

Publication date: 22 November 2006

---

---

**MINUTES OF  
MONETARY POLICY  
COMMITTEE MEETING  
8 & 9 NOVEMBER 2006**

---

---

These are the minutes of the Monetary Policy Committee meeting held on 8 & 9 November 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0611.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 6 & 7 December will be published on 20 December 2006.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 NOVEMBER 2006**

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

### **Financial markets**

2 There had been few significant developments in financial markets since the October MPC meeting. Short-term interest rates in the United Kingdom and overseas ended the month slightly higher. Market participants appeared to be pricing in a 25 basis point increase in Bank Rate at this meeting with a high probability, and that had been echoed by the unanimity in the Reuters survey of economists predicting a rate rise. Market participants put some probability on a further increase early in 2007. Elsewhere, yield curves implied that market participants expected the European Central Bank to increase rates in December, with a further increase to come in early 2007. By contrast, the balance of market expectations was that the Federal Open Market Committee would reduce rates during the first half of 2007.

3 Longer-term nominal interest rates had mirrored the movements in short-term rates, falling slightly over the month. Real forward rates had fallen, and were approaching their January lows. Implied forward inflation expectations were little changed. Equity prices had risen further in the United Kingdom and elsewhere.

4 The sterling effective exchange rate index (ERI) had edged up another 0.4%, taking it towards the top of a range it had occupied during the past eight years. Since early April, it had appreciated by 6%. Implied volatilities derived from options prices for the main currencies against the dollar – a measure of market uncertainty about exchange rates – had declined over the past few months.

## **The international economy**

5 Data for the United States during the month had been mixed, but seemed on balance still to be consistent with a modest and temporary reduction in growth, rather than a sharp or prolonged slowdown. GDP growth of 0.4% in Q3 had been a little weaker than expected. That weakness reflected a sharp fall in residential investment of nearly 5%. By contrast, non-residential investment had grown strongly, by around 2%; and consumption growth at 0.8% was in line with its 30-year average.

6 The headline index in the October Institute for Supply Management (ISM) survey for manufacturing had fallen to its lowest since June 2003. But the ISM non-manufacturing measure had rebounded strongly. Though these surveys represented only the first month of the quarter, they were consistent with a pickup in GDP growth in Q4.

7 Non-farm payrolls had risen by just 92,000 in October, which was below market expectations. But there had been substantial upward revisions to earlier months and unemployment had fallen to 4.4%, the lowest since May 2001. Those data suggested a firm labour market which, alongside the boost to real personal disposable incomes from lower gasoline prices, should help to underpin household spending. As yet, there had not been much evidence of the housing market slowdown affecting the wider economy, though risks remained.

8 In the euro area, there had been little news in the second release for Q2 GDP, with the estimate of growth unchanged at 0.9%. Output indicators from surveys pointed to only a slight moderation in growth for Q3. Surveys for October tentatively suggested that firm growth would be maintained in Q4.

9 The evolution of consumption, especially in Germany, remained important for the sustainability of continued euro-area expansion. German retail sales were down sharply in September, though these data were volatile and often revised. There was little sign that consumption was being brought forward ahead of the January VAT increase in Germany. For the euro area as a whole, retail sales were up 0.6% in Q3.

10 There might have been a slight pause in the Japanese recovery during the middle of the year, though underlying conditions remained firm. The rest of Asia was still growing strongly.

11 Overall, world economic activity was robust in 2006. Weighted by the distribution of UK exports, world GDP growth in 2006 was set to be the strongest since 2000. That had supported the recovery in manufacturing in the United Kingdom and the strong growth of UK exports.

12 Metals and food commodity prices had risen. The oil price had changed little on the month, but it had fallen by almost a quarter since the August *Inflation Report*. The fall in oil prices had led to sharp falls in producer and headline consumer price inflation in a number of countries.

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

13 The provisional estimate of UK GDP growth in Q3 was 0.7%, the same rate as in the previous three quarters. The CIPS/RBS services activity indicator rose to 59.3 in October, but the CIPS/RBS manufacturing output index fell. Coupled with the slight weakness in the CBI *Industrial Trends Survey* and the ONS's estimate of flat output in September, it suggested that activity might be levelling off in manufacturing. However, it was too early to say whether this was a pause rather than a turning point. Overall, the growth rate for GDP in Q4 looked likely to be similar to that in previous quarters.

14 Some moderation in household spending growth from its strong rate in the second quarter was necessary if the MPC's central projection for the November *Inflation Report* were to materialise. There had been tentative signs that the August Bank Rate increase was beginning to have some effect. Retail sales volumes rose by 0.8% in Q3, down from 1.9% in the previous quarter. The level of retail sales volumes had been similar to that recorded in June. In addition, the BRC/KPMG retail sales monitor had suggested that annual total nominal sales growth eased for a third consecutive month in October, though total sales were still up by 5% on a year ago in value terms. The Bank's regional Agents had observed a reasonably robust picture for retail sales, though that was by no means a uniform experience across different types of outlet and region. Overall, the information had seemed consistent with the modest slowing implied by the central projection.

15 The housing market seemed buoyant. While there were signs of slowing house price inflation in some regions, the average of the lenders' house price indices had risen by 2.5% in the three months to

October compared with three months earlier. In the preview of the Royal Institution of Chartered Surveyors' (RICS) survey, the current price balance had edged up, while the sales-to-stocks ratio had tightened. Loan approvals for house purchase had also firmed, and had reached the levels of early 2004. The lenders appeared to be increasing the supply of mortgage finance, with some easing their limits on how much they were prepared to lend.

16 Most of the business investment intentions indicators had picked up. The weighted average of the British Chambers of Commerce (BCC) manufacturing and services investment intentions balances had risen in Q3 to its highest level since 1999. Corporate borrowing had also increased. The Bank's regional Agents corroborated this picture, reporting that investment intentions were the strongest they had been for 18 months.

17 Export prospects remained firm. The BCC manufacturers' export orders balance had picked up in Q3 to its highest level since 1995. And, having been above its historical average in Q2 and Q3, the CIPS/RBS manufacturing export index had picked up further in October.

18 Nominal GDP had risen by 4.8% in the year to 2006 Q2, while nominal domestic demand – possibly a more useful indicator of domestic demand pressures – was 6% higher. These increases were roughly in line with their respective averages since the Bank had been made operationally independent. But broad money growth had risen to 14.5% in September – the highest growth rate since 1990. The sharp pickup in money growth over the past two years had been accounted for largely by increases in the deposits of non-bank financial companies. The reasons behind the increase in the demand for money by these companies were not completely clear. It could reflect a structural or a portfolio shift in demand, in which case the inflationary implications might be limited. However, there was a risk that the build-up of liquidity in this sector might eventually be translated into higher demand for other assets. That would tend to push up asset prices, and hence boost nominal demand for goods and services.

### **Costs and prices**

19 According to the Labour Force Survey, the unemployment rate had risen by 0.8 percentage points to 5.5% over the past year. But employment had also been growing, and the various surveys

had suggested that employment was likely to continue to grow at robust rates. The employment rate was broadly unchanged.

20 On the pay front, the 12-month average of settlements was unchanged in September, though it was a month in which relatively few settlements were agreed. The sharp pickup in RPI inflation of around 1 percentage point over the past year had led to heightened concerns among some Committee members that pay settlements would rise in the coming months. Regular pay growth had been around 3½% in August.

21 The CBI *Industrial Trends Survey* suggested that capacity utilisation had fallen recently. But BCC survey measures for manufacturing and services had risen over the course of the year; and information provided by the Bank's regional Agents suggested that capacity utilisation in the service sector was at its highest since 2001.

22 Manufacturers' input and output price inflation had both fallen sharply in September, reflecting lower energy costs. CIPS/RBS services input and output price balances had also fallen back in October and were now around their long-run averages, though the BCC survey suggested that inflation pressures might have picked up.

23 CPI inflation had been 2.4% in September, down 0.1 percentage points on August but stronger than the Committee had expected at the time of the August *Inflation Report*. In response to lower oil prices, CPI inflation had fallen by more in other economies such as the United States and euro area. In the United Kingdom, the depressing effect from lower petrol prices had been offset by increases in a number of other prices. In line with pre-release arrangements, an advance estimate for CPI inflation of 2.4% in October had been provided to the Governor ahead of publication.

### **The November GDP growth and inflation projections**

24 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 15 November.

25 In the MPC's central projection, assuming that Bank Rate followed a path implied by market interest rates, GDP growth remained close to its average rate over the past decade. The profile was

marginally stronger than in the *August Report*. CPI inflation picked up in the early part of the central projection, before falling back, settling around the 2% target over the medium term. The central projection for CPI inflation was similar to that in August: inflation returned to target somewhat more rapidly, reflecting the fall in oil prices since then.

26 As usual, there were substantial uncertainties surrounding these projections. These included: the implications of rapid growth in money and credit; the momentum in consumption and investment spending; the prospects for world activity; the degree of slack within the economy; and the outlook for wages and prices in the light of movements in energy and import prices. The Committee judged that there were particular uncertainties on the supply side. Overall, the risks to growth and inflation were judged to be broadly balanced, though, as in August, there was greater-than-usual uncertainty over the outlook for inflation.

### **The immediate policy decision**

27 On the demand side of the economy, consumer spending appeared to be growing at close to its long-run average rate. Although the relationship between house prices and household spending was far from clear, the greater buoyancy of the housing market might pose an upside risk to future consumption growth. But the burden of rising debt could weigh more heavily on spending than had been allowed for in the Committee's central projection. Most measures of investment intentions had strengthened. A healthy corporate financial position, falling relative prices for investment goods, and a small margin of spare capacity pointed to a supportive climate for future investment growth. Most surveys of export orders had also picked up. That was probably in large part due to the euro-area recovery, which appeared to have been sustained during the second half of 2006. And in the central projection, the robust outlook for the world economy implied continued strong growth for UK exports. There were downside risks attached to that view of exports, associated with the possibility of a sharper downturn in the United States, but for most members those risks seemed to have diminished somewhat.

28 GDP was estimated to have risen by 0.7% in Q3. Based on the available survey evidence for output, firm growth was likely in the fourth quarter also. Indeed, in the central projection, growth continued at close to that rate for the next three years, though there were clearly risks around that view.

29 Particular uncertainties lay on the supply side of the economy. The workforce had expanded rapidly. The extent of migration was very uncertain, and if anything it had probably been higher than the official figures suggested. The participation rate had also increased. An expansion of the workforce would push up growth, might raise unemployment, but would probably exert downward pressure on wage inflation. If the Committee had underestimated the growth rate of the workforce, it could be faced with somewhat lower inflation than in its central projection.

30 But there had also been an adverse supply shock associated with the rise in oil and import prices. The resulting fall in the terms of trade and the rise in energy prices meant that the real take home pay received by employees had needed to grow more slowly than the real wage costs faced by employers. Real take home pay growth had been modest. But it was far from clear that it had been modest enough, because the growth in real wage costs faced by employers had outstripped trend productivity growth. That implied a squeeze in profit margins, and a slower growth rate of labour demand contributing to the rise in unemployment. The Committee judged that there was still some further downward adjustment of real take home pay needed. It could come about through subdued nominal wage growth as in the central projection, but there was a risk that firms would choose to restore profit margins by raising prices.

31 A busy period for pay settlements was approaching and would probably take place against the backdrop of temporarily high retail prices inflation. There was a risk that employees would seek to negotiate higher wages in order to resist the erosion of their purchasing power according to that index. If they succeeded, the downward adjustment of real take-home pay might be somewhat slower, and the upside risks to inflation higher.

32 Another key uncertainty was the likely path for nominal demand and how that might translate into inflation. Nominal domestic demand growth had been strong. The prospect was for further strength, and suggested that the current monetary stance might still be accommodative. Equity prices had risen; house prices had climbed further; and long-term real interest rates had fallen back. Broad money and credit growth had picked up, posing a risk of further asset price appreciation. There was also a risk that if inflation continued above target for much longer, that might come to be reflected in inflation expectations. All these factors posed upside risks to inflation.



33 For most members of the Committee, the balance of risks suggested that CPI inflation would exceed the 2% target in the medium-term if Bank Rate were maintained at 4.75%. For those members, an immediate increase of 0.25 percentage points in Bank Rate was necessary to return inflation to target.

34 But for one member, the need for a rise was less pressing. The key uncertainty was on the supply side. There was probably scope to allow the economy to grow more quickly and take up the extra slack in the labour market. Moreover, the current spike in inflation was mainly related to large gas and electricity price increases, which were still more than offsetting the recent fallback in petrol prices. Once their immediate impact had dissipated, CPI inflation was likely to fall back sharply next year. The slack in the labour market would help to reduce the risk of the expected spike in inflation feeding into higher wages during the coming wage round. Raising rates as an insurance policy against such a risk increased the probability of undershooting the target and introducing unnecessary volatility into the economy.

35 Another member placed more weight on the downside risks to demand and inflation. There were signs of weakness in the output and retail sales data. The August rate rise had not yet been fully felt. And the downside risks from the world, especially the United States, were greater than implied by the fan charts in the *Inflation Report*. The rise in unemployment had in part been caused by relatively weak demand for labour, and so was more likely to be associated with downward pressure on wages. Moreover, the Committee had been surprised by the extent of the rise in unemployment, and there was a reasonable probability that it would be again. Inflation expectations according to surveys were flat or falling. And so prospective wage growth was likely to be muted.

36 The Governor invited members to vote on the proposition that Bank Rate should be increased by 25 basis points to 5.0%. Seven members of the Committee (the Governor, John Gieve, Kate Barker, Charles Bean, Tim Besley, Andrew Sentance and Paul Tucker) voted in favour of the proposition. Rachel Lomax and David Blanchflower voted against, preferring to maintain Bank Rate at 4.75%.

37 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

Tim Besley

David Blanchflower

Andrew Sentance

Paul Tucker

Jon Cunliffe was present as the Treasury representative.