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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
7 & 8 MARCH 2007**

These are the minutes of the Monetary Policy Committee meeting held on 7 & 8 March 2007.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0703.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 April will be published on 18 April 2007.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 MARCH 2007

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

Financial markets

2. There had been substantial volatility in financial markets towards the end of February. Global equity prices had fallen sharply on 27 February. There had been rallies and further falls in subsequent days. Share prices in many markets were around 5% lower than on 26 February. Though the movements in equity prices had been significant in daily terms, the falls were less substantial when viewed against the upward trend over the past few years. And rises earlier in the month meant that the FTSE All-Share was only 1½% lower than the starting point for the February *Inflation Report*. Spreads on riskier bond classes had widened. And the currencies of economies with the lowest interest rates had strengthened, as some carry trades – the practice of borrowing at low interest rates in one currency and investing in higher yielding assets in another – were unwound.

3. A variety of unconnected and by themselves relatively insignificant events seemed to have triggered the financial market movements: for example, rumours about the introduction of capital gains taxes in China; and some weak US indicators, particularly the fall in durable goods orders. These events had occurred against a background of worries about the compression of risk premia in some markets, and heightened concerns about the possible macroeconomic implications of a deterioration in the US sub-prime mortgage market and the associated exposures of some financial institutions.

4. The immediate causes of the recent turbulence were less important than its likely fundamental origins. One possible explanation was that market participants had for some time been uncertain about whether the low risk premia embodied in some asset prices were justified. Recent events could have sparked a period of price discovery where markets engaged in a process of trial and error to discover a

new equilibrium. Much of the information relevant to the discovery of that new equilibrium was the beliefs of other investors as reflected in the market movements themselves. That process of price discovery had been associated with asset price volatility. While prices had stabilised in the past few days, there was no guarantee that the period of volatility had ended.

5. Not all the significant market movements had been concentrated in the last week of February. UK short interest rates had fallen by nearly 20 basis points over the month to roughly where they had been at the beginning of the year, prompted by the release of the unexpectedly weak CPI inflation and retail sales data in the first half of the month. Nevertheless, market interest rates were still consistent with the expectation of a further quarter point increase in Bank Rate by the summer. That was similar to the view taken by City economists: in a survey conducted by Reuters, the median forecast was for Bank Rate to be 5.5% by mid-summer, though nine of the 64 polled thought that the increase would happen at this meeting.

6. The decline in market interest rates was probably one factor behind the depreciation of sterling. The sterling effective exchange rate index (ERI) had fallen by nearly 3% since the February *Inflation Report* and was now back within the relatively narrow band it had occupied over the past decade. Some of the depreciation had occurred during the period of market volatility at the end of February. That may have partly reflected the selling of sterling assets by those investors who were reducing their carry-trade exposure.

The international economy

7. Concern about the health of the US economy was one candidate trigger for the volatility in financial markets. However, over the past few months the activity data had been reasonably firm and economists had been revising up their projections for growth in 2007. The data this month had not changed the outlook significantly. On the downside, Q4 GDP growth was revised to 0.6% from 0.9%. The non-manufacturing Institute of Supply Management (ISM) business activity index for February fell from 59.0 to 54.3, the weakest reading since April 2003. Capital goods orders and shipments both fell. But on the upside, the manufacturing ISM index had picked up to 52.3 from 49.3. Taking both ISM indices for January and February together pointed to growth in Q1 not much different from its historical trend rate. Personal consumption and disposable income continued to post healthy monthly gains.

8. The slowdown in the US housing market had appeared to abate in recent months. But some indicators, such as new home sales and housing starts weakened in January, though that might in part have reflected the onset of cold weather after an unusually warm December. Arrears had continued to increase in the sub-prime mortgage market. Moreover, lending standards had been tightened leading to a downside risk for the housing market and household spending.

9. In the euro area, GDP was estimated to have risen by 0.9% in Q4, somewhat stronger than had been expected at the time of the February *Inflation Report*. The near-term outlook continued to be firm. The service sector Purchasing Managers Index (PMI) eased in February, but the manufacturing index ticked up slightly after three consecutive monthly falls. Taking the January and February survey data together implied above trend GDP growth in Q1.

10. German retail sales, including the automotive sector, fell by nearly 10% in January following the increase in VAT, the largest monthly fall since records for the reunified Germany began. However, early estimates for these data were typically heavily revised. And it was possible that any weakness in spending might not depress output significantly in 2007 Q1, if firms had been using their inventories to help smooth production.

11. Japanese GDP growth had rebounded in Q4, and was a bit stronger than expected at 1.2%. Growth in non-Japan Asia seemed to be pretty much in line with expectations. The spot price of oil had risen by about 6% in dollar terms, seemingly prompted by increased concerns about Middle-East supply.

Money, credit, demand and output

12. The first expenditure breakdown for UK GDP in 2006 Q4 had been published in February. The GDP growth figure itself had not been revised, and there had been few surprises in the data relative to the *Inflation Report* projection. Whole-economy investment had been a little weaker than expected, but within that business investment had been noticeably stronger. The strength of business investment partly reflected high levels of investment in the oil and gas sector. Given the propensity for investment data to be revised, they should be given only a little weight at this stage of the publication cycle. But they did not provide any reason to doubt that capital spending by businesses would remain buoyant in the near term, supporting the picture presented by reports from the Bank's regional Agents and business surveys.

13. The Committee then considered more recent developments. The CIPS/RBS measures of activity and new business in services both eased further in February. In light of the timing of the meeting, the ONS had provided the Committee with pre-publication access to the industrial production data. According to these data, energy output grew strongly in January. They also pointed to a slight fall in manufacturing output in January. But the survey data suggested that this weakness in manufacturing was unlikely to persist. The manufacturing CIPS/RBS output index strengthened in February, while the expected output balance in the CBI *Monthly Trends* survey reached levels last recorded in May 1995. Manufacturing output appeared to be strengthening in other countries, perhaps reflecting the interconnectedness of global supply chains.

14. On the spending side, the 1.8% fall in retail sales volumes in January was puzzling. The series was volatile, and the reading could prove to be erratic. None of the other available survey indicators of retail spending pointed to a similar decline. Indeed, the CBI *Distributive Trades Survey* balance in January was around the level experienced in early 2004, though it had eased back since. Contacts of the Bank's regional Agents had not suggested any easing in retail sales in January. Moreover, the BRC/KPMG measure of total retail sales on a year earlier rose in both January and February.

15. There were some signs that the housing market might be slowing. The three-month-on-three-month rate of inflation for the average of the lenders' house price indices had fallen again to 2.6% in February, down a percentage point from December. Moreover, a number of the indicators in the preview of the Royal Institution of Chartered Surveyors' survey for February had continued to ease. The survey balances for site visits and net reservations were also down sharply in January, according to the Home Builders Federation.

16. The continued strength of the world economy, and particularly the euro area, appeared to have been reflected in strong export growth. The CIPS/RBS manufacturing export orders index rose in February to its highest level since January 2004. And the February CBI *Monthly Trends* export orders balance rose to well above its average since 1997.

17. Broad money and credit growth continued to expand rapidly in January, with annual growth of M4 and M4 lending (excluding the effects of securitisations) at 13.0% and 15.5% respectively.

Costs and prices

18. The employment rate had been flat in 2006 Q4. The Labour Force Survey unemployment rate was down marginally. A measure of labour market tightness that weighted those who were not employed by their likelihood of finding a job was flat. The near-term outlook for employment growth was rather mixed according to surveys, with some of the surveys weakening and some strengthening.

19. A little more data on whole-economy settlements had emerged during the month. With about 15% of the expected final sample now in for January, the mean settlement of 3.3% was about 0.5% higher than in January 2006. But when only those settlements matched by organisation were compared for 2006 and 2007, the mean was unchanged at 3.6%, though the sample was even smaller. Either way, these numbers did not obviously represent a threat to the inflation target. Private sector regular pay growth remained at 3.8% in December. Increases in public sector pay announced by the Chancellor for later this year were restrained. The National Minimum Wage would be raised by less than last year. Taken together, these developments suggested that the upside risks from pay that had previously concerned the Committee appeared to have diminished somewhat.

20. The Committee had known at its February meeting that CPI inflation had been 2.7% in January – significantly lower than expected. But it had not been able to conduct any analysis of the CPI data until this month. As a result, the Committee now thought it possible that inflation might come out a little lower in the short term than the *Inflation Report* central projection implied. The cuts in utility prices announced so far seemed to be broadly in line with those embodied in the February *Inflation Report* forecast, though the Committee had also assumed that there would be further reductions later in the year.

21. Annual rates of import and manufacturing input price inflation had slowed, both including and excluding energy. Measures of manufacturers' output price inflation had been broadly flat on the month, though the trend excluding petroleum products had been upwards over a number of years. Services price inflation eased. Some of the monthly business survey measures of price pressures also fell slightly in February. But they remained high when compared with recent historical averages.

22. The Bank's survey measure of households' inflation expectations remained at 2.7% in February, and the Citigroup/YouGov measure had fallen back to 2.4%.

The immediate policy decision

23. In the February *Inflation Report*, the Committee's central projection had been for GDP growth to expand at a rate close to its average of the past decade. The risks were broadly balanced around that view. The central projection was for inflation to fall back below the 2% target during the first year, but then to settle at around the target over the medium term. The balance of risks to inflation was judged to be weighted to the downside in the near term, and to the upside in the medium term. Those projections had been based on market yields that implied at least one more increase in Bank Rate in the next twelve months. There had been a range of views among members about the central case and what weight to put on the different risks.

24. The Committee discussed how the news over the month had affected their views on the outlook and hence the appropriate level for Bank Rate. There had been some major movements in financial markets during the month. Equity prices had been volatile and ended the month a little down. Credit spreads had widened. But the news from financial markets was not all downside for activity and inflation. Market interest rates on less risky assets had fallen. The sterling ERI had declined. Oil spot and futures prices had risen. It was possible that the net effect of these developments – by themselves – could be to push up the inflation projection a little.

25. The Committee noted that, in the official data, manufacturing output had fallen slightly in January, but energy output had risen quite sharply. Surveys were consistent with firm overall output growth in the first quarter. Taking these data together, the Committee judged that GDP growth was still likely to be as strong in 2007 Q1 as expected at the time of the February *Inflation Report*.

26. The Committee discussed whether household spending was slightly weaker at the start of the year than was previously expected, though it was too soon to draw firm conclusions. Retail sales had fallen in January, according to the ONS, though other indicators of retail spending had been more robust. At least part of the rise and fall in the official series around Christmas probably represented data volatility. Smoothing through that volatility gave a more subdued picture of underlying consumer spending than had been the case last month. Developments in the housing market may also have been a signal that households were beginning to rein in their spending. House price inflation might have begun to slow, and some activity indicators were consistent with an easing in the growth of housing demand.

27. Business investment had grown strongly and by more than the Committee had expected. But some of that growth, which the Committee judged to be temporary, came from the energy sector. Business investment growth was likely to ease back to be more in line with the – still buoyant – path underlying the Committee’s central projection in the February *Inflation Report*.

28. The news from the United States had probably been to the downside for the Committee over the month, though not by enough to change its views on the outlook for the US economy to a significant extent. By contrast, data for the euro area, the United Kingdom’s main trading partner, had surprised on the upside. Euro-area growth in 2006 Q4 had been higher than anticipated at the time of the February *Inflation Report*. And the Committee judged that surveys of output pointed to further firm growth in 2007 Q1.

29. The Committee had previously been concerned about the prospective impact of high RPI and CPI inflation on inflation expectations and on wages. The initial recorded outturns for recent wage settlements and relatively subdued inflation expectations led the Committee to judge that the upside risk to inflation from wage growth might have started to diminish.

30. Some cost pressures had eased: import price inflation had fallen back to its lowest level since 2004; and manufacturers’ input price inflation had also declined. But manufacturers’ output price inflation had remained high, both according to official measures and business surveys. That may have been indicative of demand pressures in world markets as well as in the United Kingdom. But it might have reflected the delayed pass-through of earlier increases in energy prices. Business survey price expectations were also high in other sectors of the economy.

31. The short-term outlook for inflation was now a little lower than in the February *Report*, following the publication of the January CPI data. The announcements on consumer utility prices had been, in aggregate, broadly as expected. But the Committee had anticipated further reductions later in the year, and members were still uncertain about whether these would happen.

32. For one member, the balance of news since the February *Inflation Report* had been to the downside and therefore had increased the scope for a small monetary relaxation. For that member, there was considerable evidence of spare capacity in the labour market, and wage pressures were benign. The degree of monetary tightening, in conjunction with benign wage inflation, had started to push down consumption and housing market activity. The service sector looked a little weaker this

month. Inflation was likely to decline faster in the short term than in the Committee's central projection.

33. For most of the Committee, the news on the month was a little on the downside. Nevertheless, they remained concerned that the risks to inflation over the medium-term remained on the upside, as in the February *Inflation Report* projection. Although the risks to pay growth had not materialised in the data available so far, capacity utilisation within firms remained elevated. Business surveys continued to show strong pricing intentions. Sterling had depreciated and oil prices had risen. Money growth had eased in recent months, but it remained strong. Looking at the balance of risks, these members were content to leave rates unchanged this month.

34. For most members, the financial market volatility added to the case for holding rates this month. Although some market participants were expecting an increase in Bank Rate this month, the majority were not. An unexpected move by the Committee could provide an unwelcome addition to the uncertainty and volatility in financial markets.

35. The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.25%. Eight members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean, Tim Besley, Andrew Sentance and Paul Tucker) voted in favour of the proposition. David Blanchflower voted against, preferring a reduction in Bank Rate of 25 basis points.

36. 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.