

Publication date: 17 October 2007

**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
3 AND 4 OCTOBER 2007**

These are the minutes of the Monetary Policy Committee meeting held on 3 & 4 October 2007.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0710.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 7 and 8 November will be published on 21 November 2007.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 OCTOBER 2007

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

Financial markets and credit

2 Some financial markets remained fragile, and were still not functioning normally. There had been some improvement in US credit markets, where the recent turmoil had originated. Spreads on US mortgage-backed securities had stabilised or, for highly rated securities, declined. Investors seemed to be cautiously returning to the asset-backed commercial paper market: spreads were falling back; some issuers had found it easier to roll over paper; and maturities were slightly longer. In the United Kingdom, spreads on mortgage and other asset-backed securities had generally widened further except for the most highly rated. The volume of transactions remained at low levels. Across all markets, investors appeared to be beginning to discriminate between different instruments according to their underlying credit quality. Market conditions had been helped by the release of some more information about where losses resided, as institutions announced their financial results for the third quarter.

3 There had been some improvement in money market conditions. Very short secured sterling rates had generally been close to Bank Rate since the beginning of the monthly maintenance period on 6 September, with the Bank acting to stabilise the secured overnight interest rate.

4 Since mid-September, the spread between the three-month sterling inter-bank lending rate (LIBOR) and the expected policy rate, implied by interest rate swap agreements, had fallen back. The equivalent US spreads, which had already started to narrow, had fallen back further in the wake of the Federal Reserve's decision to reduce its target federal funds rate by 50 basis points on 18 September. Nevertheless, sterling, euro and dollar three-month LIBOR rates were all still high relative to the corresponding expected policy rates.

5 Expectations of major central banks' policy rates, derived from interest rate swap agreements, had fallen internationally. At the time of the August *Inflation Report*, the markets had been pricing in another rise in Bank Rate by the beginning of next year. But by the time of the October meeting, they appeared to be pricing in a 25 basis points cut by the end of 2007, although conditions in money markets meant that these market-based measures were highly uncertain. None of the economists polled in a Reuters' survey expected a rate change at this meeting, but a clear majority anticipated a rate cut at some point in the next six months. The decline in expected policy rates at shorter maturities had been accompanied by a rise in longer-term forward rates since the August *Inflation Report*.

6 Partly reflecting movements in relative interest rates, the sterling effective exchange rate index had depreciated by around 2% this month.

7 Despite the turmoil in some financial markets, equity prices continued to rise, with the main US and European indices up 3%-5% since August. The apparent resilience of equity prices seemed surprising given the deterioration in the major economies' growth prospects. One possible explanation was that the continuing strength of the emerging market economies was expected to help maintain sales and profits of companies in the developed world. That story was consistent with the noticeably weaker equity prices of smaller companies, which were likely to be more reliant on domestic demand. Another explanation might be that globalisation had reduced the pro-cyclicality of profits, with wages and employment now expected to bear more of the burden in downturns. It was also possible that participants in equity markets believed that central banks would act to maintain output growth. Corporate bond yields – especially for higher quality borrowers – had been broadly unchanged since August.

8 At home, the Bank of England's *Credit Conditions Survey* suggested that banks expected to raise both the price and non-price terms of their lending to non-financial companies over the next three months. Conditions facing the household sector appeared, for the moment at least, to be less affected by the financial turbulence. Quoted standard variable mortgage rates were unchanged in September. Indeed, following the decline in swap rates, some of the rates on fixed-rate mortgages were actually lower. There was little evidence of any marked change in the growth rate of aggregate household credit in August. And banks reported in the *Credit Conditions Survey* that they did not expect to reduce the availability of credit to households over the next three months.

9 The *Credit Conditions Survey* had been conducted before 14 September, when the Liquidity Support Facility was announced for Northern Rock. The extent of any subsequent and prospective tightening in bank credit was uncertain. Severe restrictions in credit supply in the past had generally been associated with a deterioration in the asset side of banks' balance sheets, caused by economic slowdowns, and rising defaults. By contrast, the current episode was characterised by difficulties on the liability side of some banks' balance sheets.

The international economy

10 Some of the data for the United States this month had been reasonably positive, outside the housing market. Industrial production rose 1.1% in the three months to August, the fastest pace since autumn 2006. On the expenditure side, consumption rose by 0.6% in August. Both of the main survey indices from the Institute of Supply Management fell, but were broadly consistent with the rate of GDP growth in the third quarter that the MPC had expected at the time of the *August Inflation Report*.

11 But the risks to the outlook for US economic activity were weighted to the downside. The continuing fall-out from the financial market problems could bear down on household and corporate spending. The stock of unsold new homes was at near-record levels and new home sales continued to fall. A benign resolution of this stock overhang seemed less likely against the backdrop of the financial market turbulence. A more prolonged correction now seemed probable, which could push down on house prices and weaken consumption, as well as holding back residential investment. Employment had declined in August, according to initial estimates of non-farm payrolls. That could have been erratic, but if it signaled the start of a sustained period of weak employment, then that would threaten consumer spending.

12 In the euro area, the September headline Purchasing Managers Index (PMI) for services showed the biggest monthly fall since the series began in 1998. The decline had been particularly sharp in Germany. The manufacturing PMI and the EC business confidence balances also fell. But as these falls came at the end of the quarter, the surveys did little to alter the Committee's view that Q3 GDP growth would show a rebound after a weak second quarter. Although the PMIs had fallen back only as far as their long-run averages, it was possible that they pointed to weaker growth further ahead.

13 In Japan, Q2 GDP growth had been revised down to -0.3% from +0.1%, while indicators for the third quarter had been mixed. But in the rest of Asia, the picture continued to be one of robust growth. Overall, the story of the past few months had been one of downside news for the major economies and upside news for the emerging market economies.

14 Commodity prices had continued to rise. Oil prices had reached another record high, and wheat prices had risen sharply. In both cases, supply factors had contributed to these price rises: heightened concerns about the impact of hurricanes on oil production in the Gulf of Mexico; and a poor Australian wheat harvest. But the strength of a range of commodity prices, despite deteriorating growth prospects in the OECD countries, provided corroboratory evidence of the continuing strength of demand in the emerging market economies.

Demand and output

15 In the United Kingdom, activity indicators had remained reasonably robust, with only limited evidence so far that the problems in money and credit markets were impacting on the real economy. But a number of external commentators had lowered their forecasts of output growth for 2008.

16 GDP growth in the second quarter was unrevised at 0.8%, although Q1 growth was revised up slightly. Solid growth still looked likely for the service sector in the third quarter. But there were signs of some easing towards the end of the quarter, with the September CIPS/NTC business activity index falling to its lowest level for a year and the new orders balance falling slightly. The Bank's regional Agents also reported an easing in service sector activity from its earlier strong pace. Within the service sector, declines in sentiment were clearly more marked among financial companies: according to the CIPS/NTC survey, business expectations in the financial intermediation sector fell sharply; and the CBI/PwC survey balance for expected output growth in financial services fell to its lowest level since 1991.

17 Manufacturing output growth looked likely to have slowed in Q3 as shipbuilding output, which had been exceptionally high in the second quarter, returned to more normal levels. But otherwise, underlying growth in the manufacturing sector appeared to be reasonably healthy. The CIPS/NTC output balance had fallen back slightly in September, but the quarterly average was the highest since 1994. The expected output balance in the September *CBI Monthly Industrial Trends Survey* had

picked up, and the Bank's regional Agents reported higher growth in manufacturing output destined for both the export and domestic markets.

18 On the expenditure side, the evidence on consumption was mixed. Retail sales volumes in August had risen by 0.6%. Although the retail sales volumes balance in the *CBI Distributive Trades Survey* fell in September, it still pointed to robust growth. Evidence from the Bank's regional Agents was consistent with some slowing in consumer spending. They had reported continued easing in the growth of retail sales values and in consumer services turnover.

19 There had been clearer signs of slowing in the housing market. The average of the lenders' price indices had been broadly unchanged in September, implying that the average rise in house prices in the third quarter as a whole was 1.3%. Both the forward and backward-looking price balances had fallen again according to the preview of the Royal Institution of Chartered Surveyors (RICS) survey for September. Mortgage approvals had declined in August. Both the RICS and the Bank's regional Agents reported a further easing in housing demand this month.

20 It was unclear what impact the tightening in credit conditions for companies might have on business investment. The effective rate on new corporate borrowing from banks had risen by about 100 basis points since June. But the Bank's regular liaison exercise with larger companies suggested that there was as yet no significant impact from recent events on business investment. Companies had other sources of funds they could draw on, for example retained profits. Some cash-constrained smaller companies might be affected. It was also possible that any reduction in the availability of credit would impact mainly on merger and acquisition activity, including leveraged buy-outs.

21 The Committee was briefed by the Treasury Representative on the broad outlines of the Chancellor's forthcoming *Pre-Budget Report*. An assessment by Bank staff of the implications for the economy would be undertaken following publication.

Supply, costs and prices

22 According to the Labour Force Survey (LFS), employment rose by 84,000 in the three months to July, while unemployment fell by 28,000. Unemployment also edged down on the claimant count measure in August. Inactivity rates had risen over the past year. Vacancies had risen a little in the

three months to August. The balances in the September Recruitment and Employment Confederation (REC) survey had recovered slightly, following the weakening that the Committee had noted last month.

23 The recovery in employment had gone some way to resolving the puzzle posed by the juxtaposition of weak employment growth and apparently elevated capacity pressures. A survey of the Bank's regional Agents' business contacts had suggested that increasing productivity may have been part of the explanation for the previously weak employment growth. That could explain why some survey measures of capacity pressures were now starting to ease even though output growth remained robust.

24 However, other labour market data were consistent with a weaker picture, and created further puzzles. According to the LFS, the majority of employment growth during the past year had been in self-employment, and there had been little change in the number of employees. Moreover, the number of temporary workers who could not find a permanent job and the number of part-time workers who could not find a full-time job had been recorded as increasing.

25 Pay growth had remained subdued. The 12-month weighted average of wage settlements was unchanged in August at 3.2%. However, the private sector component had been edging up, offset by falls in public sector settlements. Regular pay and total annual earnings growth had both ticked up to 3.5% in the three months to July, according to the Average Earnings Index. The REC survey suggested pay pressures were lower than in the first half of 2007.

26 The news on other costs was mixed. The 12-month rate of inflation for imported goods slowed in July, both including and excluding oil. In August, manufacturers' input price inflation rose to 0.6%, while the corresponding measure for manufacturers' output prices was flat at 2.5%. The CIPS/NTC manufacturing index of monthly input price inflation fell in September, while the corresponding index for services rose. Both the CIPS/NTC indices for manufacturing and services output prices picked up. Indeed many of the price survey balances remained above their longer-run averages.

27 CPI inflation had fallen to 1.8% in August. Data for September on some retailers' prices collected from the internet pointed to a large increase in non-seasonal food prices, and the rise in oil prices was likely to push up petrol prices from October. These developments could introduce further

volatility into CPI inflation during the coming months. But for Q3 as a whole, CPI inflation looked likely to be lower than in the central projection in the August *Inflation Report*.

28 The decline in CPI inflation over the past few months had not led to a decline in the various survey measures of inflation expectations. According to the Bank/GfK NOP survey, carried out between 16-21 August, median expectations of inflation over the coming year were flat. And the YouGov/Citigroup survey conducted between 20-24 September suggested that expectations of inflation for the year ahead had actually edged up.

The immediate policy decision

29 In its August *Inflation Report*, the Committee's central projection had been for inflation to fall back to, and then settle around, the 2% target. The balance of risks to that outlook had been judged to be a little to the upside. In the Committee's view, pressures on supply capacity had meant that some slowdown in output growth would be necessary to keep inflation close to the target. The central projection had been for GDP growth to slow from its recent robust levels as a higher level of Bank Rate reduced consumption and investment growth.

30 Since those projections had been made, CPI inflation had fallen back to a little below 2% and seemed likely to remain close to the target over the next few months, though it could be volatile. World commodity prices had continued to rise. Most members thought that the evidence from the labour market had pointed to some gentle tightening of conditions, although for one member the evidence pointed to some easing. All members agreed that pay growth had remained muted on most measures.

31 There had been only limited signs of slowing in the economy. Survey measures of business activity had stayed firm and, if anything, pointed to slightly stronger growth in the third quarter than had been expected at the time of the August *Report*. But there were signs that growth would ease further ahead. Although activity in the Asian economies had remained robust, output growth in the United States and euro area seemed to be slowing. In the United Kingdom, some surveys had indicated that consumer spending was moderating. Indicators of housing market activity had fallen, but were so far consistent with a gradual easing in the rate of increase in house prices rather than a sharp correction.

32 The turmoil in some financial markets meant that the downside risks to activity had increased since the *August Report*. There were signs that conditions in credit and money markets were beginning to improve, although they were likely to remain difficult for some time. There was some evidence that credit conditions had tightened in the corporate sector and they could tighten further. But the extent and duration of any tightening and its impact on the rest of the economy was still uncertain.

33 The Committee discussed whether the change in the balance of risks to output growth warranted an immediate cut in Bank Rate. Credit conditions were expected to tighten and growth prospects for the United Kingdom's main trading partners had deteriorated. A precautionary reduction in Bank Rate could forestall a sharper slowdown in output growth than had been judged necessary to meet the inflation target. The Committee should not wait for such a slowdown to materialise in the data before acting. Moreover, if the downside risks did not crystallise, then any monetary easing could be withdrawn quickly.

34 The Committee also discussed the arguments for leaving Bank Rate unchanged. It was important not to prevent the slowdown envisaged in the *August Report* by loosening monetary policy too quickly. Moreover, it did not seem that conditions in financial markets had so far had a substantial impact on consumer or business confidence, with the exception of some parts of the financial sector.

35 Since the *August Inflation Report*, the sterling exchange rate had declined and short-term risk-free interest rates had fallen. Starting from a position of strength in the economy, there was time to consider how developments in credit conditions would affect the outlook for inflation. The preparation of the November *Inflation Report* and its projections would give the Committee more opportunity both to assess the impact of market turbulence and other developments in order to reach a more considered judgement and to explain its policy stance.

36 A reduction in Bank Rate this month was not widely expected. There was a danger that such action would be misinterpreted as a signal that the outlook for growth and inflation had shifted decisively to the downside. Furthermore, the economy had just emerged from a period where inflation had been above target. On some measures, inflation expectations remained elevated, despite the fall in actual inflation. It was possible that a cut in rates this month could be misinterpreted as a signal that

monetary policy was focused on supporting the financial system and not on meeting the inflation target.

37 Weighing all these arguments together, most Committee members concluded that Bank Rate should be left unchanged this month. However, for one member, an immediate cut was warranted: the Committee's central projection for activity had already looked a little high back in August; and since then the downside risks had increased or even crystallised.

38 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.75%. 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.

39 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.