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# MINUTES OF MONETARY POLICY COMMITTEE MEETING

## 5 and 6 March 2003

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

They are also available on the Internet  
(<http://www.bankofengland.co.uk/mpc/mpc0303.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 9 and 10 April will be published on 23 April 2003.



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

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

### **The world economy**

2 US growth at the end of last year had not been as weak as had been expected previously; since the February *Inflation Report*, the estimated quarterly growth rate of US GDP in 2002 Q4 had been revised up from 0.2% to 0.4%. The estimated growth rates of consumption, investment, and government spending had all been revised upwards, and the estimated contribution of inventories to growth was also higher; but there was some offset from the revisions to net trade, with imports higher than previously thought and exports lower. In January 2003, industrial production had increased by 0.7%, with strong contributions from the auto industry and the information, communications and technology sector, and non-farm payrolls had increased by 143,000, almost reversing the fall in December; the trend in employment seemed to be flat. More recently, the ISM indices for manufacturing and non-manufacturing activity fell in February, but – at 50.5 and 53.9 respectively – indicated some continuing growth. The most recent Consensus forecast for US GDP growth in 2003 was 2.6%, in line with *Inflation Report* projections.

3 A key question for the outlook for domestic demand in the United States was whether consumer demand there would slacken. Retail sales volumes had fallen by around 1% on the month in January, but that followed a sharp increase in December, which had been temporarily boosted by auto sales. The Bureau of Economic Analysis estimate of monthly consumption had followed a similar path. The monthly pattern of auto sales had been volatile, reflecting consumer finance incentives. Excluding this component, consumer spending had been reasonably robust. There was still scope for some households to reduce their interest payments by refinancing mortgages at lower rates, and further mortgage equity withdrawal might also help to sustain consumption growth. However, there had been sharp falls in consumer confidence, with the Michigan measure dropping from 82.4 in January to

79.9 in February, and the Conference Board measure dropping from 78.8 to 64 – the lowest level since October 1993 and, apart from immediately after the terrorist attacks on 11 September 2001, the largest monthly fall since the Iran hostages crisis in April 1980. The decline in the Conference Board measure was broadly based across its components. It was likely that prospect of a war with Iraq was having a dampening effect on confidence, but it was not yet clear what the consequences would be for consumer spending. Early indications from both the Bank of Tokyo-Mitsubishi/UBS Warburg chain-store sales index and the Lynch, Jones and Ryan Redbook measure for department stores suggested that non-auto retail sales might have weakened in February.

4 Recent news had done little to affect the outlook for the euro area discussed in the February *Inflation Report*. German GDP had been flat in 2002 Q4, and domestic demand had remained sluggish, although investment had been a little stronger than expected, partly because of post-floods reconstruction activity. The German current account surplus, combined with the significant fiscal deficit, implied that the private sector was a very substantial net saver; eventually, the accumulation of wealth that that implied was likely to stimulate demand but, as the experience of Japan demonstrated, that might take a long time. The Purchasing Managers Index for business activity in services had dipped a little in February, although the index for manufacturing recovered slightly. The IFO index of business confidence had risen in February, which was perhaps encouraging. French GDP growth had been a little firmer than German growth. The Purchasing Managers Indices also suggested that the immediate outlook was more buoyant in France than Germany. In the euro area as a whole, industrial production had fallen by 1.5% in December, more than reversing the increase in November, but still consistent with a marginal increment to euro-area GDP in 2002 Q4. Survey measures of business activity in February appeared to have fallen somewhat in services and increased in manufacturing. The flash estimate of consumer price inflation in February was 2.3%, slightly up on the month, and above the zone regarded by the ECB as consistent with price stability, but that in part reflected temporary factors. There was a widespread expectation in the market that the ECB would agree a reduction in its policy rate at its meeting on 6 March. Overall, euro-area activity appeared to be consistent with Consensus forecasts of just over 1% growth for 2003 as a whole – and there was still little sign of a domestic engine of expansion.

5 In Japan, the preliminary estimate of GDP growth in 2002 Q4 had, at 0.5%, been surprisingly high, and had been accompanied by upward revisions to past data. On the face of it, this was encouraging, but the figures contrasted with the 1% decline in the METI ‘all-activity’ index in the

same quarter, and might suggest inaccuracies in the GDP deflators. Growth in non-Japan Asia remained relatively robust.

6 There were some puzzles in world trade data. Several major economies reported a slowdown in their export growth in Q4, yet their imports if anything had been stronger than expected. It was uncertain whether this reflected statistical discrepancies or increased market penetration by other countries' exporters. Subject to this caveat, large US current account deficits appeared to be persisting, as were Japanese and euro-area surpluses, but it was not clear that this pattern was sustainable indefinitely.

### **Money, credit and financial market prices**

7 This month, unlike last, there had been only a small fall in UK equity market indices. In contrast, there had been some significant movements in interest rates and exchange rates.

8 Short-term sterling market interest rates had fallen, in both nominal and real terms. One of the main triggers had been the Committee's reduction in the repo rate in February, which had been followed very quickly by a fall in yields along the curve: over 20 basis points for June 2003 contracts and around 10 basis points for June 2005 contracts. If financial market participants had regarded the Committee's decision as simply bringing forward the interest rate reduction that they had been expecting to see within a few months anyway, it might have been expected that the yield curve would only have been affected at the very short end. This was not what had happened.

9 The *Inflation Report*, MPC minutes and recent testimony to the Treasury Select Committee (TSC) should have corrected any mistaken view that the Committee's move had been precipitated by bad news about the economic outlook not yet available more widely. So why had yields fallen so sharply and remained low? One possibility was that the repo rate reduction had changed perceptions of existing data and provided an insight into the Committee's analysis of those data. A second possibility was that market observers had re-evaluated the Committee's responses to changes in output and inflation – its 'reaction function'. They might have concluded that the Committee was more concerned than they had thought about sustaining output growth and less with the risks to achieving the inflation target; or that the Committee was more willing than they had expected to reduce interest rates despite above-target inflation and rapid house price increases. In contrast to short rates, longer-

term forward rates had actually risen, and implied market expectations of inflation at all maturities appeared to have gone up, consistent with the second possibility. But they had in fact returned to around 2½% at medium-term horizons from levels a little below, so it did not seem that the credibility of the inflation target was in doubt. Indeed, the rate reduction may have reminded market participants that the Committee treats deviations of inflation above and below the target symmetrically.

10 More recently, there had been further falls in the yield curve one to two years out, so that the June 2004 short sterling futures contract, for example, was now over 50 basis points lower than it had been a month earlier. But these later falls had taken place at the same time as declines in US and euro-area yield curves, suggesting that there had also been a general downgrading of expectations of global growth prospects and inflationary pressures over the next year or two.

11 The other main financial markets news was the fall in sterling of 4% over the month, on the effective measure. Sterling had fallen against all major currencies, suggesting that it had been affected by UK-specific factors. Cumulatively, about one percentage point of the fall came in the immediate aftermath of the Committee's February decision, of the publication of the *Inflation Report* and the MPC minutes, and of the TSC testimony. Three hypotheses, not mutually exclusive, could be put forward for the decline. First, market participants might have revised their views about likely future UK interest rates relative to those in other countries, perhaps because the February rate reduction had altered perceptions of the Committee's reaction function. But relative changes in yield curves and the lack of any material increase in the volatility of interest rates implied by options prices suggested that this could be only a small part of the explanation. Second, there might have been a downward revision to the real exchange rate expected in the medium term, if market participants thought that there had been an adverse shock to UK domestic demand (relative to other countries). The Committee's reduction in rates might have contributed to a reassessment of the outlook, at a time when a considerable amount of new information about the economy was emerging. In those circumstances, markets could anticipate a further reduction in interest rates to offset the demand shock. The fall in the exchange rate and an increase in net trade would form a natural part of such rebalancing. Third, there might have been a loss of confidence due to the prospect of war in Iraq. That might have been expected to affect the dollar in the same way, and yet the dollar had not fallen as sharply over the past month. One possibility was that the value of the dollar already reflected this concern and that sterling had weakened because perceptions of the United Kingdom's position had become more closely identified with the United States. If so, a successful resolution of the international situation might

reverse the fall in sterling quickly. These hypotheses were difficult to disentangle. It was possible, for example, that market participants initially thought that the Committee was reacting to new information in a different way, but had then come to agree that the outlook for demand was weaker than previously thought. A combination of these factors might be causing a reduction in the desired relative holdings of sterling assets in the portfolios of international investors.

12 Broad money growth fell back in January to an annual rate of 6.5% (compared with 7.1% a month earlier). The annual growth rate of notes and coin – a potential indicator of retail spending activity – had recovered somewhat in February, to 6.2%, but was still below the growth rates seen over most of the past four years. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen a little in January. But annual growth of total net lending to individuals rose slightly to 13.7%; within this measure, the annual growth rate of secured lending had picked up, more than offsetting a fall in the annual rate of unsecured lending. Outside manufacturing, borrowing by firms was also robust; overall, the twelve-month growth rate of private non-financial corporations' M4 borrowing (excluding securitisations) had increased to 7.7% in January.

### **Demand and output**

13 GDP at market prices had grown by 0.4% in 2002 Q4, according to the latest ONS data; measured at basic prices, growth had been slightly weaker. On the output side, estimated service sector output growth in Q4 was revised down to 0.5%, compared with the preliminary estimate of 0.6%. Manufacturing output declined by 0.9% on the quarter, following strong growth in Q3, which in turn had probably reflected unwinding of the impact of the Jubilee in 2002 Q2. Manufacturing output had been a little weaker than envisaged at the time of the February *Inflation Report*, but estimated construction output growth in Q4 had been revised up sharply in the very latest data revision. The signs were that service sector output growth had been slowing in 2003 Q1, and that the trend in manufacturing output was flat or declining slightly. The CIPS business activity index for services fell back from 52.3 in January to 50.2 in February, while the CIPS manufacturing output index was unchanged at 50.4, with a slight pick-up in the new orders balance. Reports from the Bank's regional Agents confirmed this picture, and it looked as if, overall, output growth would be a little lower in Q1 than expected a month ago.

14 On the expenditure side, investment in 2002 Q4 had been weaker than expected, with manufacturing investment particularly weak – 18% lower than a year earlier. But public sector consumption growth had been higher than expected, and the negative contribution from net trade smaller, because imports had been unexpectedly low. Exports had fallen about 3½% on the quarter according to current data, but it seemed likely from other evidence that the estimate would be revised upwards over time. The Bank’s regional Agents’ recent special survey had suggested that export performance if anything had been a little stronger in Q4 than Q3, because of a pick-up in exports to outside the EU. Consumption growth, at 1.0% on the quarter, was much as expected. But current indicators for 2003 Q1 suggested that consumption might be slowing sooner than projected in the February *Inflation Report*. Retail sales had fallen by 1% in January, bringing them back to the same level as in October, although uncertainty about the appropriate adjustments for the seasonal pattern of retail spending made it difficult to be confident about changes in the underlying trend. According to the Bank’s Agents, retailers expected sales to slow, and the CBI’s Distributive Trades survey balance for the volume of sales fell back in February (although the balance for sales expected in March was up, and the CIPS manufacturing survey indicated that orders for and output of consumer goods were buoyant). Consumer confidence had dropped sharply: the GfK survey balance (after adjusting for seasonal variation) fell in February to the lowest level since 1995. The deterioration in respondents’ views about the general economic outlook was the main factor, but questions about respondents’ own circumstances had also elicited a more pessimistic response. Households might also have been anticipating the likely impact of higher National Insurance contributions on disposable income from 2003 Q2 onwards.

15 The outlook for consumers’ expenditure was also likely to be affected by the housing market, which appeared to be cooling. According to both the Halifax and Nationwide price indices, the three-month-on-three-month rate of increase of house prices had dropped under 5%, well below the peaks last year of around 8%. The Royal Institution of Chartered Surveyors survey also suggested that house price increases had moderated and were likely to continue to do so. Indicators of housing market activity were also consistent with weakening. However, household mortgage borrowing was still strong: the annual growth rate of total net lending to individuals secured on property rose in January, and it was likely that mortgage equity withdrawal had continued to increase in 2002 Q4. The change in the composition of household borrowing from unsecured to secured was likely to reduce the burden of debt servicing on the household sector and increase its resilience somewhat in the face of any future

adverse shocks to income, other things being equal. Moreover, fixed-rate mortgage rates might yet have further to fall, given the recent falls in swap rates.

### **The labour market**

16 Employment had increased sharply in 2002 Q4, by 150,000, comprising mainly men and mainly full-time employees, and the unemployment rate fell 0.1 percentage points to 5.1%. But total hours worked remained broadly flat, as they had for some time: average hours worked per employed person dropped nearly 1% over the year to 2002 Q4. Such falls seemed likely to be the result in part of structural factors, such as the EU Working Time Directive and shifts in labour demand away from sectors that traditionally offered jobs with long hours, rather than cyclical factors, and were therefore unlikely to be reversed. The CIPS employment surveys so far this year were consistent with continuing job losses in manufacturing and some weakening in the rest of the private sector in 2003 Q1. But these surveys did not cover the public sector, where employment was increasing, so their implications for overall employment growth were unclear.

17 The headline annual rate of increase in private sector earnings fell to 3.5% in December and regular pay – that is, excluding bonuses – increased at an annual rate of 3.8%, unchanged on the month. The corresponding rates for the public sector were higher, at 4.6% and 5.1% respectively. The average private sector pay settlement in the twelve months to January was 2.7%, unchanged on the month, and information on settlements in January itself suggested that they were running at around half a percentage point lower than a year earlier. It was reassuring that settlements had so far not picked up: the forthcoming increases in National Insurance contributions and the higher RPI inflation than a year earlier had raised the possibility that they might increase. It appeared that competitive pressures on employers were such that, despite the tightness of the labour market, they were keeping their labour costs under control.

### **Prices and costs**

18 A number of developments were likely to raise the retail price level in the near future and hence, temporarily, the rate of inflation. Some had been considered in past Committee forecasts. First, the rise in National Insurance contributions from the beginning of the next tax year was likely to do so. Second, the component of the Retail Prices Index capturing the cost of housing depreciation would



continue to rise rapidly for a while, reflecting recent large annual increases in house prices, although the impact would diminish as house prices slowed. There were now some additional factors that would raise inflation in the short run relative to the February projection. First, sterling oil prices had increased by 11% since the February MPC meeting, sufficient to add about 0.1 percentage points to the annual inflation rate during this year, with little effect from twelve months hence. This had been accompanied by somewhat higher expected future sterling oil prices. Second, Council Tax increases in April appeared likely to average about 11% to 12%, somewhat higher than anticipated by the Committee at the time of the February *Inflation Report*. This revision would add around a further 0.2 percentage points to the projected inflation rate for twelve months from their implementation. Third, the recent depreciation of the exchange rate would tend to result in higher import prices. But the extent of pass-through of exchange rates to, first, the prices at which goods are imported and, second, to goods prices in the shops was highly uncertain. It would depend on the extent to which the depreciation was expected to be permanent and what level of sales importing firms thought that they would lose to competing domestic producers if they raised sterling prices. The total impact of the depreciation on the retail price level would depend on what had caused it in the first place. If the trigger had been an adverse shock to domestic demand, the stimulus it would give to net exports would tend to cancel out the deflationary impact of that shock; otherwise, there might be second-round effects on inflation due to an increase in aggregate demand.

19 The net effect of these developments was likely to raise RPIX inflation in the short run, and it was now likely to exceed 3% in the coming months. Whether inflation around the two-year forecast horizon would be affected would depend on whether the exchange rate depreciation persisted or, indeed, went further; on the degree and speed of pass-through into retail prices; and on whether temporary rises in inflation led to higher medium-term inflation expectations amongst wage bargainers and price setters. There were some signs that expectations of inflation 12 to 24 months ahead might have risen a little. There had also been a small increase in forward inflation rates implied by yields in the gilts market, although they did not materially exceed the 2.5% target at any maturity.

### **Other considerations**

20 The Reuters poll reported that economists had attached a mean probability of about 80% to there being no change in the repo rate this month, and about 20% to a decrease of 25 basis points; none

thought that the most likely outcome was a reduction. Forecasts for the repo rate at the end of 2003 and 2004 were some 30 to 40 basis points lower than they had been last month.

### **The immediate policy decision**

21 Committee members agreed that the world outlook remained broadly similar to that described in the February *Inflation Report*; the medium-term prospect was for a slow recovery. The possibility of a war in Iraq increased uncertainty in the short run and seemed to be having a widespread impact on consumer and business confidence, but it was not clear yet what effect that would have on global activity or prices. In the United Kingdom, evidence was accumulating that household consumption was beginning to slow and the housing market continuing to cool. Combined with the depreciation of sterling over the past month, this held out the encouraging possibility of a rebalancing of demand and activity within the UK economy, and – so far, at least – without the sharp adjustment that had often accompanied retrenchment by consumers in the past. Nevertheless, the immediate prospect was for UK growth to be a little below trend and inflation to be above target. RPIX inflation was now likely to be higher in the short run than projected in February, because of the exchange rate depreciation, oil prices and the Council Tax increases.

22 In the light of this conjuncture, the Committee considered arguments for raising, reducing and maintaining the repo rate. The case for raising rates was that the extra impetus to RPIX inflation in the short run could push inflation expectations above the target, and might lead to upward pressure on pay which could in turn feed through to prices. Furthermore, sterling's recent depreciation might have a significant impact on the price level and net export demand, were it to persist. The size of that impact would depend on the degree of pass-through to retail prices.

23 A case could also be made for a reduction in interest rates. First, demand prospects were weaker than expected. There were some signs that output in the first quarter of 2003 was likely to be lower than the Committee had projected; investment remained weak; consumption might be slowing more sharply than envisaged in the February *Inflation Report*; households might save more in order to reduce their historically high debt burdens; and the substantial fall in recorded exports in 2002 Q4 might turn out to reflect actual export performance to a greater extent than had been assumed. Second, the recent falls in business and consumer confidence in many countries might not be as closely linked to the prospect of war in Iraq as many assumed, and might therefore persist even after resolution of

war-related uncertainties. Third, most of the factors that were driving inflation higher in the near term could be expected either to reverse or to have only a one-off effect on the price level, and so did not necessarily imply higher inflation further out, provided that feed-through to inflation expectations and wages was limited. The increase in National Insurance contributions and the rise in oil prices, whilst raising measured inflation in the short run, would tend to have a deflationary impact on demand. The exchange rate depreciation, to the extent that it raised retail prices, would tend to lower consumers' real income in the short term – though favourable effects on demand would come through as net trade improved. Experience from the United Kingdom in the past and from some other countries suggested that the pass-through to retail prices might, in any case, be small. Fourth, pay pressures remained muted despite the pre-announced increases in National Insurance contributions. For one member of the Committee, these arguments suggested that inflation was likely to fall below 2½% in the medium term, and that a further reduction in the repo rate was necessary to achieve the inflation target.

24 However, for most members of the Committee, the arguments for maintaining the repo rate at its current level were, on balance, persuasive. First, the evidence of the past month was not sufficient by itself to change significantly the outlook for inflation around the two-year horizon from the one laid out in February. The higher short-term inflation outlook and the fall in the exchange rate had increased the upside risks to inflation from possible rises in inflation expectations. However, evidence from the bond markets and surveys did not suggest that inflation expectations had come adrift from the 2½% target, and pay settlements were not rising. The exchange rate depreciation might not persist, particularly if it was related to some extent to fears about war in Iraq. If those fears were quickly allayed, sterling could strengthen again. News about output and demand suggested to some members that prospects were weaker than had been expected and that the upside risks had diminished, but the falls in the exchange rate and market interest rates would, if sustained, provide a stimulus to activity. Second, the case for an increase in the repo rate was not convincing. It was appropriate to look through temporary effects on inflation to the extent that they did not raise inflation expectations in the medium term. It was too soon to judge whether the implications for inflation of the exchange rate depreciation were as substantial as a mechanical adjustment to the February projections might suggest, and further analysis of its possible consequences was required. The degrees of pass-through from the exchange rate to the prices at which goods are imported, and even more from those prices to retail prices, were very uncertain, and depended on, amongst other things, the extent to which firms themselves believed the depreciation would persist. For some members, the Committee's February central projection for inflation had been a little too high, so that there was in their view scope to

accommodate some small increase in inflationary pressure. For some other members, the arguments for a repo rate of 3.75% as opposed to 4% were more finely balanced, but a decision to increase the repo rate so soon after the reduction last month would, in current circumstances, risk having a greater-than-warranted effect on market interest rates. Third, nor were the arguments for a reduction convincing for most members. It was very important that inflation expectations should remain anchored to the 2½% target. A further reduction in rates so soon, at a time when RPIX inflation was likely temporarily to rise further above the target, might dislodge that anchor. In the view of some members, the slowdown in consumption growth was still tentative, and it was not clear that the fall was faster than already envisaged in the Committee's central projection. Lending to the household sector was still very buoyant. The recent declines in consumer confidence might reflect uncertainties about the international political situation, which might be resolved in the near term. Fourth, the outlook for UK demand might be affected by the Budget next month; it would be sensible to wait for any new information it might contain about the fiscal stance.

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

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 28 February 2003, in advance of its meeting on 5-6 March. 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 Consensus Economics forecasts of US GDP growth for 2003 and 2004 had been revised down to 2.6% and 3.6% respectively in February, from 2.7% and 3.7% in January. Forecasts of euro-area GDP growth for 2003 and 2004 had been revised down to 1.3% and 2.2%, from 1.4% and 2.3%. Forecasts of Japanese GDP growth for 2003 and 2004 had remained unchanged, at 0.4% and 0.8%.

A3 According to the preliminary estimate, US GDP had increased by 0.4% on the quarter in 2002 Q4. That was higher than the advance estimate of 0.2% growth. Within the total, consumption growth had been revised up to 0.4%, from 0.2% in the advance estimate. Investment had grown by 1.1%, above the advance estimate of a 0.8% increase. Government spending had increased by 1.2%, compared with an advance estimate of 1.1%. In the preliminary estimate, import growth had been 1.8% on the quarter, while exports had fallen by 1.1% on the quarter. That had produced a negative contribution to growth from net trade of -0.4 percentage points, compared with a contribution of -0.2 percentage points in the advance estimate. Stocks had contributed +0.1 percentage points to growth on the quarter, compared with a contribution of -0.1 percentage points in the advance estimate. Non-farm business sector labour productivity had been unchanged in Q4, and unit labour costs had risen by 1.2%, following a fall of 0.1% in Q3. Non-farm payrolls had risen by 143,000 in January, following a decline of 156,000 in December. The US unemployment rate had fallen to 5.7% in January, from 6.0% in December.

A4 US manufacturing output had risen by 0.5% on a month earlier in January, following a fall of 0.4% in December. The January figure had incorporated an increase of 4.9% in the production of motor vehicles and parts, following a fall of 5.3% in December. Production of information,

communications and technology (ICT) goods had increased by 0.8% in January. Total industry capacity utilisation had risen to 75.7% in January, from 75.2% in December. The Institute for Supply Management (ISM) manufacturing index had declined to 50.5 in February, from 53.9 in January. The non-manufacturing ISM index had fallen to 53.9 in February, from 54.5 in January. New orders for non-defence capital goods had risen by 2.1% in January. The Conference Board measure of consumer confidence had fallen to 64.0 in February, from a downwardly revised 78.8 in January. The University of Michigan headline index of consumer confidence had fallen to 79.9 in February, from 82.4 in January.

A5 Real consumption in the United States had fallen by 0.3% on the month in January, and had been 2.7% higher than a year earlier. That had followed a rise of 0.9% on the month in December. Retail sales values had fallen by 0.9% in January, following a rise of 2.0% in December. Excluding sales of automobiles, retail sales had risen by 1.3% in January, following an increase of 0.2% in December.

A6 Annual headline consumer price inflation in the United States had increased to 2.6% in January, from 2.4% in December. Annual core consumer price inflation (which excluded food and energy prices) had been 1.9% in January, unchanged from December. US producer prices had risen by 2.8% in the year to January, after an increase of 1.2% in the year to December. Core US producer prices had risen by 0.5% in the year to January, after falling by 0.4% in the year to December.

A7 German GDP had been unchanged on the quarter in 2002 Q4, following an increase of 0.3% in Q3. Within the total, private consumption had grown by 0.1%, following an increase of 0.4% in Q3. Total investment had increased by 0.8%, after falling by 0.2% in Q3. Government consumption had fallen by 0.5% in 2002 Q4. Stocks had contributed 0.3 percentage points to growth in the fourth quarter, while net trade had subtracted 0.5 percentage points from growth. French GDP had increased by 0.2% on the quarter in 2002 Q4, following an increase of 0.3% in Q3. Private consumption had risen by 0.4%, total investment had contracted by 0.7% and government consumption had increased by 1.1%. Net trade had made a zero percentage point contribution to quarterly GDP growth and inventories had subtracted 0.1 percentage points from output growth in Q4. Italian GDP had increased by 0.4% on the quarter in 2002 Q4, following an increase of 0.3% in Q3.

A8 Industrial production in the euro area had decreased by 1.5% on the month in December. That had followed a monthly increase of 0.7% in November. In December, industrial production had fallen

in Germany, France and Italy. The industrial confidence indicator for the euro area in the European Commission survey had decreased to -11 in February, from -10 in January. The consumer confidence indicator had decreased to -19 in February, from -18 in January. The West German IFO index had increased to 88.9 in February, from 87.4 in January. The euro-area Purchasing Managers Index (PMI) for manufacturing had risen to 50.1 in February, from 49.3 in January. The euro-area PMI for services had fallen to 48.9 in February, from 50.0 in January. German manufacturing orders had declined by 4.1% on the month in December, following a rise of 1.4% in November. In December, foreign orders had decreased by 8.7%, while domestic orders were unchanged. French consumer spending on manufactured goods had decreased by 0.2% on a month earlier in January, following an increase of 1.8% in December. The euro-area unemployment rate had risen to 8.6% in January, from 8.5% in December. Euro-area retail sales had declined by 1.1% on the month in December, following a 0.7% fall in November. German retail sales had increased by 2.2% on the month in January, following a 1.6% fall in December. Excluding automobile sales, German retail sales had increased by 3.3% on the month in January.

A9 Annual inflation in the euro area, as measured by the harmonised index of consumer prices (HICP), had decreased to 2.2% in January, from 2.3% in December. Annual core inflation (which excluded energy, food, alcohol and tobacco prices) had fallen to 1.9% in January, from 2.1% in December. According to the Eurostat flash estimate, annual HICP inflation had increased to 2.3% in February.

A10 According to the preliminary estimate, Japanese real GDP had increased by 0.5% on the quarter in 2002 Q4. Within the total, private consumption had grown by 0.1%, business investment had risen by 1.0% and government expenditure had declined by 0.2%. Net exports had contributed 0.3 percentage points to quarterly growth, while inventories had made a zero percentage point contribution.

A11 Industrial production in Japan had risen by 1.5% on a month earlier in January, following a 0.4% fall in December. Japanese total domestic private machinery orders (excluding orders of ships and electrical power, which can be volatile from month to month) had increased by 5.2% on the month in December. They had grown by 0.3% on the quarter in 2002 Q4, after falling by 1.7% on the quarter in 2002 Q3. The Japanese index of tertiary activity had fallen by 0.7% on the month in December, and had decreased by 1.0% on the quarter in 2002 Q4. That had followed a rise of 0.4% on the quarter in

2002 Q3. The all-industry activity index had fallen by 0.6% in December compared with a month earlier, and had decreased by 1.0% on the quarter in 2002 Q4. That had followed an increase of 0.6% in Q3. Nominal retail sales had declined by 2.2% on a year earlier in January, compared with a fall of 3.4% on a year earlier in December. Annual growth in Japanese export volumes had slowed to 10.4% in January, from 13.7% in December. Within the total, export volumes to Asia had grown by 15.0%, export volumes to the United States had grown by 3.8% and export volumes to the European Union had grown by 16.0%. Annual growth in import volumes had remained unchanged at 9.4% in January. The headline unemployment rate had risen to 5.5% in January from 5.3% in December. The all-household survey had reported an annual decline of 0.8% in real spending in December, compared with a 2.0% annual decline in November.

A12 Since the Committee's previous meeting, the spot price of Brent crude oil had increased by \$2 per barrel to \$34. *The Economist* dollar non-oil commodity price index had fallen by 1.3%. Most major international equity indices had fallen since the Committee's February meeting. In local currency terms, the Wilshire 5000 had fallen by 1.8%, the Dow Jones Euro Stoxx by 6.6% and the Japanese Topix by 2.5%.

## **II Monetary and financial conditions**

A13 The twelve-month growth rate of notes and coin had increased to 6.2% in February, from 5.2% in January, but remained below the growth rates seen over most of the past four years. Annual growth of M4 had fallen to 6.5% in January, from 7.1% in December. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had fallen to 10.4% in January, from 10.7% in December.

A14 The twelve-month growth rate of households' M4 had risen strongly to 8.7% in January, from 8.2% in December. The twelve-month growth rate of households' M4 borrowing (excluding the effects of securitisations) had risen to 14.5% in January, from 14.3% in December. Annual growth of total net lending to individuals, a broader measure, had also risen slightly, to 13.7% in January from 13.6% in December. Within this measure, the annual growth rate of secured lending had risen to 13.5% in January, from 13.2% in December. However, the annual growth rate of unsecured lending to individuals had fallen to 14.5% in January, from 15.0% in December.



A15 The number of loan approvals for house purchase, after adjusting for the number of working days in the month, had fallen to 109,000 in January compared with 112,000 in December. The House Builders Federation monthly survey had shown that the balance of members reporting an increase in net reservations compared with the corresponding month of the previous year had fallen sharply in January, after allowing for seasonal factors. The number of particulars delivered had fallen to 128,000 in January, from 131,000 in December.

A16 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had fallen sharply, to 4.3% in January from 6.9% in December. The one-month flow was negative. The twelve-month growth rate of PNFCs' M4 borrowing (excluding the effects of securitisations) had increased to 7.7% in January, from 7.3% in December.

A17 Data from the major British banking groups (MBBG) on the breakdown of sterling lending had shown that the twelve-month growth rates of borrowing had risen in January for most types of firm within the corporate sector. According to Bank of England data, PNFCs had raised £3.2 billion of total external finance (including sterling and foreign currency borrowing, but excluding the effects of securitisations) in January. That had compared with an average monthly flow of £5.1 billion during the previous six months.

A18 The annual rate of growth of the M4 deposits of other financial corporations (OFCs) had fallen sharply, to 1.8% in January from 4.2% in December. The twelve-month growth rate of OFCs' M4 borrowing (excluding the effects of securitisations) had also fallen, to 2.5% in January from 4.7% in December.

A19 The FTSE 100 index had fallen by 3.1% between 5 February and 5 March. The FTSE All-Share index had fallen by 2.9% over the same period. Most sectoral indices within the FTSE All-Share had fallen. The weakest sector, by a wide margin, had been general industrials, which had declined by around 11%. However, this sector had a low weight in the aggregate. Uncertainty about the FTSE 100, as measured by implied volatility derived from options prices, had fallen slightly over the month. Nevertheless, it had remained high relative to its average over the past ten years. The skew to the distribution of expectations for the index, an indicator of perceptions about the balance of risks, had become slightly more negative. The number of downward profit warnings by UK companies in February 2003 had been a little lower than in February 2002.

A20 Short-term nominal forward interest rates had fallen substantially between 5 February and 5 March. The standard deviation of six-month interest rate expectations had fallen slightly over the month. Nominal forward interest rates had been little changed at the five-year horizon, but had risen by more than 20 basis points at ten years and by around 20 basis points at twenty years. Real forward interest rates had fallen by nearly 50 basis points at the two-year horizon and by more than 20 basis points at the five-year horizon. Conversely, they had risen by almost 20 basis points at the fifteen-year and the twenty-year horizons. Ten-year real spot rates had fallen internationally.

A21 Between 5 February and 5 March, forward implied inflation expectations had risen at all maturities. Between the five-year and the ten-year horizon, they had risen by some 20 basis points. According to the HM Treasury survey, mean RPIX inflation expectations for 2003 Q4 had been unchanged at 2.4% in February, and mean RPIX inflation expectations for 2004 Q4 had risen to 2.4%, from 2.3% in January. According to the Consensus Economics survey, mean RPIX inflation expectations for 2003 as a whole had risen to 2.6% in February, from 2.5% in January, and mean RPIX inflation expectations for 2004 as a whole had risen to 2.4%, from 2.2% in January.

A22 The Merrill Lynch index of investment-grade, sterling-denominated corporate bond spreads (over UK government bonds) had been little changed. Both corporate and government bond yields had fallen slightly.

A23 Quoted interest rates on household borrowing had fallen in February. The average two-year discounted mortgage rate quoted for new customers had fallen by 12 basis points. On the basis of pre-announcements by the main mortgage lenders following the repo rate reduction, the average standard variable mortgage rate (SVR) quoted for existing borrowers was expected to fall by a similar amount in March. The average two-year fixed mortgage rate had fallen by 35 basis points in February.

A24 The sterling effective exchange rate index (ERI) had fallen by 3.9%, to 100.4, between 5 February and 5 March. Sterling had depreciated by 2.7% against the dollar and by 4.0% against the euro. The movements in sterling exchange rates could not be accounted for by changes in relative interest rates. Forecasts in the latest Consensus Economics survey had continued to point to a fall in sterling against both the euro and the dollar.

### III Demand and output

A25 In the ONS Output, Income and Expenditure release, quarterly GDP growth at constant market prices in 2002 Q4 had been estimated at 0.4%, the same as the preliminary estimate. The estimated annual growth rate had been revised down by 0.1 percentage points, to 2.1%.

A26 Estimated quarterly service sector output growth had been revised down by 0.1 percentage points to 0.5% in 2002 Q4. Within the service sector, estimated output growth of the distribution, hotels and catering sector had been revised down by 0.3 percentage points, to 0.5%. Manufacturing output had fallen by 0.9% in 2002 Q4, following a rise of 1.0% in Q3. The pattern of manufacturing output growth in the second, third and fourth quarters had probably been affected by the Jubilee holidays.

A27 Household consumption had grown by 1.0% in Q4 and real government consumption by 0.8%. Whole-economy investment had fallen by 1.3% on the quarter. Within that, business investment had fallen by 1.1%. Exports had fallen by 3.4%, while imports had fallen by 0.3%, and net trade had reduced GDP growth by 1.0 percentage points. Final domestic demand had risen by 0.6%. Domestic demand had risen by 1.3%, with the change in inventories contributing 0.7 percentage points to GDP growth.

A28 The Bank's regional Agents had conducted a special survey of recent developments in goods exports. Responses had been received from 161 manufacturers with total turnover of around £38 billion. They were asked to compare their export deliveries in 2002 Q4 with those in the previous quarter; to assess the effects of weaker export demand on end-year stocks; and to compare expected export deliveries in 2003 Q1 with deliveries in 2002 Q4.

A29 The balance of firms, weighted by turnover, reported a slight increase in export deliveries in 2002 Q4 relative to Q3. This had seemed to contradict ONS data, which had shown a decline in goods exports of 5.6% in Q4. On a geographical basis, the Agents' survey suggested that the improvement in manufacturing export deliveries in Q4 had been stronger to countries outside the European Union. By type of good, respondents reported an increase in exports of consumer goods. According to the Agents' survey, the absence of any weakening in overall export deliveries in Q4 meant there had been no unplanned increase in end-year stock levels.

A30 Respondents had expected an increase in export deliveries in 2003 Q1 relative to 2002 Q4. The improvement was expected to be broadly based across countries. Consumer goods exports in particular were expected to improve further in Q1, while capital goods exports were expected to remain subdued. Respondents commented that uncertainty over an attack on Iraq had not been affecting orders. Recent movements in the sterling exchange rate had been affecting manufacturers' margins rather than volumes.

A31 Retail sales volumes had fallen by 1.0% in January, following a rise of 1.0% in December. The Confederation of British Industry (CBI) Distributive Trades survey had pointed to a slowing in the growth of retail sales volumes in February: the reported sales balance for retailing had fallen to +2 in February from +7 in January.

A32 The headline GfK measure of consumer confidence had fallen sharply to -9 in February, from -3 in January. Confidence about the general economic situation had fallen further, possibly reflecting worries about a conflict in the Middle East. The February balance had been the lowest recorded since October 1998. Recent indicators of house price inflation had given mixed signals in February. Although the annual rates of increase of the Halifax and Nationwide measures were similar – at 24.1% and 24.8% respectively – the Nationwide index had increased by 0.4% in February compared with a 1.7% rise in the Halifax index.

A33 The CIPS services activity index had fallen to 50.2 in February, from 52.3 in January. This was the lowest balance since December 2001. The incoming new business index had also fallen, to 49.9, from 52.8 in January. This was the lowest balance since November 2001.

A34 The CBI Monthly Trends Enquiry had suggested continued weakness in the manufacturing sector in the first two months of the year. The total orders balance had fallen to -31 in February, from -25 in January, and the expected output balance had fallen to -1, from +2 in January. The CIPS manufacturing output index had been unchanged in February at 50.4, while the new orders index had risen to 49.4 from 48.7 in January.

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

A35 According to the Labour Force Survey (LFS), employment had risen by 150,000 (0.5%) in the three months to December compared with the previous three months. This had followed a rise of 107,000 in the three months to November and a fall of 36,000 in the previous non-overlapping quarter. The latest increase in employment had been more than accounted for by an increase in the number of full-timers. That contrasted with earlier months, when part-timers had been the largest component. The working-age employment rate was 74.6%, 0.3 percentage points higher than during the previous non-overlapping three-month period. Average hours worked had fallen by 0.6% in the three months to December and total hours worked had fallen by 0.1%.

A36 The overall CIPS employment index had weakened in February and was below the 'no-change' level of 50. The manufacturing component had shown the sharpest fall on the month.

A37 LFS unemployment had fallen by 36,000 in the three months to December and the unemployment rate had fallen by 0.1 percentage points, to 5.1%. Claimant count unemployment had fallen by 11,500 in the fourth quarter and by a further 3,500 in January. Working-age inactivity had decreased by 77,000 in the three months to December, and the working-age inactivity rate had fallen by 0.2 percentage points, to 21.3%.

A38 Headline (three-month average) whole-economy average earnings growth had been 3.7% in the year to December, down 0.1 percentage points from the previous month. Headline earnings growth in the private sector had fallen by 0.2 percentage points, to 3.5%. In the public sector, it had increased by 0.3 percentage points to 4.6%. Actual whole-economy earnings growth in the year to December had been 3.4%, down 0.6 percentage points from the November figure. Whole-economy annual regular pay growth (not seasonally adjusted) had slowed, from 4.4% in November to 4.0% in December. This decrease had been accounted for by slower public sector pay growth, which had fallen by 1.9 percentage points to 5.1%, reflecting the fact that arrears payments associated with the delayed local authority settlements were no longer boosting the figures. Bonuses had made a large negative contribution (-0.7 percentage points) to average earnings growth in December.

A39 The Bank's twelve-month whole-economy mean measure of pay settlements, weighted to match the average earnings index, had been 2.9% in January. The January average for matched private sector settlements had been 2.7%, 0.5 percentage points lower than in January 2002.

## V Prices

A40 Sterling oil prices had risen by around 11% since the February MPC meeting, and were also higher on average in February than had been expected at the time of the February *Inflation Report*.

A41 Manufacturing input prices had risen by 0.8% in January, mainly owing to higher oil prices. This meant that the annual inflation rate had risen to 3.7%, from 2.9% in December. The CIPS manufacturing survey had pointed to further rises in input prices going forward. The input price balance had risen to 56.4 in February, from 51.6 in January.

A42 Manufacturing output prices excluding duties (PPIY) had risen by 0.3% in January, while the annual inflation rate had risen to 1.3%, from 1.2% in December. 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 fell to -14 in February, from -12 in January.

A43 Looking at service sector prices, the ONS's experimental Corporate Services Price Index (CSPI) had suggested that annual corporate services price inflation had declined slightly in Q4. CSPI annual inflation had fallen for the seventh consecutive quarter, to 2.0%, in 2002 Q4, from 2.1% in 2002 Q3. But the CIPS services survey had pointed to higher input prices. The input price balance had risen to 55.8 in February from 54.9 in January.

A44 The annual inflation rate of the GDP deflator at market prices had fallen to 2.9% in 2002 Q4, from 3.3% in 2002 Q3. Within this, the annual rate of inflation of the household consumption deflator had risen to 0.6% in 2002 Q4, from 0.3% in 2002 Q3. The annual inflation rate of the government deflator had been unchanged at 5.5% in 2002 Q4. The annual inflation rates of the import and export deflators had been -0.7% and 1.6% respectively in 2002 Q4.

A45 Annual RPIX inflation had been unchanged at 2.7% in January. Within this, annual goods price inflation had risen by 0.1 percentage points to -0.3%, and annual services price inflation had fallen by 0.2 percentage points to 4.6%. Annual RPI and RPIY inflation had both been unchanged on the month, at 2.9%. But annual HICP inflation had fallen to 1.4% in January, from 1.7% in December.

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

A46 The Bank's regional Agents had reported a weakening in activity and confidence in the manufacturing sector, with a rising number of business failures. The downward trend in manufacturing investment since mid-2002 had become more marked. And investment had been focused on cost cutting, with any investment in capacity usually being overseas.

A47 Service sector growth had eased, but remained positive. Cost cutting by private sector clients had affected professional services, travel and hotels. Within consumer services, domestic tourism bookings had strengthened while overseas bookings had weakened, quite sharply in some regions. Services investment had also eased; often companies had deferred information technology upgrades.

A48 Contacts had reported a pick-up in some raw materials prices, including steel and fuel, although most had been held down by continued intense competition amongst suppliers. Council tax increases were expected to be higher, on average, than in April 2002. Some councils had been expected to raise tax levels to compensate for reduced government support grants. Meanwhile, councils that had received higher grants had not been expected to reduce their council tax proportionately. Other factors included significant increases in police funding costs and reassessments of grants for councils based on new population data.

A49 Growth in retail sales had been slower than a year earlier and the outlook was for further weakening, although consumers had continued to respond to price cuts. Car sales had been weak in the first two months of 2003. Agents reported that business sentiment had weakened in the first few weeks of 2003 and initial indications had been that there had been little improvement following the repo rate reduction. External factors had generally been more significant than domestic ones. But the timing of the reduction had generally been welcomed as a response to early news of slowing consumer demand.

## **VII Market intelligence**

A50 Interest rates implied by short sterling futures contracts had been significantly lower on 5 March than they had been on 5 February. The rate implied by the June 2003 contract had been 36 basis points lower, at 3.35%, while the rate implied by the June 2004 contract had been 57 basis points lower, at 3.42%. Much of the fall had occurred in response to the MPC's repo rate reduction on 6 February. Relative to previous market reactions following a cut in the repo rate, the fall had been particularly pronounced in the curve from 10 to 24 months ahead.

A51 Market participants had generally expected that the Committee would not change the repo rate at its March meeting. Economists polled by Reuters between 25 and 27 February had attached a mean probability of 79% to there being no change in the repo rate at the March meeting, and a mean probability of 20% to a decrease of 25 basis points. The mean expectation for the repo rate at end-2003 had fallen by 0.43 basis points since the previous poll, to 3.74%.

A52 Between 5 February and 5 March, the sterling effective exchange rate index (ERI) had fallen by 3.9%. Sterling weakness had been independent of movements in the euro-dollar exchange rate, and it had been broadly based – sterling had fallen against all ten currencies that make up the ERI. Market participants suggested that there had been some reassessment of UK economic prospects during the month, and that this had been the main explanation for the depreciation of sterling.