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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 DECEMBER 2008

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These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 December 2008.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0812.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 to be held on 7 and 8 January will be published on 21 January 2009.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3-4 DECEMBER 2008**

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

### **Financial markets**

2 There had been significant movements in financial market prices over the month and trading conditions had remained difficult, including in money and bond markets. Asset prices which depended on expectations of future growth in the economy had generally fallen and credit spreads had widened. In particular, equity markets had fallen internationally with US, euro area and UK indices all down by around 10% since the November MPC meeting. Implied volatilities had risen across a wide range of financial instruments to historically high levels.

3 Sterling short-term interest rates had fallen significantly, and by more than euro or dollar interest rates, reflecting the larger-than-expected cut of 150 basis points in Bank Rate at the November meeting of the Committee, the weakening outlook for growth and inflation published in the November *Inflation Report* and further weaker-than-expected UK data. Markets had priced in a further cut of 100 basis points at the December meeting. Sterling LIBOR rates at various maturities had declined markedly, although by less than expectations of Bank Rate and so spreads had correspondingly increased, to record highs at some maturities.

4 Longer-term interest rates had also fallen internationally, especially for two or three years ahead. Using index-linked gilts to decompose bond yields into real and nominal components suggested that real rates had risen and break-even inflation rates had fallen sharply at those shorter maturities. The direction of these changes had been consistent with surveys of price expectations and other data relevant to the near-term inflation outlook, but their magnitude had probably been exaggerated by illiquid market conditions.

5 The sterling effective exchange rate index had fallen by over 6% since the November MPC meeting, weakening markedly after the publication of the *Inflation Report*. Despite the movements in very short-term interest rate differentials, relative movements in long-term interest rates had not been consistent with a significant depreciation of sterling.

6 The Committee discussed why market conditions had continued to be so poor, despite the various measures that had been taken by the fiscal and monetary authorities in the major economies. Concerns about banks' credit worthiness had diminished, following government and private sector injections of capital and the introduction of various schemes to guarantee bank funding. But the non-banks that typically lent to the banking sector, including corporate treasuries amongst others, were apparently concerned about their own liquidity positions and were holding more short-term cash rather than lending at term to the banks. Such concerns partly reflected the deterioration in the macroeconomic outlook, which was likely to put pressure on corporate cash flows and the availability of working capital.

7 In addition, a global process of de-leveraging was still taking place in many parts of the financial sector. For example, many hedge funds had lost value during 2008 and were facing calls for significant redemptions of funds. Those funds were likely to be placed back with the banking sector, although frictions in that process meant that it was far from complete. Many banks also needed to de-leverage – reducing the size of their balance sheets and their reliance on wholesale market funding. But the forced re-absorption of off-balance sheet assets, and the drawing of contingent credit facilities by corporates, were pressures in the other direction.

### **The international economy**

8 Data from the international economy had been consistently gloomy. In the United States, a number of indicators had suggested that the slowdown was intensifying. The latest release of the Q3 GDP data had confirmed a small fall in output and the latest monthly data were consistent with a larger fall in the fourth quarter. For example, in October and November, there had been sharp declines in both the manufacturing and non-manufacturing indices in the Institute for Supply Management surveys. The Beige Book, covering the period from mid-October to late November, had also been very downbeat.

9 Monthly figures for US consumption expenditure had fallen for five successive months. There was no sign yet of any turnaround in the US housing market, with a large overhang of unsold homes, house building at a 50-year low and house prices falling. The labour market data for October had shown a large fall in employment.

10 In the euro area, the data on output growth had followed a similar pattern to the United States: Q3 GDP data had recorded a small fall and the Purchasing Managers Indices (PMI) for both manufacturing and non-manufacturing had fallen sharply in October and November, consistent with a larger fall in GDP in the fourth quarter. Credit supply had also appeared to be tightening in the euro area and lending growth to the private sector had slowed.

11 Output growth had also slowed in much of the rest of the world. In China, domestic demand appeared to have remained firm but industrial production growth had continued to weaken. Survey and anecdotal information for the fourth quarter were also quite negative. Japan had recorded negative GDP growth in the second and third quarters of 2008. The Baltic Dry Index, which recorded the cost of shipping dry commodities, had fallen 94% from its peak in May. This was partly due to reduced availability of trade credit.

12 In response to the sudden deterioration in macroeconomic conditions and global financial markets, there had been monetary, fiscal and other policy interventions in many countries. For example, in the United States, there had been new measures to support the markets for securities related to consumer loans and housing. Further fiscal measures were also widely expected in the United States, a number of European countries and some emerging market economies.

13 Overall, international growth forecasts had been subject to considerable downward revisions. Reflecting the weakness in current demand and the global economic outlook, the price of oil had fallen to less than a third of its peak in July. Other commodity prices had also fallen back. The Committee noted that these falls should help to bring down short-term inflationary pressures, although futures prices suggested that not all of these falls would necessarily persist.

## **Money, credit, demand and output**

14 The main business surveys and the reports from the Bank's regional Agents had suggested significant falls in output of both services and manufacturing sectors in the fourth quarter. In particular, both the CIPS/Markit and CBI manufacturing surveys had been very weak. There had also been reports of a significant scaling back of car production in the fourth quarter, which might well continue into 2009. Much of that production would normally be exported to the rest of Europe. The forward-looking orders and expectations balances of the surveys suggested further marked falls in Q1 output, although these indicators had not always been a reliable guide to GDP growth.

15 There had been little news in the available expenditure data for the fourth quarter, although the Agents and business surveys had highlighted downside risks to business and dwellings investment. Retail sales in October had continued to show stronger growth than the surveys of retail spending but car registrations had fallen sharply. Export orders had weakened further. It was possible that the impact of weaker final demand on output was being reinforced by firms' decisions to reduce their levels of stocks. To the extent that the weak output data reflected a stock cycle, it was possible that output growth would recover relatively quickly once the pace of de-stocking slowed. But if a more persistent weakening in demand and output was in train, then the recovery would be somewhat later.

16 A key factor in the outlook for demand growth was the flow of net lending to both the household and the corporate sectors. Although volatile on a monthly basis, the latest data had indicated that the flow of lending to private non-financial companies had risen a little in October. The evidence on trade credit (such as credit insurance or letters of credit) was more downbeat, with the Agents reporting a tightening of conditions for this form of finance in recent months. Those reports had been consistent with discussions with banks and trade credit insurers. The annual growth rate of secured and unsecured lending to individuals had fallen in the October data. That was broadly consistent with the picture of a weak housing market.

17 Nominal broad money growth had reached a very high rate of over 25% in October, on a three-month annualised basis, but this had been distorted upwards by large financial sector flows which were unlikely to be related to spending on goods and services. Once adjusted for such items

as intra-group transfers and retained securitisations, M4 growth was very weak. Within this, the broad money balances of private non-financial companies had continued to contract sharply.

18 The other major domestic demand news on the month had been the Government's *Pre-Budget Report (PBR)*. The bringing forward of capital expenditures, the indexation of personal allowances and basic rate limits and the cut in the standard rate of Value Added Tax (VAT) was likely to be helpful in offsetting some of the downside risks to output growth in the near term. In addition, the Government had revised down its assumptions for effective tax rates over the recent past and its expectations for effective tax rates over the next few years. These lower effective tax rates were likely to be upside news for near-term growth, relative to the assumptions used in the November *Inflation Report* projections. But the size of this effect was uncertain, since it would depend on precisely how the deficit was expected to be reduced in the medium term. The *PBR* proposed spending cuts and tax increases from 2010-2011, which would be likely to dampen growth further out.

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

19 The employment data were available only up to September but the labour market had continued to weaken; unemployment had increased and employment had continued to fall. The Committee noted that labour market data in early 2009 might be a good indicator of whether companies believed that the slowdown in output would be short-lived, in which case they might just reduce working hours, or whether the slowdown would be more persistent, in which case they were more likely to reduce the size of their workforce. Pay growth had remained subdued up to September.

20 Manufacturing input and output price data for October had registered record falls, reflecting falling commodity prices and weakening demand. CPI inflation had also fallen back, from 5.2% to 4.5%. The Committee noted that further significant falls in consumer price inflation were likely in the coming months. Many survey measures of inflation expectations for 2009 had fallen sharply since the previous MPC meeting.

21 In the near term, it was likely that the profile for inflation would be strongly influenced by the impact of the temporary reduction in the standard rate of VAT from 17.5% to 15% for 13 months.

The direct effects might reduce CPI inflation by around one percentage point through most of 2009, followed by a corresponding addition to inflation during 2010, depending on precisely when and how retailers responded to the changes.

### **The immediate policy decision**

22 The Committee considered the policy decision in the context of how the medium-term outlook for inflation had changed since the November *Inflation Report*. There had been several major pieces of news including: consistent indicators of the weakening of near-term output growth in the United Kingdom and overseas; the continuing fall in oil and other commodity prices; the fall in the yield curve alongside a significant depreciation of sterling; and the publication of the *Pre-Budget Report (PBR)*. This news had been in the context of continuing dislocations in many financial markets that were constraining the ability of the banking sector to lend to households and to the corporate sector. Overall, the medium-term outlook for inflation appeared to have shifted downwards since the November MPC meeting.

23 The slowdown in the international economy had appeared to be remarkably synchronised in the United States, Europe and Asia. Many of the larger countries had experienced negative GDP growth in the third quarter. There were few official data available for the fourth quarter but business surveys were signaling falling output in many of the major developed economies, and sharply slowing growth in some of the larger emerging market economies. Policy measures were being introduced in a number of different countries, to ease conditions in financial markets and to moderate the slowdown in activity. It was likely that the impact of these measures would build over time.

24 In the United Kingdom, many business surveys were at historically low levels, consistent with a recession. The slowdown was particularly marked in manufacturing, but a contraction was also indicated for services. A mapping from the surveys into GDP suggested falling output in both the fourth quarter of 2008 and the first quarter of 2009. Consumption and business investment had stalled. The Committee noted that the weakness of output suggested by the surveys could be consistent with a stock cycle.

25 Some factors would be supportive of demand and output. Global inflationary pressures appeared to be abating and the price of oil had fallen back significantly since its peak earlier in 2008. Most other commodity prices had also declined over that period. Those developments should help support households' purchasing power. The yield curve had fallen. Sterling had depreciated, which should act to support net export growth.

26 The timing of discretionary spending changes announced in the *PBR*, and the cut in VAT, were likely to be helpful in offsetting the downside risks to output growth in 2009. The direct price level effects from the VAT rate changes would push down on CPI inflation during most of 2009 and would add to inflation during 2010. A reduction in budget deficits was planned for later years. Although the temporary reduction in VAT would lead to some volatility in inflation over the next two years, the new fiscal plans were unlikely to have a significant effect on inflation beyond that period. The Committee noted that, under the terms of its remit, it was required to look through short-run movements in inflation in order to avoid undesirable volatility in output.

27 The Committee noted the importance to the economic outlook of bank lending, to both households and businesses. In that context, the underlying weakness in credit and broad money growth was a concern. Banks and many other financial institutions needed to continue to reduce their leverage over a period. However, if they attempted to do that quickly by constraining their lending they would reinforce the downward pressures on the real economy. But the Committee agreed that Bank Rate was not the right policy instrument to tackle supply constraints in the credit market. Further measures to underpin lending growth would be needed, building on the Government's package announced in October to recapitalise and guarantee funding to the banks.

28 Taking all the news together, the Committee agreed that a significant margin of spare capacity would open up over the next couple of years. Abstracting from the volatility induced by the change in the VAT rate, it was most likely that, without further policy action, inflation would substantially undershoot the target in the medium term. It was therefore necessary to make an immediate cut in Bank Rate and the question was how large that reduction should be.

29 The Committee agreed that, given the significant probability of undershooting the inflation target in the medium term, a cut of at least 100 basis points was needed. The Committee discussed whether a larger cut was warranted. That might be justified by the scale of the downside risks to

inflation. A number of arguments were, however, advanced against a larger cut, to which different members attached different weights. Financial markets had priced in a cut of 100 basis points and there was a risk that going further could cause an excessive fall in the exchange rate. There was also a risk that an unexpectedly large cut could undermine confidence in the economy more widely. A cut of 100 basis points would mean that the level of Bank Rate would have been reduced from 5% to 2% in just 8 weeks; given the uncertainty inherent in the transmission mechanism, it was difficult to be certain that rates needed to be cut by more or faster than that. In addition, substantial measures had already been taken to support the financial system and to boost demand through fiscal policy. Though these measures would take time to have an impact, they would provide support to demand in 2009, alongside monetary policy.

30 The Governor invited the Committee to vote on the proposition that Bank Rate should be reduced by 1.0 percentage points to 2.0%. The Committee voted unanimously in favour of the proposition.

31 The following members of the Committee were present:

Mervyn King, Governor  
Charles Bean, Deputy Governor responsible for monetary policy  
John Gieve, Deputy Governor responsible for financial stability  
Kate Barker  
Tim Besley  
David Blanchflower  
Spencer Dale  
Andrew Sentance  
Paul Tucker

Dave Ramsden was present as the Treasury representative.