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**MINUTES OF  
MONETARY POLICY  
COMMITTEE MEETING  
8 and 9 March 2006**

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These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 March 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0603.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 April will be published on 19 April 2006.



## MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 MARCH 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 costs and prices.

### Financial markets

2 There had been some small upward movements in short-term interest rates in all the major economies over the past month, which seemed broadly consistent with the economic data and news about monetary policies. UK short-term market interest rates had risen following the publication of the *Inflation Report* and *Minutes* but this had been partly offset by the market reaction to the unexpectedly weak CPI data. Sterling money market instruments implied that interest rate expectations were broadly flat over the next year or so. The economists polled in the Reuters survey had expected no change in interest rates this month, but the majority had still expected at least one interest rate reduction later this year. Long-term interest rates in the United Kingdom, United States and euro area were little changed over the past month.

3 In the period since the February meeting, the sterling effective exchange rate index had been broadly unchanged. The dollar and euro effective exchange rates were little changed, while the yen had appreciated by around 1%, possibly in anticipation of the Bank of Japan's decision to adopt a new framework for monetary policy on 9 March. More generally, the sterling ERI had traded within a relatively narrow range for the past five years or so. Measures of implied volatility from options prices suggested that markets were not particularly uncertain about near-term movements in major exchange rates, despite their apparent focus on global current account imbalances in recent years.

4 Equity prices had continued to rise in most major equity markets, with the FTSE All-Share, S&P 500 and Eurostoxx indices all around 1%-2% higher over the month and close to five-year highs. The rise in equity prices was probably linked in part to the decline in long-term real interest rates, rather than just a change in view on future profitability. The recent fall in real interest rates, and the associated fall in the cost of capital, had also seemed to indicate that investment should have been

stronger. That was at odds with the apparent weakness of investment growth in the UK, especially relative to investment growth in some other major economies. But it was unclear how much of the rise in UK equity prices was associated with activities in the United Kingdom and how much with companies' global operations. It was possible that a significant amount of any investment by UK-quoted companies (in particular, oil companies) might be made by their global operations overseas. That being said, the FTSE 250 index of medium-sized companies had also increased, and these companies were, perhaps, less likely to be investing overseas.

### **The international economy**

5 Euro-area GDP data for 2005 Q4 had indicated growth of 0.3%, slightly weaker than expected at the time of the February *Inflation Report*. Both private and public consumption had been weaker than expected, although the fall in household consumption was at odds with the strength of household borrowing and the recent improvement in consumer confidence. Retail sales had increased sharply in January, perhaps indicating that the weakness of consumption in Q4 would prove temporary. Moreover, the output indicators looked consistent with stronger GDP growth in Q1. In particular, a weighted average of the euro-area Purchasing Managers Indices (PMIs) for manufacturing and services had increased in January and February. The German IFO index had also been particularly buoyant recently. It was important not to place too much weight on one country or survey, but overall the indicators for Q1 seemed quite positive. There had been little of significance in the movements in euro area price indices over the past month, on either the headline or core measures.

6 In the United States, the latest indicators supported a view that the weaker GDP growth observed in 2005 Q4 would prove to be temporary. Consumption seemed to have bounced back following the dip from August to October: it had risen by 0.4% in January, following strong growth in November and December. And the manufacturing and services PMIs had both increased in February. Most commentators expected growth to slow in 2006, linked to the lagged impact of monetary tightening and a slowing in the housing market, but there were risks on both sides of this outlook. Reflecting the strength of past growth, capacity utilization had now moved above its historical average and unemployment had fallen below some estimates of the short-run natural rate. Headline inflation had been 4% in January.

7 The news in Asia had been distinctly positive, with Japan recording very strong growth in Q4 and signs of continued strength in non-Japan Asia. Japanese industrial production had risen for the sixth consecutive month in January and seemed consistent with another quarter of above trend growth in Q1. Retail sales had also risen strongly in January and the labour market had continued to tighten. Inflation, excluding the fresh food component, had been positive for three consecutive months.

8 The crude oil price had fallen in recent days and had ended the month around 6% lower. OPEC had decided to leave its production ceiling unchanged. Oil stocks in the United States had been well above seasonal norms in January and February: in the past that had often presaged a fall in prices.

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

9 Most of the nominal indicators had been fairly strong. The annual growth rate of aggregate M4 had remained robust at around 12% in January. Since the Committee's February meeting, the Office for National Statistics (ONS) had published the *UK Output, Income and Expenditure* release. This showed that nominal domestic demand growth had recovered to an annualised rate of around 5 ½% in the second half of 2005. The comparable nominal GDP growth rate in the second half of the year had been somewhat lower than this, but that reflected the temporary distortion to export prices caused by insurance payouts following Hurricane Katrina.

10 The latest ONS data suggested a somewhat smoother pickup from the trough in 2005 Q1. In the first estimate of the expenditure components of GDP growth in the fourth quarter, private and public consumption and net trade had been more buoyant than expected and investment markedly weaker. But the preliminary figures are prone to substantial revisions.

11 While household spending growth in the run up to Christmas had been fairly strong, more recent indicators had been weaker. The ONS had recorded a 1.3% fall in January retail sales and the BRC-KPMG *Retail Sales Monitor*, together with reports from the Bank's regional Agents, pointed to subdued retail sales in February. That weakness had seemed broadly consistent with the monetary indicators: household Divisia money and unsecured borrowing growth had both eased and the element of secured borrowing most likely to be correlated with consumption had remained broadly flat as a share of personal disposable income, despite the pickup in the housing market. Moreover, private car

registrations had remained weak in February. The CBI/Grant Thornton consumer services index had also softened in Q1.

12 It was not clear why household spending should have weakened after Christmas. One possibility was that it simply reflected a change in the seasonal pattern. Retail sales had been strong in November and in Q4 overall. Taking an average of the October to January retail sales data might be a more reasonable guide to the underlying growth rate. Other explanations included the possibility that the amount of income available to spend on discretionary items had been reduced by the past increases in petrol and utility prices, and there was a prospect of further reductions in disposable income following the recent announcements of further gas and electricity price rises. But these explanations sat somewhat uncomfortably with developments in the housing market. The balance of new buyer inquiries had been positive for the eighth consecutive month; approvals for house purchase had been close to the peaks of late 2003/early 2004; and the sales-to-stock ratio had continued to tighten gradually.

13 Investment figures had been markedly weaker than expected, but this component of demand was both more volatile and more prone to large revisions than other components of GDP. The pattern of past revisions, coupled with the survey data, pointed to the likelihood of significant upward revisions. Some expenditure by firms was probably in areas that were hard to measure, or on items that were as yet not counted as investment in the National Accounts, so that perhaps the underlying picture was a little stronger than recorded in the official data. An upward revision might help reconcile the investment data with the strength of equity prices discussed above. But it was also possible that the recent weakness of investment was a genuine phenomenon. The relative weakness of capital goods output might be consistent with that. There were a variety of possible explanations for weak investment. The past relationship between the surveys and the official data might have changed. For example, it was possible that companies might be answering survey questions in regard to their global investment programme, rather than their investment in the UK. There remained a possibility that an increased attention on pension fund deficits was adversely affecting firms' investment decisions as firms tackled their financial obligations before focusing on any business expansion, and sharply rising energy costs might also have led them to defer spending plans. It was noted that growth had picked up more strongly in the United States and euro area than in the United Kingdom.

14 There had been little news on net trade from the latest monthly trade statistics. Looking ahead the continued signs of firm global growth might help support a stronger net trade contribution to UK GDP growth.

15 The apparent weakness of the most recent consumption and investment indicators contrasted with the relatively strong output indicators for 2006 Q1. For example, the CIPS/RBS services business activity index had risen to its highest level since early 2004, taking it well above the broad range it had occupied for much of the past two years, and the index of production for January had been stronger than expected. Taken at face value, the latest output indicators pointed to GDP growth above its historical average in Q1. It was unclear as yet what the expenditure counterparts to that apparently stronger output growth would be. As with investment, it was possible that the relationship between the sectoral surveys and their corresponding output components in the official data had been affected by structural changes, such as outsourcing. These developments had, however, been underway for quite some time.

### **Costs and prices**

16 The Labour Force Survey (LFS) measure of employment had fallen by 0.2% in 2005 Q4, the weakest quarterly growth rate since 1993, while the LFS unemployment rate had risen sharply to 5.1%. There was significant sampling variability and it was sensible not to place too much weight on the sharpness of the movements over the quarter. It was possible that the weakness of employment had reflected unwinding of labour hoarding that may have occurred earlier in 2005. Moreover, there were signs that the weakening of the labour market that had been evident over the past few months might prove temporary. In January, claimant count unemployment had fallen for the first time in a year and recent business surveys had pointed to whole economy employment growth being close to its historical average in Q1. The Bank's regional Agents had conducted a special survey which suggested that numbers employed had fallen over the previous six months, but anticipated a recovery over the next six months. The Agents' survey suggested that particularly strong growth was expected in business services, and that seemed to fit the pattern of output growth seen in the business surveys.

17 There had been little sign of any significant second-round effects from the pickup in CPI inflation in 2005 associated with the rise in energy prices. Wage settlements in January were broadly

similar to those recorded at the same time a year ago, and the Bank's regional Agents continued to report little upward pressure on pay outside the financial services sector.

18 There had been some tentative signs that consumers' inflation expectations may have shifted up in February according to preliminary indications from the Bank/NOP survey. That rise was reflected in both the backward-looking and forward-looking responses. But a rise in inflation expectations had not been seen in all the surveys of the general public – for example, the GfK cost of living balance had been broadly flat compared with last autumn – nor in financial markets or surveys of professional forecasters. It was possible that the apparent rise in inflation expectations in the Bank/NOP Survey reflected a reaction to the announced rises in utility prices.

19 Higher energy prices might still be working through the supply chain, and manufacturers' weighted costs had been estimated to have risen faster than output prices in the year to 2005 Q4, implying a squeeze on profit margins. The *CBI Monthly Trends Enquiry* expected output price balance fell in February, but remained well above the level of last summer. The corresponding CIPS/RBS services survey output price balance had eased.

20 The CPI outturn for January had been a little lower than assumed in the February *Inflation Report*. The recent announcements on gas and electricity prices had been a little larger than expected and would come through more quickly than had been assumed at the time of the *Report*.

### **The immediate policy decision**

21 There had been relatively little movement in market interest rates or exchange rates over the past month, while equity prices had continued to rise. So the broad picture for asset prices looked similar to that at the time of the *Inflation Report* and was supportive of a strengthening in economic activity.

22 The latest indicators of overseas economic activity seemed consistent with continued robust global growth through the first part of this year. There was some upside risk to the projections made at the time of the *Inflation Report* particularly in the euro area and Japan, though there were risks in both directions to the outlook for growth in the United States.

23 UK nominal domestic demand and nominal GDP growth had recovered in the second half of 2005. Output indicators suggested that GDP growth would be above trend in 2006 Q1, with business services activity particularly strong. It was unclear how the expenditure and output indicators could be reconciled. It was possible that the weaker indicators of household spending – which were heavily influenced by developments in the retail sector through January and February – might not be giving a complete guide to aggregate consumption, which might subsequently prove to have been firm in Q1. If consumer spending growth had been weak in Q1, then there might have been some rebalancing towards other components of demand. Investment indicators seemed to have remained weak and so this did not seem a likely source of stronger growth in Q1. But net exports might help to fill the gap, given robust global growth. In addition, it was always possible that output growth might eventually prove to have been weaker than the indicators currently suggested.

24 For some members, there were still downside risks to consumption, and the softer data since Christmas suggested that these might be crystallising. For others, there remained some upside risks to consumption resulting from the apparent strengthening of the housing market at a time when GDP growth was recovering.

25 The latest labour market data were not very different from what had been expected at the time of the February *Inflation Report*. The weakening of employment growth in Q4 seemed most likely to be associated with some unwinding of the labour hoarding from earlier in the year; the latest surveys still pointed to employment growth.

26 There was little evidence of second-round effects on earnings growth from the rise in energy prices; wage settlements and earnings growth remained benign. Inflation expectations data would need to be monitored carefully. There had been news that retail gas price increases were a little larger and would come through a little faster than assumed last month. But looking further ahead, the latest cost and price data did not materially change the view reached at the time of the *Inflation Report*.

27 Overall, the data suggested that output growth had recovered from the trough at the beginning of 2005 and was now close to its historical average; there was some, but not much, spare capacity in the economy; and inflation was close to the target. The outlook was, on balance, for continued growth near trend and inflation close to target. In the light of those considerations, for most members it seemed appropriate to leave the repo rate unchanged.

28 For one member there remained a case for an immediate reduction in the repo rate. The fall in GDP growth below its historical trend for much of the past eighteen months, the recent rise in unemployment and the surveys of capacity utilisation, pointed to a degree of spare capacity in the economy. There was continuing evidence of weak investment intentions, a recent weakening of consumption indicators, and subdued prospects for real labour income, particularly in the light of the forthcoming rise in utilities prices. Given this, the central projection for output in the February *Inflation Report* appeared too optimistic. It was unlikely that the degree of spare capacity in the economy would diminish as much as had been envisaged in the central projection. Given that pipeline price pressures were modest, it seemed likely that inflation would fall below target once the effects of higher energy prices had dropped out of the year-on-year calculations.

29 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, John Gieve, 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.

30 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  
Richard Lambert  
Stephen Nickell  
Paul Tucker  
David Walton

Jon Cunliffe was present as the Treasury representative.