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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 4 AND 5 AUGUST 2010

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 August 2010.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1008.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 September will be published on 22 September 2010.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 AUGUST 2010

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 Having deteriorated in the previous few months, market sentiment had improved a little on the month, especially with regard to the United Kingdom and the euro area. Equity prices had risen, corporate bond spreads and yields were down, as were bank and sovereign CDS premia. Measures of uncertainty had eased since their peaks a few months earlier.

3 The publication by the Committee of European Bank Supervisors (CEBS) of the stress tests designed to assess the resilience of the EU banking sector, and the announcement of an amended international capital and liquidity reform package by the Groups of Governors and Heads of Supervision of the Basel Committee on Banking Supervision, had contributed to the improvement in bank equity prices and CDS premia. Market contacts suggested that part of the improvement in sentiment on the month was because some of the potential downside risks had not crystallised, rather than because market participants had revised up their central view of economic prospects. Better conditions in European markets had also helped UK banks issue more unsecured debt in July than in recent months.

4 Notwithstanding the improvement during the month, prices of some risky assets were still lower than at the time of the *May Inflation Report*. For example, the FTSE All-Share index for the fifteen working days to 4 August was down 5% on the starting point for the *May Report*.

5 There had been a significant shift down in the path for Bank Rate implied by forward market interest rates over the three months since the *May Inflation Report* – by 90 basis points by the middle

of 2012. Further out, UK implied forward rates at ten years had fallen 30 basis points over the past three months: real implied forward rates had risen by around 20-30 basis points and implied forward inflation had fallen by 50-60 basis points.

6 Sterling had appreciated against the dollar and the euro on the month, and the sterling effective exchange rate index was up 2½% since the May *Inflation Report*. The main drivers for this seemed to be changing views about the prospects for the United States and euro area, rather than about the United Kingdom. That could have reflected a reassessment of risk premia, or changes in perceptions of the long-run level of the real exchange rate.

The international economy

7 This month's indicators for the world economy had painted a mixed picture, with some more upbeat data from the euro area and some softer data from the United States. Growth in emerging economies had remained robust.

8 Both the euro-area manufacturing and services Purchasing Managers' Indices (PMIs) had moved up a little in July. After strong German GDP growth in the middle of 2009, growth had stalled in 2009 Q4 and 2010 Q1. But indicators now pointed to strong growth in Q2 – German industrial production had risen 2.9% in May alone. The manufacturing PMI suggested that this strength had continued into Q3. Business confidence was also high, with the IFO measure at its highest since mid-2007. Consumer confidence had fallen in May and was broadly unchanged in June, but it had risen sharply in July, towards its late 2007 level.

9 A key question was how much of the strength in Germany was also being seen in France and the Benelux countries – which together accounted for a significant share of UK exports. If German strength had reflected activity in global capital goods markets, then the implications for the United Kingdom would be less positive than if the strength were concentrated in German domestic demand.

10 Some US indicators had been weaker on the month, and some commentators were increasingly placing weight on the possibility of a renewed slowing in US GDP growth. Recent market and press commentary had focused on the possibility that the Federal Reserve might undertake further asset purchases. GDP had risen by 0.6% in Q2, although revisions to the back data had lowered the

estimated level of output by 1%. Retail sales had fallen again in June, and consumer confidence had fallen in July. The housing market remained moribund. Manufacturing output had fallen in June, and the PMI had fallen in July. It remained possible that these weak indicators simply reflected the normal volatility of data in the early stages of recovery. And there were some positive indicators: for example, the non-manufacturing PMI had risen in July.

11 Part of the difficulty in determining the likely path of the US economy, and the sources of growth there, was that conditions were very different across states and sectors, and there were likely to be some important distributional effects at work. For example, the interaction between job losses and the weak housing market might affect labour mobility – with implications for labour market matching and the aggregate degree of slack in the economy. Recent data indicated a rise in mismatch and duration of unemployment in the US economy. Some of the external forecasters who had taken a relatively optimistic view of the prospects for US growth seemed to place weight on the likelihood of strong growth in business and residential investment in 2010 and 2011. That might simply reflect a rebound from a very low level, but it seemed surprising given the headwinds to recovery coming from the financial crisis and continuing balance sheet adjustment.

12 There remained a risk that rapid growth in emerging economies might put more widespread upward pressure on commodity prices, including energy. There had, however, been few signs of this happening over the past few months. But oil prices had risen somewhat in the days leading up to the Committee's meeting, having previously been in the \$70-\$80 per barrel range for most of the past year. And the Committee noted the sharp rise in some agricultural commodity prices in recent weeks, notably wheat. That, in part, seemed related to supply disruption in major producing countries.

Money, credit, demand and output

13 The main news on UK activity this month had been the preliminary GDP estimate for Q2, which, at 1.1%, was significantly higher than had been expected. Within that, there was a substantial increase in construction output, which was related to a rebound following the adverse weather at the start of the year. GDP growth across the first half of the year was close to its historical average rate. In line with pre-release arrangements, the Governor informed the Committee that industrial production had risen by 1.0% in the three months to June. This did not seem to alter significantly the picture for GDP in Q2 drawn from the preliminary estimate.

14 There had been a softening in some of the recent business and household surveys. The activity balances in all three CIPS/Markit PMIs had fallen in July. The Bank's Agents had also reported some weakening in business confidence, but possibly less than that implied by some other surveys. The GfK measure of household confidence had declined further, with a particularly sharp rise in the extent to which households expected unemployment to rise.

15 Some of the softening in sentiment in the household and business surveys had followed the June Budget. This had been in contrast to generally improved sentiment in financial markets. Some firms might be worried about their exposure to public sector spending directly, and also via the second-round effects on consumption arising from public sector job losses. But it was also possible that the softening in confidence reflected heightened uncertainty associated with the incidence of the fiscal consolidation on specific firms and households, rather than an evaluation of its overall impact. The more detailed spending plans to be announced in October might reduce some of that uncertainty.

16 Not all of the survey responses had weakened since the time of the *May Inflation Report*. Some of the business surveys and monthly data pointed to robust manufacturing growth continuing into the third quarter, so four-quarter growth was likely to be high relative to recent UK experience. But it was unclear how much of the strength in the output indicators would map across to the net trade position – either via production for export markets, or through domestic demand switching towards domestic products from imports. The official data for exports had remained weak, and imports had been puzzlingly strong.

17 The recent strength of money GDP growth was likely to have persisted into the second quarter, based on the data seen so far. The strength of nominal spending growth had partly reflected one-off price-level shifts that were not expected to continue. For example, the reversal of the reduction to the standard rate of VAT had boosted nominal Gross Domestic Product at market prices relative to Gross Value Added at basic prices in Q1. Nominal spending growth had been rather weaker when these factors were excluded. Money growth had remained weak, with annual growth at 1%, though possible changes in the seasonal pattern made it difficult to interpret shorter-run movements. The current weakness in broad money growth was likely to have been related to continued adjustment of bank balance sheets, and could be seen as a corollary of bank deleveraging.

Supply, costs and prices

18 CPI inflation had fallen by 0.2 percentage points in June to 3.2%. Goods price inflation had fallen in May and June, while services inflation had been rising for some months. This had followed a period where goods price inflation had been stronger than services price inflation, reflecting exchange rate pressures.

19 The recent decline in goods price inflation suggested that the impact on prices of sterling's depreciation might be near to completion. In line with pre-release arrangements, the Governor informed the Committee that producer input prices had fallen by 1% in July, while output prices had recorded a small rise. Despite the fall on the month, the annual rate of producer input price inflation was still high. And there were upside risks from wholesale food and utility prices in the near term. It remained difficult to quantify the effect of past and prospective relative price movements – such as shifts in commodity prices and in indirect tax rates – on the near-term path for CPI inflation.

20 Much of the recent strength in service price inflation could be accounted for by movements in specific components such as airfares, insurance and accommodation services. The rise in airfares had in part reflected past increases in oil prices feeding through to jet fuel costs. That rise might also reflect the changing balance between capacity and demand within the industry. More generally, the rise in services price inflation probably reflected an increase in average unit cost growth since the trough in activity some months ago.

21 Whole economy regular pay growth had fallen a little in May. Pay settlements had been stable in June, and had not responded to the recent rise in RPI inflation to around 5%. The Bank's Agents had also reported that pay growth remained muted. There had been little sign of movement in survey measures of inflation expectations on the month, with the YouGov/Citigroup measure of one-year-ahead inflation expectations having fallen slightly in July. And the range of more medium to long-term measures seemed broadly consistent with inflation around the target.

22 The LFS measure of employment had risen sharply, by 160,000 in the three months to May. This was much stronger than expected, although had been concentrated in part-time employment. Employment surveys had not shown corresponding evidence of a sharp rise – suggesting the pace of increase in May might not be sustained. Unemployment had fallen by 34,000 over the same period,

bringing the rate down to 7.8%. It was unclear the extent to which private sector employment and wages would adjust as public sector spending cuts gathered pace.

23 As well as some spare capacity within firms, there was still significant slack in the labour market. If demand were to turn out weaker than expected it would take time for capacity to decay and for workers to leave the labour force – so some downward pressure on real wage growth should persist. A key issue was whether nominal wage growth would remain relatively muted during the recovery – with inflation falling towards wages, or whether wage growth or employment would pick up alongside output. On the whole, the Committee expected slack in the labour market to continue to bear down on costs.

The August GDP growth and inflation projections

24 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 11 August. The considerable stimulus from monetary policy, together with a further expansion in world demand and the past depreciation of sterling, should sustain the recovery. But the strength of growth was likely to be tempered by the continuing fiscal consolidation and the persistence of tight credit conditions.

25 There were some key uncertainties surrounding the prospects for demand growth. The strength of domestic demand would depend on the continuing impact of the highly accommodative monetary stance and on the behaviour of private sector saving net of investment, particularly in response to the substantial fiscal consolidation and the constraints on the supply of bank lending. Improvement in net trade would depend on the vigour of the global recovery and the degree of rebalancing prompted by sterling's past depreciation.

26 The Committee judged that the recovery was likely to continue. The most likely outcome for GDP growth was lower than in the *May Report*, reflecting the softening in business and consumer confidence, the faster pace of fiscal consolidation and a slower improvement in credit conditions. But the downside risks around this central projection were judged to be smaller than in May, due in part to the fiscal measures announced in the June Budget reducing the chances of a sharp rise in long-term interest rates. Output was likely to remain well below the level implied by a continuation of its pre-crisis trend throughout the forecast period.

27 Inflation was likely to remain above the 2% target for longer than judged likely in May, in large part reflecting the prospective increase in the rate of VAT to 20% in 2011. As the temporary effects adding to inflation dropped out of the twelve-month comparison, downward pressure on wages and prices from the persistent margin of spare capacity would be likely to bring inflation below the target for a period.

28 The Committee could not be sure of the extent to which inflation would moderate. Businesses' costs and prices depended on the degree of spare capacity, both within companies and in the labour market, and therefore in part on the strength of demand. The impact of the recession on the evolution of supply would also be a key influence. Companies that temporarily adjusted their operating practices in response to the fall in demand might bring some capacity back on stream. But, over time, if weak demand were to persist, that might lead to some capacity being scrapped and individuals losing skills. Slack in the labour market would tend to bear down on earnings growth. But the size of that effect was uncertain, as it was also possible that earnings growth would recover as productivity picked up. Further out, inflation might remain higher than otherwise if the current period of above-target inflation caused medium-term inflation expectations to rise. Any further pressure on prices from the past depreciation of sterling, or substantial movements in energy prices, would also affect short-term inflation.

29 On balance, the Committee judged that, conditioned on the assumption that Bank Rate followed a path implied by market interest rates and that the stock of purchased assets financed by the issuance of central bank reserves remained at £200 billion throughout the forecast period, inflation was somewhat more likely to be below the target than above it during the second half of the forecast period, although those risks were broadly balanced by the end.

The immediate policy decision

30 GDP growth had been surprisingly robust in Q2. That had been encouraging. Nonetheless, the growth during the quarter was coming from a low base – and it would need many quarters of such growth to absorb spare capacity fully. Moreover, some of the strength in Q2 was probably erratic. Taking the first two quarters of 2010 together, growth was close to its historic average. Manufacturing output had risen strongly in Q2, and the surveys suggested this had continued into Q3, though some

surveys suggested there had been a softening in business and consumer sentiment. News on the world economy had been mixed on the month, and did not greatly change the overall outlook. A question remained concerning how much of a pickup in net trade would be seen in response to sterling's past depreciation.

31 After several months of renewed turbulence in financial markets, July had seen a return to slightly better conditions. In part, that had been associated with the publication of the CEBS stress tests on the EU banking sector, and by the Basel Committee announcements.

32 There had been a significant shift down in the path for Bank Rate implied by forward market interest rates over the past three months. That would act as a stimulus to activity. Against this, there had been a modest appreciation of sterling since the *May Inflation Report*. And credit conditions had not improved as much as previously expected. These changes in conditions needed to be factored into any decision on the stance of policy this month.

33 Money spending had risen quite robustly. But stripping out the effects of one-off price-level shocks, for example the increase in the standard rate of VAT at the start of the year, the figures looked rather weaker. Annual money growth had remained weak, consistent with banks deleveraging further.

34 Inflation seemed likely to be temporarily higher than the Committee had expected at the time of the *May Inflation Report*, in part due to the forthcoming increase in the standard rate of VAT. There had been some encouraging signs in the recent producer price data. But increases in the prices of some agricultural commodities in the days leading up to the meeting suggested that the increased volatility of CPI inflation seen in recent years might continue. Earnings growth had been muted, while employment had remained surprisingly strong given the scale of the recession.

35 The Committee considered arguments in favour of a further easing in the stance of monetary policy. Credit conditions seemed set to remain somewhat tighter for longer than expected at the time of the *May Report*. There was a risk that the level of demand would be inadequate relative to supply, once short-term one-off price shocks dissipated. The June Budget had lowered the central projection for activity, although it had at the same time reduced the downside risks stemming from the possibility of a sharp rise in long-term interest rates. And the weakening in some surveys might presage a slowing in output growth. These factors would lower the outlook for inflation in the medium term.

36 But there were also arguments in favour of a small increase in Bank Rate from its exceptionally low level. Activity had strengthened in recent quarters both domestically and internationally. UK inflation had been above target in all but nine of the past 50 months. And the increase in VAT would mean that inflation would stay above target for longer than previously expected. Although much of the rise in inflation could probably be explained by one-off shocks to the exchange rate, commodities and VAT, the degree of pass-through would depend in part on firms' inflation expectations. And there was a risk of inflation expectations becoming de-anchored. If some households and firms placed weight on past inflation outcomes, then inflation expectations might already have begun to rise. It was noted that even with a modest tightening, policy would remain very expansionary.

37 There were also arguments for maintaining the stance of policy this month. The weight of evidence continued to suggest that the margin of spare capacity was likely to bear down on inflation and bring it back to target in the medium term once the impact of temporary factors had worn off. As yet there were few signs of the risk to inflation expectations crystallising. Short-term inflation expectations measures seemed consistent with the short-term price shocks that had already hit the economy. And the range of more medium to long-term measures seemed broadly consistent with inflation around the target.

38 On balance, and against that background, most members thought that the current level of Bank rate and stock of asset purchases financed by the issuance of central bank reserves remained appropriate to balance the risks to the inflation outlook in the medium term. But those risks were substantial, and these members stood ready to respond in either direction as the balance of risks evolved.

39 For one member, the balance of risks was such that it was appropriate to start to withdraw some of the exceptional monetary stimulus provided by the easing in policy in late 2008 and 2009. Economic conditions had improved over the past twelve months and the inflation outlook had shifted sufficiently to justify beginning to raise rates gradually. The Q2 data suggested the recovery was gathering momentum and there was evidence that firms had found it easier to pass through price increases as demand had recovered. The strength in the manufacturing sector in recent months also suggested the UK economy was receiving a strong stimulus from healthy global growth.

40 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.

Eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Spencer Dale, Paul Fisher, David Miles, Adam Posen and Martin Weale) voted in favour of the proposition. Andrew Sentance voted against, preferring an increase in Bank Rate of 25 basis points.

41 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
Spencer Dale
Paul Fisher
David Miles
Adam Posen
Andrew Sentance
Martin Weale

Nicholas Macpherson was present as the Treasury representative.