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MINUTES OF MONETARY POLICY COMMITTEE MEETING

4 & 5 October 2006

These are the minutes of the Monetary Policy Committee meeting held on 4 & 5 October 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0610.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 8 & 9 November will be published on 22 November 2006.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 OCTOBER 2006

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

Financial markets

2 There had been relatively little news from financial markets since the September MPC meeting. Short-term interest rates in the United Kingdom, the euro area and the United States had risen in the first part of the month and had then fallen back following some weaker-than-expected output and inflation indicators. UK interest rate expectations had ended the month a few basis points higher at the short end of the curve, but a few basis points lower further out. Compared with the time of the August *Inflation Report*, market expectations of short-term interest rates over the next few months were around 25 basis points higher.

3 The markets had continued to price in a high probability of a 25 basis point increase in UK interest rates by November, and a small probability of that increase occurring as early as October. The Reuters survey of private sector economists painted a similar picture. Although the central expectation among respondents was for no change at the October policy meeting, the mean probability of an increase had been put at 25%, with the central expectation being for interest rates of 5% by the year-end. The markets appeared to be pricing in some possibility of a further rise in 2007 Q1.

4 Further along the yield curve nominal long-term interest rates had continued to fall, at home and abroad, and were now 30-40 basis points below the levels recorded at the time of the August *Inflation Report*. This had largely reflected a fall in real interest rates, back towards their January lows, although this might reflect lower term premia as well as a lower risk-free rate. The fall had seemed correlated with concerns about softer US activity, though it was unclear why longer term interest rates should be so sensitive to conjunctural conditions.

5 Equity prices had risen in many international markets. US profit warnings had reached their lowest three-month average level since August 2000 and corporate earnings forecasts for 2006 and 2007 remained upbeat. So any market concerns over the strength of US economic activity had not been reflected in equity prices. In contrast, the FTSE All-Share index had been little changed on the month; that appeared to reflect the greater weight of oil companies and mining in the UK index together with the recent decline in oil prices.

6 Inflation expectations inferred from financial markets had edged down in the United Kingdom this month. But over the year as a whole, there had been an increase in medium-term inflation forward rates in the euro area, the United States and the United Kingdom. It was not obvious why the rise in implied inflation expectations had been somewhat larger in the United Kingdom than elsewhere, and the Committee considered how much weight to give to this. The high institutional demand for index-linked gilts, to match pension fund liabilities, might have pushed UK real interest rates on index-linked gilts down, raising implied forward inflation rates in the first instance. But these institutions, and other market participants, would also have views on the likely future course of inflation and the appropriate risk premia: they could buy conventional gilts if the implied compensation for inflation seemed too high. It was also possible that the rise in recent quarters had reflected the inflation risk premium returning to a more normal level, perhaps reinforced by greater uncertainty about the medium-term wedge between the CPI and RPI. But in any case, allowing for a small risk premium, the implied expectation for CPI inflation was only slightly above the target at most horizons.

7 The effective exchange rate index for sterling had risen 1% on the month, with the dollar also up 1% and the euro little changed. The level of sterling had risen 6% since April and 2% since the August *Inflation Report*. While the movement earlier in the year had been associated with the fall in the dollar following the spring IMF meetings, most of the movement in sterling in the past couple of months seemed to have reflected a reaction to movements in international interest rate differentials. In addition, sterling might have been supported by inflows related to merger and acquisition activity and diversification in official holdings of reserves from dollars and euros. On a longer perspective, sterling remained within the broad range it had occupied since the late 1990s.

The international economy

8 As discussed in September, euro-area GDP growth in Q2 had been a little stronger than expected, with consumption weaker and investment stronger. Retail sales had, however, increased in August, and euro-area consumer confidence had risen slightly in Q3. And with employment strengthening, the fundamentals seemed to support further growth in household spending. The picture for German consumption still looked relatively weak, and the planned increase in VAT in the New Year clearly continued to pose a future downside risk. On the output side, the euro-area manufacturing and services Purchasing Managers' indices had eased in Q3 but remained at high levels, and the EC industrial confidence indicator had risen in Q3 to its highest rate since 2000. Together these indicators pointed to further healthy growth in Q3. The relative health of the euro-area economy might indicate that structural reforms were now having some impact.

9 In the United States, Q2 GDP growth had been revised down a little, to 0.6%, and within this there had been a sharp contraction of residential investment, which had been an important contributor to past US business cycles. It was quite possible that the slowdown in housing investment would be sharper than embodied in the August *Inflation Report* central projection. The impact of the housing market slowdown on consumer spending had so far seemed limited, with the latest data appearing broadly consistent with the August projection. Moreover, as far as total household wealth was concerned, equity market movements play an important role. It was also possible that an ongoing portfolio shift between housing and equity wealth was in progress with only limited implications for consumption. Furthermore, the recent fall in fuel prices would boost real household incomes and might help bolster consumer confidence. Turning to the output indicators, there had been a fall in the Philadelphia Federal Reserve regional survey and in the Institute for Supply Management (ISM) index of manufacturing in September. The ISM non-manufacturing index had fallen more sharply. The significance of any softness in US activity for world demand would depend, in part, on the policy reaction both in the United States and elsewhere.

10 In Asia, Japanese Q2 GDP growth of 0.2% had been a little weaker than assumed in the August *Inflation Report*. However, there was a history of large revisions to early estimates of GDP and the September Tankan survey had been stronger than financial markets had expected. Chinese output and trade indicators had also continued to indicate a robust pace of expansion.

11 There had been a continuing fall in spot oil prices to below \$60 per barrel – a fall of around 15% since the time of the previous meeting and around a quarter from its early August peak. Futures prices had, however, fallen by rather less than spot rates, and it was these that underpinned the *Inflation Report* projections. There were various possible explanations for the decline in oil prices, including: high stock levels in the United States; the absence of weather-induced supply disruptions in the Gulf of Mexico; reductions in geopolitical risks; and downgrades to projections of world oil demand. The fact that other commodity prices had, so far, not fallen to the same degree suggested that the movement in oil prices might owe more to current and prospective supply conditions than to signs of weaker demand. There had been significant falls in the wholesale price of gas as well as oil. But prospects for oil prices still remained uncertain going forward.

12 The evidence on global inflationary pressures had been mixed. Euro-area HICP inflation had fallen to 1.8% in September, the first time it had fallen below 2% since January 2005. Producer price inflation remained high in August, and the EC survey-based measure of capacity utilisation in manufacturing was above its long-run average.

13 In the United States, inflation measured by the core personal consumption expenditures deflator had risen to 2.5% in August, the highest since the mid-1990s. There was some evidence that inflation might be strengthening further up the supply chain, with core intermediate producer prices rising strongly. There had been a sharp rise in four-quarter unit labour cost growth in Q2, perhaps partly reflecting the exercise of stock options. This income was included in broader measures, such as compensation per hour, but not in the employment cost index, which had been growing at a rather lower rate through 2006.

Money and credit

14 M4 growth had picked up to almost 14% in August, the highest rate since November 1990, with the increase in recent quarters coming from other financial corporations (OFCs). A significant proportion of the recent increase in the rate of growth of OFCs' money could be accounted for by intra-group transfers – business between banks and their related non-bank entities such as securitisation vehicles. It was debatable when, or indeed whether, the latter type of balance sheet movement was likely to have much impact on future demand. However, even when those transfers were excluded, money growth had still been rapid, and was notably faster than nominal GDP growth.

There remained a risk that the balances might be used to purchase assets in the future, driving up asset prices and then nominal demand for goods and services.

15 The growth of unsecured lending to households had declined further and balances on credit cards in August had fallen for the first time since 1994. However, secured lending growth had remained buoyant. These movements might reflect a change in the behaviour of the lenders. With default rates on credit cards and other unsecured borrowing rising, possibly encouraged by easier access to Individual Voluntary Arrangements, banks would tend to reduce more risky lending in favour of lending against collateral. That was consistent with information provided to the Bank by lenders, which suggested that credit conditions for unsecured lending were tightening gradually and those for secured lending easing modestly. An alternative explanation was that the pickup in the housing market had been reflected in increased secured borrowing, and that households had been switching away from high cost unsecured credit.

Demand and output

16 The news in the Quarterly National Accounts appeared to be on the downside, with the level and growth rate of GDP at market prices in Q2 both revised down by 0.1 of a percentage point. Within the total, there was a small downward revision to services growth in Q2, and manufacturing growth had been revised up slightly. Energy output had remained weak in Q2. There had been a significant downward revision to public services output, so that growth in private sector output in Q2 – which was more relevant to the demand pressures affecting CPI inflation – had actually been revised up slightly, together with a small upward revision to the level. This in turn might translate into a slightly smaller estimate of the margin of spare capacity in the economy, though more analysis of this would be needed in the context of the quarterly *Inflation Report* projections.

17 In September, the Committee had noted that although the first estimate of nominal GDP growth (and the implied deflators) had been strong in Q2, such estimates were prone to revision. The annual growth rate had since been revised down, to 4.8% from 6.0%, following a correction by the ONS to their treatment of VAT fraud, although nominal domestic demand was estimated to have grown at 6.0%.

18 The growth in all three components of real final domestic expenditure had been revised down, while the net trade contribution had been revised up; none of these revisions significantly changed the

overall picture. Consumption growth of 0.9% in Q2 was broadly in line with the August *Inflation Report* projection. The profile for real post-tax labour income seemed to fit better the slowdown in household spending through 2004-5, and the subsequent pickup over the past year. More recently, retail sales had risen in August, and the fall in July had been revised away. The *CBI Distributive Trades Survey* reported sales balance for September had risen slightly, reaching its highest level since the end of 2004. The three-month rate of house price inflation had risen in September according to both the Halifax and Nationwide indices. While the preview of the Royal Institution of Chartered Surveyors' (RICS) survey had shown an increase in both the current and expected prices balance, other indicators of the housing market had weakened a little, with the RICS new buyer enquiries balance, the House Builders' Federation net reservations and site visitors' balances, and the number of loan approvals all down. Taking the indicators together, there seemed little reason to alter the near-term outlook for consumption seen at the time of the *Report*.

19 The small downward revision to business investment growth had still left it somewhat above the August projection. Investment intentions had remained robust. The Bank's regional Agents had reported that some manufacturers were planning to invest to expand capacity, though more investment was focused on improving productivity and reducing energy consumption in order to raise competitiveness. The firmness of aggregate demand, and the latest data on net rates of return on capital, tended to support the August projection of relatively robust investment growth.

20 The contribution to GDP growth in Q2 from net trade had been revised up. But the data were subject to great uncertainty, particularly because of the difficulty in gauging the true extent of VAT fraud. Export orders had picked up sharply in the September CIPS/RBS survey.

21 The latest output indicators still pointed to continued firm growth in both GDP and private sector output in Q3, and on a longer perspective pointed to the economy having recovered from the soft patch in the first half of 2005. The CIPS/RBS services survey activity balance increased slightly in September, and there were rises in the output and new orders balances in the manufacturing survey. In the light of the timing of the meeting, the ONS had provided the Committee with pre-publication access to the industrial production data. Overall production had been flat in the three months to August. Within the total, manufacturing had been relatively strong but this had been offset by a further fall in energy output.

Supply, costs and prices

22 According to the Labour Force Survey (LFS), employment growth had eased in the three months to July. The employment rate had fallen to 60.1%. The participation rate had continued to rise, as had the LFS unemployment measure. But other measures of ‘non-employment’ had risen by less. For example, the claimant count measure of unemployment had fallen a little in August, though the rate had been steady at 3.0% for some months. It was possible that this indicated that LFS unemployment might soon begin to ease, though there were differences of view over the likelihood of this occurring.

23 There remained a number of possible explanations for the increase in unemployment, with both the lagged effects of the earlier slowdown in activity and an increase in labour supply being consistent with an increase in slack in the labour market in recent quarters. It was particularly difficult to quantify the impact of significantly higher net inward migration on labour market activity, demand, output and inflation. It was possible that the short-run natural rate of unemployment had risen as a result of real wage resistance to the rise in energy prices. Others held the view that the rise in unemployment was cyclical.

24 A key issue continued to be whether there would be any attempt by workers to rebuild the purchasing power of their wages in the coming pay round. There had been little news on pay settlements in August. Regular pay growth eased in July. Smoothing through the volatile bonus component suggested that overall earnings growth remained below 4%. In contrast, the latest estimates suggested that real labour costs faced by employers were growing more strongly than real take-home pay.

25 Input and output price inflation had eased back in recent months. The recent decline in oil prices would not have had time to feed through fully to input prices. The Bank’s regional Agents had undertaken a special survey of firms’ price setting behaviour. Around 50% of firms reporting that they had experienced margin erosion in the recent past planned to respond by raising prices. This seemed more prevalent among manufacturing rather than those firms setting final prices, such as retailers. There had been some earlier evidence from the Agents that pricing power was returning in some sectors. Both the CIPS/RBS services and manufacturing surveys price balances were above their historical averages.

26 CPI inflation had risen to 2.5% in August. Despite the recent decline in energy prices inflation was likely to remain above target in the near-term, given the announced changes in utility prices, and the likely impact of university tuition fees.

27 The Citigroup/YouGov survey measure of the public's inflation expectations had fallen in September. The expected inflation balance on the GfK survey had also eased.

The immediate policy decision

28 Overall, there had not been a great deal of news on the month, and what there was had been mixed. The Committee reviewed how the prospects for inflation had evolved since its August *Inflation Report* and the September meeting. This included an evaluation of: the prospects for world growth; the strength and durability of the recovery in UK consumer spending; the margin of spare capacity in the economy; and the outlook for external price pressures and their interaction with domestic inflationary pressures.

29 The August *Inflation Report* central projections had been conditioned on the gently rising path for interest rates then implied by financial markets. The Committee noted that, since its September meeting, near-term market interest rate expectations had moved slightly higher, and were now pricing in a higher probability of a rate increase by the November meeting and the possibility of a further rise in 2007 Q1. Associated with this, the exchange rate had moved higher than envisaged at the time of the August *Inflation Report*.

30 The data in the United States had suggested continued downside risks to activity, although the rise in equity prices suggested that the markets were not expecting a sharp or persistent downturn. The impact on UK-weighted world demand from the crystallisation of this risk would depend, in part, on the policy responses in the United States and elsewhere. By way of contrast, the euro area seemed to be growing at least as strongly as expected. The recent strength of the UK manufacturing indicators might have reflected the gathering strength of demand from the euro area. Energy prices had moved sharply lower. That seemed likely to reduce upward pressures on global inflation and provide a boost to world activity.

31 There had been relatively little news on demand and output in the United Kingdom, with some small upside news on private sector output. Output growth in Q3 still seemed likely to be firm. But it

was too early to tell whether Q4 would be stronger or weaker than envisaged in the August central projection.

32 There were several candidate explanations for the rise in LFS unemployment, some of which would be consistent with downward pressure on wage growth. But it was not possible to tell a complete story, and the claimant count and LFS unemployment data continued to behave differently. Increased migration and participation made it difficult to assess the pace of supply growth or the extent of spare capacity. There was little news on the degree of spare capacity within firms.

33 Settlement and earnings growth remained subdued, but the question of whether the growth in real wages received by workers had slowed sufficiently to allow for the rise in energy prices remained. With the National Minimum Wage being increased in October, and the prospect of higher CPI and RPI inflation in the near-term, it would be important to monitor what was happening to settlements and earnings in the coming pay round. It was reassuring that the rise in shorter-term inflation expectations seen in August had been reversed in September.

34 Although the near-term outlook for inflation appeared a little weaker than last month, largely due to the fall in energy prices, the inflation rate was set to remain volatile. It was important to look through the short-term movements to the medium term.

35 There was a range of arguments both for raising and for maintaining the Bank Rate this month, to which different members of the Committee attached different weights. But for most members the decision was finely balanced.

36 Some members, while placing considerable weight on the reasons for waiting, concluded that, on balance, the evidence was sufficient to warrant a 25 basis point rise in the Bank Rate this month, based on the cumulative news since the *August Report*. The August projection had been conditioned on the gently rising interest rate profile expected by markets at that time. A further rise in interest rates was consistent with the August central projection, and a rise in interest rates now might reduce the possibility of needing to make a larger increase later on. Since August, there were signs that above-trend growth had continued: retail sales and housing data pointed to resilient consumption; healthy corporate profitability outside manufacturing suggested a robust outlook for investment; global activity had remained strong; and there were risks of real wage resistance and/or a rise in inflation expectations – especially since the expected rise in inflation this autumn would come just prior to the

main settlement round. It remained possible that the rapid growth of broad money, for which there was no obviously compelling structural explanation, would feed through to asset prices and eventually to nominal demand. There were puzzles in the labour market, but these were unlikely to be resolved soon, and many of the indicators were likely to be lagging ones. Evidence from business surveys and from the Bank's regional Agents suggested that firms appeared more willing or able to increase prices than in the past.

37 Other members placed considerable weight on these arguments supporting a further rise in the Bank Rate, but thought there was no pressing need to raise rates this month. An immediate rise in the Bank Rate might encourage a further increase in market interest rate expectations, and hence provide an additional degree of tightening which was not required at this juncture. The central projections in the *August Report* seemed broadly intact, but it would be helpful to process some of the news in the context of the November *Inflation Report* round, particularly the fall in energy prices and the rise in sterling.

38 Some members thought it desirable to assess the impact of the August increase, especially on the prospects for spending, before taking further action. In addition, if sustained, the decline in the oil price would reduce the peak in inflation anticipated for the fourth quarter. It would also be worth undertaking additional analysis on a number of issues, including the impact of increased labour force participation and migration, which might indicate that supply was increasing by more than had been previously assumed. That might suggest the need to look more closely at indicators of pricing pressures. One member placed particular weight on the possibility that the labour market would continue to slacken, given shocks to labour supply and the pace of demand growth, and that consequently the degree of spare capacity in the economy was somewhat larger than thought at the time of the *August Inflation Report*.

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

40 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.