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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 8 AND 9 DECEMBER 2010

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 December 2010.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1012.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 12 and 13 January will be published on 26 January 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 DECEMBER 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.

Financial markets

2 Government bond yields had been rising internationally, and much of the fall in yields seen earlier in the year had been unwound. Yields on US Treasury bonds had risen, in part as market participants had continued to digest the implications of the \$600 billion of additional asset purchases announced by the Federal Reserve on 3 November and recent announcements on US fiscal policy. In the United Kingdom, the news over the month was on balance interpreted by market participants as making a resumption of further asset purchases by the MPC less likely.

3 Yields on the government bonds of a number of euro-area countries relative to German government bonds had risen further during the month, and had remained elevated despite the announcement of a three-year EU and IMF support package for Ireland on 28 November. It was likely that this differential had reflected continuing market concerns about the fiscal positions of these countries and the stability of their banking sectors. Yields on German government bonds had also increased.

4 The cost of new debt issuance had increased over the month for a range of banks internationally, particularly for some within the euro area. But financial market turbulence within the euro area appeared to have had less effect upon other financial markets than during the similar episode earlier in the year. Capital markets had continued to function normally. The cost of short-term interbank borrowing had risen only modestly and there had been little reported diminution in most banks' ability to access funding in wholesale markets. International equity prices had been relatively stable during the month. Yields on sterling-denominated bonds issued by non-financial

companies had increased by a little more than the upward movements in UK government bond yields.

5 Near-term interest rate expectations had risen over the month in the United Kingdom, as market participants had revised their views of the speed with which the exceptional level of monetary stimulus would initially be withdrawn. According to sterling overnight index swaps, expected short-term interest rates two years ahead were about 50 basis points higher than a month previously, broadly in line with their level at the time of the August *Inflation Report*. There had been similar moves in dollar markets over the month, but expected short-term euro rates had risen by less.

6 There had been sizable movements in exchange rates over the month, possibly reflecting an increase in the risk premium attached to euro-denominated assets. The euro had fallen by about 6% against the dollar. Sterling had appreciated against the euro, but had depreciated against the dollar. In effective terms, it had appreciated by almost 2% over the month but remained close to its average during 2010.

The international economy

7 The data released over the month had pointed to continued firm – if regionally unbalanced – global growth and there were additional signs of global pricing pressures, particularly evident in markets for commodities.

8 Output in the euro area had increased by 0.4% in the third quarter and surveys of business activity had remained consistent with further moderate expansion in the fourth quarter. The prospects for different countries within the euro area had, however, diverged further. In Germany, GDP had grown by 0.7% in the third quarter and unemployment had fallen again. There were signs that domestic demand was making an increasing contribution to the recovery there: domestic demand had risen by nearly 3% in the past year. The recent data had also provided signs of firm growth in some of the countries neighbouring Germany. In contrast, economic growth had remained anaemic in some of the peripheral euro-area countries. The Irish Government had announced more details of a substantial fiscal consolidation and a further restructuring of its banking sector, with financial support from the EU and IMF. A continuation of the financial market turbulence could adversely affect credit conditions to the extent that there was a deterioration in the terms on which

banks could access funds. And it could precipitate a more widespread reduction in business and consumer confidence within the euro area.

9 In the United States, output growth in the third quarter had been revised up by 0.1 percentage points to 0.6%, compared with 0.4% in the second quarter. Net trade had again reduced growth, but final domestic demand growth had remained reasonably robust. And a range of indicators of consumer spending and business surveys pointed towards further steady growth in the fourth quarter. The unemployment rate had risen to 9.8% in November, however. Measures of core inflation had continued to decline. Recent announcements of further monetary and fiscal stimulus were likely to boost the outlook for activity and inflation.

10 Indicators had continued to point towards strong growth in Asia. Japanese GDP had increased by around 1% in Q3, although the strength of consumption had probably reflected in part the impact of temporary government subsidies. In China, the latest Purchasing Managers' Indices (PMIs) were consistent with continuing robust manufacturing growth in Q4. There were signs of increasing inflationary pressures in some emerging economies and monetary policy had been tightened in several over recent months, including China and India.

11 Commodity prices had risen during recent months. Oil prices had increased by \$5 a barrel over the month and by around \$14 a barrel since the start of 2010. The prices of metals and agricultural goods had changed by less over the month, but that was against a backdrop of substantial rises in the preceding few months. It was possible that these developments signalled a persistent increase in the prices of commodities relative to those of finished goods and services, given the potentially limited ability to increase supply in response to increases in demand, especially from emerging economies. If so, it was possible that there could be further upwards pressure on commodity prices if demand pressures intensified.

Money, credit, demand and output

12 There was relatively little news in the official data about activity this month. The ONS had lowered its estimate of construction output in Q2. This change was yet to be incorporated into the official estimates of GDP and, on its own, was likely to lead to a modest downward revision to Q2

GDP growth in next month's Quarterly National Accounts release. The preliminary estimate of Q3 GDP growth, at 0.8%, had not been revised.

13 The Q3 data were mildly encouraging because they indicated that growth had been driven by final demand, rather than by stockbuilding. That suggested that the recovery might be more securely based than if growth had been driven primarily by a temporary boost from the working out of the stock cycle. Nevertheless, the range of available business surveys had indicated, on balance, that activity growth might slow a little in Q4 and Q1 to slightly below its historic average rate. Within that aggregate rate, it was possible that manufacturing growth would remain relatively robust but that services sector growth would be more modest.

14 The *CBI Distributive Trades Survey* had continued to point towards reasonably strong consumer spending in the fourth quarter. But, looking further ahead, the prospects for consumer spending remained highly uncertain. It was possible that some households had not yet fully adjusted their spending to the likely squeeze in future incomes resulting from the fiscal consolidation. House prices and housing market activity had been stable on the month, but the housing market had remained weak, consistent with continuing subdued measures of consumer confidence and the limited availability of secured credit.

15 A range of evidence from business surveys and official data, taken together with the robust growth in manufacturing output, had provided indications that a rebalancing of activity towards net exports was underway. Net trade had made a positive contribution to growth in the third quarter for the first time since the second quarter of 2009. The latest data needed to be treated with some caution, as the positive contribution to growth was wholly attributed to trade in services, which was hard to measure and about which the ONS had only limited data as yet. It was also possible that lower growth in some euro-area countries could lead to some reduction in demand for UK exports, which could slow the pace of rebalancing. The value of goods exports to Ireland had continued to grow robustly over recent quarters, however. And exports to Ireland, Portugal, Greece and Spain accounted for only about 10% of total UK exports.

16 A more significant risk to the outlook for UK activity arising from recent developments within the euro area was the possible impact that a prolonged period of financial market tensions might have upon domestic demand within the United Kingdom. It could hamper the ongoing process of balance

sheet strengthening by the UK banks, which could in turn put renewed pressure on the cost and availability of credit to UK households and companies, especially if it were associated with a further withdrawal from UK lending markets by some euro-area banks. It could also lead to a reduction in spending as the result of a fall in household and business confidence.

17 Although the growth rates of broad money and credit had remained low, there were some signs that money growth had begun to pick up. And measures of nominal demand growth had recovered to around or above their historical average rates. Nominal GDP, consumption and domestic demand were estimated by the ONS to have grown by 5.9%, 6.6% and 7.1% respectively over the past year.

Supply, costs and prices

18 CPI inflation had risen to 3.2% in October from 3.1% the previous month, reflecting contributions from petrol and diesel, financial services and recreational goods. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 3.3% in November had been provided to the Governor ahead of publication. A detailed breakdown of these data was not yet available. Also in line with the pre-release arrangements, the Governor informed the Committee that producer output prices had increased by 0.3% in November and the twelve-month rate had fallen slightly to 3.9%. An advance estimate for producer input prices had also been provided to the Committee, showing an increase of 0.9% in November.

19 CPI inflation had been added to over the recent past by the restoration of the standard rate of VAT to 17.5% in January 2010, by the increase in import prices resulting from the past depreciation in sterling, and by the impact of substantially higher prices for food, oil and many other commodities. There was considerable uncertainty about the precise impact of these factors on overall inflation. Inflation had generally been a little higher than the Committee's central expectation in recent months. In the near term, it was possible that some firms might raise prices in anticipation of the increase in VAT to 20% in January 2011. The prospective VAT increase would raise measured CPI inflation over the year ahead and would be likely to keep inflation above the target for several quarters. Some utility price increases had been announced for December, which would also be likely to add to inflation in the near term. The MPC noted that inflation was likely to rise further over coming

months and could well reach 4% by the spring, somewhat higher than the November *Inflation Report* central projection.

20 The Committee's central view remained that the persistence of spare capacity within the United Kingdom, which reduced underlying price pressures, was likely to cause CPI inflation to fall back as the impact of temporary factors waned. But the pace and extent of that fall in inflation was highly uncertain and was likely to depend upon a number of factors.

21 Further increases in global demand relative to supply – to the extent that they were not already fully reflected in market participants' expectations – might lead to upwards pressure on global commodity prices for some time. The extent to which commodity price increases would affect UK inflation would depend in part upon what caused them and hence upon the behaviour of the sterling exchange rate. If higher commodity prices signalled a rise in generalised inflationary pressure in the world economy, it was possible that the sterling exchange rate would appreciate to offset the effects of that pressure on domestic inflation. But it was less likely that there would be an offsetting appreciation of the exchange rate if, because of supply constraints, world prices of commodities rose relative to those of finished goods and services.

22 The outlook for inflation over the medium term hinged in part upon the behaviour of households' and firms' inflation expectations. Developments in the available measures of inflation expectations had been mixed. The household surveys suggested that expectations for inflation one year ahead had risen over recent months; that was broadly in line with the Committee's own central view of near-term inflation prospects. More worryingly, however, measures of households' expected inflation two years ahead had also edged up. But longer-term measures had remained more stable. And there was less evidence of a significant rise in measures inferred from financial markets or in survey-based measures of firms' inflation expectations, which might matter more immediately for price-setting behaviour.

23 An increase in inflation expectations was unlikely to raise inflation in the medium term unless it resulted in a sustained rise in pay growth. The outlook for pay would also depend upon the behaviour of productivity as the economy recovered, the degree of slack in the labour market and the extent to which firms were willing to grant higher pay increases in order to retain employees with valuable skills. Some pickup in earnings growth was likely as the economy recovered. Earnings

growth had picked up since the summer – reflecting an increase in both pay settlements and drift – but it had remained low relative to its average in the period prior to the financial crisis. According to the average weekly earnings measure, regular pay growth had increased by 2.2% in the three months to September, compared with a year earlier. And it was possible that the pickup in earnings growth could be accounted for, at least in part, by recent increases in labour productivity. Unit labour costs had fallen in the third quarter.

24 Total employment had increased by around 170,000 in the third quarter, according to the LFS measure, reflecting an increase in both part-time and self-employment. The LFS unemployment rate had fallen slightly in Q3, while the more timely claimant count measure had decreased a little in October, following small increases in the two previous months.

The immediate policy decision

25 There had been little change in the most likely prospect for near-term growth over the month. On balance, data on global activity had been broadly as expected and pointed towards continued firm, if geographically unbalanced, growth. There had been a modest tightening in UK monetary conditions resulting from the rise in the sterling effective exchange rate and bond yields. GDP growth in the third quarter had not been revised. Taken together with evidence from business surveys and the labour market, it seemed likely that the economy had been growing at around, or a little above, its historical average rate during the second half of 2010. The Q3 data provided signs that activity growth had become less reliant on the temporary boost from the stock cycle and that the necessary rebalancing towards net trade might have begun.

26 Near-term inflation prospects had risen further. CPI inflation had increased to 3.3% in November and had generally exceeded the Committee's expectations in recent quarters. The prospective increase in VAT in January 2011 would add to measured CPI inflation over the year ahead; it was possible that some firms were already pushing up prices in the final quarter of 2010 in anticipation. There were signs that global pricing pressures had increased over the month. The temporary impact of higher energy and import prices on inflation remained hard to calibrate. But the Committee's central view remained that a substantial margin of spare capacity in the economy was

likely to persist for some time and would bear down on inflation in the medium term, as the impact of temporary factors waned.

27 The key consideration for the policy decision was whether recent developments had altered the Committee's view of the balance of risks to the prospects for inflation in the medium term. As had been the case for some months now, there were two opposing key risks.

28 On the downside, there remained the risk that private sector demand would not pick up sufficiently strongly to offset the fiscal consolidation and to erode the substantial margin of spare capacity that existed in the labour market and within firms. The persistent underutilisation of resources could then cause inflation to fall significantly below the 2% target in the medium term. Recent developments within the euro area had heightened that risk. A persistent period of financial market distress could depress activity in some of the peripheral euro-area countries and hence the demand for UK exports, although this direct effect was unlikely to be large. It could, however, also adversely affect business and consumer confidence both at home and overseas, pushing down on demand. And it could affect UK banks' ability to raise funding, leading to a deterioration in the cost and availability of credit to households and firms. The likelihood of these events occurring was hard to judge, but their impact could be large.

29 On the upside, there was the risk that a prolonged period of above-target inflation could cause inflation expectations to rise, making it more costly to bring inflation back to target in the medium term. Recent developments had heightened this upside risk. CPI inflation had risen again in November. There were also signs of increasing inflationary pressures from strong growth in the world economy. Commodity prices had risen substantially over recent months, which could herald a prolonged period of deterioration in the UK terms of trade. And there were some signs that UK households' inflation expectations were edging up. Nonetheless, available indicators of businesses' expectations and those inferred from financial markets had remained stable. And it was encouraging that earnings growth had remained moderate.

30 Committee members differed in the extent to which they had revised their views of the overall balance of risks to the medium-term outlook for inflation in response to these developments. For most members, the balance of risks had not changed sufficiently to warrant a change in policy. The weight of evidence from both home and abroad continued to indicate that the margin of spare

capacity was likely to bear down on inflation and bring it back towards the target in the medium term once the temporary impact of one-off factors had waned. The current stance of monetary policy accordingly remained appropriate to hit the inflation target in the medium term. There were sizable risks to this outcome to both the upside and the downside, and they stood ready to change the stance of policy should the balance of risks shift materially. Most of those members considered that the accumulation of news over recent months had probably shifted the balance of risks to inflation in the medium term upwards.

31 One member continued to take the view that a further expansion in the Committee's programme of asset purchases was necessary to prevent inflation undershooting the 2% target in the medium term. For that member, recent inflation outturns could be explained by the various price level shocks that had occurred and contained little news about inflation in the medium term. Financial markets provided a more valuable guide to inflation expectations than did surveys of households, and measures backed out from them had remained broadly consistent with the inflation target. That was consistent with continuing subdued growth in earnings. Looking ahead, consumption growth was likely to slow, reflecting in part the impact of the fiscal consolidation. It was likely that there was a significant margin of spare capacity and that this would persist for some time. In this member's view, that would probably act to push inflation well below target in the medium term in the absence of further measures to stimulate demand.

32 Another member continued to take the view that it was appropriate to begin to withdraw some of the exceptional monetary stimulus that had been provided by cutting Bank Rate to 0.5% alongside the Committee's programme of asset purchases. Demand had continued to recover at home and abroad, and a wide range of measures of UK nominal demand had grown at above typical pre-recession rates. Private sector activity had expanded steadily over the past year, which augured well for the economy's ability to continue to grow in the face of the prospective fiscal tightening, although the pattern of that growth might prove to be volatile. Meanwhile, inflation had remained above the target. Strong global growth was putting upward pressure on commodity prices, and there was little evidence to suggest that spare capacity was exerting significant downward pressure on UK inflation. In this member's view, a gradual withdrawal of monetary stimulus by raising Bank Rate was justified by recent economic developments and would help to reinforce the expectation that inflation would fall back to the target.

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

Seven members of the Committee (the Governor, Charles Bean, Paul Tucker, Spencer Dale, Paul Fisher, David Miles and Martin Weale) voted in favour of the proposition. Two members of the Committee voted against the proposition. Adam Posen preferred to maintain Bank Rate at 0.5% and increase the size of the asset purchase programme by £50 billion to a total of £250 billion. Andrew Sentance preferred to increase Bank Rate by 25 basis points and to maintain the size of the asset purchase programme at £200 billion.

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

Nicholas Macpherson was present as the Treasury representative.