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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 7 AND 8 APRIL 2010

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 April 2010.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1004.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 Friday 7 and Monday 10 May will be published on 19 May 2010.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 APRIL 2010

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. 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 The prices of many financial assets had risen. Equity prices had increased by almost 5% during the month in the United Kingdom, and had also risen overseas. And both investment and non-investment grade corporate bond spreads had narrowed further. These developments might have reflected a continued easing in concerns about the worst risks to economic activity. Gross issuance of debt by UK banks and non-financial companies had resumed in March, after a pause in February.

3 Near-term interest rate expectations, measured by overnight index swap rates, had fallen further as financial market participants had reassessed the rate at which the exceptional degree of monetary stimulus would be withdrawn. In the United Kingdom, expectations of Bank Rate for April 2011 had fallen by around 10 basis points during the month and by around 50 basis points since the MPC's February *Inflation Report* projections had been finalised.

4 Yields on medium and longer-term UK government bonds had increased slightly over the month, but had reacted little to the publication of the Government's *Budget 2010*. Yields on index-linked government securities had fallen slightly, so that the gap between nominal and real yields – an indicator of financial market participants' expectations of inflation – had edged up further. In contrast, other financial market-based indicators of inflation expectations, such as those derived from inflation swaps, had been stable over the past year.

5 The fiscal situation in Greece remained a key focus for market participants. During the month, euro-area Heads of State had announced their readiness to offer contingent financial support to the Greek Government, in conjunction with the IMF. But Greek government bond yields had remained elevated, with yields of ten-year government debt rising to a level around 400 basis points above those of comparable German government securities.

6 The euro had depreciated by around 2% during the month in effective terms, and by around 3½% against sterling. Largely reflecting that, the sterling effective exchange rate index had appreciated by a little over 2%, although it remained 2½% lower than at the time of the February *Inflation Report*.

The international economy

7 The global economic recovery continued, though remained uneven across the regions and countries of the world. Activity had been most vigorous in emerging Asia, with industrial output in January reaching a level around 15% above its pre-crisis peak. In China, the official manufacturing purchasing managers' index (PMI) had rebounded in March. Activity there remained supported by spending on public infrastructure, as well as by private domestic demand. In the medium term, the durability of the recovery in emerging Asia would depend upon the success of policies designed to rebalance activity towards self-sustaining domestic demand and away from net exports.

8 There had been robust near-term indicators of growth in activity in the United States, as well. GDP had risen by 1.4% in the fourth quarter. The manufacturing PMI had increased in March to its highest level since mid-2004, and the non-manufacturing index had also increased on the month. Indicators of consumer and business spending pointed towards continued growth in the first quarter of 2010. And non-farm payrolls had increased by 162,000 in March. But there remained a question over the durability of the recovery. Recent activity had been supported by the fiscal stimulus and the turning of the stock cycle, both of which were likely to have a diminishing impact on output growth as 2010 wore on. Prospects for the housing market remained uncertain, with government incentives for homebuyers set to expire at the end of April. Many commentators expected a large number of mortgage foreclosures over the coming years, which could affect banks' willingness to lend.

9 The recovery appeared most fragile in the euro area. GDP growth had been revised down to zero in 2009 Q4, with falling final domestic demand offset by positive contributions from inventories and

net trade. It was possible that the recent pattern of growth had been affected by temporary factors, including the expiry of some car scrappage schemes and, consistent with that, some business surveys pointed to a resumption of growth in 2010 Q1. There was a risk that the fiscal and competitiveness problems in Greece and some other countries would adversely affect activity in the area as a whole, either as a consequence of trade or financial linkages. And there was little evidence of a sustained pickup in domestic demand in other countries that might compensate for such weakness.

10 The volume of world trade had rebounded sharply from its crisis trough, which would act to support UK exports. But there was a risk that the geographical composition of the recovery would limit that effect. The prospects for UK exports depended more heavily on demand in the slow-growing euro-area economies than on the more rapidly growing Asian markets. And there was a possibility that robust activity growth in Asia and other emerging economies might put further upward pressure on commodity prices, resulting in stronger consumer price pressures in the United Kingdom.

Money, credit, demand and output

11 Broad money, measured by M4 excluding holdings by interbank intermediaries, had risen by 0.3% in February, but remained only fractionally above its level of a year earlier. The most recent data had done little to change the pattern of recent months: the weakness of money growth was primarily centred in the holdings of non-bank financial companies, while households' and non-financial companies' money holdings had been growing modestly.

12 Evidence from the Bank's *Credit Conditions Survey* and network of Agents indicated that credit conditions for larger businesses had eased further in the first quarter of 2010, though remained tight. But banks had as yet reported little increase in credit availability for smaller firms or for households. Looking ahead, banks continued to face significant challenges in strengthening their balance sheets over the next few years, and there remained a sizable risk that this would lead to a further tightening in credit availability.

13 Despite reports of gradually improving credit availability, net finance raised by private non-financial companies from UK banks and capital markets had fallen in February for the seventh month in the past eight. It was promising that gross bond issuance by non-financial companies had

recovered somewhat in March. That might be used either to repay outstanding debt obligations, or to finance new capital spending.

14 The ONS had revised up its estimate of GDP growth in the fourth quarter of 2009 to 0.4% from 0.3%. Several erratic factors were likely to have influenced GDP growth around the turn of the year: the restoration in January of the standard rate of VAT to 17½%; the snowy weather; and the declining impact (and ultimate expiry in March) of the vehicle scrappage scheme. Together, these factors were likely to have boosted measured output growth a little in the fourth quarter of 2009, and would probably depress it to some extent in the first quarter of 2010.

15 Looking through those temporary factors, the activity data of the past few months implied an underlying path for the level of output that was roughly in the centre of the February *Inflation Report* forecast distribution, consistent with the Committee's central expectation of a gradual recovery in activity. That was somewhat reassuring. The recent pickup in growth, and strength of some of the business surveys and indicators of spending pointed towards underlying activity growth in the first half of 2010 that was only a little below its historical average rate.

16 Despite those promising signs, there remained areas of weakness. The level of business investment had dropped dramatically – by over a quarter – since the middle of 2008, including a fall of over 4% in 2009 Q4. This was a much larger reduction than during previous recessions. To the extent that it reflected heightened uncertainty over demand prospects, business spending might pick up sharply as the economic recovery became more firmly rooted and confidence returned. But it was also possible that the increased cost, and limited availability, of investment finance would cause the weakness of business investment spending to persist.

17 As had been noted at previous meetings, the recent weakness of net trade had been puzzling. The recovery in world trade volumes had been accompanied by a pickup in both UK export and import growth. But despite the large depreciation of sterling, net trade had reduced GDP growth by 0.5 percentage points in the second half of 2009. Trade data were volatile from quarter to quarter, however, and often prone to significant revision. And it was typical for there to be a time lag between the improvement in price competitiveness caused by a currency depreciation and its effect on export and import growth. Even so, taken at face value, exports had been weaker and imports stronger than might have been expected given the evidence of past large movements in sterling. One possibility was

that tight credit conditions and heightened uncertainty had impaired domestic businesses' ability or willingness to take advantage of improved competitiveness by expanding their operations into new markets, both at home and overseas. Another possibility was that there had been a particularly large reduction in the global demand for the goods and services in which the United Kingdom specialised, such as financial services. The resilience of imports was especially difficult to explain.

18 The Committee's central expectation remained that net trade would boost GDP growth over the coming year. The strength of survey information on export orders indicated that some recovery was in prospect. But the unexplained weakness in the recent data and the uncertain prospects for demand in the United Kingdom's major trading partners created a risk that the strengthening in net trade would be less than previously anticipated.

19 The Government's *Budget 2010* had been published on 24 March. The new plans were unlikely to have a significant impact on the outlook for inflation relative to the fiscal assumptions underlying the Committee's previous projections, which had been based on the *Pre-Budget Report*. There remained uncertainty over the size, nature and impact of the fiscal consolidation that would occur over coming years.

Supply, costs and prices

20 Twelve-month CPI inflation had fallen back to 3.0% in February from 3.5% in January, largely owing to a reduced contribution from energy and goods price inflation. Inflation was likely to remain at around that level in the following few months, as weaker underlying inflationary pressure was offset by increases in some duties, the impact of the depreciation of sterling since the start of the year, and the recent rebound in oil prices. Sterling oil prices had increased by around 20% since the February *Inflation Report* projections had been finalised, and by around 7% since the March MPC meeting.

21 Nevertheless, it remained likely that inflation would moderate later during 2010, reflecting the influence on prices of the significant margin of spare capacity in the economy, and the waning of some of those temporary factors. But the size of that moderation would depend upon both the extent of spare capacity, and how businesses reacted to it. A survey conducted by the Bank's Agents had not suggested an extensive permanent scrapping of capital during the recession, which, combined with the relative resilience of employment, implied a sizable margin of spare capacity within firms. Other

survey evidence had also continued to point to a significant margin of spare capacity within firms, though there was uncertainty about its extent.

22 The sensitivity of inflation to that spare capacity would depend on the evolution of businesses' pricing margins. Margins had been squeezed during the recession as unit labour cost growth had increased and sterling's depreciation had pushed up import costs. But there was some evidence that firms' margins had begun to recover since the middle of 2009, as unit labour cost growth had fallen back. The Bank's Agents also suggested that firms' profitability had stabilised, and the Euler Hermes UK cash-flow indices for both manufacturing and service sector firms had recovered steadily during the second half of 2009. The path of inflation over the coming year would depend in part on whether firms would seek to increase margins further, perhaps in order to bolster near-term cash flows while bank credit availability remained tight; or whether competitive pressures during the economic recovery would instead cause them to trim margins in order to boost sales and gain market share.

23 According to the average weekly earnings measure, private sector regular pay had increased by just 0.4% in the three months to January compared with a year earlier. And according to the LFS measure, total employment had fallen by 54,000 in the three months to January by comparison with the previous non-overlapping quarter. But unemployment had also fallen, while there had been a rise in inactivity. The increase in inactivity since the beginning of the recession was still less than during the early 1990s, however, and had been largely accounted for by an increase in the number of students, which could raise productivity in the future.

24 Household survey measures of medium-term inflation expectations had changed little on the month. The YouGov/Citigroup measure of inflation expectations five to ten years ahead had ticked up in March, reversing the decline in the previous month's survey, but remained in line with its historical average. The Basix measure for five years ahead in the first quarter of 2010 had fallen slightly.

The immediate policy decision

25 All members agreed that the events of the past month had not been significant enough to substantially alter their views of the medium-term outlook for inflation and activity.

26 For many members, the developments at home and abroad over the two months since the publication of the February *Inflation Report* had helped ease concerns about some of the downside risks to the near-term economic outlook for the United Kingdom. Output looked more clearly to have begun to recover at the end of 2009 and, abstracting from the effect of erratic factors, with a momentum that appeared to have been carried forward into the beginning of 2010. That was broadly as had been anticipated as the most likely outcome in the Committee's February projections. Moreover, short-term interest rate expectations had fallen. And, notwithstanding this month's appreciation, the sterling effective exchange rate index was lower than two months ago. Those factors should also support growth.

27 But some risks had been brought into sharper focus over the past two months. To the downside, the economic recovery in the euro area, the destination of nearly a half of the United Kingdom's exports, appeared fragile. And there were continuing financial market concerns over sovereign creditworthiness across a number of countries, which highlighted the potential for new shocks to affect the recovery.

28 There were also some upside risks to inflation. Oil and some other commodity prices had risen substantially over the past two months, raising the near-term outlook for inflation. And, although measures of households' medium-term inflation expectations had remained reasonably stable, some measures of financial market participants' inflation expectations had been drifting up. Given that a period of above-target inflation was in prospect at a time when monetary policy was exceptionally accommodative, this was a source of concern to some members. The Committee would continue to monitor developments in inflation expectations closely.

29 Looking ahead, there remained a number of factors restraining activity and inflation. These included the impairment of the banking sector, the need for fiscal consolidation in the United Kingdom and elsewhere, and despite some recovery in activity, the continuing degree of spare capacity in the economy. Offsetting these downside factors were the past depreciation of sterling and the exceptional degree of monetary stimulus. There was a range of views among Committee members about how the balance of risks to inflation and activity had altered over the past few months. But, overall, the Committee agreed that it was appropriate to maintain the current stimulatory stance of monetary policy at this meeting.

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

Bank Rate should be maintained at 0.5%;

The Bank of England should maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

The Committee voted unanimously in favour of the proposition.

31 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

Tom Scholar was present as the Treasury representative.