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# MINUTES OF MONETARY POLICY COMMITTEE MEETING

## 7 and 8 June 2006

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These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 June 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0606.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 July will be published on 19 July 2006.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 JUNE 2006**

1 At the start of the meeting, the Committee noted that the Bank of England's system for implementing monetary policy had been reformed from 18 May. Since that date, the interest rate set by the MPC, the official Bank rate, was paid on reserves held by commercial banks with the Bank.

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

### **Financial markets**

3 Over the month, there had been sizeable movements in the prices of a range of financial assets. Equity price indices in most advanced countries, including the United Kingdom, had fallen by between 4% and 8%, while the indices for many emerging market economies had declined by 10% to 20%. Non-oil commodity prices had been volatile and the price of Brent crude oil had declined by around 6%. Credit spreads for riskier assets and the implied volatilities derived from options contracts had risen.

4 A number of market commentators had highlighted US developments as the proximate trigger for these financial market movements. In particular, unexpectedly high outturns for consumer price inflation; signs of some slowing in the pace of growth; and greater uncertainty about the outlook for monetary policy may have led investors to reappraise US and global risks. If that were the case, recent developments could perhaps be interpreted as a re-pricing of the risk incorporated in asset prices.

5 A key question was whether the recent asset price falls would prove to be a limited correction or the beginning of a more marked and sustained change. Most market commentary had suggested it was likely to be a temporary adjustment, following the rapid asset price increases over the previous three years. This appeared consistent with anecdotal evidence of there having been some unwinding of

speculative positions during May. Nevertheless, it was possible that there would be further falls in financial prices.

6 Despite the declines in equity prices, there had been little change in UK, US and euro-area government bond yields over the month. To the extent that the trigger for recent movements had been heightened concern about US prospects, it was somewhat surprising that US yields, in particular, had remained stable. It was possible that the declines in equity prices in May had been a delayed response to the rise in long-term bond yields observed between January and April. It was not clear, however, why the prices of the different asset classes had not moved in a more synchronized fashion.

7 Short-term market interest rates had also been little changed on the month. At the time of the Committee's meeting, sterling market instruments implied an expectation of a 25 basis point rise in the Bank of England's official rate by the end of 2006, with a second 25 basis point increase priced in by the end of 2007. While the majority of private sector economists surveyed in the Reuters poll, by contrast, continued to expect the official rate to be unchanged during 2006, the proportion of respondents expecting a reduction in interest rates before the end of the year had fallen in recent months, and there had been a rise in the proportion expecting the next change to be a rate increase.

8 The sterling effective exchange rate index (ERI) had appreciated over the month, leaving it almost 2% above the 15-day average value used as the starting point for the *May Inflation Report* projections. However, the sterling ERI remained within the range it had occupied in recent years. The dollar had depreciated further against a range of currencies, leaving the dollar ERI almost 7% below its level at the beginning of 2006.

### **The international economy**

9 Developments in the world economy appeared to have been broadly consistent with the projections incorporated in the *May Inflation Report*, with signs of some rebalancing of demand growth away from the United States and towards the rest of the world.

10 In the euro area, GDP growth had increased to 0.6% in Q1. The expenditure composition of Q1 growth had been encouraging; in particular, household spending had accelerated sharply. Investment growth had been weak but this appeared to have largely reflected the effect of bad weather on

construction investment and might therefore prove to be temporary. The available survey-based evidence of industrial and consumer confidence, together with the Purchasing Managers' Indices (PMI) for the manufacturing and services sectors, suggested that GDP growth had picked up further in Q2. The flash estimate of headline consumer price inflation had increased to 2.5% in May.

11 Growth in the United States had been strong in Q1 but appeared to have moderated since then. This development was most notable for consumption — the monthly growth rates of real household spending had slowed progressively since November. Contributing to this, the pace of job creation had weakened in recent months, consumer confidence had fallen, and the housing market seemed to be slowing. These developments had been a little weaker than expected. Nevertheless, the manufacturing and non-manufacturing Institute of Supply Management (ISM) survey balances had so far suggested only a modest slowdown in growth. Headline and core measures of consumer price inflation had increased in April. In addition, the University of Michigan survey of the general public's twelve-month ahead inflation expectations had picked up sharply to 4% in May. These developments appeared to have primarily reflected movements in energy prices. However, capacity utilisation had continued to increase and was now comfortably above its long-run average level.

12 There had been a steady pickup in the pace of Asian growth since the beginning of 2005. Although Japanese GDP growth had slowed in 2006 Q1 this had been expected following the very strong growth in the preceding quarter.

13 A trade-weighted average of the export price deflators of the United Kingdom's major trade partners had increased by almost 3% in the year to Q1. Although this was broadly in line with developments in recent quarters, it remained high relative to the average over the previous 20 years.

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

14 The Office for National Statistics' (ONS) second estimate of UK GDP in 2006 Q1 had left growth unrevised at 0.6%. There had been minor revisions to the sectoral composition of GDP, with manufacturing growth revised up slightly and the growth rate of the energy sector revised down.

15 The first release of the income and expenditure data for Q1 had shown an uneven pattern in the composition of growth between Q4 and Q1. Consumption growth was estimated to have slowed from

0.8% in Q4 to 0.3% in Q1. At the same time, there had also been large swings in the contributions to growth made by business investment, net trade and inventories.

16 Recent indicators appeared consistent with some rebalancing of growth away from consumption towards investment and exports. Caution needed to be applied, however, in interpreting the latest figures since there were often sizeable revisions to the first estimates of the GDP expenditure breakdown. Over the period since 1993, the average absolute revision to the first estimate of quarterly consumption growth had been around 0.3 percentage points. It was possible that the slowdown of consumption growth between Q4 and Q1 might ultimately be revised to show slightly weaker spending in Q4 and stronger consumption in Q1. However, evidence from surveys and from the Bank's regional Agents had been broadly consistent with the ONS's reported profile of strong household spending growth in Q4 followed by a slowdown in Q1. There had also been anecdotal evidence from retailers of selective price discounting ahead of Christmas and relatively low stocks (and therefore less price discounting than usual) in the post-Christmas period. If this change in the seasonal pattern of discounting were the explanation, the slowdown in consumption growth in Q1 might prove to be temporary; it would then be sensible to look through the quarterly volatility by averaging the consumption growth rates in Q4 and Q1 to give a picture of underlying quarterly consumption growth of around 0.5%.

17 Historically, business investment figures had been subject to even larger revisions than the consumption data, with a tendency for the first estimates to be revised upwards. Reflecting the considerable uncertainty about the investment figures, it might also be sensible to average their growth rates across Q4 and Q1; if that were done, the underlying pace of quarterly business investment growth in Q1 would be relatively modest at 0.4%. However, the recent improvement in survey-based evidence of investment intentions, as well as the strengthening of output indicators, suggested that a pickup in investment growth through the remainder of 2006 seemed likely.

18 The available indicators appeared to suggest that the pace of GDP growth in Q2 was at least as strong as that observed in Q1. While the manufacturing and service sector balances from the CIPS/RBS surveys had eased slightly in May, they nevertheless remained above their Q1 average and were at levels seen in the first half of 2004 when GDP growth had been relatively strong.

19 There was also evidence of a pickup in the pace of consumption growth in Q2. Retail sales had increased by 0.6% in April and the retailers' sales balance in the CBI *Distributive Trades Survey* had risen further in May, to its highest level since the end of 2004. In addition, evidence gathered by the Bank's regional Agents, together with other surveys and the most recent figures for private car registrations pointed to a strengthening of consumer spending growth.

20 Not all the indicators for consumption were positive, however. The recent falls in equity prices, if sustained, were likely to have a modest dampening effect on consumption growth; recent housing market data had been somewhat mixed; and the three-month growth rate of unsecured lending had continued to slow quite sharply. It was difficult to know how much weight to attach to this latter development. If the slowdown were related to a tightening in credit conditions by banks, it might have contributed to the slowdown in consumption growth in Q1. At the same time, however, the growth rate of households' secured lending had remained strong. It was possible that households were choosing to incorporate some of their unsecured debts into their secured borrowing, thereby lowering their cost of finance. Alternatively, household spending growth may have been supported by sales of financial assets or by faster income growth.

21 The annual growth rate of the broad money aggregate, M4, had increased steadily since mid-2003, reaching around 13% in April, its fastest annual growth rate since 1990. The strength of broad money growth, together with large increases in asset prices since 2003, posed an upside risk to the medium-term outlook for inflation — at some point these money balances might be used to finance consumption and investment spending, thereby boosting growth and inflation. In this regard, it was notable that the annual rate of nominal GDP growth had picked up in Q1, after having slowed in 2005.

### **Costs and prices**

22 The latest signals from the labour market data had been somewhat mixed. The Labour Force Survey measure of the employment count had increased by 0.4% in Q1, slightly stronger than had been assumed in the *May Inflation Report*. Moreover, employer-based surveys had suggested a pickup in employment intentions in April and May. However, unemployment had also increased further in Q1. The labour force (the sum of employment and the number of people actively looking for work) had increased by 0.6% in Q1, its fastest quarterly growth rate in 20 years.

23 Since the fourth quarter of 2004, there had been a significant rise in the labour force participation rate together with a gradual increase in the unemployment rate. In contrast, during the two previous large cyclical increases in unemployment, the participation rate had fallen, reflecting discouraged worker effects. Labour force participation rates among women and older workers had been steadily increasing, perhaps prompted by changes in the fiscal regime, social custom or a greater need to save for retirement. The Committee noted that recently the proportion of the unemployed in the 18-24 age group had risen.

24 It remained unclear whether the rise in the unemployment rate primarily reflected cyclical factors or structural considerations. Wage inflation remained subdued which would be consistent with the former interpretation, but it was not conclusive since a moderation in the real consumption wage was to be expected in the face of higher energy prices.

25 There had continued to be little evidence of any pickup in wage pressures. While the annual growth rate of the headline average earnings index had increased in February, this seemed to have been largely related to a shift in the pattern of bonus payments. Consistent with this, whole-economy earnings growth had fallen back to 4.5% in March. Preliminary indications from wage agreements struck in the three months to April suggested that pay settlements had edged down relative to a year earlier. Given that around a quarter of all private sector wage agreements typically occur in April, this was further evidence that second round effects arising from higher energy prices had been limited. It was possible that the credibility of the inflation target, together with the effects of strong competition in product markets, had led firms to believe that they would not be able to pass higher energy prices through to their output prices. Firms might, therefore, have been putting downward pressure on wages to offset higher energy-related input costs.

26 The squeeze on producers' margins appeared to be continuing. Sharp increases in energy prices had contributed to producer input price inflation remaining above 10% since late-2005. Despite this development, producer output price inflation (excluding petrol) had remained broadly stable at around 1½% to 2½% since late-2004. There had been some indications of a slight increase in price pressures in the services sector, with the average balance for April and May from the CIPS/RBS survey of prices charged increasing to its highest level since 2004 Q3.

27 In line with pre-release arrangements, an advance estimate of CPI inflation for May had been provided to the Governor ahead of publication. This had indicated that inflation was 2.2% in May, up from 2.0% in April; the increase between April and May had primarily reflected higher gas and electricity prices. Looking ahead, there were a number of considerations that were likely to impact on the short-term evolution of inflation. First, the recent fall in oil prices would likely feed through to a decline in petrol prices. Second, the introduction of student top-up fees in the autumn might contribute positively to inflation. Third, natural gas futures prices had increased since mid-February, raising the likelihood of another round of wholesale gas prices later in the year. The impact of these factors on the headline inflation rate would depend on how the prices of other goods and services were affected by the associated changes in demand.

28 The Bank of England's survey of the general public suggested that twelve-month ahead inflation expectations had eased slightly between February and May but remained around half a percentage point above the expectations recorded in August and November of 2005. The rise in 2006 might have been a temporary reaction to the recently announced large increases in domestic gas and electricity prices. However, there also appeared to have been an increase in the medium-term inflation expectations held by financial market participants — five-year forward inflation rates derived from the difference in yields on nominal and index-linked UK government bonds had increased by around 30 basis points since the beginning of the year.

### **The immediate policy decision**

29 The most significant news since the *May Inflation Report* had related to developments in financial markets. If the recent appreciation of sterling and falls in equity prices were sustained, then the consequent impact on import prices and personal sector financial wealth would tend to reduce inflationary pressures. However, the recent equity and commodity price falls had not been that large when set against the sharp price increases observed over the previous twelve months; and the sterling ERI had remained within the range it had occupied in recent years. If households and firms had already 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. If this were the case, the impact on inflation from the recent movements in financial markets might prove to be modest.

30 It was not clear whether recent asset price falls would prove to be a limited correction or the beginning of a more marked and sustained change. Most market commentators had suggested it was likely to be a temporary adjustment. There was a risk, however, of a more prolonged and pronounced correction of financial asset prices that might have a significant impact on growth and inflation in the United Kingdom and its major trade partners. This risk arose from the fact that long-term interest rates were still historically low; credit spreads were narrow relative to past norms; and the US current account deficit remained sizeable.

31 Aside from the financial market volatility, developments in the world economy appeared to have been broadly in line with the *May Inflation Report* projection. There were signs of some rebalancing in the composition of world demand, with a pickup in the pace of euro-area and Asian growth and a possible slowdown in the United States. It remained to be seen, however, if the US slowdown would be sharper than envisaged in the *May Inflation Report* and whether the recovery in the euro area would be robust enough to withstand any such slowdown in US demand growth.

32 In the United Kingdom, the second release of Q1 GDP had been slightly weaker than assumed at the time of the *May Inflation Report*. Also, consumption growth had been lower than expected. It was difficult to know what weight to attach to the first estimates of the expenditure components of GDP since the figures were prone to revision. The indicators for Q2 suggested that the pace of growth was likely to have increased to a level that was at, or slightly above, its long-run historical average. The rise in employment and the improvement in employment intentions looked consistent with this. There were also some suggestions that investment and export growth might strengthen in the second half of the year. Overall, therefore, the news about demand and output appeared to have been broadly consistent with the *May Inflation Report* projection.

33 Producer input price inflation and import price inflation were high by recent historical standards and there had been a pickup in the general public's inflation expectations since the turn of the year. Nevertheless, CPI inflation had remained close to the target. Wage pressures had shown no signs of increasing; this might have reflected the impact of continued inflows of migrant workers and the increase in labour force participation.

34 There were a number of upside risks to the outlook for inflation. Growth in the euro area and Asia might well turn out stronger than had been assumed in the *May Inflation Report*. The amount of

spare capacity in the UK economy might be less than the Committee had assumed in its central projection, particularly if some of the increase in unemployment were related to structural factors. If the pricing power of firms increased as the degree of spare capacity was removed, there was a risk that firms would seek to restore their profit margins by pushing up prices. There was also a risk of higher inflation stemming from stronger import prices than assumed in the Committee's central projection and from the recent increase in UK inflation expectations. Finally, the strength of broad money growth and the sharp increases in property and financial asset prices over the past year suggested that the present stance of UK monetary policy might be accommodative.

35 There were also, however, a number of downside risks to the outlook for inflation. While the recent correction of financial markets might prove temporary, there was a risk that it would persist or that asset prices might fall further in the coming months. The slowdown in the United States might prove more pronounced than had been assumed in the *May Inflation Report* and could adversely impact euro area growth. In the United Kingdom, Q1 growth had been slightly weaker than expected and there remained a risk that the erosion of spare capacity in the economy would be slower than envisaged in the *May Inflation Report*. Domestically generated inflation pressures remained weak and the recent increase in the labour force suggested that wage developments might remain benign. While it was important to pay close attention to movements in inflation expectations, the recent increase appeared to have been linked to the rise in domestic gas and electricity prices; there was a chance, therefore, that it would prove to be temporary.

36 Different Committee members attached differing weights to the above arguments. Given that recent developments had been broadly in line with the *May Inflation Report*, and that there were significant risks to the outlook in both directions, most members felt that the rate should remain unchanged this month. For one member, however, the balance of risks to inflation, relative to the 2% target, were sufficiently to the upside to warrant an immediate increase in rates.

37 The Governor invited the Committee to vote on the proposition that the official Bank rate should be maintained at 4.5%. Seven members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean, David Blanchflower and Paul Tucker) voted in favour of the proposition. David Walton voted against, preferring an increase of 25 basis points.

38 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  
David Walton

Simon Brooks was present as the Treasury representative.