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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 JUNE 2009

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These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 June 2009.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0906.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 8 and 9 July will be published on 22 July 2009.



## MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 JUNE 2009

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

### Financial markets

2 Financial market sentiment had generally improved on the month, although strains remained and many spreads continued to be elevated. The publication of the outcomes of the stress tests for 19 major US banks on 7 May had been received positively. Sentiment had probably also been supported by the mounting evidence that the pace of contraction in the global economy was abating.

3 The spread between the three-month Libor rate and the risk-free rate had fallen by nearly 20 basis points. Long-term bank debt and corporate bond spreads had also fallen. Three-month Libor spreads were now broadly similar to those existing prior to the failure of Lehman Brothers, although spreads on longer-term bank and corporate debt remained elevated compared with this benchmark. Some of the major UK banks had issued medium-term unguaranteed debt during May, but feedback from market participants was that the volume of term wholesale funding remained limited. Gross capital market issuance by private non-financial companies had been above the average of recent years.

4 The Committee's decision on 7 May to keep Bank Rate at 0.5% and expand the scale of its asset purchase programme to a total of £125 billion had not immediately led to significant changes in short rates of interest or gilt yields. But short-term rate expectations and medium-term gilt yields had fallen somewhat following the publication of the *Inflation Report*.

5 Medium and long-term government bond yields in the United States and euro area had increased by around 20-50 basis points over the month. UK gilt yields had generally increased by a lesser amount, particularly at medium-term maturities. Following the 21 May announcement that Standard

and Poor's had placed the United Kingdom's sovereign rating on negative outlook, medium and long-term gilt yields rose by around 10 basis points. Nevertheless, the rise in yields on the day was not confined to the United Kingdom, with reports of increased market concerns about the prospects of downgrades to industrialised countries more generally.

6 Sterling had appreciated by 4% on the month and by 12% since of the start of year. The appreciation could have been caused by a correction to excessive pessimism around the start of the year about the United Kingdom's prospects relative to its major trading partners.

7 Over the past month the dollar ERI had depreciated by 5.5%. That was consistent with investors being more willing to diversify portfolios out of the main international reserve currency as financial market sentiment improved, but could also signify increased concerns about the US economy.

8 The major equity price indices in the United Kingdom, United States and euro area were broadly unchanged over the month.

### **The international economy**

9 Euro-area GDP had contracted by 2.5% during the first quarter; a somewhat larger fall than market participants had expected. During the first quarter, activity had generally fallen most in those euro-area countries that had run current account surpluses in recent years and in which exports accounted for a larger proportion of GDP. Activity in Japan had fallen by a record 4.0% in 2009 Q1. Nevertheless, there was relatively little new information in these data, which served mainly to confirm that global activity had contracted sharply around the turn of the year.

10 More timely indicators for 2009 Q2 suggested that the rate of contraction in the global economy was declining and that the trough in activity might be reached soon. The JPMorgan global manufacturing Purchasing Managers Index (PMI) had continued to rise, reaching 45.3 in May, its highest level for nine months. The scores for both output and new orders had risen. The US and euro-area manufacturing PMIs had both increased, with the new orders component in the United States rising above 50, a balance consistent with increasing activity, for the first time since November 2007. These encouraging signs had been apparent also in Asia. The service sector activity PMI for the euro area had also risen.

11 Dollar oil prices had risen by 18% on the month to levels last reached in mid-October 2008. Other commodity prices had also increased over the month. The rise in oil prices was likely to be in part related to increasing optimism about economic prospects, set against the background of the cuts in OPEC quotas announced during the fourth quarter of 2008. But oil prices might also have been boosted by demand for a hedge against a prospective rise in world inflation.

12 These developments in near-term activity gave little insight into the likely strength and durability of the recovery in global activity. The outlook depended, in part, on the ability of surplus countries to generate more domestic demand.

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

13 Nominal GDP had fallen for the third successive quarter in Q1, and by almost 2.5% compared with a year earlier. That was the weakest four-quarter growth rate since quarterly records began in 1955.

14 M4 growth had continued to fall in April, with the three-month annualised growth rate falling to 7.8%. However, these data were distorted by the impact from money holdings of institutions that intermediate between banks. The three-month annualised rate of growth of M4 excluding the deposits of these intermediaries had increased in April. The bulk of this underlying increase had been concentrated in non-bank financial corporations' money balances. That might suggest that the programme of asset purchases was beginning to have an impact on the quantity of broad money. More timely market intelligence gathered during May indicated that a significant proportion of the gilts purchased by the Bank had been sold by institutional investors. But as yet there had been no rise in private non-financial companies' holdings of money.

15 M4 lending to households remained weak in April, and the twelve-month growth rate of lending to private non-financial companies (excluding the effects of securitisation) had fallen to 0.8%. The demand for credit was likely to have fallen as households and firms responded to the deterioration in macroeconomic conditions. But the supply of bank credit had probably been reduced too. In a survey conducted by the Agents during May, over 80% of respondents reported that external finance had become more expensive and harder to obtain over the past year. The supply of credit by banks to

households and private non-financial firms was likely to remain constrained as long as banks were restructuring their balance sheets. Non-financial firms were making greater use of capital markets to raise finance but there were limits on the extent to which capital markets could serve as a substitute for bank lending, especially for smaller firms. Moreover, despite relatively strong gross debt capital market issuance in the three months to April, repayments had also been strong, so that net borrowing had been weak.

16 The CIPS/Markit survey measures of manufacturing and services output had both increased in May, with the services index pointing to increasing activity for the first time since April 2008. These surveys pointed to a smaller contraction in activity in the second quarter than had been anticipated at the time of the *May Inflation Report*. Other surveys, however, from the British Chambers of Commerce and CBI had suggested less of an improvement. The ONS manufacturing output index had stabilised in March. Overall, it was less likely than in May that activity would continue to decline at the exceptional rates observed in the final quarter of 2008 and the first quarter of 2009.

17 Consumption was estimated to have fallen by around 1% in both 2008 Q4 and 2009 Q1. Since then, however, the available surveys on consumer spending, together with reports from the Bank's regional Agents, had suggested an easing in the pace of decline. There were a number of possible explanations for such a stabilisation. Households could already have made significant progress in adjusting their consumption plans in response to the worsened economic outlook. Or households could be currently underestimating the size of the adjustment to consumption necessary in response to the recession. Finally, it could be that the stimulatory monetary and fiscal policies were providing a greater-than-expected boost to current consumption. The apparent near-term resilience in consumption was more likely to persist if the first explanation had been an important factor, but it was not possible to discriminate between these different hypotheses on the basis of the available data. As such it would be premature to conclude that the medium-term prospects for consumption had strengthened.

18 Housing market activity had picked up. The number of loan approvals for house purchase had increased by 8% in April and the preview of the May survey of the Royal Institution of Chartered Surveyors showed further improvement across most housing market activity indicators, with new buyer enquiries and sales both picking up. Both the Nationwide and Halifax measures of house prices had increased in May, the first time that that had happened since August 2007, and had increased by an average of 1.9%. But activity remained subdued, with the level of loan approvals for house purchase

less than half of its average of the past decade. In such a thin market there was likely to be greater volatility than usual in housing market indicators. A stabilisation of house prices at current levels would benefit homeowners, limiting the reduction in their net wealth and capping the scale of negative equity, and would provide support to the balance sheet position of banks.

19 Business investment had fallen by 5.5% during the first quarter. Intelligence gathered by the Bank's regional Agents suggested that tighter financing conditions were acting as a dampening influence on capital investment.

20 Stockbuilding was estimated to have detracted less from GDP growth during the first quarter than it had a quarter earlier. It was possible that stockbuilding would make a small positive contribution to output growth in the second quarter.

21 Net trade had contributed 0.1 percentage points to growth during the first quarter. This was a smaller contribution than in the final quarter of 2008, reflecting a larger fall in exports. But net trade was likely to continue making a positive contribution to GDP as the depreciation of sterling supported exports and encouraged import substitution. That effect could, however, be attenuated by the deterioration in global demand conditions or a persistence of the more recent appreciation of sterling.

### **Costs and prices**

22 According to the Labour Force Survey (LFS), employment had fallen by 157,000 in the three months to March. And unemployment had risen by 244,000 over the same period, a somewhat larger increase than in previous months. The more timely claimant count measure of unemployment for April had increased, but by the smallest amount since October. Moreover, surveys of employment intentions had picked up in May, pointing to smaller future declines in employment than had been the case in previous months.

23 The more optimistic near-term employment indicators might prove misleading; either way unemployment was likely to continue rising significantly for some months. But the claimant count and surveys of employment intentions could also indicate that labour demand was moving in tandem with activity, rather than lagging behind, as had been the case in past downturns. Additionally, it could be that average hours, which on the LFS estimate had fallen by 1.4% in the three months to March, would

absorb a greater share of any ongoing adjustment, tempering future unemployment rises. Such outcomes would be consistent with greater labour market flexibility than in past recessions.

24 Earnings growth remained extremely subdued. According to the average earnings index (AEI), whole-economy average earnings increased by just 1.0% in the twelve months to March, having been negative during the previous two months. Total earnings had been depressed by the weakness of bonuses during the first quarter. Excluding bonuses, twelve-month AEI growth had increased by 2.8% in March, little changed compared with a month earlier. Settlements remained subdued too.

25 As expected, CPI inflation had fallen sharply to 2.3% in April. The Committee continued to expect annual CPI inflation to fall back over the remainder of 2009, moving below the 2% target. RPI inflation had fallen further and remained negative in April.

26 Medium-term measures of inflation expectations had not changed significantly on the month according to Citigroup/YouGov, and were close to their average over the past six months. Although market-based measures had increased over the month, they showed no discernable trend over the quarter.

27 The recent rise in oil and other commodity prices posed an upside risk to inflation in the short run. Set against these price rises, the exchange rate had appreciated further during May, particularly against the US dollar. That would tend to dampen inflationary pressures.

### **The immediate policy decision**

28 The Bank had acquired just less than £80 billion of assets financed by the issuance of central bank reserves. It would take a further two months to meet the £125 billion target for purchases. It remained too early to assess the impact of the asset purchase programme on nominal demand. Nevertheless, excluding the effect of money holdings of financial institutions that intermediate between banks, M4 growth had increased during April with the majority of this underlying increase concentrated in other financial corporations' money balances. This provided tentative evidence that the asset purchase programme was succeeding in boosting the money holdings of institutional investors, a first stage in the transmission mechanism from asset purchases through to the economy. But the growth rate of households' and private non-financial companies' money balances remained

subdued. The Committee would continue to monitor carefully the evidence about the effect of its asset purchases on the economy.

29 There was tentative evidence that the corporate asset purchase schemes had been helping to improve market functioning. Since the launch of the commercial paper facility the value of commercial paper issued by lower-rated companies had increased and issuance spreads had fallen. The corporate bond facility had contributed to improved price transparency in secondary markets through the disclosure of auction results, and there was evidence that bid-ask spreads had declined. But it was difficult to know whether these improvements in the secondary market had contributed to the recent strength of primary market issuance by companies. Moreover, there had not yet been a fall in many indicators of liquidity premia. The Governor informed Committee members that the Bank was planning to consult the market about the introduction of a Secured Commercial Paper Facility and a Supply Chain Finance Facility to support the provision of working capital to companies.

30 Survey and market-based measures of medium-term inflation expectations were broadly unchanged compared with a quarter earlier and did not suggest that expectations had become de-anchored from the inflation target. The Committee would continue to monitor inflation expectations and other measures of its credibility when assessing the appropriate stance of policy. It would also continue to communicate how and why the asset purchase programme would work, and that it could and would tighten policy once the current exceptional degree of monetary stimulus was no longer warranted.

31 The news over the month had been mostly encouraging. Conditions in financial markets had continued to improve. Activity indicators for Q2, especially the PMI surveys, suggested that the rate of contraction in the global and UK economies had slowed, and there were signs of improving business confidence. There had also been signs that the second-quarter decline in consumption would be smaller than the Committee had previously anticipated. The housing market showed signs of stabilising. According to the LFS, unemployment had increased sharply between February and March, but more timely indicators, including the claimant count measure of unemployment, provided some evidence that unemployment was beginning to increase more slowly.

32 Such positive developments had the potential to reinforce each other. Evidence of better-than-expected near-term demand and output could encourage firms to maintain the size of their



workforces rather than shed labour aggressively. A more muted rise in unemployment, combined with signs of stabilisation in the housing market, could also bolster household confidence and temper the need for increased precautionary saving. And such developments had the potential to limit the size of losses to which UK banks were exposed, improving their willingness and ability to lend.

33 Set against these positive developments, sterling had appreciated and oil prices had increased sharply over the month. The appreciation of sterling in recent months might represent the unwinding of some excess pessimism about the United Kingdom's prospects compared with other major industrialised economies. But it would reduce the boost to net trade arising from the depreciation since Summer 2007, particularly if sterling appreciated further in coming months. The appreciation of sterling would tend to reduce inflationary pressures in the short term, while the increase in oil prices would have the opposite effect.

34 Even if developments over the month had been positive, the increase in confidence apparent in some financial market indicators and some household and corporate sector surveys remained fragile. Adverse shocks had the potential to derail the improvement in confidence and forestall the recent improvement in economic conditions.

35 Significant risks remained domestically and overseas. Developments over the month had not altered the key downside risks to the medium-term outlook that had been identified in the *Inflation Report*. In particular, the outlook for credit supply remained constrained. Firms were making greater use of capital markets but those markets were not likely to substitute fully for the banking sector. Smaller firms and households would remain heavily reliant on the banking sector and there was no compelling evidence that the recovery in the supply of credit from banks would be any quicker than the Committee had assumed a month ago. This highlighted the importance of banks continuing to strengthen their balance sheets, without constraining lending. It would be premature to conclude from the most recent data on consumption that the risks of a pronounced rise in household savings had diminished. Savings could rise sharply if households became more uncertain about their job prospects, revised down their expectations of future post-tax incomes or became more pessimistic about their future access to credit.

36 Overall, the risk of a continued sharp contraction in output in the near term had receded somewhat. However, there was no reason to conclude that the medium-term outlook for the economy, and thus inflation, had changed materially since the *Inflation Report* had been finalised.

37 At its May meeting, the Committee had judged that Bank Rate should be maintained at 0.5% and that the asset purchase programme should be expanded to a total of £125 billion. While the near-term prospects had improved somewhat the balance of risks to inflation further out had not altered materially since then. The Committee agreed that Bank Rate should remain at 0.5% and that no change should be made to the scale of purchases under the asset purchase programme.

38 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.

39 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

Dave Ramsden was present as the Treasury representative.