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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

6 AND 7 JANUARY 2010

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 January 2010.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1001.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 3 and 4 February will be published on 17 February 2010.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 JANUARY 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 Financial market prices had been somewhat volatile over the month as thin trading volumes in many markets over the year-end had accentuated some price movements.

3 Interest rates across the yield curve had risen internationally over the month. Short-term interest rates one year ahead had risen in the United Kingdom, United States, and euro area, offsetting to varying extents the falls that had occurred the month before. Longer-term government bond yields had also risen internationally, with ten-year nominal spot rates on UK and US government debt increasing by almost 40 basis points. Long-term real interest rates had also risen in the United Kingdom, albeit from historically low levels. The rise in long-term interest rates could have reflected heightened concerns about the scale of government debt issuance. It was also possible that short and long-term rates had risen internationally as financial market participants had become more confident about the prospects for global recovery.

4 Equity prices had risen strongly on the month, with the major indices in the United Kingdom, United States and euro area increasing by 4%-7%. These increases were also consistent with greater confidence about the prospects for global recovery.

5 Dollar oil prices had risen by around 14% over the month, and were around 7% higher than the assumption embodied in the November *Inflation Report*. This rise was likely to reflect the impact of unusually cold weather in much of the northern hemisphere. Timely data suggested that total private oil stocks in the United States had fallen during the month, but remained high by recent standards.

Political instability in a number of oil-producing areas might also have contributed to the rise in oil prices.

6 On an effective exchange rate basis, sterling was unchanged compared with a month earlier and the dollar had appreciated by around 2%.

The international economy

7 Data over the month remained consistent with a continued global recovery, albeit one that remained heavily dependent on policy stimulus and subject to downside risks.

8 Indicators suggested that global manufacturing, which had contracted severely during the downturn, continued to recover. JPMorgan's global manufacturing Purchasing Managers' Index had risen further to 55.0 in December, compared with a low of 33.9 a year earlier. To some extent that rebound was likely to have reflected an unwinding of the stock cycle. The durability of the recovery in manufacturing output would be a function of developments in final demand. There were some positive indicators here too: global car sales had remained buoyant in November, despite the ending of some car scrappage schemes; and retail sales reports in many countries pointed to rising consumer spending.

9 The early stages of the global recovery had been less synchronised than the 2008 downturn had been. China had grown rapidly, with broad money growth perhaps providing an early signal that inflationary pressures were building. And there was strong activity growth in other emerging Asian economies. Indicators of fourth-quarter activity in the United States had generally been encouraging and there were signs that the housing market was stabilising. But, as in other countries, the recovery in the United States had been spurred by significant policy stimulus, and its durability remained uncertain. Recovery in parts of Europe remained weak, with headwinds from financial sector deleveraging and stretched fiscal positions in some countries combining with the appreciation of the euro to restrain activity.

10 It appeared that much of the narrowing in current account imbalances that had occurred in the recent past reflected cyclical factors, and there was a risk that the ongoing recovery would lead to a re-widening of global imbalances. If so, that could increase the risk of protectionist measures.

Money, credit, demand and output

11 M4, adjusted to exclude the money holdings of institutions that intermediate funds between banks, had increased by over £14 billion in November following a decline of nearly £10 billion in the previous month. This turnaround largely reflected the activities of other non-bank financial companies, such as pension funds and unit trusts. Those companies' activities were likely to continue to inject considerable volatility into monthly M4 flows. The growth in households' and private non-financial companies' money holdings had remained subdued. But it seemed increasingly likely that non-financial companies' money holdings had troughed during the second half of 2008: the annual growth rate in these balances had risen to nearly 5% in November.

12 UK private non-financial companies had raised net new finance in November for the first time since June. Net bank borrowing had been virtually flat; instead the funds had largely been raised from capital markets. Bond finance raised from capital markets over the first eleven months of 2009 had been at record levels, although net debt issuance had been broadly in line with previous years. Net equity issuance had been much stronger than previously. The strength of net equity issuance would support the process of corporate sector balance sheet deleveraging. Almost three quarters of listed equity issues in 2009 had been for less than £5 million, suggesting that equity markets had offered an alternative source of finance for smaller companies.

13 The supply of bank credit remained constrained and was likely to remain significantly impaired until the banking sector had completed the process of balance sheet restructuring. Nevertheless, there were tentative signs that the supply of bank credit had increased in recent months. There had been a gradual resumption in mortgage lending and the latest survey indicators, including from the Bank's *Credit Conditions Survey*, suggested that credit conditions for both households and firms had eased somewhat in recent months, albeit less so for small and medium-sized companies. The surveys suggested that lenders expected this mild improvement to continue.

14 According to the latest official estimates, GDP had declined by 0.2% in the third quarter, a marginally smaller decline than had been previously estimated. Those estimates suggested stockbuilding had subtracted even more sharply from growth around the beginning of 2009 than previous data vintages had implied, but that a reduction in the pace of de-stocking had boosted growth by an estimated 0.8 percentage points over the second and third quarters combined. It was likely that inventories would continue to make a positive contribution to growth in the near term as the pace of

de-stocking eased further. Sustained growth would be dependent on a pickup in final demand, though in this respect the Q3 data had also been positive, showing a 0.4% rise in domestic final demand on the previous quarter.

15 Household consumption was estimated to have been broadly flat over the third quarter, with a further decline in consumer services offset by higher spending on goods. More coincident indicators suggested that retail spending had continued growing during the final quarter. There were some early signs, including from the Bank's regional Agents, that spending had been robust around Christmas, although it was possible that some spending had been brought forward ahead of the increase in VAT at the start of 2010. After a series of sharp falls, total investment had risen slightly during the third quarter, while business investment appeared to be close to a trough. A fuller analysis of the Government's *Pre-Budget Report* than had been possible when the Committee had met in December implied that the published plans did not contain significant news for the outlook relative to the assumptions underlying the November *Inflation Report* projections.

16 Given the substantial depreciation in sterling that had taken place since 2007, net trade could be expected to contribute positively to a recovery. According to the latest data, however, net trade subtracted slightly from growth during the third quarter, and there was little evidence that UK exporters had increased their share in global markets. Export price data implied that UK exporters had so far absorbed the majority of sterling's depreciation in higher margins, rather than reduced their foreign currency export prices. That could imply that the boost to exports from the depreciation in sterling would come about more slowly, perhaps through an increase in export supply as new firms entered the market, than if export prices had been cut more sharply. In contrast, the majority of the depreciation appeared to have been passed through to import prices, although there was limited evidence yet of widespread expenditure switching away from imports and towards domestically produced goods and services. But trade data were particularly prone to revision and were volatile from quarter to quarter, providing grounds for interpreting the latest export and import numbers cautiously. And some survey-based indicators suggested that UK firms had become increasingly positive about the prospects for exports.

17 Survey indicators had painted a mixed picture of growth in the fourth quarter. The CIPS surveys were consistent with robust growth, but the CBI and BCC surveys suggested more subdued activity.

Supply, costs and prices

18 CPI inflation had risen to 1.9% in November, largely as a result of an increase in petrol price inflation. This factor, along with the reversal of the December 2008 VAT cut, was set to boost inflation further in forthcoming months. Moreover, the latest reports from the Bank's regional Agents suggested that the pass-through of the increase in VAT in January 2010 by businesses to final consumers might be somewhat greater than had been previously assumed, although that remained uncertain. And persistence of the unusually cold weather, which had led to an increase in wholesale energy prices, could reduce the possibility of retail utility price cuts in the spring. The combined impact of all these factors on inflation was likely to be substantial but temporary.

19 In contrast to the short-term inflation outlook, the YouGov/Citigroup survey measure of households' longer-term inflation expectations, which had edged up in previous months, had dropped back. Measures of forward inflation derived from financial market prices remained little changed. Taking the data together, there was little evidence that household or financial market inflation expectations had changed materially in the second half of 2009.

20 Pay growth remained subdued. Private sector annual regular pay growth had remained broadly unchanged in the three months to October according to the average earnings index and had declined slightly according to the average weekly earnings measure. But these measures of earnings would be substantially boosted in early 2010 if financial sector firms increased remuneration materially. The latest indications were that both the regular pay and bonus components of financial sector remuneration were set to rise significantly compared with 2009. The implications of higher bonuses in the financial sector for domestic inflation were likely to be small.

21 According to the latest LFS data, employment had risen by 53,000 in the three months to October compared with the previous non-overlapping quarter, although this increase masked a continuing decline in full-time employment. The more timely claimant count measure of unemployment had fallen by 6,000 in November, its first decline since February 2008. Survey indicators provided some evidence that hiring intentions were firming. Overall, the data continued to suggest that the labour market had fared less badly than might have been expected given the published GDP data. It was possible that there would be revisions to the National Accounts, removing some of this apparent tension, but there was also a risk that the labour market could deteriorate further. That could occur, for example, if firms had made employment decisions on the basis of output expectations

which were subsequently disappointed. An alternative risk was that an improvement in labour market conditions, consistent with recent trends and some of the surveys of hiring intentions, combined with buoyant financial sector earnings during the first quarter of 2010, could increase pay pressures more generally across the economy. That might be tempered somewhat by the prospect of public sector pay restraint.

22 There was limited new information about the supply potential of the economy. Neither the LFS nor claimant count measures of unemployment had suggested much change in the degree of labour market slack during the second half of 2009. The available measures of capacity utilisation pointed to little change in the margin of spare capacity within firms over the fourth quarter of 2009, which remained very substantial. The disruption to the supply of credit was likely to have a significant negative impact on supply potential. That might be offset, to some extent, if corporate liquidations continued to run at a low rate when compared to previous recessions. The Committee agreed that further analysis of the extent of the decline in potential output was required.

The immediate policy decision

23 It was increasingly probable that CPI inflation would rise to well above the 2% target in the early part of 2010 and remain elevated for several months. The most recent intelligence about the likely pass-through of the January VAT rise and the potential impact on energy prices from the unusually cold weather suggested that inflation in the short term would be further above target than the Committee had previously expected.

24 There was a risk that a sustained period of above-target inflation could cause inflation expectations to drift upwards. The Committee would monitor closely the extent to which price-level shocks affected inflation expectations. But so long as expectations remained consistent with the 2% target, the medium-term outlook for inflation – the key consideration when setting monetary policy – would reflect the balance between demand and the supply potential of the economy. The available evidence continued to suggest that this balance would bear down on inflation for a considerable period.

25 The most recent data provided mixed signals about the current state of demand. The quarterly National Accounts still pointed to a contraction in the third quarter. Taken together, the latest surveys were, on balance, consistent with growth during the fourth quarter. In November, private non-financial companies had raised positive net finance for the first time since the summer, and there

was evidence of some improvement in the availability of bank credit. But the growth in households' and private non-financial companies' money balances remained subdued. The pattern of developments from the rest of the world had been similar to that of previous months: there was growing evidence of a global recovery, but one that was centred on emerging Asia and in which the United Kingdom's main trading partner, the euro area, was growing only slowly.

26 Overall, the data were consistent with the view that the UK economy had begun to expand again, albeit weakly. But the strength and durability of any recovery would depend on the interplay of the significant tailwinds and headwinds affecting activity. The main supports to activity remained the significant degree of policy stimulus and the past depreciation of sterling. It was unclear how much net trade had yet responded to that depreciation, but the Committee agreed that some boost would eventually occur.

27 There remained powerful headwinds impeding the recovery. The supply of bank credit was likely to remain impaired for a sustained period as banks sought to adjust their balance sheets and refinance their own funding maturing over the coming years. Uncertainty about prospective incomes was likely to prompt more cautious behaviour by households, encouraging greater saving than in the past, and investment was unlikely to recover strongly so long as a significant margin of spare capacity existed in the economy. In addition, it was clear that a significant fiscal consolidation was needed in the United Kingdom, the precise nature and pace of which remained unclear, and to which monetary policy would need to respond as new information became available.

28 Committee members agreed that recent developments did not provide grounds for substantially changing their views about the medium-term prospects for activity. Given those prospects, and the significant degree of spare capacity in the economy, Committee members continued to expect inflation to fall below the target for a period once the various near-term price-level shocks to inflation had worked through. The projections and analysis prepared in advance of the February *Inflation Report* would enable a more comprehensive assessment of the latest information about the supply potential of the economy, as well as the impact of the various headwinds and tailwinds affecting activity and inflation.

29 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 5 November meeting, of asset purchases totalling £200 billion financed by the creation of central bank reserves.

The Committee voted unanimously in favour of the proposition.

30 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

Nicholas Macpherson was present as the Treasury representative.