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

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1007.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 4 and 5 August will be published on 18 August 2010.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 JULY 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 Stresses in financial markets had persisted during the month. Measures of volatility and spreads on a range of riskier assets had remained high.

3 These stresses had reflected in part continuing concerns among market participants about the ability of some euro-area countries to achieve necessary fiscal consolidation. Spreads between yields on German government bonds and those of a number of euro-area governments had remained elevated. Uncertainty about the scale of banks' exposures to sovereign debt, particularly within the euro area, had continued to impair bank funding markets. The costs of both interbank funding and of new bank bond issuance had remained elevated. Capital market issuance by banks had remained low. It was unclear to what extent the uncertainty would be resolved by the publication by the Committee of European Bank Supervisors of the results of stress tests designed to assess the resilience of the EU banking sector on 23 July.

4 A range of economic data had been released during the month that were interpreted as signalling that the pace of economic recovery was likely to be slower than previously expected, particularly in the United States. But over the month as a whole, UK and US equity prices had been broadly unchanged and they had risen a little in the euro area.

5 Market participants had revised down their views of the timing and speed of the withdrawal of the exceptional monetary stimulus in the United States in the light of these data. According to dollar overnight index swaps, expected short-term interest rates one year ahead were about 15 basis points

lower than a month previously. Near-term interest rate expectations had changed little over the month in the United Kingdom. Interest rates had risen slightly in the euro area, probably reflecting the fall in the amount of excess reserves within the Eurosystem following the European Central Bank's most recent market operations.

6 Yields on UK government bonds, which remained low by historical standards, had been stable following the Budget on 22 June. Over the month as a whole, yields on ten-year US and UK government bonds had declined by around 20 basis points.

7 Sterling had appreciated by nearly 4% against the dollar during the month, but was little changed against the euro. In effective terms, sterling had risen by nearly 1%.

The international economy

8 Over recent months, heightened concerns about sovereign indebtedness had prompted governments in a number of euro-area countries to accelerate their plans for fiscal consolidation. These were likely to weigh on prospects for demand growth in key UK export markets. But measures of euro-area business activity and consumer confidence, which might have been expected to provide an early indication of the economic impact of recent financial market developments, had been broadly unchanged in June.

9 In the United States, Q1 GDP growth had been revised down slightly to 0.7%. Survey indicators of activity had fallen in both the manufacturing and services sectors, although they remained at levels consistent with continuing growth. Measures of consumer confidence had been mixed, but there were signs of renewed weakness in the housing market. New home sales, housing starts and the number of new building permits had fallen. Some of that weakness was likely to reflect the ending of homebuyer tax credits in April. Non-farm payrolls had fallen in June, although that could be more than explained by the laying off of staff hired temporarily to undertake the national census: the number of private sector jobs had increased modestly.

10 Business surveys had continued to point towards robust economic growth in many parts of Asia. But some surveys had weakened a little in June in both India and China, possibly reflecting the impact

of tighter policy. Reflecting strong growth in emerging market and developing economies, the IMF had revised up its most recent outlook for global growth in 2010.

11 Against the background of continued regional divergences in growth, during the month the available data and business surveys of global activity had softened. But the signal this provided about the underlying pace of the global recovery over the medium term was unclear. It was possible that they had reflected some impact from recent renewed financial market turbulence and heralded a more persistent reduction in business and consumer confidence. But it was also possible that they had reflected temporary factors. A slowing in manufacturing growth might simply have pointed towards a waning of the temporary boost to growth from the unwinding of the stock cycle.

12 Excluding food and energy prices, inflation in the United States and the euro area had been falling during 2010. Those falls had been spread across a wide range of goods and services, which might be consistent with generalised downward pressure on prices from excess capacity. Headline inflation, however, had remained higher – at around 2% in the United States and 1.5% in the euro area – boosted over recent quarters by the impact of the past increase in oil prices. Oil prices were broadly unchanged over the month.

Money, credit, demand and output

13 Credit conditions had remained tight and recent indicators had suggested a slowing in the pace of easing. Net lending by banks to individuals and non-financial firms had been weak again in May, but net recourse to equity markets by the corporate sector had increased in recent months. Evidence from the Bank's *Credit Conditions Survey* had suggested that lenders were expecting a further slowing in the improvement of the availability of corporate credit, and a small tightening in the availability of secured lending to households. It was likely that this had been caused in part by the recent disruption to bank funding markets, which had slowed down the issuance of longer-term bank debt required for the necessary restructuring of banks' balance sheets. An unexpected slowing in the pace at which credit conditions eased was likely to dampen demand prospects. But that impact might be mitigated by the continuing substantial financial surplus of the UK corporate sector.

14 The annual growth rate of broad money, as measured by M4 excluding the holdings of interbank intermediaries, had been estimated to have been 1.6% in May. The three-month annualised rate had

risen to 9.2%, the highest since the autumn of 2007. But the significance of this pickup was unclear. The increase was mainly due to a rise in the seasonally adjusted deposits of financial companies including insurance companies and pension funds. The unadjusted data had shown a materially smaller increase, however, and it was possible there had been a change in the pattern of seasonal variation in those deposits. The deposits of households and non-financial firms were little changed in May.

15 There had been fewer official data on real and nominal activity made available this month than scheduled. Publication of the Q1 Quarterly National Accounts and associated *Blue Book* data by the ONS – which had been scheduled for 30 June – had been postponed until 12 July. According to the ONS, business investment was estimated to have risen by 8% in Q1, materially stronger than previously thought. In line with the usual pre-release arrangements, the Governor informed the Committee that industrial production had risen by 2.0% in the three months to May.

16 On balance, the available indicators from business surveys and reports from the Bank's Agents had softened during the past month. This accorded with the impression that a number of Committee members had gained from meetings with businesses around the United Kingdom. The manufacturing and services CIPS/Markit Purchasing Managers' Indices had fallen in June, although they had remained consistent with continued growth in output. More forward-looking indicators of business confidence and orders had fallen by rather more. The picture was not straightforward to interpret, however, and some indicators, such as total car registrations, the BCC survey's domestic and external sales balances, and the *CBI Distributive Trades Survey*'s retail sales balance, had picked up. Taken at face value, the business surveys had pointed towards a softening in growth between the second and third quarters. But the extent to which they had indicated more persistent weakness depended on the causes of their fall, which were far from clear.

17 One possible cause of this softening was a weakening of demand in key UK export markets, particularly within the euro area. Another possibility was that the weakening in business surveys had been related to uncertainty over the impact of the Budget on 22 June: a number of the surveys had been completed before the Budget. It was possible that there would be some recovery in the surveys over the coming months as the uncertainty surrounding the Government's overall tax and spending plans had been resolved, although the precise details of public spending would not be known until the Spending Review in October.

18 A key determinant of the medium-term outlook for activity would be the response of private sector spending to news in the Budget and the prospective Spending Review. That would depend in large part upon the extent to which the sharp rise already seen in private sector saving had reflected anticipation of the impact of the fiscal consolidation on future post-tax income. Further evaluation of the impact of the Budget on the outlook for private sector saving would be required as the Committee prepared its projections and analysis for the August policy meeting and *Inflation Report*.

Supply, costs and prices

19 CPI inflation had fallen to 3.4% in May, in large part reflecting lower contributions from food and beverages. Following the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 3.2% in June 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 input prices had fallen by 0.2% in June, reflecting in part lower oil and fuel prices. They remained over 10% higher than a year earlier. Producer output prices had fallen by 0.3% in June, their first monthly fall since November 2008.

20 Although CPI inflation had fallen by 0.5 percentage points in the past two months, it was likely to remain above the target for some months, as the impact of the past increases in indirect taxes and oil prices, and the depreciation of sterling offset downward pressure on inflation from spare capacity. It was likely that the impact of these factors on inflation would ease over coming quarters. But the increase in the standard rate of VAT to 20% from January 2011 announced in the Budget was likely to add to inflation throughout next year. It was possible that some companies may anticipate the increase by raising prices in advance.

21 The pace at which inflation returned to the target was highly uncertain, and was likely to depend upon a number of factors.

22 The impact of large changes in relative prices on the price level had obscured underlying trends in inflation. There was a wide dispersion between the different measures of UK inflation. Prices of a range of goods had been increasing by more than they had on average during the past decade, whereas prices of a range of services had been increasing by less than their average rate. That was consistent with an effect on relative prices from the fall in the exchange rate. But there had also been signs of a

pickup in services inflation in recent months and it was hard to gauge with any precision the scale or timing of the net effect of those changes in relative prices on the overall price level.

23 There remained considerable uncertainty over the extent of spare capacity in the economy and the speed with which it would press down on inflation. The recent downward trends in inflation, excluding energy and food, in the United States and euro area suggested that a substantial margin of spare capacity would cause inflation to fall back in the United Kingdom too, as the impact of temporary factors wore off. But the recent resilience of UK inflation had raised the possibility that the impact of spare capacity on inflation might be weaker or operating more slowly than in the past.

24 The outlook for inflation over the medium term would depend upon the behaviour of households' and firms' inflation expectations. While most of the household surveys suggested that expectations for inflation one to two years ahead had risen over recent months, it was likely that they had been influenced by the recent outturns for inflation itself. There was less evidence of a material rise in measures of longer-term inflation expectations, which might matter more for underlying inflationary pressure. The YouGov/Citigroup measure of inflation expectations five to ten years ahead had risen in June to 3.3%, but had remained below the readings typically recorded in the years before the onset of the recession. Measures inferred from financial markets had continued to imply that market participants placed more weight on elevated inflation in the medium term than on deflation.

25 It was unlikely that an increase in inflation expectations would raise the medium-term outlook for inflation without also being associated at some point with a sustained rise in pay growth. Private sector pay settlements had remained subdued, but current elevated levels of inflation and inflation expectations posed an upside risk to future wage settlements. The outlook for pay would also depend upon the behaviour of productivity as the economy recovered, and the extent to which public sector earnings and employment affected private sector wage bargaining.

26 Total employment had increased by 5,000 in the three months to April by comparison with the previous non-overlapping quarter, according to the LFS measure, with a particularly strong increase in part-time employment. The rate of unemployment was 7.9% in the three months to April, although the more timely claimant count measure had declined further in May, its fourth consecutive monthly fall.

The immediate policy decision

27 The prospects for GDP growth had probably deteriorated a little over the month. Although consistent with continued growth, a range of survey-based measures of activity had weakened, both in the United Kingdom and overseas. It was possible that this pointed towards a temporary slackening in the momentum of the global economic recovery. But there were factors that indicated the medium-term outlook for growth might have weakened too. Although several governments had announced plans for accelerated fiscal consolidation, conditions in international financial markets had remained stressed and firms' access to capital markets impaired. It was possible that the stress tests of the resilience of the EU banking sector, scheduled for publication on 23 July, would help to improve financial market confidence, but considerable uncertainties remained. The gradual easing in credit conditions to UK households and firms, that had been under way for several months, had appeared to slow, in part reflecting recent pressures in bank funding markets. Plans for additional reductions in public spending and increases in tax had been announced in the Budget. The implications of the additional Budget measures for output were hard to gauge and would depend upon the response of the private sector. But it was likely that they had pushed down a little on the most likely path for output, while at the same time reducing the risks to growth from a sharp rise in longer-term interest rates.

28 Near-term inflation prospects had also worsened. Although CPI inflation had fallen again in June, it was likely to be higher during the remainder of 2010 than envisaged in the *May Inflation Report* central projection. And the increase in the standard rate of VAT to 20% announced in the Budget was likely to add to inflation, particularly in 2011. Because of that, it was increasingly likely that inflation would remain above target for some time. This followed a period of several years in which inflation had been above target for much of the time. In the light of this outlook, there was a risk that the private sector's expectations of inflation over the medium term would rise, which might necessitate tighter policy than would otherwise have been needed to meet the inflation target. But there was so far little to suggest that households' longer-term inflation expectations had increased materially, although the evidence was limited. And indicators of pay growth had remained subdued.

29 In the light of the news over the month, it seemed likely that growth would be weaker than previously expected but, at least for a while, inflation was likely to be higher. But the Committee's central view remained that the substantial margin of spare capacity was likely to persist for some time and would bear down on inflation over the medium term. There were, however, considerable

uncertainties about the pace and scale of the impact of the past depreciation of sterling on the price level, about the extent of spare capacity and the strength of its influence on inflation, and about the outlook for the public's medium-term inflation expectations. It was too early to assess fully the implications for inflation of the measures announced in the Budget.

30 Against that background, the Committee assessed how the balance of risks to the inflation outlook had shifted over the past month, and what that implied for the appropriate stance of policy. Different members placed slightly different weights on the various arguments.

31 The Committee considered arguments in favour of a modest easing in the stance of monetary policy. The softening in the medium-term outlook for GDP growth over recent months would put further downwards pressure on inflation, once the impact of temporary factors had waned. Pay growth had remained subdued and there was little sign of a material pickup in medium-term inflation expectations. A further modest monetary stimulus would act to offset the softening in demand prospects and make it more likely that the inflation target would be met in the medium term.

32 But there were also arguments in favour of a modest tightening in the stance of monetary policy. Inflation was likely to remain above target for some months and there was a risk that medium-term inflation expectations would rise. The resilience of inflation over recent months had suggested that the downward impact of spare capacity could be weaker than expected and this created uncertainty around the extent to which inflation would fall back in the future. Demand growth had bounced back internationally, although the geographical distribution remained uneven. The average growth rate of the main measures of UK nominal demand in recent quarters had been around or above historical rates.

33 On balance, most members thought that it was appropriate to leave the stance of monetary policy unchanged. For them, 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 to the target in the medium term once the impact of temporary factors had worn off. There remained risks to this outcome to the downside, if the impact of the margin of spare capacity on inflation was greater than anticipated, and to the upside, if the private sector's expectations of inflation over the medium term rose. Against that background, the current level of Bank Rate and stock of asset purchases financed by the issuance of central bank reserves remained appropriate to meet the inflation target in the medium

term. The *August Inflation Report* would give the Committee the opportunity to re-evaluate the medium-term outlook for inflation in the light of all the news.

34 For one member, 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 interest rates gradually.

35 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 Adam Posen) voted in favour of the proposition. Andrew Sentance voted against, preferring an increase in Bank Rate of 25 basis points.

36 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

Robert Woods was present as the Treasury representative.