

Publication date: 23 September 2009

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 9 AND 10 SEPTEMBER 2009

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 September 2009.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0909.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 7 and 8 October will be published on 21 October 2009.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 SEPTEMBER 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 Short-term interest rate expectations had fallen in most major economies during the month. Compared with a month earlier, official policy rates were expected to remain low for longer. These moves appeared to have been prompted by announcements and comments from the monetary authorities. In the United Kingdom, the decision to extend the asset purchase programme, the publication of the *Inflation Report* and the MPC Minutes had all led to a lower and flatter short-term yield curve.

3 The announcement to increase the asset purchase programme by £50 billion to £175 billion at the beginning of August had not been widely expected. That had led to a fall in the yields on gilts eligible for the asset purchase programme by some 10-20 basis points on the day. Yields had continued to fall during the month. Government bond yields had also fallen in the United States during the month, and it was a more mixed picture across maturities in the euro zone.

4 The price of riskier financial assets had continued to rise, although trading volumes had been light during the holiday period. Equity prices in the United Kingdom and the euro area had risen. In the United Kingdom they had been boosted in part by the falls in gilt yields. Otherwise the movement in equity prices over the month appeared to be associated with: higher earnings forecasts; more positive macroeconomic outturns, particularly in the euro area; and a perception among market participants that the worst near-term downside risks to activity had decreased further.

5 Corporate bond yields had fallen further in sterling, dollar and euro markets. Measures of liquidity in the sterling corporate bond market had continued to improve, and issuance so far in 2009 Q3 had remained robust.

6 Libor rates had declined further: three-month Libor was below 1% in sterling, dollar and euro markets. Sterling Libor-OIS spreads had narrowed more quickly over the past six months than their dollar and euro counterparts. At around 30 basis points, the sterling Libor-OIS spread was close to levels last seen in January 2008. Nevertheless, the volume of trading in the interbank market had remained low. Libor was important not just as a measure of banks' funding costs, but because many loans to non-financial companies were priced off Libor, and these developments could reduce the cost of borrowing.

7 Sterling had fallen by around 3% during the previous month. That downward move had been broadly based against the dollar, euro and yen. The relative fall in sterling interest rates could perhaps explain some of the fall.

The international economy

8 The economic recovery had continued to gather pace in emerging markets, particularly in Asia. These economies would represent an increasingly important influence on the UK trade and growth outlook in future. China was in a strong position to sustain a rapid expansion. It had a low level of public debt, its banking sector had not been directly affected by the financial crisis, and supply capacity was likely to grow quickly. But if China continued to follow a development strategy based on export-led growth that would not help to solve the global economic imbalances and would reduce the probability of a sustained recovery in the world economy.

9 Recent months had seen a steady improvement in business survey indicators across the globe more generally, and that trend had continued this month. The JPMorgan Global Purchasing Managers Indices (PMIs) had increased further in August and were above the levels that prevailed just before the collapse of Lehman Brothers. The global manufacturing PMI was consistent with expanding output in manufacturing, and for services it was close to the level that was consistent with no change in economic activity.

10 Recent official data for 2009 Q2, although not as timely, indicated that a sharper recovery in some countries may be underway than the PMIs had suggested. That was especially true for the United Kingdom's main trading partner, the euro area. Euro-area GDP was estimated to have fallen by 0.1% in 2009 Q2, which was markedly stronger than the sizeable contraction that the PMIs suggested had occurred. Indeed, France and Germany had even expanded in the second quarter, according to these official data. It was difficult to judge how much weight to place on the official data relative to the surveys for the euro area at this stage.

11 In the United States there were further signs that the economy was pulling out of recession. But, as in the euro area, consumption had been boosted by the introduction of a vehicle scrappage scheme. And to the extent that these schemes had caused households to bring forward car purchases, consumption was likely to fall back once they ended. There was, therefore, some concern about the sustainability of the recovery in a number of countries.

12 Most of the major advanced economies had reported a positive contribution from net trade in 2009 Q2. Emerging market and developing economies – especially in Asia – could be at least partially responsible. But according to the available partial data, the change in the trade balances of developing economies did not appear large enough to account for movements in the developed economies trade data. Future data releases should shed more light on this issue.

Money, credit, demand and output

13 M4 growth, excluding the money holdings of institutions that intermediate between banks, had been estimated to have picked up slightly to 5.3% on a three-month annualised basis in July compared with 4% in June. The annual growth rate of non-financial corporate money holdings had become positive for the first time in over a year. That was encouraging, as one way the asset purchase programme had been expected to stimulate nominal spending was through boosting the money holdings of the non-financial private sector.

14 In contrast, bank credit to the private non-financial economy had contracted in July. There had been a small net repayment of credit by households – the first since the current version of the data began in 1993. And there had been further striking falls in non-financial corporate bank credit. Weak

credit demand was likely to have been a factor, but so too was restricted supply. The pressures on banks to shrink their balance sheets had continued to impose monetary restraint on the economy.

15 The contraction in GDP in Q2 had been revised to 0.7% from 0.8% in this month's ONS release. Since that release, the combination of new construction and industrial production data for Q2 suggested that GDP may be revised further in the same direction.

16 The latest data had provided an early guide to developments in Q3. The Index of Production for July and the survey data for August were consistent with output having stabilised in the middle of this year and suggested that growth in the second half of this year was likely to be positive.

17 Although this was a promising sign, these data had to be set in context. Over the past year, output had contracted by over 5%. The prospects for final domestic demand would be an important determinant of the sustainability of the recovery. According to initial estimates, private final domestic demand had continued to fall sharply in Q2. Within that, business investment was estimated to have declined by over 10% in Q2, a larger fall than had been implied by surveys of intentions. First estimates of business investment were typically revised. Nevertheless, falls of that size were rare in the series' history.

18 Consumption was estimated to have contracted by 0.9% in Q2, quite a bit weaker than the Committee had expected at the time of the August *Inflation Report* forecast. Indeed a theme of Committee discussions in recent months had been that household spending was holding up better than it might have done, given the economic backdrop. That assessment had been based on the signals from both retail sales and from vehicle registrations. Retail sales were estimated to have grown by 1% in Q2 and the most recent indicators pointed to a similar rate of growth in Q3. Private new car registrations had also bounced back strongly in recent months, boosted as in other countries by a car scrappage scheme.

19 It was possible that the consumption data for Q2 would be revised. The ONS had less than half of its final source data available, when producing that first estimate. Moreover, some of the unexpected weakness had been concentrated in the consumption of non-profit institutions serving households, which could prove to be erratic. Nevertheless, the weak data did suggest that the

Committee should perhaps be cautious in drawing inferences about consumption from strong retail sales and car registrations.

20 Dwellings investment had been broadly flat in 2009 Q2 after two years of substantial falls – the level of dwellings investment was estimated to be around 30% below its 2007 peak. The housing market had continued to show further signs of recovery during August. House prices were estimated to have increased again: an average of the Nationwide and Halifax indices suggested that house prices were up almost 5% from their April trough. Mortgage approvals for house purchase had also increased further in July.

21 GDP growth had received positive support from stockbuilding, net trade and government spending in the second quarter. The contribution from stockbuilding had been slightly stronger than the Committee had expected. Nevertheless, the ONS data suggested that firms had still run down their stocks in Q2, only less aggressively than in the previous quarter. That meant there was still scope for inventories to continue to add to growth over the next few quarters, as the stock cycle ran its course. As in other developed economies, net trade had made a positive contribution to growth as imports fell sharply.

Costs and prices

22 CPI inflation had been 1.8% in July. In line with the pre-release arrangements, an advance estimate for CPI inflation of 1.6% in August had been provided to the Governor ahead of publication. Inflation in these months had been higher than the August *Inflation Report* central projection had implied. There was no breakdown yet available of the August numbers, but CPI inflation excluding the contributions of food and energy prices had remained stubbornly high over a number of months, despite the large degree of economic slack that the Committee believed had opened up in the economy. One possible explanation was that the past depreciation of sterling was continuing to have a more persistent impact than previously thought.

23 There were two further potential explanations as to why CPI inflation was not falling more rapidly. The Committee might have misjudged the amount of economic slack in the economy. The financial crisis could have had a more damaging effect on the supply-side of the economy than the Committee had assessed. But this would still leave a very large amount of slack, which would put

downward pressure on prices in the medium term. An alternative explanation was that the margin of spare capacity was in line with the Committee's assessment, but that it was having less of a depressing effect on inflation than the Committee had expected. That might have reflected the fact that inflation expectations were reasonably well anchored to the 2% CPI inflation target, and that they were having a greater stabilising influence on actual inflation than the Committee had anticipated. It was impossible to distinguish between these two explanations with the current data, yet they had different implications for policy. A smaller amount of spare capacity than the Committee judged likely implied that monetary policy needed to be less stimulative, other things being equal. But the well anchored inflation expectations explanation implied little change to the policy outlook: policy still had to be sufficiently accommodative to close the output gap over a reasonable time frame, otherwise inflation would eventually fall well below the target.

24 In the August *Inflation Report*, the Committee had judged that inflation would probably be unusually volatile in the coming months and that it had been more likely than not that inflation would temporarily fall below 1% in the autumn. But part of the sharp fall in inflation expected over the next few months had been based on the assumption that there would be further cuts in utility prices in the autumn. This now appeared unlikely. Taken together with the outturns for July and August, this meant that the probability of inflation falling below 1% in the coming months had declined since the August *Inflation Report*. Nevertheless, it was still the case that, in the near term, CPI inflation was likely to be extremely volatile. It would probably fall again in September. But thereafter it could rise sharply, reflecting past changes in prices dropping out of the twelve-month comparison, the reversal of the reduction in VAT, and other tax changes. That sharp rise was likely to be temporary and so would have little implication for policy unless it was accompanied by some news about the medium-term outlook for inflation.

25 The prospects for earnings growth would have an important bearing on whether the inflation target would be met in the medium term. Whole economy average earnings growth had remained weak. In the three months to June, the average earnings index had been 2.5% higher than in the same period a year earlier. Average earnings growth excluding bonuses over the same period had been 2.5%. That weakness could partly have reflected a reaction to the sterling exchange rate depreciation. Employers facing rising import costs could have pushed down on wages. If sterling did not depreciate further then wage growth could pick up, once the adjustment to the higher level of import prices had been completed. Low wage growth could also have been a reaction to the economic slowdown. It was

possible that as the economy recovered wage growth would rise. But it was also possible that a high and rising rate of unemployment would keep wage growth too low to be consistent with meeting the inflation target.

The immediate policy decision

26 The outlook for the medium term described in the Bank's August *Inflation Report* had not changed markedly.

27 There had been a number of developments during the month with positive implications for the short term. The world economic data had generally been stronger than the Committee had expected at the time of the August *Report*. In the United Kingdom, the GDP data for 2009 Q2 had been revised upwards. The more recent data on construction and industrial production had suggested further upward revisions to the Q2 GDP data were likely, and manufacturing output had grown strongly in July. Business surveys had continued to improve. Broad money growth had picked up.

28 Asset prices had continued to rise. The recovery in equity and house prices meant that collateral values had risen, which should, other things equal, increase the availability of credit and reduce the cost of borrowing. Market expectations of future Bank Rate had fallen; the exchange rate had depreciated; and gilt yields were down. Three-month Libor had fallen to its lowest rate since the mid 1980s, and that rate was an important benchmark for the cost of companies' borrowing. All of these financial market developments were likely to boost nominal spending in due course.

29 The near-term downside risks to economic activity had lessened during the month. And there was a possibility that the recovery in asset prices and confidence could mark the start of a virtuous upward spiral for the economy. In addition to these positive developments in activity and asset markets, inflation would probably be higher in the short-term than the Committee had thought a month ago, though it was still likely to be extremely volatile.

30 But these short-term developments had limited implications for the medium-term inflation outlook. Although the data on output growth were more encouraging, the level of output had fallen significantly and there was likely still a large measure of spare capacity in the economy. Moreover, even if GDP growth had turned positive in Q3, it was unlikely to have reached the point where the

level of spare capacity was shrinking. Unemployment continued to rise, and was likely to continue increasing for some time. Growth in private final domestic demand, which was essential for a sustained recovery, had been weaker in 2009 Q2 than the MPC had expected at the time of the August *Inflation Report*.

31 There had been some promising indications from asset markets. But the lesson from previous financial crises was that they were not resolved quickly, and that there could be false dawns. The banking system still had to complete a process of balance sheet adjustment, including raising new capital, and bank lending remained weak. The drag on aggregate demand growth from the financial sector was likely to be long-lasting. High levels of public debt internationally and the persistence of global imbalances remained downside risks to the sustainability of the recovery. The implications of the financial crisis for potential growth and the degree of economic slack – and thus medium-term inflation – also remained uncertain.

32 In August, the Committee had decided on and announced a programme of asset purchases for the three months up to the November MPC meeting. The medium-term outlook had not changed markedly since then. For those members who had preferred a larger stimulus at the August meeting, a larger asset purchase programme could still be justified. But in the absence of significant news about the medium term the case for adjusting the programme now was outweighed by the benefits of following through with the programme of asset purchases announced in August. All members therefore agreed to continue with the announced programme of asset purchases this month.

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 continue with the programme, as announced following its 6 August meeting, of asset purchases totalling £175 billion financed by the creation of central bank reserves.

The Committee voted unanimously in favour of the proposition.

34 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.