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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 MAY 2009

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 May 2009.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0905.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 3 and 4 June will be published on 17 June 2009.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 MAY 2009

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and costs and prices. The Committee noted a letter from the Chancellor (attached as an annex) setting out the remit for the Committee over the following year, in accordance with Section 12 of the Bank of England Act.

Financial markets

2 Financial market sentiment had generally improved during the month. The three-month LIBOR rate had continued to fall, and spreads over risk-free rates had continued to decline. That might have in part reflected reduced demand by UK banks for this type of funding following the rise in bank reserves generated by the Monetary Policy Committee's asset purchases. But the narrowing of LIBOR spreads had also been a feature of US and euro-area markets. Major UK banks' Credit Default Swap (CDS) premia – a measure of likely default on debt – had fallen somewhat, continuing the gradual downward trend apparent since March.

3 Since the MPC's decision at its March meeting to purchase assets financed by the issuance of central bank reserves, the Bank had acquired just over £52 billion of assets through its Asset Purchase Facility (APF). Secured overnight rates had declined somewhat over the past month and had on a number of occasions traded marginally below Bank Rate.

4 The bulk of the purchases under the APF had been of gilts. Yields on gilts with maturities above ten years were around 10-30 basis points lower than at the time of the March decision to start asset purchases financed by the issuance of central bank reserves. Gilt yields had generally risen on the month. Market contacts had attributed at least some of the rise to news about the scale of the increased government borrowing revealed in the Budget.

5 The Bank's holdings of commercial paper had not changed much since the April MPC meeting. Net purchases financed by the issuance of central bank reserves still amounted to around £1 billion. The success of this scheme should not be judged by the quantity of assets purchased. Spreads in the market for commercial paper had fallen and were bunching around or below those offered by the Bank. There was also evidence that there had been more issuance of A2 rated commercial paper taking place than before the APF was introduced.

6 Market contacts had become more positive about the impact of the APF corporate bond scheme. Bid-offer spreads for eligible bonds had narrowed in the secondary market since the programme's inception, although the causal link to asset purchases was unclear. The aim of the programme was to make frequent, but relatively small, purchases in the secondary market to aid price discovery and thereby to improve the functioning of that market. There had been steady falls in sterling investment grade corporate bond yields over the month, although movements in other investment grade markets had been more pronounced. Gross issuance of corporate securities had risen since the start of the year.

7 UK equity prices had risen by 13% on the month, following a rise in the previous month, with the United Kingdom sharing a more general recovery in global equity markets. There had been further downward revisions to market analysts' expectations of UK companies' earnings growth in 2009. So it was not obvious that market participants' views about the most likely path for the economy had improved. However, it was possible that the increases in equity prices, and the improvement in financial market sentiment more generally, reflected reduced perceptions of risk associated with these assets, perhaps related to a lower probability of extreme negative outturns for the macroeconomy.

8 The sterling exchange rate index had risen slightly on the month.

The international economy

9 US GDP had fallen by 1.6% in Q1, a larger fall than many market commentators had expected, with negative contributions from investment and inventories. In the euro area, industrial production had fallen in February – the sixth month in a row; unemployment had continued to rise in March; and leading growth was slowing.

10 But there had also been some encouraging developments in the world economy. There had been signs that the sharp fall in world trade was coming to an end. According to the Netherlands Bureau for Economic Policy Analysis, the volume of world trade in goods had risen by 0.8% in February, having fallen 16.8% in the year to January. More timely, though less reliable, indicators of global trade such as air freight volumes suggested that world trade had not fallen in March also.

11 Business surveys indicated that, though the level of global output was probably still falling, the rate of contraction was slowing. The JP Morgan global manufacturing Purchasing Managers Index (PMI) had continued to rise, reaching 41.8 in April from 37.3 in March. The scores for output, employment and new orders had all increased. There had also been encouraging developments in the services PMIs, with both the US and euro-area indices increasing in April. The EC manufacturing and services business confidence measures had also picked up in April – for the first time since the middle of 2008.

12 Having deteriorated rapidly during the past six months, recent data for Asia had improved. In addition to the PMIs picking up, Japanese industrial production had risen in March for the first time in six months and production plans for April and May were for further growth. Korean GDP had risen by 0.1% in the first quarter, after falling by 5.1% in 2008 Q4. And new bank lending in China during Q1 was higher than for the whole of 2008.

13 A key question for the long-term sustainability of the recovery would be whether the major surplus countries could generate more domestic demand. If not, global growth was likely to remain subdued.

14 Counter-cyclical fiscal stimulus packages and measures to deal with losses in the global banking system had added significantly to public sector liabilities around the world. It was possible that governments would have to begin to deal with these growing debts and deficits in the near future, which could cause the world recovery to lose momentum. Equally, the realisation among households and companies of the greater tax burden that the higher public borrowing would eventually imply, could impede any pickup in the global economy.

15 Banks around the world were still in the process of restructuring their balance sheets. There was a risk that this would prolong the time it took for bank lending to return to more normal levels.

Money, credit, demand and output

16 The MPC's programme of asset purchases was intended to affect the economy by boosting the money supply and nominal spending. But it was too soon to see that in the data. Financial companies had continued to increase their deposit balances in March, though the growth rate of aggregate broad money (excluding the impact from money holdings of institutions that intermediate between banks) remained weak. Bank lending growth had also been subdued, while spreads over Bank Rate on secured and unsecured loans to households had risen. Nominal GDP data were only available for the final quarter of 2008. Nominal GDP had fallen by 1% in Q4, and the decline in 2009 Q1 was likely to have been larger. The shock to demand from collapsing confidence and the turmoil in financial markets appeared to have had a greater impact on economic activity than the Committee had projected in February. According to the latest official data on volumes, GDP had fallen by 1.9% in 2009 Q1 – the largest quarterly fall since 1979 Q3.

17 There were some promising signs from business surveys that the pace of the decline in output may have moderated in 2009 Q2. According to the CIPS/Markit surveys, the output and orders indices for both manufacturing and services had continued to pick up in April. In the services survey, the business activity balance had risen for the fifth consecutive month, and stood at its highest level since August 2008. In the manufacturing survey, the output balance had increased by three points to 44.6, twelve points above the series low seen in February.

18 The latest indicators of household spending suggested that consumption had fallen further in the first quarter, following a sharp drop in 2008 Q4. There were few indicators of spending on consumer services, but the falls in services output in the first quarter pointed to a marked contraction in that component of consumption. Spending on goods, by contrast, had not fallen, at least according to official data. The ONS estimated that retail sales volumes had risen by 0.9% in 2009 Q1, following growth of 0.7% in 2008 Q4. But these estimates were likely to be revised down somewhat in the coming months, when the ONS updated the weights used to construct the retail sales volume index.

19 The CBI *Distributive Trades Survey* balance for retail sales had jumped from -44 in March to +3 in April. But it was likely that this number was affected by the timing of Easter compared with the previous year. According to the GfK survey, consumer confidence had continued to rise in April, and the headline balance had picked up by ten points since January.

20 House prices (as measured by the average of the lenders' indices) had fallen by 1.0% in April, consistent with a further easing in house price deflation, and remained around 20% below their October 2007 peak. The preview of the April survey from the Royal Institution of Chartered Surveyors showed further improvements across most housing market activity indicators: new buyer enquiries and sales had continued to pick up. Mortgage approvals for house purchase had also recovered further in March, but remained around 60% below their long-term average.

21 The near-term outlook for business investment was subdued. Construction orders for new commercial property had fallen by 36% in the three months to February. And although some forward-looking surveys of investment in plant and machinery had stabilised in the first quarter, they remained at historically low levels, and continued to suggest that further cutbacks in investment would take place in the months ahead.

22 There had been little additional information on stockbuilding during the month. But manufacturing surveys suggested that firms may have continued to run down their inventories in 2009 Q1.

23 The Government had set out its latest fiscal plans in the April Budget. The Budget had included some additional discretionary measures, which should help to support demand in the near term. However, the Treasury's projection for public sector net borrowing had been revised up substantially and this could depress spending to the extent that households and companies expected the higher level of borrowing to lead to higher taxes in the future.

24 Exports had fallen by 3.7% in the fourth quarter. The CIPS/Markit survey index for manufacturing export orders had picked up more recently. Though it remained just below the "no-change" level, April had seen the largest rise in the index for a single month since the series began. The fall in UK exports was likely to have been smaller than the decline in world trade. The fall in global demand had particularly affected certain types of goods, and goods made up a smaller proportion of UK exports than for the world as a whole. Furthermore, it was likely that the downward pressure on UK export growth was being partly offset by the decline in the sterling exchange rate, which had fallen by more than a quarter since mid-2007. The depreciation of sterling had also

discouraged spending on imports, thus encouraging more demand for domestically produced goods and services – a trend confirmed by contacts of the Bank’s regional Agents.

Costs and prices

25 According to the Labour Force Survey (LFS), employment had fallen by 126,000 in the three months to February. And unemployment had risen by 177,000 over the same period. Business surveys of employment intentions suggested that there would be further marked falls in employment in the near term.

26 Earnings growth had fallen very sharply in the early months of 2009. According to the average earnings index (AEI), whole economy earnings fell by 0.4% in January and 2.1% in February compared with a year earlier – the first falls over a twelve-month period since the series began in 1964. The average weekly earnings measure had been weaker still, falling by nearly 6% in the year to February. The falls in overall earnings had largely reflected a sharp drop in bonuses, particularly in the financial sector. Excluding bonus payments, twelve-month pay growth had eased back to 2.9% in February, from 3.4% in January, according to the AEI. The latest wage settlements data had also pointed to weakness in earnings growth. A substantial number of settlements agreed so far in 2009 had been for no increase in basic pay.

27 The weakness in earnings growth was likely to be the result of a number of factors. The subdued wage data had probably reflected reduced demand for labour following the recent falls in output. The rise in non-labour costs could have been an additional factor putting downward pressure on wage growth. The depreciation of sterling since the middle of 2007 had had a pronounced effect on many businesses’ costs, by increasing the price of imported goods and services used in production. Some businesses had probably sought to offset some of the increases in the costs of imports by cutting back on their wage bills. Workers may also have responded to the depreciation of sterling and the onset of the recession by accepting lower or no wage increases, in an attempt to encourage their employers to achieve more of the desired reduction in labour costs through weaker pay, rather than through reductions in employment. A further possible reason for the fall in nominal wage growth was the reduction in some measures of inflation and inflation expectations.

28 CPI inflation in March had been 2.9%, above the 2% target and the Committee's central projection for inflation in the February *Inflation Report*. That surprising resilience had probably reflected the lower level of sterling continuing to exert upwards pressure on inflation. Despite the recent unexpectedly high outturns, the MPC continued to expect annual CPI inflation to fall rapidly over the remainder of 2009 to well below the inflation target. RPI inflation had turned negative in March, pulled down by the impact of reductions in Bank Rate on mortgage interest payments and by declines in the housing depreciation component of the index.

29 One-year-ahead measures of household inflation expectations had stabilised at levels which appeared consistent with CPI inflation dipping below the 2% target during the next twelve months. Longer-term measures of expectations had changed little on the quarter and remained slightly below their recent averages. The MPC would continue to monitor these data closely in the coming months.

The May GDP growth and inflation projections

30 The Committee reached its policy decision in the light of the projections to be published in the *Inflation Report* on Wednesday 13 May. The outlook for economic growth was unusually uncertain. The sharp downturn in global economic activity, combined with the process of adjustment underway in the UK economy as households and companies, especially in the financial sector, restructured their balance sheets, continued to act as a significant drag on growth. But that was counteracted by the considerable stimulus stemming from the easing in monetary and fiscal policy at home and abroad, the substantial depreciation in sterling, past falls in commodity prices, and actions taken by authorities internationally to bolster the availability of credit. That stimulus, when combined with a turnaround in the stock cycle, should lead to a recovery in economic growth over the forecast period.

31 Whatever the outlook over the next year, the strength and sustainability of the recovery in the medium term was uncertain. On the one hand, the contraction in world demand and trade could be protracted; households might save more; and the availability of credit to companies and households might improve only gradually. On the other hand, it was possible that the substantial scale of the economic stimulus in train could prompt a rapid rebound in economic activity. In particular, the impact of monetary policy on nominal spending was more difficult to judge than normal. On balance, the Committee judged that these factors taken together pointed to a relatively slow recovery in economic activity.

32 The outlook for inflation also remained extremely uncertain. The margin of spare capacity that was likely to persist over the forecast period would bear down on CPI inflation. That was partly offset by the upward pressure associated with the pass-through of sterling's depreciation to consumer prices. The balance of these factors suggested that, conditioned on the assumptions that Bank Rate followed a path implied by market yields and the stock of purchased assets increased to £125 billion, it was more likely than not that CPI inflation would be below the 2% inflation target in the medium term. In the projection for CPI inflation conditioned on Bank Rate held constant at 0.5%, the risks of inflation being above or below the 2% target became more evenly balanced towards the two-year horizon.

The immediate policy decision

33 Output had continued to contract across the world, and international trade had fallen precipitously. The global banking and financial system remained fragile. In the United Kingdom, GDP had fallen sharply in the first quarter of 2009, and by more than the Committee had expected at both the time of the February *Inflation Report* and at the time of its March meeting when it had decided to undertake a £75 billion programme of asset purchases. There were some promising signs in a range of surveys that the pace of decline in activity had moderated. But those data provided only an indication of activity in the short run and offered little insight as to how robust or sustained any recovery might be.

34 CPI inflation had been 2.9% in March, significantly higher than the 2% inflation target. CPI inflation was likely to drop below the target over the coming months, driven in part by diminishing contributions from food and energy prices. But the falls in output that had already occurred, combined with the relatively subdued outlook for growth, meant that there was likely to be a substantial margin of spare capacity bearing down on inflation for some time. The outlook for inflation indicated that, on balance, some further monetary stimulus was probably needed to ensure that inflation would meet the 2% target in the medium term.

35 Market participants appeared to expect Bank Rate to rise around the turn of the year and to continue increasing thereafter. It was possible that the publication of a projection, based on market yields, in which inflation was more likely than not to undershoot the target might lead the market yield curve to fall, delivering an additional degree of monetary stimulus.

36 There were some arguments for not extending the £75 billion asset purchase programme this month. There was uncertainty about the impact of asset purchases on this scale to stimulate nominal spending. The Committee would learn a considerable amount about the transmission mechanism of asset purchases in the coming months. There were also signs that economic conditions could be starting to improve. There was a substantial degree of monetary stimulus already in train and, given the uncertain nature of the transmission mechanism, there was a risk that the Committee would not be able to identify early enough when it should be withdrawn. With the benefit of more information on the impact of its existing asset purchase programme, the Committee would be in a better position to judge these issues at future policy meetings.

37 But there were also arguments in favour of expanding the asset purchase programme at this meeting. In *Inflation Report* months, the Committee took stock of the likely outcomes through the discussion and analysis that led up to agreeing its quarterly projections for growth and inflation. On balance, the recovery was likely to be relatively slow. There was a persistent degree of slack forecast for the economy and a high probability that inflation, in the absence of a further monetary stimulus, could significantly undershoot the 2% target in the medium term. The projections indicated that more monetary stimulus was probably needed to bring inflation back to target in the medium term. The Committee could use the instrument of asset purchases to stimulate demand, thus enabling it to reduce the period of time at which Bank Rate had to be held at extraordinarily low levels. There was an expectation in markets and elsewhere that the asset purchase programme would be extended. Failure to do so when the economic outlook suggested more monetary stimulus was necessary could harm the public's confidence in the recovery.

38 The risks of stimulating demand too little at the current time seemed greater than the risks of stimulating it too much. If the recovery faltered, then policymakers might find that their ability to stimulate demand in the face of receding confidence would be impaired. But if inflation were to rise more rapidly than expected and appeared likely to breach the inflation target on the upside, then monetary policy could be tightened through some combination of raising Bank Rate and selling assets back to the market. The Committee was alert to such risks and would take effective action should they crystallise.

39 The Chancellor had set an initial upper limit of £150 billion for the indemnity on the Asset Purchase Facility. This had been confirmed in the annual remit for the Committee attached as an annex to these Minutes. The Committee would ask the Governor to write to the Chancellor seeking an increase in that limit should economic conditions require it.

40 All members agreed that the asset purchase programme should be extended this month. The Committee discussed the case for increasing the size of the programme by either £50 billion or £75 billion. For some members, the economic outlook warranted an increase in the size of the programme of £50 billion. For other members, a case could be made for the larger stimulus. But as the precise amount that would ultimately be required was so uncertain, there was no pressing need for the larger extension at this meeting. The programme would be reviewed every month. The amount of assets purchased could then be increased or decreased in light of the Committee's assessment of economic developments.

41 In light of the outlook for inflation, the Committee agreed to maintain Bank Rate at 0.5% and increase the size of asset purchases by £50 billion to a total of £125 billion – with the remaining purchases of that new total to be completed in three months. The maturity range of the gilts purchased would be kept under review.

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

Bank Rate should be maintained at 0.5%;

The Bank of England should finance a further £50 billion of asset purchases by the creation of central bank reserves, implying a total quantity of £125 billion of such asset purchases. The Bank should seek to complete the £125 billion of purchases within the next three months.

The Committee voted unanimously in favour of the proposition.

43 The Committee noted that purchases of private sector assets under the Asset Purchase Facility would continue to be financed using central bank reserves rather than Treasury Bills and, in so far as such purchases fell short of the £125 billion total, the Bank of England would buy gilts.

44 Finally, the Governor expressed his appreciation to David Blanchflower for his contribution as a member of the Committee.

45 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.