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**MINUTES OF  
MONETARY POLICY  
COMMITTEE MEETING  
3 and 4 August 2005**

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These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 August 2005.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2005/mpc0508.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 7 and 8 September will be published on 21 September 2005.



## MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 AUGUST 2005

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; and costs and prices.

### **Financial markets**

2 In the United Kingdom, short-term market interest rate expectations had changed little over the past month, with a 0.25 percentage point rate cut priced in for this month's decision, a strong expectation of a second rate cut later in the year and the possibility of a further reduction in early 2006. In the latest Reuters poll, 43 out of 47 economists had expected a 0.25 percentage point reduction in interest rates at the August meeting, and slightly under half of the sample expected at least one further reduction this year. Financial markets had priced in a somewhat larger reduction in official interest rates over the next year than expected by economists, although the difference appeared to have narrowed somewhat in recent days.

3 It was possible that the market expectation of more than one interest rate reduction was based on extrapolations of past Committee voting patterns. Furthermore, some commentary on the UK indicators seemed surprisingly gloomy and that may have affected market sentiment. It was important not to attach too much weight to the market's central expectation; option prices suggested that market participants attached weight to a range of possible outcomes. The implied probability of a fall in interest rates had increased following the release of the Committee's July minutes. Long-term forward interest rates were little changed on the month in either the United Kingdom or overseas. Credit spreads had fallen slightly.

4 The sterling effective exchange rate index (ERI) had depreciated by 1% over the month, and had fallen by more than 3% since the May *Inflation Report*. That was one of the largest changes in the exchange rate between *Inflation Reports* since the Committee's inception in 1997. The recent depreciation could be explained only partly by movements in relative interest rates. It was possible that it reflected further reaction to previous soft UK data releases and changing views about monetary

policy. Much of the fall in sterling over the quarter occurred at the end of June and early July, coinciding with the release of the National Accounts for 2005 Q1 and the *Blue Book* revisions to historic data. But the pattern of depreciation did not fit particularly closely with any single piece of data – which made it hard to pinpoint the source of the change in view on sterling. It was also possible that some of the weaker UK data had been put into a sharper contrast by a backdrop of slightly stronger news about the global economy.

5 Equity prices had increased over the past month in the United Kingdom, the United States and the euro area. As with the exchange rate, the movements in equity prices between *Inflation Reports* had been substantial; in the United Kingdom, the FTSE All-Share index had risen around 8% since the *May Report*.

6 The Committee noted that movements in most asset prices following the terrorist attacks on the 7 and 21 July appeared to have been short-lived. However, since the counterfactual path for these prices was unknown, it was difficult to conclude with certainty that there had been no longer-term effects.

### **The international economy**

7 Economic developments in the euro area had seemed slightly more encouraging and, looking ahead, pointed to a moderate recovery in growth. The second release of the euro area national accounts data for 2005 Q1 contained relatively little news, with GDP growth unchanged at 0.5%. Industrial confidence had picked up a little in the larger euro-area economies, and both the manufacturing and services purchasing managers' indices had risen a little in July. Employment was growing moderately, and bank lending to private non-financial companies had picked up. The depreciation of the euro against the dollar over recent months should help to boost net trade. So the climate in the corporate sector seemed to have improved recently – though industrial confidence still remained below its level at the end of 2004. The outlook for consumption growth, however, continued to look a little weak, given the data on retail sales and consumer confidence. Core producer price inflation had ticked down again, while headline consumer price inflation remained above 2%.

8 In the United States, GDP growth in 2005 Q2 had been in line with expectations. Final domestic demand and net trade had both been a little stronger than expected, offset by unexpectedly weak stockbuilding. Most indicators for consumption, investment, and the labour and housing markets

suggested that prospects remained firm. Both core producer and consumer price inflation had eased in June. The Committee noted the upward revisions to the core personal consumption expenditure (PCE) deflator – the preferred inflation measure of the Federal Reserve.

9 The main news from Asia had been the move to a more flexible exchange rate regime in China. The initial 2% revaluation should have a negligible impact on the pattern of global production and trade, but did raise the possibility of further revaluations in the future. The annual rate of Chinese GDP growth remained strong and had shown no sign of slowing in 2005 Q2. There had been little news from Japan, on the month. UK trade-weighted Asian import growth had picked up in May and June.

10 The oil price had risen around 5% over the past month, and was just over 20% higher than its level at the time of the *May Inflation Report*. Looking over a longer time period, what continued to differentiate the recent rise in the spot oil price from some previous sharp movements was the parallel upward shift in oil futures prices; implying that market participants expected the rise in spot prices to persist for some time. Existing spare oil production capacity was historically low and new supply capacity – through, for example, development of new oil and gas fields and building of refineries – would take a considerable time to come on-stream in response to expectations of sustained higher prices. Continued robust expansion of world activity was unlikely to be consistent with a significant easing in the growth of oil demand. So there was a risk of a further rise in the oil price.

11 Overall, there were some mildly encouraging signs in the UK's primary export markets, consistent with continuing steady growth in world demand. Corroborative evidence of this view came from the rise in equity prices and from the Bank's regional Agents, whose contacts reported an improvement in export prospects.

### **Money, credit, demand and output**

12 The preliminary estimate of UK GDP growth was 0.4% in 2005 Q2, a little weaker than expected. Official estimates of GDP growth had now been below trend for four consecutive quarters, although such early estimates were highly uncertain. The main factor underlying this weakness had been the below average growth rate of the service sector over this period.

13 The official estimates of service sector output continued to look somewhat weaker than the picture painted by the service sector surveys. The pattern of past revisions to the official data, coupled with the survey data, suggested that services sector output growth might eventually be revised upwards. But the survey-based estimates of output were subject to a significant margin of error, and it was possible that they were not providing an accurate reading at present. Surveys could fail to capture slowdowns that were particularly concentrated in a few sub-sectors, and survey balances might not capture the intensity of changes in business conditions. Some of the surveys, such as the CIPS services survey, excluded the distribution sector which had been a major contributor to weak output growth in recent quarters. The evidence from the labour market was also broadly consistent with growth somewhat below trend. Nevertheless, on balance it still seemed likely that recent ONS output data would eventually be revised up a little.

14 The June Index of Production release had been provided to the Committee ahead of publication. The June outturn, together with revisions to earlier months, suggested stronger-than-expected manufacturing output in Q2. On the basis of these numbers, it was possible that the ONS might subsequently revise up the preliminary GDP growth estimate in the next release.

15 The survey indicators in July had been mixed, but had not shown signs of a further slowing of GDP growth in Q3. The CIPS services index had risen a little, as had the output index of the CIPS manufacturing survey. However, there had been falls in the CIPS manufacturing new orders index, and the quarterly BCC survey balances looked a little weaker, particularly for the service sector. Overall, the indicators had pointed to service sector growth in Q3 at around the same rate as in Q2, and flat manufacturing output.

16 Turning to consumption, retail sales had bounced back strongly in June. Anecdotal evidence from the Agents suggested that sales might have been boosted by protracted discounting, although the series itself was an erratic one. Retail sales data, coupled with a modest recovery in private car registrations, had pointed to stronger consumption growth in Q2.

17 The latest indicators for household spending in Q3 were mixed. The *CBI Distributive Trades Survey* for July remained weak. In contrast, the GfK survey had risen slightly on the month, and had shown a pickup in confidence about making major purchases. The July terrorist attacks in central London had seemingly not had much effect on consumer confidence or the recorded number of people

entering shops across the United Kingdom as a whole. But it was possible that some of the indicators and official data would be more volatile than normal over the summer. House prices and mortgage approvals had been broadly flat. Unsecured lending growth had continued to weaken, although it remained robust. The Bank's regional Agents had reported a somewhat slower growth rate of consumer services. Overall, the indicators did not yet provide a clear steer as to whether the stronger consumption growth now expected for Q2 would be maintained into the second half of the year, or whether the weakness over the first half of the year – taking Q1 and Q2 together – would continue.

18 Contacts of the Bank's regional Agents suggested that investment intentions had fallen in both manufacturing and services. That picture had been broadly corroborated by the latest business surveys. This softer outlook had been factored into the Committee's near-term projections for investment.

### **Costs and prices**

19 There had not been much labour market news on the month, but the data still seemed consistent with a gentle labour market loosening since the turn of the year. That was, in turn, consistent with below trend output growth over the past few quarters.

20 Since the beginning of the year, total weekly hours and the employment rate had fallen while both measures of unemployment had risen a little. Business surveys generally also pointed to a slight softening of labour market conditions. The Agents had undertaken a survey this month which had suggested a further slight weakening in employment growth prospects.

21 Average earnings growth, as measured by the average earnings index (AEI), had eased a little since the start of the year, and contacts of the Bank's regional Agents had suggested a slight easing in total labour costs per employee. The Office for National Statistics' new experimental measure of annual growth in average weekly earnings (AWE) appeared to be easing, suggesting that the contrast between the rising AWE measure and weakening AEI measure of regular pay growth had weakened somewhat.

22 The news on prices in the supply chain had been mixed over the past month. On the one hand, private sector unit labour costs had continued to rise. But the annual rate of increase in unit labour

costs had returned only to around the average of the past decade and, given the prospective weakness of the employment data relative to the output data in Q2, unit labour costs growth was quite likely to fall back. Manufacturing input price inflation had risen on the back of the latest rises in oil prices, and was at its highest rate since the current index began in 1986. On the other hand, manufacturing output price inflation had eased further, albeit from a relatively high level. The CIPS survey balances for both input and output price inflation had eased in the service sector. The fall in input and output price balances across a range of manufacturing and services surveys over recent months had been striking, leaving many close to their series averages.

23 CPI inflation was on target at 2.0% in June, a little higher than expected. Although there was continuing uncertainty about the reasons for the recent increases in CPI inflation, the oil price was likely to have played a sizable role through both direct and indirect channels, and looked set to do so for some time given the continued rise in oil prices. The pressure of demand on supply in early 2004 was also likely to have played a significant role in the rise in inflation towards the target.

### **The August GDP growth and inflation projections**

24 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 10 August.

25 The Committee's central projection, based on its collective judgement and the assumption that official interest rates followed the declining path implied by the market yield curve, was for output growth to remain subdued in the near term, reflecting the continued sluggishness of domestic demand. Growth then picked up as the impetus from recent movements in asset prices worked through to consumption, investment and net trade. The profile was weaker in the near term than in the *May Report*, but stronger further out.

26 The central projection for CPI inflation, on the market-based assumption about the path of official interest rates, was for it to move above the 2% target in the near term and then to dip, as the impact of recent increases in oil prices moderated and pressures on capacity eased. Inflation was then projected to rise above the target once more, as output growth picked up and the contribution from import prices increased. The central projection was a little higher in the near term, and also somewhat higher in the final year of the projection, than in the *May Inflation Report*.

27 The Committee's best collective judgement was that the key risks to the central projection related to: the near-term momentum in consumer spending; the sources of the recent pickup in inflation; and the outlook for oil prices. While there was a range of views among members, the Committee's best collective judgement was that, relative to the central projection, the balance of risks for activity was slightly to the downside in the near term. The balance of risks to inflation was correspondingly slightly on the downside further out.

28 Under the alternative assumption of constant interest rates, output growth was slightly weaker, so the pickup in inflation towards the end of the projection was less marked. If interest rates were to remain unchanged at 4.5% that might be a significant surprise to financial markets which were pricing in a further reduction in interest rates. That could prompt larger movements in equity prices and the sterling exchange rate than had been assumed in the constant rate projection, constituting a downside risk to activity and inflation relative to the *Inflation Report* central projection.

### **The immediate policy decision**

29 There had been relatively little news on the international economy over the past month. The prospect seemed to be one of continuing steady growth, with some mildly encouraging signs in the United Kingdom's primary export markets. ONS estimates of UK output growth had turned out weaker than expected in Q2. The latest indicators pointed to similar growth in Q3. But there remained uncertainty about the prospects for revisions to the data, especially in the service sector. On the expenditure side, the indicators pointed to some recovery in consumption growth in Q2, but there was uncertainty as to whether this would be maintained into the second half of the year.

30 Since the turn of the year, there seemed to have been a gentle labour market loosening, consistent with below trend output growth since the middle of last year. There was mixed news in the supply chain, with producer input prices continuing to rise sharply, but output price inflation easing. Oil prices had risen further both on the month and since the previous *Report*, and continued to be a major influence along the UK supply chain. CPI inflation was expected to rise above the target in the near term.



31 There had been relatively little news in financial markets over the past month, but there had been considerable news over the past quarter. In particular, the fall in market interest rates compared with the flat yield curve at the time of the *May Report* implied that the market expected the official interest rate to fall towards 4%. The effective exchange rate had fallen, while equity prices had risen. Taken together, these movements in asset prices had a material impact on the projections for output growth and inflation based on market interest rates.

32 The Committee's projections implied that inflation was likely to move significantly above target in the medium term if interest rates were to move in line with the market yield curve. The constant rate projection showed slightly lower activity and inflation in line with the target at the two year horizon.

33 For some members, a 0.25 percentage point reduction in official interest rates was necessary this month. In the first half of the year, output growth in the United Kingdom had been subdued. Household spending and business investment growth had slowed. Although there had been some signs of a pickup in consumer spending in Q2, downside risks remained in the near term given the loosening in the labour market and uncertainty about the underlying strength of consumer spending in the first half of the year. It seemed likely that the combined effect of high levels of household debt and the lagged impact of past interest rate increases had accounted for some of the unexpectedly sharp slowdown in consumer spending through 2004 and into the first quarter of 2005. It was possible that the uncertainty created by the ongoing adjustment in the housing market had also had some effect on spending. Higher oil prices might raise inflation further in the short term, but the slackening in the pressure of demand on supply capacity in the first half of the year should lead to some moderation in inflation looking further ahead. There was also a possibility that import prices might provide a smaller contribution to inflation than had been assumed in the central projection. And there had been a sharp fall in some of the price surveys, indicating less pressure along the supply chain than had been apparent a few months ago. Although the path of market interest rates should prove supportive of household spending, it was necessary to validate those expectations to some degree. A failure to reduce rates now might damage confidence. Early action would reduce the risk that greater changes in the policy rate would be needed at some point in the future, and would not preclude a rise in rates in the future if the data warranted it. For these members, there was no presumption on the future direction of interest rates.

34 For other members, the evidence did not require a change in official interest rates this month. While the growth in aggregate output had slowed, and the labour market had eased a little, the economy was still operating close to full capacity. Looking ahead, activity was likely to be supported by fiscal policy and the continuing strength of the world economy. Some of the most recent domestic indicators had been a little stronger than expected. The services surveys were consistent with slightly stronger growth than in the official data, and the recent industrial production data had been stronger than expected. The money and credit data had not pointed to a marked further softening in activity; rather, they were consistent with a recovery in consumption and GDP growth in the second half of the year. The housing market appeared to be stable, with house prices broadly flat and activity indicators picking up a little. With oil prices likely to remain strong, producer input prices rising sharply, and an acceleration in unit labour costs since the turn of the year, it was too early to conclude that inflationary pressures had abated. Adding to the strength of the recovery would risk adding to inflationary pressures while costs were still working their way through the supply chain.

35 For these members, while it was possible to build a case for a precautionary reduction in interest rates, based on the near-term downside risk to consumption, there appeared to be little risk in waiting for further data. Given the difficulty in explaining a reversal of a decision soon after a turning point, should that prove necessary in the light of future data, it was advisable to accumulate a little more evidence than usual before changing interest rates. While a decision not to cut rates would be a significant surprise, the Committee's latest projections did not support the current market view that a sequence of interest rate cuts was likely to be needed to meet the inflation target in the medium term.

36 The Governor invited members to vote on the proposition that the repo rate should be reduced by 25 basis points to 4.5%. Five members of the Committee (Kate Barker, Charles Bean, Richard Lambert, Stephen Nickell and David Walton) voted in favour. Four members of the Committee (the Governor, Rachel Lomax, Sir Andrew Large and Paul Tucker) voted against, preferring to maintain the repo rate at 4.75%.

37 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

Richard Lambert

Stephen Nickell

Paul Tucker

David Walton

Jon Cunliffe was present as the Treasury representative.