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MINUTES OF MONETARY POLICY COMMITTEE MEETING 11 and 12 January 2006

These are the minutes of the Monetary Policy Committee meeting held on 11 and 12 January 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0601.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 8 and 9 February 2006 will be published on 22 February 2006.

The Minutes of the Monetary Policy Committee meeting have in the past been accompanied by a separate Staff Annex summarising the information presented to the Committee ahead of its policy meeting. The Bank has decided to cease publication of the Staff Annex from January 2006. More detail is provided at

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/index.htm>



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 11-12 JANUARY 2006

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

Financial markets

2 UK short-term interest rates had fallen since the Committee's previous meeting. This move had appeared unrelated to international developments and had also been difficult to explain with reference to UK economic data releases.

3 At the time of the Committee's meeting, sterling money market instruments implied an expectation that the Bank of England's official rate would be reduced by 25 basis points in March or April. Surveys of private sector economists also indicated a general view that the official interest rate would be cut in 2006; survey respondents did not, however, expect a rate reduction at the Committee's January meeting and the number of economists anticipating a cut at the February meeting had fallen recently.

4 Exchange rate movements over the month had been broadly in line with changes in interest rate differentials. Sterling's effective exchange rate index (ERI) had depreciated by around 1½% relative to the starting point used in the November *Inflation Report*, leaving it broadly in line with its level a year earlier. The US dollar ERI had also declined over the month. Given the large size of the US current account deficit, market participants continued to highlight the risk of a significant dollar depreciation. This expectation had, however, also been widely held in 2005 when the dollar ERI had appreciated by around 10%.

5 Equity prices in all the major economies had increased further during the month, leaving the FTSE All-Share index almost 9% above its starting point at the time of the November *Inflation Report*.

6 Nominal long-term forward interest rates in the major economies had declined over the month, largely reflecting lower real forward rates. At the time of the Committee's meeting, 10-year real forward rates were close to recent historical lows. There were a number of possible types of explanation for the decline in real forward rates: first, structural changes in the world economy may have caused real rates to fall; second, a decline in risk or term premia in international capital markets; third, market-specific factors, particularly in the United Kingdom, relating to the demand for, and supply of, long-maturity government bonds; and fourth, long-term forward rates may have returned to average levels observed in some earlier periods.

7 These explanations were not mutually exclusive. It was important to understand the reasons why long-term interest rates were so low. Each of the potential explanations had different implications for the likely evolution of long-term interest rates and for movements in other asset prices.

8 With regard to the first potential explanation, it was possible that the decline in long-term interest rates had reflected an increased global propensity to save and lower global willingness to invest. Saving by China and other Asian countries had increased following the financial crises in this region in 1997-98 and investment rates in advanced countries had fallen following the sharp declines in equity prices between 2000 and 2002. But it was unclear why these factors might be expected to persist well into the future, thereby lowering the level of real interest rates in the long term. Alternatively, greater perceived vulnerability to large negative macroeconomic shocks (perhaps related to events such as terrorist attacks or an avian flu pandemic) might have caused precautionary saving to rise, driving real interest rates down. It was, however, difficult to square this latter explanation with the apparently low risk premium on equities and compressed corporate bond spreads.

9 Turning to the second potential explanation, an excess supply of liquidity in global financial markets might have helped to push up asset prices and compress risk premia (the so-called 'search for yield'). If this had been the dominant consideration, long-term interest rates would be expected to rise at some point.

10 With regard to the third explanation, one of the most commonly cited market-specific considerations for the lower level of sterling long-term interest rates (relative to the rates in other advanced economies) was increased demand by UK pension funds for long-maturity bonds. This appeared to have been triggered by the combined impact of demographic trends, growing corporate pension fund deficits, and actions by the regulatory authorities. Taken together, these factors had led

UK pension funds to try to match the maturities of their assets more closely with the expected maturity profile of their liabilities.

11 The fourth possibility was that the high real interest rates observed in the last two decades of the 20th Century may have been the unusual period. This might explain why current long-term interest rates had moved closer into line with the levels observed in some earlier periods of history. If this explanation were correct, it was possible that the current low level of long-term interest rates might be sustained for some while to come.

12 Overall, it remained difficult to explain why long-term interest rates had fallen. Consequently, it was also difficult to know whether there would be an upward correction in long-term rates and what implications it might have for other asset prices.

The international economy

13 Overseas indicators had suggested a strengthening of activity. World demand growth in the second half of the year appeared to have been somewhat stronger than had been anticipated in the November *Inflation Report*.

14 In the euro area, consumer and industrial confidence had picked up in the fourth quarter. The manufacturing and service sector Purchasing Managers Indices (PMIs) had also strengthened; they had pointed to GDP growth in Q4 at around or slightly above trend. Euro-area growth now appeared to be on a firmer footing and had been unexpectedly strong in the second half of 2005. In the light of this, outside forecasters had in recent months revised up their projections for growth in 2006. Looking further ahead, however, there remained some downside risks to growth: in Germany, fiscal consolidation was due to be implemented in 2007; in Italy, there were concerns about competitiveness; and uncertainty over future reforms to pension and welfare benefit schemes in a number of euro-area countries might hold back growth in consumption.

15 In the United States, the macroeconomic data released over the past month had been a little more mixed than in the euro area, but generally pointed to continued firm growth. Consumption growth appeared to have slowed in the fourth quarter and the first estimate of December non-farm payrolls had been relatively weak. Consumer confidence had rebounded, however, from the lows associated with Hurricane Katrina. Investment indicators remained positive and the Institute for Supply Management

reports for the manufacturing and non-manufacturing sectors pointed to continued healthy growth in the fourth quarter.

16 Indicators of Asian demand had continued to be positive. In Japan, the Tankan survey of business sentiment had improved further and industrial production growth and the manufacturing PMI balance had strengthened. The Chinese authorities had significantly revised up their estimates of both the level and growth rate of Chinese GDP; but trade statistics had been unrevised and so the implications of these revisions for the Committee's UK forecast were limited.

17 The Committee reviewed the evidence from some recent external studies of overseas housing markets. These had generally suggested that national housing market valuations in the United States and most euro-area countries were not far above what would be suggested by their fundamental determinants. However, if long-term interest rates were to rise, this would no longer be the case. And, as the Committee had noted, there was great uncertainty over the likely evolution of long-term interest rates.

18 The dollar spot price of Brent crude oil had increased by 10% over the month but remained below the peaks reached in 2005 whether measured in sterling or dollars. Consumer price inflation in the United States and euro area had fallen back in November, largely due to declines in retail energy prices at that time.

Money, credit, demand and output

19 The annual growth rate of the M4 money aggregate had increased to 12.1% in November, its highest rate since 1990. In contrast, however, the latest growth rates for notes and coin and unsecured lending to individuals had slowed. The annual growth rate of secured lending to individuals in October and November had been broadly unchanged from that seen in the third quarter.

20 The latest vintage of the *Quarterly National Accounts* had included revisions to historical data going back to 2004 Q1. These revisions indicated that the slowdown in GDP growth in the second half of 2004 had been a little less marked than previously reported. This, in turn, had moved the official data closer into line with estimates of growth derived from both an assessment of surveys and evidence from the historic pattern of revisions made by the Office for National Statistics (ONS). On the output side of the accounts, the revisions to GDP primarily reflected a less marked slowdown in

service sector growth in 2004; and on the expenditure side, the revisions mainly reflected a less marked slowdown in consumption growth over the same period. The ONS had left its estimates of quarterly GDP growth rates in 2005 unchanged. Evidence from surveys and the pattern of past revisions to the ONS data tended to suggest that these 2005 growth rates might ultimately be revised up somewhat, principally reflecting stronger service sector growth than indicated in the current vintage of the official data.

21 Output indicators had suggested that GDP in Q4 had risen at close to its historic average rate. In the services sector, the CIPS business activity index had increased to 57.9 in December, its highest level since April 2004. In addition, the CIPS survey responses for employment and business expectations for the year ahead had also picked up, suggesting that the improvement seen in December might be sustained into 2006. The CIPS survey balance for manufacturing output had increased between Q3 and Q4. However, official figures suggested that manufacturing output growth remained much weaker than service sector growth; comparing the three months to November with the previous three months, manufacturing output had contracted by 0.8%.

22 Consumption growth in the third quarter had been revised up slightly and spending indicators for the fourth quarter had appeared reasonably firm. Retail sales had increased by 1% in the three months to November and retail sector surveys had pointed to continued healthy spending in December. Retail contacts of the Bank's regional Agents had indicated a similar picture for the Christmas period. In contrast, however, private car sales and consumer confidence had remained weak.

23 The pickup in consumption growth in the second half of 2005 might have reflected a normal cyclical rebound following a period of weak consumption, together with a reaction to the reduction in interest rates in August. In addition, housing market indicators had generally come in slightly stronger than expected in recent months. In contrast, however, the latest vintage of official data had suggested that the growth rate of real post-tax labour income had slowed in 2005.

24 Whole economy investment growth in Q3 had been revised up to 1.6%. The growth in whole economy investment largely reflected stronger government investment; business investment growth had been weaker than expected. The sluggishness of business investment appeared somewhat surprising given the low levels of long-term interest rates, the pickup in both corporate profitability and equity prices, and the rise in investment growth in other advanced economies.

25 The Committee considered a number of potential explanations for the weakness of estimated UK business investment. First, the official data was particularly prone to revision and might be revised higher. Second, multinational firms might have decided to allocate more of their investment spending to overseas projects, reflecting the lower wage costs in many emerging market economies. Third, some of the investment undertaken by service sector firms (such as in-house software design) might not have been picked up in the official statistics though it was difficult to know whether or not this consideration had become more marked in the recent past. Fourth, there was some anecdotal evidence to suggest that firms may have chosen to cut back on investment spending in order to improve the financial position of their in-house pension funds. Finally, higher and more volatile energy prices might have increased the uncertainties about the likely returns of investment projects.

26 Domestic demand growth in Q3 had been a little stronger than expected, reflecting upward revisions to consumption and investment. That had been offset, however, by a larger drag from net trade due primarily to a 0.4% decline in exports. The fall in exports had been difficult to reconcile with the pickup in euro-area demand and the slight improvement in survey-based evidence of export orders. It was possible that the Q3 figures had been erratically weak following the very strong Q2 data or that they had continued to be affected by fraudulent activity.

Supply, costs and prices

27 The broad picture of the labour market was little changed from a month earlier. The Labour Force Survey measure of employment had increased by 0.2% in the three months to October and the various survey-based indicators of hiring intentions in the service and construction sectors had continued to point to a gradual strengthening of employment growth. Despite these developments, the unemployment rate had ticked up slightly, largely reflecting more individuals coming back into the labour force to look for jobs.

28 The annual growth rate of private sector labour productivity had fallen to close to zero in Q3. The Committee had revisited the potential explanations for this weakness: data mismeasurement (of either employment or output); cyclical labour hoarding; or a genuine slowdown in underlying total factor productivity growth. Survey-based evidence suggested a possibility that the GDP growth figures might be revised up somewhat, but there were fewer reasons to expect employment to be revised down. In principle, labour hoarding might be expected to result in some fall in average hours worked. There had, however, been little cyclical change in average hours worked over the past two

years. Previous growth slowdowns over the past decade had shown similarly muted cyclical responses of hours worked. Consequently, it was plausible that the current slowdown in productivity growth had primarily reflected normal cyclical considerations such as labour hoarding. However, this explanation might not account for all of the productivity slowdown. There remained a possibility that underlying total factor productivity growth had slowed. Each of these potential explanations had different implications for the likely evolution of inflation.

29 There continued to be few signs that employees had been bidding up wages in response to higher energy prices. Both wage settlements and regular pay growth had been broadly unchanged in recent months, while the annual growth rate of the whole economy average earnings index had fallen to 3.6% in the three months to October due to a decline in the contribution from bonuses. Anecdotal information had suggested a general expectation that wage agreements to be struck in January (a significant month for settlements) were likely to be broadly in line with developments seen in recent months. More information about the January pay round would become available in the next couple of months.

30 Manufacturing input price inflation had increased to 12.5% in November, partly reflecting a sharp increase in gas prices that month. Not all of these increased input costs had, however, been passed through to output prices; manufacturing output price inflation had fallen back slightly in November and remained at a much lower level than input price inflation. In December, the CIPS output price balances for both services and manufacturing had increased.

31 Since the severe price spike in November, wholesale gas prices had fallen back significantly. Nevertheless, wholesale gas prices had continued to trade at around double the levels observed between April and October 2005. Information from the gas futures market had suggested an expectation that the average level of wholesale gas prices in 2006 might be 60% higher than in 2005. If realised, this increase could have a potentially significant impact on consumer price inflation. There were, however, a number of uncertainties in this area. These included: the predictive power of gas futures prices; the extent to which retail gas providers were likely to pass on the increase in the wholesale gas price to their customers; and the extent to which a rise in the relative price of gas might have knock-on implications (up or down) for the prices of other goods and services in the CPI basket.

32 CPI inflation had declined to 2.1% in November. In line with pre-release arrangements, an advance estimate of CPI inflation for December had been provided to the Governor ahead of

publication. This had indicated that inflation had fallen further to 2.0% in December.

The immediate policy decision

33 Against this backdrop, there were a number of arguments in favour of leaving the Bank's official interest rate unchanged, to which different members attached different weights.

34 World demand growth had been slightly stronger than expected, particularly in the euro area. UK growth had probably picked up towards its historic average rate and had been broadly in line with the central projection contained in the November *Inflation Report*, albeit with a slightly different composition of growth. Business investment and exports had been weaker than expected and continued to pose a downside risk to the outlook. But, indicators of service sector output, consumption growth and the housing market had been stronger than expected. Finally, financial market movements should provide some stimulus to demand. Taking this evidence together suggested that growth was likely to continue broadly in line with its historic average rate in the next few quarters.

35 Consumer price inflation had returned to the target, inflation expectations appeared to be well anchored, and there had been few signs of second-round wage pressures related to higher oil prices. There was probably some spare capacity in the economy following the period of below-trend growth and this might be expected to put downward pressure on future inflation. But the extent of spare capacity was uncertain, particularly if there had been some negative effects on potential supply from the recent weakness of business investment and productivity. In the short-term, upside risks to inflation from higher oil and gas prices remained. In addition, there were uncertainties surrounding the likely evolution of import prices and the exchange rate, which were important influences on the outlook for inflation. On balance, it seemed likely that inflation would be broadly in line with the target over the medium term.

36 For one member there was a case for an immediate reduction in the repo rate. GDP growth had been below trend for some while. Reflecting this, unemployment statistics and surveys of capacity utilisation pointed to the emergence of spare capacity in the economy. While the outlook for consumption had improved, the November *Inflation Report* central projections for investment and net trade appeared too optimistic. In addition, the growth rate of government consumption spending was likely to slow from 2007. Consequently, it appeared unlikely that the degree of spare capacity in the economy would diminish by as much as had been envisaged in the November *Inflation Report*. Given

that pipeline price pressures were modest, it seemed likely that inflation would fall below the target once the effects of higher energy prices had dropped out of the year-on-year calculations.

37 The Governor invited the Committee to vote on the proposition that the repo rate should be maintained at 4.5%. Eight members of the Committee (the Governor, Rachel Lomax, Andrew Large, Kate Barker, Charles Bean, Richard Lambert, Paul Tucker and David Walton) voted in favour. Stephen Nickell voted against, preferring a reduction in the repo rate of 25 basis points.

38 Finally, the Governor expressed his appreciation to Sir Andrew Large for his contribution as a member of the Committee.

39 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.