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MINUTES OF MONETARY POLICY COMMITTEE MEETING 2 and 3 August 2006

These are the minutes of the Monetary Policy Committee meeting held on 2 and 3 August 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0608.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 September will be published on 20 September 2006.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 2-3 AUGUST 2006

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 There had been relatively little news from financial markets since the July MPC meeting. Short-term market interest rates had fallen in the United Kingdom during the first part of the month, but had risen following the stronger-than-expected CPI data on 18 July to end the period little changed. Market prices implied one rate rise in 2006 and a further rise in 2007. Implied volatility of short-term interest rates had also increased over the month, suggesting heightened uncertainty about the decision to be made at the August meeting. In a poll conducted by Reuters, 7 out of 46 private sector economists had expected an increase in August.

3 Euro-area short-term interest rates were lower on the month by around 10 basis points and in the United States short-term rates had fallen by around 25 basis points. The decline in US rates seemed to reflect the markets' interpretation of public testimony by the Chairman of the Federal Open Markets Committee on July 19, as well as weaker-than-expected data on employment and output. Longer-term nominal and real interest rates had fallen by 10-25 basis points in the United States, the euro area and the United Kingdom.

4 Consistent with developments in interest rate differentials, the sterling effective exchange rate index had risen by nearly 2% on the month, leaving it around 3% above the *May Inflation Report* forecast path. Equity prices in the major economies had initially fallen after the start of hostilities in Lebanon, but had recovered later to be little changed on the month.

5 In a widely anticipated move, the Bank of Japan had brought to an end its long-standing policy of zero short-term interest rates, raising rates to 0.25% on July 14.

The international economy

6 Oil prices had been volatile, primarily reflecting concerns about developments in the Middle East. By the start of the MPC meeting, the price of a barrel of Brent Crude had risen to over \$77 despite rising OPEC production and US oil stocks.

7 In the United States, GDP growth in the second quarter had been estimated at 0.6% following unsustainably strong growth of 1.4% in the first quarter. Some slowdown had been expected in consumption, consistent with a softer housing market, but investment growth had been unexpectedly weak. There had also been substantial revisions to earlier data, leaving the level of real GDP some 0.8% lower than previously estimated, and upward revisions to price deflators. In particular, the inflation rate of the core deflator for personal consumption expenditures (PCE) now looked to have stabilized at over 2.0% during 2005 – rather than drifting lower – and had risen to 2.4% in June 2006. It was likely that productivity data due to be released the following week would show commensurate downward revisions, raising the possibility that the growth rate of potential output in the United States was somewhat less than previously thought.

8 Some of the more recent US activity data had been more positive, with the Purchasing Managers' Index (PMI) for manufacturing increasing to 54.7 in July for example. And despite the weakness in Q2 investment, the financial conditions of corporations remained strong, credit conditions were favourable and capacity utilisation was above average. These were all factors potentially supporting investment growth going forward.

9 In the euro area, business survey evidence suggested that output growth in Q2 was likely to have been faster than in Q1. Some survey data had weakened slightly in July, but the European Commission's industrial confidence survey had reached its highest level since September 2000. In Germany, the IFO index had remained high in July. Consumption indicators for Germany and France had been reasonably positive. Looking forward, the pattern of German demand growth was likely to be distorted by the planned increase in VAT announced for 2007, bringing forward some consumption from 2007 to 2006 and hence acting as a drag on demand growth next year.

10 Output growth in Asia had remained robust, especially in China where the official estimate of GDP growth in the year to Q2 had been in excess of 11%.

11 Price inflation had been rising in many of the major economies. In the United States, in addition to the rise in core PCE inflation, the corresponding headline measure had risen to 3.5% while CPI inflation had reached 4.3% in June. Recent upwards revision to labour compensation and the prospective downwards revision to productivity growth would also imply higher unit labour costs. In the euro area, CPI inflation remained at 2.5% in June, despite some slowdown in energy price inflation. In Japan, the CPI inflation rate had reached 1%, its highest for eight years. There was also growing evidence of upward pressures on major economy import and producer output prices, possibly reflecting a limited capacity for producers to absorb further oil price increases.

12 Overall, the news on the month had been consistent with continued brisk expansion in UK export markets, albeit with some downside risks to the outlook for growth in the United States. There was also some evidence of a small, but generalised, increase in global inflationary pressures.

Money, credit, demand and output

13 Domestic activity data had been broadly positive on the month. The Office for National Statistics' initial estimate of GDP growth in the second quarter had been 0.8%, consistent with the *May Inflation Report* forecast. But within the aggregate growth rate, energy output had been erratically weak, suggesting that underlying output had grown faster than expected. Taken together with earlier revisions, GDP growth over the past three quarters looked to have been consistently at, or slightly above, its long-run average. Given that the level of GDP in 2004 had been revised up by around 1% in the previous month's National Accounts data release, and in the light of survey and other indicators, it was likely that there was less spare capacity in the economy than previously thought; this had been reflected in the *August Inflation Report* forecast.

14 Activity indicators for the third quarter had been consistent with broadly unchanged GDP growth. The CIPS/RBS indices for manufacturing and for services had both eased a little in July but remained close to recent peaks. And the drag on growth from the energy sector was likely to diminish in the third quarter.

15 In contrast to the first quarter, expenditure indicators had also been firm: retail sales had recovered since their post-Christmas dip, growing by 2.1% in the second quarter. This recovery had occurred despite the squeeze on real incomes arising from higher energy prices and taxes, although it was possible that energy prices might not yet have had their full impact. In the August forecast the central projection was for quarterly GDP growth to peak in Q3 and then ease slightly. An easing in

consumer demand compared with the second quarter would be consistent with some of the more recent indicators such as the *CBI Distributive Trades Survey*.

16 The housing market continued to be reasonably firm with the lenders' house price indices showing an average rise of 0.5% in July; a preview of the Royal Institution of Chartered Surveyors' survey had shown an increase in current and expected prices. Loan approvals had also increased. House price-to-earnings ratios remained at historically high levels.

17 There were few new data on investment or trade: business surveys of investment intentions had picked up in recent quarters and growth in the UK's main export markets had remained robust.

18 The M4 measures of broad money and lending growth had both risen in June, with broad money up around 15% on a year earlier. The increase in growth on the month had been mainly accounted for by annual growth in the Other Financial Companies (ie non-banks) component. Monetary data for this sector were subject to idiosyncratic or temporary movements. However, if institutions such as pension funds and insurance companies were building up deposits, that might over time put upward pressure on asset prices, increasing household wealth and potentially pushing up nominal spending.

Costs and prices

19 There had been limited news about the labour market. The employment rate remained broadly unchanged. The Labour Force Survey (LFS) measure of the unemployment rate had edged up further to 5.4% in May, its highest level since 2000, in contrast the claimant count measure had remained at 3.0% in June, unchanged for the fourth consecutive month. The difference between these two measures had been growing through 2006. A broader measure of non-employment that weighted together the unemployed and those people supposedly not seeking or not available for work, according to the likelihood of them finding work, had increased by rather less than the LFS measure. Growth in the working population had increased markedly in recent years, partly reflecting increased inward migration. The participation rate had been increasing gently, but it was possible that this would reverse if job seekers were discouraged by fewer job opportunities. Overall, the degree of slack in the labour market remained uncertain.

20 Pay growth had remained subdued, with the mean twelve-month settlement dipping to 3.1% in June and growth in the whole economy average earnings index picking up slightly to 4.3% in May.

There was little evidence yet of any ‘second-round’ effects of higher energy prices being passed through into higher wages. On the contrary, as reported by the Bank’s regional Agents, firms appeared to have reacted to the squeeze on their profit margins by bearing down on wage (and other) costs. It was also possible that recent downward pressure on wages reflected the more general loosening in labour market conditions during 2005.

21 Price inflation at the start of the supply chain remained high. The sterling price of oil had risen by over 7% in July. The annual rate of manufacturing input price inflation had eased a little to 11% in June while manufacturing output price inflation had picked up to 3.6%. More recent business surveys gave a somewhat mixed picture, with the manufacturing output price balance in the CIPS/RBS survey picking up a little in July, but the service sector balance declining slightly. The Agents’ business contacts had suggested a slightly increased propensity to pass cost increases through.

22 Consumer price inflation had risen to 2.5% in June, with unexpectedly strong rises in the prices of household goods and food: fresh food prices were possibly beginning to reflect the unusually hot summer conditions in Europe. Going forward, it was likely that the recent further rises in energy prices and the impact of increases in university tuition fees at the start of the next academic year would push CPI inflation further above the target in the next few months, although the impact from tuition fees on the CPI remained uncertain.

23 Some surveys of the general public’s near-term inflation expectations had declined in recent months whereas longer-term inflation expectations for the Retail Prices Index, derived from index-linked gilt prices, had edged up again to around 3% at five- and ten-year horizons.

The August GDP growth and inflation projections

24 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 9 August.

25 Conditional on assuming market participants’ expected path for interest rates, the Committee’s central projection was for UK GDP to continue to grow at a rate close to its average over the past decade. Steady growth in consumer spending, a moderate recovery in investment and a small boost from net trade offset slower growth in public expenditure. This profile represented a slightly stronger outlook than that published in the *May Inflation Report*.

26 The Committee's central projection for inflation was also a little higher than in May, rising further above the target in the near term, before easing back towards 2%. As energy price inflation moderated, and against a background of robust demand growth and limited spare capacity, some recovery in profit margins and pay growth was projected.

27 As usual, substantial risks had been identified surrounding the central projections. These included, in particular: the prospects for world growth; the strength and duration of the recovery in consumer spending; the outlook for energy and import prices and their interaction with domestic pricing pressures; and the margin of spare resources within firms and in the labour market.

28 Under the alternative assumption of constant interest rates, output growth and inflation were both projected to be a little higher.

The immediate policy decision

29 Committee members first reviewed some of the key issues arising from consideration of the August forecast and then discussed factors affecting the timing of any change in interest rates.

30 A major uncertainty was the degree of slack in the economy as a whole. On the one hand, the recent upwards revisions to the GDP data, together with the central projection for output growth, implied that there would be less slack in the economy than previously thought. On the other hand, the labour market looked as if it had loosened, with inward migration boosting the working population and with the demand for labour having eased through 2005, possibly as firms sought to offset the impact of higher energy prices by reducing labour costs. Most Committee members concluded that, on balance, the overall degree of slack was less.

31 Earnings growth remained muted, but if demand pressures were building that might well be reflected first in prices, as firms rebuilt profit margins – wage increases would then be a lagging indicator of inflation.

32 In previous months the Committee had discussed the risk of a sustained slowing in consumption growth, following the weak data for the first quarter. That risk seemed to be considerably less in the light of the robust Q2 indicators.

33 Supporting evidence of potential demand pressures in the medium term came from the rapid rates of broad money and credit growth. The implications of that for inflation would depend on the extent to which higher money balances would eventually be used to finance the purchases of either goods and services or financial and other assets, and some Committee members interpreted the money numbers as a possible indication of longer-term inflationary pressures.

34 Over the previous four years, CPI inflation had been gradually picking up and had reached 2.5% in June. During the remainder of 2006, inflation was likely to rise further above the target rate of 2.0%, before falling back through 2007. The Committee noted that the market yield curve implied a modest rise in interest rates over the next two years, and that under that assumption the central projection for inflation remained above 2% over the forecast period.

35 The Committee concluded that it was most likely that interest rates needed to rise in order to bring inflation back to target in the medium term. The question was whether an immediate increase was justified or whether there was a case for delay.

36 The Committee considered what information it could expect to receive in the near term relating to the main uncertainties. Most of the risks identified in the August forecast would take some considerable time to resolve. For example, the uncertainties about the margin of spare capacity in firms, or pricing dynamics as energy and import price inflation abated, would not become clear until 2007 or beyond. There would be more information on the labour market, but that currently seemed likely to be a lagging indicator of inflationary pressures, although there were differences of view on this point. It was unlikely that the medium-term outlook for inflation would become any clearer in the next few months.

37 There were reasons to suppose that an immediate increase in rates would not significantly exacerbate the downside risks. Consumption growth had recovered from its post-Christmas dip. Output growth overall had been robust and, according to surveys, looked set to remain so in the near term. Most members thought that increasing interest rates to 4.75% would most likely remove a degree of monetary accommodation, without restraining demand unduly; and that there would be time to reverse any increase should that prove necessary once the medium-term paths of demand growth and inflation became clearer.

38 The Committee also considered whether there could be increased upside risks from delaying an increase in rates. CPI inflation was likely to rise further above the target in the next few months. There was a risk that the short-term increase might dislodge inflation expectations, making it more difficult to bring inflation back to target subsequently. One specific factor was that inflation was likely to be rising in the period just before the majority of next year's pay settlements. An early increase in rates would reduce the risk that a sharper rise would be needed later. Although most commentators were not expecting an increase at this meeting, such an increase would not be hard to explain.

39 Against the background of firm growth, limited spare capacity, rapid growth of broad money and credit, and with inflation likely to remain above the target for some while, the Committee judged that an increase in the official Bank rate was necessary to bring CPI inflation back to the target in the medium term. Most members favoured an immediate increase of 0.25 percentage points to 4.75%.

40 For one member, the uncertainty over demand and price pressures, the mixed evidence on the tightening of capacity within firms, together with labour market conditions, was sufficient to make a case for not changing interest rates this month. In particular, the rise in the LFS measure of unemployment and subdued wage pressures could be consistent with a loosening of labour market conditions that would imply a greater degree of slack in the economy overall than inherent in the central projection of the forecast. Although finely balanced, the risk of greater slack in the labour market was sufficient to offset such inflationary pressures as observed elsewhere in the economy.

41 The Governor invited the Committee to vote on the proposition that the official Bank rate should be increased by 25 basis points to 4.75%. Six members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean and Paul Tucker) voted in favour of the proposition. One member (David Blanchflower) voted against, preferring to maintain the Bank rate at 4.5%.

42 The following members of the Committee were present:

Mervyn King, Governor
Rachel Lomax, Deputy Governor responsible for monetary policy
John Gieve, Deputy Governor responsible for financial stability
Kate Barker
Charles Bean
David Blanchflower
Paul Tucker

Jon Cunliffe was present as the Treasury representative.