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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
6 and 7 July 2005**

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2005/mpc0507.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 3 and 4 August will be published on 17 August 2005.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 JULY 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 supply, costs and prices.

Financial markets

2 The Committee reviewed recent movements in short-term and long-term interest rates, exchange rates and equity prices.

3 In the days immediately following the Committee's June meeting, short-term market interest rate expectations – as measured by the December 2005 short sterling contract – had moved higher. But they had then fallen sharply on the release of the June *Minutes*, and again after publication of revisions to the National Accounts. Overall, the December 2005 contract had declined by around 20 basis points since the Committee's previous meeting, and around 50 basis points since the May *Inflation Report*. A poll of market economists conducted by Reuters on 5 July found that only three out of 43 respondents were expecting a reduction in the official repo rate at the July Committee meeting.

4 Long-term government bond rates were little changed on the month, but remained around 30 basis points lower than at the time of the May *Inflation Report*. In previous meetings, the Committee had considered the possible explanations for the unusually low level of long rates. There was little to add to that discussion this month.

5 The sterling effective exchange rate index (ERI) had been broadly stable on the month until the release of the National Accounts, but had subsequently weakened. Compared with both the Committee's June meeting and the May *Inflation Report*, the ERI was around 2% lower. Part of the fall in the sterling ERI may have reflected the change in interest rate expectations.

6 On the month, the main equity price indices had moved higher in both the United Kingdom and the euro area, and had remained little changed in the United States. In the United Kingdom, the FTSE All-Share index was around 6% higher than at the time of the May *Inflation Report*. It was likely that equity prices had been supported by the low levels of real long-term interest rates.

The international economy

7 On balance, there had been relatively little news over the month on economic prospects in the euro area, the United States or Asia. However, there had been a further rise in both the spot and futures oil prices.

8 In the euro area, industrial production had risen in April and the June Purchasing Managers' Index (PMI) for manufacturing suggested that the pace of industrial contraction had eased slightly. Retail sales had bounced back in May from their sharp fall a month earlier. But industrial and consumer confidence were still subdued, while the June PMI for services had edged lower. Overall, GDP growth seemed likely to have been below trend in Q2. There remained significant differences in economic performance among the member countries of the euro area.

9 In the United States, the picture was one of continued strength, with the estimate of Q1 GDP revised upwards, industrial production rising during May and marked increases in the June Institute for Supply Management (ISM) indices for the manufacturing and non-manufacturing sectors. There had been further rises in US house prices. For some time, it had been difficult to understand why US consumer confidence had been subdued given the relatively brisk pace of US economic activity. The recent increase in the US Conference Board's consumer confidence index appeared to have resolved that puzzle, at least in part.

10 In Japan, GDP growth was expected to slow in Q2 from the erratically strong outturn for Q1. Nevertheless, the recovery appeared intact, and the strong Tankan survey for June was encouraging. China continued to experience robust economic growth.

11 The Committee noted that the purchasing managers' manufacturing surveys had edged higher in most of the major industrial economies, and that some of those surveys had posted sharp rises. That

suggested that the recent weakness in industrial production had come to an end, though it was too early to be certain.

12 The main international news on the month related to the price of oil. The spot price of Brent crude oil had risen by over 10% on the month in dollar terms. The futures curve had also risen further, with the oil price out to 2008 trading at almost \$60 a barrel. That compared with a figure of around \$40 as recently as February, and a little under \$50 at the time of the May *Inflation Report*.

13 The Committee discussed possible reasons for the continued rise in the oil price. On the demand side, it appeared that market participants had consistently underestimated the oil intensity of demand from industrialising countries such as China and India. On the supply side, it would take time for new capacity to come on stream. It was probable that the oil price would persist at a higher level than had seemed likely earlier in the year.

14 It was difficult to quantify the likely impact of the continued increase in the oil price on global demand growth. Standard statistical models suggested that the rise in the oil price was likely to have only a moderate dampening effect on GDP in the industrial countries. But the findings of those models, which were based on past average movements in oil prices, needed to be interpreted with care. The models were unlikely to capture fully the potential downside effects on growth of the unusually large cumulative oil price rise. Equally, there could be offsetting upside effects on global demand from the oil-producing countries, whose economies were more developed than during previous episodes of high oil prices. It could be that those countries were more likely than in the past to spend their oil receipts in the near term rather than to save them. Overall, the net downside effect of the sharp rise in the oil price on global growth could be smaller than in previous decades. Dearer oil nevertheless posed a medium-term downside risk for GDP growth and an upside risk for inflation in the industrial countries.

Money, credit, demand and output

15 Broad money growth had increased to an annual rate of nearly 12% in May, the highest since the end of 1997. In particular, there had been a marked rise in the broad money holdings of institutional investors in recent quarters. To the extent that this reflected portfolio shifts in favour of more liquid

assets, the inflationary implications could be limited. However, the Committee noted that the worldwide strength of asset prices was consistent with the strong rate of global money growth.

16 Broad money growth had remained significantly faster than growth in nominal GDP. Nominal GDP growth had fallen sharply from more than 5% in 2004 to an annualised rate of around 2% in 2005 Q1.

17 The main news on GDP this month had been in the release of the National Accounts, which had significantly revised both the estimated profile and the apparent composition of growth in recent years. There was little sign of the rebalancing of different categories of spending suggested by earlier vintages of National Accounts data. There was also a large discrepancy between the output and expenditure estimates of GDP in 2004 Q4 and 2005 Q1.

18 In the latest data, there had been upward revisions to the level of output dating back several years. The data also suggested that growth in both GDP and private sector output had been stronger than initially thought in 2003 and the first half of 2004, but that the subsequent slowdown had been sharper than first estimated.

19 The implications of those data for the likely pressures of demand on supply were not clear-cut, and would be investigated more fully during the August *Inflation Report* round. Even though there had been revisions to the level of output dating back some years, there had been no revisions to inflation, which had been relatively well contained. On one reading, this could imply that potential supply was greater than previously thought by the Committee. On another, other factors – for example, a compression of profit margins – could have had a greater restraining effect on retail price inflation than had earlier appeared to have been the case. The Committee noted that both business surveys and reports from the Bank's regional Agents had continued to imply that capacity utilisation was currently at – or slightly above – normal levels, although there had been an easing in recruitment difficulties.

20 The fact that it now looked as though private sector output and GDP were growing particularly rapidly in 2003 and the first half of 2004 raised further questions about the pressures of demand on supply. So it was possible that the revisions helped to explain the pickup in CPI inflation that had been apparent from the autumn of 2004. The revisions also implied a sharper slowing in demand and output

growth than previously thought. On the output side of the accounts, those downward revisions were concentrated in the service sector, notably transport & communications and business services & finance. That had left the latest official estimate of service sector growth below that implied by business surveys. A significant degree of uncertainty surrounded both the official estimate – early official estimates were frequently revised – and the survey-based indicators. Moreover, some of the surveys – in particular, the Chartered Institute of Purchasing and Supply (CIPS) services survey – did not cover the distribution sector, which had been particularly weak in recent months.

21 The National Accounts data also contained sizeable revisions to the expenditure and income measures of GDP. The Committee's discussions focused on the news for consumption and investment.

22 Estimated consumer spending during the first half of 2004 had been revised substantially upwards. The Committee noted that the rapid growth in household spending during this period had coincided with a marked increase in house price inflation, though the pass-through mechanism from house prices to consumption was by no means clear. There had been a downward revision of consumption growth in 2004 Q3 followed by a significant upward revision in 2004 Q4. Consumer spending growth in 2005 Q1 had been revised downwards. Given the magnitude of the revisions to consumption growth, there was a degree of uncertainty surrounding the 2005 Q1 estimate. In the past, weak early estimates of consumption growth had tended to be revised upwards.

23 There had been sizeable downward revisions to the household saving ratio in 2004. In large part, that reflected upward revisions to consumption, but there had also been downward revisions to income. The saving ratio was now estimated to have reached a low of 3.8% in 2004 Q2. According to the latest data, the saving ratio had jumped nearly a full percentage point between 2004 Q4 and 2005 Q1. On one reading, the lower level of the saving ratio could imply a downside risk to the outlook for consumer spending. But the saving ratio was volatile and prone to large revisions, so had to be interpreted with care.

24 Business investment had been revised substantially downwards during 2004, according to the official statistics, and that subdued picture was estimated to have continued into 2005. In the past, the Committee had discussed the apparent contradiction between the weakness of official statistics on business investment on the one hand, and the strength of surveys of investment intentions and reports

from the Bank's regional Agents on the other. The latest official data had made that contrast greater. But official estimates of business investment were frequently revised, and it was possible that the current business investment profile would ultimately be revised upwards.

25 It was possible that the weakness of investment in the United Kingdom, and other industrial countries, was connected with the apparent trend towards relocation of manufacturing to central Europe and Asia. That could imply a change in the composition of growth in the industrial countries, although it need not imply a change in the overall growth rate of GDP as production switched towards services.

26 The National Accounts data covered the period up to and including 2005 Q1. The Committee also discussed the indicators for 2005 Q2. Overall, the most recent statistics suggested that, if anything, growth had picked up a little. The CIPS services survey for June had remained broadly stable, and was consistent with reasonably strong growth in the services sector during Q2. Manufacturing output had been estimated as flat in May, and the June CIPS survey had pointed to an easing in the rate of manufacturing contraction. But, overall, the manufacturing sector remained weak.

27 The most recent data had also provided tentative signs of a modest pickup in UK consumer spending growth. Retail sales growth had perhaps passed its trough, with the three-month on three-month rate of growth in retail sales volumes moving higher in May. That was consistent with the picture painted by both the British Retail Consortium's June survey and the slightly stronger than expected car registrations data. Growth of consumer spending on services had held up, according to reports from the Bank's regional Agents. The housing market had continued to show signs of stabilisation: for example, the number of loan approvals for house purchase had edged higher in May. Not all the evidence pointed in the same direction, however. For example, the headline monthly retailing balance in the CBI *Distributive Trades Survey* had fallen to its lowest in 22 years.

28 The Committee considered a number of possible scenarios for the outlook for consumer spending. In one scenario, there had been a temporary slowing of household spending, and consumption growth would gently move back towards its long-term average. In another scenario, weak growth in consumer spending was likely to persist for some time, possibly associated with the greater burden of household debt or concerns about pension provisions. In neither scenario was

consumption growth likely to return to the above-average rates recorded in early 2004, at least in the near term.

Supply, costs and prices

29 There had perhaps been a slight weakening in the labour market. The headline employment rate had edged lower in April, according to official statistics. The CIPS aggregate employment index had been broadly stable in June, while reports from the Bank's regional Agents pointed to an easing in recruitment difficulties. Agents' reports continued to suggest that inward migration was playing a role in curbing labour shortages. The Committee noted that the retail sector was relatively labour-intensive, so the slowdown there might lead to a noticeable fall in employment.

30 Most earnings measures were little changed on the month. Settlements had held steady in May, and the rise in the annual change in the seasonally adjusted average earnings index (AEI) during the three months to April had been small. The Committee discussed two new measures released by the Office for National Statistics: a series for average weekly earnings (AWE) and an index of labour costs per hour (ILCH). The non seasonally adjusted AWE and AEI painted similar pictures of annual growth in average regular pay during the three months to April: both measures stood at a little under 4.5%. But the profiles of the two series were slightly different: while the growth rate of the AEI was moving lower, the growth rate of the AWE was rising.

31 News on other cost pressures had been mixed. The annual rate of manufacturers' input and output inflation had eased on the month, broadly consistent with business surveys. Surveys suggested a similar picture for the services sector. But distributors' costs were rising rapidly, partly reflecting previous increases in manufacturing output prices, as well as higher utility costs.

32 In line with pre-release arrangements, an advance estimate of CPI inflation in June had been provided to the Governor ahead of publication. At 2.0%, that estimate was a little higher than expected. In previous meetings, the Committee had considered whether the sharp rise in CPI inflation since September was a one-off adjustment to the higher oil price, or instead reflected the pressures of demand on supply. There had been evidence to support both these hypotheses this month. On the first, recent Bank analysis had implied that the oil price could have played a sizeable role in the recent increases in CPI inflation, through both direct and indirect channels. On the second, the National

Accounts had suggested that the pressures of demand on supply in early 2004 were possibly greater than initially estimated by the Committee. That was also consistent with some of the recent pickup in inflation.

The immediate policy decision

33 Over the past month, short-term interest rates had fallen further, the sterling effective exchange rate had weakened and equity prices had risen. All would be supportive of future economic activity. There had been little notable news on UK-weighted world demand. Both the spot price of oil and the oil futures curve had risen further, posing an upward risk to CPI inflation in the short term and a downside risk to growth, although it was difficult to quantify these risks with any degree of precision. There was no evidence, as yet, of any pickup in either the market-based or survey-based measures of inflation expectations.

34 The National Accounts data had contained sizeable revisions. There was a substantial amount of news on the output, expenditure and income measures of GDP. An initial assessment had suggested a number of questions. It was far from clear yet what the data implied for the outlook for growth and inflation. The forthcoming August *Inflation Report* would provide an opportunity to study those questions in greater depth.

35 Indicators for Q2 suggested that the momentum of economic activity was unlikely to soften further in the near term for example, the CIPS services survey had remained relatively strong, while the CIPS manufacturing survey had edged higher in June. There had been little news from the labour market, and the implications of the new measures of earnings growth were not yet clear. Other cost indices were mixed. CPI inflation had remained broadly stable at around the target, although recent outturns had surprised slightly on the upside.

36 For some members, the evidence warranted no change in official interest rates this month. There were a variety of arguments. The recent increases in asset prices were likely to add to inflationary pressures, and the significant decline in short-term interest rates since the May *Inflation Report* should help to support investment and consumer spending. More generally, it was unclear how deep and persistent the consumer slowdown would prove to be. There was no indication that economic growth was set to weaken materially in the near term, either in the United Kingdom or in its major trading

partners. Although the rise in the oil price could prove a drag on growth in the medium term, it was also likely to exert upwards pressure on the CPI inflation rate.

37 The National Accounts had provided considerable economic news, and asset prices had risen further. It was unclear how the news on asset prices and data revisions would affect the inflation forecast, and the August *Inflation Report* would provide an opportunity to assess these issues in greater depth. There was a danger that a reduction in rates immediately after the publication of the National Accounts data could be misinterpreted as an attempt to target output, whereas the Committee's remit was to target inflation. Overall, with economic growth stabilising, there appeared to be no great risk in waiting for more evidence and analysis before deciding whether to change the official rate.

38 For other members, the evidence warranted an immediate reduction of 25 basis points. The National Accounts suggested that output growth had slowed more sharply in the recent past than first estimated, now suggesting that growth had been a little below trend for three quarters. That implied a softer outlook going forward. High levels of household debt had increased the risk that the consumer slowdown could be protracted, and the downward revision to the estimated saving ratio suggested that the downside risks for household spending were perhaps greater than previously thought. Although the change in market interest rate expectations could prove supportive of household spending, it would be necessary to validate those expectations to some degree if that support were to be maintained. The recovery of business investment seemed more likely to disappoint. The labour market appeared to be softening slightly and survey-based measures of cost and price pressures had eased in recent months. Nominal GDP growth had slowed. To one member, this suggested that monetary policy was no longer accommodative. Although the further rise in the oil price would tend to push up on CPI inflation in the short term, it would also drag down global growth. Overall, the risks that inflation would be below target in the medium term appeared to have risen. Early action would reduce the risk that greater changes in the policy rate would be needed at some point in the future.

39 Towards the end of the policy meeting, the Committee was informed that there had been a series of explosions in central London. No reliable information on their extent was available at that time. The decision on interest rates was reached solely on the economic merits, and no Committee member argued that it should be altered to reflect unfolding events.

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

41 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.