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MINUTES OF MONETARY POLICY COMMITTEE MEETING

9 and 10 March 2005

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 March 2005.

They are also available on the Internet
(<http://www.bankofengland.co.uk/mpc/mpc0503.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 April will be published on 20 April 2005.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 MARCH 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 the labour market, costs and prices.

Financial markets

2 The main development in financial markets over the month had been the significant rise in short and long-term market interest rates. Sterling short-term interest rates had increased in response to comments by Committee members and the publication of the Minutes of the Committee's February meeting. Although none of the economists surveyed by Reuters had predicted a change in rates at this meeting – the mean probability attached to 'no change' was 75% – expectations of an increase in the Bank's repo rate by the middle of the year had risen. The rise in sterling market interest rates was beginning to feed through into increases in some fixed-rate mortgage rates. US dollar short-term interest rates had also increased, in reaction to stronger-than-expected US economic data, but equivalent euro rates were little changed.

3 Long-term nominal forward interest rates had risen internationally, at times abruptly, apparently triggered by remarks by Federal Reserve Chairman Greenspan. Part of the fall in long-term forward real interest rates over the previous few months had been reversed, although these rates remained at historically low levels. Sterling and US dollar inflation expectations, derived from yields on inflation-linked bonds, had also ticked upwards.

4 Despite higher real interest rates, the FTSE All-Share equity index was broadly unchanged over the month and the major overseas equity indices had risen in local currency terms. Spreads between yields on corporate and emerging-market bonds and on risk-free bonds had continued to narrow and implied volatilities from options prices in many financial markets remained low. Borrowers were continuing to obtain finance on favourable terms and the apparent abundance of liquidity globally would add some stimulus to world demand in the near term.

5 The sterling effective exchange rate index was unchanged since the Committee's February meeting and in line with the February *Inflation Report* number. Sterling had depreciated a little against the euro. But it had risen against the US dollar, which had resumed its fall against other major currencies, despite the stronger-than-expected US data over the month.

The international economy

6 The main news on the month had been a sharp rise in oil prices and signs that growth in the euro area would be somewhat weaker than envisaged at the time of the February *Inflation Report*, at least in the near term.

7 Oil prices had risen by more than 20% since the Committee's February meeting, in both dollar and sterling terms. Non-oil commodities prices had also increased. Significantly, the oil futures curve had shifted upwards, with the oil price expected to be over US\$40 per barrel over the next three years, well above the level assumed at the time of the February *Inflation Report*. Although unusually cold weather in Europe and North America had influenced the rise in spot oil prices, lower expectations of future oil supply appeared to have been an important factor behind higher futures prices, suggesting that oil prices might remain at higher levels than thought previously. Higher oil prices would raise the level of producer input and petrol prices, although the relatively high rates of fuel duty in the United Kingdom would limit the impact on UK CPI inflation. If sustained at the current levels, higher oil prices would also slow global growth a little in the medium term.

8 According to the first estimate, euro-area GDP had grown by only 0.2% in 2004 Q4. Final domestic demand growth had picked up only patchily, with strong consumption growth in France and Spain but more subdued spending elsewhere. Net trade had made a negative contribution to growth, perhaps reflecting the appreciation of the euro. Investment had increased for the third quarter in succession, underpinned by rising profits and a low cost of capital. Business surveys suggested that the weakness in output growth might be continuing in 2005 Q1, although rising capital goods imports in 2004 Q4 might have indicated continued investment expansion. Euro-area HICP inflation had fallen to 1.9% in January.

9 The prospects for euro-area growth over the rest of 2005 depended in large part on growth in consumer spending, which had been particularly weak in Germany. Consumption growth seemed

unlikely to pick up without more rapid growth in real labour income. There was a risk that continued weak consumption growth might in turn discourage investment, which might also be vulnerable to any further appreciation of the euro against the US dollar. However, falling unit labour costs had improved the price competitiveness of German firms, which should further improve profits, encourage investment and, in time, lead to higher income and consumption growth in Germany.

10 In the United States, estimated GDP growth in 2004 Q4 had, as expected, been revised upwards to 0.9%. Business surveys were consistent with continuing robust growth in 2005 Q1, in line with the February *Inflation Report* projections. Employment growth – non-farm payrolls had risen by 262,000 in February – strong consumer confidence and rising house prices would continue to underpin consumption growth. Core US CPI inflation had continued to rise slowly, reaching 2.3% in January, the highest level since August 2002. The Federal Reserve’s most recent *Beige Book* had noted that some manufacturers had reported increased pricing power.

11 The first release suggested that Japanese GDP growth had been marginally negative for the third consecutive quarter in 2004 Q4, with weakness in net trade and private consumption growth. Export growth had apparently been affected by slowing in the global IT industry. Rising machinery orders in 2004 Q4, however, might signal an investment-led return to positive growth in 2005. There had not been much news about growth in the rest of Asia, which seemed to have remained buoyant.

Money, credit, demand and output

12 Growth in the monetary aggregates had remained rapid in January, although the rates had been decreasing a little in recent months. Secured lending growth had also eased but unsecured lending growth remained stable and strong. It was possible that a fall in the relative cost of unsecured compared with secured debt had encouraged some switching between the two, including by property owners – for example, some lenders were prepared to take account of collateral in assessing creditworthiness without actually taking security over it. Nonetheless, continuing rapid unsecured debt growth was likely to increase the vulnerability of some consumers to future shocks.

13 The ONS estimate of growth in UK GDP in 2004 Q4 had been unrevised at 0.7%, which was in line with the Committee’s expectations at the time of the February *Inflation Report*. Services output growth had been revised downwards but had remained strong. Estimated manufacturing output growth

had been revised upwards for 2004 Q3 and Q4 and was subsequently raised again in the January Index of Production release. This had brought the ONS estimates closer to the Committee's assessment of the likely pace of manufacturing output growth in the second half of 2004, though recent business surveys had suggested still stronger growth.

14 Estimated growth in private consumption had dipped to 0.4% in 2004 Q4, but this had been expected following the weak retail sales data and other indicators of household spending. Investment had been stronger than in the previous quarter. Over 2004 as a whole, there had been some rebalancing of growth in private sector demand from consumption to investment, with annual growth in investment exceeding consumption for the first time since 1998. Nonetheless, the recent rate of expansion in business investment continued to look moderate compared with previous periods of investment recovery and given the low cost of finance and ample corporate liquidity. Companies had also been making net returns of cash to investors.

15 Output appeared to be continuing to expand at around trend in 2005 Q1. The Chartered Institute of Purchasing and Supply (CIPS) services business activity index had fallen slightly in February but remained consistent with steady growth. Reports from the Bank's regional Agents had pointed to robust growth in business services but more modest growth in manufacturing. The ONS had estimated growth in manufacturing output of 0.2% in January but lower energy sector output had left overall industrial production slightly down over the month. Despite falling in January, export volumes had been growing at just over 2% on a three-month-on-three-month basis. A survey by the Bank's Agents had suggested that UK companies expected exports to grow more rapidly over the next six months than the previous six months, particularly to the United States and euro area.

16 It remained hard to gauge the momentum in consumption growth, with only a limited amount of new evidence coming to light since the Committee's February meeting. Retail sales had risen in January following the fall in December. But the rebound had been modest and sales in the three months to the end of January were unchanged on the previous three months. The February British Retail Consortium *Retail Sales Monitor* and CBI *Distributive Trades Survey* were consistent with moderate retail sales growth in February. The Bank's Agents had, however, reported some further slowing, with contacts expecting retail sales values to be broadly flat. Total car registrations had fallen further in February and private registrations had remained particularly weak. A large proportion of new car registrations annually occurred in March and some manufacturers were reportedly discounting

in an attempt to boost sales. Overall consumer spending had grown more rapidly than retail sales in 2004 Q4 and the Bank's Agents had reported that non-retail consumer spending growth – in hotels and restaurants, for example – had remained firm.

17 The slowdown in consumer spending growth might prove temporary. For example, retail sales in February might have been affected by the cold weather. Household spending should be underpinned by recent steady growth in earnings and rising employment and equity prices. Some pickup in consumption growth in the first quarter still seemed likely. A more persistent slowdown in consumption growth would be likely to imply a rise in the household saving rate. Possible explanations for higher saving included a greater-than-expected effect of slowing house price inflation on consumer spending, a concern about the adequacy of savings for retirement or a response to higher official interest rates, which might have had a bigger impact than expected on highly indebted households in particular. But there was little clear evidence to support any of these hypotheses at this stage.

18 There was some evidence that the housing market was stabilising. An average of the lenders' indices was unchanged in February and house prices appeared to have remained more or less flat for the past few months. Indicators of activity in the housing market were mixed. On the one hand, the Royal Institution of Chartered Surveyors survey had shown that new buyer enquiries had stopped declining. On the other hand, the ratio of estate agents' sales to stocks and mortgage loan approvals had both fallen.

The labour market, costs and prices

19 Employment had risen by 90,000 in 2004 Q4 on the Labour Force Survey (LFS) measure, slightly faster than the growth in the adult population, leading to a small rise in the employment rate. Average weekly hours worked had also risen. But the various surveys had provided a mixed picture of the demand for labour. The overall balance for employment in the CIPS survey had fallen to just below the 50 'no change' level in February but the earlier British Chambers of Commerce measures of employment intentions in services and, to a lesser degree, manufacturing had remained strong. The Bank's Agents had reported subdued but stable private sector employment growth, mainly in business services.

20 There was little news on pay. The Bank had received information on only around 15% of the January wage settlements about which it would expect to receive reports. Based on this small sample, there was no evidence yet of an increase in settlements, but it was too soon to draw firm conclusions. Regular pay and overall average earnings growth had picked up in the three months to December compared with the same period a year earlier, but were flat compared with the previous three months. Bonuses had made a negative contribution. But regular pay drift had continued upwards, which was consistent with reports by the Bank's Agents, particularly in business services.

21 CPI inflation had been unchanged at 1.6% in January. Evidence about pricing pressures along the supply chain was mixed. Manufacturers' annual input price inflation had risen to nearly 10% in January, mainly because of higher oil and other fuel prices, but the CIPS survey had suggested it eased in February. Many of the contacts of the Bank's Agents had suggested that they were currently able to pass these increases in costs to their customers. But manufacturers' annual output price inflation, excluding oil, had stabilised at around 2% over the past few months and the CIPS survey pointed to some easing. Manufacturers' domestic margins appeared to have been widening in the past couple of years, mainly reflecting falling unit labour costs. Measures of capacity utilisation remained high, but had fallen slightly in the business surveys and according to the Bank's Agents. The prices of imported goods, excluding oil and erratics, had risen again in January following the fall in December. These data were not seasonally adjusted and were volatile from month to month but the underlying picture was that import prices had risen over the past three quarters, whereas they had been falling for most of the period from mid-2001 until the beginning of 2004.

22 It was striking that producer price inflation had risen elsewhere too but so far without any significant pass-through into consumer price inflation. In the United States and the United Kingdom, the ratio of consumer price inflation to producer price inflation (excluding food and fuel) had been falling since the late 1990s, although this did not appear to have been the case in the euro area.

The immediate policy decision

23 There had not been a lot of news over the month. In the United Kingdom, GDP seemed likely to continue to grow at broadly its trend rate, in line with the February *Inflation Report* projections. But the news on UK-weighted world demand had been slightly on the downside, with the rise in oil prices

and signs of weaker euro-area growth. And higher sterling market interest rates would tend to reduce activity and lower inflation.

24 For most members, the position had changed little since the Committee's February meeting. The two key risks discussed at the February meeting had neither crystallised nor clearly diminished. Members continued to differ in the weights that they attached to each and in the amount of additional evidence that they would need to justify a rise in interest rates. The first key risk was to household spending in the near term. The pickup in January retail sales and signs that the housing market was stabilising perhaps meant that a sharp decline in household spending was less likely. But the available evidence suggested continuing uncertainty about the momentum in consumption growth. If consumer confidence was fragile, a rise in interest rates could dent it further. The second key risk had concerned how rapidly consumer prices would respond to demand and cost pressures. There was still little evidence of inflationary pressures in the supply chain passing through into wages or consumer prices. Recent subdued pay and price outturns might suggest either that there was not a great deal of excess demand in the economy or that the increased availability of immigrant workers and other changes in the labour market might have dampened the upward pressure on earnings from excess demand. More evidence on the current wage round would help to shed further light on those questions.

25 For these members, the balance of risks to the inflation forecast remained sufficiently to the downside in the near term to justify maintaining the Bank's repo rate at its current level. With inflation expectations remaining well anchored, the Committee could afford to wait for more evidence to become available, though some members continued to think that a rise in interest rates might be warranted in due course if the economy evolved in line with the February *Inflation Report* central projection.

26 For some members, a rise of 25 basis points in the Bank's repo rate was warranted now. It was likely that there was already a degree of excess demand in the economy, which was apparent in indicators of capacity utilisation, producers' pricing power and output price inflation. Although there were doubts about the near-term strength of consumer spending, indicators of output growth remained robust. With the prospect of import prices no longer falling, the pressure of excess demand on domestic supply would most likely feed through into higher CPI inflation, even if improvements in the functioning of the labour market had lowered the rate of unemployment at which these pressures would be felt. Sterling market interest rates had risen over the month, tightening credit conditions

somewhat, but the Committee could not rely on that continuing unless it validated these revised expectations. A modest rise in interest rates now would help to pre-empt inflationary pressures and an increase in interest rates this month would not be a major surprise.

27 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.

28 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.