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MINUTES OF MONETARY POLICY COMMITTEE MEETING 7 AND 8 MAY 2008

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 May.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0805.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 4 and 5 June will be published on 18 June 2008.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 MAY 2008

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

Financial markets

2 There had been a modest improvement in financial market conditions during the month. In most major markets: credit default swap premia, which provided a measure of the cost of insuring against default, had fallen for financial companies; corporate bond spreads had narrowed; and equity prices had risen. In the United Kingdom, one likely factor behind the improving sentiment had been the introduction of the Special Liquidity Scheme (SLS) on 21 April, which had been designed to improve the liquidity position of the banking system and increase confidence in financial markets. The SLS allowed banks to swap temporarily their high quality mortgage-backed and other securities for UK Treasury Bills. After the Scheme became public, sterling money market spreads between Libor and expected policy rates had declined relative to those in the United States and euro area. And spreads on AAA-rated residential mortgage-backed securities had narrowed, reflecting the extra liquidity provided by the Scheme.

3 Despite signs of improvement, money market spreads in the United Kingdom, United States and euro area had remained high. Moreover, market prices suggested that those spreads would decline only gradually. Even if money market conditions did improve further, lenders still had much to do to adjust their balance sheets to reflect a more realistic evaluation of risk. That meant credit availability was unlikely to improve in the short term.

4 Expectations of policy rates, derived from financial markets, in the United Kingdom, United States and euro area had increased during the month. Expectations of Bank Rate twelve months ahead had fallen back early in April, but had then increased later in the month. That left forward rates implying a little under half a percentage point reduction in Bank Rate during the next twelve months.

Most respondents to a Reuters survey of 65 economists expected Bank Rate to be 4½% at the end of 2008. Only five of those polled expected the first reduction to come this month. The markets expected the euro-area policy rate to remain at 4% for the rest of 2008, whereas back in February almost 50 basis points of cuts had been envisaged by the summer. In the United States, policy-rate expectations had also risen and no further rate cuts were expected, following the 25 basis point cut by the Federal Open Market Committee in the previous week.

5 Several factors appeared to have contributed to the rise in interest rate expectations. Some market contacts had put it down to news on the outlook for demand being less weak than expected, especially in the United States. Another plausible explanation for the increase in rate expectations internationally was the further rise in oil prices and a growing appreciation of central banks' determination to control inflation. In the United Kingdom, market participants thought the SLS might also reduce the need for Bank Rate cuts.

6 The sterling effective exchange rate had risen slightly during the month. But since its recent peak in July 2007, it had fallen by around 12%. That downward movement in sterling could not be accounted for by changes in relative interest rates. One explanation for the depreciation was that market participants had reassessed their view of the long-run sustainable value of the currency. It was also possible that there had been an increase in the risk premium investors required for holding sterling assets. There was now a divergence between the declining path for sterling implied by relative interest rates and the rising path envisaged by Consensus forecasters.

The international economy

7 Indicators of the United States economy had generally been less weak than financial market participants had expected. But they had still been subdued and broadly in line with the MPC's own expectations. GDP growth in 2008 Q1 had been 0.1%, with modest consumption growth and a significant stockbuilding contribution offsetting the weakness in residential and, to a lesser extent, non-residential investment growth. There had been no signs of a turnaround in the housing market, with foreclosures rising rapidly. And consumer confidence was fragile. The latest Senior Loan Officer survey from the Federal Reserve confirmed that banks had continued to tighten credit supply. Non-farm payrolls had fallen for the fourth consecutive month. The headline manufacturing index

from the Institute for Supply Management had remained below the 50 no-change level in April, though the equivalent non-manufacturing index had recovered somewhat.

8 In the United States, CPI inflation remained at 4.0%. Headline inflation according to the personal consumption expenditures (PCE) price index had eased to 3.2% in March, while core PCE inflation had risen to 2.1%.

9 In the euro area, industrial production had risen by 0.3% in February. The services Purchasing Managers' Index had increased in April, while its manufacturing counterpart had edged down, and EC business confidence measures had eased. That was all consistent with GDP growth at slightly below its historical average. HICP inflation had fallen from 3.6% to 3.3% in April.

10 There had been mixed news on activity from Japan, where export volumes had rebounded in March but industrial production had fallen sharply. In the rest of Asia, activity had continued to hold up well. China had recorded annual GDP growth of 10.6% in Q1. Japanese CPI inflation had picked up to 1.2% in March, its highest annual rate since 1998; food and energy prices had provided the main impetus. Elsewhere in Asia, consumer price inflation had remained elevated.

11 The price of oil had been extremely volatile. But over the month, the sterling price of Brent crude had risen by 13%. According to the Bank's market contacts, speculative purchases did not seem to be the prime cause of the recent increases in the oil price. More fundamental demand and supply factors had probably been at the root of its steep rise during recent months, and there remained considerable uncertainty about the oil price outlook. There was little prospect of a significant increase in supply over the next two or three years. So although it was likely that the oil price would fall back at some point, that might not happen within the time horizon relevant for current monetary policy decisions.

Money, credit, demand and output

12 Further evidence had accumulated during the month that the UK economy was slowing. According to the preliminary release, GDP growth had been 0.4% in 2008 Q1 compared with 0.6% in the previous quarter. More recent data suggested that industrial production had fallen by 0.5% on the month in March – a weaker figure than that embodied in the preliminary GDP estimate.

13 The April surveys pointed to a further moderation in growth for the second quarter. The CIPS/NTC services activity measure had dropped to a five-year low. In manufacturing, the CIPS/NTC output index had also fallen. That was consistent with the pronounced reduction in output expectations and order books recorded by the latest CBI *Industrial Trends Survey*. In construction, the CIPS/NTC headline activity index had fallen again in April, and the Experian balance for March had reached its lowest level since 1996. These indicators painted a picture of slowing growth across the board, but no sharper than that envisaged in the MPC's central projection for the *May Inflation Report*.

14 According to the ONS, retail sales volumes had fallen by 0.4% on the month in March, but that still left volumes 2.0% higher for the quarter as a whole. Survey data from the British Retail Consortium and the CBI reported much weaker growth in sales. Reconciling these rather different pictures remained difficult. But surveys were giving a uniform signal and were consistent with reports from the Bank's regional Agents and consumer confidence measures. So it seemed sensible to place more weight than normal on these indicators relative to the official data in assessing the current state of consumer demand.

15 The housing market had weakened further. House prices had fallen by just over 1% in April, according to both the Nationwide and Halifax indices. The preview of the April survey from the Royal Institution of Chartered Surveyors (RICS) suggested that house price falls were widespread. On the activity side, the RICS sales-to-stocks ratio had fallen further. Mortgage approvals for house purchase had dropped to a series low of 64,000 in March, 50% lower than the peak in November 2006. There had also been a particularly marked fall in the Home Builders Federation survey balance of net reservations. Growth in mortgage lending was likely to slow further, as banks had not reached the end of their balance sheet adjustment.

16 It was unclear by how much a weakening housing market would contribute to a slowing in the rest of the economy. Construction companies' output and employment would be adversely affected. House price falls would make those expecting to trade down worse off, and hence reduce their future consumption of non-housing goods and services. But those expecting to trade up or not yet on the housing ladder would be better off, though tighter credit conditions, such as higher deposits for first-time buyers, might constrain their ability to increase consumption in the short term. Some individuals with discounted and low fixed-rate mortgages that were due to expire could face a higher cost of borrowing and consequently reduce their consumption. Many existing homeowners had built up a

sizeable amount of housing equity, but a weaker housing market and tighter credit conditions would make it harder to access this collateral to finance consumption.

17 Also significant for short-term consumption prospects was the squeeze on real income growth. Higher inflation together with slowing growth would put downward pressure on real disposable incomes. Tighter credit conditions meant that aggregate consumption could be more sensitive to disposable income developments than in normal times, when more people could borrow to smooth their spending if income fell. A period of subdued consumption growth therefore seemed likely.

18 In the corporate sector, there was mixed evidence on the impact of the credit shock. A BCC survey found that a majority of businesses reported no significant problems from the availability of credit. However, the Deloitte Chief Financial Officers survey had indicated a significant impact on business spending and employment from the tightening of credit conditions. The annual growth of private non-financial corporations' bank deposits had slowed in Q1, contributing to the slower growth in total M4.

19 The export surveys had shown little sign yet that overseas demand would support the UK economy as domestic demand decelerated. The CBI and BCC balances for goods exports had both fallen and CIPS/NTC manufacturing export orders had remained below 50 for the fourth month in a row. It was possible that sterling's depreciation since last July had initially boosted profit margins and would only later feed through into greater price competitiveness and higher export volumes, once it was clear that the depreciation would not quickly reverse. It took time to build the capacity to supply the extra demand from export markets. Some of that capacity was still being used to produce for domestic customers, and would only be gradually released as domestic demand slowed. In the short term, a weakening of demand in overseas markets might offset the impact of sterling's depreciation on exports.

Costs and prices

20 There was more evidence this month that the labour market was starting to turn. While LFS employment had risen by 152,000 in the three months to February and unemployment had fallen further, total hours worked were broadly unchanged. And many of the employment surveys had weakened: the Agents' aggregate employment intentions score had fallen; and two surveys of

company finance directors, by Deloitte and Baker Tilly respectively, pointed to a widespread scaling back of recruitment plans. There was a concern that new firm formation might be affected by the tightening of credit, which would also push down on employment growth.

21 Pay settlements had remained subdued in the first quarter at 3.1%, down 0.3 percentage points on their average for 2007. Both the Average Earnings Index and Average Weekly Earnings pointed to moderate overall earnings growth in the three months to February. There had been a marked weakening in the KPMG/REC Report on Jobs survey pay balances to their lowest in almost five years.

22 The future path for earnings would be sensitive to the behaviour of foreign workers. Other EU countries were reducing their restrictions on workers from eastern Europe, so they would have more destinations to choose in future. It was also possible that the decline in sterling and the weakening of the UK economy would discourage workers from overseas. However, other economies were weakening too, so the relative attractiveness of the United Kingdom would not diminish significantly.

23 Other cost pressures had intensified. Manufacturers' input prices had jumped 1.8% on the month in March, taking the twelve-month inflation rate above 20%. The CIPS/NTC surveys showed that input price pressures had persisted in April, the relevant balances picking up for both services and manufacturing. The CBI *Industrial Trends Survey* also showed strong cost pressures.

24 The annual rate of manufacturers' output price inflation excluding excise duties had been revised up to 6.1% in February and had remained at that 18-year high in March. The corresponding CIPS/NTC survey balance had picked up further in April. According to the Bank of England's regional Agents, manufacturers had become more active in passing on cost increases in recent months. However, in the service sector, the CIPS/NTC survey balance had fallen back for the second consecutive month, though it was still above its average level since 1996.

25 In line with pre-release arrangements, an advance estimate for CPI inflation of 3.0% in April had been provided to the Governor ahead of publication. There was only a limited amount of detail that accompanied the headline number and the MPC did not have the opportunity to analyse the data fully. But it was higher than the Committee had expected and the pickup in inflation from 2.5% in March seemed to reflect a large number of components in the index. The immediate outlook for CPI inflation in the next couple of months was uncertain given the lack of information about the most recent rise.

But the Committee expected CPI inflation to move further away from the 2% target during the summer and autumn. The effect of last year's cuts in retail gas and electricity tariffs falling out of the twelve-month rate of change would push up CPI inflation in the summer. On top of that, the Committee were assuming that a 15% increase in retail gas and electricity prices would enter evenly between July and October, though these domestic energy price increases were uncertain in both magnitude and timing.

26 A key issue for the Committee was how higher inflation would affect the expectations of those setting prices and wages. The Citigroup measure of the general public's expectations of inflation over the next twelve months had risen further in April, although the measure of longer-term expectations had eased back. In the GfK survey, the balance for consumer price expectations during the next twelve months had also risen. RPI inflation had fallen in March to 3.8%, but remained significantly above CPI inflation, which might have an unhelpful impact on expectations.

The May GDP growth and inflation projections

27 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 14 May. The projections were conditioned on the assumption that Bank Rate moved down over the next year in line with market yields.

28 The Committee's central projection was for four-quarter GDP growth to slow markedly in the early part of the forecast period, reflecting subdued real income growth, tighter credit supply and weaker world activity. Further out, GDP growth was projected to recover as credit supply conditions began to ease and net trade was boosted by the depreciation of sterling. GDP growth nevertheless remained subdued for much of the forecast period, creating a margin of spare capacity. The outlook was somewhat weaker than in the February *Inflation Report* over the first part of the projection.

29 The central projection was for CPI inflation to rise sharply in the near term on the back of higher energy and import prices. The margin of spare capacity together with the waning contribution from energy and import prices then brought inflation back to around the 2% target in the medium term. The inflation profile was higher than in the February *Inflation Report* for most of the projection.

30 There were substantial uncertainties around these projections. The key risks to inflation were: on the downside, the possibility that a more prolonged period of subdued demand opened up a rather

larger margin of spare capacity; and on the upside, the possibility that the persistent period of above-target inflation led to a lasting increase in medium-term inflation expectations. Both risks were judged to have increased since the February *Inflation Report*. Overall, the risks around the central projection to growth lay to the downside in the medium term, while those to inflation lay to the upside. There was a range of views among the Committee on both the central projection and the balance of risks.

The immediate policy decision

31 Output growth had already begun to slow, and business surveys suggested that a further moderation was in train. Indicators of household spending had been mixed. But house prices and housing activity had fallen, and weak real incomes were likely to subdue consumption growth. There had been some signs of improvement in financial markets. But the supply of credit to households and businesses was continuing to tighten. The depreciation of sterling would offer some support to export growth, though the prospects for overseas demand had deteriorated.

32 CPI inflation had risen markedly in April to 3%. Oil and gas prices had risen further and indicators of price pressures in the supply chain remained elevated. The Committee expected increases in energy and import prices to push CPI inflation further above the target this year. These increases would remain in the official measure of inflation for twelve months. The Committee agreed that to try to bring inflation to the target within this period would result in an undesirable degree of volatility in output. If energy and import prices stabilised, CPI inflation was likely to start to fall back towards the target around the end of the year. The central projection in the May *Inflation Report* implied that inflation would return to around the 2% target after two years.

33 In setting Bank Rate, the Committee continued to balance the upside and downside risks to inflation at this horizon. On the downside, a sharp slowing in the economy associated with weak growth of real disposable income and the tightening supply of credit could pull inflation below the target. There was a range of views amongst members about how much weight to attach to this risk. For some members, the economy had shown considerable resilience in the face of variation in credit conditions. Before August 2007, banks' balance sheets had expanded very rapidly, yet this did not appear to have had a substantial impact on consumer spending on goods and services. It was possible that spending would also be little affected by the current pressures on banks' balance sheets. For some other members, there was a significant risk that the impact of weakening property markets on the rest

of the economy could be more substantial than implied by the central projection. The contraction of credit supply had been intensifying and, coupled with the erosion of real incomes, was likely to depress demand.

34 The upside risk to the inflation outlook over the forecast period was that the period of above-target inflation in the near term would, by affecting the expectations of those setting prices and wages, have a greater tendency to persist than had been assumed in the central projection. Reducing inflation from persistently high levels had in the past required prolonged periods of subdued economic growth. The way in which people formed their expectations of inflation in the future was not well understood. But the Committee's behaviour was likely to have a material influence. It had to make clear to those setting prices and wages that the period of above-target inflation would be temporary and that it was committed to returning inflation to the 2% target.

35 For most members, a reduction in Bank Rate this month would make it more difficult to keep inflation expectations in line with the target. CPI inflation was already at 3% and the Committee expected it to rise further in the near term. Although economic activity was likely to slow, the Committee had judged that some slowing in the growth rate of output was likely to be necessary for inflation to settle close to the target around two years ahead. A further reduction in Bank Rate this month could create the impression that the Committee was trying to stabilise output growth rather than maintaining its focus on the inflation target.

36 For one member it was, however, particularly important to look through the short-term spike in inflation. The factors pushing inflation up – oil and other commodity prices – were beyond the MPC's control and, with pay growth remaining subdued, this period of above-target inflation would have little tendency to persist. The current and prospective weakness of demand meant that there was a clear risk of missing the target on the downside looking further ahead. An immediate reduction in Bank Rate was necessary to reduce that risk.

37 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.

38 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.