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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 4 AND 5 NOVEMBER 2009

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 November 2009.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0911.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 9 and 10 December will be published on 23 December 2009.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 NOVEMBER 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 supply, costs and prices.

Financial markets

2 Since the low in March 2009, the prices of many sterling financial assets had risen substantially. But during the past month most prices had been little changed.

3 UK equity prices had fallen by around ½% over the month. The fall was more than accounted for by a decline of around 5% in banking sector stocks, which had been prompted, in part, by announcements from competition authorities about banks that had received support from EU governments during the crisis. Nevertheless, equity prices remained well above both their March troughs, and their levels at the time of the *August Inflation Report*.

4 Short-term sterling interest rate expectations were broadly unchanged over the month. UK government bond yields had risen by a small amount. These increases had not been matched by changes in index-linked UK government bond yields so that the implied compensation that market participants required for exposure to inflation had drifted up slightly. UK government bond yields had generally increased relative to equivalent dollar and euro yields over the month.

5 Sterling Libor-OIS spreads had edged up over the month, but remained close to pre-crisis averages. Spreads on secondary market bank debt had declined further. For the second month running, a UK financial institution had issued a sterling-denominated residential mortgage-backed security; there had also been further issuance of government-guaranteed bank debt. Yields on sterling-denominated sub-investment grade bonds had declined by more than 100 basis points; investment-grade corporate bond yields had risen slightly, although spreads over government bonds

had fallen.

6 Sterling had appreciated by nearly 4% on an effective basis over the month; but remained lower than it had been at the time of the *August Inflation Report*.

The international economy

7 The world economy had continued to show signs of recovery, with further evidence that a number of emerging market economies were experiencing a strong rebound in growth. But the level of global economic activity as a whole remained significantly depressed relative to a continuation of pre-crisis trends.

8 Strong growth persisted in a number of Asian economies. Chinese GDP had grown by nearly 9% in the four quarters to 2009 Q3. A wide range of indicators suggested that Chinese domestic demand growth remained buoyant, in part supported by monetary and fiscal policy.

9 US GDP had grown by 0.9% in the third quarter, its first increase since 2008 Q2, but remained 3% below its pre-crisis peak. Part of the strength in GDP growth was likely to prove temporary. Discretionary fiscal policy, including the now closed car scrappage scheme, continued to boost spending. And stockbuilding had contributed to Q3 growth, but that large positive effect was set to decline over coming quarters. Residential investment, however, had increased during the third quarter for the first time since late 2005. That recovery was consistent with other indicators that pointed to some turnaround in the US housing market, and could provide support for private sector demand. Monthly surveys suggested that the US economy had continued growing during the start of the fourth quarter.

10 Euro-area GDP had declined by just over 5% from its pre-crisis peak through to the second quarter. Q3 GDP data had not been released yet. The available evidence suggested that output had probably increased, although growth rates remained uneven across countries. The euro-area manufacturing PMI for October had risen above 50 for the first time since May 2008 and the services business activity index had increased further to 52.6; together they pointed to continued positive growth at the start of the fourth quarter. Temporary measures, including car scrappage schemes, were likely to have supported activity into the second half of the year. Output in those euro-area economies

in which net exports typically made a significant contribution to growth, such as Germany, would also have been boosted by the global recovery.

Money, credit, demand and output

11 M4 growth, adjusted to exclude the money holdings of institutions that intermediate funds between banks, had declined by 1.7% on a three-month annualised basis in September, below estimated growth of over 3% a month earlier. A significant reduction in the money balances of financial companies that did not intermediate funds between banks – mainly institutional investors such as pension funds and unit trusts – accounted for this decline. That might imply that the fall in adjusted M4 growth had fewer implications for nominal demand than otherwise. The growth rate of household and non-financial companies' money balances had not changed much between August and September: both remained a little below 4% on a three-month annualised basis. Broad money growth would have been weaker in the absence of the asset purchase programme.

12 The flow of credit to households and non-financial firms had remained subdued. Total bank lending to individuals had grown by just 0.3% on a three-month annualised basis in September, while net lending to non-financial companies remained negative. Businesses had continued to use bond and equity markets to raise funds, counterbalancing to some extent the weakness in bank credit. Non-financial companies had raised £4 billion net funds from capital markets during the third quarter, above the levels raised in the third quarter in recent years, but much less than the £21 billion that they had raised during the second quarter.

13 The ONS had estimated that GDP had fallen by 0.4% during the third quarter, a significantly weaker outcome than the Committee had expected at the time of the *August Inflation Report*. According to the preliminary release, none of the published sectoral indices had risen in Q3. Initial estimates of GDP were prone to revision as more complete data became available, providing grounds for interpreting the release cautiously. In addition, some business surveys for the third quarter pointed to a somewhat stronger number than the initial ONS estimate.

14 The most recent industrial production data, which had been compiled after the preliminary third-quarter GDP release, however, were broadly consistent with that initial estimate. Industrial production had declined by 0.8% over the quarter, with manufacturing output little changed. The

monthly data suggested that activity had picked up towards the end of the quarter, with industrial production having grown by 1.5% in September. That was consistent with a stronger outlook for the fourth quarter, although monthly developments were volatile and had to be interpreted cautiously.

15 Households had reduced their consumption substantially over the past year or so. Weakness in current and expected post-tax income and a desire to strengthen their balance sheets in a more uncertain economic environment were likely to have contributed to this contraction in spending. But indicators of retail spending and consumer confidence had picked up during Q3 and in October, possibly heralding some stabilisation in consumption in coming quarters. Businesses continued to make sharp cutbacks to spending in the face of weak demand, uncertain growth prospects and tight credit conditions. Business investment was judged likely to fall further in coming quarters, although a reduction in the pace of de-stocking was expected to boost output growth.

Supply, costs and prices

16 CPI inflation declined to 1.1% in September having been 5.2% a year earlier. Inflation was likely to rise sharply above the 2% target in the near term, reflecting higher petrol price inflation and the upcoming reversal of last year's reduction in VAT. The near-term prospects for inflation were more uncertain than usual, in part because it was unclear how retailers would respond to the VAT reversal, but also because it was difficult to disentangle the offsetting effects on inflation of the large margin of spare capacity that had been growing and the past depreciation of sterling.

17 Most measures of household's inflation expectations for the medium term had been stable during 2009 at levels that appeared broadly consistent with the target. But there was some evidence from inflation expectations derived from bond prices, inflation swaps and surveys that the medium-term inflation expectations of market participants and professional forecasters had edged up in recent months.

18 Whole-economy earnings growth remained weak. In the three months to August both the average earnings index and average weekly earnings measures of annual regular pay growth had fallen further, to 1.9% and 1.5% respectively.

19 According to the LFS measure, the number of people employed had declined by 45,000 in the three months to August. This decline was substantially less than the decline of 269,000 in the previous non-overlapping three-month period. Employment surveys also continued to suggest that the rate of job shedding had slowed. That had been accompanied by further falls in average hours worked: the LFS measure for the three months to August had fallen sharply compared with the previous non-overlapping quarter. The wedge between the LFS and claimant count measures of unemployment had narrowed and both suggested that the rate of increase in unemployment had declined in recent months.

The November GDP growth and inflation projections

20 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 11 November. The factors shaping the outlook for economic growth were similar to those that shaped the August projections. The considerable stimulus from the past easing of policy, including asset purchases, and the depreciation of sterling was expected to lead to a recovery in economic activity. Output in the near term would be further boosted as the inventory adjustment was completed. But there were a number of headwinds that would be likely to impede the recovery. The supply of bank credit would probably remain constrained for a protracted period. And the desire to strengthen private sector balance sheets and the recognition that a significant fiscal consolidation was required would also be likely to weigh on spending. Business investment was likely to remain weak.

21 On balance, the Committee judged that the interaction of these factors pointed to a slow recovery in the level of economic activity. The projected distribution for growth was somewhat stronger than at the time of the *August Report*, but remained significantly skewed to the downside. Despite robust projected growth relative to its long-run average, output was likely to remain substantially below the level implied by a continuation of its pre-recession trend for a considerable period. That in large part reflected the substantial, lasting impact of the downturn on the supply capacity of the economy, but also the sustained weakness of demand relative to that capacity.

22 Inflation was likely to rise sharply in the near term, reflecting higher petrol price inflation and the upcoming reversal of the VAT reduction, while sterling's past depreciation would also continue to push up on inflation. Further ahead, downward pressure from the persistent margin of spare capacity

would be the dominant force. This pressure would act to bear down on CPI inflation, although its impact would gradually fade as the economy recovered. The extent to which CPI inflation would deviate from the 2% target was highly uncertain and would depend on a number of factors. The amount of downward pressure on inflation would depend on the timing and strength of the recovery, the impact of the downturn on the supply capacity of the economy, and on the sensitivity of inflation to the degree of economic slack. The profile for inflation would also depend on the extent to which companies still needed to adjust fully to the higher import costs associated with sterling's depreciation and on whether there would be further large movements in exchange rates and commodity prices.

23 Overall, on the assumption that Bank Rate moved in line with market yields and that the stock of purchased assets financed by the creation of central bank reserves was increased to £200 billion and remained there, the Committee judged that inflation was, on balance, more likely to be below the target than above it for most of the forecast period, although by the end of the projection the risks were broadly balanced. The Committee judged that the uncertainties about inflation in each direction had increased. The outlook for inflation in the medium term was somewhat higher than had been the case in August, reflecting the stronger projected distribution for GDP growth.

The immediate policy decision

24 The Committee discussed the merits of changing the structure of remuneration on commercial bank reserves. A reduction in the rate of remuneration relative to Bank Rate on a proportion of commercial bank reserves would bear down on short-term market rates, and could ease monetary conditions further. The Committee noted that such an action would be unlikely to have a significant impact on the outlook given the already low levels of short-term market rates, and that asset purchases were currently a more effective instrument for affecting monetary conditions. While all members agreed that they did not wish to make use of this option at the present time, they agreed that it might be a useful policy tool in some circumstances, and therefore should be available in future.

25 According to the ONS's initial estimate, GDP had declined during the third quarter. This was a surprise. While there were some reasons to anticipate a small upward revision in future data releases, it was likely that activity had been more subdued in the third quarter than the Committee had previously anticipated. But the available data suggested that similar weakness was unlikely to persist

into the fourth quarter.

26 The latest data implied that output had fallen by almost 6% from its peak in 2008. Whether or not GDP data were revised, this highlighted the strength of the factors that had pulled down on demand and that would continue to act as a restraint. These factors included tight credit conditions, which were likely to persist while banks reduced their leverage; the recognition that a large fiscal consolidation would be necessary; and, for both firms and households, uncertainty over future incomes and concern over their own balance sheets. It was also likely that world output and trade would remain below levels consistent with a continuation of their pre-crisis trends, which would depress the demand for UK exports. Set against that, the effects of the substantial monetary stimulus to date and of past depreciation of sterling would provide significant spurs to activity.

27 Projections based on the conditioning assumptions that Bank Rate followed the path implied by market expectations and that the stock of purchased assets remained at £175 billion suggested that inflation was more likely than not to be below the 2% target for most of the forecast period. Even with the rebound in growth that underlay that projection, the Committee anticipated that there would be a slow recovery in the level of economic activity and that a material margin of spare capacity was likely to persist into the medium term.

28 Most Committee members favoured an extension of the asset purchase programme. That would reduce the margin of spare capacity and bring inflation back to target more quickly than otherwise, so that the risks of inflation being above or below the target in the medium term were brought closer into balance. Additional asset purchases would support household and business spending, attenuating downside risks, including from the ongoing weakness in the banking system and the anticipation of further fiscal consolidation. Moreover, some members thought that the downside risks to activity in the near term were somewhat greater than implied by the *Inflation Report* projections.

29 A number of Committee members noted that one consequence of additional asset purchases would be to bring forward the point at which the extraordinary degree of stimulus could begin to be withdrawn, if the projected impact was realised.

30 The Committee agreed that any extension to the asset purchase programme should last three months. The most natural time for the Committee to consider the case for further changes to the

programme would be in the context of the analysis and discussions leading up to the February *Inflation Report*. Most members thought that purchases totalling an additional £25 billion would be appropriate given the balance of risks to inflation.

31 One member favoured an expansion of £40 billion in order to provide greater insurance against the downside risks to growth and inflation arising from constrained credit supply. That would maintain a similar rate of purchases as had been the case in the previous three months, once the intended break in the purchase programme at the end of December was taken into account.

32 While recognising the potential benefits of a more expansionary policy given the downside risks to the economy, one member also stressed the potential risks of such a policy. Monetary policy was already extraordinarily stimulatory. The considerable uncertainty about the degree of spare capacity and the behaviour of inflation when output was growing at above trend meant there were risks from attempting to eliminate the margin of spare capacity more rapidly. There was also a risk that further substantial injections of liquidity might result in unwarranted increases in some asset prices that could prove costly to rectify, complicating the task of meeting the inflation target in future. Overall, this member judged that these risks were best balanced by maintaining the current stance of policy.

33 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 £25 billion of asset purchases by the creation of central bank reserves, implying a total quantity of £200 billion of such asset purchases.

The Bank should seek to complete the additional purchases within the next three months.

Seven members of the Committee (the Governor, Charles Bean, Paul Tucker, Kate Barker, Paul Fisher, Adam Posen and Andrew Sentance) voted in favour of the proposition. Two members of the Committee voted against the proposition. David Miles preferred to increase the size of the asset purchase programme by £40 billion to a total of £215 billion. Spencer Dale preferred to leave the size of the asset purchase programme unchanged at a total of £175 billion.

34 Following the MPC's decision, the Governor and Chancellor of the Exchequer exchanged letters about the expansion of the Asset Purchase Facility.

35 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

Spencer Dale

Paul Fisher

David Miles

Adam Posen

Andrew Sentance

Dave Ramsden was present as the Treasury representative.