

Publication date: 17 September 2008

MINUTES OF MONETARY POLICY COMMITTEE MEETING 3 AND 4 SEPTEMBER 2008

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 September.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0809.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 8 and 9 October will be published on 22 October 2008.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 SEPTEMBER 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 The most striking news from financial markets over the past month had been the sharp depreciation of sterling, with the effective exchange rate index (ERI) falling by around 5%. Sterling had weakened by around 3% against the euro and by even more, around 9%, against the US dollar. The sterling ERI was around 16% lower than in July 2007. The fall in sterling over the past month could not be fully accounted for by changes in short-term interest rates. Sterling, US dollar and euro interest rates had all declined over the month, at both short and ten-year maturities. Market participants appeared to be pricing in a reduction of up to 75 basis points in Bank Rate by the middle of next year – a significant downward revision from last month. Inflation ‘breakeven’ rates derived from the gilts market had risen a little over the month, but at three and five years were well below their peaks in July 2008.

3 Equity markets’ performance in local currency terms had varied, with the FTSE All-Share up by about 1% on the month, the DJ Euro Stoxx 300 down by 0.3% and the S&P 500 down by about 1%. But in common currency terms, UK and European indices had fallen by more than the US index, suggesting perhaps some deterioration in the expected relative performance of the UK and euro-area corporate sectors.

4 Given that relative interest rate developments appeared to account for only a small fraction of the most recent depreciation of sterling, the Committee discussed a number of other possible explanations. First, there might have been a net shift in global demand away from UK producers, perhaps because of the United Kingdom’s relative specialisation in financial services. Second, the depreciation might

have reflected the recognition that a lower real value of sterling would be necessary to achieve the rebalancing of aggregate expenditure from domestic towards export demand in the UK economy. However, the need for rebalancing had been evident for some time. Third, there might have been an increase in the risk premium on sterling assets, relative to those denominated in other currencies, perhaps because of a rise in the relative uncertainty about short-term macroeconomic prospects or about policymakers' likely responses. The Committee agreed that the causes of the depreciation in sterling, and its likely persistence, were as yet unclear.

5 Conditions in money and credit markets remained difficult. The rise in credit default premia for UK and US banks pointed to a deterioration in the outlook for financial institutions in both countries. Three-month spreads between unsecured interbank borrowing rates and expected policy rates had risen over the past month, and the pattern of forward spreads suggested that financial-market participants were beginning to be concerned about end-of-year funding pressures. Banks' funding costs now seemed likely to remain elevated for longer than previously expected. Given the costs and other difficulties associated with raising additional capital, banks were likely to continue to accrue profits and rein back the growth of their assets for some time to boost their capital ratios. That would probably be associated with a further tightening of overall credit conditions.

The international economy

6 Activity in the euro area appeared to have slackened in 2008 Q2, with the latest estimate of GDP indicating a fall of 0.2% on the quarter. Some slowdown had been anticipated, as growth in 2008 Q1 had been erratically strong, but this outturn was weaker than expected at the time of the *August Inflation Report*. Expenditure data suggested that both consumption and investment had also fallen in the second quarter. Retail sales had declined 0.4% in July. It was possible that tightening credit conditions were having more of an impact than expected. But the Purchasing Managers Indices for July and August, as well as other surveys, had been broadly consistent with weak but positive growth in 2008 Q3, in line with the *August Report*.

7 Euro-area inflation remained elevated. The twelve-month rate of producer price inflation had risen to 9% in July, the highest rate since 1982. Consumer price inflation had eased a little, to 3.8% in August on the flash estimate of the HICP, but was still well above the ECB's target. As the degree of wage indexation was significant in several euro-area countries, there was a risk that higher prices

might be passed through directly to higher wages and that the required adjustment in real wages might be harder to achieve.

8 In the United States, the estimate of quarterly GDP growth in 2008 Q2 had been revised upward, by 0.3 percentage points, to 0.8%. That reflected a significant contribution from net trade, the largest since 1980. The weak outturn for US imports, which were 2% lower than a year earlier, was, however, a discouraging signal about the likely demand for other countries' exports, including those from the United Kingdom. The Institute for Supply Management indices pointed to US growth in 2008 Q3 a little stronger than expected at the time of the *August Report*. But the Federal Reserve's Senior Loan Officer survey in July had reported a further tightening of lending standards and consumption had fallen by more than expected. News about the US housing market had been mixed, with home sales rising in July, but house prices continuing to fall.

9 Twelve-month US finished goods producer price inflation had risen to nearly 10% in July, the highest rate for 27 years. Headline CPI inflation had also increased, to 5.6%, a 17-year high. The inflation rate of the core personal consumption expenditures price index, which excluded energy and food prices, had also increased. But the Michigan measure of short-term inflation expectations had fallen back in August.

10 Japanese GDP was reported to have fallen by 0.6% in 2008 Q2, a much weaker outturn than expected at the time of the *August Report*. In addition to falls in consumption and investment, falling exports had contributed to the contraction, which might be a sign of weakening demand elsewhere in Asia. But Japanese GDP data were volatile, so not too much weight should be put on one quarter's data.

11 The most significant news about the international economy had been the further decline in US dollar oil prices. The fifteen-day average was now over 10% below the starting level in the *August Report* projection and the spot price was more than 25% below its July 2008 peak. The decline in oil prices probably reflected weaker-than-expected demand for oil, due to both weaker activity and price substitution effects. Oil prices had remained volatile, however, reflecting, among other factors, the military activity in Georgia and weather conditions in the Gulf of Mexico. Over the month, sterling oil prices were little changed, due to the offsetting impact of the depreciation of sterling against the US dollar.

Money, credit, demand and output

12 The ONS had revised downward its estimate of output growth in 2008 Q2 to zero. The CIPS/Markit indicators for activity in services and manufacturing had both increased in August, after falling sharply in recent months, but were still suggesting that output might contract slightly in the third quarter. Taken together, the main business surveys suggested that output growth in 2008 Q3 would be broadly as envisaged in the *August Report*.

13 The official expenditure data for 2008 Q2 painted a weaker picture. The ONS estimated that final domestic demand had fallen by 0.8% on the quarter, with consumption flat and business investment nearly 2% lower than in the first quarter. Final domestic demand growth had, therefore, been considerably weaker than the current estimate for output growth in the second quarter. In contrast, final domestic demand was estimated to have grown faster than output in 2008 Q1. The ONS statistical adjustment to align output and expenditure estimates was substantial in the first quarter. It was possible that future data revisions would reduce this alignment adjustment and might thus moderate the estimated decline in final domestic demand growth in the second quarter. Surveys of investment intentions pointed to the possibility that the official investment data might be revised upwards in due course. However, the Bank's regional Agents had received reports of an unanticipated build-up of stocks among both retailers and wholesalers, which might point to weaker output growth in the future.

14 Monthly indicators of household spending, including retail sales data, surveys and reports from the Bank's Agents, suggested that consumption was likely to fall in 2008 Q3, consistent with the sharp slowing in consumption in the *August Report's* central projection. Business investment also seemed likely to be weak – perhaps more so than anticipated in the *August Report* – given the sharp fall in services investment intentions that had been reported to the Bank's Agents and the decline in the CIPS/Markit capital goods orders balance. In the housing market, the latest data pointed to continuing declines in both transactions and prices. The Government's recently announced package of microeconomic measures for the housing market was not expected to have a material impact on the overall macroeconomic outlook.

15 The central projection in the *August Report* entailed a rebalancing of the aggregate expenditure measure of GDP from domestic spending towards net trade. The fall in the value of sterling over the

past year and the slowdown in UK activity would help to reduce import growth, while the drop in the exchange rate would also encourage exports. But export growth was vulnerable to weaker-than-expected euro-area demand growth and the rebalancing between domestic demand and net trade in the United States. There was also the possibility that the decline in sterling's effective exchange rate reflected a shift in global demand away from goods and services in which the United Kingdom specialised. The official data for UK exports suggested that they had fallen in 2008 Q2, although business surveys and the contacts of the Bank's Agents were generally more encouraging. Lags between exchange rate depreciation and subsequent increases in the net trade contribution were to be expected and had been observed in previous episodes of sterling depreciation. Importers and exporters might take some time to adjust trade flows significantly, because they would first need to conclude that the decline in sterling was likely to persist and then adjust their marketing and production plans.

16 The evidence over the past month about credit conditions had been mixed. The signs of increased tensions in money and credit markets pointed to further tightening. But, while the overall flow of new mortgage lending had continued to fall, banks had reduced interest rates charged on two- and five-year fixed-rate mortgages to customers with 75% loan-to-value ratios. Falls in quoted rates were likely, in part, to reflect greater differentiation by lenders among potential borrowers according to their credit risk. New corporate bank borrowing and total corporate financing had slowed in the past month and companies' money balances had declined further. It was possible that some companies' liquidity buffers and committed credit lines were being exhausted. Difficulties in obtaining credit would probably particularly inhibit the growth of start-up companies and small and medium-sized businesses, which had contributed disproportionately to recent growth.

17 The decline in broad money growth was pronounced once allowance was made for transactions within the financial sector that were unlikely to be related to spending on goods and services. Adjusted for those transactions, the level of M4 had been broadly unchanged between April and July. The values of notes and coin in real terms had fallen over the past three months. The overall picture was consistent with current monetary conditions weighing down on the growth of nominal demand.

Costs and prices

18 The most recent data suggested that the labour market had weakened. According to the Labour Force Survey (LFS), although employment had increased slightly, total hours and average hours

worked per head had fallen in 2008 Q2 compared with the previous quarter. The LFS unemployment rate had risen by 0.2 percentage points. In July, the claimant count unemployment rate had risen and vacancies had fallen.

19 Twelve-month pay growth (including bonuses) had fallen to 3.3% in June on both the Average Earnings Index and Average Weekly Earnings measures. The slowdown in aggregate demand was likely to reduce pay drift, the difference between pay growth and settlements. If wage bargainers' inflation expectations rose, that might be reflected in upward pressure on settlements, although the slackening of labour demand would tend to work in the opposite direction. The early data for July suggested that settlements remained subdued, although the number of settlements had been small.

20 CPI inflation had reached 4.4% in July, an increase of 0.6 percentage points on the month. Food prices had risen a little less than the Committee had expected. The uncertainty at the time of the *August Report* about the latest round of retail energy price rises had been resolved, as the remaining major energy retailers had announced their increases, broadly in line with expectations. Some of the inflationary pressures along the supply chain had eased a little, with manufacturing input prices falling slightly and output prices rising less rapidly on the month in July. The twelve-month rates of increase, however, had remained high.

21 The short-term outlook was still for CPI inflation to peak in the autumn and then to remain around 5% for several months, before the recent sharp increases in the level of retail energy and food prices dropped out of the twelve-month comparison. However, the recent depreciation of sterling would tend to increase upward pressure on sterling import prices and had offset the impact of the fall in US dollar-denominated oil prices on the sterling price of oil. Goods import price inflation had again risen sharply in June. There had been a number of upside surprises from the import price inflation data over the past year. It was possible that these surprises simply reflected faster pass-through than expected from exchange rate changes into domestic prices. In that case, there might now be fewer import price increases in the pipeline from the earlier depreciation of sterling. But it was also possible that the surprises indicated that companies were finding it easier to pass on cost increases to their customers or were expecting the depreciation to persist.

22 There had been mixed signals about movements in inflation expectations, although overall the latest surveys provided some reassurance that medium-term expectations had, so far, remained

anchored. According to the August Bank/NOP survey, the median household's expectations for inflation over the coming year had risen by significantly less than had CPI inflation over the past quarter. Inflation expectations were lower than perceptions of current inflation, and the gap had widened. The Barclays Basix survey for August had suggested that expectations of inflation one, two and five years ahead remained elevated at roughly similar levels. But the Citigroup survey reported that expectations of inflation in five to ten years' time had fallen in August to their lowest level in twelve months.

The immediate policy decision

23 The Committee had for some time been monitoring two main risks around its central projections for CPI inflation in the medium term. On the downside, the risk was that the slowdown in demand would be more pronounced, pulling inflation below the target in the medium term. On the upside, the risk was that the rise in inflation in the near term would lead to higher inflation expectations and hence more upward pressure on wages and prices and greater persistence of above-target inflation. The *August Inflation Report* had concluded that both risks had risen since May and, while the central projection was for inflation to fall to a little below the target in two years' time, the balance of risks was on the upside. The Committee considered how the news over the past month affected this assessment.

24 As far as the downside risk to inflation in the medium term was concerned, indicators of output for 2008 Q3 were broadly consistent with the August central projection of output growth although the ONS estimate of GDP in 2008 Q2 had been a little lower than expected. Signals from the labour market about the demand for labour from employers had been weaker than anticipated.

25 There had been downside news about the growth of final domestic demand, which ONS data had suggested had fallen sharply in 2008 Q2. A fall was not surprising, given the squeeze on real take-home pay and tight credit conditions envisaged in the Committee's central projection. Although, taken at face value, the reported size of the slowdown was somewhat greater than expected, that might simply reflect the unwinding of the unexplained strength in the first quarter. Underlying money and credit growth had also fallen sharply. Developments in financial markets had increased the likelihood that UK credit conditions would remain tighter for longer than had been expected in the early summer, as banks attempted to adjust their balance sheets in part by reducing the growth of their assets.

Official data and surveys of retailers pointed to weak sales in July and August and there had been reports of unanticipated build-ups of inventories by wholesalers and retailers. In the UK housing market, activity and prices had continued to fall.

26 However, the Committee's central projection had envisaged some rebalancing from final domestic demand towards external demand. The substantial depreciation of sterling over the past month – if it persisted – would probably stimulate net trade, subject to the normal lags in adjustment of trade flows. Switching towards UK suppliers would provide a boost to domestic output. However, the recent news suggesting slower-than-expected growth in the euro area, and a potentially weaker outlook abroad more generally, would tend to limit UK export growth.

27 The main news about the upside risk to inflation in the medium term had been the recent sharp depreciation of sterling. If that were to persist, it would amplify the relative price shock from world food and energy prices and put further upward pressure on import prices generally. Such changes in relative prices did not necessarily entail a persistent increase in inflation. But import price inflation had repeatedly surprised on the upside over the past year. There was a possibility that these surprises reflected increased confidence on the part of importers that they could pass on increases in nominal costs without affecting sales. That increased the risk that CPI inflation would take longer to start falling back towards the target, even if retail energy and food price inflation slowed as expected.

28 CPI inflation had increased sharply in July. Rises in inflation had been largely confined to the retail energy and food sectors. But inflation had picked up for services as well as imported goods. That partly reflected the indirect impact of higher food and energy prices, but possibly also higher inflation expectations affecting companies' price-setting behaviour.

29 Surveys of individuals' inflation expectations had been broadly reassuring. Survey measures of inflation expectations over longer horizons had not risen and there was some evidence from the Bank/NoP survey that people expected inflation to fall back in the near term. There was little evidence from settlements data that wage bargains were being driven upwards by higher inflation expectations.

30 A case could be made for an increase in Bank Rate. There still remained a significant risk to inflation expectations from the expected short-term rise in CPI inflation. The recent fall in sterling, if sustained, might postpone the point at which inflation started to fall back sharply towards the target.

High import price inflation and sterling's depreciation could be symptomatic of a weakening of confidence in the Committee's determination to return inflation to the target. An increase in Bank Rate now would emphasise the MPC's commitment to price stability and might result in an appreciation of sterling, relieving some of the upward pressure on import prices. However, the Committee had concluded that there was little evidence that medium-term inflation expectations had been dislodged. Moreover, the impact of an unexpected increase in Bank Rate on sterling was uncertain. For example, the surprise might encourage a broader reassessment of UK economic prospects. For some members, the downside risk to inflation in the medium term from slackening demand had increased, offsetting any increase in the upside risk from inflation expectations. And some members put particular weight on the slowing of nominal variables such as nominal demand, money and credit, viewing that as likely to be inconsistent with significantly higher inflation expectations.

31 A case could also be made for a reduction in Bank Rate. Aggregate demand, and particularly final domestic demand, had slowed significantly. Financial conditions had remained stressed for longer than expected. Although some slowing in demand was necessary to bring inflation back to the target, most members thought that the downside risk to final domestic demand growth had increased. A reduction in Bank Rate would help to counter any resulting risk of inflation undershooting the inflation target in the medium term. However, the prospects for export demand and import penetration were more encouraging, given the likely impact of sterling's depreciation. And that depreciation was likely to have a direct effect on inflation in the short run through higher import prices. For most members, as there had been news this month for inflation prospects on the upside as well as on the downside, a reduction in Bank Rate now might suggest that the Committee put undue weight on activity indicators, signalling some slackening in the MPC's commitment to meet the inflation target in the medium term.

32 Most members judged that maintaining Bank Rate at 5% this month was necessary if inflation was to be brought back to the target in the medium term. That would continue to balance the upside and downside risks to inflation appropriately. For most of these members, although there had been news on the month about both of these risks, it had not significantly changed the medium-term outlook for inflation described in the *August Report*. It was more than usually important to stress that the Committee would continue to make its judgement each month on the basis of the changing evidence.

33 For one member, the prospects for UK demand had clearly worsened over the month, increasing substantially the downside risk to inflation in the medium term. There was no evidence that inflation expectations were pushing up nominal pay growth. The slowdown might be amplified by financial institutions' responses to increased financial fragility. A significant undershooting of the inflation target in the medium term, at a time when output and employment would be well below potential, risked damaging the credibility of the monetary framework.

34 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, Charles Bean, John Gieve, Kate Barker, Tim Besley, Spencer Dale, Andrew Sentance and Paul Tucker) voted in favour of the proposition. David Blanchflower voted against, preferring a reduction of 50 basis points.

35 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.