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# MINUTES OF MONETARY POLICY COMMITTEE MEETING 6 & 7 DECEMBER 2006

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These are the minutes of the Monetary Policy Committee meeting held on 6 & 7 December 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0612.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 10 & 11 January will be published on 24 January 2007.



## MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 DECEMBER 2006

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

### Financial markets

2 The main news in financial markets since the November meeting had been a depreciation in the effective exchange rate index (ERI) of the dollar, by around 2%. This had fallen quite abruptly in the middle of the month, but was perhaps best understood in a longer-term context. Over a number of years, the growing US current account deficit had been interpreted by many commentators as pointing towards a weaker dollar and the dollar ERI had depreciated by over 25% since its previous peak in early 2002. During 2006, an additional factor might have been the gradual downward shift in interest rate expectations relative to those in the other major economies: markets were now pricing in some 50 basis points of easing by the Federal Open Markets Committee during 2007. The most recent fluctuations in the dollar had been larger against European currencies, including the euro and sterling, than against other major currencies.

3 Sterling had appreciated against the dollar but depreciated slightly against the euro on the month. Overall, the sterling ERI was around ½% higher than at the time of the November *Inflation Report*, had risen 6% since the start of 2006, and was towards the top of the range it had occupied since 1997.

4 The expectation of a rise in official interest rates in the United Kingdom had receded somewhat. Market contacts had suggested that the probability of an increase by February 2007 had fallen to below 50%. Financial market expectations of sterling and euro rates for mid-2007 had fallen by around 15 basis points although longer-term forward rates were little changed. In contrast, dollar interest rates had fallen by a little more from mid-2007 onwards. These relative changes seemed to be consistent with the direction of exchange rate movements on the month.

5 Equity prices, measured in local currency, had fallen a little in the United Kingdom and in the euro area over the month, but had risen a little in the United States. These fluctuations also appeared to be broadly consistent with the pattern of interest rate and exchange rate movements. During the

course of 2006, the FTSE All-Share and S&P 500 stock market indices had risen by around 10% and the Eurostoxx index by even more. Part of these rises could be explained by strong corporate earnings growth.

### **The international economy**

6 In the United States, the main focus continued to be on the slowing of the housing market and the implications for the rest of the economy. The data on the housing market had been somewhat mixed: recent house price indicators had given conflicting signals; and housing starts and building permits were weak in October. Overall, residential investment in Q4 might be weaker than the Committee had expected at the time of the November *Inflation Report*.

7 There continued to be little sign of the US housing market slowdown having had wider effects on the economy. Although residential construction had fallen, non-residential investment had been robust. Personal consumption growth in October had been estimated at 0.4% following a rise of 0.7% in Q3, although this strength had been supported by falling fuel prices. Survey data suggested weakening manufacturing output at the start of Q4, although non-manufacturing output growth appeared to have remained strong. Q3 GDP growth had been revised up a little to 0.5%.

8 In the euro area, there had been relatively little news since the November *Inflation Report*. Final domestic demand in Q3 had grown robustly, partly offset by net trade. Consistent with that, Japanese and American exports to the euro area had been noticeably strong. German retail sales continued to be puzzlingly weak, given the relatively high reading for 'propensity to buy' in the GfK consumer confidence survey. The indicators for Q4 euro-area output remained firm although the Purchasing Managers Index (PMI) for manufacturing ticked down in November, echoing the weaker manufacturing surveys in the United States and the United Kingdom.

9 Euro-area consumer price inflation had been little changed in October. Headline US consumer price inflation had continued to show the effects of falls in energy prices, but measures excluding food and energy were little changed. The spot oil price had risen quite sharply on the month, by some 13% in dollar terms and by around 9% in sterling. But the oil futures curve, on which the November *Inflation Report* central projection had been based, was little changed in sterling terms, despite the movement in the spot price.

## Money, credit, demand and output

10 In the United Kingdom, Q3 GDP growth had been unrevised at 0.7%. Within the expenditure components, consumption had been weaker than expected at 0.4%, while business investment had been stronger than expected. The Committee noted that the first estimates of the GDP expenditure components were frequently subject to substantial revisions.

11 The momentum in consumption growth was not clear. On the one hand, data over the past two years could be taken to imply that consumption growth had reached a trough in early 2005 since when it had recovered. On the other hand, throughout this period, growth above its historical average had been recorded in only one quarter and retail sales had been weaker over the summer. More recently, retail sales in October had picked up strongly but survey indicators for November had shown some weakness. The Bank's regional Agents had reported increased household spending growth. The housing market continued to be robust with the lenders' price indices suggesting strong house price increases in November. Most of the various activity indicators of housing demand had continued to point to expansion, although a preview of the RICS survey for November had shown a sharp fall in the balance of new buyer enquiries.

12 Secured lending to individuals had continued to accelerate and had reached annual growth of over 11%. Discussions with lenders had pointed to some loosening in the criteria for secured lending. At the same time, the criteria for unsecured lending appeared to have been tightened and its growth rate had been falling during 2006. That might have been a response to increasing default rates on unsecured loans, especially on credit cards. Broad measures of money and credit growth continued to grow strongly, largely reflecting a rapid growth in deposits held by Other Financial Corporations.

13 Early indicators for the fourth quarter had been consistent with some easing in manufacturing output growth. Official data recorded a 0.4% fall in October and the available surveys for November were signaling slowing growth, although reports from the Bank's regional Agents had suggested continuing strength. In the service sector, reports from the Agents and the CIPS/RBS business survey had indicated continued firm growth, although profit warnings had increased during the course of the year.

14 The Government's *Pre-Budget Report* had been published on 6 December. A preliminary assessment suggested that the fiscal projections did not contain substantial news for monetary policy

relative to the 2006 Budget. It was possible that the composition of projected spending and receipts could have implications for the Committee's forecast and further analysis would be needed. The Committee noted that the ratio of current receipts to GDP was projected to rise by over one percentage point between 2005/06 and 2008/09.

### **Costs and prices**

15 Labour market data for the third quarter had been broadly consistent with the Committee's expectations. Numbers in employment had continued to rise – mainly accounted for by self-employment – and the overall employment rate was stable. The participation rate had risen slightly and the unemployment rate had ticked up slightly, but there were some signs that the upward trend in unemployment might have been beginning to flatten off.

16 The Bank's regional Agents had undertaken a survey of business contacts concerning their use of migrant labour. This had suggested that a majority of firms were expecting to make greater use of such labour over the year ahead. Contacts had reported that this was intended to meet both skilled and unskilled labour shortages rather than to substitute for the domestic workforce.

17 Regular pay growth had been 3.5% in Q3, the lowest since 2003 Q2. Total earnings growth was 3.9% in the three months to September and the level of pay settlements had remained unchanged in October. The growth in the workforce suggested that slack in the labour market should continue to restrain pay growth but the Committee noted that there could also be upward pressures arising from the recently implemented increases in the National Minimum Wage and from temporarily higher RPI inflation.

18 Annual producers' input price inflation had fallen from 5.1% to 3.8% in October, partly reflecting falls in energy prices. Total output price inflation had been steady at 1.7%, though the measure excluding food, beverages, tobacco and petroleum products had increased from 2.0% to 2.5%. Survey indicators and the Bank's regional Agents also suggested some upward pressure on output prices in November. This could point to some rebuilding of margins, at least in the manufacturing sector. In contrast, services price data continued to point to a modest easing in inflationary pressure in that sector.

19 CPI inflation was unchanged at 2.4% in October, as expected at the time of the November *Inflation Report*. The impact from higher university tuition fees had been somewhat less than expected but that had been offset by news across a range of other items. In line with pre-release arrangements, an advance estimate of CPI inflation for November of 2.7% had been provided to the Governor ahead of publication.

20 Inflation expectations of the general public for 12 months ahead, as sampled by the Bank of England/NOP survey, had picked up a little in November to 2.7%. The Citigroup/YouGov survey for the same horizon continued to show expectations stable at around 2.4%.

### **The immediate policy decision**

21 The Committee reached its policy decision against the backdrop of its analysis of the outlook for inflation contained in the November *Inflation Report* and the news since then. The Committee's central projection in that *Report*, based on the conventional assumption that interest rates followed a path expected by financial markets, was for inflation to pick up in the near term, before falling back and settling at around the 2% target over the medium term. The central projection for four-quarter GDP growth was for it to remain close to its average rate over the past decade, edging down towards the end of the forecast period as government spending slowed.

22 Overall the news on the world economy since the previous meeting had not altered the outlook significantly. The euro-area data had been broadly as expected. Data for the United States had been mixed, but were still consistent with a modest and temporary reduction in growth rather than a sharp or prolonged slowdown. The US housing market continued to slow but most Committee members considered that there had been little evidence to date to suggest that it would have a big impact on the wider economy, although one member placed rather more weight on this downside risk. Surveys suggested some signs internationally of a weakening of manufacturing output in November. Growth remained strong in Asia and the oil price had recovered somewhat.

23 Perhaps the most widely publicised event on the month had been the sudden depreciation of the dollar, although the Committee viewed this in the context of the longer-term downward adjustment over the previous few years and the underlying imbalances in the global economy. The sterling ERI had strengthened a little as a result of the dollar weakening.

24 In the United Kingdom, money and credit had continued to grow at elevated rates perhaps posing an upside risk to inflation but had not accelerated further. It remained difficult to interpret the high contribution from money holdings by Other Financial Corporations. Secured lending to households had continued to accelerate, associated with increased turnover of houses at higher prices. The growth in unsecured lending, most notably on credit cards, continued to slow. It seemed likely that at least some of this contrast reflected changing behaviour by the lenders.

25 The momentum in consumption was difficult to judge. Consumption growth had picked up since its low point in early 2005 but the rate of growth had more often been below its previous average than above. And the most recent data on retail sales had also been mixed – strong for October, but weaker surveys for November. These data were probably consistent with the Committee’s central projection that consumption growth would pick up only to around its historical average as the economy rebalanced towards investment and net trade. There had been some news on the housing market where prices had clearly risen faster than expected and, for some members, this was judged to be an upside risk to the near-term outlook for consumption.

26 The Committee placed little weight on the initial breakdown of GDP into its expenditure components, given that these data were usually subject to significant revisions. However, the strong preliminary estimate for business investment growth in the third quarter had been supported by reports from the Bank’s regional Agents and business surveys.

27 On the output side, the official data and business surveys suggested that the manufacturing sector was weakening a little in Q4 whereas the service sector appeared to be strengthening.

28 The labour market data had been broadly stable, continuing to suggest some slack. In addition, the Agents had reported that firms expected to make increasing use of migrant labour. The Committee judged that these factors would probably help to restrain pay growth but also noted that the increases in the National Minimum Wage and the pickup in RPI inflation could work in the opposite direction. It appeared that some firms – at least in the manufacturing sector – might have been rebuilding profits by raising output prices, though they could be squeezed again by the rise in the oil price.

29 CPI inflation had risen, much as the Committee had anticipated, although some members thought that there seemed to be a little more underlying inflationary pressure than expected. While inflation was still projected to fall back in 2007 as the effect of higher energy prices faded, the Committee remained concerned that the pickup in the near term could affect forthcoming pay increases.

30 The Committee agreed that the overall prospect for inflation was broadly unchanged from the November *Inflation Report*. Some members placed more weight on the news about upside risks from: money growth; investment; housing market developments; and inflation expectations. Other members placed more weight on the potential downside risks from: the growth outlook in the United States, as the housing market there slowed; the slack in the UK labour market; and slower-than-average UK household consumption growth. Moreover, it was too soon to judge the effect of recent rises in interest rates. Taking the news and analysis together, members concluded that it was appropriate to leave interest rates unchanged.

31 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.0%. The Committee voted unanimously in favour of the proposition.

32 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  
Tim Besley  
David Blanchflower  
Andrew Sentance  
Paul Tucker

Jon Cunliffe was present as the Treasury representative.