

Publication date: 20 April 2005

MINUTES OF MONETARY POLICY COMMITTEE MEETING

6 and 7 April 2005

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 April 2005.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0504.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 to be held on Friday 6 and Monday 9 May will be published on 18 May 2005.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 APRIL 2005

1 Before turning to its immediate policy decision, the Committee discussed the developments in financial markets; the international economy; money, credit, demand and output; and supply, costs and prices. The Committee noted a letter from the Chancellor (attached as an annex) setting out the remit for the Committee over the following year, in accordance with section 12 of the Bank of England Act 1998.

Financial markets

2 Financial market developments over the past month appeared to have been consistent with the economic news. Sterling short-term market interest rates had fallen over the month in response to data for consumption and the housing market. These rates were still slightly higher, however, than at the time of the February *Inflation Report*. Implied forward rates for December 2005 had fallen, by around 20 basis points, and a further quarter-point rise in the repo rate was no longer fully priced into the yield curve. According to the Reuters survey of economists, the mean expectation for the Bank's repo rate at the end of the year was 4.85%, the same as last month. In the United States, in contrast, short-term market interest rates and implied near-term forward rates had risen further over the past month, reflecting generally strong data and the Federal Open Market Committee's (FOMC's) latest statement. The US dollar yield curve suggested that market participants expected quarter-point interest rate increases at most FOMC meetings during the rest of this year. Euro short-term market interest rates had increased only slightly, and the market curve was pricing in one increase in the policy rate later this year. Long-term nominal forward interest rates had fallen a little on the month both here and abroad, but remained around 25 to 50 basis points higher than at the time of the February *Inflation Report*. Part of that rise since February might be explained by a rise in inflation expectations or the inflation risk premium in the US and UK bond markets, judging by a comparison of the prices of traditional and index-linked bonds. But real interest rates were also higher, accounting for much of the increase.

3 Nevertheless, the low level of long-term forward real risk-free interest rates was still a puzzle. The Committee noted three main possible explanations: a higher expected global propensity to save,

a lower expected global propensity to invest, or a temporary mis-pricing of long-dated financial assets. A range of arguments could be advanced for each of these. For example, higher propensities to save could reflect concern about prospects for pensions in many developed countries and the build-up of precautionary savings balances by Asian nations. However, the outlook for some developed-country public sector deficits pointed in the opposite direction. Lower investment propensities could reflect, among other factors, a desire to strengthen balance sheets and an increased caution on the part of firms following the equity market correction and concerns about corporate governance and accounting earlier this decade. But some of these factors might be temporary. For example, it seemed likely that in China the aggregate propensities to save and invest would both eventually fall from their current high levels.

4 The historically low level of credit spreads was another puzzle considered by the Committee. Spreads suggested that there was a continuing ‘search for yield’ consistent with an increased appetite for risk. However, there had been some signs over the past month that the compression of spreads might be beginning to unwind, perhaps reflecting the earlier rise in longer-term rates and the recent General Motors profit warning. So far, this unwinding had been orderly, without the liquidity problems and pricing distortions seen in some previous episodes. But spreads were still low, and it was still not certain that their adjustment to more normal levels would be smooth.

5 The main development in exchange rates on the month had been the appreciation of the US dollar, by over 3% in effective terms, broadly consistent with the changes in relative market interest rates. Sterling had fallen against the US dollar, but risen against the euro and the yen, leaving it about 1% higher on the effective exchange rate index.

6 The major equity indices had fallen over the month, reversing the previous month’s increases, but leaving the FTSE All-Share index a little above the baseline for the February *Inflation Report* forecast.

The international economy

7 In the euro area, industrial production had been relatively strong in January, but there were signs that the momentum of output might have slackened over the first quarter of this year. The manufacturing Purchasing Managers’ Index (PMI) had fallen quite sharply in March and the services

PMI had been unchanged, only a little above its 2004 Q4 level. Outside forecasts for euro-area GDP growth in 2005 had generally been revised downwards. Industrial confidence had fallen, which did not bode well for investment, but the growth of bank lending to the corporate sector had steadily increased over the past year, which could point in the opposite direction. And the news about consumption – retail sales had risen in February – and net exports was perhaps more encouraging. Net exports had increased sharply in January.

8 US growth appeared still to be robust, and in recent months outside forecasters had been revising up their projections for GDP growth in 2005. On the output side, the Institute for Supply Management's (ISM's) manufacturing PMI changed little in March, while the ISM index for non-manufacturing rebounded; the level of both indices remained consistent with above-trend growth rates. On the expenditure side, real consumption in January and February had been well above its average Q4 level. Although the March non-farm payrolls figure had been lower than expected, which might have contributed to the slight weakening in consumer confidence, past gains in employment, equity and housing wealth were likely to help to sustain household spending growth. Investment growth also seemed likely to remain strong, despite the ending of the depreciation tax allowance, with new orders and shipments of non-defence capital goods remaining close to historically high levels in January and February. The US current account deficit had been over 6% of GDP in 2004 Q4 and the growth of import demand was likely to stay high.

9 In Japan, the official estimate of GDP growth in 2004 Q4 had been revised up; it no longer appeared that there had been three consecutive quarters of falling output. However, the upward revision was accounted for by revisions to stockbuilding and government spending, while investment and consumption still looked weak. That did not point to a substantial rebound in GDP growth in the near term. The manufacturing PMI suggested that industrial production growth was picking up, but the latest Tankan survey had reported a sharp fall in confidence among large manufacturers.

10 Growth elsewhere in Asia, despite slowing somewhat, appeared to be more robust than in Japan. The rapid increase in demand from China continued to be a major factor in sustaining world trade.

11 The spot price of oil had risen a little over the month, and was still some 20% higher than at the time of the February *Inflation Report*. If this increase persisted, it was likely to have material effects on forecasts of inflation. In the short run, the direct impact on costs was likely to dominate. In the

longer run, there might be second-round effects on costs – if, for example, wage demands were to increase – but demand effects were likely to work in the opposite direction. Oil futures prices had also increased further over the past month. Although futures prices were not always a good guide to the prices expected to prevail in the medium term, their upward shift suggested that the pressure on oil prices was not due to short-term supply constraints alone.

12 In the United States, in addition to energy price increases, there had been signs of increasing inflationary pressure more generally, with further small increases in February to the inflation rates for core finished goods producer prices and core consumer prices. Bond prices suggested that inflation expectations had edged up since mid-February. Public debate had begun to focus more on the upside risks to US inflation (and their implications for the FOMC) and less on the possibility of price deflation. After a lengthy period in which rapid productivity growth had held cost pressures in check, unit labour costs had started to rise. Nevertheless, the exceptionally high rate of productivity growth in the US retail sector appeared to be continuing, so the low rate of pass-through of producer price increases to consumer goods prices might persist for some time.

13 In the euro area, in contrast, core producer price inflation had declined slightly in February and the core Harmonised Index of Consumer Prices inflation measure had fallen quite sharply in January and February, consistent with the economy being less buoyant than in the United States.

Money, credit, demand and output

14 UK consumption growth appeared to have slowed in the recent past. The latest ONS data suggested that growth had fallen sharply in 2004 Q4, below the rate implied by the February *Inflation Report* forecast. That appeared to be broadly consistent with the reports of the Bank's regional Agents and the *CBI Distributive Trades Survey*. Spending on durable goods had been largely responsible for the slowdown.

15 Some weakness in consumption seemed to have persisted in 2005 Q1, judging by the indicators currently available, although little was known yet about spending on consumer services. Retail sales had increased slightly in February, but there had been some downward revisions to estimates for earlier months. The balances reported in the *CBI Distributive Trades Survey* had fallen in March. The volume of sales balance had been at its weakest since January 1999. The Bank's regional Agents

had reported that retail contacts had been disappointed by sales volumes in the Easter period. The evidence pointed to somewhat weaker Q1 retail sales than expected at the time of the February *Inflation Report*. Private car registrations in the three months to March, an important month for car dealers because of the registration plate change, had been over 14% lower than a year earlier.

16 The Committee considered to what degree this apparent slowdown was likely to persist. On the one hand, the underlying determinants of consumption appeared still to be quite strong. The employment rate was stable and earnings were growing steadily. Nor were equity or housing wealth falling abruptly. Although house price inflation had fallen off sharply and housing market activity had declined from its peak, the most recent data suggested that the market might be stabilising. According to the average of the Nationwide and Halifax house price indices, the three-month on three-month rate of house price inflation had changed little between February and March, and remained positive; net reservations and mortgage approvals were no longer declining month to month. The weakness in consumption could have been brought about by temporary factors, such as uncertainty about how quickly the housing market would stabilise or about the path of interest rates. The slowdown might partly have reflected the recent low level of housing turnover, affecting purchases of the durable goods associated with moving house, but it was evident in spending on some other items, too, such as vehicles.

17 On the other hand, there were plausible explanations for an increase in household saving ratios and hence a consumption slowdown. As in March, the Committee had discussed three such explanations. First, the fall in house price inflation might have had a bigger impact on consumption growth than expected; the Committee might have underestimated the strength of this link. Second, the increase in official interest rates up to last August might now be having a larger-than-anticipated effect on spending. It was difficult to assess precisely what the consequences for spending would be of historically high aggregate household debt, not least because its distribution across different types of household mattered. Third, households might have been becoming more concerned about the adequacy of their arrangements for income in retirement, although it was not clear why that would have led to a sharp rise in saving at this particular time. At present, it was not easy to distinguish among these three hypotheses or quantify their implications.

18 Output growth had been robust in 2004 Q4, growing by 0.7% on the quarter according to the measure based on output at market prices. There was a problem, however, in reconciling this figure

with the expenditure components, including consumption, which pointed to lower growth: the quarterly alignment adjustment, added by convention to stockbuilding, had increased sharply in Q4.

19 Output growth had continued at a similar pace in 2005 Q1, judging by the CIPS business surveys in the first three months of the year. That was consistent with reports from the Bank's Agents. There were some signs that business optimism had improved. The February industrial production data had been weaker than expected, with a contraction in both the overall index and the index for manufacturing, but there was no evidence to suggest that the output of services had slowed. So soon after the end of the quarter, evidence was limited and there was still considerable uncertainty about the momentum in output growth.

20 The buoyancy of business surveys so far this year did not sit comfortably with the hypothesis that output in 2004 Q4 had been sustained by an unanticipated build-up of stocks that would need to be unwound. When there had been a large initial alignment adjustment in the past, subsequent data revisions had tended to affect the expenditure-based estimate of GDP more than the output-based estimate. So it was possible that there would ultimately be upward revisions to some components of final demand for 2004 Q4. Consumption was not the most likely candidate for an upward revision, given the available evidence, but other components of demand might have been more robust than currently thought. If so, that might also help explain the apparently conflicting signals from output and consumption indicators for the first quarter of this year. However, there was little direct evidence as yet that these other expenditure components had indeed been stronger than expected.

21 There had been little news on government spending in the Budget, although its precise impact on the government's demand for resources – the concept relevant for the Committee's analysis of the balance of demand and supply – was not yet clear.

Supply, costs and prices

22 There had been little news over the past month from the labour market. The unemployment rate had been broadly stable in the three months to January on both the claimant count and Labour Force Survey measures. There had been some signs of an increase in labour demand, with employment around 127,000 higher in the three months to January than in the previous three months, the CIPS employment survey showing a rebound and the Recruitment and Employment Confederation survey

pointing to a reduction in availability of staff. However, the Bank's regional Agents had noted reports of a weakening in the private sector employment growth expected over the next six months. Overall, the picture was consistent with output growth near trend. The one surprise had been the continuing sharp increase in average hours worked per head. The increase might simply have reflected the normal volatility of these data. If instead it reflected a temporary adjustment by employers unsure about the persistence of improvements in their own sales prospects, it was puzzling that there had not been a marked rise in overtime and that weekly earnings had not risen.

23 Pay settlements had continued in February in the 3-4% range in which they had remained ever since the Committee had been set up. They had risen a little on the headline figure, but fallen a little for settlements matched with those for the same groups of workers last year. The Bank's regional Agents had received reports of slightly higher settlements, due to rises in RPI inflation and the National Minimum Wage, together with continuing skill shortages in some occupations. Regular pay growth had remained at an annual rate of around 4½% in January, although bonuses had been stronger than expected. There was no sign of inflation expectations among the general public rising.

24 Judging by the CIPS surveys of business activity, the economy appeared to be operating with high capacity utilisation as well as a low unemployment rate. Input price inflation – even excluding oil – was high, at around 6% at a three-month annualised rate in February. However, manufacturers' output price inflation (excluding petroleum products) had been lower. The CIPS price surveys suggested that input price pressures might ease a little in the near future in manufacturing and construction. The short-term outlook was for slightly higher CPI inflation than expected last month, primarily because of higher oil and utility prices.

The immediate policy decision

25 The news over the past month about the international economy had been mixed. US growth appeared to have been a little stronger than expected. Business surveys suggested that euro-area growth might have been a little weaker than expected, but retail sales and trade data had perhaps been more encouraging; members differed in the weights they attached to those different pieces of evidence. US short-term interest rates had increased on the month, and yield curves around the world remained higher than in February. The spot price of oil was considerably higher than at the time of the

February *Inflation Report* and futures prices had also risen, suggesting that the pressure on costs from oil might persist.

26 In the domestic economy, estimated consumption growth had slowed more rapidly than expected in 2004 Q4. Information about expenditure on consumer goods suggested that this weakness had started in December and had persisted in the first quarter of this year. But there was not much hard evidence yet about recent demand for consumer services. In contrast, business surveys suggested that overall output growth remained strong, despite the weakness of the most recent industrial production data. There had not been much news on the month from the labour market; it remained tight, but pay growth remained subdued – judging by, for example, matched settlements. The sharp rise in reported average hours worked per head was a puzzle, as it was not reflected in data on overtime and weekly earnings. Firms continued to report substantial pressures on their costs, but there was little evidence of greater pass-through to consumer prices; output price inflation, excluding oil, had been stable.

27 In recent meetings, the Committee had focused on two key risks to the inflation outlook. The first had been the risk of weakness of household spending in the near term. There were signs that this risk had crystallised to some degree. But the outlook for most of the underlying determinants of consumption, such as real incomes, employment and wealth, had been resilient. Hence consumption growth might pick up after the weakness around the turn of the year. Also, it was possible that other components of demand might be taking up the slack, given that output growth seemed to have remained robust. The second key risk had concerned how rapidly consumer prices would respond to demand and cost pressures. There had been little news about the strength of this response and it was uncertain how the substantial rise in oil prices this year would feed through if it were maintained. Different members gave different weights to these risks.

28 For the Committee members who had voted last month to maintain the repo rate at its current level, the main question was whether, after another month's data, the balance of risks to the inflation forecast remained sufficiently to the downside in the near term to justify leaving the repo rate unchanged again. For these members, although they varied in their assessment of the evidence, the data suggested that the overall risk to the inflation forecast was still to the downside. What news there had been did not warrant a change in their votes. For that reason, an increase in the repo rate this month would also be difficult to explain and would surprise financial markets. More data were required to assess further the extent and persistence of the apparent slowdown in household spending,

and whether other sources of demand would grow rapidly enough to maintain output growth around trend, as expected in February. An increase in the repo rate was not necessary this month to keep CPI inflation on track to meet its target in the medium term.

29 For some other members, however, there had not been much news over the month, so overall they continued to prefer an immediate rise in the repo rate of 25 basis points. The international outlook had changed little since the February *Inflation Report*, and there were risks in both directions. Household spending appeared to have slowed somewhat faster than the Committee had expected, but its underlying determinants were firm, so some rebound was likely. The risk of sharp falls in house prices and housing market activity had diminished, reducing one of the sources of downside risk to the forecast. Output growth remained robust, and companies seemed to be operating with high levels of capacity utilisation. Oil prices were pushing up companies' costs. Inflation expectations in sterling bond markets had possibly risen a little. A quarter-point rise in interest rates now would help to contain medium-term inflationary pressures.

30 The Governor invited members to vote on the proposition that the repo rate should be maintained at 4.75%. Seven members (the Governor, Rachel Lomax, Kate Barker, Charles Bean, Marian Bell, Richard Lambert and Stephen Nickell) voted in favour. Two members (Andrew Large and Paul Tucker) voted against, preferring a rise in the repo rate of 25 basis points.

31 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

Jon Cunliffe was present as the Treasury representative.