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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
5 AND 6 SEPTEMBER 2007**

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0709.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 3 and 4 October will be published on 17 October 2007.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 SEPTEMBER 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 There had been considerable disruption in financial markets during August. The original cause of the concerns had been a continuing deterioration in the US housing market and increasing default rates on sub-prime mortgages. Securities backed by such mortgages had seen a significant fall in price and hence widening of spreads during July, and this trend had continued into August. As investors had re-considered the risks associated with sub-prime mortgages, there appeared to have been a widespread re-pricing of all asset-backed securities (ABS), including mortgage-backed securities of higher credit standing, mortgage-backed securities in other countries including the United Kingdom, and ABS backed by other assets or receivables such as credit card payments. In turn, this had affected structured credit products backed by portfolios of ABS. These wider market developments seemed to be caused in part by a loss of investor confidence in the ratings given to such securities by the ratings agencies and also by difficulties in assessing the level and final ownership of the risks underlying structured credit products.

3 As spreads for ABS had widened, and large losses by a few individual firms were reported, investors also became reluctant to invest in asset-backed commercial paper (ABCP): short-term instruments which had been issued to fund various off-balance-sheet conduits and structured investment vehicles which held, among other assets, portfolios of ABS and structured credit products. As demand for ABCP had dissipated, many of these conduits looked likely to need to draw on committed liquidity lines from the banks. As a result, many banks were faced with a sudden and unexpected prospect of either providing that committed liquidity or bringing the assets backing the paper on to their own balance sheets. This was happening at a time when, as discussed at the August MPC meeting, some banks had already had to accommodate a higher-than-normal stock of leveraged

corporate loans, for which the market had previously become illiquid. The need to provide funding for potentially large portfolios of loans, ABS and related products had led banks to demand extra liquidity via other short-term money market instruments. The extra demand for short-term liquidity, and uncertainties about who had large exposures to US sub-prime mortgages, meant that banks had, as a general matter, become reluctant to lend to each other at maturities beyond a few days in most currencies, including sterling.

4 Short-term market interest rates had risen internationally, despite expectations of policy rates implied by overnight index swap markets having fallen. This reduction in expectations had been confirmed by discussions with market contacts. For a short period in mid-August, the overnight rate for secured sterling borrowing, which was normally just a few basis points above Bank Rate, had risen significantly, although it had since fallen back towards Bank Rate. Market interest rates from overnight out to several months had become elevated internationally, with unsecured rates having generally risen by more than secured. Sterling three-month LIBOR had risen by around 75 basis points on the month, for example. In contrast, medium-term forward interest rates had fallen, with implied sterling rates three years ahead lower by around 20 basis points. Bond markets had seen a shift in preference towards low-risk assets, with the yield on US Treasury Bills falling briefly below 2% in mid-August.

5 Other financial markets had been affected less. Equity prices had fallen in mid-August but had since recovered. In the foreign exchange market, the main development had been a sharp appreciation in the yen, as there had been some unwinding of speculative currency positions funded by borrowing in yen. The sterling effective exchange rate index had fallen by 0.4% on the month.

6 It was not clear how long these disrupted conditions would persist. The deterioration in the US housing market, and the attendant rise in defaults and foreclosures, might carry on for some time. Committee members noted that eventually market participants should be able to re-evaluate the risks involved, re-price the relevant securities and probably re-assess the price of credit more generally, discriminating better between different assets. The adjustment process should be temporary but overly compressed credit risk premia in markets had been an issue for some time, as discussed in past issues of the Bank's *Financial Stability Review and Report*, and a sustained re-pricing of credit risk would not, in itself, be unwelcome. It was likely that a degree of de-leveraging by some market participants would take place, which could affect a wider set of financial markets while the transition was made.

The faster all these changes happened, the sooner market activity would start to normalise, and it was possible that this might happen quite quickly. Once these processes were complete, the demand for additional liquidity, and the associated rise in LIBOR spreads, should fall back. But September was a month when a large proportion of ABCP was expected to mature in a short time interval so, in advance of that, money market liquidity could become increasingly concentrated at overnight and very short-term maturities, unless ABCP conduits were able to re-issue paper, or banks could put alternative funding in place. And some of the structured investment vehicles had less access to committed liquidity lines (although they would also have a higher proportion of medium-term funding). Quarter-end results for many financial firms would reveal the extent of any losses through this period, although the valuation of some instruments was difficult where there was little trading taking place. So the adjustment path might well not be smooth.

7 There was little evidence as yet that banks had changed their assessment of corporate or consumer credit beyond the US sub-prime mortgage sector. Investment-grade bond yields had been broadly unchanged although, as government bond yields had fallen, investment-grade spreads had widened. Going forward, the impact on consumer and corporate credit would depend on factors such as whether there was a sustained re-pricing of credit risk; whether banks constrained use of their funds because of a heightened perception of liquidity contingencies; whether the elevated levels of short-term money market rates would cause lending rates to the corporate and retail sectors to rise significantly or would ease back once balance-sheet adjustment took place; and the impact of falls in the price of collateral. Existing floating-rate loans linked to LIBOR would have seen rates rise quite sharply already, but more generally it was too early to tell how significant the consequences might be for the price and quantity of credit.

The international economy

8 In the US economy there was further evidence of housing market weakness: a falling level of existing home sales, subdued house prices and a further tightening in lending standards to the sub-prime sector recorded in the Senior Loan Officer Survey. This contrasted with the resilience of the economy more generally: Q2 GDP growth had been revised up to 1% from 0.8%, with downwards revisions to residential investment more than offset by upwards revisions to consumption and non-residential investment. Survey data for the third quarter had been consistent with somewhat slower US growth, as expected at the time of the August *Inflation Report*. Headline US inflation had

fallen in July, reflecting lower energy prices, though core inflation measures had been unchanged and unit labour costs had accelerated. Following the financial market disturbances, the markets were now expecting cuts in US interest rates of at least 50 basis points before the end of 2007.

9 In the euro area, second-quarter GDP growth had been 0.3%, reflecting weaker-than-expected consumption growth and stockbuilding. Weak output growth might have reflected erratic effects from the number of working days and the weather. Surveys continued to be consistent with firm Q3 growth, although some contemporaneous and forward-looking balances had eased in August. The first estimate of HICP inflation for August had been 1.8%. Following the financial market disturbances, the markets were no longer expecting increases in the ECB's official interest rates in the near future.

10 In Asia, Japanese Q2 GDP growth had been subdued at 0.1% and monthly indicators for the third quarter had not been very strong. Importantly, other Asian economies, such as China and India, and other emerging market economies, continued to make a strong contribution to world activity.

11 Oil prices had been volatile on the month, initially falling by some 12%, perhaps reflecting some spill-over from other financial markets as speculative positions were reduced, but the price had since recovered to be around 3% lower than at the time of the *August Inflation Report*. In other commodity markets, the *Economist* dollar metals index had fallen by over 6% but food prices had risen strongly, with wheat prices up over 20%.

Demand and output

12 The second estimate of Q2 domestic GDP growth had been unrevised at 0.8%. The first estimate of consumption growth in Q2 was 0.7%, which was weaker than expected. Business investment growth had been 0.8%.

13 In the third quarter, surveys of manufacturing output continued to suggest strong underlying growth relative to the previous ten years. The latest ONS data had shown a small fall in manufacturing output in July. However, the ONS data in Q2 had been influenced by some erratic strength in shipbuilding in Q2 and so Q3 data might show slower growth than Q2. Reports from the Bank's regional Agents, had been consistent with some slowing in the annual rate of growth in August. In the services sector, the data had been mixed, although the survey balances continued to suggest somewhat

firmer growth than the official data. The CIPS/NTC business activity balance had edged up in August, but the new orders balance had eased back a little. The Bank's regional Agents had suggested some slowing in business services growth for the third quarter, and both the Agents and the CBI/Grant Thornton survey had also suggested a slowing in consumer services. It was also possible that the disturbances in financial markets could lead to slower growth in financial sector output, which accounted for around 8% of GDP on the ONS measure.

14 Consumption indicators for the third quarter were mixed. Retail sales volumes had risen by 0.7% in July, reflecting a sharp fall in the level of the price deflator – retail sales values had actually fallen. Reports from the Agents had suggested a slowing in retail sales and consumer services in August. The CBI *Distributive Trades* survey retailers' balance fell, but the British Retail Consortium survey edged up, narrowing the previous difference between them. The housing market data remained consistent with a gentle slowdown: the average of the lenders' house price indices, as measured by the three-months on previous three-months growth rate, had slowed to 1.7% in August and surveys of housing activity had mostly continued to point to some further gentle slowing ahead.

15 Manufacturing investment had fallen in the second quarter, which was perhaps surprising given the strength in manufacturing output. Investment intentions had remained strong, with the EEF survey balance reaching a new series high. One heightened uncertainty arising from financial market disturbances was the possible impact on the level of business investment in commercial property. Surveys pointed to continued firm growth of exports in the third quarter.

Supply, costs and prices

16 Employment data had continued to show a recovery from weakness earlier in the year. Employment had risen by 93,000 in the three months to June and the Labour Force Survey measure of unemployment had fallen by 45,000, with the unemployment rate easing down to 5.4%. There had also been further rises in recorded vacancies, although inactivity had risen by 45,000. The Recruitment and Employment Confederation survey, which had been particularly strong, pointed to a noticeable weakening of the labour market in August, although this survey had not generally been a reliable indicator of the official data. The Agents had also reported some weakening in employment intentions.

17 Pay pressures remained muted. Those pay settlements so far recorded for July suggested an unchanged annual rate of 3.2%. Overall average earnings growth had fallen back to 3.3% in the three months to June.

18 Manufacturers' input prices had fallen in July, with the twelve-month rate of inflation falling to zero from 2.1% the previous month. The CIPS/NTC manufacturing survey input prices balance for August had fallen, although it remained at a high level. The corresponding services balance had also dropped, to its series average.

19 The evidence on producer output prices was somewhat mixed. The CIPS/NTC manufacturing survey price balance had fallen, while the CBI *Monthly Trends* balance had risen. Both remained at high levels relative to the previous ten years. The CIPS/NTC services output price measure had edged up slightly, although the CBI *Distributive Trades* and CBI/Grant Thornton services surveys had both recorded sharp falls in their consumer price balances.

20 The CPI inflation rate had fallen sharply to 1.9% in July, a slightly bigger fall than that expected in the August *Inflation Report*. This was the largest monthly fall in the annual inflation rate in five years and reflected weaker prices for household goods prices and for food and soft drinks. There had also been a fall in petrol prices, although the underlying oil price remained volatile. CPI inflation was still likely to remain around, or a little below, the 2% target for the next few months, but the Committee noted that it could also be subject to a number of erratic influences from food and energy prices and from the seasonal pattern of discounting in sales.

The immediate policy decision

21 As usual, the Committee considered the developments on the month in the context of the most recent *Inflation Report*. The central projections from the August *Report* had been for inflation to remain close to the 2% target over the forecast period and for output growth to ease, reflecting a slowing in both consumer spending and business investment. Overall, the risks to growth had been judged to be balanced. The risks to inflation had been weighted slightly on the upside in the medium term, although there had been a range of views among the Committee on both the central projection and the risks.

22 The recent news from the real economy had not materially changed the outlook. The international economy had continued to grow at a healthy pace, although some of the data – including that for the US housing market, and euro-area Q2 GDP growth – had weakened. In the United Kingdom, GDP growth for the second quarter had been unrevised and indicators for the third quarter had been consistent with continued robust growth, with some indicators of a possible moderation in consumption. Consumption growth in the second quarter had been slightly weaker than expected. The housing market appeared to be gently slowing.

23 In the labour market, employment had been growing more strongly than earlier in the year but pay growth remained muted. One possible explanation was that migrant workers might be having an effect on the level of wages, especially for lower-paid jobs. A second was that higher non-wage costs required further downward adjustment in real wages. There were some contrary survey indicators on the pace of employment growth but the Committee judged that it would need further evidence before placing weight on those, rather than on the official data.

24 The margin of spare capacity in the economy appeared limited and indicators of pricing pressure remained somewhat elevated. CPI inflation had fallen to just below the 2% target and it seemed most likely to remain around that level over the next few months, although some components were likely to be erratic. The Committee noted that the fall in CPI inflation to around the target level should help contain inflation expectations going forward.

25 Since the August MPC meeting, heightened concern in financial markets about a variety of asset-backed securities had led to disruption around the world, not only in markets for those financial instruments but also in money markets more generally. The impact of financial market disruption would depend on how long it persisted and how widespread it turned out to be. This was still very unclear. Short-term money market rates had remained elevated, but the Bank had announced action intended to ensure that the secured overnight rate – and expectations of that rate – were brought back into line with Bank Rate.

26 Most of the problems had been manifested in the inter-bank markets or between banks and other financial institutions, rather than linked to any underperformance of the wider economy: only the US housing market had actually weakened significantly. Losses from mortgage defaults in the United States remained small relative to the capital of the banking system. The major banks had recently

enjoyed strong profits and it appeared that they were well capitalised, so that even if all of the ABS funded by ABCP had to be absorbed by banks' balance sheets, they should have sufficient capital above their regulatory minima to accommodate the impact in the long term. And as non-bank investors switched away from credit and related markets, the flows into other assets, including bank deposits, should find their way back on to banks' balance sheets to help provide some of the necessary funding. Once the process of adjustment in banks' balance sheets had taken place, the demand for higher liquidity should ease and the elevated LIBOR rates fall back. In the interim, however, there could be marked transitional effects; for example, if banks sought to restore their previously desired levels of capital or hold unusual levels of liquidity.

27 The Committee noted that its mandate was to set interest rates so as to meet the Government's inflation target of 2%, so the issue was the extent to which developments in financial market intermediation would affect the wider economy and hence the outlook for inflation. Committee members highlighted a number of channels through which this could occur. One channel was through market interest rates. To the extent that there was a sustained re-pricing of risk, that could feed through to retail or corporate lending rates and credit conditions would tighten without any further change in Bank Rate. A second channel was via the associated impact on asset prices, which would reduce wealth and affect the value of collateral available to borrowers. A third channel could be through pressure on banks' balance sheets, as described above. Fourth, a more direct channel could arise because the financial sector – including the wholesale markets – was itself an important part of the UK economy and any fall in activity levels would have a direct impact on UK GDP growth. Finally, greater uncertainty about the economic outlook might lead to a postponement of business investment.

28 Taking into account the data on the real economy and financial market developments, the Committee agreed that the upside balance of risks to inflation in the *August Inflation Report* projections had probably receded. The outlook was now more uncertain. As stated in its *August Inflation Report*, the MPC was monitoring closely the evolution of both credit spreads and the quantities of credit extended, alongside all other data relevant to the outlook for inflation.

29 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.

30 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.