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**MINUTES OF  
MONETARY POLICY  
COMMITTEE MEETING  
7 & 8 FEBRUARY 2007**

These are the minutes of the Monetary

## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 FEBRUARY 2007**

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

### **Financial markets**

2 The main development in UK financial markets this month had been the reaction to the January increase in Bank Rate. Most commentators had been surprised by the timing of the interest rate decision, but had expected a rate rise in February. Interest rates implied by short-sterling contracts had risen, and had continued to edge up over the month to end the period around 20-25 basis points higher. Financial markets did not expect a further rate rise this month, but another rise had been fully priced in by May, and there was a significant probability of a further rise in the summer. The views of economists, as reflected in the average probabilities of future interest rates as revealed by the Reuters poll, had seemed consistent with this.

3 There was considerable uncertainty in the financial markets about the near-term path for interest rates, with a noticeable pickup in three-month implied volatility. There was approximately a 30% probability attached to an interest rate increase this month by respondents to the Reuters poll. Interest rates had also risen further along the yield curve.

4 There had also been approximately a 10 basis point rise in short-term interest rate expectations in the United States, probably reflecting a batch of stronger data and speeches by members of the FOMC. Longer-term nominal forward interest rates had moved up internationally over the past month. There had been no obvious news that might have altered perceptions of the long-term global saving-investment balance or of a marked change in global liquidity.

5 The sterling effective exchange rate index had risen by around 1½% over the past month, and in both nominal and real terms was at its highest level since the early 1980s. Relative interest rate differentials were able to account for a significant proportion of the appreciation since the trough in April of last year. The rise in the sterling exchange rate tended to support the observation that long-term inflation expectations in the financial markets had remained well anchored.

6 The major equity indices had risen again on the month. The rise in equity prices in the United Kingdom had occurred despite the rise in UK market interest rates.

### **The international economy**

7 In the euro area, business surveys pointed to growth recovering to an above-trend rate in Q4, though the weaker industrial production data pointed to some downside risks. The manufacturing purchasing managers' index (PMI) had fallen for the third successive month in January, but the services index had strengthened. German retail sales had risen strongly in December. The latest information pointed to a muted impact on German growth in the first quarter from the January VAT increase. Euro-area inflation had remained unchanged in December.

8 In the United States, GDP had been estimated to have grown by 0.9% in the fourth quarter. The non-manufacturing Institute for Supply Management index had risen in January, though the manufacturing index had fallen and was pointing to a contraction of output in that sector. Consumption growth had remained strong, supported by healthy nominal labour income growth in the fourth quarter. The January estimate of growth in non-farm payrolls had been weaker than market participants expected, but there had been upward revisions to earlier data. There were signs that the decline in housing market activity might be coming to an end. But with a substantial stock of unsold houses, it seemed unlikely that residential investment would recover for a while. Headline US CPI inflation picked up sharply in December, reflecting movements in energy prices, but the core measure was steady.

9 The sharp decline in US imports in Q4 might be related to the slowdown in manufacturing activity. There had been some signs of weakness in manufacturing output and indicators in a number of countries.



consumer spending in the past, so this was not compelling evidence of slowing consumer spending growth in response to past interest rate increases. Although it was too early to be sure, there was some evidence that higher interest rates might be having an effect in the housing market, with a mixed batch of indicators recently. There had been a sharp drop in mortgage loan approvals in December, and the preview of the Royal Institution of Chartered Surveyors' (RICS) survey suggested a continuing fall in the balance on new buyer enquiries in January. In contrast, the RICS ratio of sales to stocks remained high. Even if the housing market did show signs of turning, the implications for consumption were by no means clear – there might be different correlations from those recorded in the past, depending on which factors were currently driving the housing market and household spending.

15 There were no new estimates of nominal GDP growth this month. Despite a slight easing in annual growth rates in December, broad money and credit growth remained robust. Households' M4 growth was broadly unchanged, and remained close to its average over the past five years.

### **Costs and prices**

16 The Labour Force Survey (LFS) measure of unemployment had fallen slightly in the three months to November compared with the previous three months, leaving the rate unchanged at 5.5%. A significant share of the pickup in unemployment over the past two years was accounted for by the 16-24 age group. The employment rate had fallen slightly in the three months to November, while the inactivity rate had risen slightly. Full-time employment had contracted while part-time employment had risen. A considerable part of the rise in part-time employment over the past year had reflected a rise in those reporting that they wanted full-time work. Similarly, there had been growth in the number of temporary workers who reported they were unable to find permanent jobs, particularly in the most recent quarter. As far as the outlook for labour demand was concerned, the picture had been mixed, with some surveys weakening and some strengthening.

17 The annual rate of average earnings growth, excluding the volatile bonus component, was broadly the same in the three months to November 2006 as in the equivalent period the previous year. The three-month AEI-weighted average of private sector settlements had increased slightly through the year to stand at 3.5% in December. What evidence there was had continued to suggest a further slight increase in January. But there was relatively little information, as yet, and the early figures were subject to revision as further settlements were recorded. The Bank's regional Agents had conducted a

special survey on pay prospects, which pointed to slightly higher pay growth this year than last, with the main drivers being the rise in RPI inflation and the need to recruit and retain staff. The feed-through from settlements to earnings growth had not always been strong in the past.

18 Latest estimates suggested that, as of 2006 Q3, some further adjustment was still required in the real consumption wage, following the various energy, tax and import price shocks of the past few years. That could either come through nominal wage restraint or higher prices. But given the more recent falls in energy prices and import cost pressures, the total adjustment required was smaller than had been the case at the time of the November *Report*.

19 Import and producer input price inflation had continued to fall following the recent energy price falls, but producer output price inflation had risen slightly. Business surveys suggested that companies were more confident in their ability to raise prices, with the British Chambers of Commerce survey, the CBI *Industrial Trends Survey* and the CBI/Grant Thornton *Service Sector Survey* of consumer services all showing strengthening and historically high price balances.

20 CPI inflation had risen to 3.0% in December, and RPI inflation had risen to 4.4%. In line with pre-release arrangements, an advance estimate for CPI inflation of 2.7% had been provided to the Governor ahead of publication. This was weaker than had been expected, but analysis of the data would not be possible until after publication. There had also been an announcement by an energy distribution company, on the Thursday morning of the Committee's meeting, of cuts in gas and electricity retail prices. But information on the likely response of the rest of the industry, and the possibility of further price reductions in the future, was very limited. Domestic energy price reductions were likely to be quantitatively significant for the near-term outlook for inflation. For the purposes of the central projection in the February *Inflation Report*, the Committee had assumed cuts in the retail prices of gas and electricity, taken together, of around a fifth, spread evenly over the four quarters from 2007 Q2.

21 The Citigroup/YouGov measure of the public's inflation expectations had continued to pick up, and had reached 2.7% in January, with the polling occurring after the release of the December CPI data. This slight pickup broadly corroborated the most recent Bank/NOP November survey of the public's expectations, which was at the same level as in February 2006.

## **The February GDP growth and inflation projections**

22 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 14 February.

23 Conditional on market participants' expected path for interest rates, the Committee's central projection was for UK GDP to expand at a rate close to its average over the past decade, underpinned by steady growth in household spending and buoyant business investment. Growth eased a little towards the end of the forecast period as public spending and consumption slowed. The profile was similar to that contained in the November *Report*. Overall, the risks to growth were judged to be balanced.

24 The Committee's central projection was for CPI inflation to fall back quite sharply to below the target during the first year, as the reduction in energy costs and lower import price inflation fed through into consumer prices and into business costs. But that was partly offset by higher pay growth and some rebuilding of corporate profitability. Inflation then settled around the target over the medium term. The medium-term outlook was similar to that in the November *Report*, but the near-term volatility was more pronounced. The central projection for CPI inflation under constant interest rates was a little higher than under market rates.

25 As usual, there were substantial uncertainties surrounding these projections. These included: the behaviour of wages and prices in the face of robust demand growth but sharp falls in companies' non-wage costs; the degree of spare capacity in the economy; and the evolution of inflation expectations. As in November, there was a greater than usual uncertainty over the outlook for inflation. The additional uncertainty in the near term was associated with the path of retail gas and electricity prices, and the width of the inflation fan charts had been further enlarged to reflect this. The risks to inflation were weighted to the downside in the near term and to the upside in the medium term. There was a range of views among the Committee on both the central projection and the balance of risks, and these were discussed in the context of the immediate policy decision.

## **The immediate policy decision**

26 On the demand side of the economy, sales over the Christmas and New Year period had seemed to be robust, and the broad picture remained of consumer spending having been volatile, but with an underlying upward trend. The prospects seemed to be for growth to be a little higher than its long-term historical average in the near term, before easing back, but there were risks on both sides. On the downside, there was a risk that higher interest rates and a larger stock of debt would have a dampening effect on consumer spending. There was also a risk to consumption from the possibility of a downward adjustment to asset prices. On the upside, the decline in energy prices and possible increases in pay growth might boost take-home pay. The risks of a downturn in US activity stemming from the retrenchment in the housing market had appeared to have receded recently. Some downside risks to world output growth remained, but the immediate prospect was of another robust year, albeit slightly below the pace of the past two or three years. But the recent and prospective strength of UK business investment (which was relatively import intensive) and the appreciation of sterling suggested that the prospects for net trade might be a little weaker than at the time of the November *Report*.

27 Overall, the near-term prospects for GDP growth did not appear to have changed greatly this month. UK GDP growth had picked up slightly in Q4. Based on the available evidence for output, firm growth was also likely for the first quarter, and the central projection was for it to remain close to its average rate over the past decade.

28 Most members thought that the margin of spare capacity within businesses was limited, and the prospect was of a slight tightening in the labour market as demand for labour started to outstrip supply over the forecast period. There had been little movement in pay settlements in recent months. The evidence for January 2007 was still far from clear, although the Agents' survey pointed to the possibility of a modest pickup during this year. Earnings growth had remained stable. The fallback in non-wage costs might reduce the need for firms to put downward pressure on real take-home pay. That would be consistent with only a limited pickup in nominal pay growth. But there were significant risks in both directions. One member thought that the degree of spare capacity in the labour market was larger than in the central case, and would continue to depress real wages.

29 The latest survey evidence was consistent with some pickup in the public's short-term inflation expectations. This might reflect the rise in actual inflation over the past year, particularly of frequently

purchased items, and hence might reverse if inflation fell towards the target. But, given the size of the increase in inflation, it was also possible that expectations would take time to return to target.

30 Business surveys and reports from the Bank's regional Agents pointed to some pickup in firms' expectations about their ability to raise prices. It was possible that they might be able to push through larger price increases than assumed in the central case, but continued competitive pressures might prevent this.

31 The recent outturns for inflation had been volatile, as shown by the data in recent months, and increased the uncertainty over the near-term profile for CPI inflation. There was particular uncertainty about the path of retail gas and electricity prices, and the corresponding adjustment of non-energy costs and prices. Changes in the prices of gas and electricity had a material impact on the recent and prospective near-term profile of CPI inflation. Some members placed considerable weight on the downside risks to inflation in the near term. But some members also continued to put weight on the fast pace of growth of money and credit and the buoyancy of asset prices, which represented an upside risk to nominal spending and inflation in the medium term.

32 The market expectation was for at least one more increase in Bank Rate. The rise in market interest rates since the November *Report*, and the sharp appreciation of sterling, implied a substantial tightening of monetary conditions. There were lags between rises in interest rates and the impact on spending and inflation, so it would take some time for the full effects of the past tightening to be seen. It was difficult to judge whether, and if so by how much, policy might need to be further tightened to keep inflation on track to meet the target.

33 Some members thought there was a risk that another rise in interest rates would induce a further rise in the yield curve. Other members thought that, since the market had already priced in the possibility of a further rise, there need not be a marked reaction to a further near-term tightening of policy.

34 There was a range of views among the Committee on the relative weights to place on the different risks to growth and inflation highlighted above. But most members thought that the balance of all these risks was such that it was appropriate to leave Bank Rate unchanged this month. A closely

spaced series of interest rate increases might lead to excessive tightening. There was time to observe the impact of past decisions and to see whether any of the upside or downside risks were crystallising.

35 Some other members thought that the balance of risks was such as to warrant an immediate rise in Bank Rate of 25 basis points. These members put particular weight on the upside risks to inflation in the medium term because of: the rise in near-term inflation expectations; the evidence of firms' willingness to increase prices, consistent with the robust picture for demand; and the likely path of nominal variables in the light of recent money growth and asset price movements. For these members, the degree of policy tightening since August was still modest relative to the rise in inflation and the prospective robust outlook for demand, so a further rise in interest rates was required to return inflation to target.

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

Jon Cunliffe was present as the Treasury representative.