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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
6 & 7 JUNE 2007**

These are the minutes of the Monetary Policy Committee meeting held on 6 & 7 June 2007.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0706.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 July will be published on 18 July 2007.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6-7 JUNE 2007

1 Before turning to its immediate policy decision, the Committee discussed financial markets developments; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 The most notable development in the financial markets during the month had been the general rise in market interest rates, both along the yield curve and across countries. In the United Kingdom, three-month-ahead forward rates had picked up by 10 basis points. A substantial part of that rise had occurred after the release of the May MPC *Minutes*. One-year-ahead forward rates had risen by around 30 basis points, though these increases had been less obviously related to specific news about monetary policy. Two further 25 basis point increases in Bank Rate by the end of 2007 appeared to have been priced in to market interest rates, although the expectation of market participants for a move at this meeting was low. In a Reuters survey of economists, five out of 58 expected a 25 basis point rise in Bank Rate this month, though the average probability attached to such an increase across all respondents was 29%. Longer-term nominal forward interest rates had also risen, by around 10 basis points at the ten-year horizon, mainly reflecting higher real rates.

3 Equity prices had strengthened globally for most of the month. The coincident rise of equity prices and higher interest rates could be explained by financial market participants revising up their view of future economic activity. Even though equity prices had fallen during the past few days, major US and European indices remained above the levels prior to the turbulence earlier in 2007. Corporate bond spreads had edged lower internationally and most of the late-February increase in spreads had now unwound. Despite this, market contacts had suggested that there remained a degree of fragility in financial markets.

The international economy

4 The international data released during the month broadly confirmed the outlook for the world economy described in the *May Inflation Report*. In the euro area, the latest estimate of GDP growth in 2007 Q1 was unrevised at 0.6%. These data included the first expenditure breakdown for Q1. Investment had been strong; the 2.5% increase was the sharpest for a decade. The weakness in consumption partly reflected the German VAT increase in January, but subdued household spending had also been recorded elsewhere. Business surveys were pointing to further strength in GDP growth during the second quarter. Strong investment in the euro area had been a particular feature of the current recovery. Employment growth was healthy.

5 US quarterly GDP growth in 2007 Q1 had been revised down from 0.3% to 0.2%. However, there were signs of a revival during Q2. The Institute for Supply Management's headline index for manufacturing had ticked up in May, while its non-manufacturing counterpart had risen sharply to its highest level for a year. Employment growth had remained robust, with non-farm payrolls increasing by 157,000 in May. Housing starts and other indicators pointed to less of a drag on economic activity from residential investment. The further recovery of capital goods shipments and new orders (excluding defence and aircraft) in April suggested that the slowdown in business investment over the past few quarters would prove to have been temporary.

6 The Brent spot oil price had risen by over 10% in both dollar and sterling terms since the May MPC meeting, and was around 40% higher than its recent trough in January. Developments in other commodity prices during the month had been mixed: agricultural prices had risen, but industrial metals prices had fallen. Inflation in the United States as measured by the Personal Consumption Expenditures deflator excluding food and energy had fallen to 2.0% in April, its lowest level since March 2006. HICP inflation in the euro area had remained at 1.9% in May.

7 The Committee had noted the rise in pricing balances from UK business surveys in previous meetings. These trends had been apparent in the euro area too. It was perhaps less surprising that there had been common trends in manufacturers' prices as these goods were traded on world markets. But similarities had also been apparent in price movements in the less-internationally-traded service sector. That suggested a common shock might have been the cause. It was possible that the rise in these price balances could have reflected the common rebuilding of margins following the earlier oil

price hike. Equally, it could have represented the build-up of inflationary pressure across a number of countries.

Money, credit, demand and output

8 GDP growth in 2007 Q1 was unrevised at 0.7%. Nevertheless, the pattern of past revisions and business survey data suggested that growth was likely to be revised upwards at some point in the future.

9 The divergence in activity indicators for Q1 between business surveys on the one hand and ONS data on the other was most marked in manufacturing. However, looking at the past four quarters as a whole there was much less of a difference. Moreover, part of that pattern in the ONS data could be explained by the lumpiness of production in the aircraft sector, where output had risen strongly in 2006, but had fallen sharply in 2007 Q1. Movements of that kind were unlikely to be properly captured in business survey balances.

10 The latest GDP data had provided the Committee this month with its first look at the associated expenditure breakdown in Q1. The pattern of expenditure growth had broadly corresponded to that embodied in the *Inflation Report* central projection. The main surprise was business investment, which had been reported to have fallen by 1.3%. But investment data were volatile, and they had a higher propensity to be revised than other categories of spending. Moreover, even taking the investment data at face value, business investment was still nearly 10% higher than a year earlier.

11 For Q2, business surveys and Agents' reports pointed to continued robust output growth, despite the cumulative increase in Bank Rate of one percentage point since August. The CIPS/NTC services activity index had been unchanged in May, though the business expectations index had fallen back. There was evidence of stronger service sector activity in the CBI/Grant Thornton survey for Q2. In manufacturing, the CIPS/NTC output measure for May had ticked up, though the index for new orders had eased a little. The April Index of Production release had been provided to the Committee ahead of publication. Industrial production had grown by 0.3% in April.

12 Some of the household expenditure indicators for Q2 provided tentative signs of a softening in consumer spending. Retail sales volumes had fallen by 0.1% in April. In May, both the BRC measure

of total twelve-month retail spending growth and the CBI retailers' survey balance had fallen. But data for retail sales were volatile from month to month, and the April CBI balance had been at a three-year high. Annual growth in unsecured lending had continued to decline, and household Divisia growth had fallen to its lowest for six years. The Bank's Agents had also reported a slight softening in the more discretionary items of spending.

13 There had been some further signs of easing in the housing market. The survey balances for new buyer enquiries and site visitors were both negative. New instructions to sell had increased markedly, though that could partly have been a result of sellers putting their house on the market before the originally expected date for the introduction of Home Information Packs. The number of mortgage loan approvals had fallen. And the Royal Institution of Chartered Surveyors' sales-to-stock ratio had declined further in May. However, the three-month on three-month rate of change for the average of the lenders' house price indices was broadly unchanged at 2.7% in May.

14 Broad money and credit continued to expand rapidly. M4 and M4 lending (excluding the effects of securitisation) had grown by just over 13% in the year to April. The Committee discussed the possible implications for the wider economy. It was important to understand what lay behind these increases in order to assess the consequences for spending and inflation. Monetary developments could reflect two different causes: changes in the demand for money; and changes in the supply. Movements in the demand for broad money relative to spending in the economy, perhaps reflecting shifts in portfolio preferences, need have few implications for spending or the path of inflation. Increases in the supply of broad money, however, could lead to an imbalance in the relationship between money and prices. This could have implications for higher asset prices, money spending and the general price level, to which monetary policy would have to respond. It was also possible that inflated asset prices might fall back, producing a contraction in the supply of money and credit.

15 The practical problem was to distinguish between shocks to the demand for money and shocks to its supply. That was not easy, especially when some shocks could affect both demand and supply. But the difficulty in analysing banks' balance sheets did not mean that the Committee could ignore what was happening to them. The analysis was complicated by the changing nature of those balance sheets. For example, increasing securitisation of banks' assets meant that a rise in the supply of bank credit might not always be reflected in bank deposits, as measured by M4.

16 Despite these difficulties, it seemed plausible that there had been some increase in the supply of credit, as evidenced by the increased loan-to-income ratios that banks were willing to extend and the evidence from talking to the banks themselves. For that reason the rapid growth of money and credit created an upside risk to inflation.

Costs and prices

17 Employment had fallen by 55,000 in 2007 Q1, taking the growth rate on a year earlier to just 0.3% – its lowest since 1994. It seemed likely that some of that weakness reflected lower growth in public sector employment. The Committee noted that the total number of employees had fallen by 100,000, while self employment had increased by 45,000. As participation had also fallen in the first quarter, the LFS unemployment rate had been flat since the end of the previous year. Claimant count unemployment had fallen to 2.8% in April.

18 There was little sign yet of increasing pay pressures. April was a month when many pay deals were settled, and the current estimate of the mean settlement was 3.2%. Taking the January to April period as a whole, the settlements that could be matched to the same employers were only a touch higher than a year earlier. Annual pay growth, according to the Average Earnings Index (AEI) was 3.8% in March, both including and excluding the effect of bonuses. The gap between the AEI and Average Weekly Earnings (AWE) measures had narrowed, but a bonus-smoothed AWE measure was noticeably higher than its AEI counterpart. The discrepancy between the two series appeared to relate to bonuses, partly due to the different treatment of outliers. The Committee remained concerned that the ONS was unable to account adequately for the difference between the AEI and AWE indices, despite the fact that they were both calculated from the same raw data.

19 There had been mixed signals about pricing pressures emerging from the manufacturing and services sectors. In manufacturing, the annual rate of input price inflation had fallen back in April, as had output price inflation. In contrast, both the CIPS/NTC output price index and the CBI expected price balance had ticked up in May, and both series remained high.

20 In the service sector outside retailing, developments on the month had been more subdued. Services producer price inflation had fallen in Q1. According to CIPS/NTC, input price inflation had eased back in May; and there had been a particularly sharp decline in the CIPS/NTC output price

balance. There had also been falls in the CBI/Grant Thornton measures of expected average selling prices for consumer services and business and professional services. It was unclear what lay behind this easing in service sector price inflation. It could have been a diminishing impact of higher energy prices.

21 However, the picture from business surveys was different for retailers. The backward-looking prices balance in the CBI *Distributive Trades Survey* had risen sharply to a nine-year high in May, while the one-month-ahead price expectations balance had also increased.

22 The Bank's Agents had conducted a special survey into retailers' pricing. In part it was designed to shed light on puzzles thrown up by an earlier survey for the MPC meeting in April. The previous survey had suggested that retailers' expected price increases over the next twelve months to be fairly subdued. But they also expected to increase margins, despite higher costs. That message was still evident in retailers' responses this time. The apparent contradiction was reconciled partly by the fact that distribution costs were expected to fall and it appeared that some firms had not treated those as a cost in their responses. As the pattern of demand had shifted, retailers were also switching their product lines towards higher margin goods. In principle, that should not be recorded as higher inflation.

23 As expected, CPI inflation had fallen back to 2.8% in April as gas and electricity price cuts entered the calculation and retailers reduced household goods prices. Retail food prices, however, had picked up further, rising by 6% on a year earlier. The rise in food price inflation in recent months seemed to reflect both rising farm-gate prices and other factors, such as energy-price pass-through. In line with pre-release arrangements, an advance estimate of CPI inflation of 2.5% in May had been provided to the Governor ahead of publication. This was consistent with the Committee's central expectation that CPI inflation was likely to fall back during 2007 as the sharp rises in retail gas and electricity prices during 2006 dropped out of the 12-month inflation rate and announced cuts were phased in. Food price inflation had also fallen back.

24 The latest Bank/NOP survey had been conducted after the Governor's Open Letter to the Chancellor, but largely before the April CPI release. Household perceptions of current inflation had picked up, but that had not affected inflation expectations for the year ahead, which had remained

stable at 2.7%. The corresponding Citigroup measure of the general public's inflation expectations – conducted after the April CPI release – had remained at 2.5% for the third consecutive month.

The immediate policy decision

25 The Committee agreed that the news on the month was mixed. Data for output and the associated indicators suggested that growth continued to be robust in 2007 Q2, and broadly in line with the May *Inflation Report*. One reason for that robustness was the ongoing strength of the world economy. CPI inflation was turning out largely as expected. There had been a marked increase in the spot price of oil and a rise in market interest rates around the world.

26 Some members preferred no change in Bank Rate this month. There was a range of views about the weights to place on different factors.

27 The economy had so far remained resilient in the face of the interest rate rises since August 2006. There were some tentative signs of an easing in household spending and the housing market. Although the slowing had not yet been particularly pronounced, there might be more to come. Previous tightening cycles had suggested that consumption took some time to weaken. That should give the Committee reason to think carefully about the downside risks to near-term consumption growth. Additionally, higher household debt levels might have increased the final impact of interest rate changes, which suggested raising interest rates at a measured pace.

28 The labour market had remained subdued. Employment growth was weak. That was puzzling in light of the capacity pressures that firms were reporting. Moreover, pay growth appeared to be muted.

29 Survey measures of the general public's inflation expectations had remained stable, despite the pickup in actual inflation over the winter. That broad stability of inflation expectations was not out of line with the experience of other countries, such as Canada, Australia and Sweden, which had also seen some volatility in headline inflation during recent years. And surveys of pricing pressures in service sector businesses had eased.

30 The rise in market interest rates over the month had already provided a degree of tightening in monetary conditions. That gave the Committee the scope to hold Bank Rate this month before

considering whether to raise again. A no-change decision this month would not come as a surprise to market participants, and so was unlikely to affect the yield curve. Correspondingly, a decision to raise rates this month would probably push the yield curve higher, which would not be warranted.

31 Other members preferred an immediate increase in Bank Rate. There were risks in both directions, but there had been little news on the month to affect the judgement in the *May Inflation Report* that the balance of risks to the outlook for inflation was on the upside. That projection had been conditioned on a path for interest rates that included one more increase in Bank Rate. For these members, there was no compelling reason to wait. Moreover, by raising now, the peak in interest rates could eventually be lower. It was not clear that a rate rise would be much of a surprise. The Reuters survey had suggested that economists attached a one-in-three chance to an increase this month.

32 The economy was still growing robustly despite the rise in official interest rates since August 2006. A slowing of demand growth to below potential was probably necessary if inflation was to hit the target in the medium term. It was not clear what would precipitate that slowing without a further rise in Bank Rate. The easing in the household spending numbers was at best tentative, as these data were volatile from month to month. House price inflation was higher in 2007 Q1 than in the third quarter of 2006 in nearly every region of England and in all the other countries of the United Kingdom. The rapid growth of money and credit in part reflected the easiness of credit conditions, and posed an upside risk to spending and inflation. That would need to be offset by a higher level of Bank Rate.

33 Business investment showed strong year-on-year growth and investment intentions were still very positive. The evidence pointed to a confident and buoyant corporate sector. Survey measures of capacity pressures were generally high and increasing. The world economy was also strong.

34 Oil prices had risen, which could give some unexpected upward impetus to CPI inflation in the near term. Goods price inflation was still high, and contrasted with falling prices earlier in the decade. In order to meet the inflation target there had to be some offsetting weakness in service sector price inflation. Though service sector inflation had eased back in the short term, those lower rates of price increase might not persist if demand remained strong.

35 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.5%. Five members of the Committee (Rachel Lomax, Kate Barker, Charles Bean, David Blanchflower and Paul Tucker) voted in favour of the proposition. The Governor, John Gieve, Tim Besley and Andrew Sentance voted against, preferring an increase in Bank Rate of 25 basis points.

36 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.