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# MINUTES OF MONETARY POLICY COMMITTEE MEETING 5 AND 6 DECEMBER 2007

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These are the minutes of the Monetary Policy Committee meeting held on 5 & 6 December 2007.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0712.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 9 and 10 January will be published on 23 January 2008.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 DECEMBER 2007**

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

### **Financial markets**

2 Conditions had deteriorated across a range of financial markets during the month. Spreads on a number of asset-backed securities had widened further, partly prompted by downgrades from rating agencies. Further declines in the value of these securities and a series of announcements by banks had accentuated concerns about the distribution and scale of possible losses from the recent financial market turmoil.

3 Those heightened concerns had increased investor perceptions of the risks associated with individual banks, as evidenced by higher premia on credit default swaps. That had also contributed to a sharp tightening in money market conditions, with the spread on inter-bank lending rates over the expected policy rate rising substantially during November. Credit risk appeared to have been a factor behind the very recent increase in inter-bank lending rates. That was in contrast to the developments during August and September, when the inter-bank spread had seemingly been driven up largely by liquidity concerns. There had also been some increase in demand for liquidity during the past month, reflecting a desire by financial institutions to adjust their balance sheets for reporting purposes ahead of the year-end. These year-end problems had added to pressures on financial companies' balance sheets at a time when market conditions were already difficult.

4 Equity prices had fallen for much of November, before staging a recovery towards the end of the month. Corporate bond spreads had widened, and that in large part also appeared to reflect increased credit risk. But lower government bond rates meant that yields on investment-grade bonds were little changed, though yields on sub-investment grade bonds had risen substantially.

5 Overall, the re-pricing of assets suggested that there had been a general re-evaluation of risk. Were that to continue, it could lead to further falls in asset prices, posing further downside risks to the economy.

6 Expectations of the future UK policy rate over the next year had declined during the month, particularly in the days running up to the meeting. The markets were now attaching around an 80% probability to a 25 basis point cut at this meeting. In the euro area, policy rates were expected to stay on hold for the next six months. In the United States, by contrast, rate cuts were largely priced in for each of the next three meetings of the Federal Open Market Committee. So the belief in markets seemed to be that policymakers' concerns about the adverse impact of the credit shock would outweigh any concerns about heightened inflationary pressures. Further out, international nominal forward rates derived from yields on government bonds had changed less beyond the five-year horizon.

7 The sterling effective exchange rate index had fallen by around 3% during the month. That had been consistent with the direction – though not the magnitude – of relative interest rate movements. The weakening of sterling was equivalent to a monetary loosening and would be conducive to the necessary re-balancing in the United Kingdom from domestic to external demand. Options prices suggested that market participants had weighted the risks towards further sterling depreciation.

### **The international economy**

8 In the United States, output growth in Q3 had been revised up by 0.2 percentage points to 1.2%. In contrast, a number of monthly indicators pointed to a substantial slowing in the fourth quarter: consumption growth; the surveys from the Institute for Supply Management; and orders and shipments of non-defence capital goods (excluding aircraft). But these monthly data were largely consistent with the Committee's November *Inflation Report* projections.

9 The US housing market remained weak. Although new home sales and housing starts had both ticked up in October, new building permits had fallen to a new fourteen-year low, and house prices had fallen in Q3 according to both the Office of Federal Housing Enterprise Oversight and Case-Shiller indices.

10 In the euro area, the latest data were also broadly consistent with the slight weakening in growth towards the end of the year that the Committee had expected at the time of the November *Inflation Report*. There had been some strengthening in the manufacturing sector, with the Purchasing Managers' Index (PMI) and the EC industrial confidence measure both rising. But the respective service sector surveys had pointed to some weakening. Consumer confidence had also edged down.

11 Japanese GDP growth in Q3 had been stronger than expected, and industrial production was up sharply in October. Elsewhere in Asia, the latest GDP releases for the third quarter, as well as monthly indicators for October, confirmed a picture of strong growth.

12 Oil prices had been volatile. Prices had dipped in the first half of the month as the International Energy Agency revised down its forecasts for global oil demand, before rising to a record high on the back of weaker inventories data from the US Energy Information Administration. But over the past few days, prices had fallen back sharply. News on other commodities had been mixed. Metals prices had fallen sharply, though agricultural commodity prices had edged up.

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

13 Data published during the month had provided further evidence that output growth had begun to slow in the fourth quarter. The business activity balance for services in the CIPS/NTC survey had declined again in November. In the same survey, the indices for new orders and business expectations over the next twelve months had also fallen. However, manufacturing activity had picked up in November, with the CIPS/NTC output and new orders balances rising sharply. The CBI *Monthly Trends Enquiry* and reports from the Bank's regional Agents had painted a similar picture. The buoyancy in UK manufacturing was possibly a result of robust demand from overseas. Overall, these survey data were broadly in line with the *Inflation Report* projections for 2007 Q4, though the correspondence between the surveys and ONS data was imprecise.

14 The volume of consumer spending had grown by 1% in 2007 Q3, but recent indicators seemed consistent with a slowing in Q4. Retail sales volumes had fallen by 0.1% in October. There were also falls in consumer confidence surveys, as well as in the Bank's regional Agents' scores in November for retail sales values and the turnover of consumer services companies. But the retailers' reported

sales balance in the CBI *Distributive Trades Survey* had edged up a little in November; likewise the BRC *Retail Sales Monitor* had reported an increase in total sales growth.

15 Quoted mortgage rates had been fairly flat over the month, as higher spreads over risk free rates for some products had been offset by the impact of lower risk-free rates. But there was anecdotal evidence of lenders reducing the availability of some mortgage products. That might mean that when some customers on fixed rates or discounted products came to re-mortgage, they would be faced with having to pay the much higher standard variable rate. In turn, that could lead to households cutting back on spending. Mortgage approvals had fallen again in October. Unsecured borrowing growth had increased recently, which might have reflected substitution towards forms of unsecured borrowing as a result of secured credit becoming harder to obtain.

16 The housing market had continued to weaken. House prices had fallen by almost 1% in November, according to the average of the lenders' indices. And the latest preview of the Royal Institution of Chartered Surveyors' (RICS) survey had shown further decreases in the price balances; price expectations were now at their lowest since the series began in October 1998. The Home Builders Federation site visitors balance was at a record low. The net reservations balance remained around the levels seen in 2004 and 2005. The RICS survey preview balances for new buyer enquiries and instructions to sell had ticked up. But they remained negative, which implied that activity had fallen again on the month.

17 According to the ONS there had been three consecutive quarters of negligible growth in business investment since the start of the year. That sat oddly with a wide range of survey evidence, which had pointed to firm growth. Moreover, there were no compelling explanations as to why investment spending might have been weak earlier in the year.

18 There were signs that tighter credit conditions had begun to affect firms' spending plans. The Bank of England's regional Agents had conducted a survey in November. It suggested that, weighted by turnover, nearly 30% of all those asked expected changing credit conditions to affect their investment plans. A CBI survey that focused on an unweighted sample of small and medium size companies suggested that investment by 10% of respondents would be negatively affected.

19 In October, commercial property prices had fallen for the fourth month in a row and the annual rate of inflation had turned negative, according to the Investment Property Databank. A weak commercial property market might discourage construction of new buildings. But there was also a risk that banks might tighten corporate lending conditions further if companies started to delay repayment or default on previous loans extended for commercial property deals.

20 Broad money growth had slowed very sharply in October, though it was too soon to say whether this would be sustained and to what extent it posed a risk to nominal demand.

### **Costs and prices**

21 Over the three months to September, employment had risen by 69,000. Unemployment according to the Labour Force Survey (LFS) had edged up by 6,000 in the three months to September, although the claimant count had declined in October by 10,000. The KPMG/REC *Report on Jobs* suggested that there had been a further slowing in the growth of permanent placements by recruitment consultancies in November to its lowest level for 21 months, while the report suggested no change in the robust growth of temporary or contract staff.

22 On the pay front, settlements had been subdued, easing in October to 3.2% on the three-month mean measure. Annual earnings growth in the three months to September had picked up for both the average earnings index (AEI) and the experimental average weekly earnings (AWE) measure, though growth had been broadly flat according to both series if bonuses were excluded. The two indices were continuing to give different indications about wage pressure with the AEI rising at an annual rate of close to 4%, and the AWE rising at a rate closer to 5%. Evidence from the ONS Annual Survey of Hours and Earnings and the LFS was consistent with muted pay growth. Without more information on the source of the divergences, it was difficult to draw conclusions about current pay pressures.

23 Other costs and prices were generally increasing more rapidly than last month. Manufacturers' input prices had risen sharply in October on the back of higher energy prices. And CIPS/NTC input price balances for manufacturing and services had increased in November. Manufacturers' output prices had risen by 0.4% in October, taking the annual rate to 3.7%, its highest level since 2004, and the corresponding CIPS/NTC balance had picked up in November. The annual inflation rate of the ONS's experimental services producer price index had edged up in Q3. The CIPS/NTC services

output price balance had risen slightly in November. There had also been sharp jumps in retailers' reported and expected selling prices in the *CBI Distributive Trades Survey*, with the balance on reported prices hitting its highest level since 1998. CPI inflation had risen by 0.3 percentage points to 2.1% in October.

24 The November *Inflation Report* had projected a pickup in inflation over the next twelve months that was largely driven by temporary cost shocks, whose impact was expected to diminish. But the projected pickup in inflation could have a bearing on the medium-term outlook, if it were to affect inflation expectations. The gap between forward rates implied by conventional and index-linked gilt yields had picked up again this month at the five-year horizon. It was possible that this month's rise reflected special factors in the index-linked gilts market rather than an increase in financial markets' inflation expectations. Household inflation expectations had also moved up further, according to both the Bank/NOP and Citigroup/YouGov surveys. One way that elevated inflation expectations could affect actual inflation was through wages.

### **The immediate policy decision**

25 In its November *Inflation Report*, the Committee's central projection had been for GDP growth to slow during the next year to below its long-run average. The projection had been based on market yields that implied a reduction in Bank Rate over the forecast period. Since the *Report*, survey data had indicated slowing UK output growth in the fourth quarter, broadly as expected. The Committee's central projection had been for CPI inflation to rise above the 2% target during 2008, reflecting the impact of higher energy and food price inflation, and also the depreciation of sterling. CPI inflation had then been projected to ease back to target, as pressures on capacity moderated. The risks to growth had been judged to lie to the downside, but the risks to inflation had been balanced.

26 In the United States and euro area, the United Kingdom's largest trading partners, there appeared to be signs of softer growth. Emerging market economies continued to grow strongly, implying a further rebalancing of world growth.

27 Financial market conditions had deteriorated further, with more evidence of credit risk being priced into some financial assets than there had been during August and September, when the concerns had been more obviously about liquidity risk. There were increasing worries about the scale and

location of banks' losses, and the implications for banks' capital positions. Inter-bank lending spreads had returned to levels seen in September.

28 Evidence on the impact of financial market conditions on lending to the rest of the economy was still patchy. There were some clear signs of slowing in secured lending to households, and the Bank's regional Agents had reported evidence of a tightening in credit conditions faced by firms. Renewed financial market problems had increased the risk of a more severe reduction in the availability of credit. UK property markets had deteriorated. The slowdown in the housing market seemed more pronounced than expected. And commercial property prices had fallen further.

29 News on the month had also suggested that the short-run trade off between activity and inflation had worsened. Though oil prices had fallen back in recent days, they remained at very high levels by historical standards, and options prices continued to suggest greater upside risks than was the case a few months earlier. The sterling effective exchange rate index had declined further during the past month, and that would put more upward pressure on sterling import prices. Many price indicators in business surveys had risen. Measures of inflation expectations had risen further.

30 The Committee discussed a number of policy options. Continued upward pressure on prices and costs in the near term and elevated inflation expectations suggested that no change in Bank Rate might be appropriate to keep inflation on track to meet the target. But the worsening financial market turmoil, and the consequent tightening of credit conditions, had increased the downside risks to activity and inflation in the medium term. Signs of slowing growth in the industrial world were already apparent. That suggested a substantial loosening in policy might be needed. However, a large reduction in Bank Rate now would increase the upside risk to inflation.

31 On balance, the Committee thought that the downside risks to the economy and inflation in the medium term from the deterioration in financial market conditions outweighed the potential upside risks to inflation from short-run cost pressures. The level of interest rates, following a marked tightening in policy last year, was already restrictive, and the expected slowdown in domestic demand should act to dampen inflationary pressures. That put the Committee in a good position to act pre-emptively to reduce the risks stemming from the tightening of credit without losing credibility among wage and price setters.



32 Against that background, the Committee judged that an immediate decrease in Bank Rate of 25 basis points was necessary to meet the inflation target in the medium term.

33 The Governor invited the Committee to vote on the proposition that Bank Rate should be reduced by 25 basis points to 5.5%. The Committee voted unanimously in favour of the proposition.

34 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

Dave Ramsden was present as the Treasury representative.