Publication date: 22 July 2009

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

8 AND 9 JULY 2009

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

They are also available on the Internet http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0907.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 5 and 6 August will be published on 19 August 2009.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 JULY 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 The cost of banks' funding as represented by Libor rates had continued to fall during the month in both the United Kingdom and the euro area. Global equity prices had fallen on the month, though that had reversed only a part of the rally seen since March. In the light of mixed data during the past month, market participants had probably become less optimistic about the outlook for the world economy. Other asset markets had also apparently been affected by a similar change in sentiment. Longer-term risk-free interest rates, having risen for the past couple of months, had eased back recently, both in the United Kingdom and in the United States. And the dollar price of Brent oil had fallen by 9% since the June MPC meeting.

3 Despite those asset price moves, sterling corporate bond spreads had continued to fall. Investment grade spreads had fallen by around 60 basis points since the June MPC meeting. In part, that appeared to reflect a general improvement in the liquidity of corporate bond markets globally. But market contacts suggested that some of the improvement in UK liquidity also probably reflected the impact of the Asset Purchase Facility (APF). Since the announcement of the establishment of the Asset Purchase Facility, measures of liquidity – such as the difference between corporate bond yields and credit default swap premia – had fallen by more for bonds which were eligible for purchase by the APF than for ineligible ones.

4 The sterling effective exchange rate had changed little on the month, falling by 0.3%. That masked a slightly bigger depreciation against the dollar, compared with a small appreciation against the euro.

The international economy

5 There were further signs this month that the global economy was approaching a trough in activity. The JPMorgan Global Composite Purchasing Managers Index (PMI) had risen closer to the level consistent with no change in economic activity. But economies were recovering at different rates. In Asia, the Chinese manufacturing PMIs had moved a little further into expansionary territory – a sign of a strengthening recovery in that part of the world. In the United States, both the manufacturing and non-manufacturing PMIs had risen sharply, with the manufacturing index reaching levels last seen at the time of Lehman Brothers' collapse in September 2008. In the euro area, the manufacturing index had picked up in June, but the services business activity index had faltered. Moreover, the level of the euro-area PMIs remained well below those in the United Kingdom and the United States.

6 Nevertheless, the global outlook remained extremely uncertain. One risk to the economic recovery in the United States and possibly the world was the US housing market. There seemed to be three channels through which US house prices might have an impact on the macroeconomy. First, house prices affected the value of US households' collateral and hence their ability to borrow. Second, and relatedly, they could have a significant effect on the net asset position of US, and possibly of other, banks that still had exposures to the US housing market. Third, house prices influenced the level of residential investment. In recent months, the pace of US house price declines appeared to have moderated. But the number of vacant properties remained high. A major contributory factor to that supply overhang had been the rise in repossessed properties on the market. The outlook for repossessions depended in part on employment. The rate of job loss had increased in June according to the non-farm payrolls data, and the unemployment rate had risen to 9.5% – a 26-year high. These factors seemed likely to dampen any recovery in the housing market.

7 The evolution of global imbalances added to the uncertainties surrounding the outlook for world economic activity in the medium term. These imbalances had diminished recently with a narrowing of current account deficits and surpluses in a number of countries. But there was a question mark over how sustainable that correction of imbalances might prove to be if world growth were to recover. To some degree it had been the result of the sharp fall in the price of oil from its peak in 2008. If oil prices were to rise as the world economic recovery proceeded further, then at least some of the imbalances would tend to widen again. For the non-oil producing surplus countries, the decline in

their surpluses largely reflected the collapse in foreign demand for consumer durables and capital goods. But any recovery in the deficit countries would probably lead to a bounceback in spending on these items.

8 Imbalances were therefore likely to re-emerge unless surplus countries could raise their own spending. There was some evidence that domestic spending in parts of Asia was showing some resilience. But it was unclear to what extent it would last beyond the support it was receiving from temporary fiscal expansion. If surplus countries could not raise private domestic spending on a sustained basis then there could be a continuation of the imbalances with the attendant risks of large asset price corrections and increased pressure for protectionist measures.

Money, credit, demand and output

9 In the United Kingdom, there was a marked contrast between the extremely weak official data that described developments around the turn of the year, and the survey data that reflected economic activity in 2009 Q2. In the *Blue Book*, the ONS had revised down its estimates of GDP growth in 2008 Q4 and 2009 Q1. According to these new estimates, the recession was deeper than previously thought. Output had fallen for four quarters, and was already estimated to have contracted by twice as much as the peak to trough fall in the 1990s recession. In the four quarters to 2009 Q1, nominal GDP had declined by 4%, by far the largest contraction since quarterly records began in 1955.

10 But the survey indicators of more recent developments were encouraging. In particular, the CIPS/Markit surveys for manufacturing and services had reached levels in June consistent with output having stabilised. Though the CBI and BCC surveys suggested a weaker picture, they also pointed to a moderation in the pace of contraction in Q2. The recent official data pointed to some stabilisation in output. Although industrial production had fallen in May, the monthly profile of manufacturing output had been relatively flat during most of 2009. The volume of service sector output had changed little between February and April. Taken together, all these data suggested that GDP had probably fallen by less in the second quarter than had been assumed in the May *Inflation Report* central projection.

11 A key issue for the Committee was how sustainable the apparent turnaround in activity was likely to be. One aspect of this question was the extent to which the better news on output was likely to reflect a temporary boost from the stock cycle. Survey data for manufacturing suggested that the

contribution from stockbuilding had probably been relatively modest. Furthermore, a significant amount of the slowdown in the pace of decline during Q2 looked to have been accounted for by services output, which was less affected by changes in inventories.

12 Some of the turnaround in GDP growth during 2009 Q2 probably reflected government spending, which had been erratic and generally weak in the first quarter. But it also appeared to reflect a partial stabilisation of households' spending. Retail sales, car registrations and consumer confidence all picked up in Q2 and were consistent with an outturn for consumption growth that was stronger than the Committee had thought likely in May. Indicators of housing market activity had continued to improve, and house prices had been broadly flat in Q2.

13 The weakness of bank lending continued to hang over the prospects for recovery. It was likely that demand for loans had fallen and also that the ability of UK banks to lend was being constrained by a lack of capital. There had been subdued growth in bank lending to households and companies in the twelve months to May. An early read of June's lending panel data suggested that net lending had remained weak in June. That was despite banks reporting a modest improvement in the availability of credit in the Bank's *Credit Conditions Survey* for 2009 Q2.

14 An important judgement was how significant a constraint the low level of bank lending to companies would be on a recovery of the economy. Previous recoveries had not always been associated with strong growth in bank lending, at least in their early stages. Retained earnings were the main source of finance for many firms. Some companies were able to raise finance from capital markets. But access to those markets was mainly restricted to larger companies and recent equity and debt issuance had not compensated for the decline in bank lending flows.

15 The growth of broad money provided a useful diagnostic for the initial impact of the Bank's asset purchases. At first sight, the available estimates suggested that the three-month annualised growth rate of broad money, excluding the money holdings of institutions that intermediate between banks, had fallen back slightly in May. But the monthly estimates of this measure of underlying broad money growth were less reliable than the quarterly data that would be available next month. And even taking the May data at face value suggested that broad money growth, excluding the deposits of institutions that intermediate between banks, had picked up sharply on a three-month annualised basis

since the turn of the year to over 7% – in line with its historical average, and significantly above the lows reached last year.

16 The monetary data did not provide a precise guide to the success of the Bank's asset purchases. It was possible that the impact of the asset purchases this month on the money numbers had been offset by insurance companies and pension funds running down their deposits to buy UK banks' new long-term debt or equity. More generally, companies might use the proceeds from the increased issuance of corporate securities to reduce bank debt rather than increase deposits. If the asset purchases helped banks and businesses to repair their balance sheets, that should support bank lending and money spending in the future.

Supply, costs and prices

17 In line with the pre-release arrangements, an advance estimate for CPI inflation of 1.8% in June had been provided to the Governor ahead of publication. That represented a fall from the 2.2% outturn for May. Little detail had been provided on the breakdown of these numbers, but the fall had been concentrated in food, furniture and household goods.

18 Despite the latest fall, inflation had been surprisingly high over a number of months given both the VAT cut and the large degree of slack that the Committee thought had opened up in the economy. CPI inflation was higher than in the other major economies. The depreciation of sterling was, plausibly, one factor that helped to explain this. Indeed, the profile of CPI inflation in the United Kingdom was similar to those in a number of other developed economies that had recently experienced large exchange rate depreciations. But it was also possible that those factors that were pushing down on inflation, including the recent rise in the degree of slack in the economy, were taking longer than expected to influence the path of inflation.

19 Another potential factor that could explain the resilience of inflation was that the supply potential of the economy may be lower than assumed. Economies that had had significant financial crises in the past seemed to have suffered large and persistent supply contractions. The Committee had already assumed in its May *Inflation Report* projections that the growth of potential supply was likely to weaken considerably. But it was impossible to judge the scale and timing of any effects from the current financial crisis and the recession on the UK supply side with any precision.

20 The labour market had weakened on the month. But employment had come in higher and unemployment lower than the Committee had anticipated. The fall in employment over the past year had been moderate relative to the scale of the output loss. That might in part reflect the fact that a large amount of the fall in output in recent quarters was accounted for by an inventory adjustment, and that firms looked through those temporary fluctuations in output when deciding on the size of their workforce. Another possible explanation was that real wages had adjusted to the lower demand by more than in previous downturns, reducing the need for redundancies. Increased labour market flexibility was one explanation for the weakness of real wages.

21 Growth in money wages was also weak. That was particularly true in the National Accounts measure, where four-quarter wage growth was estimated to have fallen by around seven percentage points in five quarters. Some of the weakness in 2009 Q1 was related to bonuses. Nevertheless, underlying wage growth looked set to weaken further. It was possible that firms were pushing down on wages, in response to rises in import and other costs, rather than putting up prices. That might reflect credibility in the inflation target.

The immediate policy decision

22 At the time of the May *Inflation Report*, the Committee had judged that keeping Bank Rate at 0.5% and purchasing £125 billion of assets was most likely to keep CPI inflation on track to meet the target over the medium term. At its June meeting, the Committee had made no change to Bank Rate or the scale of the asset purchases. The key question for the Committee at the current meeting was whether it needed to make an immediate change to the total of planned asset purchases. It was important to recognise that the degree of monetary stimulus associated with the asset purchase programme was determined by the stock of the assets purchased rather than by the flow of purchases. Decisions on the appropriate degree of monetary stimulus would depend on the outlook for nominal demand and inflation.

23 The downward revision to the GDP data in the *Blue Book* suggested that the contraction in activity in 2008 Q4 and 2009 Q1 had been even more marked than the data had suggested in May. Set against that, the more recent output surveys had continued to rise. The mapping between the surveys

and the likely outcome for GDP was uncertain, but the surveys were consistent with a smaller contraction of GDP in Q2 than the Committee had anticipated two months ago.

24 The surveys suggested that the momentum going into the second half of the year was greater than the Committee had expected in May and the near-term inflation outlook may be a little higher. But there was a strong case for focusing on the underlying forces driving the economy and not placing too much weight on month-to-month movements in short-term indicators. The main factors that had influenced the outlook for economic activity in May were still relevant. The turnaround in the stock cycle, the substantial policy stimulus, and the exchange rate depreciation would all act to boost activity. But balance sheet constraints would tend to limit demand growth. Most obviously the balance sheets of the financial sector at home and abroad needed to adjust. That would restrain lending and could hold back the recovery in the global economy. It was extremely uncertain how large the adjustments would be and how quickly they would occur. Overall, little evidence had emerged since May to change the Committee's views about the broad shape of the prospects for the economy in the medium term, although the downside risks to GDP in the near term had probably diminished.

25 The Committee had not learnt much from developments over the past month that would enable it to assess whether the Asset Purchase Programme would prove more or less effective than it had judged previously. Underlying broad money growth had picked up since the turn of the year, although the monthly money numbers were volatile. More reliable quarterly numbers were due to be published next month. Corporate credit markets had improved, though there was little firm evidence of the impact that the policy of asset purchases was having on a broader range of asset prices.

26 There had not been enough clear evidence to suggest that the £125 billion target should be changed at this meeting. In the short term therefore, asset purchases would continue over the month ahead as they were still short of the target level of £125 billion. The Committee would keep the scale of the programme under review, and the preparation of the August *Inflation Report* offered an opportunity to reassess the stock of asset purchases in the light of a fully updated assessment of the outlook for inflation and growth at its next meeting.

27 The Governor invited the Committee to vote on the proposition that:

Bank Rate should be maintained at 0.5%;

The Bank of England should continue with the programme, as announced following its 7 May meeting, of asset purchases totalling £125 billion financed by the creation of central bank reserves.

The Committee voted unanimously in favour of the proposition.

28 The Committee noted that the Bank would purchase the assets to meet the current £125 billion target at a slower rate over the next month than it had under the programme so far, and that the purchases would continue up until the next policy meeting in August.

29 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
Spencer Dale
Paul Fisher
David Miles
Andrew Sentance

Robert Woods was present as the Treasury representative.