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MINUTES OF MONETARY POLICY COMMITTEE MEETING

8 and 9 June 2005

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 June 2005.

They are also available on the Internet (http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2005/mpc0506.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 6 and 7 July will be published on 20 July 2005.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 JUNE 2005

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

Financial markets

2 Over the past month, market interest rates had fallen at all maturities, equity prices had risen and there had been little movement in sterling's effective exchange rate index.

3 Short-term market interest rate expectations, as measured by the December 2005 short sterling contract, had fallen in the United Kingdom by around 30 basis points since the previous meeting. The fall over the past month in the United Kingdom had been larger than in the United States and in the euro area. The decline in UK short-term market interest rate expectations since earlier in the year was even more substantial. The markets now appeared to be pricing in a reduction in the official repo rate in the second half of the year – although no change in interest rates was expected at this meeting. The magnitude of the fall in short-term market interest rates in the United Kingdom seemed a little surprising in the light of the mixed data. The weaker view on UK interest rates that had been priced into the short end of the yield curve was not shared by all commentators. All 45 of the economists surveyed by Reuters had expected no change in official interest rates this month, and their mean expectation for the end of 2005, though down on the month, implied no change in the repo rate. There had been some increase in measures of uncertainty – as measured by implied volatility on short sterling options contracts – but this increase had not been particularly large by recent historical standards.

4 Longer-term risk-free forward interest rates had also fallen, by around 10-20 basis points in Europe and around 50 basis points in the United States, more than unwinding the rise in yields that had occurred earlier in February and March. The decline was accounted for by falls in both inflation expectations and real interest rates. Some commentators had been placing more weight on the

flattening of the yield curve as an indicator of a near-term slowdown in global economic growth, but it was hard to see why that could account for a fall in ten-year forward rates. As the Committee had discussed at previous meetings, there were a variety of possible explanations for the fall in long-term forward rates over the past year, none of which was entirely compelling. There had been no new evidence this month regarding those explanations. There remained a risk that long-term interest rates might rise again quite sharply.

5 Sovereign bond spreads between some euro countries, for example Germany and Italy, had widened a little following the recent referenda in France and the Netherlands on the European Union Constitutional Treaty. Despite some volatility in recent weeks, there had been a rise in credit spreads on investment and high-yield bonds since January in the United States, the euro area and the United Kingdom. But credit spreads remained lower than they were a year earlier. There had been no significant changes in emerging market bond spreads over the past month.

6 Domestic and foreign equity prices had risen since the previous meeting. While that might seem at odds with the mixed economic news, it could in part reflect the decline in real interest rates noted above. There had been some rebound in the share prices of United Kingdom retailers, broadly in line with other sectors.

7 The sterling effective exchange rate index (ERI) had moved little since the previous meeting. The ERI had depreciated in the first part of the month – broadly in line with movements in domestic and foreign interest rates – but had appreciated against the euro in the later part of the month following the referenda. Once again, sterling had been in the middle of fairly large movements in the dollar against the euro; the dollar had appreciated by over 4% against the euro in the past month.

The international economy

8 The Q1 GDP data in both the euro area and Japan seemingly painted a strong picture this month. But the detail lying beneath these headline figures was rather less encouraging.

9 Growth in the euro area in 2005 Q1, at 0.5%, was stronger than had been expected at the time of the May *Inflation Report*, and was close to trend. But because of difficulties in adjusting for the number of working days in Germany around the turn of the year, the underlying picture there had been

somewhat weaker. Adjusting for this, euro-area growth had probably been broadly similar in each of the past three quarters, and below trend. Euro-area domestic demand was recorded as being flat in 2005 Q1, meaning that the increase in GDP had been accounted for by net trade. That in turn reflected weaker imports rather than stronger export demand. There had also been some expectation of a recovery in investment through this year, but that had so far failed to materialise; investment had fallen 0.7% in Q1. Within aggregate euro-area GDP, there were signs of weakening in some countries such as France and GDP had now fallen for two successive quarters in Italy.

10 The more recent euro-area indicators were also mostly discouraging. Retail sales had fallen in April, and both consumer and industrial confidence had fallen in May. The manufacturing Purchasing Managers' Index (PMI) had fallen further below the neutral 50 mark in May, though the services PMI index had been a little stronger than expected. Taken together, the latest indicators pointed to weaker GDP growth in Q2 than expected at the time of the May *Inflation Report*.

11 Within the euro area, there had been a gradual shift in competitiveness over the past few years, with Germany gaining competitiveness against countries such as Italy, Spain and Greece. There was a possibility of stronger GDP growth in Germany – and weaker growth in the other countries – over the coming years as this worked its way through to exports and production.

12 Japanese GDP growth of 1.3% in Q1 was more robust than had been expected, but seemed likely to have been erratically strong. More generally, there were signs of growth slowing elsewhere in Asia, broadly in line with expectations.

13 Estimated growth in Q1 was revised up slightly to 0.9% in the United States. The previous estimates had shown a large contribution from inventories, but this had been revised down, as had the strength of imports. Growth had now been in the 0.8% – 1.1% range in all but one of the past eight quarters. The slightly weaker Institute of Supply Management (ISM) manufacturing and non-manufacturing indices suggested, perhaps, a moderate deceleration in GDP in Q2, but that was consistent with what had been expected at the time of the May *Inflation Report*. With consumption still looking robust, long rates falling and house prices rising, there seemed to be little reason to expect growth to slow sharply in the near term. So it was puzzling why some measures of consumer confidence indicated that US consumers were worrying about job prospects.

14 The US inflation indicators were mixed. Both the US 'core' Consumer Price Index (CPI) and the Federal Open Market Committee's (FOMC's) preferred 'core' personal consumption expenditure deflator inflation measures had eased a little in April, while the headline CPI measure had risen. But there had been a recent acceleration in measured unit labour costs, which had increased by around 4½% in the year to 2005 Q1.

15 The spot price of Brent crude oil had risen back above $50 per barrel, with futures prices, averaged over the curve, about 10% up over the past month, reflecting expectations of dwindling spare supply capacity and strong demand. However, base metal prices, which were also likely to be affected by expectations of world demand growth, had fallen on the month.

Money, credit, demand and output

16 In the United Kingdom, the downward revision in the second estimate of GDP growth in Q1 to 0.5% had been expected, given the weak March industrial production data that was available to the Committee at the time of its previous meeting. Industrial production had bounced back in April, broadly as expected, but the latest manufacturing survey data remained fairly weak. Business services and finance appeared to have been growing strongly, but that was a sector of the economy for which there were few good indicators. The Bank's regional Agents had undertaken a special survey of this sector, which had indicated only moderate slowing in the pace of growth through the rest of this year. The Chartered Institute of Purchasing and Supply (CIPS) services survey also seemed consistent with relatively stable growth. The CBI Grant Thornton survey of consumer and business services painted a weaker picture. Taken together, the indicators did not point to a marked weakening of GDP growth between Q1 and Q2, though the balance of evidence suggested that the outcome might, if anything, be a little softer than expected at the time of the May *Inflation Report*.

17 Turning to the expenditure side of the National Accounts, the quarterly growth rate of final domestic demand had now slowed for five successive quarters, and was 0.3% in Q1. For the first time in around ten years, it had been below 0.6% for the past two quarters.

18 There did not, as yet, seem to be decisive evidence on the extent or breadth of the slowdown in consumer spending. Consumption growth of 0.3% in 2005 Q1 had been only a little weaker than expected at the time of the May *Inflation Report*. The latest retail sales data for April were in line with

the Committee's expectations. The May CBI *Distributive Trades Survey* and the British Retail Consortium survey had both increased slightly, but remained weak. The Bank's regional Agents reported no significant change in retail conditions on the month, but saw some signs of a moderate easing in consumer services. Consumer confidence had edged down. Private car registrations, although volatile and difficult to adjust for the changing seasonal pattern, showed some tentative signs of recovery, but remained weaker than a year earlier. The housing market continued to evolve largely as expected at the time of the *Inflation Report,* with house prices broadly flat and activity indicators mixed. Money and credit data had provided ambiguous signals too. Unsecured lending growth had fallen as effective interest rates on credit cards had risen, in contrast to other market interest rates. Household deposit growth had risen but growth in household Divisia money had eased. Narrow money growth had been slowing. Overall, there seemed to be few signs of further deceleration in consumer spending, but nor were there any signs of a marked bounceback. Some of the data seemed consistent with the possibility that there was an ongoing, but temporary, adjustment to the stock of durables and that faster consumption growth would then resume, while other indicators hinted at a more widespread and protracted slowing in consumer spending.

19 The weakness of imports in Q1 seemed to match neatly with the recent weakness of consumer spending on durables and of business investment, both of which were relatively import-intensive. The monthly trade data for April had suggested a slightly smaller positive contribution from net trade in Q1 than seen in the second GDP release. But more analysis of these data would be required before firm conclusions could be drawn.

20 The May *Inflation Report* projections had been predicated on some rebalancing of growth, with trade and investment contributing more strongly to overall growth than in recent years, and consumption growth making a smaller contribution. But business investment had fallen by 0.1% in Q1, and had been rather weaker than expected. Although past evidence suggested that upward revisions to the investment data were likely, which would be consistent with the business surveys and the evidence from the Bank's Agents, there was a risk that investment would turn out to be weaker than expected at the time of the *Inflation Report*. More generally, the latest evidence from the manufacturing sector on production and orders did not sit easily with a rebalancing of expenditure growth towards exports and investment.

21 There were mixed signals from some other economic indicators. Real broad money – as measured using M4 divided by the GDP deflator – had been growing at its fastest rate for some years. That raised questions about the extent of the weakness in domestic demand. Excluding other financial companies, however, broad money growth had eased since the middle of last year and nominal GDP growth had been decreasing steadily since the first half of 2004.

The labour market, costs and prices

22 There had been a small rise in pay settlements in the year to April to 3½%. But the outturn for regular pay drift – the difference between regular pay growth and settlements – had been unexpectedly weak in March. It was possible that the rise in settlements reflected the earlier rise in RPI inflation and/or the increases in the National Minimum Wage, as previously suggested by the contacts of the Bank's regional Agents. The evidence on whether pay drift tended to lead settlements or vice versa was not conclusive, though, on balance, it probably pointed to pay drift leading settlements. If so, the fall in pay drift, and regular earnings growth, was the more significant of the two pieces of news and would be consistent with a slight easing of labour market conditions.

23 There had been no significant news on employment, unemployment or inactivity this month, nor on average weekly hours. The CIPS surveys were weaker on the month, which was consistent with a slowdown in employment growth. There seemed to be further evidence, from the Recruitment and Employment Confederation survey, that availability of staff was decreasing less rapidly, while the Bank's regional Agents continued to report signs of diminishing difficulties in recruitment.

24 Import prices had risen in the year to 2005 Q1, and had been moving broadly as expected at the time of the May *Inflation Report*. That rise was partly accounted for by the direct effect of higher oil prices. But there were further signs of other components – such as the price of imported finished goods – falling at a much decreased annual rate. Short-run measures of producer price output inflation excluding petroleum products had fallen in April. The CIPS input and output price balances for both manufacturing and service sectors had fallen in May. A little further along the supply chain, distributors' weighted costs appeared to be accelerating in Q1 – reflecting the earlier movements in manufacturers' and utility prices. It remained unclear how much of the first-round effects of past oil price rises was still to work through the supply chain.

25 CPI inflation in April had turned out lower than expected. In line with pre-release arrangements, an advance estimate of CPI inflation in May had been provided to the Governor ahead of publication. This suggested that inflation in May was a little higher than expected. The month-to-month movements continued to reflect, in part, fluctuations in food and transport services prices. But these small monthly fluctuations did not appear to contain any significant news for the medium-term outlook.

The immediate policy decision

26 The news on UK-weighted world demand had been slightly on the downside over the past month – with prospects for the euro area looking a little weaker than expected at the time of the *Inflation Report*, although growth in the United States remained stable. In the United Kingdom, GDP growth in 2005 Q1 had been revised down, broadly as expected at the previous meeting following the weak March industrial production data. The latest indicators, particularly CIPS services, pointed to output growth continuing to be close to trend in Q2. A succession of weaker surveys suggested that, on balance, the risks to the near-term *Inflation Report* output projection were perhaps slightly more to the downside. But those surveys tended to be drawn largely from manufacturing. There were fewer indicators on the stronger, and much larger, service sectors – where analysis continued to be heavily reliant on the CIPS services survey. In terms of expenditure, the latest data and surveys had also highlighted the risk that investment and export growth, taken together, might not fill the gap left by slower consumption growth. But more evidence was needed on the volatile investment and trade components of GDP, and the Quarterly National Accounts and annual Blue Book data were due to be published shortly.

27 There was little news on labour market quantities, and what news there was hinted at a slight easing of labour market conditions. Regular pay growth had slowed. Import prices in Q1 had risen broadly as expected. There were some signs of an easing in the rate of increase in input and output prices in both the official data and surveys. Earlier increases in prices were moving further along the supply chain into the distribution sector. Consumer price inflation remained close to target and there had been no significant news in the April and May outturns.

28 For most members, the evidence warranted no change in official interest rates this month. There were a variety of arguments, on which different members placed different weights. For those

members, although recent indicators pointed to slightly weaker growth in the near term, the outlook for inflation had not changed sufficiently since the May *Inflation Report* to justify a change in interest rates. The two most important risks identified in the May *Report* had concerned the outlook for consumption and the reasons for the rise in CPI inflation. Both of these risks remained unresolved. Although there was no new information on the latter, on the former there were signs that household spending growth might have stabilised, albeit at a low rate. The indicators did not provide conclusive evidence of whether the slowdown in consumption was a temporary adjustment, concentrated primarily in durables and semi-durables spending, or whether this was the beginning of a wider slowdown in private sector spending. So there was not enough evidence to decide between the competing hypotheses discussed at the previous meeting, nor to move away from the central projection made at the time of the *Inflation Report*.

29 There had been a fall in market interest rate expectations over the past month. That amounted to a loosening of monetary conditions and would consequently tend to support activity. But there was time to gather further evidence on the depth and extent of the slowdown in consumption to see if lower interest rates were warranted. A reduction in interest rates at this juncture would be a significant surprise, and would run the risk of the inference being drawn that the Committee believed that the situation had deteriorated more than it, in fact, thought. And if the latest consumption indicators, in fact, presaged a return to stronger domestic demand growth, a reduction in rates now might accelerate the recovery in consumption growth and lead to inflationary pressures.

30 For some other members, the evidence over the past month was enough to warrant a reduction in interest rates of 25 basis points this month. The further weakness in the euro area pointed to weaker UK-weighted world demand. Domestically, the composition of GDP growth in Q1, together with the latest monthly indicators, a slowdown in unsecured lending and tighter credit conditions, amounted to some downside news to the outlook for activity. Nominal GDP growth had been slowing, while the labour market had shown signs of easing. This, and the recent slowing of producer price inflation, suggested that demand pressures were less than previously thought. As a result, it now seemed more likely that much of the recent increase in inflation had reflected higher oil and other commodity prices passing through the supply chain, rather than the pressure of excess demand on supply capacity. Although output growth had so far been fairly resilient in the face of weaker consumption, GDP growth was likely to be weaker than in the May *Inflation Report* central projection, notwithstanding the shift in market interest rates. Inflation might therefore be below target in the medium term. While

there were arguments in favour of waiting for more information before taking action, that risked the slowdown in consumption becoming more entrenched. A small reduction in rates now might obviate the need for a larger reduction in interest rates at a later date.

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

32 Finally, the Governor expressed his appreciation to Marian Bell for her contribution as a member of the Committee.

33 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.