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MINUTES OF MONETARY POLICY COMMITTEE MEETING 7 AND 8 NOVEMBER 2007

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

They are also available on the Internet http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0711.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 December will be published on 19 December 2007.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 NOVEMBER 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 market developments; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 Some financial markets remained fragile, and were still not functioning normally. Spreads on non-prime mortgage-backed securities had risen further in the United States, following rating agency downgrades, and this had had a knock-on effect to UK markets. However, conditions in asset-backed commercial paper markets had improved slightly during October. There had been further announcements of write-downs by some global financial institutions, primarily stemming from their exposure to the US sub-prime mortgage market. But these cumulative announcements had so far accounted for only a proportion of the eventual aggregate losses that were expected by many market participants. This had led to continuing uncertainty about the location of losses, which had been reflected in the equity prices of some financial companies.

3 In money markets, conditions had improved at the very short end, with secured overnight rates in the United Kingdom remaining close to Bank Rate. But longer-term money market interest rates internationally were still elevated relative to expected policy rates, and these premia were expected to persist for some time. Lending volumes in these markets had also been significantly below normal.

4 Policy rates implied by interest rate futures had picked up internationally in the first half of October, before falling back. In the euro area, expectations of the future policy rate were broadly unchanged over the past month, while in the United States they had shifted down, with a further reduction in interest rates priced in. For the United Kingdom, near-term expectations of the official rate were slightly up over the month as a whole. A 25 basis point reduction in Bank Rate was priced in by February, with at least one further cut expected by market participants beyond that. Only five out of the 60 respondents to a Reuters poll had expected a cut in Bank Rate this month, although 48 of them expected a cut by the end of the first quarter of 2008. There was considerable uncertainty about

the future path of rates among market participants, consistent with the level of implied volatility in options markets.

5 International nominal forward interest rates had declined by 10-20 basis points at the five-year horizon. That appeared to reflect a fall in expected real interest rates, and was probably indicative of a continued flight to quality. Spreads over risk-free rates on investment grade corporate bonds were slightly higher in many of the major currencies, but the fall in government bond yields meant that the yields on those corporate bonds were down a little over the past month or so. Yields on sterling and dollar denominated sub-investment grade corporate bonds had edged up.

6 Although volatile in the days running up to the meeting, equity prices had generally remained resilient, despite the turmoil in other financial markets. For the month as a whole, equity prices had declined by 1-4% in the US, UK and euro area. The FTSE All-Share index was, however, 4% above the starting level at the time of the August *Inflation Report*. Measures of implied volatility in US, UK and euro area equity markets had remained elevated. There had been continued marked rises in many emerging market indices.

7 Sterling had risen by more than 3% against the dollar, reaching its highest bilateral rate for over two decades. That largely reflected the general depreciation of the dollar against many currencies, while the sterling effective exchange rate index had been little changed on the month, leaving it down 2½% compared with its August *Inflation Report* level.

The international economy

8 Oil prices had risen strongly over the past month, and had been well above $90 per barrel immediately before the meeting, a rise of over 20%. The recent rise seemed to have been driven predominantly by supply factors, including output restrictions in Mexico. US inventories had also been reported lower than expected. As some of these concerns related to temporary factors, it was not clear whether the recent very high oil price would persist. Nevertheless, in the long term high oil prices were underpinned by strong global demand, especially in Asia. Many other commodity prices remained firm, notably food prices.

9 The contrast between the housing market and the rest of the United States economy had seemed to be, if anything, more marked this month. The first GDP release for 2007 Q3 had suggested growth of 1% on the quarter, above what had been expected a month or so ago. Consumption and business investment had both recorded solid growth, as had export volumes. Net exports had made a positive contribution to GDP growth. The increase in non-farm payrolls in October had been stronger than expected by the market. But residential investment had fallen again in Q3. Sales of existing homes in the United States were at their lowest level for almost ten years in September, and housing starts and permits-to-build had reached fourteen and twelve-year lows. The National Association of Home Builders' sentiment index for October had fallen to its lowest level since the series began in 1985. There had been signs of tighter credit conditions on residential mortgages, according to the Senior Loan Officer survey. The wider impact on consumption of developments in the housing market remained uncertain.

10 Euro-area industrial production data and business surveys had pointed to robust growth in the third quarter, but there had been some signs of slowing in the fourth quarter, with only a mild recovery of the services Purchasing Managers Index in October following the previous month's sharp decline, and a fall in the manufacturing survey index. Even so, the surveys were generally still consistent with growth on the quarter being close to its long-term average. And the euro-area labour market had remained quite firm.

11 The October euro-area bank lending survey had seemed broadly consistent with a reduction in the supply of credit to households for house purchase, and a more marked reduction to businesses. It was notable that the supply of lending for mergers and acquisitions activity appeared to be more vulnerable than lending for fixed investment.

12 Most Japanese activity indicators had been weak on the month. Growth in non-Japan Asia had remained robust, with Chinese GDP up 11.5% in the year to Q3, and most of the monthly indictors strong elsewhere. Many other regions had also recorded relatively strong growth in recent quarters, for example countries in Latin America and the Middle East.

13 US CPI inflation had risen sharply to 2.8% in September, partly reflecting energy prices, while inflation on the core CPI and personal consumption expenditures deflator measures had remained steady at 2.1% and 1.8% respectively. Euro-area HICP inflation had risen sharply in October,

according to the flash estimate. That partly reflected energy price declines last year falling out of the calculation of the annual rate of inflation.

Money, credit, demand and output

14 Aside from the likely impact of events in financial markets, the main question was whether growth had been slowing and, if so, whether it was at a rate consistent with keeping inflation in line with the target in the medium term. While this month's data had provided further evidence of robust growth in the past, there were also some signs that the economy was slowing, as anticipated in the August *Inflation Report*.

15 GDP growth in Q3 was 0.8% for the fourth consecutive quarter, according to the preliminary GDP release, with strong service sector growth but weaker growth in production. That had been slightly higher than expected at this stage in the data cycle. But the preliminary estimate was based on only two months of service sector data, and the financial market turmoil could well have pushed activity down in September. Furthermore, since the GDP data had been released, the ONS had published a weaker-than-expected set of industrial production data for September, with manufacturing output down 0.6%.

16 Overall, the indicators pointed to some slowing of GDP growth in the fourth quarter. The CIPS/NTC business activity and new orders indices for services had weakened sharply in October, recording the largest one-month decline since 2001, and were at their weakest level since 2003. But since this survey excluded distribution as well as the public sector, it would be particularly affected by movements in financial services. The survey respondents had appeared to view the slowing as temporary, as the index for business expectations in the year ahead had only fallen slightly. The CIPS/NTC manufacturing output and new orders indices had also weakened, though the British Chambers of Commerce (BCC) domestic sales balance had increased to its highest level since 1994.

17 Turning to the expenditure components of GDP, there had been mixed news on consumption growth. Retail sales volumes had risen strongly in August and September. But the CBI *Distributive Trades Survey* retailers' balance had fallen in October, as had the British Retail Consortium's measure of annual growth in retail sales. The ONS retail sales estimates had indicated deep discounting by retailers. But there was an unusually large wedge between the retail sales deflator and the

corresponding components of the Retail Prices Index, which raised the possibility that retail sales volumes were not as strong as recorded. Consumer confidence measures had weakened. But the recent data on car registrations had appeared to be quite firm and unsecured credit growth had ticked up in Q3.

18 The data on house prices had also been mixed. The Nationwide index had risen and the Halifax index had fallen in October. According to the preview of the Royal Institution of Chartered Surveyors (RICS) survey, price and price expectations balances had fallen again. The activity picture looked somewhat clearer, with the number of mortgage approvals for house purchase falling in September, and the RICS sales-to-stocks ratio, the Home Builders Federation net reservations and site visits balances all down on the month. Looking more broadly at the property market, average buy-to-let gross yields had fallen below mortgage rates in recent months, while commercial property prices had fallen further.

19 Further information on credit conditions had been gathered from the major UK lenders. The latest intelligence appeared broadly consistent with reports for the euro area. While the full UK survey, produced ahead of the October MPC meeting, had suggested that recent events would have only a limited impact on households' access to credit, the latest intelligence indicated that the supply of credit to households had already been reduced and that this was expected to continue. The latest mortgage rates already reflected some of this tightening, with quoted two-year fixed rates up five basis points since July, whereas they would have fallen by around 30 basis points had they moved in line with their usual relationship with interest rate swaps.

20 As far as corporates were concerned, much of the tightening that had been planned at the time of the *Credit Conditions Survey* had seemed to have occurred, according to the latest intelligence. A small balance of lenders had expected to tighten conditions further over the next three months. The impact on business had appeared limited so far, with the Bank of England's regional Agents' contacts reporting few direct effects from the turmoil, mainly because many of them had no present need to undertake new borrowing. It was also possible that the tightening would be more likely to impinge on mergers, acquisitions and leveraged buyout activity than on fixed investment. The decline in investment intentions in the quarterly CBI *Industrial Trends Survey* and reported by the Bank's regional Agents, had seemed more likely to be connected with uncertainty about demand prospects than an increase in the direct cost or availability of finance.

21 Aggregate M4 and M4 lending growth had remained strong in September, at 12.8% and 15.1% respectively. Adjusting lending for the estimated impact of recent financial market turmoil on intra-group transfers and leveraged-buyout activity suggested that the underlying growth rate was lower than indicated by the headline figures, and had been slowing sharply.

Costs and prices

22 There had seemed to be little news in the labour market quantities this month. The Labour Force Survey (LFS) showed that employment of the 16+ age group had risen by 22,000 in the three months to August. Unemployment had edged down according to both the LFS and claimant count measures, although inactivity had risen substantially.

23 Pay settlements had remained subdued, and had averaged 3.3% in the 12 months to September. The Annual Survey of Hours and Earnings had pointed to an attenuation in wage pressures in the period up to last spring. But both the average earnings index (AEI) and average weekly earnings (AWE) measures of pay growth had ticked up in the three months to August. And a wedge between the AEI and AWE measures of regular pay growth had opened up since the spring, with the latter suggesting a somewhat faster rate of increase. The ONS was still undertaking further work on the reconciliation of the two series, which were based on the same underlying data.

24 Little was known yet about the prospects for settlements at the beginning of next year. The first quarter was a particularly important period for private sector settlements; it was possible that employees would seek to resist the falls in their real take-home pay induced by the past and prospective rises in energy prices. And although CPI inflation had fallen to around the 2% target since the spring, other measures of inflation continued to run at a higher rate.

25 Turning to other costs, manufacturers' input prices had risen 3.2% in September, reflecting higher energy prices. The CIPS/NTC manufacturing index had fallen back in October, but the corresponding services index picked up. The rise in manufacturers' output prices in September had seemed broadly in line with recent months, and the survey balances had remained elevated. The CIPS/NTC services price index had risen. But there had been signs of easing capacity pressures in the Bank of England's regional Agents' latest reports, and in the CBI *Industrial Trends Survey*.

26 CPI inflation had been unchanged in September at 1.8%, with downside news mainly coming from weaker-than-expected transport fares. In line with pre-release arrangements, an advance estimate of CPI inflation of 2.1% in October had been provided to the Governor ahead of publication. The recent rise in wholesale oil and gas prices would affect inflation in the months ahead, but as usual there remained uncertainty about the timing and extent of this impact. There were also upside risks to the near-term path of inflation from rising food prices.

27 Inflation expectations remained elevated according to the Citigroup/YouGov survey, which were unchanged in October despite inflation having fallen back to around the target in recent months.

The November GDP growth and inflation projections

28 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 14 November.

29 The Committee's central projection for GDP growth was based on the assumption that Bank Rate would move in line with market expectations over the forecast period. Since August, there had been a considerable reduction in the path of Bank Rate implied by market yields and the sterling exchange rate had fallen. Notwithstanding those changes, the central projection was for UK output growth to slow to below its long-term average as consumer spending and business investment decelerated, reflecting past increases in Bank Rate, tighter conditions in credit markets and heightened uncertainty. Growth was then projected to recover as the effect of lower official interest rates and the lower value of sterling worked through and uncertainty dissipated. The slowing in the first year of the projection was a little sharper than in the August *Report*, and the subsequent pickup correspondingly stronger.

30 The Committee's central projection was for inflation to rise above the target during 2008, reflecting the impact of higher energy price inflation and the depreciation of sterling. It then eased back as pressures on capacity moderated, settling at the target in the medium term. The profile was somewhat higher next year than in the August *Report*.

31 As usual, there were substantial uncertainties surrounding these projections. These included: the implications of financial market developments for credit conditions, asset prices and spending; the

prospects for world growth and prices; and the evolution of wages and inflation expectations. Overall, the risks to growth were judged to be on the downside, while those to inflation were balanced. The uncertainties surrounding the medium-term outlook were judged to be higher than in August. There was a range of views on the Committee about both the central projection and the balance of risks.

The immediate policy decision

32 Recent data on the UK economy had been mixed, although the broad picture was consistent with that painted in the August *Inflation Report*. But there had been substantial news about the outlook since then, particularly the developments in financial markets over the past three months, triggered by news from the United States. Credit and money markets had remained illiquid and fragile. There was uncertainty about the extent of the slowdown in US domestic demand, but world activity was still being supported by rapid expansion in many emerging market economies, especially in Asia. There had been sharp rises in oil and other commodity prices. And there had also been major changes in short-term yield curves and exchange rates. UK inflation had fallen back since the previous *Report*, and was currently close to target.

33 A key question was whether growth had been slowing as projected in the August *Report* and, if so, whether it was at a rate consistent with keeping inflation in line with the target in the medium term. Members generally agreed that some slowing in UK activity appeared to be underway. There was little evidence in the official output data, which, if anything, had been stronger than expected. Nonetheless, there were indications of a slowdown from business surveys, the housing activity data and the commercial property market. Members had a range of views as to how significant this slowing in activity would prove to be, and whether it was more or less than had been expected at the time of the August *Inflation Report*.

34 It remained hard to gauge the extent of the eventual adjustment in financial markets, and the impact that would have on the world economy, domestic activity and inflation. The combination of circumstances in financial markets in recent months was unique, so it was not easy to use past episodes of financial market turbulence as a guide. Much would depend on the future course of global equity and property prices and on the wider impact of the downturn in the US housing market.

35 There were also risks to inflation arising from the rises in energy, food and other commodity prices. These reflected a variety of temporary and permanent supply and demand-side influences. Not only was the future path of energy and commodity prices uncertain, but the precise impact on domestic activity and inflation remained difficult to judge. The central projection assumed these pressures would have a significant upward impact on inflation in the near-term.

36 Although market participants attached some probability to a cut in Bank Rate at this meeting, few respondents in the Reuters survey expected an immediate move. But the central projection in the *Inflation Report* was conditioned on a market path which included cumulative interest rate reductions of 50 basis points over the next twelve months, and a little more thereafter. That implied reduction in interest rates was sufficient to leave the central projection for inflation close to the 2% target looking two years or so ahead. But there was substantial uncertainty about the prospects for activity and inflation, and hence the future path of interest rates. In this context, the Committee discussed whether the prospects for inflation warranted an immediate reduction in Bank Rate.

37 There was a variety of arguments in favour of maintaining Bank Rate at its current level this month. While some slowdown in activity was probably needed to meet the inflation target in the medium term, recent GDP data had, if anything, been firmer than expected. There was time to wait and see whether, and to what degree, the projected slowing emerged in the data. While there had been a clear change in financial markets and credit conditions, the evidence of significant effects on household or business activity was so far limited. Meanwhile the renewed rise in oil and other commodity prices posed an upside inflation risk. Inflation expectations had not fallen back, and some measures of pay growth had picked up.

38 There were risks attached to a pre-emptive cut in Bank Rate if the slowdown in activity was more muted than in the central case, and the rise in inflation in the early part of the forecast period was sharper than expected. If inflation expectations and wage growth picked up as a result, then the necessary policy tightening could prove costly. Moreover, since a reduction in Bank Rate was not widely expected this month, there was a danger that an immediate cut would be misinterpreted, precipitating an unwarranted further fall in the market yield curve.

39 There were also arguments in favour of a reduction in Bank Rate this month. The effect of earlier rises in interest rates on the commercial property and housing markets were now apparent and

there was some evidence of a slowdown in activity. Pay growth remained muted. The central projection, which was conditioned on interest rate reductions over the next year, showed a sharp slowing of growth. Waiting for further evidence before cutting interest rates towards a more neutral level risked making the slowdown sharper and longer than it needed to be to bring inflation back to target. Moreover, with the continuing turmoil in financial markets and the consequent tightening of credit conditions, the balance of risks to growth was to the downside. Although an early reduction in rates would be something of a surprise to the markets, the Committee had been willing to move ahead of market expectations on the way up and the reasons for a reduction would be plain from the *Inflation Report*.

40 Weighing up all these arguments, most Committee members concluded that Bank Rate should be left unchanged this month. However, some members thought that an immediate cut was warranted.

41 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.75%. Seven members of the Committee (the Governor, Rachel Lomax, Kate Barker, Charles Bean, Tim Besley, Andrew Sentance and Paul Tucker) voted in favour of the proposition. Two members of the Committee (John Gieve and David Blanchflower) voted against, preferring a reduction in Bank Rate of 25 basis points.

42 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.