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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 5 AND 6 DECEMBER 2012

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 December 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1212.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 9 and 10 January will be published on 23 January 2013.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5 AND 6 DECEMBER 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 Financial markets had been relatively stable over the month. The tone from market contacts had been of a further improvement in sentiment and cautious near-term optimism, albeit against a background of subdued trading volumes and concerns that significant risks remained, particularly related to some euro-area countries.

3 Global equity indices had fallen early in the month, in part reflecting concerns about the implications of the results of the US election for negotiations over the programmed fiscal contraction due to take place in 2013. But they had subsequently risen, as optimism increased that negotiations to resolve the issue would be successful, and in the context of the announcement by the EU authorities and the International Monetary Fund of a further package of support for Greece. Peripheral euro-area sovereign bond yields, relative to those of comparable German government bonds, had fallen on the month.

4 UK government bond yields had been broadly unchanged on the month. Respondents to the Reuters survey of economists had revised down their expectations that the Committee's asset purchase programme would be expanded further at some stage. Expectations of a cut in Bank Rate had also diminished again. Sterling's effective exchange rate had depreciated a little on the month, but remained near the top of the range it had occupied over the past couple of years.

5 In bank funding markets, short-term Libor-OIS spreads had stabilised at close to pre-crisis levels in the United Kingdom and abroad. Measures of longer-term bank funding costs had been relatively stable on the month, but had fallen considerably since the policy announcements in the euro area and the United Kingdom in the summer. Banks, including those from Italy, Spain, Ireland and Portugal,

had continued to take advantage of the improvement in market conditions to issue more term debt. Issuance of bank debt capital instruments had been particularly strong since the summer, initially by continental European banks and more recently by a number of UK banks.

6 There had been little change in investment grade non-financial corporate bond spreads over risk-free rates, and the yields on these bonds had remained at historically low levels. Spreads of European non-investment grade bonds over risk-free rates had fallen further, and the primary markets for issuance had remained open, including for companies in peripheral euro-area countries that had been effectively unable to issue earlier in the year before the ECB's announcement of its prospective programme of Outright Monetary Transactions (OMTs). In the United Kingdom, non-financial corporate bond issuance had been very strong in 2012; but, in aggregate, corporate bond issuance had been offset by net repayments of bank debt and, to a lesser extent, equity buy-backs.

The international economy

7 The data on the world economy had been mixed, but on balance had been consistent with a stabilisation of global growth, although prospects in the euro area, the United Kingdom's most important trading partner, were more subdued.

8 In the United States, the second estimate of third-quarter GDP had seen it revised up by 0.2 percentage points to 0.7%. The expenditure breakdown had been less reassuring, with stockbuilding having accounted for much of the upward revision. The US manufacturing PMI had fallen in November while the non-manufacturing PMI had risen slightly. Output was likely to be broadly unchanged in the fourth quarter, in part because of the impact of recent storms. Data on the housing market had suggested a continued improvement. Employment gains had been solid in recent months and the unemployment rate had continued to edge down. There had not yet been agreement by the US authorities on a moderation of the programmed fiscal contraction, which might have contributed to caution by businesses and households over major spending decisions.

9 In China, following stabilisation of growth in the third quarter, there had been positive signs in some of the higher frequency data, pointing to stronger growth in the fourth quarter. Alongside this, there had also been a pickup in new export orders in the global manufacturing purchasing managers' index (PMI).

10 In the euro area, GDP had contracted by 0.1% in Q3. Both the manufacturing and services PMIs had picked up a little in November, but they remained at levels consistent with a further contraction in output in the fourth quarter. The improvement in credit conditions following the ECB's announcement of OMTs and other policy actions was likely to take some time to feed through.

11 More generally, recent policy actions announced by the euro-area authorities, including those related to Greece, served mainly to provide time and support for the necessary real adjustments to take place in the periphery countries. There appeared to have been some improvement in competitiveness in several periphery countries, suggesting that some progress had been made in external rebalancing. But some countries had made more progress than others, and the improvements in competitiveness and external balances had to a large extent been achieved at the cost of large rises in unemployment. The process of fiscal consolidation and rebalancing in these economies would need to continue for some time yet, with the consequence that euro-area activity was likely to remain subdued for quite a while.

12 Oil prices had picked up a little on the month, although they remained little changed since the summer. Industrial metals prices had risen, consistent with the slightly more positive outlook for global demand. Prices of agricultural commodities had changed little on the month, but low stock levels meant prices were vulnerable to further shocks.

Money, credit, demand and output

13 The Committee noted the fiscal policy measures announced by the Chancellor in the Autumn Statement. Preliminary analysis had suggested that their impact on the outlook for growth over the Committee's forecast horizon was likely to be small.

14 It remained difficult to gauge the underlying state of the UK economy with precision, given the continuing influence of a number of temporary factors on the output data. In the ONS's second estimate of GDP in the third quarter, growth had been unrevised at 1.0%. It seemed likely that headline GDP growth had embodied a substantial contribution from the combined effects of the bounce-back in activity following the reduction in output associated with the additional Jubilee bank holiday and of a boost to activity from the Olympic Games. The ONS's initial estimates of the expenditure breakdown suggested that household consumption had increased by 0.6% in the third quarter, which had been less than the Committee had expected given the anticipated boost from the Olympic Games. While that might suggest that underlying consumption had been weaker than

previously thought, the initial expenditure breakdowns were often subject to revision. In accordance with the usual pre-release arrangements, the Governor had informed the Committee that industrial production had fallen by 0.8% in October.

15 The major business surveys had been mixed on the month. The Markit/CIPS manufacturing output and orders indices had both risen. In services, the Markit/CIPS activity and business expectations indices had both declined, whereas in the latest CBI service sector survey, business volumes and expectations balances had both picked up. In any case, it was difficult to know how much weight to put on the business surveys at the current juncture, as they had recently been giving a weaker signal than the official output data. The Committee's best judgement was that the outlook was for broadly unchanged underlying output over the turn of the year. Taken together with the unwind of the third-quarter boost to GDP from the Olympic Games, it was quite likely that headline GDP would register a contraction in the fourth quarter.

16 The recovery in activity embedded in the Committee's projections published in the November *Inflation Report* continued to incorporate a rebalancing of demand in the UK economy towards net exports. The nominal trade deficit had, however, widened further in October. And more generally, the extent of external rebalancing over the past two years had disappointed. It seemed that only a portion of the disappointing trade performance had been accounted for by weaker demand growth abroad relative to that in the United Kingdom. Much of the weakness relative to past trends had been concentrated in exports of services, especially of business and financial services in which the United Kingdom tended to specialise. In addition to the relatively weak trade performance, current account data for the first half of the year had shown a deterioration in net investment income from abroad, concentrated in the net income earned on foreign direct investment.

17 Against that background, the gradual appreciation of sterling between mid-2011 and mid-2012, as prospects for the euro area had deteriorated, had been unwelcome. Although the nominal effective exchange rate remained well below its pre-crisis level, some measures of sterling's real exchange rate provided a less comforting view of the improvement in UK competitiveness. In particular, a measure based on relative manufacturing unit labour costs was now only 10% below its level in 2007, and just 5% below its average in the decade prior to the depreciation. It was therefore possible that the real exchange rate consistent with current account balance might be lower than its current value.

18 The Bank had published the first data on use of the Funding for Lending Scheme (FLS), covering the quarter to end-September. The flow of net lending by FLS participants had been £0.5 billion, and total FLS drawdowns from the Bank had been £4.4 billion. There were now 35 groups participating in the FLS, covering just over 80% of the stock of lending to the real economy. It remained too early to assess the impact of the FLS on lending flows, given the lags involved in banks changing their lending strategies and in potential borrowers submitting loan applications. But there were other indicators that might give an early signal of its likely impact. Wholesale and retail bank funding costs had fallen since the summer, when both the FLS and the activation of the Extended Collateral Term Repo (ECTR) facility had been announced, and a number of euro-area policy statements had been made. The dispersion of UK banks' retail funding costs had narrowed since the summer. UK banks had announced lower lending rates for a variety of business loans and household mortgages, although there had been signs of a levelling off in the extent of the reductions in mortgage rates over the past month. Lower bank funding costs and some reduction in lending rates were encouraging indicators for the supply of credit to the economy. A recent survey by the Bank's Agents of firms' investment and research and development intentions had suggested an improvement in spending over the next year.

19 The Committee noted the recommendation made by the Financial Policy Committee (FPC) at its November meeting. The FPC had recommended that the Financial Services Authority (FSA) took action to ensure that the capital of UK banks and building societies reflected a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. Where such action revealed that capital buffers needed to be strengthened to absorb losses and sustain credit availability in the event of stress, the FPC had recommended that the FSA should ensure that firms either raised capital or took steps to restructure their business and balance sheets in ways that did not hinder lending to the real economy. Historical experience in other countries had suggested that more rapid progress in tackling balance sheet problems would support both improved funding conditions and the ability of banks to extend new loans to households and businesses. The FPC's recommendation had been aimed at achieving such an outcome.

Supply, costs and prices

20 At its November meeting, the Committee had been provided with an advance estimate for twelve-month CPI inflation of 2.7% for October, an increase of 0.5 percentage points from September and higher than had been anticipated by the Committee; this had been reflected in the November

Inflation Report. The subsequent data release had confirmed that that had reflected a larger contribution to inflation from university tuition fees than expected, and higher food price inflation.

21 In addition to the continuing impact of higher university tuition fees, a number of domestic utility and other administered and regulated prices were set to raise inflation. These included increases in domestic energy prices that largely reflected rises in costs other than those of wholesale gas, such as distribution costs. A partial offset to these factors pushing up the short-term outlook for CPI inflation had been provided by the cancellation of the fuel duty increase in January, and the postponement until September of the increase that had been scheduled for April, announced by the Chancellor in his Autumn Statement. Taken together, these administered and regulated prices had a weight of only 13% in the CPI basket and yet were likely to contribute around one percentage point to CPI inflation over the next year, and possibly beyond that. To the extent that was the case, other prices in the economy more exposed to market forces, including wages, would need to rise correspondingly less in order to achieve the inflation target.

22 According to the Average Weekly Earnings measure, annual private sector total pay growth had fallen to 1.8% in the three months to September. Viewed over a longer perspective, the annual growth rate of private sector total pay had been broadly stable at around 2% for the past two years. In the context of rising employment and weak output growth, private sector productivity had remained broadly unchanged in the third quarter, and around 3% lower than a year earlier. In consequence, private sector firms' unit wage costs had risen by around 5% over the previous year, compared to a historical average of a little over 2%. The outlook for inflation in the medium term depended on the balance between demand and supply capacity, and on the relationship between demand and productivity. The Committee's central view was that a gentle recovery in output growth would be accompanied by a commensurate increase in productivity, so reducing inflationary pressure from unit wage costs over the forecast horizon.

23 Overall, the near-term outlook for inflation remained in line with the Committee's projections in the November *Inflation Forecast*, with inflation likely to remain a little above target for the next year or so. Short and longer-term expectations of inflation had risen in the latest quarterly Bank of England/GfK NOP Inflation Attitudes Survey in November. The Committee had noted, however, that other survey measures of short-run inflation expectations had fallen and that longer-term inflation expectations had remained within recent ranges.

The immediate policy decision

24 The Committee set monetary policy in order to meet the 2% inflation target in the medium term. The twelve-month rate of CPI inflation had risen to 2.7% in October, which had been higher than the Committee had anticipated, due in large part to a greater-than-expected contribution from university tuition fees, and also from higher food prices.

25 Inflation was likely to remain above the 2% target for the next year or so, owing in part to the continuing impact of the rise in university tuition fees and higher domestic gas and electricity and other administered and regulated prices. There was little that monetary policy could do to influence these prices directly. Even though they made up only 13% of the CPI basket, they looked set to contribute around one percentage point to inflation in the near term; for CPI inflation to be close to the 2% target in that period, the rate of inflation in those sectors influenced more by market pressures would have to be unusually low. In the medium term, the Committee's central expectation remained that inflation would fall back to 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. These included continuing adverse weather disrupting planting in some crop-producing regions, leading to the risk of another poor harvest and higher food prices.

26 The news on UK activity on the month had again been mixed. The Committee's view remained that the stronger-than-expected third-quarter GDP growth had incorporated large positive contributions from temporary factors, and that these would dissipate or, in the case of the boost from the Olympic Games, unwind, probably resulting in a contraction in headline GDP in the fourth quarter. The major business surveys had provided mixed messages, and it remained difficult to know how much weight to put on them as, taken together, they had recently been giving a weaker signal than the official output data. On balance, the surveys, taken in conjunction with the October industrial production data, were consistent with broadly flat underlying output in the near term.

27 The immediate risks emanating from the euro area seemed less pressing than they had in the summer, and financial market sentiment had improved. A period of stability, without negative headlines and unusual market volatility, was likely to be necessary to give businesses and households the confidence to increase spending. Nevertheless, the drag to activity from fiscal consolidation and rebalancing in the periphery was likely to continue into the medium term. Data released during the

month pointed to continuing contraction in the euro area but a stabilisation in global growth. Risks remained, including from the United States where agreement had not been reached on a moderation of the programmed fiscal contraction in 2013. The deterioration in UK competitiveness over the past couple of years represented a potential headwind to the ability of UK exporters to benefit from a pickup in global growth.

28 The Committee noted the decision by the Government to use the gilt coupons transferred from the Asset Purchase Facility (APF) to reduce Treasury bill rather than gilt issuance in the current financial year, although that might be unwound in the subsequent financial year. That decision implied slightly less of an easing in monetary conditions in the very short term than had gilt issuance been reduced this financial year. The Committee agreed that an early understanding of the Government's gilt issuance plans for the 2013/14 financial year would be helpful for its monetary policy decisions.

29 Most members agreed that developments on the month had done little to alter the balance of arguments between maintaining and increasing the size of the monetary stimulus. Growth remained subdued. The impact of the most recent round of asset purchases was still to be fully felt. While it was too soon to assess the effectiveness of the FLS in supporting lending and demand, the early signs of its impact had been encouraging; the next few quarters would bring more information. Although inflation was at 2.7%, and seemed likely to remain above the target for the next year or so, it was judged likely to fall back to the target over the medium term. In the light of all this, the current size of the asset purchase programme seemed appropriate for the present.

30 For one member, the case for undertaking additional asset purchases at this meeting was nonetheless strong. On balance, the near-term outlook for growth seemed a little weaker. Although inflation had risen again, and seemed unlikely to fall very substantially below the 2% target in the medium term, the degree of slack in the economy, and the likely response of supply capacity to increased demand, meant that it would be possible to achieve higher output growth without causing any material inflationary pressure. That would help to avoid potentially lasting destruction of productive capacity and increases in unemployment.

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

Bank Rate should be maintained at 0.5%;

The Bank of England should maintain the stock of asset purchases financed by the issuance of central bank reserves at £375 billion.

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

Regarding the stock of asset purchases, eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher, Ian McCafferty and Martin Weale) voted in favour of the proposition. One member of the Committee (David Miles) voted against the proposition, preferring to increase the size of the asset purchase programme by a further £25 billion to a total of £400 billion.

32 Since the Committee's previous meeting, it had been consulted over the size and terms of the Bank's ECTR facility, in advance of the monthly auction on 21 November.

33 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
Ian McCafferty
David Miles
Martin Weale

Dave Ramsden was present as the Treasury representative.