

Publication date: 23 July 2008

MINUTES OF MONETARY POLICY COMMITTEE MEETING 9 AND 10 JULY 2008

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 July.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0807.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 6 and 7 August will be published on 20 August 2008.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 JULY 2008

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

Financial markets

2 UK short-term interest rates had increased initially during the month by around 50 basis points. But over the days prior to the meeting, short-term market rates had fallen back, following the flow of weak activity data, heightened concerns over the housing market and the weakness in banks' equity prices. Nevertheless, that left forward market interest rates still pricing in a high probability of one 25 basis point increase in Bank Rate during the year ahead. Market prices implied a negligible probability of a rise in Bank Rate this month. In contrast to financial market participants, most City economists continued to expect that the next move in Bank Rate would be down, though none of the economists responding to a Reuters poll expected a change at this meeting.

3 Breakeven inflation rates derived from UK government bonds were about 50 basis points higher three to five years ahead than at the time of the May *Inflation Report*. Smaller increases in breakeven inflation rates had been seen in the euro area and the United States.

4 The main international equity indices had fallen significantly on the month. There had been large falls in the equity prices of UK financial and construction companies. But most other sectors had also fallen substantially. Markets were possibly beginning to factor in the prospective impact of weakening demand and sharply rising costs on a wider range of companies.

5 Against the background of continued international financial fragility and deleveraging by financial institutions, the process through which UK banks were raising capital was proving difficult. At the same time, the decline in house prices and the prospective impact of a slowing economy on

mortgage defaults would increase banks' regulatory capital requirements. Some banks' balance sheets were also likely to be adversely affected by the deteriorating financial position of house-builders. Given these factors, it was not surprising that credit default swap premia for financial companies had risen during the month.

The international economy

6 In the euro area, GDP had been boosted by erratic factors in 2008 Q1, which were likely to unwind in the second quarter. Business surveys had weakened through the first half of the year. Taken together, these two developments suggested that euro-area GDP would probably record little or no growth in 2008 Q2, though the underlying slowdown was less marked. HICP inflation rose to 4.0% in June from 3.7% in May. The ECB had raised its official policy rate by 25 basis points to 4.25% on 3 July.

7 In the United States, a number of indicators were pointing to a much stronger outturn for GDP in 2008 Q2 than had been expected at the time of the May *Inflation Report*. That appeared to reflect to some extent an earlier-than-expected boost to consumption from the tax rebates. But consumer confidence had continued to fall. The housing market had remained weak: housing starts, new building permits and new home sales had all declined. The labour market had eased further. Non-farm payrolls had fallen by 60,000 in both May and June. The unemployment rate had remained at 5.5% in June. CPI inflation had picked up to 4.2% in May from 3.9% on the back of higher energy prices, though the rates of increase in the headline and core personal consumption expenditure deflators had been relatively stable at 3.1% and 2.1% respectively.

8 Japanese Q1 GDP growth had been revised up to 1.0% from 0.8%. But activity indicators were pointing to weakness in Q2. CPI inflation had picked up to 1.3% in May, its highest rate in a decade.

9 Elsewhere in Asia, inflation was high – the result of rapid demand growth, which had been a key factor underpinning the relentless rise in commodity prices in recent years. But those economies were unlikely to grow at such a fast pace indefinitely. Output produced by energy-intensive technologies would become less profitable. Moreover, rising commodity prices were worsening many of these economies' terms of trade, which would depress demand eventually. It was also possible that the authorities would take further policy action to bring their inflation rates under control. However, there

was not much sign of any slowing in economic activity yet, and there was a good chance that these economies would continue to grow strongly in the near term.

10 The slow response of oil supply to the rapid increase in demand had been an important factor behind the increase in the price of oil during recent years. There was a legacy of insufficient investment in new fields and refining capacity, so that new sources of supply had been slow to come on stream as old fields ran down. A shortage of qualified personnel and capital equipment, together with geo-political factors and regulatory constraints, had also hampered the expansion in supply.

11 The oil price had been volatile in recent weeks, but had ended the month some 10% higher in dollar terms. Concerns about the security of supply in the Middle East and Nigeria seemed to lie behind the most recent rises. Food and metal commodity prices had also increased during the month.

Money, credit, demand and output

12 The growth rates of broad money and lending had slowed sharply in the past few months. The three-month annualised growth of M4 had virtually halved since July 2007, while the equivalent growth rate of M4 lending had declined by a third. This was a possible sign of future weakness in economic activity.

13 GDP growth for 2008 Q1 had been revised down to 0.3% from 0.4%. Upward revisions to activity in 2007 had also made the current slowdown look sharper.

14 The latest monthly output data and survey indicators were pointing to a further slowing of GDP growth in the second quarter. Manufacturing output had fallen by 0.5% in May, alongside a sharp weather-related drop in energy-sector output. The CIPS/Markit activity indices for both manufacturing and services had fallen further in June, reaching their lowest levels since 1998 and 2001 respectively, and the indices for new orders had fallen well below their ‘no change’ level. Both the CIPS/Markit and Experian surveys for construction had also been weak. The BCC survey for Q2 (conducted between the end of May and mid-June) had been markedly downbeat.

15 However, while the output indicators had been consistently subdued, the indicators for spending were more mixed. The official expenditure figures suggested a much stronger picture than the output

data. But the estimate of 1.1% for household consumption growth in Q1 was at odds with evidence from survey indicators and the reports from the Bank's regional Agents. Moreover, real post-tax labour income growth had been slowing sharply over the past year and had actually fallen in Q1. The mismatch between official consumption data and the surveys looked even more marked in Q2. According to the ONS, retail sales volumes had risen by 3½% in May, the largest monthly change since 1979. Good weather and difficulties adjusting for bank holidays may have accounted for part of the unusual strength. By contrast, the low retail sales balance in the CBI *Distributive Trades Survey*, downbeat trading statements from large retailers, weak car sales, and the lowest consumer confidence balances since 1990 all painted a much weaker picture for consumption in Q2.

16 As the determinants of consumption had clearly weakened and the surveys were giving a broadly consistent message, it was likely that the official expenditure data were overstating the current strength of consumer spending. But consumer surveys had not been well correlated with mature official estimates of quarterly consumption growth in the past, so it might not be appropriate to discount the official data entirely.

17 The housing market had continued to weaken rapidly. The average of the lenders' house prices indices had fallen by 1.4% in June, and 4% on the quarter, which appeared to be the largest nominal quarterly decline since the early 1950s. However, in the preview of the June survey from the Royal Institution of Chartered Surveyors (RICS), the backward- and forward-looking price balances were slightly less negative. Housing market activity had declined sharply. Mortgage approvals for new house purchase had fallen again in May, to reach a third of their level at the end of 2006. Private sector housing starts had fallen by 18% on the month in May, according to the National House-Building Council. But the RICS new buyer enquiries series was less negative in June.

18 The weakening in the housing market accorded with the reduced availability of secured credit to households as reported in the Bank's *Credit Conditions Survey*. The survey suggested that there was a further tightening to come. Unsecured credit availability was also reported to have been reduced.

19 Business investment growth in Q1 had been revised down slightly to -1.8%. And the prospects for the rest of the year were poor. CIPS/Markit capital goods orders had fallen sharply and the Bank's regional Agents had reported that many contacts had been putting off investment decisions until next year. Those contacts suggested that firms' reluctance to invest appeared to reflect mainly the

prospective slowdown in the economy, alongside heightened uncertainty. Tighter credit conditions might have been relevant for some businesses, but many appeared to have been unaffected so far, probably because they had a cushion of retained earnings or access to already committed facilities which they could draw down.

20 Net trade had been estimated to have contributed a substantial 0.5 percentage points to Q1 GDP growth: export growth had picked up, while imports had fallen more sharply than in the previous quarter. The latest data for exports in Q2 were mixed: export volumes were down in May, and CIPS/Markit new export orders had fallen in June; but the BCC survey of manufacturers pointed to healthy growth in export demand.

Supply, costs and prices

21 CPI inflation had been 3.3% in May, 0.3 percentage points higher than in the previous month. The rise partly reflected base effects from falls last year in the prices of food and retail energy. In line with the pre-release arrangements, an advance estimate for CPI inflation of 3.8% in June had been provided to the Governor ahead of publication. That was higher than the Committee had been expecting. The Governor's open letter to the Chancellor on 16 June had explained that inflation was likely to rise sharply in the second half of the year to above 4%. If anything, the outlook for inflation had worsened since then. But the magnitude and timing of rises in retail energy prices could change the profile of CPI inflation over the coming months significantly, and these were extremely uncertain. For example, if energy companies chose to pass increases through more slowly, that might result in a smaller, but more prolonged, pickup in inflation. The extent to which CPI inflation was likely to rise in the short term did not seem to have been fully appreciated by many outside commentators.

22 Some survey-based measures of household inflation expectations had also risen. The Citigroup/YouGov survey had reported a rise in median one-year-ahead expectations to 4.6% in June from 4.1% in May. There had also been a marked pickup in the Barclays Basix measures on the quarter, for both one-year ahead and, perhaps more worryingly, two-years ahead. But the five-to-ten year ahead Citigroup/YouGov series had edged down to 3.8% in June from 3.9% in the previous month and had been around that level for much of the year.

23 In part reflecting commodity price developments, non-labour cost pressures had intensified further. Manufacturers' input prices had risen by almost 4% in May, pushing the twelve-month inflation rate to nearly 28%. The CIPS/Markit index of manufacturers' input price inflation had reached a new record high in June. These pressures were also evident further along the supply chain, with manufacturers' output price inflation up sharply to 9.1% in May. The CIPS/Markit manufacturing output price inflation index had edged up in June, also to a new high. The CBI *Monthly Trends Enquiry* survey balance for manufacturers' expected prices had remained elevated, albeit down slightly on the previous month.

24 According to the Labour Force Survey (LFS), employment rose strongly in the three months to April. But there were signs that the labour market was turning down. The Workforce Jobs series had painted a weaker picture of employment growth. Both LFS unemployment and the claimant count had edged up. The number of recorded vacancies had decreased. And most of the employment surveys had weakened; BCC employment intentions for services, for example, had been the lowest for 15 years. There had also been a number of high profile announcements of staff cuts, particularly in the building and financial sectors.

25 There were few signs of rising labour cost inflation. Settlements were unchanged in the three months to May at around 3½%. The Average Earnings Index (AEI) and the experimental Average Weekly Earnings (AWE) series had drifted apart again, with the AEI pointing to relatively stable earnings growth of just under 4%, while the AWE measure had picked up to 4½%.

The immediate policy decision

26 The central projection in the May *Inflation Report* had been for inflation to rise to a little below 4% in 2008 Q4, before falling back towards the target. The Committee had identified two major risks to that outlook. On the upside, there was a risk that rising CPI inflation would lift medium-term inflation expectations and thereby lead to a more prolonged period of above-target inflation. On the downside, the risk had been that weaker incomes and tighter credit would lead to a sharper and more prolonged slowdown in the economy that would pull inflation below the target further out. On balance, the risks to inflation had been to the upside. At the Committee's June meeting, most members had concluded that the balance of risks to inflation in the medium term had moved further in that direction.

27 Since June, there had been more bad news for the inflation outlook. Gas and oil price futures had risen again. The advance estimate of CPI inflation in June had been higher than expected. Some survey-based measures of inflation expectations had picked up, particularly at shorter horizons. And measures of breakeven rates of inflation at three- and five-year horizons had also increased. Against that, earnings growth so far had remained relatively subdued. The near-term prospects were for a higher rate of inflation than projected in the May *Inflation Report* and higher than the Committee had believed at the time of the Governor's letter to the Chancellor in mid-June.

28 There had also been downside news during the month for activity, and hence for inflation in the medium term. Equity prices had fallen, and the falls had been fairly broadly based across the sectors, indicating a growing pessimism about the macroeconomic outlook. Higher energy prices would weigh down on economic activity. The financial sector remained fragile. The latest Bank of England *Credit Conditions Survey* had suggested that the credit tightening was continuing and that more was to come. The housing market downturn had gathered momentum; house prices had already fallen by around 8% since their peak. The GDP data for Q1 growth had been weaker than the Committee had expected in May. Although GDP growth in Q2 might turn out to have been slightly stronger than expected, there had been some very weak survey data towards the end of the quarter. Those, together with weakening surveys of retail spending and reports from the Bank's regional Agents, suggested that growth was continuing to slow. So the outlook for growth in the rest of the year would most probably be weaker than the Committee had projected in May.

29 Against the backdrop of these risks to the inflation outlook, the Committee discussed the appropriate level of Bank Rate. The higher than expected outturns for CPI inflation could mean that there was more inflationary pressure in the economy than the Committee had thought. That might be because pressures on supply capacity were greater, or because a weaker exchange rate was feeding through more strongly to consumer prices.

30 Although it could do little to alter the path of inflation in the near term, the Committee could, by raising Bank Rate this month, send a strong signal that it was focused on inflation and remained determined to bring it back to target in the medium term. There was a risk that medium-term inflation expectations might move significantly away from the target. If that were to happen, a more pronounced slowing in activity would be needed to bring inflation back to target.

31 However, there were also a number of arguments for maintaining Bank Rate at 5.0% this month. The Committee had previously signalled that a margin of spare capacity would be required to reduce the risk of medium-term inflation expectations rising. The upside news on inflation during the month had made it necessary to have more spare capacity. But there had been downside news on economic activity during the month too, so it was possible that a higher level of Bank Rate would not be needed in order to generate that. An increase in Bank Rate in the current circumstances, when confidence was low and the financial sector fragile, could impart a downward momentum to the economy that risked a significant undershoot of inflation in the medium term. Keeping Bank Rate at 5.0% when the economy was slowing was arguably already sending a strong signal of the MPC's commitment to reducing inflation. A rate change this month would be a surprise at a time when credit and other financial markets remained fragile, and any change in rates would be better communicated alongside the Bank's August *Inflation Report*.

32 For all members of the Committee, the decision was a difficult one. There was a range of views about the weights to place on different arguments. But all members agreed that, relative to the central projection in the May *Inflation Report*, the path of inflation in the near term would be higher and the slowdown in activity more pronounced. The discussions and analysis in the forthcoming *Inflation Report* forecast round would help to shed more light on the implications of these developments for the inflation outlook in the medium term.

33 Most members judged that the risks to inflation in the medium term were most likely to be balanced by maintaining Bank Rate at 5.0% this month.

34 For one member, the arguments in favour of raising Bank Rate this month were most telling. While acknowledging the downside risks to activity from the energy shock and credit crunch, an immediate increase in Bank Rate was needed to keep medium-term inflation expectations anchored and ensure the Committee's credibility in light of the current and prospective increase in CPI inflation.

35 For another member, the news on the month had reinforced the case for an immediate reduction in Bank Rate in order to avoid inflation undershooting the target in the medium term. The activity data had been uniformly gloomy and broad-based and activity now seemed likely to contract sharply in the near term, possibly for several quarters. Long-term inflation expectations remained contained and

domestically generated inflation remained low. As a result, there was little or no likelihood of a rise in wage growth. So it continued to be important to look through the short-term spike in inflation.

36 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.0%. Seven members of the Committee (the Governor, Charles Bean, John Gieve, Kate Barker, Spencer Dale, Andrew Sentance and Paul Tucker) voted in favour of the proposition, and two (Tim Besley and David Blanchflower) voted against. Tim Besley preferred an increase of 25 basis points, and David Blanchflower preferred a reduction of 25 basis points.

37 The following members of the Committee were present:

Mervyn King, Governor
Charles Bean, Deputy Governor responsible for monetary policy
John Gieve, Deputy Governor responsible for financial stability
Kate Barker
Tim Besley
David Blanchflower
Spencer Dale
Andrew Sentance
Paul Tucker

Dave Ramsden was present as the Treasury representative.