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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

8 AND 9 APRIL 2009

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 April 2009.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0904.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 6 and 7 May will be published on 20 May 2009.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8-9 APRIL 2009

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 At its March meeting, the Committee had agreed to purchase £75 billion of assets within a three-month period, financed by the creation of central bank reserves. The purchases were to be made through the Asset Purchase Facility. The aim of these measures was to increase the supply of money as well as lending and nominal spending with the ultimate objective of keeping CPI inflation close to its 2.0% target. The Committee had agreed to purchase corporate bonds and commercial paper with the aim of improving conditions in those credit markets. But the majority of the purchases were expected to be of conventional gilts in the secondary market with 5-25 years to maturity.

3 Asset purchases during the month had been broadly on track to meet the £75 billion total; around £26.5 billion had been purchased since the Committee's March meeting. The announcement that the Committee planned to use asset purchases for monetary policy purposes had not been a surprise to markets. But the size of the programme and the maturities of gilts to be purchased had not been widely anticipated. Yields on gilts with 5-25 years to maturity had fallen on the announcement. But the falls in those yields had been partially reversed during the month.

4 According to market contacts, the Bank's asset purchases had already helped to improve the functioning of corporate markets. Around £2 billion of commercial paper had been purchased: £1 billion had been purchased before the MPC's March decision, and had been financed by issuing Treasury Bills; and £1 billion had been purchased since the Committee's March meeting, funded by central bank reserves, and was part of the overall £75 billion programme financed by reserve issuance. Those numbers compared with a total outstanding stock of sterling commercial paper of around £7 billion. Commercial paper spreads over risk-free rates had fallen during the month. The corporate bond facility, launched on 25 March, had so far made purchases of £414 million. Although early days, there were some reports that this facility had improved price discovery and transparency in the market. Over time it should help to reduce spreads and stimulate issuance.

5 Reactions in the foreign exchange markets to the MPC's announcement of asset purchases had been relatively muted. Sterling was broadly unchanged over the month.

6 Near-term OIS rates had risen a little, but LIBOR rates had fallen on the month. Three-month LIBOR-OIS spreads had fallen considerably, reaching their lowest level since September 2008. Secured overnight rates had been a little above Bank Rate. This probably reflected the announcement on 5 March that the Bank would suspend reserve averaging, and would pay Bank Rate on all reserves account balances, and was consistent with the rise in OIS rates.

7 There had been a general recovery in global equity prices; UK equity prices had risen by around 8% during the month. Some of the rise in prices could be accounted for by stronger than expected data outturns in both the United Kingdom and the United States. There had also been a boost to equity prices from the announcements after the G20 Leaders Summit at the beginning of April. Positive news for financial markets had emerged from the banking sector, both abroad and in the United Kingdom. Announcements from major UK banks, including those relating to the Government's Asset Protection Scheme, had also been viewed favourably by the market.

The international economy

8 There had been a sharp deterioration in world trade. Over the latest twelve month period for which data were available, the value of goods exports had fallen by around 20% in the United States, France, Germany and China. In Japan, the corresponding fall had been around 50%. According to the Netherlands Bureau for Economic Policy Analysis (an independent research institute), the volume of world trade had declined by around 17% in the twelve months to January, while the three-month-on-three-month fall had been 12%. Falls in trade volumes of this magnitude and speed were unprecedented.

9 World output growth had also been weak, but the collapse in world trade appeared to be much more severe than its long-term average relationship with output would have implied. One possible explanation for this related to the nature of the slowdown. The tightening of credit supply and the fall in confidence had led spending on high value internationally traded items, such as capital goods, to decline. Moreover, the greater use of global supply chains in recent years may have increased the extent to which the slowdown in demand affected international trade. The need to run down inventories in sectors which were highly traded, such as motor vehicles, may have also contributed to

the collapse in trade. A further possibility was that there had been a particularly severe contraction in the supply of trade credit that financed international transactions. It was difficult to judge how much weight to put on the different explanations. And the precise implications of the substantial decline in world trade for the UK economy were not obvious.

10 Purchasing Managers Indices (PMIs) from a wide variety of economies were suggesting that the pace of deterioration in global output might be moderating. At the same time, the rise in commodity prices during the past month had also hinted at an incipient recovery in world demand. Some of the divergence between the most recent world trade and economic activity indicators might have been a function of timing. Other than in raw materials, trade occurred after production, and it was the new orders components of the manufacturing PMIs that had been picking up most noticeably. So it could be that the trade data were a lagging indicator of demand developments and would recover during 2009 Q2. Nevertheless, the sharp drop in world trade was a concern and a source of significant uncertainty for the outlook for UK GDP growth.

11 The G20 summit in London on 2 April, among other things, had agreed to increase substantially the funds available to the IMF. These funds should support growth by increasing the funding available for countries in financial difficulty. That meant that one potential downside risk to world demand had diminished.

Money, credit, demand and output

12 The CIPS/Markit indices for output and business activity for manufacturing and services had both risen in March. The monthly increase in the manufacturing output index had been the largest since the survey began in 1991. The services index had increased for four months in a row. These data were still consistent with falling output. But the steady slowing in the rate of contraction during 2009, implied by the central projection in the February *Inflation Report*, seemed broadly on track.

13 Although several indicators were showing signs of improvement, it was possible that this turnaround in the data might prove ephemeral. There were key uncertainties relating to stockbuilding, household spending and the supply of credit from the banking system.

14 The fall in stock levels in 2008 Q4 had been the largest since quarterly records began in 1955. It seemed likely that the unusually large decline in stocks could have reflected improvements in stock management techniques, with companies reducing their actual inventory levels towards their desired

levels more quickly than in previous recessions. So the sharp decline in stocks at the end of 2008 might have implied that the stock cycle would be shorter in this recession than in the early 1980s or 1990s. Indeed, it was unlikely that stockbuilding would continue to reduce GDP growth for a prolonged period, as this would require progressively larger falls in stocks. But it was possible that the unprecedented scale of de-stocking seen in 2008 Q4 indicated something about the size or nature of the shock, rather than the speed at which companies were adjusting to it. For example, it could have been signalling that firms were extremely pessimistic about future demand and that sharp cuts in employment and investment would follow.

15 The possibility of a substantial further retrenchment by the household sector was perhaps one of the biggest downside risks facing the economy. Consumption had fallen by 1.0% in 2008 Q4, a significantly weaker outturn than had been projected in the February *Report*. But households' income and the saving ratio had been higher than projected. And the household sector's financial balance had been positive for the first time since 2001. Increased uncertainty about job prospects and the economic outlook more generally were probably factors behind the increase in household saving, although some of the rise in the saving ratio in 2008 Q4 might prove to be erratic. Moreover, household net financial wealth had fallen by 17% in the year to 2008 Q4, and so households may have increased saving in order to rebuild their stock of assets.

16 Developments in household spending since the end of 2008 had been more encouraging. Data on retail sales and car registrations had suggested some bottoming out in the decline of consumption. There were signs that some indicators in the housing market were turning, albeit from low levels. And the GfK measure of consumer confidence had risen a little – with the increases being most pronounced in the forward-looking balances. Nevertheless, it was too soon to be sure whether a relatively orderly adjustment of households' balance sheets was in train or whether a more significant retrenchment in consumers' expenditure was in prospect.

17 The prospects for spending depended, in part, on the behaviour of banks. Ahead of the start of the MPC's asset purchases, there had been some signs of a pickup in the underlying growth rate of broad money. The annualised three-month-on-three-month growth rate of bank deposits held by households and private non-financial companies had risen to 7.1% in February from 4.4% in the previous month. The corresponding figures for bank lending to those sectors had been comparatively weak, registering 3.4% growth in February. The prospects for lending would be a major influence over the speed of recovery in both household and corporate spending.

18 Those banks participating in the Government's Asset Protection Scheme had already made commitments to increase their secured lending to households. But additional secured lending was likely to be required from the other banks if nominal spending growth by households were to recover enough to be consistent with inflation being at target in the medium term. These banks' willingness to provide that credit would depend on both the strength of their balance sheets and on their desire to increase their exposure to the UK housing market. There was a risk that this extra supply of credit would not materialise.

19 On the corporate side, the Bank of England's *Credit Conditions Survey* for Q1 had shown an improvement in the expected availability of corporate credit. But that was not indicative of a broad-based turnaround across all banks. Moreover, UK companies had a considerable amount of debt with overseas banks. There was a risk that some of those loans might not be renewed as they matured if overseas banks retrenched to home markets. So even though growth in lending from UK-resident banks to companies might recover, it could still be too moderate to support a sufficient pickup in investment spending.

20 The volume of UK exports had risen in February, despite the weakness in world trade, and imports had fallen. These monthly numbers were volatile, but on balance they suggested that the positive contribution from net trade to GDP growth was likely to have fallen back in the first quarter.

Supply, costs and prices

21 Dollar oil prices had risen by around 13% on the month, and increases had also been seen in some other commodity prices. But the significant fall in prices since the middle of 2008 had led many commodity producers to postpone or abandon investment projects, dampening supply growth. So if the global economy were to recover strongly following the range of recent policy actions and announcements that might lead to renewed upward pressure on commodity prices relative to the prices of other goods and services.

22 The latest trade data showed that goods import prices had risen 7.6% in the year to February. Excluding the impact of past falls in oil prices, import prices had risen broadly as expected at the time of the February *Inflation Report*. An important question was how much of the rise in import prices, associated with the depreciation of sterling, would be absorbed in labour costs or margins and how much would be seen in final CPI inflation.

23 It was possible that these exchange rate effects were already being seen. CPI inflation had risen to 3.2% in February, and had been higher than the Committee and many market commentators had expected. Although there was a range of possible explanations it seemed likely that the increase largely reflected the faster, or greater, than expected pass-through from the depreciation of sterling. Much of the upside news had been in CPI components that were thought to have a relatively high import content. The Committee had noted an upside risk to the inflation projection from the exchange rate in the February *Inflation Report*, so perhaps that was crystallising.

24 Labour costs had been very weak on the month. Some of that reflected the sharp fall in bonuses. But other components of earnings had also shown further signs of weakness. Settlements had fallen sharply, and there had been continued evidence of pay freezes. The gap between regular pay growth and settlements had also fallen to zero in recent months. There had been signs of considerable nominal pay flexibility, with firms acting quickly to adjust costs.

25 Unemployment, as measured by the claimant count, had risen rapidly in February. The small rise in employment in the Labour Force Survey in the three months to January was more than accounted for by a rise in the number of self-employed. Although there were few available data, it was likely that these people would have even more flexible remuneration than the employees covered by the official measures of earnings.

26 There was relatively little news on supply, and the available data tended to point in opposite directions. Labour market participation had so far held up a little better than expected. In contrast, survey measures of capacity utilisation were, if anything, coming in at, or above, the level expected at the time of the February *Inflation Report*, perhaps consistent with firms adjusting supply in the light of the sharp fall in demand.

The immediate policy decision

27 The latest indicators pointed to output falling in 2009 Q1 at a similar rate to that recorded at the end of 2008, and were consistent with the broad shape of the central projection in the February *Inflation Report*. Final domestic demand had fallen in Q4, reflecting weak spending by households and businesses. Business surveys – especially for new orders – had suggested that the rate of contraction in output might be starting to moderate in Q2. This might indicate that the pace of destocking was starting to ease and the past depreciation of sterling was encouraging stronger net trade. Housing market activity indicators had appeared to stabilise in recent months, albeit at low

levels. Equity prices had risen. There were some signs that credit availability might be starting to improve a little. But it was too soon to be sure that these improvements would continue, as many of the indicators were volatile from month to month and were vulnerable to further shocks. A sharp rise in unemployment was already underway, and this might prompt further falls in confidence and adjustments to household spending. Overall, the risks to the domestic economy remained weighted to the downside.

28 The latest data had shown sharp falls in goods exports around the world. What had caused the sharp decline in world trade was still unclear. The competing hypotheses put forward could have very different implications for UK trade. Prospects for UK net trade also depended on the impact of the lower exchange rate. As well as encouraging UK exports, the depreciation would encourage substitution of consumption away from imports towards home-produced outputs.

29 The rise in UK CPI inflation to 3.2% in February had been unexpected, and was likely to have reflected, to a significant degree, the pass-through of the depreciation of sterling into domestic prices. Despite the pickup in February, inflation still seemed likely to fall below the target by the second half of this year, reflecting diminishing contributions from retail energy and food prices and rising spare capacity. Nominal earnings growth had been weak. The next *Inflation Report* would enable the Committee to reassess the pressures on costs and prices from the exchange rate depreciation and from the increasing degree of spare capacity within firms and in the labour market.

30 At the March meeting, the Committee had judged that a reduction in Bank Rate to 0.5% and an initial programme of asset purchases of £75 billion was appropriate in order to meet the inflation target. The Committee agreed that no further change in Bank Rate was warranted this month.

31 So far, around £26.5 billion of assets had been purchased and it would take a further two months to complete the programme. As expected, the bulk of the purchases had been of gilts, with smaller volumes of purchases in commercial paper and corporate bonds. The initial effects of the Committee's asset purchase programme had been encouraging. Yields on gilts had fallen by a sizeable amount following announcement of the programme, with the falls concentrated in the range of eligible maturities. Some of those falls had subsequently been reversed. It was difficult to know if the falls in yields would persist once the £75 billion programme of purchases was complete: it was possible that some of the falls would be temporary, and only last while the purchases were being made. Alternatively, the falls in yields might increase as additional assets were purchased. There had been

some early signs of improved conditions in corporate bond and commercial paper markets, with some spreads narrowing.

32 The latest money and credit data had been for the month of February – prior to the asset purchases. It had been encouraging that the three-month annualised rate of growth of money held by households and private non-financial companies had picked up since the start of the year. It was too early for data to reflect how the purchases of assets were being transmitted into broad money and credit and into nominal spending, and thus to enable the Committee to judge its overall efficacy.

33 As well as considering the level of Bank Rate, the Committee had agreed to review the scale and timing of the asset purchase programme each month. In principle, if the evidence warranted it, the Committee could decide either to increase or reduce the programme of purchases. Though there remained a high degree of uncertainty over the appropriate scale of asset purchases necessary to keep inflation at target in the medium term, the Committee agreed that there had been no material change in the conditions that had led them to the decision last month on the necessary scale and timing of asset purchases that was required.

34 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 0.5%. The Committee voted unanimously in favour of the proposition.

35 The Governor invited the Committee to vote on the proposition that it should continue with the programme, as agreed at the March meeting and announced on 5 March, of asset purchases totalling £75 billion financed by issuance of central bank reserves. The Committee voted unanimously in favour of the proposition.

36 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
Kate Barker
Tim Besley
David Blanchflower
Spencer Dale
Paul Fisher
Andrew Sentance

Dave Ramsden was present as the Treasury representative.