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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
3 and 4 May 2006**

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 May 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0605.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 7 and 8 June will be published on 21 June 2006.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 MAY 2006

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed developments in financial markets; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 Domestic short-term market interest rates had increased over the month, partly in response to the strength of economic activity indicators. At the time of the Committee's meeting, sterling money market instruments implied an expectation of a 25 basis point rise in the Bank of England's repo rate by the start of 2007; the markets also attached a reasonably firm chance to a further 25 basis point tightening by the end of 2007. This represented a substantial change from the position at the time of the February *Inflation Report*, when the short-term interest rate curve had been broadly flat. In contrast, the mean expectation from the latest Reuters poll of private sector economists was for the official rate to remain unchanged at 4½% through 2006 and 2007.

3 Interest rates on long-term government bonds had continued to edge up in the United Kingdom, the United States and the euro area, leaving 10-year nominal forward rates around 65 to 80 basis points above their lows earlier in the year. Most of these moves appeared to have been associated with higher real rates, but there had also been a small rise in implied inflation expectations. Credit spreads on corporate bonds had continued to be stable.

4 The sterling effective exchange rate index (ERI) had appreciated by almost 3% over the month. This development had largely occurred in the days immediately prior to the Committee's meeting; the ERI had consequently ended the month above the 15-day average value used as the starting point for the May *Inflation Report* projections. While the change over the month had been relatively large, the sterling ERI had not moved outside its trading range of recent years and was only around 1½% above its level at the time of the February *Inflation Report*. The dollar effective exchange rate index had

depreciated by around 3½% over the month. This seemed to have been prompted, in large part, by an increased focus by market participants on global imbalances, following recent statements by policymakers at the G7 and IMF Spring Meetings. Given the significant size of the US current account deficit, many commentators continued to highlight the risk of a sizeable adjustment in the dollar's value.

5 The FTSE All-Share index had ended the month broadly unchanged although it was around 5½% above its level at the time of the February *Inflation Report*. The rise in long-term interest rates and further increases in oil prices had apparently had little dampening effect on the upward move in equity prices; this might suggest that all three developments were at least partly linked to the strength of global output growth.

The international economy

6 News about world activity had been consistent with continued robust global economic growth.

7 In the euro area, the balances from the manufacturing and service sector Purchasing Managers' Indices (PMI) and from the European Commission's consumer and industrial confidence surveys pointed to a pickup in GDP growth in Q1 to above trend. The official data relating to retail sales had, however, been weaker. Nevertheless, the available business surveys had all increased further in April. At the national level, the German IFO index had risen to a 15-year high. Taken together, this evidence suggested continued strong growth momentum at the start of Q2.

8 As expected, growth in the United States had rebounded strongly in the first quarter, from the weak fourth quarter. GDP had increased by 1.2% in Q1, the fastest quarterly growth rate in two and a half years. Growth appeared to have been strong at the start of Q2 — the PMI balances for both the manufacturing and non-manufacturing sectors had risen in April. There were, however, some suggestions that growth might slow; in particular, an increasing number of indicators pointed to a possible turning point in the housing market.

9 Economic activity in Asia had remained strong. The growth rate of Chinese GDP in the year to 2006 Q1 had been reported at 10.2%, up slightly from 2005 Q4. While there was likely to have been

some slowing in the pace of Japanese GDP growth in Q1, the March Tankan survey had pointed to a continuation of the recovery.

10 Commodity prices had increased further. Over the month, crude oil prices had risen by around 10% to new record highs. Once again this seemed to have reflected the combined influences of strong demand growth, low global spare production capacity and concerns about oil supply disruptions, particularly in Nigeria and Iran. A number of metals prices had also increased sharply over the month leaving them significantly higher than a year earlier. Export price inflation in the United Kingdom's major trade partners had picked up in 2005 Q4 and had been stronger than assumed in the February *Inflation Report* projections.

Money, credit, demand and output

11 The preliminary estimate of 2006 Q1 GDP growth in the United Kingdom was 0.6%. While this outturn was slightly weaker than had been expected at the time of the February *Inflation Report*, the level of GDP in Q1 was 2.2% higher than a year earlier and this had been in line with the February *Inflation Report* projections. The quarterly growth rate of GDP had been unchanged between 2005 Q4 and 2006 Q1, but the composition of that growth had changed. The manufacturing and energy sectors had rebounded sharply in Q1, while service sector output growth had slowed.

12 The deceleration of service sector activity in the first quarter had been largely accounted for by the distribution, hotels and catering sector. This appeared to have been the main counterpart to the apparent slowdown in consumption growth and was consistent with the retail sales data, as well as a range of other indicators relating to the distribution sector. But, the initial estimates of distribution sector output growth have tended to be revised significantly; the correlation between the initial and final estimates produced by the Office for National Statistics (ONS) had been low historically. So, there remained considerable uncertainty about service sector growth in Q1.

13 On the expenditure side of the National Accounts, it seemed likely that consumption growth had slowed in the first quarter since the volume of retail sales had fallen by 0.7% and the growth rate of unsecured borrowing had declined further. After very strong growth in 2005 Q4, retail sales had fallen markedly in January. Since then, however, household spending appeared to have recovered. Retail sales had increased in February and March and the retail component of the CBI *Distributive Trades*

Survey had picked up quite strongly in April. Vehicle registrations had also increased in March and house prices had continued to rise.

14 There were some suggestions of a shift in the composition of growth towards net trade and investment. The ONS had revised up the figures for both exports and imports in the latest monthly trade release. And the most recent CBI and BCC surveys had shown an improvement in export orders as well as stronger investment intentions while the CBI survey had also shown an increase in capital goods output. Information gathered by the Bank's regional Agents had been consistent with these developments.

15 The available output-based indicators suggested a pickup in the pace of GDP growth in Q2. On the manufacturing side, the CIPS/RBS output balance for April had increased sharply to its highest level in seventeen months; the new orders and output balances from the CBI's quarterly *Industrial Trends Survey* had increased between January and April; and the orders balances from the BCC's *Quarterly Economic Survey* had risen strongly in Q1. On the services side, the CIPS/RBS business activity index had also increased in April, reaching its highest level in more than two years and the BCC survey had pointed to an improvement in orders.

16 Broad money growth had continued to be strong. M4 deposits had increased by 12.3% in the year to March while the growth rate of M4 lending (excluding the effects of securitisations) had risen to 13.3%, its highest rate since September 2004.

Costs and prices

17 Consistent with the evidence of a pickup in growth, there had been some signs of an increase in the demand for labour. The Labour Force Survey (LFS) measure of employment had risen a little in the three months to February and the available private sector surveys, together with evidence gathered by the Bank's regional Agents, pointed to a further increase in labour demand going forward. Nevertheless, the unemployment rate had also increased slightly as the number of people actively looking for work had risen, thereby swelling the labour force. Taking a longer-term perspective, there had been a notable increase in the participation and employment rates among the over-50 year old age cohort.

18 As the Committee had previously discussed, the rise in energy prices would require the growth rate of the real consumption wage to be slower than it would otherwise have been if employment levels were to be sustained. This adjustment could come about via higher inflation, lower nominal wage growth, or some combination of the two. Overall, there remained little evidence of any pickup in wage pressures. While the annual growth rate of the headline average earnings index had increased sharply in February, this was likely to prove temporary since it had partly reflected a shift in the timing of annual bonus payments, particularly in the financial services sector. A matched sample of wage settlements that only included the same firms in it for the first quarters of 2005 and 2006 suggested a fall in wage settlements, with weakness being particularly evident in the retail sector. And the Bank's regional Agents had continued to report little sign of pay pressures. The absence of a pickup in wage inflation could reflect a number of factors, including the rise in unemployment; the impact of increased inflows of foreign workers from the new member states of the European Union; and also a response by firms to larger actual and prospective contributions to their in-house pension schemes. Although wage inflation had remained broadly stable, this had not prevented a small rise in the growth rate of the real product wage faced by firms since the start of 2005.

19 Producer input price inflation remained well in excess of 10% while producer output price inflation had been reasonably stable in recent quarters at between 2½% to 3½%. This suggested that firms' profit margins may have been squeezed. The latest CIPS/RBS and CBI surveys had provided little indication of any significant changes in input and output price pressures although there was some anecdote of firms having increased pricing power in some sectors.

20 CPI inflation had edged down to 1.8% in March. Given the recent further rise in oil prices and the announced sharp increases in retail gas and electricity prices, it seemed likely that the CPI inflation rate would rise above the 2% target in the near-term. The Citigroup/YouGov and GfK surveys of the general public's 12-month ahead inflation expectations had both fallen back slightly in April. Surveys of one-year ahead inflation forecasts made by private sector economists had been largely unchanged in recent months.

The May GDP growth and inflation projections

21 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 10 May.

22 The Committee's central projection, based on its collective judgement and the assumption that official interest rates followed the path implied by the market yield curve, was for output to continue rising at a rate close to its long-term average. Steady growth in consumer spending, a modest recovery in investment and a small boost from net trade were forecast to offset slower growth in public expenditure. Reflecting these developments, the four-quarter growth rate of GDP was expected to continue to edge up through 2006 as the period of weak growth in 2005 dropped out of the calculation. The profile for GDP growth was slightly weaker than in the February *Inflation Report*.

23 The corresponding projection for the consumer price index was for inflation to rise above the 2% target in the near term, reflecting higher energy and import costs. Energy and import price inflation were projected to ease over the forecast period contributing to CPI inflation falling back to around the 2% target. Compared with February, the inflation profile was higher in the first part of the projection and similar thereafter.

24 The Committee's best collective judgement was that the key risks to the central projection related to: the outlook for spending by households and businesses; the prospects for world activity; the evolution of energy and import prices; the extent of wage and price inertia; and the margin of spare capacity.

25 Under the alternative assumption of constant interest rates, output growth and inflation were both a little higher.

The immediate policy decision

26 Although energy-intensive items and non-energy imports had together been making a large positive contribution, CPI inflation had been slightly below the target in March. In its central projection, the Committee judged that as upward pressures on energy and import prices abated, the income available for spending on other items would pick up, pushing up on those prices, so that overall inflation would remain close to the target. However, there was significant uncertainty around those projections. The range of Committee members' views about the economic outlook had widened. Some members felt inflation was likely to turn out a little higher than in the central projection; others

felt it was more likely to come in a little lower. Reflecting this, the Committee discussed the arguments for raising rates, for leaving rates on hold, and for cutting them.

27 There were a number of arguments in favour of higher rates. A broad range of business surveys indicated that the pace of output growth had now risen above trend and that the prospects for exports and investment were improving. This posed an upside risk to the Committee's central projection for GDP growth. There remained considerable uncertainty about the amount of spare capacity in the economy, especially following the large rise in energy prices, but it was likely to be small. Over the past couple of years, changes in survey measures of capacity utilisation had not been large. And part of the recent increase in unemployment might have been related to structural factors. There was also a risk of higher inflation stemming from stronger commodity and import prices than assumed in the Committee's central projection. These factors, in turn, increased the risk of a shift upwards in UK inflation expectations if policy was not tightened. Finally, asset price developments and rapid broad money growth suggested that monetary policy was currently somewhat accommodative.

28 A number of arguments were also advanced in favour of lower rates. There remained a risk that consumption growth would come in somewhat weaker than had been assumed in the central projection owing to the negative effects on post-tax labour income of weak wage and employment growth, higher energy prices, and the projected gradual increase in the effective tax rate. While the pickup in recent investment and export surveys was encouraging, similar strength had not yet been observed in the official data. Consequently, it seemed more likely that growth would be maintained at, or a little below, its long-run average and that some degree of spare capacity in the economy would be maintained throughout the forecast period. This spare capacity would keep downward pressure on domestically generated inflation. Although commodity prices were likely to remain high and volatile in the short-term, their impact on inflation would dissipate unless they continued to rise at a rapid rate. There remained no signs of any second-round impact onto wages from higher energy prices. UK inflation might, therefore, fall below the target once commodity and energy prices stabilised.

29 Different Committee members attached differing weights to the above arguments. Most members, however, felt that the risks to the central projection for UK GDP growth were broadly balanced in aggregate, with upside risks to the projections for investment and exports and downside risks for consumption. Equally, most members felt that the risks to the central projection for inflation were also broadly balanced. In the near term, the risks to inflation were likely to be on the upside,

related to the possibility of higher commodity and energy prices. But further out, the inflation risks could well be on the downside, related to the possibility that inflation could fall back as energy prices stabilised. Some Committee members also highlighted the need to be cautious about the scope for using changes in interest rates to fine-tune small movements in inflation expectations. Finally, most members felt that the uncertainty about the degree of spare capacity in the economy meant that it was, for the moment, sensible to wait for further evidence about the likely direction of inflationary pressures.

30 On balance, most members felt there was no need to stimulate demand at this time given the signs of a pickup in growth and the near-term risks to inflation from higher energy prices. Equally, there appeared to be no pressing need to tighten policy given the continued weakness of domestically generated inflation. One member felt that the balance of risks to inflation, relative to the 2% target, had shifted a little too much to the upside for comfort and that warranted an immediate increase in rates. Another member felt that a small reduction in interest rates was warranted to stimulate demand and help increase the level of domestically generated inflation back towards 2%.

31 The Governor invited the Committee to vote on the proposition that the repo rate should be maintained at 4.5%. Six members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean and Paul Tucker) voted in favour of the proposition, and two (Stephen Nickell and David Walton) voted against. Stephen Nickell preferred an immediate cut in the Bank's repo rate of 25 basis points, and David Walton preferred an immediate increase of 25 basis points.

32 Finally, the Governor expressed his appreciation to Stephen Nickell for his contribution as a member of the Committee.

33 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
Stephen Nickell
Paul Tucker
David Walton

Jon Cunliffe was present as the Treasury representative.