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MINUTES OF MONETARY POLICY COMMITTEE MEETING

7 and 8 May 2003

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 May 2003.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0305.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 4 and 5 June will be published on 18 June 2003.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 MAY 2003

1 Before turning to its immediate policy decision, the Committee discussed the world economy; money, credit and asset prices; the labour market, prices and costs; the projections for GDP growth and inflation to be published in the May *Inflation Report*; and some other considerations.

The world economy

2 There was still some contrast between recent developments in international financial markets and recent data and surveys from the world economy. Oil prices had fallen further, and equity prices in most major markets had risen further, on the month. However, while there were signs of recovery in consumer confidence in the United States following the end of the hostilities in Iraq, other indicators had been mixed, and the news from the euro area was weaker.

3 In the United States, GDP growth in 2003 Q1 was estimated to have been 0.4%, somewhat lower than had been projected at the time of the February *Inflation Report*. Consumption had been weak in the first quarter as a whole, but had strengthened in March, supported by spending on cars. After the fall of Baghdad, both the Conference Board and the Michigan indices of consumer confidence had risen sharply, and weekly measures of retail sales had also recovered. Longer-term US interest rates had declined during the month, and this was likely to encourage further remortgaging and equity withdrawal, which would in turn lend support to consumption. However, non-farm payrolls had fallen by over half a million since October 2002, and the unemployment rate had risen. Weaker labour market conditions posed a downside risk to consumption looking forward. Indicators from industry and manufacturing were mixed. Business investment had fallen in the first quarter, despite a recovery in output in the information, communications and technology (ICT) sector. Surveys of producer activity had not shown a uniform post-war rebound: the Institute for Supply Management (ISM) non-manufacturing index had risen in April, but the ISM manufacturing index had fallen.

4 The latest indicators for the euro area, taken together, looked weaker. There had been a small rise in euro-area industrial production in February. But there had been no evidence of improvement in the euro-area manufacturing and services PMI for April, after the fall of Baghdad, and the latest business confidence indices from the European Commission and IFO in Germany had fallen, although

euro-area consumer confidence had moved up in April for the first time in seven months. Although there had been upward revisions to earlier quarters, GDP in France was estimated to have fallen in 2002 Q4, which reinforced the view that the slowdown in the euro area at the end of 2002 was more marked than previously thought. The April Consensus forecast for euro-area GDP growth in 2003 had fallen to 1%, from 1.3% in February. Moreover, the recent further rise in the euro could be expected to weaken the contribution of net trade to aggregate demand growth. The appreciation could provide some short-term offsetting support to consumption, through an improvement in the terms of trade, lower inflation, and possibly lower interest rates than would otherwise have prevailed.

5 In Japan, the all-activity index for 2002 Q4 had been revised up, which was consistent with the GDP data for that quarter. Retail sales and household spending growth had increased in 2003 Q1, although the latter was still negative. But industrial production had fallen in March, and the annual rate of growth of exports had weakened. Equity prices in Japan had not risen by as much as in other major markets, perhaps reflecting longer-term structural problems in the Japanese economy. The SARS epidemic was likely to depress activity temporarily in a number of other Asian countries.

6 The recent appreciation of the euro against the dollar had perhaps been surprising, given that growth prospects for the euro area seemed to have worsened relative to the United States, and that there might now be less uncertainty affecting the dollar associated with the situation in Iraq. The Committee noted that the previous persistent strength of the dollar and the weakness of the euro had also been difficult to explain, and that its reversal should help to address the current account imbalances in the international economy, but changes in relative domestic demand would probably be needed as well.

7 The Wilshire index had increased by around 8% since the Committee's April meeting, and although the rise in the Eurostoxx index had been less than 5%, German equities had risen by almost 10%. The FTSE All-Share index had risen by over 4%. In addition to the reduction in uncertainty following the war in Iraq, global equity prices had probably been helped by corporate earnings reports from the United States in the first quarter being better than expected. Because the firms quoted in the major equity price indices typically sell their products, and own assets, in foreign markets as well as their home market, any perceived improvement in one major international market tends to raise equity prices in all the major centres.

8 In summary, therefore, oil and equity price movements in the past month had been supportive for international economic activity, but economic data and surveys had been more mixed. The rise in the euro against the dollar might help to correct current account imbalances.

Money, credit and financial market prices

9 Sterling had depreciated by around 2½% in effective terms since the Committee's April meeting, and at the time of the meeting was roughly 2% below the 15-day average rate incorporated in the May *Inflation Report* central projection. The fall in sterling could not be fully explained by relative interest rate changes and appeared to have been influenced by the fall in the dollar against the euro. The most recent Consensus survey, published in early April, had shown a fall in medium-term expectations for sterling, but that might simply have reflected the decline in sterling over the previous two months, and it could not account for the further depreciation over the past month.

10 Since the Committee's April meeting, sterling wholesale market forward interest rates had fallen at short and medium maturities, but had risen slightly at long maturities. The inflation expectations derived from index-linked and conventional government bond forward rates had also fallen slightly at short and medium maturities. They had risen slightly at longer maturities, but remained close to the inflation target.

11 The monthly flows and annual growth rates of total secured and unsecured lending to individuals had both been strong in March, although the annualised three-month growth rates had eased since late in 2002 for both secured and unsecured lending. The substantial rise in house prices over the past year had increased the housing equity owned by the household sector, which could support relatively high mortgage equity withdrawal for some time. The continuing robust growth of unsecured lending could signal buoyant consumption growth ahead, but it was also possible that it reflected a desire by some households to smooth the impact on consumption of adverse shocks to real disposable incomes – slower earnings growth and the short-term rise in inflation. Notes and coin in circulation had increased strongly in April, but this partly reflected contingency measures in response to the threat of strike action at a security carrier responsible for the distribution of banknotes.

Demand and output

12 GDP was estimated to have risen by 0.2% in 2003 Q1, according to the preliminary ONS release. This was less than the Committee had previously expected, and materially below the underlying rate of growth in the second half of 2002. Part of the slowdown reflected a fall in energy output, which could be attributed to unseasonably warm weather, but services growth had also slowed, to 0.3%, and that slowdown had apparently been broadly based. Although manufacturing output had been estimated to have risen in January and February, this reflected an exceptional increase in output in the ICT sector in January. During its meeting, the Committee was informed of the March index of production data, which showed that manufacturing output had fallen by 0.4% in March, and by 0.1% in 2003 Q1 as a whole which also reflected downward revisions to the hitherto puzzling January and February data. That could by itself imply a small downward revision to the GDP estimate. However it was not clear how this would be reflected in the expenditure counterparts.

13 There were some signs that output growth might have recovered following the end of the hostilities in Iraq. The CIPS services activity and new orders balances survey had risen in April. The Q1 CBI manufacturing survey had suggested a fall in output, but the survey had been taken during the war in Iraq; the more recent CIPS manufacturing survey had shown a bounceback in the activity balance although both this and the new orders balance still implied a contraction.

14 Indicators of consumer demand were mixed. Retail sales had risen by 0.6% in March, which had been unexpectedly strong and implied a slight rise for the first quarter as a whole. Nevertheless, this was the weakest quarterly growth rate in retail sales for over four years. The CBI Distributive Trades survey had shown a sharp rise in the balance reporting an increase in retail sales in April, but this may have been affected by the timing of Easter. The British Retail Consortium survey had also suggested increasing retail activity, but reports from the Bank's regional Agents were more mixed. The GfK index of consumer confidence had risen in April, mainly reflecting less negative perceptions of the general economic situation, although the aggregate balance had not recovered to its January level. Overall, the month-to-month pattern of consumption growth was hard to read.

15 There was evidence that housing market activity was slowing. The number of loan approvals for house purchases, seasonally adjusted, had fallen in March. The March survey by the Royal Institution of Chartered Surveyors had shown a fall in the number of sales and a rise in the stock of unsold

properties. The same survey had shown a percentage balance of 48 expecting a fall in house prices over the next three months. The relationship between this balance and the behaviour of house prices was not strong, but there was further evidence that house price inflation was slowing, perhaps more rapidly than assumed in the February *Inflation Report* projections. The Nationwide index had been unchanged in April, and the Halifax index had risen by only 0.4%. It was suggested that some banks were tightening lending criteria in the buy-to-let market.

The labour market, prices and costs

16 Employment had risen by some 33,000 in the three months to February according to the Labour Force Survey, and the rate of employment was flat. Unemployment had changed little since its trough in mid-2001. Total and average hours had fallen in the three months to February, continuing their recent trend. According to the CIPS survey, employment trends had improved a little in April, and the implied rate of job losses in manufacturing had slowed. Most employment intentions surveys were consistent with employment continuing to rise broadly in line with the rate of increase in the labour force in the second quarter.

17 Against a background of slightly easier labour market conditions, but with the headline rate of RPI inflation some 1½ percentage points higher than in mid-2002, wage pressures continued to ease. The headline increase in average earnings had fallen 0.5 percentage points to 3% in February. This largely reflected a strong negative contribution from bonuses, in turn mainly reflecting developments in the financial services sector. Overall new pay settlements in the private sector showed much the same rate of increase as a year earlier, although those in the construction sector remained well above the rate of inflation. In the public sector, the Pay Review Body awards, which took effect in April, had averaged about 0.5 percentage points less than in 2002. The Committee discussed alternative explanations for the continuing moderate level of pay settlements despite the pick-up in headline inflation and the imminent increase in National Insurance contributions. It was possible that medium-term inflation expectations were now well-anchored around the target rate, so that the recent temporary rise in inflation against a background of slower activity growth in the private sector would not result in significant upward pressure on pay. Alternatively, wage bargaining might not yet have responded to the increases in inflation and National Insurance contributions.

18 RPIX had increased by 3.0% in the twelve months to March. This was a slightly larger rise than envisaged in the February *Inflation Report* projections. The Budget announcement that increases in fuel duties would be deferred from April until October would reduce the rate of RPIX inflation expected between April and September by about 0.1 percentage point. Further up the supply chain, manufacturing input price inflation excluding oil had risen in March, and output price inflation had also risen, reflecting the earlier rise in petroleum prices. The recent exchange rate depreciation would put upward pressure on input and output price inflation. Surveys of financial market participants suggested that inflation was expected to peak in 2003 and then fall back to around the target. The Consensus survey of inflation expectations from five to ten years ahead had shown a fall, to 2.1%.

The May GDP growth and inflation projections

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

20 On the assumption of an unchanged official repo rate of 3.75% over the next two years, quarterly output growth was expected to be close to its trend rate throughout the forecast period. This implied a slightly lower level of GDP in the near term than was expected in February – reflecting the weaker-than-expected outturn in 2003 Q1 – but a higher level in the second year of the projection. The outlook reflected a slowdown in consumption growth, offset by continuing buoyant growth in public expenditure and a gradual increase in the contribution from net trade – due to the recovery in global demand together with an improvement in UK competitiveness associated with the lower value of sterling – and ultimately a modest pick-up in business investment. The central projection for RPIX inflation showed a continuing rise in the next few months followed by a fall to slightly below the target by early 2004, as the smaller contributions of housing depreciation and petrol prices offset the initial impact of the lower exchange rate. Inflation was then expected to pick up gradually and to be around the target, and still rising, two years ahead.

21 The Committee noted that the outlook for inflation two years ahead was similar to that in February. Evidence, both from overseas and from recent episodes of sharp movements in sterling, suggested that the effects of exchange rate changes on inflation expectations and on domestic prices and wages might be less than on average in the past. The Committee had taken this into account when judging the most likely impact of sterling depreciation in the May projections. In addition, the

Committee had adjusted the judgments it had previously reached about inflationary pressures in the labour market. In particular, earnings had not so far responded to the recent temporary rise in inflation or to the rise in employee National Insurance contributions, suggesting that the impact of pay pressures could be less than previously envisaged.

22 The Committee judged that the risks around the central projection for output and inflation were broadly balanced at the forecast horizon. It reduced the adjustment to the variance of the fan charts made in February to reflect the uncertainties associated with the war in Iraq, but judged that the uncertainty of economic prospects was still greater than it had been six months earlier.

23 Further analysis of the Budget had confirmed the Committee's earlier judgment that the macroeconomic implications of the Budget were likely to be small. There was a modest divergence between the growth projections in the latest forecast by HM Treasury and the Committee's latest central projection, principally reflecting the former's higher view of the growth of potential output and consumption spending.

Other considerations

24 The Reuters poll of economists suggested that economists on average attached a probability of 45% to a no-change decision, and 54% to a rate reduction. Anecdotal evidence suggested that the foreign exchange market on balance expected a reduction in repo rate, so that if such a reduction were made it was unlikely that sterling would immediately fall much further. The sharp fall in sterling in recent days appeared to have diminished money market expectations of a repo rate reduction, suggesting that market sentiment was currently finely balanced, but neither a 25 basis point reduction nor a no-change decision would be a major surprise.

The immediate policy decision

25 Over the past few weeks, some of the setbacks to the recovery of world activity growth had unwound. Military action in Iraq had ended; dollar oil prices had fallen back to the levels prevailing in mid-2002; equity prices had recovered somewhat; and consumer confidence in the United States and the United Kingdom had also picked up. That meant that the longer-standing uncertainties once again assumed prime importance. For the world economy, these were the strength and timing of

recovery, and the distribution of domestic demand growth between different countries, which had implications for the sustainability of growth. For the UK economy, the key uncertainty was the overall pressure of demand, reflecting the balance between the pick-up in government expenditure, and the prospective improvement in net trade and ultimately investment, and the slowdown in consumption. In that context, news in the latest month did not significantly change the picture, although the further decline in sterling would help support activity in the UK. The Committee's central projections in the *May Inflation Report* round were consistent either with a small reduction in the repo rate, or with a decision to leave the repo rate unchanged. The policy decision therefore depended in large measure on the balance of risks surrounding the projections.

26 Various arguments, to which different members gave different weight, suggested that a reduction in interest rates was appropriate now. First, on the central projection, at unchanged interest rates, the level of output would be below potential throughout the forecast period, initially by a greater margin than in the February projections, and inflation would fall in 2004 to below the target rate. Indeed, for one member, the most likely path for output lay below the central projection and directly justified a reduction in the Bank's repo rate. Second, there were downside risks to the activity projections. Consumption might be even weaker in the remainder of 2003, given the downward influences on real disposable incomes and the possible downside risk to house price inflation. It was possible that housing market inflation and activity might slow more rapidly than expected, and that equilibrium house prices were lower than was currently assumed. And the reported weakness of exports late last year and so far in 2003 might be indicative of a weaker underlying trade position, so that net trade might turn out weaker than projected. Moreover, looking forward, the response of exports to the fall in the exchange rate might be delayed, given the weakness of world demand and the possibility that supply might be constrained by the cumulative loss of capacity in UK export industries. Third, in the euro area, there were few signs of imminent recovery, and the strengthening in the euro would further weaken net trade there. In the United States, the weakness of the labour market suggested a downside risk to consumption going forward and there were downside risks also to investment. In the United Kingdom, the latest indicators of output in both manufacturing and services had been weaker than expected. Fourth, the rising profile for inflation at the two-year horizon could be given less weight, because there would be time for policy to respond to that prospect if the economy did indeed recover as projected. Finally, for some members the consequences in current circumstances of failing to make a necessary repo rate reduction were more serious than the consequences of making one which turned out not to be needed. In the latter event, the reduction could be reversed quickly. But if the rate was

left unchanged when, with hindsight, a reduction would have been appropriate, it was possible that confidence might weaken further; against that background, policy might be less able to support recovery.

27 There were also various arguments for leaving interest rates unchanged this month, to which different members again gave different weight. First, on the central projection, inflation was close to the target, and rising, at the forecast horizon. Second, there were a number of upside risks to this projection for inflation. The downward adjustments made to the assumed extent and pace of pass-through from sterling's depreciation to retail price inflation might have been too great. These judgments implied a favourable short-term relationship between output growth and inflation in the context of sterling depreciation. The risks to inflation were probably on the upside of this central case; for example, earnings might eventually respond, albeit with a lag, more strongly to the negative influences on real disposable income in the first half of 2003 than was now envisaged. There might also be an upside risk to the central projection for consumption growth, since this envisaged a sharp slowdown in the remainder of 2003. In practice, consumers might borrow more than assumed, particularly given the large amount of housing equity which would still be available as collateral. Third, sterling had fallen sharply in the days before the Committee's meeting, and stood some 2% below the 15-day average incorporated in the projections. Moreover, the FTSE All-Share index stood more than 2% above the average incorporated in the projections. If sustained, both these developments implied stronger prospects for activity and higher inflation. Most members thought that it would be prudent to wait to see whether sterling stayed at its new, lower level and to assess further evidence on the evolution of business and consumer confidence after the hostilities in Iraq. Other things being equal, if sterling reversed its recent decline, and if activity continued to be weaker than expected, the case for an interest rate reduction would then be stronger. Finally, for some members, the consequences of making an unnecessary repo rate reduction now would be more serious than those of delaying inappropriately, if that rate reduction were to lead to further sharp falls in the exchange rate.

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

29 Finally, on the occasion of Christopher Allsopp's last Committee meeting, the Governor and Mervyn King recorded their appreciation of the contribution he had made to monetary policy, both in the Committee's discussions over the past three years and previously as a member of the Bank's Court of Directors. The Treasury representative added the Chancellor's thanks for the way in which Mr Allsopp had fulfilled his responsibilities.

30 The following members of the Committee were present:

Eddie George, Governor
Mervyn King, Deputy Governor responsible for monetary policy
Andrew Large, Deputy Governor responsible for financial stability
Christopher Allsopp
Kate Barker
Charles Bean
Marian Bell
Stephen Nickell
Paul Tucker

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 2 May 2003, in advance of its meeting on 7-8 May. At the start of the Committee meeting itself, members were made aware of the information that had subsequently become available, and that information is included in this Annex.

I The international environment

A2 According to the advance estimate, US GDP had risen by 0.4% on a quarter earlier in 2003 Q1, following a quarterly rise of 0.3% in 2002 Q4. GDP had been 2.1% higher in Q1 than a year earlier. Consumption had risen by 0.3% on a quarter earlier. Private investment had increased by 0.1% over the same period, reflecting a rise of 2.9% in residential investment and a fall of 1.1% in non-residential investment. Government spending had increased by 0.2% in Q1 compared with a quarter earlier. The contributions to quarterly growth from stockbuilding and net trade were -0.1 and +0.2 percentage points respectively.

A3 Total industrial production had fallen by 0.5% in March compared with February. Over the same period, production of information, communications and technology (ICT) goods had increased by 1.6%. Total industry capacity utilisation had declined by 0.5 percentage points, to 74.8%, in March. New orders for non-defence capital goods had increased by 3.0% in March compared with a month earlier.

A4 Nominal retail sales had risen by 2.1% in March compared with February, an increase of 5.3% compared with a year earlier. The Conference Board measure of US consumer confidence had increased in April to 81.0, from a downwardly revised 61.4 in March. The rise in the overall index had reflected improvements in both the expectations and the current situation components of the index. The University of Michigan measure of consumer confidence had increased to 86.0 in April, from 77.6 in March. The Institute for Supply Management (ISM) manufacturing index had fallen to 45.4 in April, from 46.2 in March, while the ISM non-manufacturing index had risen to 50.7 in April, from 47.9 in March. Non-farm payrolls had fallen by 48,000 in April. The unemployment rate had increased to 6.0% in April, from 5.8% in March.

A5 The US headline consumer price index had increased by 3.0% in the year to March, the same as in February. Annual core consumer price inflation (excluding food and energy) had also been unchanged in March, at 1.7%. US producer prices had risen by 4.2% in the year to March. Core producer prices (excluding food and energy) had increased by 0.9% over the same period.

A6 In the April second release, the estimate of French GDP growth in 2002 Q4 had been revised down by 0.3 percentage points, to -0.1%, compared with a quarter earlier. However, revisions to National Accounts data for earlier quarters had meant that the estimated level of French GDP in 2002 Q4 was now 0.3% higher than estimated in the first release. Estimated quarterly private consumption growth had been revised down, to 0.3%, compared with the 0.4% estimate in the February first release. Estimated quarterly business investment growth had been revised down to -1.8%, from the first estimate of -0.7%. Estimated government consumption growth had also been revised lower, to 0.7%, from the first estimate of 1.1%. Stockbuilding had contributed -0.2 percentage points to quarterly growth in Q4, compared with a contribution of -0.1 percentage points in the first release. Net trade made an estimated zero contribution to growth, the same as in the first release. Estimated annual French GDP growth for 2002 had been 1.2%, unchanged from the first release.

A7 Euro-area industrial production had increased by 0.2% in February on the previous month. It had increased by 0.6% on a month earlier in France, while in Germany and Italy it had fallen by 0.4% and 0.3% respectively. German manufacturing orders had fallen by 3.9% in March compared with a month earlier, reflecting falls in both domestic and foreign orders. The euro-area purchasing managers' index (PMI) for manufacturing had fallen to 47.8 in April, from 48.4 in March. The euro-area PMI for services had been unchanged in April, at 47.7.

A8 The European Commission measure of consumer confidence had risen to -19 in April, from -21 in March, while business confidence had declined to -13 from -12. The German IFO business climate index had decreased to 86.6 in April, from 88.1 in March. The decline had been attributable to falls in both the business expectations and the current situation components of the index. Euro-area retail sales volumes had fallen by 0.8% in February on the previous month. French consumer expenditure on manufactured goods had increased by 0.3% in March compared with the previous month. The rate of unemployment in the euro area had increased by 0.1 percentage points in March, to 8.7%.

A9 Annual harmonised consumer price inflation in the euro area had been at 2.4% in March, as it had been in February. Annual core inflation (excluding energy, food, alcohol and tobacco) had slowed to 1.8% in March, from 1.9% in February. Annual headline inflation in Germany had been unchanged at 1.2% in March compared with a month earlier. Consumer prices in France and Italy had increased by 2.6% and 2.9% respectively in the year to March. The Eurostat flash estimate for euro-area HICP inflation had indicated a rate of 2.1% in the year to April. Annual producer price inflation in the euro area had fallen to 2.4% in March, from 2.7% in February.

A10 In Japan, industrial production had grown by 0.2% in 2003 Q1 relative to a quarter earlier, compared with a rise of 0.4% in 2002 Q4. The index of tertiary activity had fallen by 0.8% in February compared with a month earlier, and the all-activity index had declined at the same rate. Export volumes had risen by 6.0% in the year to March, while import volumes had increased by 7.2% over the same period. Nominal retail sales had increased by 1.6% in 2003 Q1 compared with a quarter earlier, while worker households' real expenditure had fallen by 0.3% over the same period. The unemployment rate had increased to 5.4% in March, from 5.2% in February.

A11 Since the Committee's previous meeting, the spot price of Brent crude oil had fallen by about \$1.20 per barrel, to around \$24 per barrel. The Economist dollar non-oil commodity price index had been unchanged. Most major international equity indices had risen since the Committee's April meeting. The Wilshire 5000 index had increased by 7.8%, the FTSE All-Share by 4.4%, the Dow Jones Euro Stoxx by 4.6% and the Japanese Topix by 2.7%.

II Monetary and financial conditions

A12 The twelve-month growth rate of notes and coin (adjusted for the effect of the threat of strike action at a security carrier affecting the distribution of notes) had risen to an estimated 7.4% in April, from 6.4% in March. The headline twelve-month growth rate of notes and coin had increased to 8.7% in April. Annual growth of M4 had risen to 7.2% in March, from 6.6% in February. Excluding the deposits of other financial corporations (OFCs), the annual M4 growth rate had risen by just 0.1 percentage points, to 8.1%, in March. The twelve-month growth rate of M4 lending (excluding the effects of securitisations) had risen to 11.0% in March, from 10.8% in February. Annual growth of M4 lending excluding borrowing by OFCs had also risen slightly.

A13 The twelve-month growth rate of households' M4 had fallen to 8.0% in March, from 8.6% in February. The twelve-month growth rate of households' M4 lending (excluding the effects of securitisations) had risen slightly, to 14.5% in March from 14.4% in February. Securitisations of household debt had been strong in March at £7.7 billion (not seasonally adjusted). The annual growth rate of the broader measure of total net lending to individuals had risen by 0.1 percentage points, to 13.8%, in March. Annual growth of net secured lending to individuals had risen slightly, to 13.6% in March from 13.5% in February. The annual growth rate of unsecured lending to individuals had also risen, to 14.5% in March from 14.3% in February.

A14 The number of loan approvals for house purchase (after adjusting for the number of working days in the month) had fallen further, to 97,000 in March compared with a downwardly revised 100,000 in February. The House Builders' Federation monthly survey had shown that the percentage balance of respondents reporting an increase in net reservations over the corresponding month a year earlier had risen slightly in March compared with February, but was still strongly negative; and the number of particulars delivered had fallen to 123,000 in March, from 124,000 in February.

A15 The twelve-month growth rate of private non-financial corporations' (PNFCs') M4 deposits had risen sharply, to 8.4% in March from 5.1% in February. The twelve-month growth rate of PNFCs' M4 lending (excluding the effects of securitisations) had increased to 8.6% in March, from 8.2% in February.

A16 Within the quarterly industrial breakdown of sterling bank lending, the annual rate of debt repayment by the manufacturing sector had eased somewhat in 2003 Q1. The annual growth rate of lending to real estate companies and the construction sector had risen further in Q1.

A17 PNFCs had raised a monthly average of £3.0 billion of total external finance in 2003 Q1, lower than the average monthly flow of £4.9 billion in 2002 Q4.

A18 The annual growth rate of M4 deposits of other financial corporations (OFCs) had risen, to 4.1% in March from 2.0% in February, although the one-month flow had been negative. The twelve-month growth rate of OFCs' M4 lending (excluding the effects of securitisations) had risen slightly, to 4.1% in March from 3.9% in February.

A19 Changes to quoted interest rates on household borrowing had been mixed in April. The average standard variable mortgage rate was unchanged at 5.49%. The average two-year discounted mortgage rate quoted for new customers had fallen by 16 basis points in April, whereas the average two-year fixed mortgage rate had risen by 8 basis points in April. The proportion of fixed-rate mortgages in total new mortgage lending business was estimated to have risen to 47% in March from 39% in February, according to the most recent release from the Council of Mortgage Lenders.

A20 One-year nominal forward rates had between 9 April and 7 May fallen at horizons out to 14 years. At the two-year horizon, they had fallen by 26 basis points. At longer maturities, nominal forward rates had risen slightly, by 7 basis points at 25 years. Uncertainty about future interest rates, as measured by three-month implied volatility from short sterling option contracts, had fallen slightly over the month. However, expectations of future volatility over the next year had remained high. One-year real forward rates derived from index-linked gilts had fallen by 14 basis points at the two-year horizon. They had fallen by less at horizons out to 15 years.

A21 Between 9 April and 7 May, one-year forward inflation expectations derived from bond markets had fallen by more than 10 basis points at two years, to 2.3%. Implied inflation forward rates had fallen by less at longer horizons, and had remained close to target beyond ten years. Short-run survey measures of inflation expectations had increased in April, broadly reflecting the rise in inflation outturns over the same period. The Consensus Economics survey measure of mean RPIX inflation expectations for 2003 had increased to 2.8% in April, from 2.7% in March. Their mean measure of RPIX inflation expectations for 2004 had been unchanged at 2.4%. HM Treasury's survey measure of mean RPIX inflation expectations for 2003 Q4 had been unchanged at 2.6% in April. However, their measure for 2004 Q4 had fallen to 2.3% in April, from 2.4% in March. The biannual Consensus survey of long-run inflation expectations had shown that average annual RPIX inflation expectations for 2009 to 2013 inclusive had fallen to 2.1% in April, from 2.2% in October 2002 (for 2008 to 2012 inclusive).

A22 The Merrill Lynch index of sterling investment-grade corporate yields had fallen by 27 basis points between 9 April and 7 May. Dollar and euro corporate yields had also fallen, by 43 and 36 basis points respectively.

A23 The sterling effective exchange rate index (ERI) had depreciated by 2.4% since the Committee's previous meeting. It stood at 97.3 on 7 May, compared with 99.7 on 9 April. Over this period, sterling had depreciated against the euro by 3.6% and appreciated against the dollar by 2.4%. These movements in exchange rates could not be fully accounted for by changes in relative interest rates. The latest Consensus survey, dated 7 April, had suggested that medium-term expectations for the sterling ERI had fallen, but that had been little change to expectations of the exchange rate for the euro against the dollar. Option prices indicated that the market had expected current levels of uncertainty to persist, and had come to see a greater risk of a further appreciation of the euro and sterling relative to the dollar.

A24 The FTSE All-Share index had risen by 4.4% between 9 April and 7 May. There had also been rises in other UK equity indices. ICT stocks had outperformed broad indices, as they had done in other major markets. Factors boosting equity prices had included positive news about corporate earnings and a reduction in uncertainty. Uncertainty about UK equity prices, as measured by the implied volatility from option prices, had fallen to levels last seen in mid-2002; and implied forward volatility had suggested that market participants did not expect significant changes in uncertainty over the remainder of the year.

III Demand and output

A25 The ONS' preliminary estimate for quarterly GDP growth at constant market prices in 2003 Q1 had been 0.2%, following 0.4% growth in 2002 Q4. Annual GDP growth had picked up a little, to 2.3%, from 2.2% in Q4.

A26 The preliminary estimate for quarterly service sector growth had been 0.3%, following growth of 0.5% in 2002 Q4. Within the service sector, quarterly output in the distribution, hotels and catering sector had been estimated to have risen by 0.3%, following a 0.6% rise in 2002 Q4.

A27 Manufacturing output had been estimated to have risen by 0.2% in January and by 0.3% in February. This had followed a fall in manufacturing sector output of 1.0% in 2002 Q4.

A28 Retail sales had risen by 0.6% in March, following a rise of 0.4% in February and a fall of 1.0% in January. Quarterly retail sales had risen by 0.1% in Q1, following 1.6% growth in 2002 Q4. The latest outturn had been the lowest quarterly growth rate of retail sales for over four years.

A29 Turning to indicators of expenditure for 2003 Q2, the Confederation of British Industry (CBI) Distributive Trades survey's retailers' sales balance had risen in April. According to data supplied by the Society of Motor Manufacturers and Traders (SMMT), new private car registrations in April had been 10.5% lower than a year earlier. Over the three months to April, new private registrations were 0.7% lower than in the same period a year earlier. The Nationwide house price index had been unchanged on the month in April, with the annual inflation rate falling to 22.2%, from 26.2% in March. The Halifax house price index had risen by 0.4% in April, with the annual inflation rate (adjusted by the Bank for the change in calculation method by the Halifax in December 2002), picking up slightly, to 25.0% from 24.8% in March. The percentage balance of estate agents reporting house price rises over the past three months had fallen on a seasonally adjusted basis, to -25 in March, from -9 in February, in the Royal Institution of Chartered Surveyors (RICS) survey. This had been the lowest balance since August 1995. Looking ahead, the seasonally adjusted percentage balance of estate agents expecting price increases over the next three months had also fallen, to -48 in March from -40 in February. This had represented the lowest balance since the introduction of the question in October 1998.

A30 The GfK consumer confidence headline balance had risen to -5 in April, from -10 in March, driven by a significant recovery in the forward-looking balance for the general economic situation, which had risen to -19 in April, from -34 in March.

A31 The 2003 Q1 British Chambers of Commerce (BCC) survey of business confidence regarding future profitability in the service sector had shown the percentage balance falling, to +28 from +38 in 2002 Q4. The evidence on manufacturing optimism had been mixed. The BCC manufacturing sector balance had been broadly unchanged, whereas the 2003 Q1 CBI Quarterly Industrial Trends survey business optimism percentage balance had fallen to -27 in Q1, from -19 in Q4.

A32 The 2003 Q1 BCC survey had also pointed to a decline in investment intentions and capacity utilisation in both the service and manufacturing sectors. The service sector percentage balance on planned investment in plant and machinery had fallen to +3 in Q1, from +13 in 2002 Q4. The

proportion of firms operating at full capacity had fallen to 36% in Q1, from 39% in Q4. The planned investment percentage balance for the manufacturing sector had fallen to +2 in Q1, from +8 in Q4, and the proportion of firms operating at full capacity had fallen to 33% in Q1, from 38% in Q4. The 2003 Q1 CBI Quarterly Industrial Trends survey had also pointed to a fall in investment intentions: the percentage balance had fallen slightly, to -23 in Q1 from -22 in Q4.

A33 Turning to indicators of output for 2003 Q2, the BCC survey had pointed to a slowdown in the service sector. The percentage balance on domestic orders had fallen to +7, from +16 in Q4, and the percentage balance on export orders had fallen to -9 in Q1, from +2 in Q4. However, the April Chartered Institute for Purchasing and Supply (CIPS) services survey in April had pointed to a recovery in service sector output for 2003 Q2: the business activity balance in April had risen to 50.7, from 49.0 in March. The balance on new orders had also picked up, to 49.3 in April, from 48.8 in March, and there had been a bounceback in the business expectation balance, to 71.7, close to its February level.

A34 The April CIPS manufacturing survey had pointed to a contraction in the manufacturing sector for 2003 Q2. Although the output balance had risen to 48.4 in April, from 45.8 in March, and the new orders balance had risen to 49.8, from 45.2 in March, both had remained below the 50 'no-change' mark. The BCC survey and the CBI Quarterly Industrial Trends survey had also pointed to a slowdown in the manufacturing sector. The BCC percentage balance on domestic orders had fallen to -2 in Q1, from +13 in Q4, and the percentage balance on export orders had fallen to -3 in Q1, from +8 in Q4. The CBI percentage balance on total new orders had fallen to -21 percentage points in Q1, from -9 in Q4, and the percentage balance on domestic orders had fallen to -23 percentage points in Q1, from -13 in Q4. Both these balances had been at their lowest levels since 1999 Q1.

A35 The Bank's regional Agents had conducted a survey on recent developments in manufacturing output, covering 141 companies with a total UK turnover exceeding £29 billion. Responses had been weighted on the basis of turnover. A positive balance of respondents had reported a slight decrease in output for the domestic market in 2003 Q1 relative to 2002 Q4, especially in the semi-finished goods or components category. Lower overall output had been reported for export both to the European Union and to the rest of the world. Total responses were split almost evenly between manufacturers who said that weak demand had not caused finished goods stocks to be higher than planned at the end of 2003 Q1, and those who said stocks had been a little higher. A majority of respondents had

reported that the war in Iraq had not affected output for the domestic market. In export markets, the picture had been more varied. Slightly more than half the weighted sample had said that output for export had been unaffected by the war. Most of the remaining respondents had expected recovery to pre-war levels to occur within three months.

IV The labour market

A36 According to the Labour Force Survey (LFS), employment had increased by 33,000 in the three months to February, compared with the previous three months. This had followed a rise of 57,000 in the three months to January, and a 107,000 fall in the previous non-overlapping quarter. The rise in employment in the three months to February had been more than accounted for by self-employment (up by 60,000). The working-age employment rate had remained unchanged on the previous quarter, and had increased by 0.2 percentage points on the year, to 74.5%.

A37 Total hours worked in the three months to February had fallen by 0.2% compared with the previous non-overlapping quarter. Average hours had declined by 0.2% in the three months to February, reflecting a 0.2% fall in average hours for full-time workers and a 0.3% fall for those working part-time.

A38 The overall CIPS employment index for April had improved slightly on the previous month, but had remained below the 'no-change' level of 50. The rate of implied job losses in manufacturing and services had slowed slightly. Surveys of employment intentions (Manpower and CBI services sector) had been consistent with some moderate growth in employment for 2003 Q2. The Recruitment and Employment Confederation (REC) survey had shown that demand for both temporary and permanent staff had decreased slightly in April. It had also indicated that availability of agency staff had continued to become more widespread. The 2003 Q1 BCC survey had shown a further fall in the number of firms recruiting in Q1, but also that the number of firms reporting recruitment difficulties had remained high.

A39 LFS unemployment had fallen by 22,000 in the three months to February compared with the three months to November, but had been 20,000 higher than in the same three months a year earlier. The unemployment rate had fallen by 0.1 percentage points, to 5.1%. The claimant count had risen by 1,800 in March after a (revised) increase of 5,700 in February. Working-age inactivity had risen by

40,000 in the three months to February. This had been more than accounted for by the 157,000 increase in those who did not want a job. The working-age inactivity rate had increased by 0.1 percentage points, to 21.4%.

A40 Headline (three-month average) whole-economy annual average earnings growth had eased by 0.5 percentage points, to 3.0%, in February. Headline earnings growth in the public sector had picked up by 0.2 percentage points, to 5.1%, and headline earnings growth in the private sector had fallen by 0.7 percentage points, to 2.5%. Actual whole-economy earnings growth had fallen by 0.8 percentage points, to 2.4%, in February. Whole-economy regular pay growth (not seasonally adjusted) had fallen by 0.3 percentage points, to 3.7%, in January. Bonuses had made a negative contribution of 1.1 percentage points.

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

V Prices

A42 Sterling oil prices had fallen by around 7% since the April MPC meeting, and were around 17% lower on average in April than in March.

A43 Manufacturing input prices were unchanged in March. But owing to an oil-related base effect, the annual inflation rate had fallen to 4.4% in March, from 6.1% in February. The CIPS manufacturing survey had pointed to increasing input prices going forward, although the input price balance had fallen to 56.5 percentage points in April, from 61.8 in March.

A44 Manufacturing output prices excluding duties (PPIY) had risen by 0.2% in March, while the annual inflation rate had risen to 1.8%, from 1.6% in February. Looking ahead, survey data had continued to point to downward pressure on output prices. Although the expected output price balance from the CBI Quarterly Industrial Trends survey had risen, it had remained negative at -6 percentage points in April.

A45 Annual RPIX inflation was unchanged in March, at 3.0%. Within this, annual goods price inflation had risen by 0.2 percentage points, to 0.3%, in March, while annual services price inflation was unchanged, at 4.5% in March. Annual RPIY inflation had risen by 0.1 percentage points, to 3.2%

in March. Annual RPI inflation had fallen to 3.1% in March, from 3.2% in February. Annual HICP inflation was unchanged, at 1.6% in March.

VI Reports by the Bank's Agents

A46 The Bank's regional Agents had reported that the housing market had weakened since the end of last year. The number of properties on the market had increased rapidly since January and house builders had seen a downturn in both site visits and reservations. Transaction times had increased and negotiation on price had become more prevalent. This weakness had been exacerbated by the effect on confidence of the war in Iraq. Only the three northernmost English Agencies and Scotland had reported contacts predicting double-digit house price inflation in 2003; and this had excluded the most expensive properties.

A47 Agents' contacts had only occasionally mentioned war in Iraq as a cause of weak consumer spending, most notably for cars. Retail contacts had considered the weather and the timing of Easter to be more significant factors. Sales of big ticket items had been most affected by the slowdown in consumer spending, which contacts had suggested was due to concerns about house prices, personal indebtedness, tax rises and job insecurity. Overall, however, underlying retail sales growth in April had probably been a little stronger than in March.

A48 Agents believed that the greatest impact of the war had been on air travel and foreign holiday business. Since the end of the war, travel to the Far East had been affected by fears about SARS (Severe Acute Respiratory Syndrome), but bookings to other destinations had picked up.

VII Market intelligence

A49 On 7 May, interest rates implied by short sterling futures contracts had generally been lower than on 9 April. The rate implied by the September 2003 contract had been 6 basis points lower, at 3.38%, and that implied by the September 2004 contract 29 basis points lower, at 3.84%. Implied rates had generally fallen over the period, despite having risen immediately following the April MPC decision. The falls had reflected some weaker-than-expected UK economic data, including first-quarter GDP and the RICS survey. The falls had also reflected the market's response to comments from Chairman

Greenspan to the House of Representatives Committee on Financial Services on 30 April and to the statement following the FOMC decision on 6 May.

A50 Market participants had attached a slightly higher probability to a 25 basis point reduction in the repo rate than to a no-change decision at the MPC's May meeting. Economists polled by Reuters between 29 April and 1 May had attached a mean probability of 51% to a 25 basis point reduction in the repo rate at the May meeting, and a mean probability of 45% to no change; most of these economists perceived the decision to be closely balanced. The mean expectation for the level of the repo rate at end-2003 had fallen by 7 basis points since the previous poll, to 3.48%, while the forecast for end-2004 had fallen by 17 basis points to 4.02%.

A51 Between 9 April and 7 May, sterling's effective exchange rate had fallen by 2.4%. Market participants had suggested that the fall in sterling against the euro was in line with what might have been expected, given the fall of 5.9% in the dollar against the euro and the past correlation of sterling and the euro against the dollar.