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# MINUTES OF MONETARY POLICY COMMITTEE MEETING 6 & 7 September 2006

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These are the minutes of the Monetary Policy Committee meeting held on 6 & 7 September 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0609.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 4 & 5 October will be published on 18 October 2006.

Correction, paragraph 38

The minutes have been corrected for an error in the version first released. The sentence relating to the Average Earnings Index should have referenced June rather than July.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 SEPTEMBER 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 supply, costs and prices.

### **Financial markets**

2 The decision to raise the official Bank rate at the August meeting had not been anticipated by most participants in financial markets, despite an upward sloping yield curve and the prediction of a rate rise by a few commentators. Interest rates at the short end of the UK yield curve had moved upwards by around 20 basis points and the sterling effective exchange rate (ERI) had appreciated immediately after the decision to raise Bank Rate was announced. Both interest rates and the exchange rate had fallen back after the Minutes had been published on August 16.

3 Towards the end of August, short-term interest rates in the major overseas economies had generally fallen, largely reflecting softer data in the United States and downward revisions to inflation data in Japan. Having depreciated following publication of the Minutes, the sterling ERI had picked up again towards the end of the month as interest rate differentials between the United Kingdom and the major overseas economies had widened. At the start of the September meeting, the ERI was 0.4 percentage points higher than it had been at the August meeting and was around 1% higher than the profile assumed for the August *Inflation Report* forecast. Equity markets had picked up a little overseas, but in the UK, the FT-SE All-Share index had ended the month broadly unchanged. Most major equity markets had now recovered around half of their losses from the steep falls in May.

4 By the start of the September MPC meeting, the markets' expected path of interest rates over the next few years was slightly higher than had been the case at the time of the August meeting, and higher than assumed in the August *Inflation Report* forecast. The markets now thought it most likely that there would be a further increase in Bank Rate before the end of 2006. Interest rates were expected to peak in 2007, and decline slightly thereafter.

5 Further along the yield curve, nominal long rates had fallen by 15-20 basis points in the United Kingdom and the euro area, and by somewhat less in the United States. In the United Kingdom and the United States, the fall in longer-term nominal forward rates had been more than accounted for by a fall in real rates. Measures of longer-term break-even inflation rates derived from index-linked bonds had continued to drift up, even at those maturities where the bonds were least likely to have been affected by market-specific factors. It was not clear whether this represented a genuine change in longer-term inflation expectations, or a rise in the inflation risk premium. One possible explanation for the latter was that market participants may previously have held an exaggerated belief in the ability of central banks to control inflation, perhaps reflecting the perceived deflationary pressures of global competition. If expectations had become more realistic – as those global deflationary pressures had abated somewhat – then the inflation risk premium would have increased. However, there had been little indication of increased implied volatility of longer-term forward interest rates.

6 Given higher actual UK inflation data and news about further near-term energy price increases and the possible effect of tuition fees, it was less surprising that inflation expectations had also increased at shorter horizons, as shown both in surveys of the public and in data from the inflation swap market. But the upwards movements in medium-term break-even inflation rates was both puzzling and a possible concern.

7 A noticeable feature of recent months had been the number of countries raising official interest rates. Of 19 central banks in the OECD countries, 16 had increased their policy rates since May, and 9 had done so during August. The weighted average of current policy rates in the G7 countries was now around 4%: a little below the weighted average of rates 5 years forward. The degree of monetary accommodation internationally had clearly been decreasing. While the full impact of tightening had not yet been seen, there remained a possible upside risk to global inflation prospects from the withdrawal having happened too slowly.

### **The international economy**

8 In the euro area, the overall GDP data had been slightly stronger than expected with growth in the first quarter revised up to 0.8% and growth in the second quarter estimated at 0.9%. The growth rates of Q2 GDP components had been mixed, with investment growth of 2.1% and consumption growth of 0.3%. The relative weakness in consumption was mainly accounted for by German

consumption which fell unexpectedly by 0.4% on the quarter, however euro-area retail sales had grown by 0.6% in July and the near-term outlook for euro-area consumption as a whole remained firm. The prospective increase in German VAT in 2007, which might have been expected to boost consumption in 2006, together with the weaker German data, left considerable uncertainty about the outlook for German consumption growth.

9 The euro-area manufacturing PMI had fallen in August for a second consecutive month and the services PMI had reached a seven-month low. In Germany, the IFO index had fallen slightly and the ZEW index more sharply in August. Although suggesting some slowing in the third quarter, these indicators remained consistent with euro-area GDP growth around, or slightly above, trend.

10 In the United States, Q2 GDP growth had been revised up a little to 0.7% and monthly and survey data for July and August suggested that output and expenditure growth was likely to remain robust in the third quarter. The substantial downward back revisions to output growth noted at the August MPC meeting had been reflected in lower productivity growth data and higher unit labour cost data, as anticipated.

11 The main risk to the outlook for US growth seemed to be from the slowing housing market. Some housing activity data had fallen sharply from their recent peaks, although activity levels were not yet historically low and house prices nationally were estimated to have risen by 1.2% in the second quarter, albeit with substantial regional variations including rapid declines in New England and the Midwest. Those house owners with mortgages fixed at recent very low rates could find that rates would be significantly higher should they move and have to take out a new mortgage. This effect could explain some of the sharp decline in transactions. There had not yet been much evidence of direct effects of the housing market slowdown on consumption. However, the residential investment component of GDP had fallen by 2.6% in the second quarter. In the United States, that might be one of the main channels through which GDP would be affected.

12 Non-farm payrolls had risen by 128,000 in August, in line with expectations, and the unemployment rate had fallen to 4.7%, suggesting little immediate threat to labour income and household expenditure.

13 The US headline inflation rate had moderated slightly but remained high at 4.1% in July, while the core PCE deflator was at 2.4%, having drifted upwards in recent months. In August, the Michigan inflation expectations survey measure had increased sharply, to above 4%.

14 In Asia, with the exception of China, growth seemed to have eased slightly, although there were some indications of higher inflationary pressures.

15 The spot price of oil had fallen by over 15% on the month, reflecting a number of factors. These included: a cease-fire in Lebanon; the announcement of an earlier-than-expected resumption of BP's production in Alaska; high stock levels in the United States; and the limited effect so far of the hurricane season in the Gulf of Mexico. Options contracts for oil prices were still skewed to the upside but the extent of this had diminished on the month as futures prices had fallen.

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

16 Nominal GDP growth in the second quarter in the United Kingdom had been estimated at 2.2%, its highest quarterly growth rate in almost 12 years. The news was largely in the price deflators, particularly for investment and for trade, although it was noted that the GDP deflators were often erratic. Nevertheless, annual growth in nominal GDP had been increasing and was now estimated to be 6%, a level consistent with average CPI inflation a little higher than its target. Broad money and credit growth had eased slightly in July but remained high.

17 Measured in real terms, the output and expenditure estimates for Q2 GDP growth and its components had been reasonably close to the projections incorporated in the *August Inflation Report* forecast. GDP was estimated to have grown by 0.8%, reflecting strong consumption growth of 1.0% and business investment growth of 1.7%. Overall domestic demand growth had been recorded at 0.9%, offset slightly by a small negative contribution from net trade. The trade numbers had been difficult to interpret, with continuing difficulties in ascertaining the true impact of VAT fraud. Both exports and imports had been weaker than expected, although surveys of UK exporters continued to show a healthy rate of growth.

18 The relatively few available indicators for Q3 suggested GDP growth at, or slightly above, trend. Manufacturing output had grown by 0.2% in July. The CIPS/RBS surveys of both manufacturing and

services had eased in August but remained at relatively high levels. The CBI *Monthly Trends* survey and reports from business contacts speaking to the Bank's regional Agents also supported a firm near-term outlook. Consumption indicators for the third quarter had been a little mixed so far, but were broadly consistent with the August *Inflation Report* central projection of consumption growth around its historical average.

19 In the corporate sector, investment intentions had strengthened a little, according to the Bank's Agents, while the EEF had released a strong quarterly survey suggesting that manufacturers' plans for new investment were at their highest for 8 years, largely reflecting optimism about exports.

### **Supply, costs and prices**

20 The employment rate was unchanged at 60.1% in the second quarter but the participation rate had increased by 0.2 percentage points to 63.6% and the Labour Force Survey measure of the unemployment rate had risen by 0.3 percentage points to 5.5%, its highest level since 2000 Q2. The Bank's Agents had reported a firming of employment intentions, but the CIPS/RBS survey employment balances for manufacturing and for services had both slipped back in August. Despite the recovery in output growth since 2005, it appeared that employment was not growing fast enough to offset growth in the labour force.

21 The claimant count measure of unemployment had remained unchanged at 3% in July. The rise in the claimant count rate since early 2005 had been accounted for by fewer unemployed leaving the register (the outflow rate) rather than an increase in new claimants (the inflow rate). At the same time, there was little evidence of any increase in redundancies. This suggested that the rising claimant count rate of unemployment had not been caused by job losses but by insufficient job creation. This was consistent with both a lag in the cyclical recovery of employment growth and an increase in the supply of labour.

22 There were a variety of explanations for the recent rise in the participation rate. Participation could have been increased as a result of structural reforms, but those reforms would probably have had effects spread over a longer period. Around half of the recent increase was arithmetically accounted for by an increase in the numbers of the over-50 age group reporting that they were available for work: that could have reflected a higher demand for labour encouraging older workers to re-enter the labour

force. In addition, the strong growth in net inward migration was likely to continue to boost the working population as a whole. The 2005 official projections from the Government Actuary's Department suggested that net migration had reached a peak in mid-2005 following the accession of east European countries to the European Union in 2004, and would fall back in 2006-08. The recent increase in net migration had probably reflected a stock adjustment, but it was not yet clear how large and prolonged that would be, given the potential supply of migrants and wage differentials between the United Kingdom and some accession countries. This would also depend on the strength of demand for labour in the United Kingdom.

23 The implications of immigration for the economy were likely to vary through time. In the short term, higher immigration was a positive supply shock and migrant workers from eastern Europe would most likely place downwards pressure on domestic wage growth, particularly in the low-paid, low-skill sectors where the largest numbers are employed. It was not clear how far this effect was being reflected in the Average Earnings Index, which excluded the self-employed and employees working for the smallest firms.

24 Recent migrants were likely to have high savings rates to finance remittances abroad, reducing the short-term impact on aggregate demand. In the longer term this was likely to diminish as migrant workers would be likely to attract dependents to the UK and increase their own spending rates, adding to domestic demand growth. A migrant workforce might also affect the degree of cyclicity in the labour market: some of the immigration had probably been encouraged by the strength of UK employment growth.

25 In the 12 months to June, average earnings growth was estimated to have been 5%, reflecting a small rise in regular pay growth and a significant increase in the contribution from bonus payments. The Bank's Agents had also reported increasing bonus and overtime payments, especially in firms with skill shortages.

26 Producer input and output price inflation had both eased in July, with smaller contributions from oil and petrol prices. In contrast, surveys of pricing intentions suggested increasing underlying pressures on output prices, with the Agents reporting that manufacturers were finding it easier to pass on higher costs.

27 CPI inflation had fallen to 2.4% in July but, within the aggregate data, goods price inflation had risen to 1.8%, its highest level since the CPI series began in 1997, although services inflation had continued to drift lower. In line with pre-release arrangements, an advance estimate of CPI inflation of 2.5 % in August had been provided to the Governor ahead of publication. Looking forward, CPI inflation was still likely to rise somewhat over the remainder of the year, given information about the likely contributions to inflation from food and announced changes in utility prices and university tuition fees.

### **The immediate policy decision**

28 The Committee reached its policy decision against the backdrop of its analysis of the outlook for inflation contained in the *August Inflation Report*. The Committee's central projection in that *Report*, based on the conventional assumption that interest rates followed the modestly rising path then implied by financial markets, had been for inflation to rise further above the target in the near term, before easing back towards the target. The risks around that projection had been judged to be broadly balanced.

29 The Committee noted that since its policy decision in August and the publication of its assessment of the outlook in the *August Inflation Report*, market expectations of interest rates had moved slightly higher, pricing in one more rate rise in 2006.

30 The Committee reviewed how the main risks embodied in the outlook for inflation had evolved. These included: the prospects for world growth; the strength and duration of the recovery in consumer spending; the margin of spare capacity in the economy; and the outlook for external price pressures and their interaction with domestic inflationary pressures.

31 Data for the international economy had appeared to be broadly in line with the *August Inflation Report* projections, notwithstanding that those projections were towards the upper end of the range of external forecasts. In contrast, financial markets had seemed to react more negatively to data releases. The difference might be accounted for by the fact that the data showing robust output growth and firm inflation related mainly to the near-term outlook, whereas the markets had seemed to be more concerned with the possibility of lower growth and inflation during 2007.



32 Overall, a majority of Committee members felt that the outlook for demand in the UK's major export markets was at least as strong as expected, albeit with a somewhat larger downside risk to global activity from the slowing US housing market, although different members placed different emphasis on the extent of that risk. The data had continued to show evidence of rising inflation in a broad range of countries.

33 The Committee noted that the Q2 data on output, income and expenditure in the United Kingdom were very close to those incorporated in the August *Inflation Report* projections. The recovery in output growth since its weakening in 2005, and in particular the recovery in consumption since its post-Christmas dip, were now well established. Output had been growing a little faster than its historical average and the Committee's central projection anticipated a slight slowing over the forecast period. Forward indicators of the third quarter and beyond seemed to be consistent with that projection, as was the continued robust growth of broad money and credit.

34 The Committee agreed that the labour force was likely to grow more quickly than its historical average as a result of inward migration, but the pace of that migration and its implications for monetary policy were highly uncertain. The near-term impact was most likely to be felt in the labour market, adding to spare capacity, but in the longer term there might be some off-setting pressure on resources as immigrants generated extra demand for goods and services.

35 There was a broad range of views around how to interpret developments in the labour market and the interaction of wages and prices. In previous months, the Committee had discussed the extent to which higher energy prices had squeezed profit margins and firms had borne down on wage costs rather than increasing final prices, with the apparent slack in the labour market helping to keep wage pressures subdued. The intensity of this process could depend on the current state of demand for goods and services: if demand pressure was high enough going forward, it was likely that firms would seek to re-build profit margins by raising prices, and the Bank's Agents had indeed reported that manufacturers were finding it somewhat easier to pass on cost increases.

36 Short-term pricing pressures had remained firm, with CPI inflation above the target of 2.0%. There would be further upward influences in the next few months from foods, and announced changes in utility prices and university tuition fees, offset in part by lower petrol prices. Surveys of the public's expectations of CPI inflation over the next year or so were around 2 ½%. The Committee remained

concerned about the pick-up in longer-term implied inflation expectations and the possibility that higher short-term inflation expectations might affect wage settlements during the next pay round.

37 The Committee concluded that there had been a little news about the risks in both directions, but that, overall, the risks to the outlook for inflation remained broadly balanced. Given that inflation was projected to remain above target for some time, a majority of Committee members judged that the data had been supportive of the decision they had taken in August to reduce the degree of monetary accommodation. But they concluded that the news since then had not been sufficient to warrant a change in the Bank Rate this month.

38 For one Committee member, the decision to vote for no change in August had been a very close call, with concerns about the weak labour market data and mixed survey evidence of future activity just outweighing recent above-trend growth and concerns about inflationary expectations. Despite increased uncertainty about the outlook for the US economy, the tick-up in UK average earnings in June, added to the continued concerns about inflationary expectations meant that, even if minded to seek a reversal of the rate rise in due course, the signal to wage- and price-setters in advance of the next pay round was sufficiently important that it would be unwise to vote for reducing rates this month.

39 The Governor invited the Committee to vote on the proposition that the official Bank rate should be maintained at 4.75%. The Committee voted unanimously in favour of the proposition.

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  
Paul Tucker

Nicholas Macpherson was present as the Treasury representative.