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MINUTES OF
MONETARY POLICY COMMITTEE MEETING
6 AND 7 FEBRUARY 2008

These are the minutes of the Monetary Policy Committee meeting held on 6 & 7 February 2008.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0802.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 March will be published on 19 March 2008.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 FEBRUARY 2008

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed financial markets developments; the international economy; credit, demand and output; and costs and prices.

Financial markets

2 Financial markets had continued to be stressed. Markets for most asset-backed securities (ABS), particularly those backed by mortgages, had remained largely closed and spreads had continued to widen. In both the United States and the United Kingdom, spreads on ABS backed by credit card repayments and commercial property had also widened.

3 In inter-bank money markets, unsecured interest rate spreads over expected policy rates had continued to narrow in early January, with funding conditions for UK banks reported to have improved a little. But towards the end of the month, these spreads had begun to edge slightly wider and market contacts reported that liquidity conditions had started to deteriorate again. Forward markets suggested that money market spreads were expected to narrow slowly during 2008.

4 The news on the month had indicated that pressure on banks' balance sheets had continued to intensify. Some large US and European banks had reported revised and higher write-downs related to sub-prime mortgage ABS. There remained considerable uncertainty in financial markets about the positions of firms that had yet to report any significant losses. In some cases, this was because of different reporting cycles, but in part it also possibly reflected the potential for differing accounting and regulatory practices across countries.

5 In addition, there had been ratings downgrades for some of the major non-bank financial guarantors (known as 'monoline' insurers). These guarantors sold credit protection on a variety of assets including US municipal bonds and structured credit products. As default probabilities had risen on assets guaranteed by the insurers, there had been mounting concern about counterparty credit exposures, and hence the value of the insurance had fallen. Further downgrades were likely. It was possible that banks might have to make provisions against their exposures to the monolines, or take

further write-downs on the insured assets, and might feel pressure to sell some of those assets into an already depressed market. The changing value of insurance would not in itself increase the overall scale of losses related to sub-prime mortgages, but it would have the effect of redistributing those losses towards the banking system, among others, and would raise the already high degree of uncertainty about banks' capital ratios.

6 International equity markets, which had previously been affected less by the developments in credit markets, had fallen sharply in the middle of the month and had remained volatile since. The falls had been prompted by further news about bank write-downs and the monoline downgrades as well as weaker data, especially for the US economy. The major UK and US equity indices were 5-6% lower since the previous MPC meeting, and euro-area indices had fallen by around 10%. Emerging-market indices had previously been more resilient, but they too had fallen by an average of around 8% on the month.

7 In the United Kingdom, short-term interest rates were little changed on the month. In the euro area they had fallen by 40-50 basis points. In the United States, the Federal Open Market Committee had cut their policy rate twice, by a total of 125 basis points, including 75 basis points in an unexpected inter-meeting move on 22 January. Uncertainty about the future path of interest rates had risen internationally.

8 Longer-term nominal forward interest rates in the United Kingdom, the euro area and the United States were generally higher on the month, by up to 25 basis points. In the United States, there had been a fall of around 25 basis points in five-year forward real interest rates, five years ahead, and a larger increase in the corresponding implied inflation rates. This seemed to be consistent with a rise in future inflation uncertainty, given the increase in implied interest rate volatilities at the same maturity. In the United Kingdom, longer-term implied inflation rates derived from index-linked gilts had continued to move slowly upwards but implied volatilities had not increased to the same extent as in the United States.

9 The sterling effective exchange rate had been broadly unchanged on the month. The balance of risks, as derived from options prices, continued to suggest that market participants placed greater weight on the risk of further falls, rather than rises. The starting point for the sterling effective

exchange rate index (the ERI) in the February *Inflation Report* was around 6% lower than that for the November *Inflation Report*.

The international economy

10 There had been a variety of weak data for the United States over the month. GDP growth in the fourth quarter had been estimated at just 0.2%, partly reflecting the largest fall in residential investment for 26 years. Stockbuilding had also made a significant negative contribution, whereas consumption and non-residential investment had been more robust. The manufacturing survey by the Institute for Supply Management (ISM) had indicated some modest expansion in January, but the non-manufacturing business activity balance had declined by 12.5 points to 41.9. The January non-farm payrolls data had shown a contraction in employment and downward revisions to the level and growth of employment during 2007. US housing activity data had also been weak, with declines in housing starts, new building permits and new home sales. The latest Senior Loan Officers' Survey had indicated a further tightening in lending standards.

11 The US authorities were responding to the deteriorating outlook for growth by relaxing both monetary and fiscal policy. In addition to the cuts in interest rates, a fiscal package was being negotiated, with proposals to include tax rebates for people on lower incomes and measures designed to stimulate capital spending on new equipment. The overall stimulus to activity would be substantial.

12 In the euro area, there had been less significant news, but growth also seemed to have been slowing. Consumption growth appeared to have eased, with retail sales down 1% in the fourth quarter and the European Commission consumer confidence survey had weakened further in January. A mixture of survey data for manufacturing and services had pointed to modest growth in the first quarter of 2008. The latest credit conditions survey had also suggested tightening credit availability.

13 In Japan, there had been little news on output growth. Elsewhere in Asia, growth had been robust. The Committee concluded that it was too early to tell how far the emerging market economies would be affected by slowing growth in the developed economies. There had been some weather-related disruption in China, which should prove to be temporary, but rising inflationary pressures indicated that growth there might need to slow somewhat.

14 HICP inflation in the euro area had reached 3.2% in January, its highest since the inception of the euro. US CPI inflation had fallen a little, to 4.1% in December, although the core measure had picked up to 2.4%. In Japan, annual core CPI inflation had reached 0.8% in December, its highest rate for nearly ten years. But the sterling price of oil had fallen by over 8% on the month.

Credit, demand and output

15 In the United Kingdom, the provisional estimate of GDP growth in the fourth quarter had been 0.6%, around its post-war average rate. Manufacturing output was reported to have been broadly flat for the second successive quarter and there had been a fall in service sector growth to 0.7%. The CBI *Quarterly Industrial Trends* and the British Chambers of Commerce (BCC) surveys had been consistent with slightly stronger Q4 growth, especially in manufacturing. But persistent differences between the strength of the official and business survey data for manufacturing were not unusual.

16 Business survey data for output in January had generally indicated continuing growth, but the more forward-looking elements were consistent with slowing activity. The CIPS/NTC survey for manufacturing output continued to indicate positive growth in January but the new orders balance had signalled contraction. The services survey output balance had edged up, but the business expectations balance had been its lowest level since 2001.

17 Consumption growth appeared to have eased. Retail sales volumes had fallen by 0.4% in December, although were still 2.7% higher than December 2006. The survey evidence for January had been consistent with some further easing, although the changes in the CBI *Distributive Trades Survey* balance, and the Agents' scores for retail goods, had been small. The GfK NOP consumer confidence survey on behalf of the European Commission (seasonally adjusted by the Bank) had fallen further, to its lowest level since December 1992, and retailers' profit warnings had increased.

18 Activity in the housing market had continued to decline, with mortgage approvals for house purchase reaching their lowest since 1995. Forward-looking indicators of activity had also fallen, including the balances for site visitors (seasonally adjusted) recorded in the Home Builders Federation survey and new buyer enquiries in the preview of the Royal Institution of Chartered Surveyors survey. House prices had been broadly flat in January.

19 The Committee discussed the potential impact of a housing market slowdown. A period of relative stability in house prices would be welcome. A small number of borrowers for whom fixed mortgage rates would be re-set during 2008 could face higher repayments, which might affect their saving and consumption plans. Given the general uncertainty about economic prospects and access to credit, it was possible that precautionary saving would rise. But there was little evidence to suggest that a slowing housing market would lead to widespread financial distress and defaults in the United Kingdom unless there was also a significant rise in unemployment or mortgage rates, which had both been factors in the rise in possessions in the early 1990s.

20 There had been little new evidence on the supply of corporate credit. Although sterling corporate borrowing continued to grow robustly, the growth of total credit facilities granted to non-financial companies had slowed, which might indicate some financing constraints on future business investment. The CIPS/NTC capital goods new orders index had also fallen sharply in two successive surveys, alongside a fall-off in export orders. The commercial property market had weakened significantly. Although investment in non-residential construction accounted for only a small percentage of GDP, a sharp contraction could reduce growth significantly.

Costs and prices

21 In the labour market, there had been a growing divergence between the evidence from the robust official data and the softer signals from business surveys. In the three months to November, employment was estimated to have increased by 175,000, the largest three-monthly rise since 1997, and the unemployment rate had fallen slightly. This reflected the strength in UK activity growth during 2007. In contrast, the CIPS/NTC surveys suggested that employment growth had drifted down in recent months. And most indicators suggested that recruitment difficulties had been declining, especially in manufacturing.

22 Pay settlements were broadly unchanged in December and for early data on January. That had been consistent with the annual survey on pay carried out by the Bank’s Agents. Total average earnings growth, at 4.0%, had been unchanged in the three months to November. The Average Weekly Earnings series indicated some slowing in pay growth, narrowing the wedge over the Average Earnings Index measure.

23 Annual manufacturing input price inflation had risen to 11.2% in December. Unlike in previous months, this latest rise had not been driven by energy or food but by imported materials, perhaps an early sign of the consequences of the weakening exchange rate. Output price inflation had also risen, to 5% in December, its highest since August 1991. Many of the manufacturing survey price balances were also showing readings that were at their highest since the series began, although most did not have long histories. In the services sector, both the CIPS/NTC and BCC surveys had recorded output price increases, the latter a record high.

24 CPI inflation had been unchanged in December at 2.1%. In line with pre-release arrangements, an advance estimate of CPI inflation of 2.2% in January had been provided to the Governor ahead of publication. The Office for National Statistics had also confirmed that they would cease the phasing-in of utility prices, starting with the February index. CPI inflation was likely to rise sharply in the following few months, given previously announced changes in electricity and gas prices, the upward pressure on oil and food prices, and more general pressure on imported prices following the recent depreciation of sterling. And rises in the twelve-month inflation rate would also reflect cuts in energy prices during 2007 dropping out of the annual calculation.

25 Short-term measures of inflation expectations had remained elevated. This was not surprising, given the Committee’s own projections, but inflation expectations had not fallen back in line with actual CPI inflation following its temporary rise during 2007. The GfK NOP consumer confidence survey in January had reported that perceptions of current inflation had risen over the previous year to their highest since the question was first asked in 1995, although the forward-looking measure remained close to its series average. The Citigroup/YouGov measure for year-ahead price expectations had risen by 0.6 percentage points to its highest-ever reading. However, the longer-term (five to ten years ahead) expectations measure in this survey was broadly stable.

The February GDP growth and inflation projections

26 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 13 February. The projections were conditioned on the assumption that Bank Rate followed the path implied by market yields, falling to around 4.5% by the end of 2008.

27 The Committee's central projection for GDP growth was for output to slow markedly through 2008 as tighter credit conditions and weaker real income growth bore down on domestic demand. Growth was projected to recover as credit conditions improved and the effects of lower interest rates and weaker sterling worked through. The projected slowdown was somewhat deeper and more prolonged than in the November *Inflation Report.*

28 For CPI inflation, the Committee's central projection was for higher energy, food and import prices to push inflation up sharply in the near term. Inflation was then projected to ease back to a little above the 2% target in the medium term, as the rise in energy prices dropped out of the twelve-month rate and capacity pressures moderated. The profile was higher than in the November *Inflation Report*, particularly in the near term.

29 As usual, there were substantial uncertainties around these projections. The key risks were: on the downside, the potential for a greater tightening in credit conditions, and the associated impact on demand, at home and abroad; and, on the upside, the possibility that the short-term rise in inflation would lead to a more persistent rise in medium-term inflation expectations. Overall, the risks around the central projection to growth lay to the downside, while those to inflation were balanced. But there was a range of views among the Committee on both the central projection and the balance of risks.

The immediate policy decision

30 The Committee discussed the immediate policy decision in the context of the key risks identified in the February *Inflation Report*.

31 The prospects for output growth abroad had deteriorated and the disruption to global financial markets had continued. That posed a downside risk to inflation in the medium term. Growth seemed likely to slow in the United States, the euro area and Japan. There was no sign of slowing yet in commodity-producing countries and the emerging Asian economies, which continued to grow strongly. The Committee thought it most likely that UK-weighted global growth would slow gradually, with the risks judged to be to the downside.

32 The turmoil in financial markets had spread to some markets that had been relatively unaffected previously. International equity prices had been volatile and had fallen sharply during the month, including those for emerging market economies. Although spreads over expected policy rates had narrowed in inter-bank money markets in December and early January, they had started to move up again towards the end of the month. In the face of continuing uncertainty about the scale and distribution of write-downs by banks relating to sub-prime mortgage assets, and the further complications arising from ratings downgrades for some of the major non-bank financial guarantors, it seemed likely that conditions in credit markets would remain difficult for some time to come.

33 In the United Kingdom, activity data during the previous six months had been broadly consistent with the modest slowdown in growth envisaged in the central projection of the August 2007 *Inflation Report.* Credit conditions for households and businesses had been tightening and consumption growth appeared to have softened. Although the substantial fall in the sterling exchange rate was likely to boost net exports, promoting a rebalancing of total demand, output growth had moderated to around its post-war average rate and measures of consumer confidence and business surveys suggested that further slowing was in prospect, as projected in the February *Report*.

34 CPI inflation, at 2.2% in January, was close to the 2% target. But the Committee expected that higher energy and food prices would raise inflation, possibly quite sharply, in the coming months. Producer input and output prices were already rising rapidly and the decline in the sterling ERI would boost import costs further. The impact of these short-term pressures on CPI inflation was likely to fade later in 2008, so that inflation was likely to fall back towards the target. But measures of inflation expectations had not fallen in line with actual CPI inflation following its peak during 2007. There was a risk that above-target CPI inflation in the near term would affect inflation expectations, and hence have some tendency to persist in the medium term.

35 Given this outlook for inflation, the Committee noted that some slowing of demand growth, by reducing the pressure on capacity, was likely to be necessary to return inflation to target in the medium term. The Committee needed to balance the risk that a sharp slowing in activity would pull inflation below the target in the medium term against the risk that elevated inflation expectations would keep inflation above target. Changes in Bank Rate could not be expected to smooth out all short-term fluctuations in output growth.

36 For a majority of Committee members, balancing these key risks required an immediate reduction in Bank Rate of 25 basis points. Interest rates were probably still bearing down on demand, partly because higher market spreads meant that the level of Bank Rate consistent with any given monetary stance was lower than it had been before spreads had widened. The February *Inflation Report*, and its accompanying projections, would set out in detail the upside and downside risks to the outlook for inflation. The central projection suggested that there was most likely to be some spare capacity in the economy, even if interest rates followed the path implied by market yields. That would therefore help to ensure that inflation returned to the 2% target in the medium term.

37 For one member, more weight should be placed on the risk of a very sharp slowdown in UK growth. There were similarities between the recent data and outlook for the United Kingdom and those for the United States several months previously, especially in the labour market. Subdued pay pressures and increasing spare capacity in firms would mean that the prospective short-term rise in inflation should not carry through to the medium term. For this member, a larger, precautionary reduction in Bank Rate was warranted, bringing forward cuts already built into the yield curve.

38 The Governor invited the Committee to vote on the proposition that Bank Rate should be reduced by 25 basis points to 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 50 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.