

Publication date: 18 June 2008

**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
4 AND 5 JUNE 2008**

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 June.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0806.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 9 and 10 July will be published on 23 July 2008.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 JUNE 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 costs and prices.

Financial markets

2 In the United Kingdom, market expectations of interest rates for twelve months ahead had risen during the month by around 70 basis points. More than half of this change had followed the higher producer and consumer price inflation data, and the May *Inflation Report*, which had shown a markedly higher short-term inflation outlook than the February *Report*. Interest rate expectations had also reacted to stronger-than-expected retail sales data. Financial markets had previously priced in cuts of up to 50 basis points during 2008 but had moved to pricing in some chance of an increase in Bank Rate over the year ahead. In contrast, a recent poll of economists by Reuters suggested that rate cuts during 2008 were still expected by City commentators.

3 Expectations of short-term interest rates had also risen by around 60 basis points in the euro area. As in the United Kingdom, market prices had changed during the month to imply increases in interest rates rather than cuts, reflecting data news and the anticipated monetary policy reaction. US short-term rates were broadly unchanged on the month.

4 Longer-term forward nominal interest rates in the United Kingdom, from around eight years ahead, were slightly lower on the month. Implied UK inflation rates derived from inflation swaps had risen markedly at shorter maturities, especially around three years ahead, but were unchanged from around ten years forward.

5 In dollar and sterling money markets, there had been a further narrowing of spreads between unsecured inter-bank borrowing rates and expected policy rates. The sterling spread at three months had fallen to around 80 basis points, the same level as the corresponding euro spread. This might have

partly reflected the impact of the Special Liquidity Scheme introduced during April, which had been designed to improve the liquidity position of the UK banking system. But conditions in money markets and many fixed-income markets remained stressed as the process of de-leveraging continued across the financial sector.

6 Equity prices had fallen by around 4½% in the United Kingdom, 4% in the euro area and 1% in the United States. A major factor in accounting for these declines had been weaker prices for financial sector stocks, notably in the United Kingdom for banks undertaking rights issues. Further evidence on the weakness of the UK housing market, including evidence of rising default rates in the buy-to-let sector, had helped push down the stock prices of the relevant mortgage lenders. Large house-building company stock prices had also been weak. In contrast, energy company stock prices had been strong internationally. Over the past 18 months, non-financial and non-energy stock prices had been broadly stable, in both the United States and the United Kingdom. Although some stock prices would have been supported by the fall in risk-free interest rates and other actions taken by monetary and fiscal authorities, this stability had been somewhat surprising given the range of significant cost and demand shocks over that period.

7 The sterling effective exchange rate index (ERI) had been broadly unchanged since the previous meeting, despite a movement in relative interest rates that would have been consistent with a small appreciation. That suggested some underlying sterling weakness and relative interest rates continued to suggest a declining forward path for the ERI. In contrast, the Consensus Economics survey forecast was for an appreciation over the next couple of years.

The international economy

8 In the euro area, the first estimate of Q1 GDP growth had been unexpectedly strong at 0.8%. That partly reflected strong growth in Germany, which had been boosted by high construction output associated with unusually mild winter weather, and by stockbuilding, both of which might have been erratic. Euro-area consumption growth had been relatively subdued. Indicators for the second quarter, such as the Purchasing Managers' Indices, had been consistent with slower GDP growth. The EC survey of consumer confidence remained weak and the ECB's latest Bank Lending Survey pointed to a further tightening of credit conditions. Continental European banks had suffered losses on US sub-prime investments and their equity prices had been falling broadly in line with comparable US and UK

sectoral indices. So the effects of the credit market turmoil on bank balance sheets might still lead to reduced lending in the euro area.

9 In the United States, Q1 GDP growth had been revised up slightly to 0.2% and surveys by the Institute for Supply Management in May had suggested a positive rate of growth in the second quarter. Although there might be beneficial effects for consumption during 2008 if tax rebates were spent by credit-constrained consumers, there could also be a negative impact on real incomes from high petrol prices. Private residential construction had continued to decline; existing home sales and house prices had continued to fall.

10 The first estimate of Japanese Q1 GDP growth had been strong at 0.8%, but this might in part have reflected the absence of an adjustment for the leap year. Indicators for the second quarter had been somewhat weaker. Many emerging market economies (EMEs) in Asia and elsewhere had also continued to experience strong growth in the first quarter.

11 Inflation had remained elevated internationally. In the euro area, HICP inflation had picked up to 3.6% in May. In the United States, April headline CPI inflation had been 3.9% and the inflation rate of the personal consumption expenditures (PCE) index had been 3.2%. Core PCE inflation – which excluded energy and food prices – had remained at 2.1%. Oil prices had risen further and had been volatile during the month. The sterling spot price of oil was some 2% higher and the futures curve had risen by more, to become broadly flat. The continuing rise in oil prices was creating problems for policy makers in many countries. For example, some EME governments had announced a reduction in fuel subsidies because of the pressure on public finances. Countries with exchange rates linked to the US dollar would find it increasingly difficult to set an appropriate monetary policy if their domestic inflation continued to pick up and the dollar remained weak. That could lead to a bigger correction and hence a greater slowdown in growth at some point in the future, though short-term growth prospects in these economies appeared strong.

12 There had been some public debate about the impact on the spot price of oil of greater trading activity in the futures market. It was difficult to find hard evidence to support the proposition that speculative activity had been driving up oil prices, as opposed to the more fundamental forces of demand and supply which had been putting upward pressure on commodity prices for the past five years or so and which had remained in place over the past few months. However, if traders in the spot

market were to take trading activity in the futures market as a signal of a larger rise in fundamental demand than had actually been the case, then the spot price could be elevated temporarily. And when asset prices were rising persistently there was always some chance of a price bubble forming, and a consequent overshoot. Whatever the cause, it was not clear that the prevailing high price of oil could be sustained: there should be some reduction in demand, and possibly some increase in supply, if prices remained elevated. But the timing of any fall back was also uncertain and further price rises could not be ruled out in the coming months.

Money, credit, demand and output

13 The ONS *UK Output, Income and Expenditure* data release for the first quarter had left GDP growth unrevised at 0.4%, but recorded consumption growth had been surprisingly strong at 1.4% and business investment surprisingly weak, falling by 1.4%. This was in contrast to survey data and anecdotal information that had continued to suggest a weaker picture of household spending. The Committee noted that the first quarter numbers were likely to be revised in due course: early estimates of growth in the financial and construction sectors were based on very little hard data and information available since the GDP release had suggested that the reported growth in both sectors might get revised down.

14 Indicators for the second quarter had pointed to some further slowing in GDP growth. The CIPS/NTC activity indicators for manufacturing and services in May had recorded no growth and construction surveys had weakened further. On the expenditure side, consumer confidence surveys had remained at extremely low levels and retail sales had fallen slightly in April, although not as much as financial markets had expected. The CBI retailers' survey balance had been weak in May, although less negative than in April. The Q2 CBI Grant Thornton survey had recorded a weak level for the output of consumer services for the previous three months. Anecdotal evidence from the Banks' regional Agents had been mixed. Some sectors had reported a significant slowing in the past two months – including some business and leisure services, as well as financial services and parts of the construction industry – whereas other sectors were quite buoyant. Despite export volumes having been reported as flat in the Q1 data, some manufacturing contacts were relatively optimistic, partly reflecting a boost to profit margins from the weaker exchange rate.

15 Housing market indicators painted a clearer picture, with both the lenders' house price indices falling by around 2½% in May. On these measures, house prices had fallen by around 7% since their peak in the second half of 2007 and further significant falls were probable. The prices balance in a preview of the Royal Institution of Chartered Surveyors' survey remained significantly negative. A range of survey and other data, notably the fall in mortgage approvals for house purchase, had indicated a rapid slowdown in housing market activity. Discussions with contacts in the housing market suggested that the pace of deterioration had quickened, particularly in the past two months, and appeared to have been driven by a significant tightening in the availability of mortgage finance. Commercial property prices had also continued to fall sharply. The prospects for the UK private construction sector generally looked weak.

16 Broad money growth appeared to have slowed over the previous few months. Bank lending to private, non-financial companies, excluding the effects of securitisations, had continued to grow strongly. But discussions with bank contacts suggested that this strength of bank lending in part reflected the drawdown of committed credit lines and the high price of, and restricted access to, other forms of credit.

Costs and prices

17 At its previous meeting, the Committee had received an advance estimate of the April CPI inflation rate. Subsequent analysis of the component breakdown had shown that the rise in the inflation rate to 3% had reflected upside news across a range of prices. Taking that into account, along with the further rise in oil prices and other inflation indicators, the Committee concluded that the immediate outlook for short-term inflation had worsened. It was likely that inflation would rise to a peak well above its current level later in 2008. Although the financial markets and other commentators had responded to the rise in observed inflation, it did not appear that the full extent of the likely rise had yet been appreciated. But the factors behind the increase should be temporary and it remained most likely that, even if the oil price stayed at its current high level, the inflation rate would, at some point over the next year or so, move back towards the 2% target.

18 Other indicators of inflation showed that cost pressures were moving along the supply chain. Imported goods prices had risen by 8.1% in the first quarter on a year earlier. Manufacturing input prices had risen 23.1% in the twelve months to April. CIPS/NTC survey balances for input prices in

manufacturing remained high, though they had fallen modestly in May, and the balance for services had risen further. Manufacturing output prices had also risen 7.5% in the twelve months to April and the CIPS/NTC and CBI survey balances had remained at high levels. The CBI had also reported a high balance for price rises among retailers. Around the country, the Bank's business contacts had been reporting a greater expectation that higher material and fuel costs could be passed on than had been the case two years or so earlier.

19 In the labour market, the evidence had been somewhat mixed. According to the ONS *Labour Force Survey*, employment had risen in the first quarter, although more slowly than in previous months, and total hours worked had risen by 1.2%. But unemployment had increased and vacancies had fallen. And business surveys had shown a generally consistent picture of slowing labour demand.

20 The number of new registrations of workers from the A8 accession countries on the Worker Registration Scheme had slowed somewhat, which could have reflected weaker employment opportunities in the United Kingdom compared with other destinations, and the effect of sterling's depreciation reducing the foreign value of UK labour earnings. When the labour market had been tightening, inward migration had helped to offset some of the upward pressure on wage growth. As growth in the economy slowed, it was possible that inward migration would lessen and so there would be less slack created in the labour market than otherwise would have been the case. But the impact on labour supply of migrant and other inflows of workers would depend on a range of factors, such as length of stay and propensity to work, so the overall impact would be uncertain.

21 There had been little evidence so far that wage growth was being driven upwards by higher short-term inflation. Data on wage settlements had suggested little change, averaging around 3¼% in the three months to April. Average earnings in the first quarter had been boosted by a higher contribution from bonus payments but had still pointed to relatively moderate growth around 4%. It remained an open question as to whether there was sufficient slack in the labour market to allow shocks to other input prices to be offset by labour costs or whether workers would try to resist reductions in real take-home pay. The Committee noted that the recent changes to tax allowances might help offset the latter pressure somewhat, by boosting the consumption wage relative to the wage costs facing the employer.

22 Both the Bank/NOP and the Citigroup/YouGov surveys suggested that the median household's inflation expectations one year ahead had increased to over 4%. The Committee considered a range of broad indicators of medium-term inflation expectations. Some comfort could be taken from the relative stability of nominal forward interest rates from five to ten years ahead. If markets had expected that inflation would persist at high levels, then these rates would most probably have risen. The exchange rate had been broadly stable on the month. Indicators of broad money growth, including M4 and Divisia money, had slowed somewhat. And annual nominal domestic demand growth had fallen back in the first quarter. These high-level indicators could only give a broad-brush indication but they did not suggest a marked loss of confidence in the ability of the MPC to achieve the inflation target in the medium term.

The immediate policy decision

23 The *May Inflation Report* had identified conflicting risks to inflation from a more prolonged slowdown in demand growth and from the impact of persistently elevated inflation on inflation expectations. Overall, the balance of risks around the central projection had been judged to lie to the upside. The Committee considered how developments over the month had altered the balance of these risks.

24 Considering the downside risks of a prolonged slowdown in demand growth, GDP growth in the first quarter had been stronger than anticipated in the euro area and Japan and had been revised up slightly in the United States. And activity remained robust in many emerging market economies. But the US housing market had continued to deteriorate and the risk of a protracted slowdown in US output growth had not changed materially.

25 In the United Kingdom, the official ONS data had presented a rather puzzling picture of relatively strong consumption. But other evidence, including business surveys, reports from the Bank's regional Agents, and Committee members' own discussions with businesses around the country, pointed to a slowdown in consumption which was likely to continue into the second half of the year. Given that the survey and anecdotal evidence had mostly been for April or May, and some had been forward-looking in nature, the MPC judged that it was most likely that growth was on track to slow in the second quarter, consistent with the *May Inflation Report* projections.

26 The speed and depth of the slowdown remained difficult to judge. Housing market conditions had deteriorated sharply and the effects of the ongoing tightening in credit conditions were still working through to the real economy. Financial markets, though, had been somewhat more settled over the month. Overall, the Committee judged that the downside risks to the inflation outlook in the medium term, arising from the prospective slowdown in growth, were little changed, although there remained a range of views about the extent of those risks.

27 Considering the upside risks, the short-term outlook for CPI inflation had deteriorated further. Oil prices had risen again, producer input and output price inflation had reached their highest levels for over twenty years and many business survey price balances were at, or close to, record highs. Analysis of the April CPI release and news on energy prices had suggested that the path of CPI inflation over the next year was likely to be higher than the central projection of the May *Inflation Report* and could reach a rate higher than had been recorded since the start of inflation targeting in 1992. There remained, however, considerable uncertainty about the path of inflation in the near term, which would depend in large part on what happened to world prices for energy and food and particularly on the path of domestic gas and electricity prices, none of which could be influenced by the MPC.

28 The Committee's central view remained that CPI inflation would peak around the end of the year and then begin to fall back towards the 2% target. But inflation would have some tendency to persist above the target if those making decisions about wages and prices began to expect higher inflation in the future. There was also a risk that, given the likely squeeze on real income growth as a result of the changing relative prices for energy, food and imports, employees could respond by raising wage demands. Although wage growth had remained moderate in recent months, surveys indicated that higher inflation had already had an impact on the public's expectations of inflation, at least in the near term. As such, the Committee continued to judge that a slowdown in activity, reducing pressure on supply capacity and helping to contain wage growth, would be necessary to ensure inflation returned to the 2% target.

29 Most members concluded that developments this month had meant that the risks to inflation in the medium term had moved further to the upside. It was possible that a somewhat greater degree of slack would now be necessary to ensure inflation returned to the target. As a result, there was no case for a reduction in Bank Rate this month, although that position could change as information about the path of activity and inflation accumulated in the coming months.

30 For some members, the news had been sufficient to consider whether an immediate rise in Bank Rate was warranted. If there were a serious threat to medium-term inflation expectations then a pre-emptive rise in rates would be appropriate. Delay would only increase the eventual costs of bringing inflation back to target. However, there were a number of arguments against. A range of nominal indicators suggested that medium-term inflation expectations remained anchored, so a rise in Bank Rate was not required urgently to stabilise inflation expectations. The implications of higher short-term inflation for the medium term were still not clear. Credit constraints, risk premia and the rise in the yield curve over the month were dampening demand and there was increasing evidence that these developments were affecting the real economy. Although some chance of an increase in Bank Rate over the next twelve months had been priced into the market, there was no immediate expectation of a change. An unexpected increase in Bank Rate might be counter-productive by appearing to exaggerate the Committee's concerns about the medium-term prospects for inflation. The Committee should continue to judge, one month at a time, how activity growth and inflation expectations developed in response to slowing demand and rising short-term inflation.

31 For one member, the news on short-term inflation developments had been more than outweighed by the prospect of slowing activity growth and its likely impact on medium-term CPI inflation. Similarities could be drawn between developments in the United Kingdom and the earlier slowdown in the United States. And, for this member, the impact of declining house prices on household spending was likely to be greater than embodied in the central projection of the *May Inflation Report*. Although a recession in the United Kingdom was not the central expectation, there was a small but growing risk of a very negative outcome that would cause inflation to undershoot the target in the medium term. For this member, an immediate reduction in Bank Rate was warranted.

32 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.0%. 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 of 25 basis points.

33 Finally, on the occasion of Rachel Lomax's last Committee meeting, the Governor expressed his appreciation both for the contribution she had made to the Committee and for all she had done as Deputy Governor responsible for Monetary Policy.

34 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.