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**MINUTES OF  
MONETARY POLICY  
COMMITTEE MEETING  
5 & 6 July 2006**

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These are the minutes of the Monetary Policy Committee meeting held on 5 & 6 July 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0607.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 2 & 3 August will be published on 16 August 2006.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 JULY 2006**

1 At the start of the meeting, the Committee stood in silence in remembrance of David Walton, who died on 21 June.

2 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**

3 Financial markets had been relatively uneventful this month, with asset prices stabilising after the falls recorded the previous month. Equity price indices had risen a little over the month in many developed economies, but were still below the levels at the time of the *May Inflation Report*. Emerging market indices were rather weaker. There had been some further widening of bond spreads this month, although they remained relatively narrow compared with recent years. As previously discussed by the Committee, one interpretation of recent developments was that there had been a re-pricing of the risk incorporated in some asset prices.

4 Short-term market interest rates had risen a little over the past month in the United States, and to a lesser degree in the euro area and the United Kingdom. The UK short-term yield curve was now markedly higher than at the start of the year, when markets had been pricing in a reduction in the official Bank rate in 2006.

5 Further along the yield curve, long-term forward interest rates had crept up in the United Kingdom, United States and euro area. Both nominal and real forward interest rates were substantially higher than at the start of the year.

6 The dollar had appreciated somewhat over the month, following the earlier depreciation since May. Associated with this, sterling had fallen against the dollar, and with little change against the euro, the sterling effective exchange rate index (ERI) had fallen a little over the month. The ERI was nevertheless 1¼% higher than in the *May Inflation Report*.

7 Measures of implied volatility of most major equity prices and of many exchange rate pairs had fallen over the past month. That fall was rather less apparent in measures of implied volatility for short-term interest rates – especially for the United States.

### **The international economy**

8 Developments in the world economy appeared to be broadly consistent with a continued rebalancing of demand growth away from the United States and towards the rest of the world.

9 In the euro area, the manufacturing Purchasing Managers' Index (PMI) had increased for the fifth consecutive month in June, leaving the index at its highest level since August 2000, and the European Commission industrial confidence measure had risen in Q2 to its highest level since late 2000. The German IFO index had continued to be unusually strong, although the answers to some of the questions on which the index was based, as well as the ZEW survey of financial analysts, suggested that there was somewhat less optimism about the near future than was apparent from the headline IFO index. The euro-area services PMI had increased further in June. Overall, the survey-based evidence suggested GDP growth was likely to have been strong in Q2, and higher than the Committee had expected at the time of the *May Inflation Report*. It suggested that some of the near-term upside risks to euro-area activity might be crystallising.

10 Consumption growth had bounced back in the euro area in Q1 and consumer confidence had crept up. However, retail sales had fallen back in May, following the sharp increase in April, so it was difficult to discern a clear trend in the data. Labour market conditions had continued to improve slowly, with the euro-area unemployment rate falling below 8% for the first time since 2001. The harmonised index of consumer prices (HICP) had increased by 2.5% in the year to May, up on the corresponding figure for April.

11 Growth in the United States had been revised up in the first quarter. The latest indicators had continued to point to annualised growth of around 3% in Q2. As far as households were concerned, consumption growth had eased over the course of the year. Real personal disposable income growth had been broadly flat in April and May, while growth of nominal wages and salaries had also flattened. Other influences on consumption had pointed to a slowing: there had been a sharp oil-induced deterioration in the terms of trade, a fall in equity prices, and an easing in house price inflation. Real personal disposable income growth might pick up again, particularly if energy prices did not rise further, but more subdued household spending growth seemed in prospect. Nonetheless, business investment had continued to look robust.

12 Headline US CPI inflation had risen in May, accompanied by a tick up in inflation excluding food and energy prices. The Federal Reserve's preferred inflation measure – the core private consumption expenditure deflator – had been unchanged in May.

13 Japanese GDP growth had been revised up substantially to 0.8% in Q1 on the back of large upward revisions to business investment and government spending. The Tankan survey had strengthened, and was consistent with continued robust growth in Q2. Elsewhere in Asia, Chinese activity indicators had also strengthened.

14 Oil prices had risen slightly over the past month, mostly in the days leading up to the meeting. Other commodity prices had fallen over the past month.

15 Measures of world export price inflation had generally picked up over the past year or so. The outlook for global export prices, and hence the prospects for UK import prices, was an important issue that the Committee would wish to examine further in the quarterly *Inflation Report* round.

### **Money, credit, demand and output**

16 The revisions contained in the latest Quarterly National Accounts – consistent with the annual 2006 *Blue Book* – had been fairly modest compared with those seen in some past years. With incorporation of the 2004 Annual Business Inquiry and the first balancing of the 2004 data, perhaps the greatest interest related to the revisions for that year. Growth in 2004 and some earlier years had

been revised up. The picture for 2004 was broadly consistent with survey-based estimates of output growth, coupled with the historical pattern of past revisions at this stage in the data cycle.

17 The picture for 2005 had been broadly unchanged by the recent release (with a slightly faster pickup in output growth from the 2005 Q1 trough, little change in consumption and only modest upward revisions to investment); although the National Accounts data for 2005 would not be fully balanced until next year's *Blue Book*. The latest vintage of data indicated that the alignment adjustments in Q4 and Q1 were large and of opposite signs, reflecting the difficulty of reconciling the output and expenditure measures of GDP growth in these two quarters.

18 The quarterly GDP growth rates for both 2005 Q4 and 2006 Q1 had been revised up, as expected, to 0.7%, although the first three quarters of 2005 remained weak. The latest indicators continued to point to a further acceleration of activity in Q2, with the CIPS/RBS surveys suggesting strong growth in both manufacturing and services.

19 The new data for business investment had not changed the picture of relatively subdued growth in the wake of the 2003-2004 cyclical pickup in output growth. Reflecting the absence of significant revisions to those data, there now seemed a greater likelihood that the weakness of investment growth in recent years was real, despite the slightly firmer survey indicators of investment intentions over that period, the healthy financial position of the corporate sector, the fall in the relative price of capital goods, and the relatively low cost of capital. The Committee had previously discussed various possible explanations for this. Off-shoring of investment might be one way of reconciling the surveys of investment intentions with the data. The Bank's regional Agents had undertaken a special survey of the effects of pension deficits, which suggested that this particular factor was likely to have had only a small effect on investment. Overall, the upwardly revised investment-to-GDP ratio had raised the estimated capital stock, making the recent levels of spending look less weak.

20 The slowdown in annual consumption growth through 2004 and 2005 appeared to have been sharper and was longer lived than previously thought, with the first three quarters of 2005 all now looking rather weak. There had been downward revisions to real post tax labour income, consistent with the new path for consumer spending, and the weaker-than-expected pickup in labour income in 2006 Q1 might suggest a downside risk to future household spending. There was estimated to have been a slightly larger fall in the terms of trade in 2005 than previously thought; that too might weigh

on consumption prospects. However, the Q1 data for consumer spending growth had been revised up slightly. The latest indications from the retail sales data and the CBI *Distributive Trades Survey* pointed to stronger growth in Q2.

21 The latest housing indicators had been mixed. The Nationwide house price index had risen by 0.3% in June, while the Halifax index had fallen 1.2%. An average of the two lenders' indices for Q2 was a little weaker than expected at the time of the *May Inflation Report*. However, loan approvals as well as indicators of the number of site visitors, the sales-to-stock ratio and the current and forward-looking price balances in the preview of the Royal Institution of Chartered Surveyors' survey had all risen. Although estimates of household sector income gearing had fallen in recent quarters, the prospective trend still seemed to be upward, but that was to be expected given the increase in the stock of secured borrowing. It remained difficult to assess the equilibrium house price-to-earnings ratio, and to draw meaningful international comparisons given the differences in housing markets across countries.

22 There had been less news in the National Accounts concerning recent movements in public sector demand or net trade. The recent pickup in exports to the euro area had seemed consistent with the reports from the Bank's regional Agents and the apparent strengthening of demand in the euro area.

23 The annual rate of nominal GDP growth had increased in Q1, and was now close to 5%, after having slowed in 2005. This was close to its average growth rate over the previous decade. Broad money growth had eased in May: it remained strong, but was now slower than at any time since September 2005. Nevertheless, money growth continued to pose an upside risk to the medium-term outlook for inflation.

### **Supply, costs and prices**

24 The Labour Force Survey (LFS) of employment growth in the three months to April had remained a little stronger than had been expected at the time of the *May Inflation Report*, and the annual growth rate was close to the average since 1997. A significant share of this employment growth was accounted for by self-employment. The LFS unemployment rate had also been a little higher than expected, at 5.3% in the three months to April, despite the rise in the employment rate

since last autumn. Surveys of labour availability presented a mixed picture. The Bank's regional Agents had reported a strengthening of employment intentions among their contacts, but that recruitment difficulties remained muted.

25 Earnings growth, as measured by the Average Earnings Index (AEI), had been slightly weaker than expected at the time of the *May Inflation Report*. Some of that may have been accounted for by bonuses and elements of regular pay drift, but settlements had also continued to be weaker than at the same time last year, and a little below expectations. There were a variety of other earnings measures, some of which were less timely and of lower frequency than the AEI, which also pointed to a softening in average earnings growth in recent years. The Bank's regional Agents had reported no evidence of widespread pay pressures, but their special survey had indicated that the need to finance defined benefit pensions might be bearing down on other labour costs. There was a broader question about the extent to which earnings growth was being determined by narrow labour market conditions, or by other wider cost pressures. RPI inflation had fallen through much of 2005, but had risen broadly in line with CPI inflation in recent months, and remained the single most cited inflation index used in pay bargaining.

26 There had been a pickup in the annual growth rate of unit labour costs in Q1. This, in part, had been broadly boosted by an upward revision to non-wage employment costs in 2005 Q4 and strong growth in Q1. To the extent that this reflected a series of special payments to deal with past 'legacy' pension deficits, it did not necessarily reflect the cost of employing new labour.

27 The participation rate was now at its highest level since 1991. This reflected the increased participation of older workers and various cohort effects (as, for example, younger generations with higher participation rates replaced older generations with lower rates).

28 Substantial pressures on firms' costs from the increases in energy prices had continued. Input price inflation had fallen back in May, but remained at high levels. Output price inflation had ticked up in May. Survey measures of pricing pressures in both manufacturing and services had generally been firmer this month. Non-oil import prices were rising at the fastest rate for some years.

29 CPI inflation had risen to 2.2% in May. Within this, goods price inflation had risen by 0.9 of a percentage point to 1.3%. That reflected the impact of higher prices of both energy and other imported goods. The general public's inflation expectations had appeared to ease.

30 The relative stability of aggregate CPI inflation over recent years was notable, following significant movements in import and energy prices. It was possible to construct a variety of different measures of domestically generated inflation that attempted to strip out the effects of import prices and energy prices, using various assumptions about the speed of pass-through of these prices along the supply-chain. These measures had generally been volatile in recent years, compared with the broader stability of aggregate CPI inflation. This pointed to an inverse relationship between energy and import prices on the one hand and domestically generated inflation on the other. That, in turn, suggested that it was not appropriate to aggregate independently derived projections of import, energy and domestically generated inflation components of CPI in a mechanical way without considering the interrelationships between them

### **The immediate policy decision**

31 Following the sharp movements in financial markets prior to the Committee's June meeting, the financial markets had been more stable over the past month. Equity prices were lower and sterling was higher than at the time of the *May Inflation Report*, and if sustained, would tend to reduce inflationary pressures. But the falls in equity markets had to be put in the context of the substantial price increases observed over the previous twelve months. If firms and households had assumed that some of the asset price increases over the past year were unlikely to be sustained, then they might not change their spending significantly in response to the recent price corrections, and the implications for inflation might therefore prove modest. Despite the stability over the recent month, it was too early to know whether the recent falls in prices would prove to be a limited correction or whether there would be a more marked and sustained change.

32 Developments in the world economy appeared to have been consistent with some signs of rebalancing in the composition of world demand, with a pickup in the pace of growth in the euro area and Asia and a possible slowdown in the United States.



33 In the United Kingdom, the Quarterly National Accounts had not led to particularly large revisions by past standards, although the level of GDP was somewhat higher than previously estimated. But there was still considerable uncertainty about the National Accounts estimates for 2005, which had yet to be balanced. It was difficult to reach firm conclusions about the implications of the revisions for the overall balance of demand and supply until the data had been fully analysed in the context of the *Inflation Report* round.

34 On the expenditure side, the slowdown in consumption in 2005 now looked more pronounced. Business investment had been revised up a little, but by much less than expected and remained relatively subdued in the recent past. There was little significant news for net trade.

35 GDP growth had been revised up slightly over the past six months, broadly as expected on the basis of the survey and anecdotal evidence. And the latest indicators still pointed to stronger GDP growth in the second quarter. So the overall picture for the near-term prospects for output did not look materially different from that expected at the time of the *May Report*. The latest consumption indicators appeared to be consistent with stronger growth in Q2, following the weakness in Q1. The latest survey indicators, and demand developments in the euro area, still suggested an upbeat outlook for exports. But it remained difficult to reconcile fully the movements in the output and expenditure measures of GDP over the past few quarters.

36 Producer input price inflation and import price inflation were high by recent historical standards, and the surveys of manufacturing and services prices were still firm. Earnings growth remained subdued, perhaps as firms squeezed labour costs in the face of rising input and import prices. The expansion of the labour force with continued inflows of migrant workers and rising participation rates may have also acted to subdue wage growth. The immediate prospects for real labour income were bolstered by slightly stronger employment growth than had been expected. CPI inflation had risen recently, but broadly as expected at the time of the *Inflation Report*. The general public's inflation expectations appeared to have edged down following the rise earlier in the year, increasing the probability that the rise would prove temporary.

37 The upside risks to the outlook for inflation were broadly the same as those identified by the Committee the previous month. Growth in the euro area and Asia might well turn out stronger than had been assumed in the *May Inflation Report*, and associated with this was the risk that global

inflationary pressures might turn out to be stronger than expected. Although broad money growth had recently eased, its past and continuing strength, together with the sharp increases in property and financial asset prices over the past year, was still a risk to inflation in the medium term. The apparent inverse relationship between energy and import prices on the one hand and estimates of domestically generated inflation on the other – with aggregate inflation broadly stable – was striking. This seemed to reduce the probability that inflation might for a while settle below the target as energy effects on CPI inflation dissipated.

38 There were also a number of downside risks to the outlook for inflation. There was a risk that asset prices might fall further in coming months. The slowdown in the United States might prove more pronounced than had been assumed in May, and could adversely affect growth in other UK markets, especially the euro area. In the United Kingdom, although Q1 growth had been revised up slightly, and Q2 output indicators remained robust, there remained a risk that the erosion of spare capacity in the economy would be slower than envisaged in the *May Inflation Report*. The combination of higher participation and weaker earnings in the latest data was perhaps suggestive of a positive supply shock.

39 Different committee members attached different weights to those arguments. But given that recent developments had seemed broadly in line with the *May Inflation Report*, and that there were significant risks in both directions, members felt that the interest rate should remain unchanged this month.

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

41 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.