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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
4 & 5 APRIL 2007**

These are the minutes of the Monetary Policy Committee meeting held on 4 & 5 April 2007.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0704.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 May will be published on 23 May 2007.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 APRIL 2007

1 At the start of the meeting, the Committee noted a letter from the Chancellor (attached as an annex) setting out the remit for the Committee over the following year, in accordance with Section 12 of the Bank of England Act. 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 The past month had seen an unwinding of most of the falls in equity prices that had occurred in the period leading up to the March MPC meeting. The FTSE All-Share index had risen 3½% on the month, leaving it 2% up on the level at the time of the February *Inflation Report*. There had been similar movements in the euro area and the United States. By contrast, less than half of the rise in sub-investment-grade corporate bond spreads had been reversed over the month, although the remaining rise was small when set against the substantial fall in spreads over the past few years.

3 The Committee discussed whether the financial market turbulence of the past few weeks had reflected heightened concerns about US economic prospects and/or a general re-pricing of risk. Since the asset price movements had been seen across various international financial markets, that might point to global factors rather than US-specific ones. However, the two explanations did not need to be seen as alternatives. It seemed possible that a number of pieces of downside news in the United States had coincided with growing concerns about the US sub-prime mortgage market, and might have led investors to believe that the world was riskier than they had hitherto thought. The rapid reversal of asset price falls had suggested that there were limited implications for the outlook for UK inflation.

4 Short-term interest rates had picked up internationally. Euro-area interest rate expectations had risen over the month to end the period where they had been in early February. In the United States the rise still meant that an interest rate cut was expected by the autumn. In the United Kingdom, short-

term interest rates had risen around 20 basis points over the month, and implied that the financial markets were pricing in one rise in Bank Rate by the summer. That left the path for short-term interest rates a little below that at the time of the February *Inflation Report*. Of the 60 City economists polled by Reuters this month, 11 had been expecting an immediate rise in rates, and 35 had predicted a rise in May. Only one person expected more than one increase. The median view had been that any rise in Bank Rate in Q2 would be reversed by early next year. Further along the yield curve, there had been a 15-25 basis point rise in real forward interest rates internationally.

5 In the foreign exchange markets, there had also been a reversal of some of the sharp movements seen in the previous month, particularly for the yen. Partly reflecting this, the sterling effective exchange rate index (ERI) had appreciated by 1% over the month, though it remained around 2% down on the level at the time of the February *Inflation Report*. Relative interest rate movements, and such evidence as there was on speculative positions, had appeared to be broadly consistent with the strength of sterling prior to February, and its subsequent depreciation. Despite the volatility of the past few months, sterling was currently within the broad range that it had traded in for much of the past ten years. Option prices suggested there had been an increase in the demand for protection against a yen appreciation with respect to a number of currencies – including sterling.

The international economy

6 GDP growth in the United States had been unrevised at 0.6% in 2006 Q4, though that had been somewhat weaker than expected at the time of the February *Inflation Report*. Some of the short-term activity indicators had pointed to growth below potential. The Institute of Supply Management (ISM) manufacturing business activity index had eased in March, taking it back to its Q4 average, and the non-manufacturing index had eased further to 52.4 – the weakest since April 2003. In contrast, non-farm payrolls growth had remained firm.

7 The focus of commentary on the United States economy in the past few weeks had been on the sub-prime mortgage market. Sub-prime mortgages constituted around 10%-15% of the market, and the proportion of those loans in arrears of 30 days or more had picked up to around 13% of sub-prime borrowing in 2006 Q4. Around a third of sub-prime mortgages were due to have their interest rates reset upwards this year, so it was probable that delinquency rates would rise. But the direct impact of these developments on the wider economy seemed likely to be moderate. The affected households

constituted a small proportion of the total, and these were likely to be low-income households, whose impact on aggregate spending would be correspondingly low. The latest consumption indicators pointed to healthy Q1 growth of nearly 1%, while consumer confidence indicators did not point to deteriorating prospects.

8 Potentially of wider significance was the incipient weakness in US non-residential investment. That had fallen in Q4, and given the turndown in durables goods orders and shipments this year, also looked likely to have declined in Q1. If so, it would represent the first consecutive quarterly declines in non-residential investment for four years. The weakness looked puzzling given high levels of capacity utilisation and the profit rate.

9 The picture for the rest of the world was robust, suggesting a continuing broad rebalancing of growth. Economic activity in Asia had been strong. In the euro area, both the manufacturing and non-manufacturing Purchasing Managers Indices (PMIs) had dipped in March, but remained consistent with above-potential output growth in Q1. The latest data suggested that the VAT increase in Germany at the turn of the year had had little effect on output. Although there had been some structural improvements in some euro-area countries, the most likely explanation of more rapid output growth in recent quarters was a cyclical recovery. There had been signs of more sustained investment growth, and labour market conditions were supportive of stronger consumption growth: employment had been rising and unemployment had been falling for some time.

10 Inflation in the United States had edged up to 2.4% in February on the Federal Reserve's preferred core measure of the personal consumption expenditures deflator. Headline consumer price inflation in the euro area had been 1.9% in March.

11 Spot oil prices had risen further and were up around 10% on the month as a whole, though the movement in the futures curve was less. Spot and futures oil prices were higher than assumed in the February *Inflation Report*. Some of the rise appeared to have been related to the political tensions in the Middle East. Continued volatility appeared likely as conditions in the oil market seemed set to remain tight, and it would take considerable time for the rise in prices over the past few years to feed through to increased production capacity. In the United Kingdom, the mild winter and improved supply had prevented a reoccurrence of the sharp rise in wholesale gas prices seen the previous year.

Other international commodity prices, such as those of metals and food, had also been rising in recent months.

Money, credit, demand and output

12 UK GDP growth had been revised down to 0.7% in Q4, compared with 0.8% in the previous release. There were also some revisions to earlier quarters, leaving the level of current output largely unaffected and the annual rate of growth unchanged at 3.0%. Turning to Q1, the CIPS/RBS services balances for business activity and new orders had been little changed in March and, although still strong, had been below the peak readings of late 2006. The corresponding manufacturing balances had fallen in March, while the ONS estimate of manufacturing output had been a little weaker than expected in February. But overall, the picture for Q1 GDP growth looked similar to Q4, except that output growth was likely to be temporarily boosted by output from a new oil field which had come into production earlier than expected. That might suggest that Q1 output growth had been a little above that expected at the time of the February *Inflation Report*.

13 Turning to the demand counterparts, the revised data suggested a continuation of the volatility of consumption growth over the past year, but the underlying picture had not changed substantially. Retail sales had rebounded in February as expected, and the Bank's regional Agents and the CBI *Distributive Trades Survey* had pointed to a firm picture for retail sales in March.

14 Some slowing in consumption growth might be expected in response to slowing household income growth and rising interest rates. An indicator of softer consumption growth might be the slower annual growth of unsecured lending, with the latest information provided to the Bank by lenders suggesting that there had been some tightening in unsecured credit supply conditions. Consumer confidence was also relatively subdued, although the link to consumption had not been particularly good in the past.

15 The average of the lenders' indices for Q1 indicated that house prices had risen by around 2½%, though it had turned out a little lower than had been expected at the time of the February *Inflation Report*. A number of indicators, such as the Royal Institution of Chartered Surveyors' measure of the sales-to-stock ratio, were still tight. Secured lending had remained buoyant in February, but other housing market indicators were mixed.

16 Prospects for business investment appeared buoyant; growth had been revised up to 4.5% in Q4, and there had been upward revisions to earlier data. The sectoral pattern of growth pointed to broad-based strength. Moreover, outside the energy sector, the rate of profitability had risen to 14.7% in Q4, the highest since the series began in 1989. That should help to sustain investment. The Bank's regional Agents' service sector score for investment had been at its highest level since it started in 1997.

17 The Budget had included reductions in capital allowances with effect from April 2008. While the net effect of the changes on the capital stock might be small in the long run, it might induce firms to bring forward planned spending into this year. Otherwise, a preliminary assessment suggested that the macroeconomic impact of the Budget would be broadly neutral, taken over the next few years as a whole, compared with the 2006 *Pre-Budget Report*. The Committee would want to process the detailed spending and tax plans more fully in the context of its May *Inflation Report*.

18 The survey data for exports had pointed to a more positive picture than the official data. The net trade contribution to GDP growth in Q4 had been revised, and was now close to zero. Moreover, the large negative contribution to GDP growth from the alignment adjustment suggested that this might be further revised downwards. The recorded current account deficit had increased to 3¼% of GDP in 2006.

19 Broad money and credit continued to expand rapidly in February, with annual growth of M4 and M4 lending (excluding the effect of securitisations) at 12.7% and 15.2% respectively.

Supply, costs and prices

20 Employment among the 16-59/64 age group had fallen slightly in the three months to January according to the Labour Force Survey (LFS), with the employment rate ticking down 0.1 of a percentage point. However, the unemployment rate had remained flat, reflecting lower participation/higher inactivity. Measures of weighted non-employment had been broadly stable over the second half of 2006. There had been a rise in the number of part-time workers who wanted a full-time job and temporary workers who wanted a permanent job.

21 The various measures of labour market tightness extracted from surveys had continued to tell somewhat different stories about the amount of slack in the labour market at the current conjuncture, and did not provide clear signals as to whether the labour market was tightening or loosening. In particular, there had been distinct differences in the perceived skill shortages across sectors. It was possible that the situation had been clouded by greater availability of migrant workers in recent years.

22 The three-month AEI-weighted measure of whole economy settlements had been around 3.3% in February. With just under a third of the settlements normally expected for January now collected, and February being a relatively quiet month, the picture on pay settlements looked similar to that at the end of last year. Annual growth in regular pay edged down in the three months to January to 3.6%. There had been a pickup in overall earnings growth in January to 4.2%, which reflected bonuses. The ONS had suggested that some of the companies paying bonuses in January this year might have paid them in February last year. Smoothing through the bonus contribution suggested that whole economy earnings growth had remained broadly flat at around 4%. So the data continued to suggest that so far there had been little pickup in pay pressures.

23 Excluding food, beverages, tobacco and petroleum, manufacturing output price inflation had picked up to 2.7% in February. The latest available official estimate for services producer output price inflation had been 3% in 2006 Q4. Movements in the surveys of producer prices had been mixed on the month, but the balances generally remained high, in line with the official data and suggesting that output price inflation would continue at close to recent rates in the near term.

24 The Bank's regional Agents had conducted a special survey on pricing intentions over the next twelve months. This suggested rising inflation in consumer services, moderating inflation in manufacturing, and flat prices in retailing. But retailers were also expecting margins to rise, despite an expected rise in costs of the domestic producers. There were a variety of ways in which these apparently different expectations for prices could eventually be reconciled: for example, through changes to the quantity and/or price of imported retail goods, or through changes in retailers' other costs. But further investigation by the Agents was needed.

25 CPI inflation had picked up to 2.8% in February. That reversed some, but not all, of the aggregate news in the previous month's release. Inflation was now more in line with the February *Inflation Report* projection. The near-term outlook would be affected by the rise in oil prices over the

past month. The YouGov/Citigroup measure of expected inflation over the next 12 months had risen to 2.5% in March, and had continued to show signs of being correlated with actual outturns for inflation in recent months.

The immediate policy decision

26 Financial market asset prices had largely bounced back from their falls the previous month, although credit spreads remained wider. UK short-term interest rate expectations were a little below where they were at the time of the February *Inflation Report*. In contrast, the exchange rate had appreciated a little over the past month, but was down around 2% compared with the time of the previous *Report*.

27 The world economy had remained robust. There were further signs of the recovery in the euro area becoming more entrenched, with investment strengthening, and conditions in place for faster consumption growth looking ahead. By contrast, there had also been signs of greater vulnerabilities in the United States.

28 At the time of the February *Inflation Report*, the Committee's central projection had been for GDP growth to expand at a rate close to its average of the past decade, with broadly balanced risks around that. The official data for UK GDP growth had been revised slightly through 2006, but the picture remained one of steady growth.

29 There was evidence of a shift in the balance of domestic demand, with further strength of business investment. But consumption had remained volatile. Some indicators suggested that the likely near-term outlook for consumption spending was weaker than expected at the time of the February *Inflation Report*, though there had also been a bounce back in retail sales over the previous month. There had been a tightening of unsecured credit conditions and income was looking weaker, though this weakness might be temporary. House price inflation had probably slowed at the end of last year. But the housing market indicators were not giving clear signals as to what might happen next, and the outturn for house price inflation in Q1 was still high, even though it had been lower than expected.

30 Weaker real labour income – in part a reflection of weaker-than-expected employment growth – was one reason to expect a dip in consumption growth in Q1. Some members found it puzzling that the continued capacity pressures recorded in surveys had not as yet fed through into faster private sector employment growth. One possibility was that firms were still adjusting to the rise in energy prices, so that some further downward adjustment to the level of real take-home pay of employees was still required, and this was weighing on employment growth. But the continued volatility of energy prices made the degree of adjustment difficult to assess.

31 Pay developments had continued to be relatively benign, with no significant rise in settlements over the winter months, and total earnings growth had remained flat after allowing for the volatility of bonus payments. It was possible that the greater availability of migrant labour, both skilled and unskilled, had reduced the response of pay to activity. It was likely that pay was a lagging indicator of activity. There was uncertainty about the degree of slack in the labour market and there were varying views among the Committee.

32 CPI inflation had remained volatile. It had risen in February, and this had offset most of the downside news in January, leaving the near-term outlook for inflation not very far from that expected at the time of the February *Inflation Report*. Surveys of inflation expectations had continued to follow actual movements in inflation recently. Oil and some other commodity prices had risen further over the past month. Changes in the prices of gas and electricity continued to have a material impact on the prospective near-term profile for CPI inflation. The announcements made by utility companies so far had been broadly in line with the assumptions made at the time of the February *Inflation Report*.

33 For some members, there was no compelling case for a change in interest rates this month. For these members there were particular uncertainties about the outlook for the US economy and for UK consumption. The evidence on the degree of slack within firms and in the labour market did not suggest a clear need to raise interest rates. There remained both upside and downside risks to the prospects for inflation, but the near-term prospect was of a fall in inflation towards the target in the next few months. It would be particularly useful to process the news in the context of the May *Report*.

34 Other members also concluded that no change in Bank Rate was warranted this month, but that the balance of risks to inflation remained on the upside in the medium term, as had been highlighted in the February *Report*. Domestic demand continued to grow robustly. Manufacturing and service sector

producer price inflation was running at an annual rate of around 3% – an unusual conjunction. If that were to persist for any length of time, it seemed incompatible with achieving the inflation target in the medium term. Nevertheless, there was only a limited expectation of a move in Bank Rate this month, and a rise might lead to an unwarranted upward shift in the yield curve. Any change would also be better explained in the context of the *May Inflation Report* projections.

35 Some other members also thought that the balance of risks to the outlook to inflation was on the upside, and that these were sufficiently strong to warrant an immediate rise in Bank Rate of 25 basis points. These members thought the fundamental determinants of consumption remained firm, that business investment and global demand were strong, and that profitability was very healthy. Survey evidence suggested a shift in sentiment on the part of firms about their ability to push through price increases. So overall, demand pressures were likely to add to existing tight capacity pressures, slowing the reduction in CPI inflation in the short-term and adding to medium term risks. Developments in money, credit and asset prices also posed an upside risk to inflation in the medium term.

36 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.25%. Seven members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean, David Blanchflower and Paul Tucker) voted in favour of the proposition. Tim Besley and Andrew Sentance voted against, preferring an increase in Bank Rate of 25 basis points.

37 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.