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MINUTES OF MONETARY POLICY COMMITTEE MEETING
12 and 13 January 2005

These are the minutes of the Monetary Policy Committee meeting held on 12 and 13 January 2004.

They are also available on the Internet (http://www.bankofengland.co.uk/mpc/mpc0501.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 February will be published on 23 February 2005.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 12-13 JANUARY 2005

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

Financial markets

2 The Bank's effective sterling exchange rate had fallen by just over 2% since the Committee's December meeting, taking it back close to the level at the time of the November *Inflation Report*. Sterling had depreciated against all other currencies. Over the month as a whole, sterling short-term market interest rates were broadly unchanged whereas US dollar and euro rates had risen. That pattern of exchange rate and interest rate movements seemed broadly consistent with the economic news.

3 The sterling money market yield curve suggested that the repo rate was expected to remain unchanged for the first half of the year at least. The most recent Reuters poll of economists presented a similar picture, although the range of economists' forecasts for the end of 2005 – above and below the current repo rate of 4.75% – was wider than the range of forecasts for the end of 2004 had been in January of that year. 44 of the 45 economists surveyed had expected 'no change' this month. That was consistent with anecdote from market participants and the pattern of very short-term interest rates.

4 The FTSE All-Share index had risen by more than 2% over the past month in sterling terms. But it was broadly unchanged in US dollar terms, as were broad US equity indices.

5 Looking at developments in financial asset prices over a longer period, the Committee noted the low levels of both long-term forward real market interest rates and of implied risk premia across a range of financial assets globally. Low risk premia were more evident in bond markets whereas equity markets were perhaps still tainted by memories of the unwinding of the late-1990s bull market.

6 The Committee discussed possible explanations. Credit risk on corporate bonds might have fallen following the restructuring of corporate balance sheets in recent years. But spreads on bonds issued by emerging market governments had also narrowed and implied volatilities from many (but not all) interest rate and exchange rate options were also low by historical standards, perhaps suggesting an assessment that the degree of uncertainty was low in the world economy more generally. At a time of low risk-free bond yields, a further possibility was that falls in risk premia reflected attempts by investors to maintain the yield on their portfolios by taking on more risk – the so-called ‘search for yield’.

7 The low level of long-term real forward risk-free market interest rates was equally puzzling, especially given rising government indebtedness in most of the major economies. Demographic change might have been part of the explanation if savings had risen or if market participants had re-evaluated the implications for long-term savings. Other possible factors included the effect of the recent relatively rapid official purchases of government bonds, particularly of US government bonds.

8 In the immediate future, low long-term bond yields and risk premia would continue to facilitate new borrowing and refinancing of existing debts on favourable terms. Looser credit conditions would add some stimulus to global demand. The Committee judged that there might be some downside risk of an asset price correction. However, it was possible that developments in derivatives markets had made it possible for investors to diversify their portfolios better, spreading risk more effectively across a wider population of investors. This was most plausible in credit markets, where it was now easier for investors to diversify across sectors and regions and to adjust their exposures. Moreover, the UK financial sector appeared strong and the global economy had weathered a number of financial shocks in the past decade without significant long-term damage.

The international economy

9 The Committee judged that there had been little change in the outlook for UK-weighted world activity this month. United States’ GDP growth had been unrevised at 1% in 2004 Q3, and was expected to remain strong in Q4. Industrial production had risen in November, and the December manufacturing and non-manufacturing Institute of Supply Management (ISM) indices had both risen. There had been further steady growth in employment, and consumer confidence had risen in December. However, the US trade data had recorded a fall in exports in November, pointing not only

to the net trade contribution in 2004 Q4, but also the possibility of activity in the rest of the world, being weaker than expected.

10 Estimated euro-area output growth in 2004 Q3 had been 0.3%, which was unrevised on the previous release. Taken together, the latest indicators were mixed but still pointed to growth in 2004 Q4 at broadly the same pace as in Q3. Retail sales had been revised down in October and had been flat in November. The Purchasing Managers Indices had looked a little stronger in December – the manufacturing index had increased for the first time since July. There were some expectations of a bounce-back of GDP growth in France in the fourth quarter, although the latest indicators for Germany had remained weak. The appreciation of the euro against the US dollar appeared to have already had some effect on the export shares of some euro area countries.

11 Japanese GDP in 2004 Q2 and Q3 still seemed likely to have been broadly flat. Some of the survey-based indicators remained more positive. In particular, the outlook for consumption looked promising and should be sustained by falling unemployment. The latest Tankan survey had suggested a more positive outlook for the business sector. The latest indicators were consistent with slowing growth in non-Japan Asia, although the latest Chinese trade data had been particularly volatile and were hard to interpret. The Asian tsunami, though devastating in human terms, was expected to have only a very small impact on global growth.

12 The spot price of oil had risen nearly 20% on the month in dollar terms, in part reflecting the OPEC agreement to cut production, but the futures price had been broadly unchanged at longer maturities. There seemed only limited concern among market participants that oil prices might rise further in the long term. But much would depend on how oil industry investment in exploration and extraction responded to the existing rise in oil prices – especially given the political uncertainties in a number of the countries where the further development was likely to be concentrated.

13 The first-round effects of the past increases in oil prices still appeared to be working through, with headline producer and consumer price inflation rising in the United States in November and the December flash estimate of Harmonised Index of Consumer Prices (HICP) inflation up a little in the euro area. ‘Core’ producer and consumer price inflation had continued to tick up in the United States, which might be consistent with there having been some small second-round effects from oil prices, but could equally reflect growing demand pressures.

Money, credit, demand and output

14 UK GDP growth had been revised up to 0.5% in 2004 Q3 in the National Accounts release, bringing it into line with the November *Inflation Report* projection. The revisions to the basic price adjustment meant that the level of GDP measured at basic prices had been revised up, while the level of GDP at market prices had been revised down. The Committee judged that those revisions, which were largely concentrated in 2003, should not make a material difference to the assessment of inflationary pressure.

15 There was judged to be little news in the latest estimates of the expenditure components of GDP in 2004 Q3. The revisions to the expenditure components had moved them more into line with expectations at the time of the November *Inflation Report*, although government spending remained stronger than expected while investment was weaker. To the extent that stronger government spending represented higher nominal spending and that spending for the financial year was largely fixed, it might be unwound in 2004 Q4 and/or 2005 Q1.

16 Equally, there was little news on the income side of the accounts. Stronger-than-expected household income growth had been accompanied by downward revisions to back data in 2004, leaving the saving ratio broadly flat over the past few years. The Q3 National Accounts had suggested a fall in the gross operating surplus of companies in 2004 Q3 (excluding the quarterly alignment adjustment). This had been concentrated in financial companies. However, the gross operating surplus of companies was often subject to significant revision in subsequent ONS releases.

17 The Chartered Institute of Purchasing and Supply (CIPS) services business activity and new orders indices had fallen in December, but remained at healthy levels. Industrial production had fallen by a little more than had been expected in the three months to November. Overall, the latest indicators pointed to GDP growth at around its trend rate in 2004 Q4, as expected at the time of the November *Inflation Report*. There remained some tension between the weakness of industrial production and the rather stronger picture painted by surveys – although the CIPS manufacturing and CBI *Monthly Industrial Trends Survey* output indicators had both fallen in December.

18 The Bank's regional Agents had noted heavy discounting by retailers before Christmas, but it was not clear to the Committee the extent to which this was different from what had happened in earlier years when discounting had also been reported. The GfK consumer confidence measure had

risen in December, for the third month in a row. Taken as a whole, the latest monthly retail sales indicators from the CBI and the British Retail Consortium, and evidence from the Bank's regional Agents, did not suggest a substantial change to the outlook for retail sales and consumption growth at the turn of the year. It would be necessary to look at December and January data together to obtain a clearer picture, because of variations in the timing of sales around Christmas and the New Year.

19 The average of the Halifax and Nationwide house prices indices had risen by 0.6% in 2004 Q4, a little stronger than expected at the time of the November *Inflation Report*. The preview of the Royal Institution of Chartered Surveyors (RICS) survey for December had shown a further small fall in the sales-to-stock ratio. The number of approvals for new mortgages had continued to fall in November, though it was possible that the change in mortgage regulation had temporarily distorted the figure. It was too early to draw firm conclusions, but if anything the latest indicators suggested that house prices might remain a little stronger through the first months of 2005 than expected at the time of the November *Inflation Report*.

20 The Committee had previously noted the potential upside risks from rapid annual growth in nominal GDP, which had appeared to have been increasing up to 2004 Q2. However, recent nominal GDP growth rates had been revised down in the Q3 National Accounts. Measures of broad money and credit growth had continued to ease in November.

Wages, costs and prices

21 There seemed to be very little news in the labour market this month. Employment had increased in the three months to October on the Labour Force Survey (LFS) measure – although there had been a fall in the Workforce Jobs measure in 2004 Q3. Inactivity had continued to rise, but at a slower pace than a few months ago, and unemployment had fallen further on the LFS measure. The overall picture for employment was broadly in line with what had been expected at the time of the November *Inflation Report*. Looking forward, the latest CIPS employment indices for services, manufacturing and construction were weaker in December, as were the Recruitment and Employment Confederation survey measures of demand for labour. The picture from the surveys seemed consistent with reports from the Bank's regional Agents.

22 The Committee had noted at its December meeting that there had been a small rise in the shorter-run three-month measure of private sector pay settlements in October. That rise appeared to have been

sustained in the three months to November. However, the twelve-month measure remained broadly flat, as it had been throughout 2004. Growth in regular pay had continued to increase gradually since the beginning of 2003, but the rise in recent months was in line with expectations.

23 Private sector productivity growth had remained strong in the year to 2004 Q3. Although there was little change in the annual growth rate compared with the second quarter, it remained much higher than a year ago. Given that investment had been subdued, it was no surprise that the rapid growth in labour productivity had been accounted for, in large part, by growth in total factor productivity. It seemed likely that much of the recent increase in productivity was cyclical and could reflect the unwinding of earlier labour hoarding by companies. However, there was a possibility that some part of the recent rise in the productivity growth rate reflected a change in the underlying trend, for example resulting from increased use of information and communications technology. The rise in the private sector productivity growth rate had had a striking impact on unit wage costs, which were estimated to have been broadly flat in the year to 2004 Q3.

24 The data on supply-chain costs and prices were a little weaker this month. Input price inflation had fallen in November, both including and excluding oil. The annual rate of increase of producer output prices, excluding petroleum products, had also fallen slightly in November – though the longer-term picture remained one of rising inflation since 1999.

25 The Committee discussed the reasons for low price inflation of consumer goods. These reasons had changed over time. From 1999 to the first half of 2001, falling margins in distribution had offset rising domestic and imported prices. Over the following year or so, the major influences on consumer prices had been falling domestic and imported producer prices. Thereafter, despite the pressure of domestic demand on supply, which had led to rising prices of domestically produced goods, consumer goods price inflation had been held down by distributors and retailers continuing to find cheaper sources for goods in overseas markets, and by competitive pressures and efficiency gains in the distribution sector.

26 Annual CPI inflation had risen to 1.5% in November, which was a little higher than expected. In line with pre-release arrangements, an advance estimate of CPI inflation for December had been provided to the Governor 3½ days ahead of publication, and this suggested a rise in the inflation rate to 1.6%. Over six months, inflation had fallen from 1.6% to 1.1% and had then returned to 1.6%. More analysis would be required, but there were no obvious signs in the advance estimate of heavy price

discounting by retailers – although that might be because of the timing of the CPI collection day relative to the pre-Christmas discounting.

The immediate policy decision

27 Overall, the Committee agreed that there had been relatively little news this month. Nor was there any evidence to suggest that the main risks identified at the time of the November *Inflation Report* were materialising – with the possible exception of slightly weaker world activity that had been identified in the December Minutes. The outlook for UK-weighted world activity had not changed much over the past month. The US economy continued to progress broadly in line with expectations at the time of the November *Inflation Report*. Euro-area and Japanese growth remained weaker than expected in November. Views differed slightly on the prospects for a pickup in euro-area growth in the near term, partly hinging on the extent to which corporate sector investment might drive faster growth.

28 On domestic activity, the Q3 National Accounts had contained little news, but had brought the official data more into line with the November *Inflation Report* central projection than the previous Output, Income and Expenditure release. The latest indicators pointed to GDP growth of close to trend in 2004 Q4, broadly in line with the *Inflation Report* central projection.

29 The Committee saw no clear evidence of a significant change in the pace of consumption growth relative to that expected at the time of the *Report*, despite some initial downbeat press comments about the weakness of retail sales over the Christmas period. The latest house price indicators were, if anything, a little stronger than expected at the time of the November *Inflation Report*, but it was too early to draw firm conclusions about the pace of the housing market slowdown. There were further signs of slower money and credit growth, which for some members slightly reduced the upside risks to inflation.

30 The Bank's effective sterling exchange rate index had fallen a little over the past month, bringing it back to the level at the time of the November *Inflation Report*. There had been little movement in UK short-term interest rate expectations. The Committee had discussed the low levels of both long-term forward real interest rates and risk premia. In the immediate future, this meant credit conditions globally were a little looser, which would add to global demand. There was also some risk

of asset price adjustments. But it was difficult to assess the significance of this risk or the likely consequences for output and inflation if it crystallised.

31 There had been little news on pay pressures, which remained subdued and, coupled with strong productivity growth, had translated into broadly flat private sector unit wage costs over the past year. Supply-chain price pressures appeared to have eased a little, but producer output price inflation was still around 2%. There was continuing uncertainty about the path of import prices and whether the previous trend of declining prices would continue, or whether import prices would now start to rise.

32 Consumer price inflation had picked up a little more rapidly than expected in the November *Inflation Report*. Recent outturns had illustrated that, over short periods, CPI inflation could be volatile. Apart from the likelihood of a slightly higher short-term profile for CPI inflation, the November *Inflation Report* central projection of a pickup in inflation through 2005, reflecting the pressure of demand on supply and higher input and energy costs, still looked reasonable. Inflation had then been expected to rise more slowly, reaching the 2% target after two years and remaining slightly above this level thereafter. There would be an opportunity to reassess the projections in the process of preparing the February *Inflation Report*. In the absence of significant news, members concluded that no change in the repo rate was appropriate this month.

33 The Governor invited members to vote on the proposition that the repo rate should be maintained at 4.75%. The Committee voted unanimously in favour of the proposition.

34 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.