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MINUTES OF MONETARY POLICY COMMITTEE MEETING

5 and 6 June 1997

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 June 1997.

They are also available on the Internet (<http://www.bankofengland.co.uk>).

The Chancellor of the Exchequer announced on 6 May that the Government was giving 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 no later than 6 weeks after each meeting. Accordingly, the minutes of the Committee meeting held on 9 and 10 July will be published on 13 August.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING ON 5-6 JUNE 1997

1 Sections I to V of this minute summarise the analysis presented to the Monetary Policy Committee by Bank staff and the Bank's regional agents, and incorporate also information that became available to the Committee after the presentation but prior to the 6 June meeting.

I Monetary conditions

2 The 12-month growth rate of notes and coins had fallen back since January, when it was 7.1%. It had fallen to 6.3% in April and the provisional estimate for May was 6.1%. It was not yet clear whether the fall simply reflected a deceleration in demand for cash following the recent fall in retail price inflation, or whether it had implications for future spending.

3 Broad money, too, decelerated in April: its 12-month growth rate fell back to 10.2%, having been above 11% in February and March. M4 went up by 0.2% in April: retail M4 fell and wholesale M4 decelerated, perhaps partly because the month's public finances were stronger than expected. Individuals' M4 holdings had accelerated modestly this year - to a 12-month growth rate of 6.5% in April, from 5.8% in December. The last monthly data followed a quarter (Q1) in which ICCs' holdings grew by 9.3% (annualised). The trend growth of real M4 remained around 8%, which continued to indicate strong future real demand growth.

4 Lending growth continued at around 9% in April. Borrowing by ICCs, which had decelerated in Q1, picked up again in April, and unused credit facilities (mainly to ICCs) continued to rise quickly (the 12 month increase was about 13% in April). Interest rate spreads seemed to have narrowed for ICCs and OFIs in Q1, which suggested that banks had become more willing to lend, perhaps in response to competition from other forms of financial intermediation.

5 Lending to individuals remained robust in Q1 and in April: unsecured lending went up by 16.7% in the year to April and secured lending by 5.2%, consistent with the recovery in the housing market. Loan-deposit interest rate spreads widened slightly for the personal sector in 1996 Q4, so the recent growth probably reflected strong demand for credit, particularly for unsecured loans.

6 Gilt yields had fallen sharply since the announcement of independence of the Bank on 6 May. Index-linked yields had not changed much, and so the implied future rate of inflation calculated from a comparison of the yield curves for conventional and index-linked gilts had fallen: the implied rates for ten years ahead had fallen by about 0.5 percentage points on 6 May itself. That could in principle reflect either lower inflationary expectations or a lower inflation risk premium. If the true explanation

had been a lower inflation risk premium, a fall in the volatility implied by options on long gilt futures might have been expected to occur. In fact it had not occurred to a material extent. That, and the absence of a material change in the spot exchange rate were both consistent with the view that the explanation of the fall in conventional gilt yields had been a fall in inflationary expectations. In that case, it was suggested that the main effect would be modestly to increase the likelihood that inflation would turn out below the central projection over the next year or two, as indicated in the May Inflation Report. Even after the fall in bond yields following the announcement of Bank independence, the inflation rate implied by the conventional and index-linked gilt yield curves for 10 years ahead was still around 3 1/2%. That was one percentage point above the Government's target; one percentage point was at the top end of the range of estimates of the risk premium.

II Demand and output

7 There were substantial discrepancies, dating back to 1995, among the three estimates of GDP. The output estimate had in the past typically been revised by less than the expenditure estimate, and it seemed likely that the expenditure estimate would be revised upwards to bring it into line with the output estimate. Revisions were due on 27 June.

8 The most recent estimate of GDP growth in 1997 Q1 was 0.9% (revised down from the preliminary estimate of 1.0%, though estimated non-oil growth remained at 1.0%), but the recent pattern of strengthening output growth was unchanged. Of the expenditure components of GDP in Q1, investment growth was surprisingly strong (3.3%), though there was no clear change of trend. Net exports made a negative contribution in Q1 but this was not exceptional. Services output growth remained very strong in Q1 (1.2% on the quarter); manufacturing picked up a little (to 0.6%) and the revival of construction went further (up 1.8% on the quarter). Manufacturing output rose by 0.6% in April; taking account of revisions to estimates for earlier months, it was 1.7% up on a year earlier. New construction orders rose in April.

9 Consumer spending had been growing at an average of about 1% a quarter since the beginning of 1996, consistent with the growth of real personal disposable income. Retail sales had risen by only 0.1% in April but the estimate for March in particular had been revised upwards. The Bank's agents reported a sharp rise in spending at the end of March (which could account for the revision) followed by a slowdown in April and a pick up in May, but the CBI distributive trades survey indicated some deceleration of retail sales in May. Because of recent rises in the prices of shares, and particularly bank shares, the expected size of windfall gains arising from demutualisation of building societies and other institutions in 1997 had increased to perhaps £35 billion from the £28 billion quoted in the May Inflation Report.

10 House price inflation (measured on a 12-month basis), having risen quite sharply in 1996, had not risen appreciably further so far this year, though the Nationwide index suggested that there might have been a pick-up in May. Indicators of housing market activity showed a similar pattern, with relatively stable levels in 1997 after sharp rises in 1996, although mortgage approvals rose sharply in April.

11 The small rise in total stocks in Q1 was broadly consistent with the expected longer-run trend of a falling stock-output ratio. Stocks had increased in the retailing, construction and manufacturing sectors. In manufacturing the rise had been concentrated in raw materials and work in progress; stocks of finished goods had fallen.

12 There was as yet no clear downtrend in net exports. Exports to non-EU countries had risen sharply: the USA had grown very fast in Q1, but it was expected by US commentators to slow down spontaneously. Net exports to EU countries had been resilient. GDP growth in France and Germany (though not Italy) had picked up to just below trend, but domestic demand growth in those countries had been subdued.

13 Comment from the corporate sector suggested that the effects of exchange rate appreciation on net exports and output were likely to appear only after a lag, because of contracts in which the price and quantity were fixed for a period, because UK exporters seemed to be prepared to accept lower margins for a period in order not to lose markets that had taken time to develop, and because in some cases forward cover taken out by either the exporter or importer meant that the exchange rate appreciation had not yet affected either party's profits. Some manufacturers expected to benefit from lower imported material prices. Nevertheless, the Agents reported that some companies had lost export orders, and that cheaper imports had made domestic markets more competitive. Manufacturers' output expectations were still positive according to the CBI and CIPS surveys although export orders were weakening.

III Labour market

14 Indicators of employment and unemployment pointed to a rapidly tightening labour market. Income from employment had risen unusually fast in Q1, by 2.1%. Claimant unemployment had fallen by 59,000 in April. Unfilled vacancies, which edged up further, were at their highest since the series began in 1980. The Agents were reporting growing skill shortages, and the fact that receipts of PAYE and national insurance contributions had been unexpectedly high in April suggested that employment income growth was remaining strong. Surveys showed increasing percentages of employers planning to recruit.

15 Recent claimant unemployment figures had been influenced by the introduction of the Job Seekers' Allowance. Claimants now had to sign a Job Seekers' Agreement, and to be genuinely seeking work, in order to be eligible for benefit, which was now available without means testing for six months rather than 12 as hitherto. The six month transition period ended in April, by when all claimants had to have signed a Job Seekers' Agreement. The changes had deterred a number of former claimants. Analysis by Bank staff suggested that about half of the fall in claimant unemployment over the six months to April might be attributed to non-searching claimants leaving the register. Excluding the JSA deterrent effect, the monthly fall in unemployment seemed to have been around 30-35,000.

16 The main news about earnings was the downward revision of estimated underlying average earnings growth in the year to February from 5% to 4 1/2%, at which rate it remained in March. About half of that revision reflected late information. In addition, the estimate of underlying average earnings incorporated a forecast of earnings a month ahead because it was a 3-month centred moving average. The ONS had over-forecast bonus payments in March when compiling the February figure, and had corrected the over-forecast when revising the figure. The Bank staff estimate of underlying average earnings growth excluding bonuses had been revised down as a result of the ONS revision, but only slightly: from 4 1/2% to 4 1/4-4 1/2%.

17 Average earnings had been growing faster in the private than in the public sector since around 1993. The gap between the growth rates was currently wide by historical standards.

18 The decline in the preliminary estimate of three-month average of pay settlements in April reflected the large number of phased public sector settlements in April, and probably did not indicate a change of trend: indeed the three-month average of private sector settlements had risen slightly in April.

IV Prices

19 Commodity prices (including oil), as measured by the Bank's index, had fallen by 2.4% in April.

20 Recorded import prices were little changed (down 0.7%) from November to March, and were only 5% lower in March than a year earlier, despite the exchange rate appreciation. Changes in prices of imports from EU and non-EU sources had been surprisingly similar, given the difference in the extent of exchange rate appreciation. Both the trade statistics and reports from the Agents suggested that imported intermediate products had fallen more in price than imported finished products. Export prices had fallen by less than the exchange rate appreciation might have suggested,

though the contrast between prices of exports to EU and non-EU countries was more marked than was the case for imports.

21 Manufacturers' input prices fell by 1.9% in April, and were 10.5% down on a year earlier. The CIPS survey had indicated that input prices had continued to fall in May, but the input price index had in fact risen by 0.6%, reflecting a rise in oil prices. Output prices had been flat or falling in every month of this year, and were up 0.8% in April on the same month a year earlier (only 0.1% excluding excise duties); in May they were up by 1.0% on a year earlier (0.2% excluding excise duties).

22 Twelve-month RPIX inflation fell for the third consecutive month to 2.5% in April. Elsewhere in Europe consumer price inflation had continued to fall, in spite of significant exchange rate depreciation; and inflation had also fallen back this year in the United States.

23 In the UK, there was a continuing contrast between goods and services inflation. Goods inflation fell further in April, to 1.9%, compared with 2.1% in March and over 3% in late 1996. Services inflation, which had been as low as 2% in Spring 1996, was unchanged at 3.2% between March and April this year. The April figure for services inflation was particularly significant because approaching half of services prices are recorded in a survey held in the first month of each quarter. Within the category of services, utility and rent inflation fell between March and April, while other services inflation continued to rise.

24 Although manufacturers' output prices had been flat, their margins on domestic sales appeared to have been rising, mainly owing to falling costs and productivity improvements rather than rising prices. Within services, many rents and utility charges were fixed in April for a year, suggesting that 12-month inflation of these items was likely to remain low. But there were not similar factors affecting inflation of other services.

V Financial markets

25 Short-term interest rates expected over the next couple of years appeared to have fallen immediately after the announcement that the Bank was to be given operational independence, but the fall had since been broadly reversed. Prices of short sterling futures were consistent with three-month LIBOR of 6.99% in December 1997 and 7.32% in December 1998, compared with a cash market rate of 6.59% on 5 June 1997. Expectations that the Bank would increase interest rates in June had been growing.

26 The sterling ERI, which stood at 99.7 (1990 average = 100) at the close of business on 5 June, had not changed much on balance since the eve of the announcement of the Bank's operational independence. It was up 17 1/2% since August 1996. Market comment suggested that sterling had in the last few days been supported by uncertainties about EMU and an associated softening of the Deutschemark, and by growing expectations of a rise in interest rates.

27 The evolving prospects for EMU had continued to be an important influence on sterling. As the £/DM exchange rate had appreciated since last summer, the pattern of correlations among the exchange rates of European currencies had been consistent with a growing market expectation of a broader monetary union but not including sterling, and with the view that sterling had been regarded as a safe haven.

28 Equity prices had risen by 0.8% over the last month as measured by the FTSE-100 index, which stood at 4557 on 5 June, compared with 4519 on 6 May. The continuing rise was difficult to explain by changes in either real interest rates or announced dividends, and might therefore reflect either a rise in expected future real dividend growth or a reduction in perceived uncertainty about future dividends.

VI Policy implications of the analysis

29 The Committee began its review of the policy implications of the analysis by discussing the problems posed for policy by the combination of strong domestic demand growth and a sharp appreciation of the exchange rate. Members agreed that the main issue at present was to assess the prospective strength of domestic demand against the effect of the exchange rate appreciation.

30 The latest data pointed to continuing strength in domestic demand growth. The Committee noted the increase, through the rise in equity prices, in the estimated size of windfall gains arising from demutualisation of building societies and other institutions in 1997, and discussed the likely effects on consumer demand. For consumers who were not liquidity constrained, the effect on spending in the near term might be no greater than the annuity value of the windfalls. Consumers who were liquidity constrained were likely to spend more than the annuity value of the windfalls in the near term, though if they did so, the increase in their future wealth would be correspondingly smaller.

31 In discussing asset price developments, members noted the rise in house prices since summer 1995, and the fact that prices in south east England had risen more than in other parts of the UK. They noted that rising equity prices might reflect either a strengthening outlook for corporate profits

or a falling risk premium in equity yields.

32 The most likely outcome for consumer spending over the next few months was continued growth at around the rates observed recently, notwithstanding indications (from notes and coins and the CBI distributive trades survey) of some possible softening in retail sales, and of regional variations in the strength of demand. Asset price developments - rising house prices and equity prices - implied some upside risk to that outlook.

33 Conditions for investment were promising: the stock market valuation of the corporate sector was well above the estimated replacement cost of its capital equipment, and ICCs' M4 balances were high in relation to estimated demand.

34 It was surprising that the effects of the exchange rate appreciation on external demand had not yet become apparent in recorded export or import volumes, but the Committee thought it most likely that they had simply been delayed and that a deterioration in net exports, consistent with survey indications, was to be expected. The projection in the May Inflation Report had incorporated such an assumption. Nevertheless, taking account of the outlook for both domestic and external demand, total output was likely to continue growing at above-trend rates.

35 The Committee discussed the labour market. It was not clear how low a level of unemployment would be compatible with maintaining a stable rate of inflation, but members viewed the gradual rise in real average earnings growth since late 1995 as evidence that labour market conditions had been tightening. In discussing recent price developments members noted the contrast between falling goods price inflation and rising service sector inflation (other than rents and utilities). The fall in goods inflation was probably a temporary reflection of the appreciation of sterling, which was likely to have a one-off effect on the price level rather than a material continuing effect on inflation. The rise in services inflation (other than rents and utilities) however seemed to be mainly the result of growing demand, which was likely to continue. There were therefore sound reasons for expecting goods price inflation and overall inflation to rise, when the one-off effect of the exchange rate appreciation had worn off.

36 Members discussed financial market developments and noted that financial markets appeared to be discounting a rise in three-month interbank interest rates to around 7 1/4% over the coming twelve months. They discussed the appreciation of sterling since the summer of last year and its possible causes, including changes in current and expected future monetary policy in the UK and overseas, and possible safe-haven portfolio effects related to EMU. It was difficult to be confident about the relative significance of various possible causes, but there was little reason to change the analysis in

the May Inflation Report. The effect of the appreciation on the economy would depend on what the causes were and how persistent the rise in sterling proved to be.

37 The Committee reviewed current uncertainties related to the domestic economy, which included the specific uncertainty about the forthcoming Budget as well as the normal uncertainties about the economic outlook and about the reaction of financial markets - particularly the foreign exchange market - to any change in interest rates.

38 Taking all the evidence into account, members agreed that the prospect for domestic demand was sufficiently buoyant that, despite the probable future impact of the higher exchange rate on activity, there was a need for tighter monetary policy in order to hit the inflation target looking two years or so ahead.

39 The Committee then turned to its immediate decision. They considered whether the timing of a rise in interest rates should be influenced by the timing of the Budget, but concluded that there was no strong reason why it should be. They also discussed the likely influences on the exchange rate in the near term, and the possible effect of a rise in interest rates. The Committee noted that the foreign exchange market was now expecting a small rise in interest rates to be decided at the meeting, and that sterling might be pushed up further by EMU uncertainties in the next month or so. It debated whether delaying a rise in interest rates would mean that the ultimate effect on the exchange rate would be any less, but concluded on balance that there was no strong reason to think that that was so, while a delay would mean some increase in the inflationary risks to the domestic economy.

40 Taking all the factors into account, the Committee judged that a modest increase in interest rates was needed immediately and all members voted for an immediate increase of 1/4% in interest rates.

VII Procedures

41 The Committee discussed the timing of the publication of the minutes of its meetings, and concluded that as a general rule the minutes of each meeting should be published on the Wednesday after the following meeting.

42 The following members of the Committee were present:

The Governor
The Deputy Governor
Professor Buiter
Professor Goodhart

Mr King
Mr Plenderleith

The Treasury representative, Sir Alan Budd, was also present.

TEXT OF BANK OF ENGLAND PRESS NOTICE OF 6 JUNE 1997**BANK OF ENGLAND RAISES INTEREST RATES BY 0.25% TO 6.50%**

The Bank of England has today raised its official dealing rate (the repo rate) by 0.25% to 6.50%.

The Bank's Monetary Policy Committee has reviewed the latest monetary and economic data. It concluded that the latest evidence is consistent with the outlook described in the Bank's Inflation Report published on 13 May. Notwithstanding the strength of the exchange rate, which is expected to restrain retail price inflation temporarily in the near term, the Report concluded that "the central projection for inflation, and the risks surrounding it, suggests that, on the present evidence, there is still likely to be a need for some further moderate tightening of policy in the months ahead."

The Committee accordingly voted to raise the Bank's repo rate by 0.25% to 6.50%. It believes that this action to tighten the monetary stance, taken with the aim of meeting the government's inflation target, offers the best chance of achieving continued growth in output and employment at a sustainable pace.

The increase takes immediate effect.