1 Money and asset prices

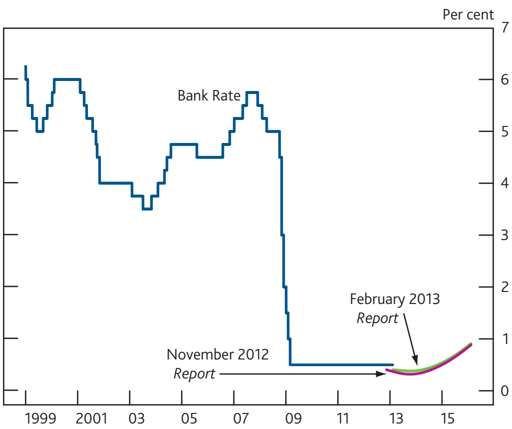
Policy initiatives taken by several major central banks since Summer 2012 have contributed to a revival in financial market sentiment. Since the November *Report*, investors' perceptions of near-term risks have diminished further and their willingness to hold risky assets has increased. The perceived reduction in risk, together with the Funding for Lending Scheme, has reduced UK bank funding costs. Those falls in bank funding costs have been reflected in lower loan rates to households and businesses, and there have been signs of an improvement in credit availability. Loan growth remained subdued. The sterling ERI fell.

Monetary policy in most advanced economies has remained highly stimulative (Section 1.1). That, together with a range of other policy measures introduced since Summer 2012, has contributed to a revival in financial market sentiment (Section 1.2). Indicators of UK bank funding costs have fallen further, in part reflecting the impact of the Funding for Lending Scheme (FLS) (Section 1.3), and there are signs that credit conditions are improving. But it will take time for lower bank funding costs, and the extra incentives to lend provided by the FLS, to be reflected in increased lending. Relative to recent years, household deposit growth remained strong (Section 1.4).

1.1 Monetary policy

Since the November *Report*, the MPC has maintained Bank Rate at 0.5%. And a 25 basis point increase in Bank Rate is not priced into overnight index swap rates until 2015 (**Chart 1.1**).

Chart 1.1 Bank Rate and forward market interest rates(a)



Sources: Bank of England and Bloomberg.

(a) The November 2012 and February 2013 curves are estimated using overnight index swap rates in the fifteen working days to 7 November 2012 and 6 February 2013 respectively.

At its February meeting, the MPC voted to maintain its programme of asset purchases, financed by the issuance of central bank reserves, at £375 billion and to maintain Bank Rate at 0.5%. The reasons behind the MPC's recent policy decisions are discussed in more detail in the box on page 10. A Reuters poll of economists, conducted on 30 January, suggested that the median expectation was for no further asset purchases.

Monetary policy remains highly stimulative in most advanced economies, with policy rates remaining very low in the euro area, the United States and Japan. At its December meeting, the Federal Open Market Committee (FOMC) announced that it would continue purchasing agency mortgage-backed and longer-term Treasury securities, until it observed a substantial improvement in the outlook for the US labour market, subject to considerations of the costs and

Monetary policy since the November *Report*

The MPC's central projection in the November *Report*, under the assumptions that Bank Rate followed a path implied by market interest rates and that the stock of purchased assets financed by the issuance of central bank reserves remained at £375 billion, was for a sustained, but slow recovery in demand growth. Under the same assumptions, the MPC judged that CPI inflation was likely to remain a little above the 2% target for the first part of the forecast period, although the risks around the target were broadly balanced by the end of the forecast period.

At the time of the MPC's meeting on 5–6 December, the Committee noted that it was difficult to gauge the underlying state of the UK economy with precision though, on balance, the outlook for underlying output growth was broadly flat over the turn of the year. There had been mixed news from survey indicators of UK growth, and the Committee's view remained that the unexpectedly strong third-quarter GDP growth had incorporated large positive contributions from temporary factors, and that the unwinding of these would probably result in a contraction in headline GDP in 2012 Q4.

The twelve-month rate of CPI inflation had risen to 2.7% in October, which was higher than the Committee had anticipated, due in large part to unexpectedly large contributions from university tuition fees and food prices. Inflation was likely to remain above the target for the next year or so, owing in part to the continuing impact of the rise in tuition fees and higher domestic gas and electricity prices.

The Committee's central expectation remained that, in the medium term, inflation would fall back to the target, as the influence of past rises in energy and import prices faded and as a pickup in productivity attenuated domestic cost pressures. Substantial risks nevertheless remained around that central projection, including from higher food prices.

Against that backdrop, most members agreed that there had been little news on the month to alter the balance of arguments between maintaining and increasing the size of the monetary stimulus. Although growth remained subdued, the impact of the most recent round of asset purchases was still to be fully felt. For one member, the case for undertaking additional asset purchases at this meeting was nonetheless strong. Eight members voted to maintain the stock of asset purchases at £375 billion, while one member voted to increase the size of the asset purchase programme by a further £25 billion to a total of £400 billion. The Committee voted unanimously to maintain Bank Rate at 0.5%.

At the time of the MPC's meeting on 9–10 January, the Committee noted that it remained difficult to judge the underlying strength of growth in the United Kingdom. Employment growth had stayed firm and revisions to official output data had suggested that, abstracting from the impact of one-off events, there had been modest growth in manufacturing and services output during the first three quarters of 2012. But indicators of output growth in Q4 had been mixed. Moreover, the unwind from the Olympic Games was expected to depress Q4 GDP growth significantly.

International developments had been, on balance, positive as some of the tail risks that had weighed on sentiment and activity appeared to have become less acute. Domestically, there had been some evidence that credit conditions were easing as lower bank funding costs began to pass through to lower loan rates and the Bank's *Credit Conditions Survey* had pointed to expectations of a further easing that could help support lending and demand over the course of the year. These developments were broadly in line with expectations of how the Funding for Lending Scheme would operate in its early stages. Substantial headwinds to recovery remained, however, including the drag to activity from fiscal consolidation, a further squeeze in household real incomes, and the deterioration in UK competitiveness over the past couple of years.

CPI inflation had remained at 2.7% in November, and there had been little news on the near-term outlook for inflation, which was judged likely to remain a little above the target over the rest of 2013. There was a risk that the prospect of continued above-target inflation could result in an erosion of the credibility of the monetary policy framework, which could affect wage and price-setting behaviour. Against that, growth remained subdued and the economy continued to face a number of headwinds that would squeeze real incomes. Moreover, there was likely to be some excess capacity and some members put weight on the possibility that output could be expanded without generating much additional inflationary pressure.

Most members judged that it was not necessary at this meeting to change policy in order to meet the inflation target in the medium term. For one member, the case for undertaking additional asset purchases was nonetheless strong. Eight members voted to maintain the stock of asset purchases at £375 billion, while one member voted to increase the size of the asset purchase programme by a further £25 billion to a total of £400 billion. The Committee voted unanimously to maintain Bank Rate at 0.5%.

At its meeting on 6–7 February, the Committee voted to maintain Bank Rate at 0.5%. The Committee also voted to maintain the stock of asset purchases financed by the issuance of central bank reserves at £375 billion.

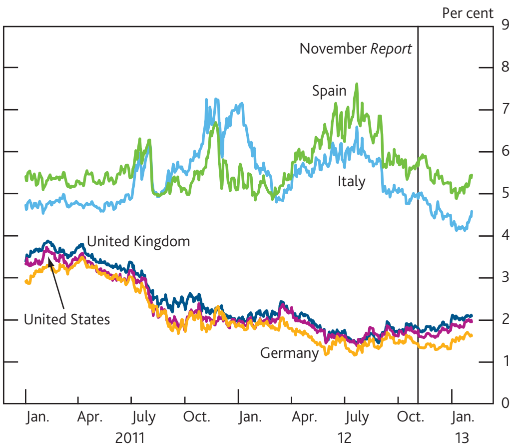
efficacy of such purchases. The FOMC made explicit the economic conditions under which it would consider raising its target interest rate. Also in December, the Bank of Japan announced further large-scale asset purchases, and in January, announced a move from a price stability goal of 1% inflation to an inflation target of 2%.

1.2 Financial markets

Over the past year, policymakers have not only maintained very stimulative monetary policy, but have also announced a range of other supportive measures. In September 2012, the European Central Bank (ECB) announced its willingness to use Outright Monetary Transactions to buy the short-term debt of euro-area countries that agree to receive official support.(1) In addition, at the start of 2013, agreement was reached to moderate the programmed fiscal contraction in the United States. And Japanese authorities put in place various measures aimed at boosting growth (Section 2).

In the United Kingdom, the Bank's £375 billion asset purchases, completed at the end of October 2012, have increased investors' money holdings and have helped to support demand for more risky assets. One way this occurs is through investors, who are holding fewer gilts as a result of the purchases by the Bank, rebalancing their portfolios by seeking to buy other assets.(2) Indeed, the more generalised improvement in risk sentiment is likely to have boosted the effectiveness of this rebalancing channel. The FLS, which involves the creation of more UK Treasury bills, could have similar portfolio rebalancing effects if banks using the Scheme buy back, or issue less, longer-term debt.

Chart 1.2 Selected ten-year government bond yields(a)



Source: Bloomberg.

(a) Yields to maturity on ten-year benchmark government bonds.

Euro-area government bonds

Continuing the trend started last summer, euro-area periphery sovereign debt yields have fallen further since the November *Report* (**Chart 1.2**), as the perceived risk of holding those assets receded. Stronger-than-expected investor demand at several euro-area periphery sovereign bond auctions in January provided further evidence of the improved risk outlook.

That said, euro-area periphery sovereign bond yields remain elevated relative to those on German government bonds (**Chart 1.2**). That reflects continuing concerns about the indebtedness and competitiveness of those countries (Section 2) — problems that the ECB's potential purchases of short-term sovereign debt are not able to solve. Indeed, yields on both Spanish and Italian bonds picked up a little in the

(1) For details see www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.
(2) The portfolio rebalancing effects of quantitative easing are discussed in more detail in Joyce, M, Tong, M and Woods, R (2011), 'The United Kingdom's quantitative easing policy: design, operation and impact', *Bank of England Quarterly Bulletin*, Vol. 51, No. 3, pages 200–12.

Chart 1.3 Sterling exchange rates

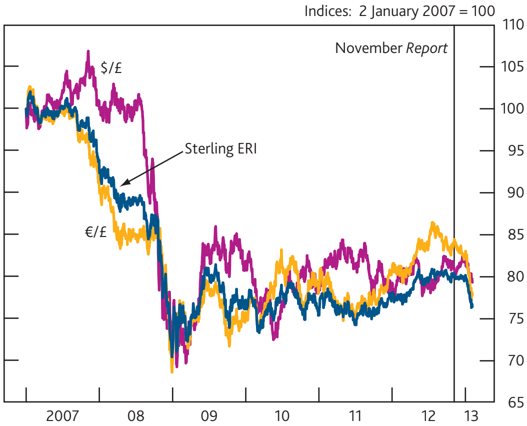
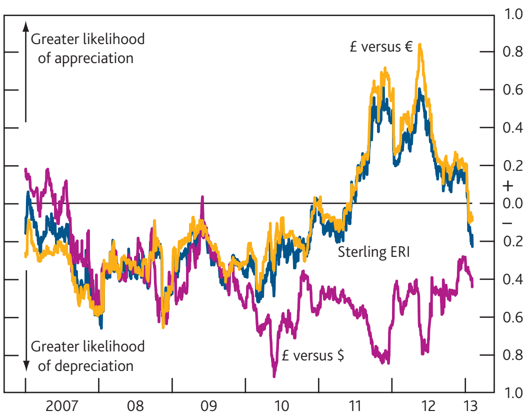


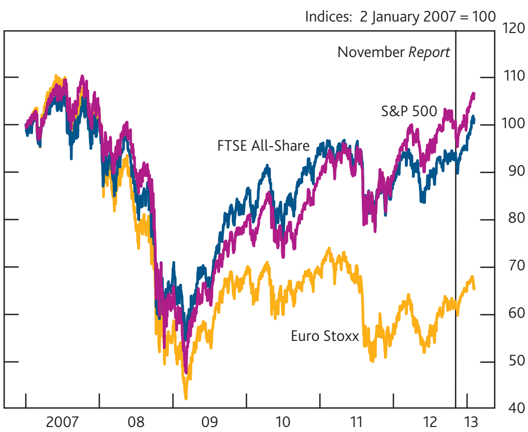
Chart 1.4 Option-implied asymmetries for selected exchange rates(a)



Sources: Bloomberg, British Bankers' Association and Bank calculations.

(a) Three-month measure. Option-implied asymmetries are measured by the skewness of the distribution of three-month foreign exchange returns implied by options price data. Returns are defined as the logarithmic difference between current forward rates and the spot rate.

Chart 1.5 International equity prices(a)



Source: Thomson Reuters Datastream.

(a) In local currency terms.

weeks immediately prior to the February *Report*, reflecting renewed political uncertainty in those countries.

UK government bonds

Ten-year gilt yields have risen by around 20 basis points since the November *Report*, although they remain close to historic lows (**Chart 1.2**). Some of the recent rise is likely to reflect the further reduction in investor risk perceptions; gilts are generally viewed as safe-haven assets, and so become relatively less attractive to investors when risks lessen. Market contacts also report that investors are beginning to focus on the prospects of a UK credit rating downgrade, and that this possibility is already reflected in gilt prices to an extent.

Gilt yields were not materially affected by the UK Government announcement regarding the transfer of coupon payments from the Bank's Asset Purchase Facility (APF) on 9 November 2012, or by the details of planned debt issuance released on 5 December as part of the Government's Autumn Statement.[1] The Autumn Statement did, however, contain news of a Government consultation covering pension fund deficit calculations, which investors interpreted as likely to reduce pension companies' demand for longer-term gilts. Following this news, yields on gilts with maturities longer than ten years rose by around 10 basis points.

On 10 January, the National Statistician announced the outcome of a consultation on options for improving the retail prices index. Uncertainty about the outcome of this affected the decomposition of nominal gilt yields into real and breakeven inflation components (Section 4).

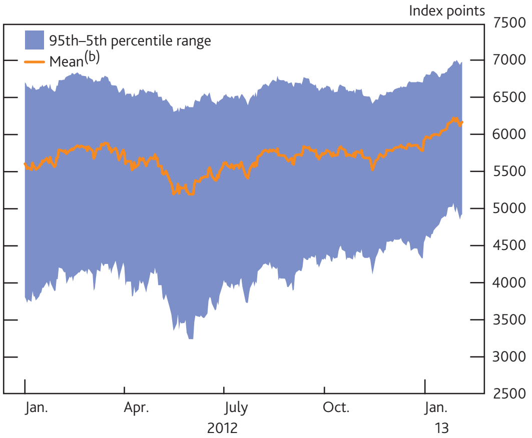
Exchange rates

The sterling effective exchange rate was 3.3% lower in the run-up to the February *Report* than was the case three months earlier (**Chart 1.3**). The move primarily reflected a fall against the euro, and was probably largely related to the perceived amelioration of near-term risks in the euro area and elsewhere. Since January, however, sterling has also depreciated against a broader range of currencies, with financial market participants citing sterling-specific explanations, such as weaker-than-expected data on UK growth. Nevertheless, the sterling ERI remains around 1% higher than its 2011 average.

Information derived from option prices suggests that investors' views on the outlook for sterling have shifted materially since the turn of the year, and that, relative to the recent past, they place more weight on the possibility of a further depreciation than on an appreciation (**Chart 1.4**).

(1) For details on changes to APF cash management arrangements see www.hm-treasury.gov.uk/press_109_12.htm. For the Chancellor's Autumn Statement see www.hm-treasury.gov.uk/as2012_index.htm.

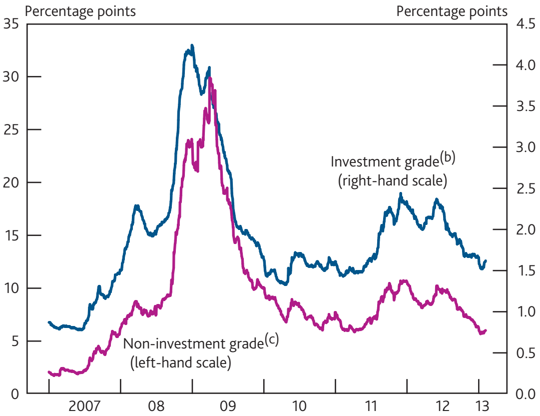
Chart 1.6 Option-implied distributions for the FTSE 100 index(a)



Sources: Bloomberg, NYSE Euronext and Bank calculations.

(a) Six-month measure.
(b) Six-month futures price.

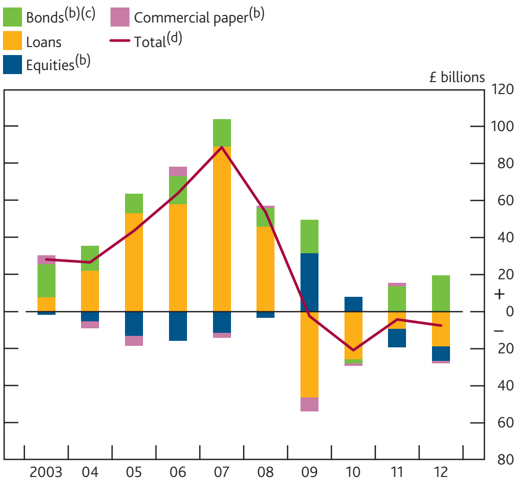
Chart 1.7 Non-financial companies' sterling corporate bond spreads(a)



Source: Bank of America Merrill Lynch.

(a) Excludes utility companies. Option-adjusted spreads over equivalent-maturity government bonds.
(b) Aggregate index of bonds with a composite rating of BBB3 or higher.
(c) Aggregate index of bonds with a composite rating lower than BBB3.

Chart 1.8 PNFCs' net external finance raised(a)



(a) Includes sterling and foreign currency funds.
(b) Non seasonally adjusted.
(c) Includes stand-alone and programme bonds.
(d) The total may not equal the sum of its components as some components are non seasonally adjusted.

Equities and corporate bonds

Equity prices have risen markedly since the November *Report*, continuing the broad upward trend since June 2012 (**Chart 1.5**). Much of the rise since the summer appears to reflect greater investor willingness to hold risky assets, supported by policy, rather than a revision to earnings forecasts. Although it remains higher than before the crisis, the compensation investors require to take equity risk — the equity risk premium — therefore appears to have fallen. This is corroborated by information from equity options prices. The lower tail of the option-implied distribution of equity prices has risen across major indices, which suggests that the value that investors place on insuring themselves against large price falls has declined (**Chart 1.6**).

The evolution in investor attitudes to risk over recent months is also evident in other financial markets, including the corporate bond market. Since the November *Report*, non-financial corporate bond spreads have continued to fall (**Chart 1.7**). Meanwhile, the Bank's Corporate Bond Secondary Market Scheme has been a net seller of bonds, another indication of strong investor demand.[1] Lower bond spreads are likely to have encouraged companies to issue more debt. In net terms (that is, taking account of debt being repaid), corporates issued more debt in 2012 than they had in any year since 2003 (**Chart 1.8**). Total net external finance raised by companies was negative in 2012, however, as the rise in bond issuance was more than offset by net repayments of equity and bank loans (Section 1.3).

1.3 The banking sector and credit conditions

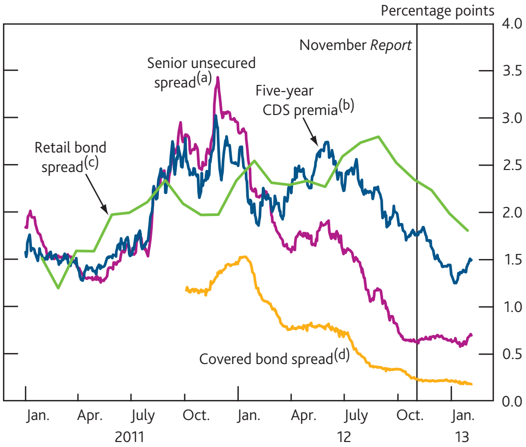
The cost and availability of bank credit depends, in part, on conditions in bank funding markets. The FLS, together with the general improvement in financial markets, has led to lower bank funding costs since the summer. But the key issue remains the extent to which these falls feed through to private sector credit conditions and support credit growth.

Operation of the FLS

The FLS provides a cheap source of funding for participating banks and provides incentives for them to increase net lending to the UK real economy.[2] As at 4 February, 39 lenders had signed up to the Scheme, covering just over 80% of the stock of loans to the real economy. Lenders have also started to access the Scheme: as at 30 September 2012, £4.4 billion had been drawn. Based on conversations with FLS participants — and as expected given the early stage in the Scheme's operation — this figure represents a small fraction of the likely eventual usage.

(1) For details on the Bank's Corporate Bond Secondary Market Scheme see www.bankofengland.co.uk/markets/Pages/apf/corporatebond/default.aspx.
(2) For a detailed description of how the Scheme works and how it aims to provide additional stimulus to the economy, see Churm, R, Leake, J, Radia, A, Srinivasan, S and Whisker, R (2012), 'The Funding for Lending Scheme', *Bank of England Quarterly Bulletin*, Vol. 52, No. 4, pages 306–20.

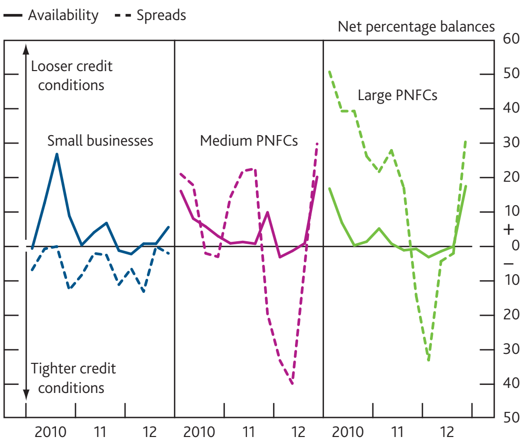
Chart 1.9 UK banks' indicative longer-term funding spreads



Sources: Bank of England, Bloomberg, Markit Group Limited and Bank calculations.

(a) The data show a simple average of the spread between euro-denominated senior unsecured bonds and equivalent-maturity swap rates for a selected bond issued by each of the major UK lenders. The selected bonds have residual maturities of between two and six years.
(b) The data show a simple average of the five-year CDS premia of major UK lenders.
(c) Sterling only. Spread over the three-year swap rate. The three-year retail bond rate is a weighted average of rates from banks and building societies within the Bank of England's normal quoted rate sample with products meeting the specific criteria (see www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/household_int.aspx).
(d) The data show a simple average of the spread between euro-denominated covered bonds and equivalent-maturity swap rates for a selected bond issued by each of the major UK lenders. The selected bonds have residual maturities of between three and seven years.

Chart 1.10 *Credit Conditions Survey*: changes in corporate credit availability and spreads by size(a)



(a) Weighted responses of lenders. A positive (negative) balance indicates that more (less) credit was available or that spreads over reference rates had fallen (risen) over the past three months.

Table 1.A *Deloitte CFO Survey*: views on credit

Net percentage balances

	Averages		2012			
	2010	2011	Q1	Q2	Q3	Q4
Attractiveness of bank borrowing(a)	23	36	25	30	35	41
Attractiveness of corporate bonds(a)	40	46	41	38	56	72
Expected demand for credit over the next year(b)	23	25	19	13	13	28
Overall availability of new credit(c)	1	15	18	-3	20	32
Overall cost of new credit(d)	-33	-10	-5	6	12	43

Source: Deloitte.

(a) Percentage of respondents who thought that the source of funding was attractive less the percentage who thought that it was unattractive.
(b) Percentage of respondents who expected their demand for credit to increase less the percentage who expected it to decrease.
(c) Percentage of respondents who thought that credit was available less the percentage who thought that it was unavailable.
(d) Percentage of respondents who thought that credit was not costly less the percentage who thought that it was costly.

According to 2012 Q3 data, FLS members had, in aggregate increased net lending by £0.5 billion. But it will take time for the Scheme to feed through into material increases in lending. As an aim of the Scheme is to encourage lenders to extend more loans than they otherwise would have done, and given that some banks had planned to reduce lending, the absolute flow of lending is not in itself a good indicator of the effectiveness of the Scheme (see the box on pages 14–15 of the August 2012 *Report*). That said, it is anticipated that the Scheme, together with the more general improvement in financial market conditions, will have a more material impact on lending through the first half of this year. And overall, as summarised in the box on page 17, the Scheme's impact to date has been largely as anticipated by the MPC at the time of the November *Report*, although credit conditions have improved less quickly than anticipated in August when the FLS started.

The rest of this subsection considers bank funding costs and credit conditions for households and businesses.

Bank funding conditions

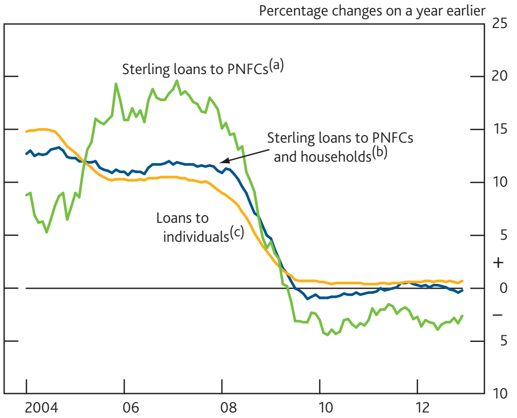
Some indicative measures of UK banks' funding spreads have fallen further since the November *Report* (**Chart 1.9**). Credit default swap (CDS) premia — a proxy for the credit risk component of bank funding costs — fell. Having fallen materially since the start of 2012, senior unsecured and covered bond spreads flattened off. The reduction in long-term retail deposit rates is a by-product of these more favourable bank funding conditions.

According to market contacts, one factor reducing funding costs in public markets is the limited supply of UK bank debt, relative to investor demand. And many lenders say that they plan to issue less public market debt this year than in 2012. In part, the anticipated lower bank issuance reflects some lenders reducing the size of their balance sheets and increasing their reliance on retail funding. But it also reflects banks planning to use the FLS to meet a portion of their funding needs. The extent to which FLS funding is cheaper than other sources of funds varies by bank, however, and has fallen over recent months as market funding costs have come down.

Funding costs are a key influence on the supply of bank credit. But credit supply is also affected by the quality of banks' assets and the size of their balance sheets relative to their capital. At its November meeting, the Bank's Financial Policy Committee (FPC) recommended that the Financial Services Authority takes action to ensure that the capital positions of UK banks and building societies are prudently stated and, where necessary, to ensure that firms either raise capital or else restructure their balance sheets in ways that do not hinder lending to the real economy.(1)

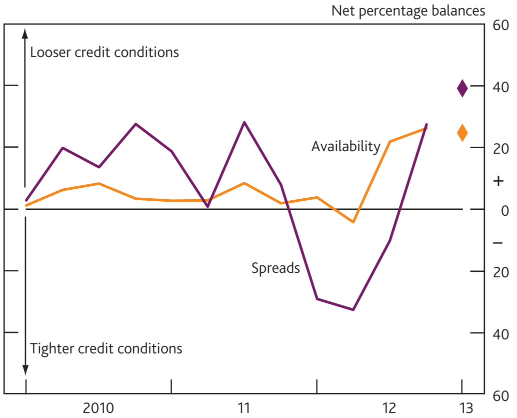
(1) For more details on the FPC's recommendation, see the November 2012 *Financial Stability Report*.

Chart 1.11 Loans to PNFCs and households



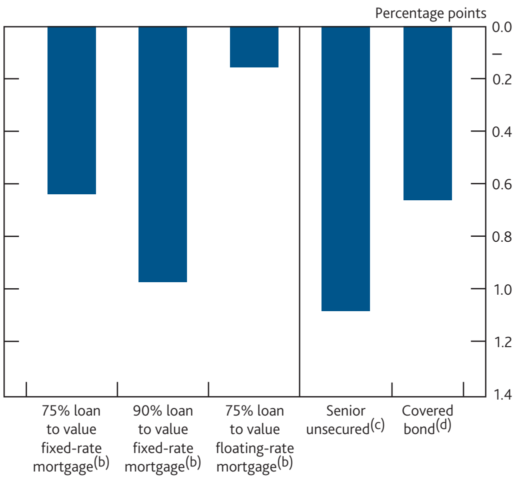
(a) M4 loans excluding the effects of securitisations and loan transfers.
(b) Sterling loans by UK-resident monetary financial institutions (MFIs) and related specialist mortgage lenders excluding the effects of securitisations and loan transfers. Funding for Lending Scheme measure. Non seasonally adjusted.
(c) Sterling loans by UK-resident MFIs and other lenders. Excludes student loans.

Chart 1.12 *Credit Conditions Survey*: changes in availability of and spreads on secured loans to households[(a)]



(a) Weighted responses of lenders. Changes over the past three months. A positive balance indicates that more (less) credit was available or that spreads over reference rates had fallen (risen) over the past three months. The diamonds show lenders' expectations for the next three months, reported in the 2012 Q4 survey.

Chart 1.13 Changes in average quoted new mortgage rates and indicative UK bank funding costs since June 2012[(a)]



Sources: Bank of England, Bloomberg and Bank calculations.

(a) Change between 30 June 2012 and 31 January 2013.
(b) Two-year mortgages.
(c) The data show a sum of the five-year swap rate and an indicative average of UK banks' senior unsecured bond spreads as defined in footnote (a) to **Chart 1.9**.
(d) The data show the sum of the five-year swap rate and an indicative average of UK banks' covered bond spreads as defined in footnote (d) to **Chart 1.9**.

On 6 January, the Basel Committee on Banking Supervision announced changes to the Liquidity Coverage Ratio — the international standard governing the quantity and types of assets that banks are required to hold for liquidity insurance purposes. The changes, which included an expanded definition of high-quality liquid assets, and a longer implementation timeline, were seen by market participants as likely to reduce the cost of meeting liquidity requirements. Bank equity prices subsequently rose a little. Depending on how the revisions affect UK liquidity rules, banks are likely to hold fewer liquid assets. This could, at the margin, boost their willingness to lend to the real economy.

Bank lending to companies

There appears to have been some increase in the quantity of credit that banks are willing to supply to businesses, as well as some reduction in the associated loan rates. Evidence from the Bank's 2012 Q4 *Credit Conditions Survey* (*CCS*), together with indications from business surveys, suggests that credit availability has increased for companies of all sizes, albeit by less for small businesses (**Chart 1.10**). This is corroborated by reports from the Bank's Agents for larger businesses, although they note that credit conditions for small businesses were little changed. Responses to the *CCS* also suggested that banks intended to reduce the cost of credit further for medium-sized and large companies in 2013 Q1.

For the increase in credit supply to result in higher lending, demand for bank credit will have to rise. Over recent years, this demand appears to have been, in aggregate, subdued. Since the start of 2009, companies have been shifting their sources of external finance away from bank loans (**Chart 1.8**). And recent reports from the Bank's Agents suggest that some companies continue to pay down bank debt, while the demand for new bank credit among many companies remains muted. According to the latest *Deloitte CFO Survey* of large corporates, demand for credit from external sources is expected to increase somewhat in 2013. But that may not be reflected in bank borrowing: on balance, bond finance was rated as a relatively more attractive source of external finance (**Table 1.A**).

The combination of the tight supply of, and the weak demand for, bank credit was reflected in a continued fall in the stock of bank loans to private non-financial corporations (PNFCs) in the twelve months to December 2012 (**Chart 1.11**). Although likely to remain subdued, the flow of lending to companies may be less weak in 2013 (Section 5).

Bank lending to households and the housing market

Secured credit conditions facing households have also become more favourable since the November *Report*. Lenders reported in the *CCS* that they had increased the availability of household credit in 2012 Q4, and they expected a further improvement in availability in 2013 Q1 (**Chart 1.12**). 2012 Q4

Table 1.B Housing market indicators

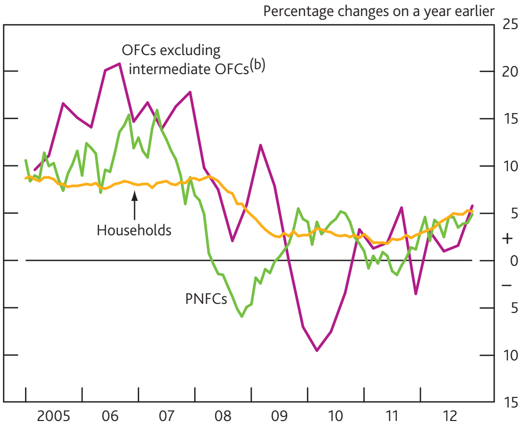
	Averages since 2000[a][b]	2011[a]	2012 H1[a]	2012 Q3[a]	2012 Q4[a]
Activity					
Property transactions (000s)[c]	95	74	78	76	79
Mortgage approvals (000s)[d]	85	49	51	49	54
RICS sales to stocks ratio[e]	0.35	0.21	0.23	0.23	0.24

	Change 2007 Q4–2012 Q4	Average monthly changes 2011	2012 H1	2012 Q3	2012 Q4	2013 Jan.
Prices[f]						
Halifax	-17.9	-0.2	0.3	-0.5	0.8	-0.2
Nationwide	-11.2	0.1	-0.2	0.0	0.2	0.5

Sources: Bank of England, Halifax, HM Revenue and Customs, Land Registry, Nationwide, ONS, Royal Institution of Chartered Surveyors (RICS) and Bank calculations.

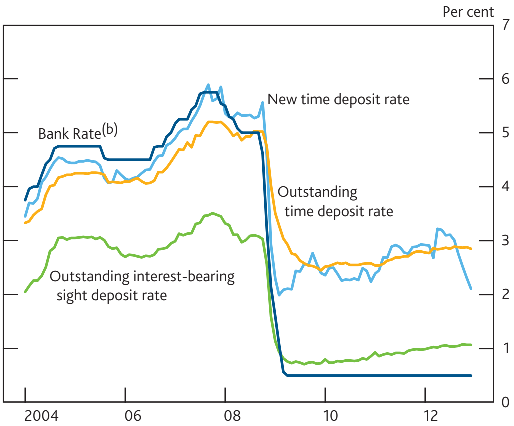
(a) Averages of monthly data.
(b) Except for property transactions, which is an average since April 2005.
(c) Number of residential property transactions with value £40,000 or above.
(d) Loan approvals for house purchase.
(e) Ratio of sales recorded over the past three months to the level of stock on estate agents' books at the end of the month.
(f) Percentage changes.

Chart 1.14 Sectoral broad money[a]



(a) Monthly data unless otherwise specified.
(b) Quarterly data. Intermediate other financial corporations (OFCs) are: mortgage and housing credit corporations; non-bank credit grantors; bank holding companies; securitisation special purpose vehicles; and other activities auxiliary to financial intermediation. In addition to the deposits of these five types of OFCs, sterling deposits arising from transactions between banks or building societies and 'other financial intermediaries' belonging to the same financial group are excluded from this measure of broad money.

Chart 1.15 Household effective deposit interest rates and Bank Rate[a]



(a) Monthly average of UK-resident MFIs' sterling household deposit rates. The Bank's effective interest rate series are compiled using data from 24 UK MFIs.
(b) Monthly average.

CCS responses also indicated that secured credit availability had increased for both high and low loan to value mortgage customers, which should broaden the pool of households with access to credit.

Interest rates on many secured and unsecured loans have continued to fall. For example, average quoted fixed-rate mortgage rates have fallen by between around 65 and 95 basis points since the end of June. But some of the falls have been smaller than the corresponding declines in bank funding costs, particularly for floating mortgage rates, which are only a little lower (**Chart 1.13**). Even absent further falls in funding costs, average quoted household loan rates are likely to fall further. Indeed, respondents to the *CCS* expect to reduce loan spreads in 2013 Q1 (**Chart 1.12**).

Mortgage approvals are one indicator of the response of household credit demand to lower mortgage rates and greater credit availability. As anticipated at the time of the November *Report*, these have picked up, but they remain well below pre-recession levels (**Table 1.B**). Other indicators of housing market activity also remained subdued, though house prices, on average, rose slightly in 2012 Q4. Further rises in mortgage approvals are expected over the coming months and would be in line with the expectation that lower bank funding costs and incentives provided by the FLS will generate stronger net lending in 2013, following several years of stagnation (**Chart 1.11**).

1.4 Money

Four-quarter growth in broad money was higher than in recent years in 2012 Q4, though well below pre-recession rates across all sectors (**Chart 1.14**). Money growth was boosted in 2012 Q3, and to a lesser extent Q4, by the MPC's most recent round of asset purchases, which started in July 2012 and finished at the end of October. Other things equal, aggregate money growth, therefore, could fall back in 2013 Q1.

Household deposits continue to account for the bulk of the recent strength in money growth, although PNFC deposit growth has also increased. The rise in household balances may be a result of the proceeds from past MPC asset purchases feeding into household money. That could occur, for example, as individuals receive, or withdraw, cash from investments with non-bank financial intermediaries, such as retail fund managers.

In recent months, flows into household sight deposits — accounts typically used for transactions purposes — have been a key contributory factor to the strength in household money. This may signal that households intend to increase spending. But the recent fall in the interest rates banks pay on longer-term savings products (**Chart 1.15**) may mean that households view sight and time deposits as closer substitutes than in the past. The near-term outlook for household spending is discussed in Section 2.

Summary of indicators of FLS transmission

The generalised improvement in UK bank funding markets, aided by the Funding for Lending Scheme (FLS), should act to support an improvement in credit conditions. The MPC is monitoring data from a range of sources to help to assess the extent to which conditions are improving (see pages 14–15 of the November *Report*). This box summarises developments in these indicators so far, which suggests that conditions are improving at a similar pace to that envisaged at the time of the November *Report*, although they have improved less quickly than anticipated in August when the FLS started. The box also sets out what these indicators are expected to show as 2013 progresses.

	Recent developments	In line with expectations?	Anticipated as the year progresses, should the Scheme work as expected
Stage 1 Bank funding costs	Continued falls in indicators of bank funding costs — for example, average UK bank five-year CDS premia have fallen by 35 basis points since the November *Report*, and by around 90 basis points since the end of June (**Chart 1.9**).	Broadly in line.	Bank funding costs are expected to drift down a little further in 2013. In the event of any deterioration in public funding market conditions, the FLS should act as an effective backstop.
Stage 2 Quoted terms and credit availability	Evidence of lower spreads on loans to larger corporates and better credit availability (**Chart 1.10**); improvements less marked for small businesses. Average quoted two-year fixed-rate mortgage rates down between around 40 and 90 basis points since early November, and between around 65 and 95 basis points since end-June (**Chart 1.13**). Quoted floating mortgage rates little changed. Increase in secured credit availability for high and low loan to value borrowers in the *Credit Conditions Survey*.	Broadly in line.	Further reductions in household and corporate loan rates are expected. Lenders expect lower spreads and greater availability in Q1 for both households and larger companies, according to the *Credit Conditions Survey*.
Stage 3 Loan applications and approvals	Business surveys suggest a modest increase in large companies' appetite for borrowing (**Table 1.A**); little sign of small companies' applications rising. The Bank's Agents report that demand for bank borrowing remains muted. Mortgage approvals rose in Q4 (**Table 1.B**).	Broadly in line, although approvals rose a little more than expected.	Business survey evidence that small and medium-sized enterprises are more willing to apply for and are able to get loans. Rise in mortgage approvals to continue.
Stage 4 The flow of credit and effective rates	Lending to businesses and households remains weak (**Chart 1.11**).	Too soon to say.	Expect to see gradual improvement through the first half of this year.