of employment intentions suggested that the pattern of stable or gently increasing employment was likely to continue.

18 The rate of growth of earnings had been steady in the second half of 2002 at between 3½% and 4% overall, although public sector earnings growth was increasing again after being subdued for several months in the summer. There were some possible upward influences on earnings over the next few months. The twelve-month rate of increase in the Retail Price Index in November had been 1.7 percentage points higher than a year earlier, and the corresponding figure for the Tax and Price Index (an index which reflects the impact of tax changes as well as of changes in the prices of goods and services on personal disposable income) had been 3.3 percentage points. This could put upward pressure on pay settlements this spring. But the likely effect of the forthcoming rises in employers'

and employees' National Insurance contributions remained uncertain. Corporate profitability remained quite weak, which would limit the ability of employers to pay large increases.

Prices and costs

19 The spot price of Brent crude oil had risen by over \$4 per barrel, or 17½%, since the Committee's December meeting. The increase had been mitigated a little by the appreciation of sterling against the dollar, but was still 15½% in sterling terms. The outlook for oil prices in the near term had recently been affected by several diverse factors, for example: industrial action cutting production in Venezuela; the risk of hostilities in the Middle East; the level of US government oil stocks; and the ability and willingness of the OPEC countries to continue to produce in excess of previously agreed quotas, or to raise quotas, when prices were high. Spot oil prices were therefore particularly uncertain month-to-month and could be very volatile. However, the price of six-month oil futures had been more stable, implying that the recent volatility in oil prices need not have substantial consequences for the medium-term outlook for inflation, as long as short-term movements in oil prices did not become entrenched in inflation expectations and wage behaviour.

20 Overall, inflation in 2003 Q1 would probably now be higher than projected in the November *Inflation Report*. But this need not have implications for inflation in the medium term, as the factors responsible for this were likely to be transitory. The rise in spot oil prices, and its effect on petrol prices, implied short-term upward pressure on RPIX inflation. The strong growth in house prices in 2002 had contributed to a rise in the housing depreciation component of RPIX, but if the equilibrium level of house prices to earnings had not changed, the recent faster-than-expected increases in house prices implied, at the very least, slower increases in future. The swing in RPIX inflation from around 1½% in mid-2002 to close to 3% by the end of 2002 illustrated the extent to which inflation could be driven by temporary influences which were of limited significance for underlying inflationary pressures and monetary policy.

Other considerations

21 There was little market expectation of an immediate change in the repo rate. The latest Reuters poll of economists showed that respondents attached a mean probability of 14% to a 25 basis point reduction at the January meeting, and none was forecasting a reduction.

The immediate policy decision

22 The Committee agreed that, although there was a wide range of information to take into account this month, the net impact of the news was difficult to assess. The world economy was on balance slightly weaker. The overall news from the United States might be slightly on the upside taking account of the fiscal package, but the euro area, especially Germany, was weaker. Some Committee members remained concerned that weak confidence in Germany might begin to spill over to other countries in the euro area. The effects of the current international political tensions were not clear, although they might be having some dampening effect on survey indicators of confidence, and perhaps also on demand, both in the rest of the world and the United Kingdom. In the United Kingdom, there had been some signs that retail sales growth had been sluggish in early December, but it had probably since picked up and the recent underlying trend in consumption was not yet clear. There were some tentative signs that the rate of increase in house prices was moderating. Both these developments had been expected to materialise at some stage. Output growth had recently been around trend, and there was no sign in the monetary or labour data that the economy was about to weaken abruptly, despite the gloomy tone of some recent commentators. RPIX inflation looked likely to be a little stronger in the near term than at the time of the *Inflation Report*, but this was as a result of factors which seemed likely to be temporary.

23 Most members had taken the view at the December meeting that inflation was broadly on track to meet the target in the medium term and that the risks around the projection were roughly balanced. For these members, the information received this month, taken together, did not contain a clear message about the prospects for inflation. Various arguments, to which different members attached different weights, supported this judgement. First, although the balance of indicators on the world economy was probably negative on the month, the impact on UK inflation in the medium term might be relatively limited. And in the event that the downside global risks were to crystallise, there was scope for policy responses overseas to support activity. Second, house price inflation looked likely to be stronger in 2002 Q4 than projected, although there were some signs of the long-expected slowdown. Third, the evidence that consumption growth was moderating, as had been envisaged in the November *Inflation Report* projections, was still tentative, and the monetary data suggested that growth in credit would support consumption and, possibly, investment. Fourth, the depreciation in sterling relative to the *Inflation Report* assumption, and the substantial fall in short and medium-term interest rates relative to market expectations at that time, would support activity and tend to increase

inflation if they were sustained, although the fall in equity prices would moderate this to some extent. Overall, both monetary and fiscal policy were already supportive. Finally, the recent diverse news – about the world, about the domestic economy, and from financial markets – could be assessed more fully in the forthcoming forecast round. These arguments, taken together, implied that no change in the repo rate was needed this month.

24 Some members, however, continued to believe that an immediate repo rate reduction was warranted. First, these members had and still thought that the most likely path for inflation over the next two years would be slightly lower than the central projection in the November *Inflation Report*, and that the balance of risks lay on the downside. Second, the balance of news from the world economy over the past two months had been negative; there were longer-term downward pressures on world inflation coming from increased international competition; and there were significant downside risks, in particular from the euro area, where consumer confidence was weak. Third, the upside risks to inflation were modest, with labour market conditions benign, and consumption and house price increases moderating. Finally, on this view, the risk of an unsustainable build-up in household debt and the current account deficit might not be as severe as some thought, and, in any case, should not prevent a repo rate reduction which was needed to support activity and maintain inflation close to target in the medium term. The current account was around its average level of the past four decades, and the household sector had been close to financial balance in recent quarters.

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

26 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
 Jon Cunliffe 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 3 January 2003, in advance of its meeting on 8-9 January. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is recorded in this Annex.

I The international environment

A2 Industrial production in the United States had risen by 0.1% in November compared with a month earlier. Manufacturing output had increased by 0.1% in November compared with a month earlier, and output in the information, communications and technology (ICT) sector had increased by 0.6%. The Institute for Supply Management (ISM) manufacturing index had increased again in December, to 54.7, from 49.2 in November. The new orders sub-index had increased to 63.3 in December, from 49.9 in November. The ISM non-manufacturing index had fallen to 54.7 in December, from 57.4 in November. Non-farm payrolls had fallen by 40,000 in November, following an increase of 6,000 in October. The unemployment rate had risen to 6.0% in November, from 5.7% in October.

A3 Real consumption had risen by 0.5% in November compared with a month earlier, following a 0.2% rise in October. Spending on automobiles had increased by 3.2% in November on a month earlier. Nominal retail sales (excluding automobiles) had also increased by 0.5% in November on a month earlier. The final release of the University of Michigan measure of consumer confidence had picked up in December, to 86.7, while the Conference Board index had fallen to 80.3, from 84.9 in November. That fall had been largely attributable to a fall in the present situation index. Export volumes had fallen by 1.9% in October compared with a month earlier, following a 0.6% fall in September. Import volumes had fallen by 4.0% in October compared with a month earlier, which could be related to the dock strike on the US west coast. President Bush had announced a proposed fiscal package which the administration estimated would, if passed, provide tax relief worth \$98 billion over the next 16 months.

A4 In Italy, quarterly GDP growth was estimated at 0.3% in 2002 Q3. Total investment had contributed 0.6 percentage points. Industrial production in the euro area had fallen by 0.2% in October

compared with a month earlier. Industrial production had fallen in October by 1.4% in Germany and by 0.6% in France. The euro-area manufacturing Purchasing Managers' Index (PMI) had fallen to 48.4 in December, from 49.5 in November. In Germany, the PMI had fallen to 46.9 in December, from 49.0 in November; while in France it had fallen to 48.7, from 49.6 in November. The euro-area services PMI had fallen to 50.6 in December, from 50.8 in November. The German IFO index had fallen to 87.1 in December, from 87.3 in November. That fall had been attributable to a decline in the current conditions component. The French INSEE measure of manufacturing confidence had risen in December, reflecting an improvement in both current conditions and expectations. The European Commission measure of euro-area consumer confidence had fallen by 2 points in December, to -16, while the measure of industrial confidence had increased by 2 points, to -9. German manufacturing orders had increased by 1.1% in October compared with a month earlier. Orders of consumer goods had risen 2.7% in October compared with a month earlier. Consumer spending on manufactured goods in France had fallen by 1.7% in November compared with a month earlier, following a 1.6% increase in October. The volume of retail sales in the euro area had increased by 0.7% in October, compared with a month earlier, following a 0.9% fall in September. Euro-area unemployment was unchanged in November, at 8.4%.

A5 In Japan, worker households' real expenditure had fallen by 3.4% in November compared with a year earlier, and nominal retail sales had declined by 2.4% in November compared with a year earlier. Industrial production had fallen by 2.2% in November compared with a month earlier. Export volumes had increased by 18.2% in November compared with a year earlier, following a 12.5% rise in October compared with a year earlier. Annual growth in the value of exports to the United States had increased to 17.7% in November. The Bank of Japan's Tankan large manufacturers' diffusion index had increased by 5 points, to -9, in December, but the large non-manufacturers' diffusion index had fallen by 3 points, to -16. According to the most recent data, the value of exports from many South East Asian economies had remained strong and industrial production had continued to hold up.

A6 The price for physical Brent crude oil had risen to around \$30 per barrel in early January, an increase of around \$4.50 per barrel from the price at the time of the Committee's previous meeting. *The Economist* commodity all-items dollar price index had fallen by 0.9% since the Committee's previous meeting, while the industrial metals index had fallen by 2.0% over the same period. *The Economist* non-food agricultural commodities index had risen by 0.7%; *The Economist* dollar food

index had risen by 0.6%.

A7 In the United States, producer prices had fallen by 0.4% in November, compared with a month earlier, following a 1.1% rise in October. Core producer prices had also fallen, by 0.3% in November compared with a month earlier, reflecting in part the lower cost of vehicles due to recent sale incentives. Annual consumer price inflation had increased in November, to 2.2%, compared with 2.0% in October. Annual core consumer price inflation (which excludes energy and food prices) had, however, continued to fall, to 2.0% in November compared with 2.2% in October, reaching its lowest level since December 1999. Euro-area producer prices had risen by 1.1% in the year to November, compared with 0.9% in October. The euro-area harmonised index of consumer prices (HICP) had increased by 2.2% in the year to November, compared with a 2.3% increase in October; the flash estimate for the twelve months to December was 2.2%. The preliminary estimate of German HICP inflation in the year to December had been 1.0%, unchanged from November. In Japan, annual consumer price inflation had been -0.4% in November, compared with -0.9% in October.

A8 The interest rates in the United States and the euro area implied by futures contracts had fallen since the Committee's previous meeting. Longer-term yields had also fallen in the United States, the euro area and Japan. Equity indices had fallen in the United States (the Wilshire 5000 had fallen by 0.9%) and the euro area (the Dow Jones Euro Stoxx index had fallen by 5.0%) since the Committee's previous meeting. In Japan, the Topix had fallen by 4.0%. Corporate spreads had been little changed since the Committee's previous meeting. US dollar-denominated sovereign bond spreads in most Latin American markets had also been little changed over the month and had actually fallen in Brazil.

II Monetary and financial conditions

A9 The twelve-month growth rate of notes and coin had fallen to 5.1% in December, from 6.9% in November. The twelve-month growth rate of M4 had risen slightly, to 5.8% in November from 5.4% in October. Annual growth of M4 lending (excluding the effects of securitisations) had risen by 0.7 percentage points, to 10.5%, in November. Excluding other financial corporations (OFCs), the annual growth rate of M4 had fallen slightly in November, while the annual growth rate of M4 lending had risen slightly.

A10 The twelve-month growth rate of households' M4 was unchanged, at 7.9%, in November. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had continued to rise, to 14.1% in November from 13.9% in October. Within total net lending to individuals, the annual growth rate of secured lending had risen, to 13.0% in November compared with 12.8% in October, but the annual growth rate of unsecured lending had fallen slightly, to 15.4% in November.

A11 Mortgage equity withdrawal (MEW) had risen in 2002 Q3 to £12.0 billion, an estimated 6.6% of personal disposable income (PDI), compared with £10.1 billion, or 5.7% of PDI, in 2002 Q2.

A12 The number of loan approvals for house purchase, after adjusting for the number of working days in the month, had risen slightly, to 123,000 in November from 122,000 in October.

A13 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had fallen to 5.6% in November, from 6.7% in October. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had increased to 5.6% in November, from 4.8% in October. Data from the major British banking groups (MBBG) had shown slight increases in annual rates of lending growth to most categories within the corporate sector in November, although there had been a modest easing in the annual growth rate of lending to real estate companies. PNFCs had raised £6.4 billion in total external finance in November, compared with an average monthly flow of £5.3 billion in 2002 Q3.

A14 Corporate income gearing had fallen slightly in Q3. But capital gearing at market value had risen substantially in the quarter.

A15 The twelve-month growth rate of other financial corporations' (OFCs') M4 deposits had risen to 0.3% in November, from -2.0% in October. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had also risen, by 1.5 percentage points, to 5.9% in November.

A16 The FTSE All-Share and FTSE 100 indices had fallen by 3.1% between 4 December 2002 and 8 January 2003. Over the month, the indices for all sectors had fallen apart from utilities and resources, which had posted modest increases. The worst-performing sector had been information technology,

which had declined by about 11%. Uncertainty about the FTSE 100 index, as measured by the volatility implied by options prices, had risen over the month, but the skew to expectations for the index, an indicator of perceptions of the balance of risk, had become slightly less negative. Profit warnings in December had been higher than in December 2001.

A17 Short-term nominal forward rates had fallen at all but the very shortest maturities, and by about 40 basis points at the one-year horizon. The skew on six-month short sterling interest rates had fallen below zero since the Committee's previous meeting. The standard deviation of interest rate expectations, a measure of uncertainty, had increased slightly over the month. Over longer maturities, nominal forward rates had also fallen over short to medium horizons, by about 15 basis points at ten years, but had risen further out, by 11 basis points at 20 years. Real forward rates derived from index-linked gilts had fallen significantly over the month, particularly at shorter maturities.

A18 Since the Committee's previous meeting, implied inflation expectations showed little change at short and medium horizons, but had risen by about 10-15 basis points at around 20 years. Mean inflation expectations, in HM Treasury's survey for 2002 Q4, had risen to 2.4% in December, from 2.3% in November. The Consensus Economics forecast of average inflation for 2002 was unchanged at 2.2%, while the forecast for 2003 had increased to 2.4%, from 2.3% in November.

A19 The Merrill Lynch index of investment-grade sterling corporate spreads was little changed. Aggregate yields had fallen by 26 basis points.

A20 Quoted interest rates on household borrowing had been little changed since the previous meeting. However, the rate on two-year fixed-rate mortgages had increased by 19 basis points since November, when there had been a rise in swap rates. According to the most recent Council of Mortgage Lenders' press release, the estimated proportion in gross lending of fixed-rate mortgages had increased sharply, to 32% in November from 28% in October.

A21 The sterling effective exchange rate index (ERI) had fallen by 1.4%, to 104.7, between 4 December 2002 and 8 January 2003. Sterling had appreciated by 1.8% against the dollar and had depreciated by 2.0% against the euro. The movements in sterling exchange rates could not be accounted for by interest rate news. During 2002, sterling had appreciated by about 11% against the dollar and had depreciated by about 4% against the euro. The sterling ERI had remained relatively

stable.

III Demand and output

A22 In the Q3 National Accounts, published on 23 December, quarterly GDP growth at constant market prices in 2002 Q3 had been revised up, to 0.9%, from 0.8% in the previous release. Annual growth had been revised up to 2.1%, from 1.8%. The Q3 National Accounts included revisions to GDP and its components in 2001 and 2002. The net impact of these revisions had been to raise the level of GDP at market prices in 2002 Q3 by 0.2%.

A23 On the output measure, GDP growth at basic prices had been unrevised from the previous release, at 0.8% in 2002 Q3. Within this, service sector growth had been unrevised at 0.9%, manufacturing output growth had been revised down a little, to 1.0% from 1.1%, and construction output growth had been revised up, to 1.7%, from 0.5% in the previous release. The ONS had published estimates of the effect of the Jubilee Bank Holidays on GDP growth over 2002. These had suggested that, had it not been for the effect of the Jubilee holidays, growth in Q2 would probably have been stronger than in Q3.

A24 On the expenditure measure, quarterly final domestic demand growth in 2002 Q3 had been revised up a little, to 0.7%, from 0.6% in the previous release. Household consumption growth (including NPISH) had been unrevised at 0.8% in 2002 Q3. Within this there had been a fall in spending on vehicles, but this had been offset by continued strength in spending on other goods. Whole-economy investment growth (including valuables) in 2002 Q3 had been revised up, to 0.1%, from -1.1% in the previous release. Within this, business investment had fallen by 2.2%. But this was offset by a 5.6% rise in government investment and a 1.0 percentage point contribution from valuables.

A25 The contribution of inventories to quarterly GDP growth in 2002 Q3 had been revised down, to 0.4 percentage points, from 0.5 percentage points in the previous release. Excluding the alignment adjustment, stocks had contributed 0.4 percentage points to GDP growth, while the alignment adjustment had contributed 0.1 percentage points. Domestic demand growth had been revised up a little, to 1.1% in 2002 Q3, from 1.0% in the previous release.

A26 Export growth had been revised up, to -1.2% in 2002 Q3 (from -1.7% in the previous release), as had import growth, to -0.5% (from -0.7%). Within exports, there had been a 3.4% fall in exports of goods, but this was partly offset by a 5.9% rise in exports of services. The net trade contribution to quarterly GDP growth in Q3 had been revised up, to -0.2 percentage points, from the previous estimate of -0.3 percentage points.

A27 Households' real post-tax income growth had risen by 1.4% in 2002 Q3. This growth had mainly reflected an increase in non-labour income. Households' real post-tax labour income, which excludes dividends and other non-labour income, had risen by 0.6%. The saving ratio had risen to 5.6% in 2002 Q3, from 5.0% in Q2. Households' net financial deficit had narrowed to -0.1% of GDP in 2002 Q3.

A28 The gross operating surplus of private corporations (excluding the alignment adjustment) fell by 0.2% in 2002 Q3, following a rise of 3.0% in Q2. Private corporations' financial balance (excluding the alignment adjustment) had remained in surplus for the second successive quarter in 2002 Q3. Together with the pick-up in the households' net financial balance, this had resulted in a slight increase in the private sector net financial surplus. In contrast, the public sector net financial deficit had widened slightly in Q3.

A29 The current account deficit had narrowed to £2.2bn in 2002 Q3, following a deficit of £3.6bn in Q2.

A30 Turning to 2002 Q4 data, retail sales volumes had risen by 0.1% in November, following a rise of 0.7% in October. New private car registrations had been 8.0% higher than a year earlier in December, according to data from the Society of Motor Manufacturers and Traders (SMMT). In Q4 as a whole, however, registrations had fallen by 6.8% on a year earlier. House prices had continued to grow strongly. In December, the Nationwide measure had risen by 1.7%, leaving the annual growth rate broadly unchanged at 25.3%. The Halifax measure had risen by 1.0% on an underlying basis in December, although the headline measure had fallen by 2.1%. The GfK consumer confidence aggregate indicator had fallen sharply, to -3.7, from 2.3 in November. This fall had mainly reflected a fall in expectations about the general economic outlook over the next twelve months.

A31 The CBI Distributive Trades Survey in December had shown a sharp fall in annual retail sales growth, with the reported sales balance falling to -3, from +21 in November. However, the CBI survey had only covered the period from 4 to 18 December, and later evidence from the Bank's regional Agents had pointed to a pick-up in retail sales in the week before Christmas. The Agents had conducted an informal survey of retailers at the end of December. Most of these retailers had said that sales had been poor in the first part of December, but that they had picked up strongly immediately before Christmas and for the first few days of end-of-year sales.

A32 Manufacturing output had fallen by 0.7% in October. The CIPS manufacturing survey output index had picked up a little, to 51.6, in December, from 51.4 in November, but the orders index had fallen sharply, to 49.9, in December, from 52.2 in November. The CBI Monthly Trends survey had also shown a sharp fall in its orders balance in December (the balance fell to -32, from -22 in November). The CIPS services survey activity index had fallen to 53.2 in December, from 54.9 in November, and the incoming new business index had also fallen to 53.0 in December, from 53.9 in November.

IV The labour market

A33 According to the Labour Force Survey (LFS), employment had risen by 105,000 in the three months to October, compared with the previous three months. This had been much stronger than the rise of 29,000 in the previous non-overlapping quarter and the fall of 36,000 in the three months to September. The rise in employment had again been more than accounted for by part-time employment (up 110,000). The working-age employment rate had been 74.5%, up 0.2 percentage points on the quarter. Total weekly hours worked had risen by 0.4% on the previous quarter, but had been unchanged on the previous year.

A34 In contrast to LFS employment, the number of Workforce Jobs had fallen by 27,000 in Q3. The largest falls had been in production and in finance and business services. There had been revisions to previous Workforce Jobs data. In particular, the employee jobs figures had been revised to incorporate information from the December 2001 Annual Business Inquiry. This had increased the number of jobs. However, self-employed jobs had been revised downwards following the recent revisions to LFS data as a result of the 2001 Census.

A35 The overall CIPS index of employment had eased a little in December compared with the previous month. Surveys of employment intentions had broadly pointed towards a small increase in the employment rate in the fourth quarter.

A36 The LFS measure of unemployment had risen by 19,000 in the three months to October, compared with the previous three months, though the unemployment rate had remained at 5.2%. Over the same period, claimant count unemployment had fallen by 9,300. It had fallen by a further 6,200 in November. Inflows into the claimant count had remained below the levels seen earlier in the year. Working-age inactivity had fallen by 70,000 in the three months to October, and the rate had declined by 0.2 percentage points, to 21.3%.

A37 Headline whole-economy annual earnings growth, as measured by the Average Earnings Index (AEI), had been 3.7% in October, down 0.1 percentage points from September. Headline earnings growth in the private sector had decreased by 0.2 percentage points, to 3.6%. In the public sector, headline earnings growth had risen by 0.2 percentage points, to 3.8%. Actual whole-economy earnings growth had been unchanged in the year to October.

A38 Whole-economy regular pay growth (not seasonally adjusted) had risen from 3.5% in September to 4.1% in October. This had largely reflected a sharp rise in public sector regular pay as the local authorities pay settlement came into effect, and included the related payment of arrears. Bonuses had continued to grow broadly in line with regular pay, and so had made no contribution to average earnings growth in October.

A39 According to settlement information available to the Bank, the AEI-weighted whole-economy mean settlement had been 2.9% in the year to November, unchanged from the October figure. Information had so far been received on only 20 settlements effective in November itself, covering around 45,000 employees.

A40 Annual growth in productivity, on the official National Statistics measure, had risen by 0.8 percentage points, to 2.1%, in Q3. Annual growth in unit wage costs had fallen by 1.0 percentage point, to 1.5%, in Q3.

V Prices

A41 Sterling oil prices had risen by around 15% since the December MPC meeting, and were also higher on average in December than had been expected at the time of the November *Inflation Report*.

A42 Manufacturing input prices had fallen by 3.4% in November. This meant that the annual inflation rate had fallen to -0.9% in November, from 1.6% in October. But the CIPS manufacturing survey had pointed to rising input prices going forward. The input price balance had risen to 51.9 in December, from 46.6 in November.

A43 Manufacturing output prices excluding duties (PPIY) had risen by 0.1% in November, while the annual inflation rate had risen to 1.0%, from 0.6% in October. 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 risen slightly, but remained negative, at -12, in December.

A44 The annual inflation rate of the GDP deflator at factor cost had risen to 3.5% in 2002 Q3, from 3.1% in 2002 Q2. Within this, the annual rate of inflation of the household consumption deflator was unchanged at 0.3% in 2002 Q3. The annual inflation rate of the government deflator had risen to 4.7% in 2002 Q3. The annual inflation rates of the import and export deflators had been -1.2% and 3.9% respectively in 2002 Q3. The terms of trade had fallen in Q3 but remained high by historical standards.

A45 Annual RPIX inflation had risen by 0.5 percentage points, to 2.8%, in November. Within this, annual goods price inflation had risen to -0.1%, from -0.7% in October, and annual services price inflation had been unchanged, at 4.8%. The increase in annual RPIX inflation had mainly reflected a 0.2 percentage points pick-up in the contribution of petrol prices, and a 0.1 percentage points pick-up in the contribution of housing depreciation. Annual RPI and RPIY inflation had both risen by 0.5 percentage points, to 2.6% and 2.9% respectively. Annual HICP inflation had risen by 0.2 percentage points, to 1.6%.

VI Reports by the Bank's Agents

A46 The Bank's regional Agents had spoken to, or received reports from, more than 100 retailers, mostly on 30 and 31 December. Most had said that sales had been poor in the first part of December,

but that they had picked up strongly immediately before Christmas and had remained buoyant for the first few days of end-of-year sales. Retailers had reported big increases in December compared with the same period in 2001 in sales of electrical goods, including television sets, computers, mobile phones and especially digital cameras. Clothing sales had, however, remained weak, and this had resulted in early discounting.

A47 Retailers in London and the South East had reported what appeared to be the weakest sales performance. The combination of a reduced flow of tourists from the United States, terrorist warnings and redundancies in the City had affected retail sales in London. Sales growth in Scotland, Wales and Northern Ireland had appeared to be strongest, particularly later in December.

A48 A review of the year's comments on the housing market by the Agencies suggested that the market had peaked around May. There had been evidence of slowing in London and the South East, with longer transaction times and flattening prices. But the Agencies had not thought that, overall, the housing market was weak. Any slowing had appeared to be most evident in London and the South, and least evident in Scotland and Wales.

A49 The picture on manufacturing had been particularly difficult to read, with different Agencies changing their views in opposite directions. There had appeared to be no clear direction in output and orders, and the earlier recovery might have stalled. Car production had appeared to have peaked after a buoyant period, and demand for capital goods and industrial gases had continued to be weak. But strength in output and orders had continued for companies supplying the public sector with medical equipment and construction products. There had also appeared to be some improvement in ICT-related demand.

VII Market intelligence

A50 On 8 January, interest rates implied by short sterling futures contracts had generally been lower than on 4 December. The rate implied by the June 2003 contract had been 40 basis points lower at 3.81%, and that implied by the June 2004 contract had been 49 basis points lower, at 4.39%. Implied rates for contracts maturing in 2003 and 2004 had fallen for much of the period, partly in response to some weaker-than-expected US economic data (non-farm payrolls, unemployment rate, durable goods), and partly due to international developments (falls in equity markets and concerns about a

possible conflict in the Middle East).

A51 Market participants had generally expected the Committee not to change the Bank's official repo rate at its January meeting. Economists polled by Reuters between 30 December and 3 January had attached a mean probability of 83% to no change in the Bank's repo rate at the January meeting, and a mean probability of 14% to a decrease of 25 basis points. The mean expectation for the repo rate for end-2003 had fallen by 0.17 percentage points since the previous poll, to 4.25%.

A52 Between 4 December and 8 January, sterling had fallen by 1.4% on an effective basis. The dominant factor in foreign exchange markets over the period had been the appreciation of the euro against the dollar by 3.9%. Broadly consistent with the historical correlations between sterling and these two currencies, sterling had appreciated against the dollar by 1.8% and had depreciated against the euro by 2.0%. There were two main themes in market participants' commentaries over the period: some weaker-than-expected US data, which had added to concerns about the size of the US current account deficit; and concerns over a potential war with Iraq.