

Publication date: 15 August 2007

**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
1 AND 2 AUGUST 2007**

These are the minutes of the Monetary Policy Committee meeting held on 1 & 2 August 2007.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0807.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 September will be published on 19 September 2007.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 1-2 AUGUST 2007

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

Financial markets

2 At its previous meeting, the Committee had noted, in the light of concerns about the US sub-prime mortgage market, that risk premia on a range of assets had been unusually compressed for some years, and, if these returned towards previous levels, there was a risk that many asset prices might fall, which could have implications for consumption and investment.

3 The main news this month in financial markets had been the sharp deterioration in credit markets and the associated falls in equity prices and changes in market interest rates. A trigger for this turbulence appeared to be renewed concerns about the US sub-prime mortgage market, the losses of some prominent hedge funds, and the revisions to the ratings of some mortgage-backed securities; this had led to a reduction in demand for products such as sub-prime mortgage-backed securities and collateralised debt obligations. The movements in markets for sub-prime securities had spread to corporate credit yields, although corporate default rates remained very low, and particularly to the leveraged loan markets and collateralised loan obligations. Contributing to that had been nervousness about the robustness of rating agency assessments of securitised products more generally. There had been a far less pronounced widening of spreads on lower-rated mortgage-backed securities in the United Kingdom. Conditions in the leveraged loan and wider corporate credit markets were described by market contacts as illiquid, and investment banks would have to hold the large number of deals in the pipeline for longer. It might take a while for all the effects to work through as further downgrades were made and losses were recognised on instruments that were not frequently traded.

4 The Committee also noted that yields on risk-free assets had declined somewhat. So the rise in yields on some riskier assets had not been quite as much as the rise in spreads. But not all of the

adjustment might be taking place in yields. It was possible that the quantity of credit – from banks and capital markets – might also be reduced by more than the fall induced by the observed change in market yields alone.

5 It was not clear how far the downturn in financial markets would go, nor how long it would persist. To date, the movements amounted to a sharp correction of the unusual compression of credit spreads, which had been a source of concern for some time. If it stopped at that, the macroeconomic effects of events could be limited, and were likely to be more pronounced in the United States than elsewhere. If the movements gathered momentum, however, there could be a more marked effect on the wider economy.

6 Equity prices had fallen sharply towards the end of the month, with the FTSE All-Share, Euro Stoxx and S&P 500 all declining by around 4-6%. The falls in equity prices had been broadly based. In the case of the FTSE, the late-July falls had unwound all of the gains recorded since the beginning of the year. Given that risk-free interest rates had fallen, that suggested that the decline in equity prices might be ascribed to either heightened perceptions of risk, a removal of the takeover premium or downward revisions to expected earnings. However, there was, as yet, little evidence of a fall in expected earnings.

7 Short-term market interest rates had fallen by around 15-35 basis points in the United Kingdom, the United States and the euro area. A further rise in Bank Rate was no longer fully priced into the market by the end of the year, and, although 60% of City economists responding to a Reuters poll expected a further rise in Bank Rate by the end of the year, none thought it would occur this month. There had been steeper falls further along the yield curve, mostly accounted for by falls in real interest rates. Despite the recent falls, forward interest rates some twelve to eighteen months ahead had remained around 20-30 basis points higher than at the time of the *May Inflation Report*.

8 The sterling effective exchange rate index had appreciated a little over the first part of the month, but had fallen back by the time of the meeting. The dollar had depreciated over the month as a whole.

The international economy

9 Aside from the developments in financial markets, there had been relatively little news on the international economy since the previous meeting. In the euro area, estimated GDP growth in Q1 had been revised up slightly to 0.7%, reflecting upward revisions to consumption and net trade, partly offset by downward revisions to investment and stockbuilding. The broad pattern of the expenditure breakdown of GDP growth had remained unchanged.

10 Beyond the first quarter, the Purchasing Managers' Indices (PMIs) pointed to growth in the second quarter in the euro area at a similar rate to the first, although the monthly industrial production and expenditure indicators implied a rather weaker figure. There were declines in both the manufacturing PMI and the flash estimate for the service sector in July. As yet, there had been little sign of the diminishing margin of spare capacity pushing up on inflation, with euro-area HICP inflation edging down to 1.8% in July.

11 In the United States, there had been substantial downward revisions to the estimated level of GDP for the previous three years. But Q2 GDP growth of 0.8% had been broadly as expected. Non-residential investment had strengthened, and the previous quarter's weakness in net trade had unwound. Consumption growth had been subdued, but that might reflect the squeeze on real incomes from the rise in petrol prices, following a temporary shortage of refining capacity. However, some commentators had become more pessimistic, particularly about the housing market, where the unsold stock of new dwellings had risen substantially in recent months. Annual CPI inflation had been unchanged in June, but the Federal Reserve's preferred core inflation measure based on the personal consumption expenditures deflator had fallen slightly.

12 Turning to Asia, four-quarter GDP growth in China had been estimated to have increased to almost 12% in the second quarter. The monthly indicators in Japan, however, had continued to point to some slackening in growth in the second quarter. Elsewhere, activity had seemed to be generally strong in the Middle East and Africa.

13 Spot oil prices had risen on the month by around 2-3% in sterling terms. But futures prices had been little changed, suggesting that the rise in spot prices was expected to be temporary. The bigger question was whether the underlying upward trend in oil and other commodity prices was set to

continue, or reverse. That rise in oil and other commodity prices probably reflected the rapid growth of the global economy pushing up on commodity demand in the face of short-term inelastic supply. The rise in prices should eventually induce an expansion of supply capacity. However, the latest projections for the oil market from the International Energy Agency suggested that, if anything, the gap between available supply and demand would fall further over the next few years.

Money, credit, demand and output

14 The Committee then turned to domestic demand, and the question of whether any deceleration was visible in response to the previous increases in Bank Rate. Retail sales had risen by 1.1% in Q2, but that had partly reflected the weakness of spending in the first quarter. The average monthly growth rate over the past three months had been below 0.2%, suggesting that some slowing in household spending growth might be taking place. However, the monthly data were volatile and the correlation of retail sales with overall consumption was not strong. Early, and uncertain, estimates of the growth of distribution, hotels and catering output suggested a slowing in Q2; this might provide some corroborative evidence, as a similar development had signalled the slowdown in consumption growth in 2004-05. Further evidence of some softening in consumption growth in recent months had come from the CBI *Distributive Trades Survey* and reports from the Bank's regional Agents.

15 The evidence from the housing market still seemed to be consistent with a gentle slowing. The Nationwide house price index had risen by just 0.1% in July, while the Halifax index had risen by 0.7%. A preview of the Royal Institution of Chartered Surveyors survey had shown a fall in the price balances in July. Mortgage approvals had held up in June, but might have been influenced by the introduction of Home Information Packs. More forward-looking indicators, such as the Home Builders Federation site visitors and net reservations balances, continued to point to further slowing.

16 The latest investment indicators had remained strong. Although the British Chambers of Commerce (BCC) measure of investment intentions for the service sector had edged down in the second quarter, they had risen sharply for the manufacturing sector. The CBI *Industrial Trends Survey* had also shown an increase in investment intentions. By contrast, commercial property yields were currently below the cost of funds and there seemed to be a considerable amount of office building in the pipeline. The latest CBI and BCC surveys suggested that export orders had remained relatively strong.

17 Aside from the financial market risks to activity, there was little news in the latest monthly data on money and credit. The M4 growth rate had slowed to 12.9% in the year to June, while M4 lending (excluding securitisations) had risen by 13.5% over the same period.

18 Turning to output, the provisional estimate of Q2 GDP growth had been a little weaker than expected last month, at 0.8%. This was the sixth consecutive quarter in the 0.7-0.8% range. The four-quarter growth rate was 3.0%. Market sector output growth had been rising more strongly than GDP growth.

19 Some of the pickup in recorded GDP growth between the first and second quarters had reflected temporary factors affecting manufacturing output. Aircraft production had boosted manufacturing output in 2006, but dipped sharply in the first quarter, while recorded shipbuilding output had pushed up in the second quarter. Those temporary factors should abate in the third quarter, which would therefore reduce manufacturing output growth. The manufacturing CIPS/NTC activity index edged up in July, while the new orders index rose more strongly. But there had been a decline in the activity balances of the CBI *Industrial Trends Survey*. For services, the CIPS/NTC activity and new orders indices both fell, and the activity index, although well above its neutral level of 50, had been at its lowest since the previous autumn.

20 The recent floods would have depressed agricultural output and curtailed output of some other lines of business, such as tourism and leisure services. There could also have been indirect effects as a result, for example, of travel disruption. Similarly, there could have been depressing effects on consumers' expenditure, although that might simply be offset by involuntary stockbuilding by retailers. Moreover, consumers might make up for any reduction in spending later in the year, or by spending more elsewhere. In addition, output and expenditure should eventually be boosted by reconstruction activity and the replacement of damaged property.

Costs and prices

21 The Labour Force Survey measure of employment had risen by 93,000 in the three months to May compared with the previous three months, reversing the downward trend observed over the

previous few months. Unemployment had fallen by 35,000, and had been sufficient to edge the unemployment rate down to 5.4%.

22 Pay settlements in the twelve months to June had averaged 3.2%. Annual pay growth, according to the Average Earnings Index (AEI), had fallen back in the three months to May, both including and excluding bonuses. Annual pay growth on the experimental Average Weekly Earnings (AWE) measure remained around a percentage point higher than the AEI growth rate. According to a reconciliation table published by the Office for National Statistics (ONS), a significant part of the difference in early 2007 had been accounted for by the different treatment of outlying observations, although other factors had been important in earlier periods. It remained difficult to know which earnings measure to put most weight on. The ONS were continuing to do further work to extend the analysis, by adding to the detail and assessing the sensitivity of the results.

23 Manufacturing input price inflation had picked up slightly to 2.1% in June, partly reflecting higher oil prices. The CIPS/NTC survey had suggested that manufacturing input price pressures intensified in July. However, the CIPS/NTC input price index for services had declined a little.

24 The fraction of firms working at full capacity had risen in the CBI *Industrial Trends Survey*, and more firms had reported that capacity was a constraint on output. By contrast, capacity utilisation balances had declined for both manufacturing and service sector companies in the BCC survey. The picture from the manufacturing surveys on output prices was mixed this month, while the CIPS/NTC services output price index had fallen.

25 CPI inflation had fallen to 2.4% in June. The near-term outlook remained somewhat uncertain, particularly given the recent volatility in food, household goods and utility prices. For example, the recent poor weather and flooding might lead to upward pressure on wholesale food prices. But the size and timing of any effect at the retail level was difficult to gauge, especially given the decline in food inflation in recent months.

The August GDP growth and inflation projections

26 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 8 August.

27 Conditional on market participants' expected path of interest rates, and using current ONS estimates of recent GDP growth, the Committee's central projection was for UK output growth to moderate to around its long-term average, as consumer spending and business investment decelerated in the near term and public spending growth eased further ahead. The GDP profile in the August *Report* was somewhat weaker than in May, reflecting the rise in interest rates and the exchange rate. Judging by the past pattern of revisions and indicators from business surveys, the Committee considered it likely that recorded output growth in recent quarters would eventually be revised up.

28 The Committee's central projection was for inflation to fall back during the second half of this year, and to settle around the 2% target. Compared with the corresponding projection in the May *Report*, the profile was a little higher in the near term, reflecting higher oil prices and a slightly smaller margin of spare capacity in the economy. Further out, it was marginally lower, reflecting the weaker projections for output growth.

29 There were substantial uncertainties surrounding these projections. These included, in particular: the prospective impact on domestic demand of past increases in Bank Rate and recent developments in credit markets; the degree of spare capacity in businesses and the labour market; the likely duration of the global expansion, and its implications for world prices; and the evolution of inflation expectations. There remained a greater-than-usual uncertainty about the outlook for inflation, as in May. Overall, the risks to growth were judged to be balanced. The risks to inflation were weighted slightly to the upside in the medium term. There was a range of views on the Committee about both the central projection and the balance of risks.

The immediate policy decision

30 There was little, if any, expectation in the markets of a change in Bank Rate this month. The main news had been the substantial volatility in financial and credit markets in recent days. It was too early to know whether these movements would be sustained or go further. The changes in equity prices, yield curves and exchange rates had been factored into the latest *Inflation Report* projections. But it was unclear whether, beyond these narrow asset price effects, there would be more substantial real effects on the economy in the United States, or on the rest of the world. Moreover, it might take time to see the full extent of these shocks, and for financial market prices to reach new equilibria. At

present, members largely viewed the credit market developments as posing a risk to their projections for output and inflation, rather than a factor directly influencing their central view. The Committee would want to monitor closely data on both the price and quantity of credit over the coming period in order to assess this risk.

31 The world economy had continued to grow briskly. The central assumption was for somewhat slower UK-weighted world growth in future years, but there were risks in both directions. It remained particularly difficult to weigh the risks around euro-area consumption growth, and around residential investment in the United States. The recent strength of the global economy had underpinned the continuing rises in oil and commodity prices, which were feeding through to the UK's terms of trade and could pose an upside risk to inflation.

32 Turning to domestic demand, it was still too early to be confident whether the signs of softening in some UK consumption indicators were a reaction to the past increases in Bank Rate, or simply reflected volatility – including unusual weather – with underlying household spending being resilient. Different members placed different weights on the evidence from the ONS data, the surveys and the reports from the Bank's regional Agents. The housing market showed signs of softening this month. Although business investment had fallen in the first quarter, the surveys suggested that intentions remained robust in the near term. But, further ahead, investment might also be expected to respond to the past rises in Bank Rate and recent credit market turbulence.

33 The latest Q2 GDP data had been slightly weaker than anticipated. Although there was a range of views, the Committee thought that, on balance, estimated output growth was likely to be revised up. The key issue was by how much growth would slow, given past increases in Bank Rate, and when and whether that would be sufficient to keep inflation close to the target, since it was not only the size of the gap between potential supply and demand that mattered, but how that translated into pressure on inflation.

34 Employment had strengthened in the latest data, and so had lessened somewhat the previous puzzle of weak employment in the face of robust output growth. There was a range of views about the margin of spare capacity in the labour market. Survey measures of capacity utilisation within businesses remained elevated. While some of the output price surveys had eased over the past month,

a number remained above their historical average. Some members thought that these factors remained an upside risk to inflation.

35 CPI inflation had continued to return towards the target in June, reducing the probability that inflation expectations would become dislodged. But the near-term outlook was still clouded with uncertainty, particularly about the path of household goods, food and utility prices. Given the experience of rising inflation last winter, and the fact that other measures of inflation – such as RPI and RPIX – remained high, there was a risk that inflation expectations would be particularly sensitive to further adverse cost shocks. Although there were still more effects to come from the recent rise in oil prices, some of the earlier rises in energy prices had now largely fed through to retail prices. So it was possible that there would be a somewhat clearer view of the relationship between the gap between demand and potential supply and the outlook for inflation than there had been in the recent past.

36 Given all of the above factors, and in the light of the projections for output and inflation, Committee members favoured leaving Bank Rate unchanged. There was a range of views about the risks to inflation and growth. The future path of Bank Rate would depend on the evidence in the months ahead about whether and how the risks were crystallising; most members emphasised that they had no firm view on whether rates would need to rise further.

37 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.75%. The Committee voted unanimously in favour of the proposition.

38 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

Nicholas Macpherson was present as the Treasury representative.