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MINUTES OF MONETARY POLICY COMMITTEE MEETING 4 and 5 February 2004

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 February 2004.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0402.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 3 and 4 March will be published on 17 March 2004.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 FEBRUARY 2004

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed developments in financial markets; the international economy; money, credit, demand and output; the labour market, costs and prices; and some other considerations.

Financial markets

2 Over the past month, movements in interest rates had been small. Short-term sterling interest rates were barely changed on the month, while short-term dollar and euro rates were around 10 basis points lower. Forward rates now implied that an increase of 25 basis points in the Bank's repo rate this month was widely expected and largely priced into the yield curve. Forward interest rates also suggested that market participants now expected official euro-area and US rates to be increased a little later than had been anticipated at the time of the January MPC meeting. Long spot interest rates were little changed on the month in the United Kingdom and a little lower in the United States and the euro area, with the bulk of the falls accounted for by changes in expectations about near-term interest rate prospects. Changes on the month in the major equity price indices around the world had ranged from an increase of 1.3% for the DJ EuroStoxx to a fall of 2.8% for the Topix, with the FTSE All-Share index dropping by 0.9%. Uncertainty about future equity prices appeared to be below average in the United Kingdom and elsewhere.

3 Exchange rates had been volatile during the past month. Overall, since the previous MPC meeting, the euro had depreciated by around 1½% against the dollar, and the sterling effective exchange rate index had risen by 1½%, touching its highest level since February last year – at nearly 3% above its value at the beginning of 2004. It seemed likely that sterling's appreciation reflected market participants' expectations of a repo rate increase in February and the positive news about UK domestic demand growth in the past couple of months. It was also possible that, in the light of fears of renewed dollar weakness and slow domestic demand growth in the euro area, sterling assets had become relatively more attractive to international investors.

4 Comparing interest rates with their levels in November, the sterling, dollar and euro yield curves were all lower. Over that period, there had been a more marked fall in long-term forward rates in the United States than elsewhere, perhaps associated with hedging activity in the US mortgage-backed securities market. These falls in yield curves were difficult to explain in terms of news about demand and output, as that had been broadly positive since November. It was more likely that market participants had reassessed the probable actions of the monetary authorities. In the United States, the FOMC statement published in December had been widely interpreted as implying that US rates would remain low for some time. This interpretation might also have suggested that interest rates elsewhere in the world would be lower than previously expected, as a result of the likely impact of US interest rates on exchange rates against the dollar. In the United Kingdom, the MPC's November inflation projections and the subsequent MPC minutes might have led market participants to conclude that the sterling yield curve immediately after the November repo rate increase implied a greater degree of monetary tightening than would in fact be necessary.

The international economy

5 Evidence of a more broadly based recovery in the world economy had continued to accumulate. In the United States, quarterly GDP growth had been 1% in 2003 Q4, according to the advance estimate. As expected, this was below the rate of growth in the third quarter, but still strong, and had probably been affected by erratically low government spending. Investment growth had slowed on the quarter and had been a little weaker than expected, but the overall picture of a broadly based revival of investment was still intact. Output indicators had been consistent with continuing robust growth, with the twelve-month growth rate of industrial production rising in December, the Institute for Supply Management's (ISM's) manufacturing Purchasing Managers' Index (PMI) in January at its highest level since December 1983 and the ISM non-manufacturing PMI increasing sharply. Although the stock of broad money had fallen again in December, its velocity remained well below the rates prevailing in the late 1990s. The Federal Reserve's most recent Senior Loan Officer Opinion Survey suggested that credit conditions for corporate borrowers had eased while those for households had tightened a little, thus counteracting to some extent the past imbalance between investment and consumption growth. Total bank lending to large and medium-sized firms had risen, slightly, for the first time since 2000. Indeed, banks had reported that companies were finding it easier to raise internal funds and to borrow from outside the banking

system, so the bank lending data probably underestimated corporate spending growth.

Consumption growth had, as expected, fallen in the fourth quarter, as growth of spending on durable goods had slowed. Consumers may have been cautious because of uncertainty about job prospects: contrary to market expectations, non-farm payrolls had barely increased in December. However, the household-based employment survey, which might be better at capturing jobs created in new firms, painted a stronger picture, and new and continuing unemployment claims had continued to decline. Consumer confidence measures had rebounded in January, mortgage refinancing had picked up and surveys of activity in the housing market had remained strong, so it seemed likely that household spending would hold up.

6 The sustainability of the US recovery this year now seemed less in question, given the continuing expansionary policy stance and the weaker US dollar. It was, however, unclear when inflationary pressures might begin to emerge. On the one hand, productivity growth was still rapid and there appeared to be a substantial margin of spare capacity in both product and labour markets; inflation on the core consumer expenditures deflator measure was falling; and forward interest rates did not suggest that market participants were expecting inflation to rise significantly in the medium term. On the other hand, non-oil commodity prices had increased by around 20% in dollar terms in the past six months or so and input and output producer price inflation had been picking up. The larger price rises for those components of the US Consumer Prices Index omitted from the 'core' measure, such as food and energy, might reflect the strengthening recovery of world demand rather than temporary factors. It was also unclear whether the large US current account deficit would continue to be financed by inflows on the capital account without further falls in the value of the US dollar. These uncertainties entailed some risk that US long bond yields might rise significantly.

7 The latest estimate of GDP growth in the euro area in 2003 Q3 was 0.4%, unchanged from the previous release. Data revisions had reduced but not eliminated the puzzle of the apparently strong contribution of net trade in the third quarter despite the strength of the euro. Indeed, one possible explanation – that producers had been reducing their margins in order to maintain sales volumes – now looked less plausible in the light of upward revisions to the estimated export deflator. But trade data for October and November suggested that there had in any case been a reduction in the value of exports from the euro area in the fourth quarter, and it seemed unlikely that net trade would continue to drive the euro-area recovery. Estimates of euro-area GDP growth in the fourth quarter

were not yet available, but German data for 2003 as a whole implied that Q4 GDP growth there was likely to have been around 0.3%. The IFO index (for western Germany) had risen a little in January, because of a rise in the 'current situation' component, which was consistent with growth continuing in 2004 Q1.

8 Economic indicators suggested that there might be greater strength to euro-area corporate spending than to consumption. Growth of French household consumption of manufactured goods had slowed in Q4 and German retail sales (excluding sales of motor vehicles) had contracted at a faster rate than in Q3; the latter had fallen about 8% from their peak in 2001. The latest IFO index for retailers pointed to continuing weakness. Euro-area consumer confidence had been unchanged in January, remaining below its long-run average. But, although industrial production growth had weakened in November, probably because of the effect of the warm weather on energy production, the euro-area manufacturing PMI had increased in January for the seventh consecutive month; the services PMI had risen by even more on the month.

9 In Japan, the all-activity index had fallen a little in November, but the broad picture of an increase in growth from around the middle of last year was intact. China continued to provide a significant impetus to world demand, with GDP in 2003 Q4 estimated to have been around 10% higher than a year earlier. It seemed unlikely, on current evidence, that avian flu would have a large or lasting effect on Asian economies.

Money, credit, demand and output

10 The past month's news about UK activity had generally been positive. According to the preliminary estimate, GDP growth at market prices in 2003 Q4 had been 0.9%, the strongest quarterly figure since 2000 Q1, and broadly in line with the MPC's November central projection. Business surveys had been consistently positive in their messages about the likely strength of demand and output in 2004 Q1: the Chartered Institute of Purchasing and Supply's (CIPS') services business activity balance had suggested that activity had increased at its most rapid rate since mid-1997; the British Chambers of Commerce quarterly survey showed sharp improvements in sales and orders balances for both the manufacturing and services sectors; the CBI quarterly Industrial Trends survey had reported a marked and broadly based improvement in the prospects of the manufacturing sector, and the largest increase in the output balance since the survey began; and

the CIPS manufacturing PMI had stayed in January at a level not seen since December 1999, with a sharp rise in new orders offset by a sharp fall in stocks, some of which was probably involuntary and so consistent with strong demand. The Bank's Agents had reported that manufacturing orders and output continued to improve and that growth in services output was still gathering pace. Given these indicators, which reflected actual activity as well as expectations, it was likely that GDP growth in 2004 Q1 would exceed that in 2003 Q4. There had also been a sharp rise in reported investment intentions in both services and manufacturing; according to the Bank's Agents, these were around their highest level for three years. The CIPS manufacturing index for new orders for investment goods industries had been above 60 for three months now, the highest level since August 1995. This suggested that firms' confidence in future demand had risen significantly; and there might also be a backlog of postponed investment projects in the pipeline.

11 The signs were that household spending remained robust. Retail sales growth in 2003 Q4 had been 1.9%, the strongest quarterly growth rate since 2002 Q1, although, as usual, there was considerable uncertainty about the pattern of spending around Christmas and hence about the implications for retail sales at the beginning of the new year. Consumer confidence had risen slightly in January, according to the GfK measure, on a seasonally adjusted basis. The CBI Distributive Trades survey for January had shown the highest balance of retailers since April 2002 reporting annual growth, although reports from the Bank's Agents suggested that volume growth had been driven to a large extent by relatively high price discounting for the time of year. Interpretation was complicated by the shift of spending towards supermarkets and internet retailers with lower prices. Total lending to individuals had remained robust in December, because of the strength of secured lending. Unsecured lending growth, which had slowed over 2003 as a whole, had dropped sharply in December, reflecting strong repayments of credit card debt, possibly influenced by the expiry of low-interest rate offers. The monetary aggregates were consistent with continued resilience of consumption. Indicators suggested that there had been little change in the housing market in December. The rate of increase of house prices had remained strong that month, according to the average of the rates reported by the Halifax and Nationwide; loan approvals and particulars delivered had been little changed; and, according to the Royal Institution of Chartered Surveyors, the ratio of sales to stocks on estate agents' books had risen slightly. House price inflation had not slowed as much as the Committee had expected last November.

12 Aggregate consumption last year had been buoyed by increases not only in housing and financial wealth but also in the total benefits paid to the household sector, which were unlikely to rise as fast again this year, and by increases in employment. Also, HM Treasury was projecting a rise in effective tax rates over the coming year.

13 The Bank's Agents reported that their contacts regarded domestic demand in foreign markets, rather than exchange rates, as the dominant influence on exports at the moment; the strongest markets were said to be in the United States and Asia, despite sterling's appreciation against the US dollar and the Asian currencies linked to it. Nevertheless, the margins of UK exporters to these regions were likely to be compressed by the appreciation, which might slow future export growth.

The labour market, costs and prices

14 Recent data and surveys were consistent with a gradual tightening in the labour market since around the middle of last year. Employment had increased (although total hours worked had fallen slightly), and, on the Labour Force Survey measure, the unemployment rate had fallen to 4.9% in the three months to November. The CIPS employment survey for January was little changed on the month, still indicating modest private sector employment growth; the Recruitment and Employment Confederation demand and availability measures for agency staff both pointed to further tightening; and the Agents' contacts painted the same picture for regional labour markets.

15 The annual growth rate of regular pay in the private sector rose slightly in November. The annualised three-month-on-three-month growth rate was now one percentage point above its low point last year. Wage drift – the difference between pay settlements and earnings growth – seemed largely to have disappeared, but it was likely to return this year; bonuses in particular were likely to make a positive contribution to earnings growth. The Bank's Agents had conducted their annual informal survey of contacts' expectations for the coming pay round, and this suggested that pay settlements would be at levels similar to those in 2003, although non-wage labour costs were expected to rise faster, largely because of pension contributions and, over the year as a whole, higher National Insurance contributions. Difficulties in recruiting new labour had been cited more often than last year as an important factor in employers' attitudes to pay bargaining. However, given the recovery in aggregate demand, it was perhaps surprising that there had not been more

reports of labour shortages. It was possible that labour supply – including that from overseas – had become more responsive to changes in vacancies and pay.

16 CPI inflation had been 1.3% in December. Goods price inflation had been picking up for some time, with increases across most components of the index, while services price inflation had fallen, largely because of lower prices for package holidays. There was some evidence of growing inflationary pressure in the supply pipeline. Twelve-month producer input price inflation had risen to 2.7% in the second half of last year, propelled by commodity prices, which had risen in sterling, not just US dollar, terms. This had been corroborated by the input price component of the manufacturing PMI. Although movements in commodity and other input prices did not have a close relationship with changes in the Consumer Prices Index, the rises were indicative of the general upward pressure on prices from the broad-based recovery in global demand. There was also some evidence that UK corporate services inflation had been rising during 2003.

Other considerations

17 A rise in the official repo rate was widely expected. Out of 47 economists polled by Reuters in the week before the meeting, 44 expected the rate to be increased. The mean probability attached to a 25 basis point increase was 67%.

The February GDP growth and inflation projections

18 The Committee reached its policy decision in the light of the projections published in the *Inflation Report* on Wednesday 11 February.

19 The Committee's central projection, based on the assumption of an official repo rate of 4.0%, was for the growth rate of GDP at market prices to pick up at the beginning of 2004, giving a somewhat stronger near-term profile than the central projection in November. Thereafter, growth was likely to moderate to a rate broadly similar in the second year to that projected three months earlier. The Committee's central projection was for CPI inflation to increase gradually towards the 2% target over the next two years. During 2004, some factors, such as planned utility price increases, would make temporary positive contributions to the overall inflation rate. Domestic inflationary pressures were expected to rise throughout the next two years and were likely to be

stronger than expected last November, although their impact on prospective CPI inflation would be mitigated by the higher sterling exchange rate incorporated in the latest projection. Domestic pressures would be accompanied towards the end of the period by the impact of increasing world import prices. At the two-year horizon, on the central projections, CPI inflation would be around 0.5 percentage points below RPIX inflation.

20 The Committee noted various risks surrounding these central projections. With respect to the world economy, uncertainty remained about whether the large US current account deficit would trigger a further fall in the US dollar, weakening the outlook for UK-trade-weighted world demand. But the Committee judged that the downside risk to external demand for UK output had diminished since November. With respect to the UK economy, there was an upside risk to consumption growth and house prices in the near term, with a corresponding downside risk at some later date; there was an upside risk to pay, given the slowdown in employees' real take-home income last year; and there was uncertainty about the current and prospective levels of potential supply.

21 Overall, the Committee regarded the risks to the central projections for both GDP growth and CPI inflation as broadly balanced. There were relatively small differences in view amongst members of the Committee about both the central projections and the balance of risks around them.

The immediate policy decision

22 Compared with the outlook in November, and consistent with the news in the past month, near-term prospects for US growth now seemed to be more assured, Asian economies were strengthening and there were clearer signs that the euro area was beginning to recover. The world recovery was, in short, becoming more broadly based, though the outlook in UK-trade-weighted terms was only marginally stronger than in November. The prospects for UK aggregate demand had strengthened, primarily as a result of the strength of domestic demand, particularly the unexpected resilience of household consumption. That would increase prospective inflationary pressure. However, potential supply in the UK economy appeared to the Committee to be a little higher than previously thought and, because of data revisions, the estimated level of GDP at basic prices was a little lower, so that the amount of spare capacity in the economy at the beginning of the forecast period was a little larger than previously expected and inflationary pressure

correspondingly lower. And the rise in sterling's effective rate since November would also tend to reduce inflationary pressure.

23 Against that background, and in the light of the MPC's new forecast for GDP growth and CPI inflation, members of the Committee identified a number of arguments in favour of increasing the repo rate this month. Members attached different weights to these arguments but, taken together, found them to be persuasive. First, the forecast suggested that, on the central projection for CPI inflation, a small increase in the repo rate was necessary to bring inflation back to the 2% target by the two-year horizon. The projected acceleration of activity in the first quarter, consistent with the latest survey evidence, meant that the margin of spare capacity in the economy was likely to be eroded quickly. Also, the risks around the GDP projection were now balanced rather than slightly to the downside. It would be appropriate, in the light of prospective demand growth, to withdraw some of the stimulus that the monetary policy stance was currently giving the economy. This was broadly consistent with the implication of November's forecast, that interest rates were likely to need to rise gradually to keep inflation close to target in the medium term. Second, a decision to maintain the repo rate at this meeting, when an increase in the rate was widely expected by financial market participants, might lead to a fall in the sterling exchange rate, thus removing a key factor offsetting the increased inflationary pressure from prospective domestic demand growth. Third, in the view of some members, it could be argued that it was appropriate to look through the first-round impact of the rise in sterling's exchange rate on prices, treating it as a 'one-off' downward shock to the price level which should be disregarded in setting interest rates. It should be treated as an offset to domestic inflationary pressure only if it affected subsequent wage and price setting behaviour. In any case, the rise in sterling's exchange rate might turn out to be temporary. Committee members also noted that a 25 basis point increase in the repo rate now would be consistent with a cautious approach to adjusting rates, given the current uncertainty about the impact of rate rises on household spending against a background of unusually high ratios of debt to income.

24 The Committee also noted several arguments for delay. First, CPI inflation was at present significantly below target and, on the central projection, would remain below it for most of the next two years. Second, although there were signs that price and unit labour cost increases earlier in the supply chain were edging up slowly, as yet they had had little impact on retail prices, and inflation expectations were well anchored to the inflation target. Third, there was a risk that potential supply

might be higher than on the MPC's central projection. If so, inflationary pressures might be slower to emerge. But the Committee did not find these arguments persuasive, as it was important that policy should be, and be seen to be, forward-looking, reacting to the prospective pressure of demand on supply capacity and the inflationary pressure associated with it, not simply to the current inflation rate. Also, the Committee had judged that, overall, the risks to the central projection for inflation were broadly balanced.

25 The Governor invited members to vote on the proposition that the repo rate should be increased by 25 basis points to 4.0%. The Committee voted unanimously in favour of the proposition.

26 The following members of the Committee were present:

Mervyn King, Governor
Rachel Lomax, Deputy Governor responsible for monetary policy
Andrew Large, Deputy Governor responsible for financial stability
Kate Barker
Charles Bean
Marian Bell
Richard Lambert
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 30 January 2004, in advance of its meeting on 4-5 February. At the start of the Committee meeting itself, members were made aware of information that had subsequently become available, and that information is included in this Annex.

I Financial markets

A2 Since the previous MPC meeting, short-term interest rates had changed little in the United Kingdom and had fallen in the euro area and the United States. The central market expectation had been that official rates in the United Kingdom would be increased at the February meeting. The expected timing of an increase in official interest rates in the United States, implied by overnight indexed swap rates, had been put back slightly, initially following weaker-than-expected non-farm payrolls data on 9 January. Expectations of rate rises in the euro area had also been put back slightly.

A3 Ten-year nominal forward rates had fallen slightly in the United Kingdom and the euro area. In the United States, they had fallen by around 17 basis points. Ten-year break-even inflation spot rates had risen by around 10 basis points in the United States, and ten-year real spot rates had fallen by around 22 basis points. In the United Kingdom, forward annual RPI inflation expectations, as implied by index-linked and nominal gilt yields, had fallen at horizons of less than five years, but had risen at horizons beyond that. For the first time, Consensus and HM Treasury survey-based measures of UK CPI inflation expectations had been available. Consensus surveys had suggested that annual CPI inflation would average 1.5% and 1.8% in 2004 and 2005 respectively. The HM Treasury survey had suggested an expected average annual rate of 1.6% in 2004 Q4.

A4 The sterling effective exchange rate index (ERI) had appreciated by 1.5%, to 103.4, between 7 January and 4 February. Sterling had appreciated by 1.8% against the euro and by 0.4% against the US dollar. This appreciation of sterling against the euro could partly be accounted for by the movements in longer-term interest rate differentials. The US dollar had appreciated by 1.4% against

the euro and had depreciated by 0.5% against the yen. The dollar effective exchange rate had appreciated by 1.3%.

A5 The FTSE All-Share index had fallen by 0.9% and the FTSE 100 index by 1.7%, while the FTSE 250 and FTSE Small-Cap indices had risen by 2.9% and 4.0% respectively. Within the FTSE All-Share, the Non-Cyclical Services and Resource sectors had fallen the most. The DJ EuroStoxx index had increased by 1.3%, the S&P 500 index had remained virtually unchanged and the Topix index had fallen by 2.8%. Uncertainty about future movements in the FTSE 100 and S&P 500 indices, as measured by the three-month volatility implied by options prices, had risen, but had remained below recent averages. Uncertainty about future movements of the DJ EuroStoxx index had remained broadly unchanged. The number of UK profit warnings in January had fallen slightly, both on the month and compared with January 2003. Profit warnings in the United States had risen on the month, but had remained below the number recorded in January 2003. Sterling, dollar and euro-denominated option-adjusted investment-grade spreads had risen. Sterling-denominated investment-grade bond yields had also risen, but euro and dollar-denominated investment-grade yields had fallen a little. Sterling-denominated option-adjusted high-yield spreads had fallen over the same period, but dollar and euro-denominated spreads had risen.

II The international environment

A6 According to the advance estimate, US GDP had grown by 1.0% in 2003 Q4 on a quarter earlier, following a rise of 2.0% in Q3; it had been 4.3% higher in Q4 than a year earlier. Government spending had risen by 0.2% on a quarter earlier, and defence spending had increased by 0.5%. Consumption had grown by 0.6%. Private investment had grown by 2.0%; residential investment had increased by 2.5% and non-residential investment by 1.7%. Stocks had contributed 0.2 percentage points to GDP growth on the quarter. Exports and imports had both risen, with net trade making no contribution to GDP growth in Q4.

A7 US industrial production had risen by 0.1% on a month earlier in December, following a rise of 1.0% in November. The December rise had included an increase of 0.6% in the production of motor vehicles and parts, and a 1.9% increase in the production of information, communications and technology (ICT) goods. Total industry capacity utilisation had been unchanged in December, at 75.8%. New orders for non-defence capital goods had risen by 1.5% in December, compared with a

month earlier. The Institute for Supply Management (ISM) Purchasing Managers' Index for the manufacturing sector had increased to 63.6 in January, its highest level since December 1983; the ISM index for the non-manufacturing sector had also risen, to 65.7 in January from 58.0 in December.

A8 Employment costs had increased by 0.7% in 2003 Q4, compared with an increase of 1.0% in the previous quarter. Following a downwardly revised increase of 43,000 in November, non-farm payrolls had risen by 1,000 in December. The unemployment rate had fallen to 5.7% in December, from 5.9% in November. US retail sales values had increased by 0.5% in December, following a rise of 1.2% in November. The University of Michigan headline index of consumer confidence had risen to 103.8 in January, according to the final release, from 92.6 in December. The Conference Board measure of consumer confidence had risen to 96.8 in January, from 91.7 in December. For both indices, the increase in the overall index had reflected increases in both the expectations index and in the present situation index.

A9 Annual headline consumer price inflation in the United States had increased to 1.9% in December, from 1.8% in November. Annual core consumer price inflation (excluding food and energy prices) had been unchanged, at 1.1%, in December. US producer prices had risen by 4.0% in the year to December, compared with an increase of 3.4% in the year to November.

A10 Euro-area GDP growth had increased by 0.4% in 2003 Q3 in the second release, unchanged from the previous estimate. According to the first estimate from the German Federal Statistics Office, German GDP had fallen by 0.1% in 2003, the second decline in annual GDP in Germany since re-unification in 1991. In the euro area, industrial production had risen by 0.1% on the month in November, but energy production, one of its components, had fallen by 3.3%. The euro-area unemployment rate (ILO measure) had been 8.8% in December, unchanged from November. According to Eurostat, the volume of retail sales in the euro area had been unchanged on a year earlier in October, compared with a fall of 0.3% on a year earlier in September. German retail sales had fallen by 3.7% in the year to December, following a fall of 2.2% in the year to November.

A11 According to the European Commission survey, the euro-area business confidence indicator had increased to -7 in January, close to its average level since 1990. The improvement in business confidence had mainly been the result of an increase in the production expectations index, which had risen to 10 in January, from 6 in December. Business confidence in January had risen in Germany and

Italy, but fallen in France. The euro-area Purchasing Managers' Index (PMI) for manufacturing had increased to 52.5 in January, the seventh consecutive monthly increase and the highest level of the index since early 2001. The services sector PMI had increased to 57.3 in January, from 56.6 in December. The IFO index (for western Germany) had increased to 97.4 in January, from 96.9 in December. This was the ninth consecutive rise in the index. According to the European Commission survey, the euro-area consumer confidence indicator had been unchanged, at -16, in January.

A12 Annual inflation in the euro area, as measured by the harmonised index of consumer prices (HICP), had fallen to 2.0% in December, from 2.2% in November. Annual core inflation (excluding energy, food, alcohol and tobacco) was 1.6% in December, unchanged from November. The Eurostat flash estimate for euro-area HICP inflation had indicated a rate of 2.0% in the year to January. Producer prices in the euro area had risen by 1.0% in the year to December, down from 1.4% in November.

A13 The Japanese all-activity index had fallen by 1.3% in November compared with the previous month. In 2003 Q4, industrial production in Japan had increased by 3.6% on the quarter. The unemployment rate had fallen to 4.9% in December, from 5.2% in November. Japanese export volumes had risen by 13.0% on a year earlier in December, compared with 1.7% in November. Export volumes to the rest of Asia had risen by 13.0% on a year earlier in December.

A14 Growth in much of the rest of Asia had remained strong. In China, GDP had risen by 9.9% in 2003 Q4 compared with a year earlier, and estimated growth in the third quarter had been revised up to 9.6%, from 9.1% previously. In 2003 overall, GDP in China had increased by 9.1%, compared with 8.0% in 2002. The value of Chinese exports had increased by 50.7% on a year earlier in December, compared with 33.8% in November.

A15 Since the Committee's previous meeting, the spot price of Brent crude oil had fallen by \$1.91 per barrel, to \$29.33. *The Economist* dollar non-oil commodity price index had risen by 1.9%.

III Money and credit

A16 This month, the published money and credit data had been seasonally adjusted using for the first time X-12-ARIMA, a method better equipped to deal with the characteristics of each individual series.

A17 The annual growth rate of notes and coin (adjusted for special factors) had risen to 7.4% in January, from 7.1% in December. Annual growth of M4 had been unchanged, at 6.8%, in December. Annual growth of M4 lending (excluding the effects of securitisations) had risen to 11.5% in December, from 10.9% in November. Excluding other financial corporations (OFCs), the annual M4 growth rate had fallen to 8.4%, from 8.7%, and the annual M4 lending growth rate (excluding the effects of securitisations) had fallen by 0.4 percentage points, to 12.0%.

A18 The annual growth rate of households' M4 had been unchanged, at 8.4%, in December. Annual growth of households' Divisia had risen to 9.2% in 2003 Q4, from 8.2% in Q3, the highest rate since 2002 Q2. The annual growth rate of M4 lending to households (excluding the effects of securitisations) had fallen by 0.1 percentage points, to 13.8%. Within total net lending to individuals, a broader measure of households' borrowing, annual secured borrowing growth had fallen to 14.2% in December from 14.4% in November, and annual unsecured borrowing growth had fallen to 12.4%, from 13.1%. The monthly flow of unsecured borrowing had been particularly small in December at £0.8 billion, the lowest since December 2000. The annual rate of growth of credit card borrowing had fallen to 17.5%, from 18.7%, and annual growth in other unsecured lending had fallen to 10.2%, from 10.7%.

A19 The average standard variable mortgage rate (SVR) quoted for existing borrowers had been unchanged, at 5.58%, in January, and the average two-year discounted rate had fallen by 21 basis points, to 4.01%. According to the latest data from the Council of Mortgage Lenders, the take-up of fixed-rate mortgages had fallen slightly, to 28%, in December, from 29% in November.

A20 Interest rates for unsecured lending quoted by banks and building societies in January had been broadly similar to their levels in June 2003 (when the repo rate was previously at 3.75%). The exception had been for personal loans: the average quoted rate for a personal loan of £10,000 had fallen 79 basis points between the end of June and the end of January, to 8.03%, continuing a trend of lower spreads on unsecured debt.

A21 After adjusting for seasonal effects, the number of approvals of loans for house purchase had fallen to 121,000 in December, from 124,000 in November. Housing transaction completions, measured by particulars delivered, had fallen by 15.9% in the three months to December, compared with the same period a year earlier. Unsold stocks of properties had risen to 62 per surveyor in December, from 61 in November, according to the Royal Institution of Chartered Surveyors (RICS), while the number of sales per surveyor had risen to 32 in December, from 31 in November.

A22 The annual rate of growth of private non-financial corporations' (PNFCs') M4 had fallen to 8.3% in December, from 10.0% in November. The annual rate of growth of M4 lending to PNFCs (excluding the effects of securitisations) had fallen to 6.8% in December, from 8.0% in November. The flow of total external finance, which includes capital market issues and foreign currency borrowing, in addition to sterling borrowing from UK banks and building societies, had been small at £1.2 billion in December. However, the flow over the quarter had been large at £10.7 billion in Q4, up from £5.8 billion in Q3.

IV Demand and output

A23 The ONS preliminary estimate for GDP growth at market prices had been 0.9% in 2003 Q4, following 0.8% growth in Q3. This had been the strongest quarterly growth rate since 2000 Q1. Annual GDP growth at market prices had picked up, to 2.5% in Q4 from 2.1% in Q3. Gross Value Added (GVA) growth at basic prices had been estimated at 0.8% in Q4.

A24 The preliminary estimate for quarterly growth in service sector output in 2003 Q4 had been 1.0%, up from 0.9% in Q3. Within services, quarterly output growth in the distribution, hotels and catering sector had remained at 0.9%. The preliminary estimate for production sector output had shown it unchanged on the quarter, following a 0.1% fall in Q3.

A25 Retail sales volumes were estimated to have risen by 0.9% in December. Estimated retail sales growth in November had been revised up, to 0.4%. Retail sales growth had picked up, to 1.9%, in Q4, following growth of 1.3% in Q3. The GfK consumer confidence headline balance had risen to 0 in January, from -5 in December.

A26 The Nationwide house price index had risen by 0.7% in January, which had been its smallest monthly rate of increase since April 2003. In contrast, the Halifax house price index had risen by 2.2% in January. The three-month on three-month rates of change of the Nationwide and the Halifax house price indices had also risen, to 4.0% and 4.8% respectively. The new monthly ODPM house price index had shown annual house price inflation of 9.7% in November, a slowdown from 12.1% in October. It had pointed to lower annual house price inflation than that implied by the Nationwide and Halifax indices since February 2003, the earliest available annual rates of change of the new monthly ODPM index. Data from both the Halifax and the Nationwide had suggested that house price inflation in the London and South East region had risen in Q4. House price inflation in the Midlands and North England had fallen slightly.

A27 Recent surveys had suggested that business confidence in the services and manufacturing sectors had picked up sharply in Q4. For the services sector, the British Chambers of Commerce (BCC) survey's balance of business confidence regarding profitability had risen to +47 in 2003 Q4, from +40 in Q3, the highest level since 1997 Q3. The Chartered Institute of Purchasing and Supply (CIPS) survey's index of business expectations in the services sector had fallen slightly, to 80.1, in January, following a rise to 80.2 in December.

A28 For the manufacturing sector, the CBI Quarterly Industrial Trends survey's business optimism balance had risen to +17 in Q4, from -7 in Q3. The BCC survey's balance of business confidence regarding profitability had fallen slightly to +36 in Q4, from +37 in Q3, but had remained above its historical average.

A29 Surveys of investment intentions had also picked up strongly. The BCC investment intentions (plant and machinery) balances for the services and the manufacturing sector had both risen to +18 in Q4, from +13 and +4 respectively in Q3. The CBI investment intentions balance for the manufacturing sector had been positive for the first time since 1997 Q4: it had increased to +6 in Q4, from -14 in Q3. More positive investment spending intentions had been broadly consistent with the survey measures of capacity utilisation, which also picked up in Q4.

A30 The CIPS services business activity index had risen to 59.8 in January, from 58.5 in December, and the incoming new orders balance had risen to 60.4, from 59.0. The BCC services survey's domestic orders balance had risen to +25 in Q4, from +18 in Q3.

A31 In manufacturing, the CIPS output balance had fallen slightly, to 58.3, in January, from 58.4 in December. But the CIPS survey's new orders balance had risen sharply, to 60.2, in January, from 58.0 in December. In 2003 Q4, the CBI total new orders balance had risen to +13, from -16 in Q3. The BCC domestic orders balance had also risen to +8 in Q4 from -2 in Q3.

V The labour market

A32 According to the Labour Force Survey (LFS), employment had increased by 41,000 in the three months to November, compared with the previous three months. Employee numbers had continued to fall – down 32,000 over the same period. The working-age employment rate had been unchanged on the quarter, at 74.6%, but had fallen 0.1 percentage points on the year. Total hours worked had fallen by 0.8% on the quarter and by 0.3% on a year earlier. Average hours had fallen by 0.9%, both on the previous three months and on a year earlier.

A33 The overall CIPS employment index for January had been little changed, and remained above the no-change level of 50. The January Recruitment and Employment Confederation (REC) survey had revealed that demand for agency staff had continued to increase, while the availability of such staff had continued to fall.

A34 LFS unemployment had fallen by 29,000 in the three months to November, and had been 64,000 lower than a year earlier. The unemployment rate had fallen to 4.9%, 0.1 percentage points lower on the quarter and 0.2 percentage points below its rate a year earlier. At 3.0%, the claimant count unemployment rate had been unchanged in December. Inflows to the claimant count had fallen by 1,200 on the month, while outflows had been unchanged. Working-age inactivity had increased by 48,000 in the three months to November. The working-age inactivity rate had increased by 0.1 percentage points on the quarter and by 0.3 percentage points on the year, to 21.5%.

A35 Overall annual whole-economy earnings growth had been 3.5% in the three months to November, 0.1 percentage points lower than in October. Public sector pay growth had fallen by 0.6 percentage points, to 4.8%, while private sector pay growth had been unchanged, at 3.2%. Whole-economy earnings growth in the year to November had fallen more sharply, to 3.2%, down 0.5 percentage points on the year to October. Earnings growth excluding bonuses had been 3.6% in the three months to November, down 0.1 percentage points on the three months to October.

The comparable public sector growth rate had fallen by 0.5 percentage points, to 4.9%, while the private sector growth rate had been unchanged, at 3.3%.

A36 According to settlements information available to the Bank, the mean whole-economy twelve-month Average Earnings Index (AEI)-weighted settlement had been 3.2% in the year to December, unchanged on the equivalent figure for the previous two months. The twelve-month sample-weighted mean settlement in both the private and the public sector had also been unchanged, at 3.1% and 3.4% respectively.

A37 The Bank's regional Agents had conducted an informal survey of 298 firms on the prospects for earnings growth in 2004. Weighted by employment, a net balance of -2% of the firms sampled had expected their pay settlement to be lower than last year, up 3 percentage points from last year. A net balance of +8% of companies had expected stronger total pay growth per employee this year compared with last year, down 5 percentage points. A balance of +51% had expected the growth of total labour costs to be higher, compared with +76% last year. Pensions, National Insurance contributions and recruitment had all been cited as exerting upward pressure on the expected increase in total labour costs during 2004.

VI Prices

A38 Sterling oil prices had been broadly unchanged in January, compared with December.

A39 Manufacturing input prices had fallen by 0.2% in December. The annual inflation rate had fallen to 1.9% in December, from 4.2% in November, mainly because of base effects. But the CIPS manufacturing survey had pointed to a subsequent rise in input prices: the input price balance had risen to 60.6 in January, from 56.6 in December.

A40 Manufacturing output prices excluding duties (PPIY) had risen by 0.2% in December, while the annual inflation rate had risen by 0.1 percentage points to 1.7% in December. Survey data had pointed to small subsequent rises in output prices: the expected output price balance from the CBI Quarterly Industrial Trends survey had been +1 in January, its highest level for three years.

A41 Annual CPI inflation had been unchanged, at 1.3%, in December. Within this, annual goods price inflation had risen by 0.2 percentage points, to -0.1%, in December. Annual services price inflation had fallen by 0.4 percentage points, to 2.8%, in December, its lowest rate since April 2000. Annual RPIX inflation had risen by 0.1 percentage points, to 2.6%, in December. And annual RPI and RPIY inflation had also risen, to 2.8% and 2.2% respectively.

VII Reports by the Bank's Agents

A42 The Bank's regional Agents reported that retail sales had grown strongly in the period immediately before Christmas. This had continued into the winter sales in early January. Retail sales growth had eased thereafter, although there had been no signs of retrenchment by consumers. Even so, retailers had begun the year in a cautious mood, with concerns that the growth of households' disposable income might slow and that consumer demand might weaken as a result. Contacts reported that the housing market had started the year strongly. Demand had been comparatively weak from first-time buyers, as past house price increases had reduced affordability. The repo rate increase last November had so far had little effect on confidence in the housing market. Contacts had reported that further rate increases could cool demand, and they had expected increases in house prices in the first half of 2004 to moderate compared with 2003. Turning to news on exports, manufacturers had been concerned that the weakness of the dollar against sterling had squeezed profit margins. But there had been some offsetting benefits from the appreciation of the euro.