Publication date: 21 September 2005

MINUTES OF MONETARY POLICY COMMITTEE MEETING

7 and 8 September 2005

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 September 2005.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2005/mpc0509.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 5 and 6 October will be published on 19 October 2005.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 SEPTEMBER 2005

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

Financial markets

2 The Committee's August decision to reduce the Bank of England's interest rate by 0.25 percentage points had been fully anticipated by market participants and consequently had had very little impact on financial markets. However, immediately following the release of both the August *Inflation Report* and the *Minutes* of the Committee's August meeting, UK short-term market interest rates had increased and sterling had appreciated. These developments appeared to be a reaction to the published forecasts for growth and inflation contained in the *Report*, which had been stronger than market participants had anticipated, as well as the closeness of the Committee's vote.

3 These immediate financial market movements had been broadly in line with what the Committee had anticipated. Nevertheless, over the month as a whole, short-term market interest rates had declined, while sterling had appreciated and equity prices had increased a little. Taken together, these developments were more difficult to explain.

4 The fall in short-term interest rates could have reflected a reaction by market participants to domestic activity data releases, which may have been perceived to point to continued below trend growth.

5 Despite the fall in short-term interest rates, the sterling effective exchange rate index (ERI) had appreciated by 2.5% since the Committee's August meeting. Even after taking into account a fall in US short-term interest rates, sterling's appreciation could not be explained by movements in relative interest rates. Long-term sterling real interest rates had fallen by around 20 basis points. The FTSE All-Share index had increased by 0.9%.

Oil

6 The US dollar price of Brent crude oil had increased by around 5% since the Committee's previous meeting, leaving it roughly twice its level at the beginning of 2004. In addition, natural gas and petroleum prices had increased sharply in the United States. As the Committee had discussed on previous occasions, most of the price rise over the previous 18 months appeared to have reflected the combined effects of strong growth in the global demand for oil (particularly in the US and China) and limited spare global production capacity. These effects had been augmented in the past month by the supply shock emanating from the damage caused by Hurricane Katrina. Over the month as a whole, long-term oil futures prices had increased by much less than the observed rise in spot prices, suggesting that market participants viewed the hurricane-induced rise in oil prices as likely to be temporary.

7 In the first week of September, spot prices for crude oil had fallen back, reflecting the decision by member countries of the International Energy Agency to release stocks of oil products and indications by Saudi Arabia that it would be willing to increase its oil production. But wholesale prices for natural gas and petrol had at that stage only fallen back slightly. There remained considerable uncertainty about the time it would take to restore the damaged oil refinery and natural gas facilities.

8 The Committee considered the prospects for future oil demand and supply growth. Strong increases in oil demand over the past three years were likely to have been related both to cyclical and structural factors, with the latter primarily reflecting the rapid expansion of China. The Committee noted that it was difficult to separate out cyclical and structural considerations; as a result, forecasts of demand were very uncertain.

9 Forecasts of future oil supply growth were subject to even greater uncertainty. Estimates of the price elasticity of oil supply in non-OPEC countries varied widely, and the oil sector investment and supply decisions of OPEC countries were influenced by a range of considerations that were not easy to forecast. Given that new investment in oil extraction often took five to seven years to come on stream and that global spare production capacity remained at historically low levels, the Committee judged that oil prices could remain high for some while and might even rise further in the near term.

10 The continued rise in the oil price presented a dilemma for monetary policy. The key question was how to choose an interest rate path that kept inflation expectations well-anchored. The choice of interest rate path depended both on the size and location of real rigidities in the economy and on whether oil prices continued to rise. Regardless of the path chosen for interest rates, the growth rate of the real consumption wage would be somewhat lower than it otherwise would have been.

11 The Committee could choose to accommodate the first-round impact of higher oil prices and allow headline CPI inflation to rise temporarily above the target. If wage settlements did not pick up in line with the increase in CPI inflation, this would reduce the growth of real consumption wages. But this accommodative strategy could prompt an increase in agents' inflation expectations and an associated rise in wage settlements. If this were to occur, the tightening in monetary policy needed to bring inflation back to target might be associated with larger fluctuations in output and employment.

12 Alternatively, monetary policy could respond to the first-round effects of the oil price shock and seek to bring CPI inflation back to target more quickly, thereby limiting any change in agents' inflation expectations. This would imply a tighter monetary policy in order to reduce inflation in the non-oil sector, offsetting the direct effects arising from higher oil prices. This would push down on growth and employment, reducing the growth in real consumption wages through lower wage settlements.

13 In considering these issues, the Committee noted that the various measures of inflation expectations (both from surveys and derived from government bonds) had remained well-anchored in recent years. They also noted that, over the past twelve months, whole-economy average earnings growth had not picked up by as much as the rise in CPI inflation. This was consistent with the gradual easing in the labour market. It might also have partly reflected the fact that RPI inflation – which was more often used as a benchmark in wage bargaining – had fallen back in 2005.

The international economy

14 Over the month, the most significant event affecting the UK's major trading partners had been the damage caused by Hurricane Katrina in the United States. Early estimates of the physical damage ranged up to 0.8% of 2004 US GDP. The preliminary assessment of most private sector economists

was that hurricane-related effects were likely to push down slightly on US GDP growth in the third and fourth quarters of this year and that thereafter the positive effects on growth arising from reconstruction would probably dominate. This assessment appeared consistent with the relatively modest movements in US equity prices during the month and with the experience after previous natural disasters. The Committee noted, however, that there remained uncertainty about the likely economic impact arising from Hurricane Katrina.

15 US data published since the Committee's August meeting related to the period prior to the damage inflicted by Hurricane Katrina. These data generally pointed to continued robust growth, particularly in the non-manufacturing sectors. The personal sector savings rate had turned negative in July, reaching its lowest level since the 1930s. Taking this news together with the strong increases seen in house prices, suggested that the risks of a correction in US consumption might have increased.

16 In the euro area, quarterly GDP growth in the second quarter had been 0.3%; the annual growth rate had slowed to 1.1%. The expenditure decomposition of this growth showed a fall in consumption, weak investment growth, and an increase in stocks. On the available indicators, GDP growth in Q3 was likely to be broadly similar to that seen in Q2. Overall, this news seemed broadly consistent with the outlook for the euro area at the time of the August *Report*.

17 News over the month pointed to continued strong growth by the Asian economies and the Japanese Q2 National Accounts data had highlighted better-than-expected consumption and investment. Overall, UK trade-weighted world import growth appeared to have rebounded in the second quarter, following the erratically weak growth in Q1. Reflecting these developments, the outlook for the United Kingdom's major export markets was broadly in line with the assessment made at the time of the August *Inflation Report*.

Money, credit, demand and output

18 The second release of the Q2 National Accounts had revised up quarterly UK GDP growth by 0.1 percentage point, to 0.5%. This change had reflected an upward revision to the estimate for manufacturing output growth, which the Committee had been aware of at the time of its August meeting. However, the service sector output figures had been left unrevised and continued to look weaker than the service sector surveys.

19 The National Accounts provided the first expenditure breakdown of GDP for the second quarter. Consumption was estimated to have increased by 0.2% in Q2, only marginally stronger than the 0.1% growth recorded in Q1. The continued weak consumption growth in Q2 appeared to have reflected a sharp decline in spending by UK residents on overseas trips. This fall in spending abroad looked unusual relative to the past behaviour of this series and it was possible that it would be revised upwards when more comprehensive data became available, with an offsetting change in net exports.

20 Whole economy investment and exports had both increased sharply in Q2, rising by 2.0% and 4.3% respectively. Here too, however, there were reasons to be cautious in interpreting the data. The investment figures had frequently been heavily revised in the past. And, the pickup in exports had primarily reflected a surge in exports to non-EU countries; this may have reflected seasonal adjustment problems relating to the new trade reporting system, or be a by-product of fraudulent activity. Offsetting the strength of investment and exports in the Q2 National Accounts data, inventories (including the alignment adjustment) were estimated to have subtracted 0.7 percentage points from GDP growth.

21 The available indicators for July and August suggested quarterly GDP growth broadly in line with that seen in Q2. On the output side of the accounts, manufacturing activity had increased by 0.1% in July but energy output had fallen by 1.9%; as a result, industrial production was 0.3% lower than its level in June. The output balance of the CIPS manufacturing survey had increased to 52.0 in August, suggesting a slight strengthening in the growth rate of manufacturing output. In contrast, however, manufacturing orders in the CBI Monthly Trends survey had declined in August. Although the CIPS services business activity balance had fallen back slightly in August, it remained at around its level for the previous twelve months.

22 On the expenditure side, the three-month on three-month growth rate of retail sales had picked up to 0.7%, despite a slight fall in July sales. Housing market indicators suggested some modest improvement, with a stabilisation of prices and a further small increase in the number of loan approvals for house purchase. Car registrations had fallen in the three months to August and the Bank's regional Agents had reported some easing in the growth of demand for consumer services and a subdued outlook for retail sales. Other surveys of consumer spending and confidence painted a mixed picture.

23 The annual growth rates of secured and unsecured lending had remained quite high although both had been slowing. The growth rates of narrow and broad money had picked up in recent months.

The labour market, costs and prices

24 The latest data continued to suggest a gentle softening in labour market conditions. This was, in turn, consistent with below trend output growth over the past few quarters. In Q2, the employment rate had declined slightly and unemployment and inactivity had edged upwards. The available survey evidence, including that from the Bank's regional Agents, had suggested some weakening in employment intentions in Q3.

25 Whole economy average earnings had risen 4.2% in the year to June, a slight decline from the growth rate recorded in Q1. The available evidence relating to wage settlements indicated that agreements struck in July were also slightly lower than those seen in the first half of the year. The Bank's Agents had reported that pay pressures had remained subdued in most sectors, reflecting the softer labour market and the effect of inward migration of workers, particularly from other European countries.

26 The news on prices in the supply chain had largely been on the upside. The rise in oil prices, together with the effects of robust world demand growth in 2004 had contributed to a pickup in import price inflation to 2.7% in Q2, from -1.0% a year earlier. Manufacturing input price inflation had risen to 13.4% in July, largely reflecting the impact of higher oil prices. Although firms were continuing to absorb much of these input price increases, manufacturers' output price inflation (excluding duties) had also increased in July, rising to 3.1%. Excluding petroleum products, however, output price inflation had been more modest, at 1.5% in July. The CIPS survey balances for input and output prices had picked up in August for both manufacturing and service sector firms after several months of easing balances.

27 CPI inflation had increased to 2.3% in July. This was a higher figure than had been expected and was up from 1.1% in September 2004. The inflation rates for both goods and services had increased in July, with the former suggesting that price discounting by retailers may not have been as widespread as previously thought. In line with pre-release arrangements, an advance estimate of CPI

inflation in August had been provided to the Governor ahead of publication. This indicated that CPI inflation had increased further to 2.4%. While it seemed likely that less than half of the pickup in inflation since September 2004 had been related to the direct and indirect effects of higher oil prices, there were a number of uncertainties surrounding such calculations.

The immediate policy decision

28 Committee members were in agreement that the near-term outlook for UK-weighted world demand growth seemed broadly similar to the one at the time of the August *Inflation Report*. While there remained uncertainty about the likely effects of Hurricane Katrina on US GDP growth, past experience suggested that those effects might be relatively small and short-lived. However, higher oil prices continued to pose a downside risk to world demand and an upside risk to world export prices.

29 On the domestic front, the slight upward revision to Q2 GDP left growth slightly below trend for the fourth quarter in a row. Consumption growth had been weaker than expected, but this may have reflected mismeasurement issues relating to the net tourism figures. Acting in the opposite direction, export growth might have been overstated. Overall, Committee members felt it would not be appropriate to attach much weight to the expenditure decomposition at this early stage in the data reporting cycle. Data releases and survey indicators relating to July and August suggested that GDP growth in Q3 was likely to be broadly similar to that in Q2.

30 Committee members were in broad agreement about the nature of the risks to the outlook for inflation. But members attached slightly different weights to the various risks. UK consumption and business investment and euro-area domestic demand had continued weak. If sustained, these developments were likely to push down on UK GDP growth and deliver a lower inflation outturn than the one envisaged in the August *Inflation Report*. Sterling's appreciation would also push down on inflation. However, equity prices had continued to increase, money growth was strong, and activity developments over the previous month could be viewed as having been broadly consistent with the August *Inflation Report.* Inflation outturns had also been higher than anticipated over the past year and reflected more than the impact of higher oil prices. There remained a risk that oil prices would rise further. This posed an upside risk to the inflation projection. But, there were few signs of any second-round effects arising yet from the increase in oil prices. Inflation expectations appeared to be well-anchored, though there was no room for complacency.

31 Give these considerations, the Committee agreed that it was appropriate to leave interest rates unchanged.

32 The Governor invited the Committee to vote on the proposition that the repo rate should be maintained at 4.5%. The Committee voted unanimously in favour of the proposition.

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
Richard Lambert
Stephen Nickell
Paul Tucker
David Walton

Jon Cunliffe was present as the Treasury representative.