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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 7 AND 8 MARCH 2012

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These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 March 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1203.aspx>

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 to be held on 4 and 5 April will be published on 18 April 2012.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 MARCH 2012**

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

### **Financial markets**

2 The significant improvement in market sentiment since the European Central Bank's first long-term refinancing operation (LTRO) in December had been maintained and further supported by the second LTRO on 29 February. A total of over €1 trillion had been lent in the two operations, with a net injection of around €500 billion after taking account of maturing funding. It seemed likely that European banks, including UK banks, had been able to achieve a significant proportion of their near-term funding needs through market issuance and the LTROs. While spreads on the senior unsecured debt of UK banks had fallen sharply in January, they had not fallen much further over the past month and remained elevated compared to the first half of 2011, reflecting the longer-term challenges and risks that remained.

3 The net increase in market liquidity generated by the LTROs had continued to support short-term bank funding markets in the euro area. The cost of borrowing dollars against euros in forward foreign exchange markets and euro Libor rates had both fallen further, and market intelligence had suggested some marginal improvement in lending by US investors to European entities. UK short-term interest rates had changed little on the month.

4 There had been some further divergence in government bond yields over the month. The spreads between Spanish and Italian government bond yields and those on German bunds had narrowed further, which had been associated in part with increased holdings of domestic government debt by Spanish and Italian banks. But yields on Portuguese government debt had remained very high. And

yields quoted on Greek government debt had risen markedly after it had been downgraded to ‘selective default’ by Standard & Poor’s.

5 The overall level of yields on UK government bonds had been broadly unchanged on the month and remained at very low levels, although there had been some slight steepening in the curve. In particular, yields had fallen at shorter maturities and risen at longer maturities by 5-15 basis points after the Asset Purchase Facility gilt purchase announcements in February. These had included an operational change implying a shift in the proportions of gilts purchased at different maturities. The slight steepening in the yield curve had persisted and provided evidence that yields were influenced by the amounts of gilts of different maturities outstanding in the market. Gilt-OIS spreads had continued to decline, particularly at maturities of less than ten years.

6 Major international equity indices had continued to rise over the course of the month, but had fallen back in early March as markets became nervous about the willingness of investors to participate in Private Sector Involvement (PSI) as part of the Greek debt swap programme. Corporate bond spreads had continued to fall and UK non-financial corporate bond issuance had remained robust.

7 The sterling effective exchange rate had continued to move within a narrow corridor and had been broadly unchanged on the month.

### **The international economy**

8 The recent near-term activity indicators had developed broadly as expected and continued to point to a gradual recovery in global growth. JPMorgan’s global composite Purchasing Managers’ Index (PMI) had risen further, though the implied pattern of activity was more geographically diverse than in earlier months.

9 In the euro area, GDP had fallen by 0.3% in the fourth quarter of 2011, unrevised from the first estimate. There was significant cross-country diversity in growth across the euro area, with output growing in France, contracting slightly in Germany and falling more substantially in Italy and Portugal. GDP in Greece had contracted by 7% in the four quarters to the end of 2011. The February PMIs pointed to a smaller contraction in euro-area output in the first quarter and continued

cross-country diversity. A range of sentiment indicators for the German economy had picked up since the autumn and were consistent with a resumption of modest growth in the first quarter.

10 In the United States, the second estimate of GDP growth in the fourth quarter of 2011 had been 0.7%, unchanged from the first release. Taken together, the manufacturing and non-manufacturing ISM activity indicators for February 2012 were consistent with continued growth in the first quarter, though other indicators suggested that this might be weaker than at the end of 2011. Perhaps more significantly, official estimates of growth in real personal disposable income in the second half of 2011 had been revised up, suggesting a firmer foundation for the observed pickup in consumption spending. There had also been signs of an improvement in the labour market. Falling unemployment through much of 2011 had been accounted for mainly by falls in the participation rate, but more recently employment had picked up: non-farm payrolls had increased by 243,000 in January.

11 The first estimate of Japanese GDP was for a fall of 0.6% in the fourth quarter, driven largely by weakness in net trade and stockbuilding. While this had been weaker than expected, such early estimates were prone to revision. Elsewhere in Asia, it had been difficult to interpret the signal from data releases around the time of the Chinese lunar new year, though the PMI surveys for February still pointed to expansion in the first quarter, with the Chinese manufacturing PMIs picking up for the third consecutive month.

12 The major development during the month had been the sharp increase in crude oil prices. The price of Brent crude oil had increased by around 12% since the end of January and had largely reversed the decline in prices since the previous peak in April 2011. It seemed likely that the renewed strength in oil prices on the month had been primarily driven by supply factors, including the phased EU embargo on imports of Iranian oil. By contrast with some previous episodes, the increase on the month had taken place against the backdrop of relatively little upside news for global activity, which pointed to only a limited role for global demand. That was corroborated by the fact that metals prices had not risen. Moreover, the oil futures curve had become more strongly downward sloping, consistent with a heightened risk of temporary supply disruption. But from a longer perspective, the improved outlook for global activity could also have contributed to the rise in prices. That was consistent with the more general firming in commodity prices since early October.

## Money, credit, demand and output

13 According to the second ONS estimate, GDP had fallen by 0.2% in the fourth quarter of 2011, unchanged from the first estimate. The initial estimates of the expenditure components had suggested that the contraction in the fourth quarter had been driven by a sharp fall in business investment and lower stockbuilding, consistent with the unwinding of unusually strong stockbuilding earlier in the year. Consumption was estimated to have risen by 0.4% in the fourth quarter, the first increase for over a year. Net trade volumes had also increased.

14 GDP growth over 2011 as a whole was currently estimated to have been 0.8%, towards the bottom end of the forecast distribution in the February 2011 *Inflation Report*; excluding oil and gas, growth was somewhat stronger at 1.1%. The main expenditure counterpart to the unexpected weakness in GDP growth had been a 0.6% contraction in household consumption over the course of the year. The source of the weakness in consumption had not been real incomes, which had evolved broadly as expected, but the saving ratio, which had not fallen as had been anticipated. One possible explanation for the flattening off in the saving ratio was that households had responded only gradually to the very sharp squeeze in real incomes around the end of 2010 and beginning of 2011 and that the adjustment had been spread out subsequently. But saving might also have been higher because households had become concerned that they were not saving adequately for retirement in view of prospective changes to the state pension age or because of changes in the income distribution, including the effects of a squeeze on the earnings of young people. These factors suggested that consumption would continue to be weak in 2012 with households responding only gradually to the anticipated pickup in real income growth. By contrast, if higher household saving had been a reaction to greater uncertainty in the second half of 2011, consumption might pick up more sharply if confidence improved.

15 Business investment had also surprised to the downside in 2011, in large part due to an estimated contraction of over 5% in the final quarter. The fall in overall business investment may have constituted a reaction by companies to persistently weak demand and greater uncertainty in the second half of 2011. Given the strength and liquidity of many companies' balance sheets, business investment could pick up sharply once these factors dissipated. Moreover, the fall in investment in the fourth quarter of 2011 was not broadly based and so might prove to have been erratic.

16 Early indicators of consumer spending at the beginning of the year were mixed. Retail sales had risen by 0.9% in January and by 1.3% in the latest three months. But other indicators had been less positive. Consumer confidence had remained weak. And the latest *CBI Distributive Trades Survey* had reported that retail sales volumes were broadly flat in the year to February, although this represented a sharper improvement on January than retailers had anticipated.

17 The CIPS/Markit activity indices for both services and manufacturing had fallen back in February, but remained consistent with a resumption of growth in the first quarter of 2012. In line with the usual pre-release arrangements, the Governor informed the Committee that industrial production had fallen by 0.4% in January, broadly in line with expectations, driven largely by a fall of 1.5% in the output of the energy sector. Manufacturing output had risen by 0.1% in January.

18 Money growth had picked up strongly in January following the sharp slowdown at the end of 2011. The seasonally adjusted flow into M4 excluding intermediate OFCs in January was £29 billion, considerably stronger than the December outflow of £11.7 billion. This turnaround was consistent with an unwinding of exceptional year-end balance sheet effects, mainly affecting the deposits of securities dealers. Accordingly, the three-month annualised growth rate had risen to 4.2%.

19 While the improvement in bank funding markets at the turn of the year had been sustained, the cost of raising retail and wholesale deposits remained high for most UK lenders following the strains in bank funding markets during the second half of 2011. This was continuing to feed through into increases in the cost of credit for some borrowers. Hitherto, this had mainly affected the cost of borrowing for those renewing or taking out new loans. But, more recently, some lenders had increased the cost of mortgage borrowing for some existing customers by raising their Standard Variable Rate. It was estimated that announced increases of up to 50 basis points would affect around a million mortgage borrowers from the beginning of May. In itself, this would have a limited impact on aggregate household cash flows and spending, but it was indicative of the continuing pass-through of high bank funding costs to their customers.

20 There had been some signs of a pickup in housing market activity despite the increase in mortgage rates. Mortgage approvals had increased strongly in January, and were up nearly 30% on a year earlier. And HMRC property transactions had been almost 20% higher in January than a year earlier. Part of this increase in housing transactions might be attributable to purchases by first-time

buyers being brought forward ahead of the expiry of the temporary stamp duty exemption in March. But there was also evidence of strength in demand from cash buyers and buy-to-let investors. That suggested that some of the pickup in housing market activity might be sustained.

### **Supply, costs and prices**

21 Twelve-month CPI inflation had fallen to 3.6% in January, down from its recent peak of 5.2% in September. This decline had largely matched the Committee's expectation, including the effect of the previous year's rise in the standard rate of VAT dropping out of the twelve-month comparison. Some further fall in twelve-month CPI inflation was expected over the coming months, reflecting a reduced contribution to inflation from energy prices and any remaining effect of the previous year's VAT increase.

22 In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 2.1% in February. That increase had mainly reflected higher crude oil prices. Producer output prices had increased by 0.6% in February.

23 While the recent fall in CPI inflation had been much as expected, the extent of any further decline was less certain. The Bank of England/GfK NOP survey in February suggested that expectations for inflation one, two and five years ahead had fallen since the previous survey in November. But seasonally adjusted annualised monthly inflation rates had remained somewhat higher than the inflation target. A fall in domestically generated inflation would probably be needed for CPI inflation to decline in line with the Committee's own central projection contained in the February *Inflation Report*.

24 The level of domestically generated inflation was likely to depend, in part, on the degree of spare capacity in the labour market and how effective that was in putting downward pressure on wage costs. The LFS unemployment rate had risen to 8.4% in the final quarter of 2011, broadly as expected, but significantly above the average of around 5½% seen over the decade prior to the recession. That suggested a significant degree of spare capacity in the labour market. But other indicators suggested that there might be less spare capacity. Since the second quarter of 2011, the number of vacancies had

been broadly stable while unemployment had increased, suggesting that the unemployed were less able to fill those vacancies. There had also been some survey evidence suggesting a pickup in recruitment difficulties.

25 It was not clear which indicator of the degree of slack in the labour market provided the best guide to future wage costs. According to the average weekly earnings measure, total pay had increased by 2% in the fourth quarter of 2011 compared with a year earlier. There were some early indications that private sector wage settlements had picked up at the beginning of the year.

26 Recent trends in employment had also been difficult to read. After surprisingly strong growth in the first half of 2011, private sector employment fell sharply in the third quarter before apparently picking up in the fourth quarter. Total employment had risen by 60,000 in the three months to December by comparison with the previous three months. Recent employment surveys had been mixed and generally pointed to small falls in employment in the near term, although the REC/Markit survey had suggested that overall demand for staff rose in February at the fastest pace in four months.

### **The immediate policy decision**

27 The Committee set monetary policy in order to meet the inflation target in the medium term. Twelve-month CPI inflation had fallen to 3.6% in January from a recent peak of 5.2% in September. This decline had largely matched the Committee's expectation, including the effect of the previous year's rise in the standard rate of VAT dropping out of the twelve-month comparison. While the decline in inflation in January had been as expected, there was less certainty about the extent and pace at which inflation would fall subsequently. The Committee's central view was that inflation would fall further as the contributions of energy and import prices continued to wane and as spare capacity weighed on wages and prices.

28 The Committee discussed how the risks to the medium-term outlook had evolved since its previous meeting. Just as CPI inflation had fallen broadly in line with expectations, so the Committee was of the view that much of the other new information during the month had tended to confirm a picture of moderate underlying growth, consistent with the central case of the Committee's projections set out in the February *Inflation Report*. But substantial risks to the medium-term inflation outlook remained.

29 A clear risk surrounded the outlook for crude oil prices. The increase on the month appeared to have been driven primarily by fears of future disruption to the supply of oil. Any worsening of the underlying tensions in the Middle East could have significant implications for future oil prices. And with an underlying upward trend in global demand, the risks might be more to the upside than suggested by the oil price futures curve which was used as a guide in constructing the Committee's inflation projections. If oil prices were to rise to a level significantly higher than the Committee currently assumed, then that would tend to slow the global and domestic recovery, reduce supply growth, and put upward pressure on domestic costs and prices. The magnitude of the impact on CPI inflation would depend on the balance of these opposing effects, their interaction with other developments in the economy, such as the amount of spare capacity and the extent of deleveraging, and the policy response both at home and abroad.

30 There were other risks that meant that inflation might fail to fall back as the Committee expected. In the domestic economy, labour market slack had helped ensure that earnings growth had been relatively subdued. But there was a risk that this might be a less powerful restraining force in the future, especially if another round of energy price rises were to materialise. There had been some signs of an upward drift in pay settlements which, alongside continued uncertainty about the outlook for productivity, could indicate some upward pressure on unit labour costs in the future.

31 On the downside, there were significant risks to economic activity that might result in inflation falling materially below the target in the medium term. While it appeared more certain that underlying growth was likely to pick up in the United Kingdom in the near term, many of the risks to the outlook were still present. In particular, concerns remained about the indebtedness and competitiveness of some euro-area countries. The ECB's two LTROs had helped improve financial market sentiment and relieve the near-term funding pressures facing European banks, but funding costs remained elevated for many lenders and these had begun to feed through into higher borrowing costs for UK households and businesses, including to existing mortgage borrowers. The prospect of higher borrowing costs, as well as the risk of higher energy prices, might make households less confident about the outlook for real incomes and so result in higher saving rather than a pickup in spending. It was also possible that higher household saving was a reaction to forthcoming changes in the state pension age or a shift in the income distribution, and so could be more enduring. If consumer demand were to weaken further, then there was a risk that the expected recovery in business investment spending might also be further delayed.

32 The Committee had expanded its programme of asset purchases in February, which would take a further two months to complete. Although the Committee was monitoring the impact of the continuing purchases on financial markets and the wider economy, there was no compelling evidence that the impact on nominal demand would be materially different from the first round of asset purchases. Gilt-OIS spreads had continued to decline, particularly at maturities below ten years, while spreads on sterling corporate bonds relative to gilt yields had fallen and UK equity prices had risen significantly since October.

33 Overall, the Committee judged that the recent data had evolved in line with its expectations and that there had been little change to the balance of risks to UK activity and inflation. Most members saw no reason to change either Bank Rate or the quantity of asset purchases agreed at the Committee's previous meeting. Two members continued to think that a larger monetary stimulus was warranted to reduce the risk that persistently weak growth would damage the future supply capacity of the economy. In their view, policy should be loosened further to stimulate demand quickly, but the stimulus could then be withdrawn were it to become clear that there was a significant risk of inflation rising above target in the medium term.

34 The Governor invited the Committee to vote on the propositions that:

Bank Rate should be maintained at 0.5%;

The Bank of England should continue with the programme of asset purchases totalling £325 billion financed by the issuance of central bank reserves.

Regarding Bank Rate, the Committee voted unanimously in favour of the proposition.

Regarding the stock of asset purchases, seven members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher and Martin Weale) voted in favour of the proposition. Two members of the Committee (David Miles and Adam Posen) voted against, preferring to increase the size of the asset purchase programme by a further £25 billion to a total of £350 billion.

The following members of the Committee were present:

Mervyn King, Governor

Charles Bean, Deputy Governor responsible for monetary policy

Paul Tucker, Deputy Governor responsible for financial stability

Ben Broadbent

Spencer Dale

Paul Fisher

David Miles

Adam Posen

Martin Weale

Dave Ramsden was present as the Treasury representative.