Publication date: 19 March 2008

MINUTES OF
MONETARY POLICY COMMITTEE MEETING
5 AND 6 MARCH 2008

These are the minutes of the Monetary Policy Committee meeting held on 5 & 6 March 2008.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0803.pdf

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 9 and 10 April will be published on 23 April 2008.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 MARCH 2008

1 Before turning to its immediate policy decision, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 Sentiment in international credit and money markets appeared to have deteriorated over the month. Term interbank spreads had risen in the US and UK money markets, probably reflecting heightened concerns about counterparty credit risk. Conditions in primary markets for securitised assets remained difficult and there had been a general widening of spreads on asset-backed securities (ABS). Spreads on US and UK investment-grade corporate bonds had risen sharply. Spreads had also risen in the US municipal bond market.

3 It was difficult to pinpoint the precise reasons for this change. The recent financial reporting season for European banks had not produced any major unexpected losses or problems with reported capital buffers. There had been some encouraging news about the possible recapitalisation of the major non-bank financial guarantors (the ‘monolines’). However, as various asset prices fell, highly leveraged borrowers were being forced to sell assets in the face of increased margin calls, thereby possibly amplifying the downward movement in asset prices. That further encouraged lenders to try to reduce overall exposures to such borrowers. These concerns had probably been heightened by developments in the US municipal bond market and the failure of the Peloton Partners ABS hedge fund in the United Kingdom. Increasing default rates on US mortgages had brought into question the quality of securitised mortgages with higher credit ratings than those in the sub-prime category. The continuing uncertainty about where asset prices would settle was discouraging potential investors from buying, not least because they might fear posting substantial mark-to-market losses in the short run.

4 International market interest rates had risen over the month, with forward rates for the end of 2008 some 10 to 20 basis points higher, perhaps reflecting a growing awareness of upside risks to inflation and central banks’ likely reaction to them. Longer-term forward rates had also risen, although, perhaps surprisingly, these increases had been associated with rises in long-term risk-free

real interest rates, which might have been expected to fall, given the apparent 'flight to quality' in bond markets. As for inflation break-even rates, these had increased noticeably on the month only in the euro area, and only at horizons under five years and over fifteen.

5 Equity prices ended the month broadly unchanged, as earlier gains had been lost over the few days prior to the MPC meeting. The comparative resilience of equity markets had been surprising, given that market interest rates had risen. Investment analysts' earnings expectations had been revised downward, and spreads on corporate bonds had widened sharply, reflecting increased risk aversion and/or perceptions of increased corporate credit risk. However, non-financial corporate default rates had not yet picked up significantly.

6 The major news in the foreign exchange markets had been the continued fall of the US dollar, for which the effective exchange rate index was some 3% lower than a month earlier. The euro effective rate had appreciated by around 2%, while the sterling effective rate had fallen around 1½% over the month. These movements appeared to be broadly consistent with conjunctural developments and expectations of larger cuts in US and UK policy rates than in the euro-area rate. Options prices suggested that market participants believed that movements in sterling had become more closely correlated with the dollar and, possibly to some extent reflecting that, the risks to the sterling effective exchange rate were skewed to the downside.

The international economy

7 For the United States, the main question was how long the current downturn would last and how deep it would be. There had been little news in the latest estimate for growth in the fourth quarter of 2007, which was unchanged from the previous release at 0.2%. Data for the first quarter of 2008 so far suggested that growth had been subdued. On the output side, industrial production had risen slightly in January but the Institute for Supply Management (ISM) index for manufacturing for February had fallen to a little below the 50 no-change level. The ISM non-manufacturing index had rebounded in February to just above the 50 level from a very low January reading, but had remained well below its historical average. Expenditure indicators were also lacklustre. The Federal Reserve's *Beige Book* suggested that the slowdown was now broadly based by industry sector and region. Bank lending to the US corporate sector remained robust, but that might reflect the drawing down of credit lines agreed before the deterioration in credit market conditions last August and the inability of banks to sell on corporate loans. Data on both activity and prices suggested that the US housing market had continued

to weaken. Despite the fall in the federal funds rate, some households were facing higher interest rates. Consumer confidence measures had fallen further in February, with the Michigan measure hitting a 16-year low. Meanwhile, indicators of inflation had risen. Annual producer price inflation had reached 7.4% in January, while headline inflation according to the personal consumption expenditure deflator and CPI had increased to 3.7% and 4.3% respectively.

8 In the euro area, data on the expenditure components of GDP in the fourth quarter had suggested that consumption had been surprisingly weak. Activity indicators for the first quarter were in line with the expectations embodied in the February *Inflation Report.* The February services and manufacturing Purchasing Managers' Index measures, for example, were both consistent with positive, but below-trend, growth. The European Commission's surveys of business confidence in the industrial and services sectors painted a similar picture. Lending to the corporate sector appeared to be holding up, and it was less clear that euro-area banks as a whole had had the same experience as US banks with 'stuck' loans and committed credit lines. As in the United States, producer price inflation had increased, reaching 4.9% in January. HICP inflation remained at 3.2% in February, above the level deemed by the European Central Bank to be consistent with price stability.

9 In Asia, the estimate of Japanese GDP growth in Q4 had been 0.9%, markedly stronger than expected. However, Japanese GDP data were often revised substantially. Industrial production was reported to have fallen 1.9% in January, but export growth had held up. Growth in the fourth quarter in non-Japan Asia had also been somewhat higher than expected at the time of the February *Inflation Report*. China posted an annual growth rate of 11.2% and was showing signs of increasing inflationary pressures. Annual producer price inflation had risen to 6.1% in January and annual consumer price inflation hit an eleven-year high of 7.1%.

10 World commodity prices had continued to rise rapidly over the month. The price of Brent crude, for example, had reached a new high, increasing by 12% in sterling terms. A range of factors were responsible, with the importance of each factor varying by commodity. Some of the price increases would affect consumer prices rapidly, while others might take a long time to work through the supply chain. It seemed unlikely that these inflationary pressures would abate soon, despite the slowdown in advanced economies. First, demand for commodities from emerging markets, particularly in Asia, was likely to continue to increase rapidly. For example, many of these economies still had much lower energy use per head than did OECD countries, and some degree of convergence with advanced economies was to be expected as the gap between levels of GDP per head narrowed. Second, OPEC

did not seem inclined to increase oil production quotas. Third, in several emerging-market economies, price subsidies continued to dampen any reduction in demand. Fourth, it was possible that commodities had become a more attractive asset class to both financial intermediaries and ultimate investors, perhaps partly as a hedge against a weakening US dollar and partly because of the current problems in advanced economies' credit markets. Greater involvement of financial firms might also affect the dynamics of commodity prices in the short run.

Money, credit, demand and output

11 The ONS *UK Output, Income and Expenditure* data release had contained an unchanged estimate of 0.6% for the Q4 GDP growth rate. On the output side, there had been some small downward revisions to estimated growth in both services and manufacturing. However, the first release of expenditure data had showed consumption growth slowing sharply to 0.2% and business investment contracting by 0.5%, implying the weakest growth in final domestic demand for five years. The contribution from net trade had increased, and the annual growth rate of stocks in 2007 was the fastest since 1973. Overall growth had been only a little lower than in the third quarter, although private sector output had slowed by more.

12 These data raised the possibility that there had been a sharp and unanticipated slowing in domestic demand growth, leading to an involuntary build-up of stocks. If that were the case, output growth could be expected to fall during 2008 as firms sought to unwind this build-up. But there were several reasons for caution. First, the initial ONS expenditure data releases, particularly for business investment, were prone to substantial revisions. Second, most of the increase in stocks was reported to have been in the construction sector, not the retail or manufacturing industries, and so did not necessarily indicate a broad-based slowdown in the demand for goods and services. The Home Builders Federation (HBF) survey suggested that stocks of homes and work in progress relative to demand had been at their highest levels in the fourth quarter since the series began in 1992, which was consistent with the sectoral pattern of stockbuilding reported by the ONS. Third, market intelligence from retailers did not suggest that there had been such a sharp fall in retail spending growth in the fourth quarter as a whole. Fourth, survey evidence did not show a sharp fall in demand for consumer services.

13 More timely indicators of consumption had been mixed. Retail sales volumes had rebounded in January, growing by 0.8%, but the latest CBI *Distributive Trades Survey* implied a slowing in

February. Interpretation of these data was complicated by uncertainty about both the seasonal adjustment of retail sales data at this time of the year and the slowing of the retail sales deflator relative to the analogous RPI series. The GfK headline measure of consumer confidence (seasonally adjusted by the Bank) fell in February to its lowest level since 1992, with a further drop in the proportion of respondents who thought that this was a good time to make a major purchase. The latter might reflect a tightening in credit conditions facing households. The low levels of the GfK headline and other consumer confidence measures might also reflect more general pessimism about economic prospects.

14 Investment intentions had so far been less affected by the turmoil in credit markets, although the rate of growth of lending to the private non-financial corporate sector had slowed. The commercial property sector remained under stress, with property prices continuing to fall significantly. There was little news about the non-financial sectors in the broad monetary aggregates; the annual growth rate of households' money had remained steady at around 9% in January, although private non-financial firms' money had slowed somewhat.

15 Output indicators for this quarter had shown some resilience, and did not seem consistent with a slowdown in response to earlier unanticipated demand weakness. Both the manufacturing and services CIPS/NTC activity measures picked up in February, and, together with January's data, suggested that output growth in the first quarter might be a little above the level expected at the time of the February *Inflation Report*.

16 The housing market was evolving broadly in line with the assumptions underlying the February *Inflation Report* projections. The average of the lenders' house price indices had fallen 0.4% in February and the preview of both the backward and forward-looking Royal Institution of Chartered Surveyors (RICS) survey price balances had suggested that they had fallen again in February. The preview of the RICS sales-stock ratio had suggested that this had dropped to its lowest level for over a decade. But the other RICS activity indicators were broadly unchanged and those provided by the HBF had strengthened slightly. Mortgage approvals for house purchase had also increased a little. The spread between two-year fixed rates on mortgages and swap rates (lagged one month) had increased further and was now around a percentage point higher than in August last year, while the annual growth rate of secured lending to households had fallen in January to its lowest level since 2001.

17 Forward-looking surveys and feedback from contacts of the Bank's regional Agents were consistent with the deceleration of demand in the February *Inflation Report's* central projection. There was little evidence that the downside risks to inflation from a sharper-than-expected slowdown in activity, flagged as a risk in the February *Inflation Report*, had begun to crystallise. But the impact of the deterioration of credit conditions remained very uncertain.

18 The Committee was briefed by the Treasury representative on the broad outlines of the Chancellor's forthcoming Budget. An assessment by Bank staff of the implications for the economy would be undertaken after the details were published.

Costs and prices

19 The contrast between the fairly strong official data for employment and the indications from some of the surveys of a weakening labour market had increased. The Labour Force Survey measure of employment was reported to have increased by 175,000 in the fourth quarter and the unemployment rate had dropped to 5.2%. In most sectors, vacancies had been higher in the three months to January than they had been in the previous three months. Total hours worked had fallen, which was consistent with a reduction in labour hoarding or weakening labour demand. The KPMG/REC *Report on Jobs* for February suggested that vacancies had been increasing more slowly and growth in the demand for labour slackening. The Chartered Institute of Personnel and Development had reported that the proportion of businesses expecting to make some staff redundant in the near term had risen. The Bank's Agents also reported a weakening of employment intentions.

20 Pay settlements had remained steady in January, with the twelve-month measure at 3.4%; shorter-run measures were lower. Earnings, including bonuses, had increased at an annual rate of 3.8% in the fourth quarter on the Average Earnings Index measure and 4.2% on the Average Weekly Earnings measure. The corresponding figures excluding bonuses were 3.7% and 4.1%.

21 In contrast to pay, other cost pressures had intensified. Manufacturers' input prices had risen 2.6% in January alone, taking the twelve-month rate to nearly 20%. In February, the input price indices from the CIPS/NTC manufacturing and services surveys had picked up. Although the increases had been mainly due to energy and food prices, the contribution of imported items had generally continued to rise, partly reflecting sterling's depreciation. Manufacturing producer output prices in January had risen at a twelve-month rate of almost 6%, its highest since 1990, while the CBI

Monthly Trends Enquiry and CIPS/NTC output price indicators had risen in February. A survey by the Bank's regional Agents had suggested that firms selling directly to final consumers would not pass on their higher costs in full. The extent and speed at which cost increases would pass through into retail prices remained unclear.

22 CPI inflation had risen in January to 2.2%, but that was a little lower than expected. Households' inflation expectations had risen according to the Bank/NOP survey for February; the median measure, at 3.3%, was 0.3 percentage points higher than in the previous quarter. Additional questions in the February survey suggested that there were several reasons for the rise, given that respondents said that they attached importance to a number of factors in forming their expectations, including perceptions of past inflation, the level of interest rates, the strength of the economy, the inflation target and media reports. In the light of the likely rise in CPI inflation over coming months, that was not reassuring in respect of the upside risk to inflation from rising inflation expectations. However, the more frequent Citigroup/YouGov survey measure had fallen back on the month, from 3.3% to 3.1%, and its measures of expectations of inflation in five to ten years had remained stable.

The immediate policy decision

23 The latest *Inflation Report* had explained the balance of risks to inflation facing the Committee in February. On the downside, there had been considerable uncertainty about the extent to which demand would slow, reflecting the risks of a further tightening of credit conditions, both at home and abroad. That entailed the possibility of a higher margin of slack in the economy than expected and hence a downside risk to inflation in the medium term. But, on the upside, there had been a risk that another period of above-target inflation, coming so soon after the previous one in 2006-07, might raise medium-term inflation expectations. That implied a risk that upward shocks to inflation – from commodity prices, for example – might persist longer than expected, as wage and price setters acted on their revised expectations. Both the upside and downside risks persisted this month, and some of the news suggested that the risks on both sides might have increased. The challenge facing the Committee was to balance those risks in order to keep inflation on track to meet the target in the medium term.

24 A further tightening of credit conditions remained possible. Sentiment had deteriorated in the money markets and longer-term credit markets. Fears of asset price falls brought about in part by forced selling on the part of hedge funds and other leveraged investors had increased. It remained very difficult for banks to securitise lending. Spreads on mortgages and investment-grade corporate bonds

had risen. European banks' recent financial results had not produced any major adverse surprises, but banks were facing more challenging conditions this quarter than had been expected.

25 There was now mounting evidence of a weakening economy in the United States. But while there were still downside risks to demand growth in the euro area and Asia, growth there did not seem to be seriously affected by the problems in financial markets so far. In the euro area, consumption growth had been surprisingly weak and the rise in the value of the euro would tend to reduce net exports. In China, domestic demand was growing briskly and domestic policy was being tightened in an attempt to contain inflation. Overall, this was consistent with the outlook for the world economy in the February *Inflation Report*.

26 In the United Kingdom, indicators of activity in the current quarter had given mixed signals, but, if anything, pointed to less of a slowdown than expected at the time of the February *Inflation Report*. Reports from the Bank's Agents still suggested that, outside the financial and property sectors, business prospects had not deteriorated markedly. Although it was not sensible to put a great deal of weight on the first data release for expenditure, the initial breakdown for 2007 Q4 raised the question of whether the growth of final domestic demand had fallen more sharply than producers had anticipated. Looking forward, surveys of consumer confidence had weakened.

27 Against the downside risk to inflation in the medium term from weakening output prospects, there were risks in the opposite direction from rising energy and other commodity prices. The news on this front over the month had been adverse for near-term inflation prospects, with rises in oil and food prices and increasing evidence of price pressures further down the supply chain. Supply responses would be forthcoming eventually, but the upward pressure on the level of commodity prices was unlikely to abate in the short term, given prospective global demand developments and short-run supply constraints. In the United Kingdom, that was compounded by the fall in the sterling effective exchange rate, which had been greater than expected at the time of the February *Report*. UK producer input and output price inflation had risen significantly, as had import price inflation. As commodity and import price increases worked their way through the supply chain – a process that could take some time – it was likely that the upward pressure on prices would extend beyond the energy and food sectors where it had been most pronounced so far.

28 Due to higher household gas and electricity prices, CPI inflation was likely to rise quite sharply in the coming months. And rising cost pressures were also rippling through the supply chain. The

impact of these pressures on CPI inflation in the short term was, however, uncertain. The recent survey by the Bank's Agents suggested that businesses facing consumers felt unable to pass all of their cost increases forward to higher prices.

29 Further ahead, inflation was likely to fall back as commodity prices stabilised. The extent to which it did so would depend on whether inflation expectations remained anchored on the 2% target. Measures of inflation expected over the next twelve months had risen recently but the evidence on longer-term inflation expectations was mixed.

30 There was also a question about how quickly the economy would be able to expand without placing additional upward pressure on inflation in the medium term. Real take-home pay had been falling and, following the sharp rise in businesses' input costs, would need to fall further. Pay settlements and earnings data offered some reassurance that there had been little, if any, pass-through to wages so far. It was unclear whether employees would, to some degree, resist further erosion of their spending power. If they did so, the rise in commodity prices could only be accommodated without putting pressure on inflation if there were to be some rise in unemployment. Furthermore, there was uncertainty about the extent to which the labour force would expand if the net inflow of labour from Eastern Europe were to fall, now that the gap between real earnings had narrowed.

31 The Committee discussed the balance of upside and downside risks to the inflation outlook. For several members, the risks on both sides had increased over the past month. There was a range of views about whether that had affected the balance significantly in either direction.

32 For the majority of members, despite some differences in their assessments of the risks, the balance of risks had not changed sufficiently to merit a change in Bank Rate this month. So far, output and CPI inflation were evolving broadly in line with the central projection in the February *Inflation Report.* The economy appeared most likely to be roughly on track for CPI inflation to return to target in the medium term. Although the central view was predicated on the assumption of some further modest easing of Bank Rate, back-to-back reductions might lead observers to think that the Committee was focusing on downside risks to demand at the expense of the medium-term outlook for inflation. That in turn could lead to an exaggerated response of the market yield curve to a rate reduction. The Committee would continue to review the balance of risks to inflation, and its implications for the appropriate level of Bank Rate, as it received new information each month about the economic outlook and the uncertainties around it.

33 Some members saw the balance of risks differently. The prospects for the US economy had deteriorated over the month; financial markets had taken a further turn for the worse and stressed conditions were expected to last for longer. This increased the downside risk to UK growth in the short term and to inflation further out. While the immediate pressures from oil and commodity prices had increased, there was no sign that this was likely to feed through to wage settlements and the Agents' survey confirmed the pressures on firms not to pass through cost increases in consumer prices. The reductions in interest rates since last summer had been offset by increases in market rates so the stance of policy might still be on the restrictive side of neutral. The evidence continued to point to the need for some reduction this spring, broadly in line with the market expectations embodied in the yield curve. The downside risks argued against delay so these members judged that a reduction in Bank Rate of 25 basis points was appropriate this month.

34 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.25%. Seven members of the Committee (the Governor, Rachel Lomax, Kate Barker, Charles Bean, Tim Besley, Andrew Sentance and Paul Tucker) voted in favour of the proposition. John Gieve and David Blanchflower voted against, preferring a reduction in Bank Rate of 25 basis points.

35 The following members of the Committee were present:

Mervyn King, Governor
Rachel Lomax, Deputy Governor responsible for monetary policy
John Gieve, Deputy Governor responsible for financial stability
Kate Barker
Charles Bean
Tim Besley
David Blanchflower
Andrew Sentance
Paul Tucker

Dave Ramsden was present as the Treasury representative.