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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING
7 AND 8 JANUARY 2009

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 January 2009.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0901.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 4 and 5 February will be published on 18 February 2009.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7-8 JANUARY 2009

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

Financial markets

2 Financial markets had been volatile since the December MPC meeting. Despite this, there had been a few encouraging signs. Sentiment in some markets had improved a little in the few days since the start of 2009. Equity prices had risen internationally on the month and the FTSE All-Share index was back close to the level prevailing at the time of the November *Inflation Report*. There had recently been some investment-grade corporate bond issuance which had been largely absent during the previous few months. Corporate bond spreads remained high but non-investment grade spreads in both sterling and euro had fallen a lot over the previous week. Premia on credit default swaps for UK banks had been broadly unchanged on the month, although they had edged down over the previous few days, coming into line with European premia and back to their mid-November levels. But market conditions remained fragile.

3 Dollar interest rate expectations had moved lower in December after the Federal Open Market Committee had reduced policy rates to a target range between zero and 25 basis points. Expectations for euro interest rates over the next six months had also fallen somewhat on the month. In sterling money markets, a cut of 50 basis points for Bank Rate at the January meeting had been priced in, with some expectations of a larger cut. Market expectations of Bank Rate further ahead suggested a low point of around ¾% during 2009. Three-month LIBOR rates had steadily declined following a sharp fall after the December MPC meeting. The spread of three-month LIBOR over the average of expected policy rates had fallen by around 90 basis points on the month, to its lowest level since September. The year end had passed without any evidence of escalating funding pressures for banks.

4 The sterling exchange rate had moved markedly during the month. There had been a sharp depreciation until the end of 2008 followed by a rapid rebound, leaving the sterling effective exchange

rate index (ERI) nearly 3% lower than at the time of the December meeting. Despite the rally in early January, the most recent 15-day average of the ERI was around 14% below the starting value for the projections in the November *Inflation Report* and nearly 20% lower than the starting value for the August *Report*. The fall in the ERI over the eighteen-month period to the end of December had been the largest depreciation since the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s.

5 The Committee identified three potential factors that could have played a part in the depreciation of sterling. First, relative positions in the business cycle could be responsible for exchange rate movements through their impact on relative interest rate expectations, which might also reflect a perception that policymakers had been content with a limited fall in sterling. Although the news in relative short-term interest rates had been reasonably well correlated with the ERI since August, the scale of the depreciation could not be accounted for by interest rates alone. A second possible factor was changes in risk premia. It was possible that portfolios of sterling assets were perceived to have increased in riskiness relative to portfolios denominated in other currencies, requiring an increase in compensation. But such risk premia were not directly observable which made it difficult to evaluate this explanation. A third possible factor was a fall in market perceptions of the sustainable value of sterling. For example, a decrease in the demand for UK financial services might imply that a sustained depreciation would be necessary to correct the resulting current account deficit. It was possible that each of these explanations had played some role. In addition, some of the more volatile movements in December had probably reflected market illiquidity.

6 The Committee noted that, although there had been a few encouraging signs in financial markets, there was likely to be further bad news ahead if the global economy continued to slow in line with the Committee’s expectations. Many banks were due to report their 2008 results soon, and any evidence of larger losses than expected by the markets could cause further financial market volatility.

The international economy

7 The sharp downturn in the international economy appeared to have been remarkably synchronised. Although growth had declined in many countries in the first half of 2008, and in some cases during 2007, the rate of decline had quickened from the early autumn onwards. This change was apparent, for example, in activity indices from Purchasing Manager surveys across a number of

countries. By December, the JP Morgan Global Purchasing Manager Indices, for both manufacturing and services, had reached levels well below that indicating no change in activity levels, and were below their previous troughs in 2001.

8 As a counterpart to this general slowdown in activity, there had been a marked reduction in international trade, possibly accentuated by a restriction in the supply of trade credit. The Baltic Dry Index remained at a low level. US and euro-area exports were likely to have contracted in the fourth quarter of 2008. And there had been sharp falls in Japanese export volumes in November, and in nominal export growth elsewhere in Asia.

9 The US labour market had eased substantially, with recent unofficial data indicating a very large number of job losses in December. The reaction of the labour market to slowing output growth would usually be lagged somewhat, but there did not seem to be much delay apparent in the US data. Employment growth in the euro area was also weak.

10 Although output growth had slowed already in many countries, it seemed likely that the collapse of Lehman Brothers in mid-September and consequent upheavals in financial markets had triggered a deterioration in business and consumer confidence more widely. In addition, business investment and output also appeared to have been directly affected by the tightening in the price and availability of credit. The effects of tighter credit conditions could have been amplified by the earlier steep rise in commodity prices, which had left companies short of cash. Finally the synchronised nature of the slowdown might also have been reinforced by the increasingly global nature of supply chains and credit markets.

11 In the United States, output growth had been slowing for some time. The target federal funds rate had been cut to near zero, with signals that it was expected to remain low for some time. The US authorities had also announced a wide range of measures to boost market liquidity and to support the supply of credit to the corporate and household sectors. It was widely expected that there would be a second US fiscal package, much larger than the first.

12 In the euro area, interest rates had been cut by 175 basis points during Q4 and other ECB policy measures had focused on liquidity provision. EU governments had endorsed proposals to implement

stimulatory fiscal measures worth 1.5% of GDP in aggregate. Member states would be responsible for deciding the degree of stimulus appropriate for their individual economies.

13 Oil prices had been volatile over the month. Prior to the MPC meeting there had been some recovery to nearly $50 per barrel, but they had fallen back on the first day of the meeting. The prices of some food commodities had also been volatile, but had risen on the month. Both oil and food prices remained well below their mid-2008 peaks.

Money, credit, demand and output

14 The news on UK output in 2008 Q4 had been broadly consistent with the sharp contraction expected at the time of the December meeting. The CIPS/Markit business surveys for December had actually increased a little. There was not much evidence available yet regarding 2009 Q1, but the forward-looking survey components suggested that there could be another large contraction. That was consistent with the survey from the British Chambers of Commerce (BCC). Although not always a reliable indicator of GDP growth in the past, the Q4 BCC survey had a notably weak tone.

15 In line with new pre-release arrangements, the Governor had been supplied with the industrial production data for November, a day ahead of publication. These data had shown a sharp contraction in manufacturing output, broadly as indicated by the business surveys.

16 The near-term path of output growth would partly depend on the dynamics of stockbuilding. Even if there was a continuous and substantial rate of de-stocking, once that rate stabilised it would no longer contribute a drag on GDP growth. If de-stocking were already in train, then the slowing in output growth would be greater than the slowing in final demand. In this scenario, there might be a significant negative contribution to GDP growth for only a quarter or two from stockbuilding. A more pessimistic scenario would be if the weakness in output growth reflected final demand and de-stocking had yet to start, in which case the drag on GDP growth in 2009 would likely be larger. The official data on stockbuilding were only available to Q3 and among the most uncertain in the GDP statistics and so it was difficult to judge what had happened to stocks recently, though business surveys generally showed that stock levels were higher than companies desired.

17 In addition to the prospects for weak output growth, employment had fallen sharply and unemployment had risen. Business employment surveys suggested that was likely to continue in the coming months, reflecting the sharp slowdown in output. Continuing job losses could contribute to further deterioration in consumer confidence.

18 Indicators of retail demand had suggested that consumption expenditure might be holding up rather better than feared towards the end of the year. Reports from retail stores and the Bank's regional Agents suggested sales had weakened further, but there was no suggestion so far that consumption expenditure had collapsed. In part, this probably reflected aggressive price discounting. But it was always difficult to judge the influence of seasonal factors on the pattern of retail sales over the year end. Private car registrations had also been weak.

19 The latest Bank of England *Credit Conditions Survey* had revealed a further reduction in the availability of credit to both households and corporate sectors during the fourth quarter of 2008. Additional tightening was expected in the first quarter of 2009. Data on bank lending had been weak but the growth of mortgage lending had not slowed any further in November. The largest lenders to UK individuals had sustained their mortgage lending growth during the autumn, but many smaller lenders had sharply contracted lending or left the market altogether. The growth of loans to non-financial businesses also appeared to have stabilised, although at a low rate, and corporate credit conditions remained tight. The Bank's regional Agents had reported that businesses had seen a further tightening in availability of both bank funding and trade credit. Business investment looked set to remain weak for much of 2009. The Committee noted that those firms which were relatively successful through this period would eventually increase investment to take advantage of the opportunity to grow their businesses faster.

Costs and prices

20 In line with new pre-release arrangements, the Governor had been supplied with the producer price data for December, a day ahead of publication. These data had shown a small fall in output prices and a large fall in input prices.

21 CPI inflation had fallen to 4.1% in November and a significant fall was likely in December, partly reflecting the VAT change. Together with the effect of declines in commodity prices and

subdued demand, it was likely that CPI inflation would fall towards, and possibly below, the 2.0% target during the first half of 2009. Looking further ahead, CPI was likely to be volatile in response to the effects of the VAT change on the twelve-month rate, as discussed at the December MPC meeting.

22 The main uncertainties for the short-term CPI outlook were the continuing volatility of commodity prices and the impact of the depreciation in the sterling exchange rate. The effect of the exchange rate would depend in part on how persistent the lower level of sterling was expected to be. Over the longer term, a depreciation in the nominal exchange rate would be associated with a change in relative prices rather than inflation, but there would be an upwards effect on the price level. The scale of the depreciation made the potential size of the price level effect important for the inflation outlook, at least in the short-term.

23 Earnings in the three months to October and wage settlements data for November had been broadly stable. Looking ahead, a BCC survey had suggested that many firms were planning to freeze pay and some were planning cuts in wages. The Recruitment and Employment Confederation survey for December suggested that firms were paying lower salaries on average for comparable new job placements relative to the previous month.

The immediate policy decision

24 The world economy was undergoing an unusually sharp and synchronised downturn. Although the business cycle in the United States was somewhat more advanced than in Europe, the pattern of the slowdown in 2008 had shown a consistent intensification from the early autumn onwards in many countries. A global weakening of consumer and business confidence had taken place, exacerbated by the collapse of Lehman Brothers in September 2008 and the ensuing financial crisis. UK output needed to re-balance from domestic demand towards net exports and that would be more difficult if export growth was limited by weak world demand. But the substantial depreciation in the exchange rate, if sustained, would aid that re-balancing.

25 In the United Kingdom, data over the month had been consistent with the Committee's expectation of a significant contraction in activity in the fourth quarter of 2008. And credit conditions had continued to tighten, pointing to the need for further measures to encourage the flow of lending to the non-financial sector. But there was little firm evidence on which to judge the near-term outlook for

2009. There were a number of factors with the potential to support UK activity: cuts in Bank Rate of 300 basis points since September 2008; measures to support UK banks in October; the fiscal package announced in the *Pre-Budget Report*; the substantial depreciation of sterling since the summer of 2008; the sharp fall in commodity prices since their mid-2008 peaks; and the decline in consumer price inflation. Collectively these amounted to a very significant stimulus to demand, the effects from which were only beginning to work through the economy.

26 The Committee noted that the extent of the monetary impetus depended on the level of Bank Rate, not changes to it. The fact that Bank Rate had been cut from 5% in September to 2% meant that there was a substantial monetary stimulus already in the system. The transmission mechanism of monetary policy, while impaired, was not broken. For example, cuts in Bank Rate would reduce the servicing costs of existing debt for many businesses and households even if growth in the supply of new credit was limited.

27 The implications of the depreciation of sterling depended on the factors behind it. If there were indications – perhaps from lower gilt prices for example – that a weakening exchange rate reflected a loss of credibility in UK economic policy, then that would be bad news for the medium-term outlook. However, to the extent that the falls in the exchange rate were a response to real economic developments, then they should act as a shock absorber, increasing growth by boosting the relative demand for UK output. The prospects for sterling and UK exports would depend in part on the success of economic policies pursued overseas.

28 CPI inflation had fallen to 4.1% in November. Given the reduction in VAT from December, the decline in commodity prices since mid-2008 and subdued demand growth, CPI inflation was likely to fall quickly towards, and possibly below, the 2.0% target in the coming months. But the extent to which the downward pressures on inflation would be offset by the boost to import prices from the lower exchange rate was uncertain.

29 The Committee discussed whether, amidst all the news about the outlook for growth, there remained any substantial upside risks to inflation over the next few years. These could arise, for example, from a sharp fall in the exchange rate, beyond that warranted by economic fundamentals; a renewed surge in commodity prices; or a quicker than expected rebound in the real economy. But, on

balance, the weakening prospects for output growth, at home and abroad, suggested that the balance of risks to the medium-term inflation outlook remained to the downside.

30 In the light of this balance of risks, members discussed how large a cut in Bank Rate was appropriate this month. Some arguments could be made for leaving Bank Rate unchanged. There had been a lot of news, which was broadly offsetting for the inflation outlook. Policy measures already in train were having, and would have, a significant impact, which would be supplemented by the depreciation in the sterling exchange rate and sharp falls in consumer price inflation. Because these effects took time to work through, there would probably be further weak data in the near term. Since Bank Rate was set in anticipation of these developments, the Committee should not be expected to react to weak data unless the assessment of the economic outlook changed as a result. Moreover, the February *Inflation Report* would give the Committee a chance to re-evaluate the medium-term inflation outlook in the light of all the news. So there was a reasonable case for maintaining Bank Rate at 2.0%, at least until the next meeting.

31 However, the news on the month had left the balance of risks to output and inflation, relative to the target, to the downside. And despite the impairment in the monetary transmission mechanism associated with the dysfunctional credit markets, a cut of 50 basis points could still have a significant effect on the income of many businesses and households, adding to the considerable monetary and fiscal stimulus which was already in train. The markets had priced in a cut of 50 basis points and either leaving Bank Rate unchanged this month, or implementing a larger-than-expected cut, could damage confidence further in both financial markets and the real economy. Weighing these arguments together, most members concluded that a cut in Bank Rate of 50 basis points was appropriate.

32 For one member, the news on the month had been more decisively to the downside and it was becoming increasingly probable that there would be a deep and prolonged recession. House prices continued to fall sharply, which would have negative effects on many self-employed who used their homes as collateral for business loans. There had been no real improvement in financial markets and conditions in labour markets were worsening quickly. The monetary transmission mechanism was impaired, which would limit the effectiveness of the various monetary and fiscal stimuli. Unemployment would rise sharply, especially amongst the young, and there were indications of some

wage rates falling. The risks from delaying further cuts were bigger than those from cutting too far. For this member an immediate cut of 100 basis points in Bank Rate was warranted.

33 The Governor invited the Committee to vote on the proposition that Bank Rate should be reduced by 50 basis points to 1.5%. Eight members of the Committee (the Governor, Charles Bean, John Gieve, Kate Barker, Tim Besley, Spencer Dale, Andrew Sentance and Paul Tucker) voted in favour of the proposition. David Blanchflower voted against, preferring a reduction of 100 basis points.

34 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

Nicholas Macpherson was present as the Treasury representative.