

Publication date: 23 June 2010

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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 9 AND 10 JUNE 2010

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These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 June 2010.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1006.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 7 and 8 July will be published on 21 July 2010.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 JUNE 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 stresses had persisted during the month. Measures of volatility and spreads on a range of riskier assets had been high.

3 The stresses in financial markets had been triggered by concerns among market participants about the ability of some euro-area countries to achieve necessary fiscal consolidation and had been only partially offset by the announcement of a package of measures by the EU, IMF and ECB on 10 May. The spread between yields on German government bonds and those of some peripheral euro-area governments had remained elevated over the month.

4 Pressures in bank funding markets had remained acute, reflecting heightened uncertainty over recent months about banks' exposures to sovereign debt. Yields on unsecured bank bonds had increased and new bank debt issuance had remained low. The cost of interbank funding had risen in both spot and forward markets. The strains had been especially evident in dollar markets, and market contacts reported that the average maturity of transactions had shortened. Spreads on corporate bonds had widened further, especially for financial companies, and equity markets had weakened internationally on the month. Primary issuance in capital markets had remained subdued.

5 Yields on safer assets had fallen, in part as investors sought to protect themselves against the more uncertain outlook. Yields on ten-year US, UK and German government bonds had declined by around 20 basis points.

6 There had been sizable movements in exchange rates during the month, largely reflecting developments within the euro area. The euro had fallen by about 5% against the dollar and the yen. Sterling had appreciated against the euro, but depreciated against the dollar. In effective terms, it had risen by over 2%.

7 Near-term interest rate expectations had fallen a little further over the month, as market participants had revised their views of the timing and speed of the withdrawal of the exceptional monetary stimulus. According to sterling overnight index swaps, expected short-term interest rates one year ahead were about 10 basis points lower than a month previously. There had been similar moves in dollar and euro markets.

### **The international economy**

8 Heightened concerns in financial markets about sovereign indebtedness had resulted in a renewed focus on faster fiscal consolidation among policymakers. Additional measures to tighten fiscal policy had been announced in a number of countries. This was likely to dampen prospects for demand growth in key UK export markets, unless offset by other actions to raise demand.

9 The latest data suggested that the global economic recovery had continued, albeit at an uneven pace. In the euro area, GDP had risen by 0.2% in the first quarter of 2010. Much of that growth had been due to increases in government spending and to the contribution of stockbuilding. Private final domestic demand growth had remained weak. Business surveys were consistent with a moderate expansion in the second quarter, but retail sales pointed towards continuing weakness in consumption.

10 Recent indicators of activity in the United States had been broadly positive, but there remained concerns about the durability of the recovery. Final domestic demand had continued to recover in 2010 Q1, expanding for a third consecutive quarter. Business surveys had remained at levels consistent with continuing growth in both the manufacturing and services sectors. And manufacturing export orders had risen further. Employment had increased sharply in May, although that could be explained by the temporary hiring of staff needed to undertake the national census. House prices had fallen in the first quarter and the stock of mortgages in foreclosure had continued to rise.

11 Indicators continued to point towards robust economic growth in many parts of Asia. Output had increased strongly in Japan, Korea and India in the first quarter of 2010. Business surveys in

China had weakened a little in May, but remained consistent with continuing rapid expansion in activity there.

12 As in the United Kingdom, headline inflation around the world had been boosted over recent quarters by the impact of the increase in oil prices. But, excluding food and energy, inflation had been falling in the euro area and the United States, probably reflecting the downward pressure on wages and prices from excess capacity. Oil prices had fallen during the month, possibly reflecting the impact of recent financial market turbulence on expected global demand. If sustained, these developments could lead to lower headline inflation in due course.

### **Money, credit, demand and output**

13 Recent indicators suggested that the availability of bank credit to households and firms had continued to ease, but remained tight. Net lending by banks to individuals and non-financial corporates had remained weak in April. Recent news on UK banks' balance sheets had been mildly encouraging. Write-off rates on household and non-financial corporate debt had fallen. But the restructuring of banks' balance sheets was likely to continue to restrain the availability of credit for some time. This was likely to require significant issuance of longer-term bank debt and the recent disruption to bank funding markets would probably slow that process down.

14 The annual growth rate of broad money, as measured by M4 excluding the holdings of interbank intermediaries, had been estimated to have remained weak in April, at around 1%. But the three-month annualised growth rate had risen to 6.6%, its highest since 2008 Q2. The increase was mainly due to a rise in the deposits of financial companies, including insurance companies and pension funds. The deposits of non-financial companies had fallen in April, the first monthly decline in nearly a year. These developments might have reflected the lack of primary issuance by firms in capital markets.

15 Nominal GDP had increased by 2.1% in the first quarter. Following the increases in the second half of 2009, it was 3.3% higher than a year earlier. Most of the quarterly increase had been accounted for by an increase in the GDP deflator rather than in real activity, including a small impact from the restoration of the standard rate of VAT to 17½%.

16 According to the ONS, real GDP had grown by 0.3% in the first quarter, 0.1 percentage points stronger than previously estimated. Final domestic demand was also estimated to have grown by 0.3% in the first quarter, compared with 0.1% in the preceding quarter. This suggested more momentum in the recovery than if growth had been driven primarily by the temporary boost from the working out of the stock cycle. Monthly data indicated that output growth had picked up during the first quarter.

17 Several indicators were consistent with continued growth in the second quarter. The manufacturing and services CIPS/Markit Purchasing Managers' Indices in May had remained well above the level consistent with growth, and the construction index had increased further. In line with pre-release arrangements, the Governor informed the Committee that industrial production had fallen back by 0.4% in April, only partly offsetting the sharp estimated increase of 2.0% the previous month. Taken as a whole, the evidence continued to point towards underlying economic growth during the first half of 2010 at only a little below its historical average.

18 Business investment was estimated to have increased by 6% in the first quarter, the first increase since 2008 Q2 and stronger than the Committee had expected. Early estimates of business investment were frequently subject to significant revision, so it was unwise to place too much weight on them. But it was possible that the data had signalled that the drag on business investment from the sharp rise in generalised uncertainty after the collapse of Lehman Brothers was beginning to unwind more quickly than anticipated. If that were so, it could point towards a stronger future profile for business investment over coming quarters. But it was also possible that the increase had simply reflected news about the timing of business investment in the near term, with little information about the future outlook. Business surveys and reports from the Bank's Agents continued to point towards only modest growth in business investment.

19 Consumption was estimated to have fallen by 0.1% in the first quarter. The weakness was likely to have reflected the impact of the snow in January, the restoration of the standard rate of VAT to 17½% at the start of the year, and the declining impact of car scrappage schemes. Even after allowing for the impact of the car scrappage schemes, the share of durables spending within total consumption had remained higher than during previous recessions. That was puzzling given that tight credit conditions and lower income expectations could be expected to have acted as a particular drag on durables spending. The retail sales data for April had pointed towards a stronger profile for consumption in the second quarter.

20 A key determinant of the outlook for activity over the medium term remained how public sector borrowing and private sector saving would evolve. The Government had announced measures on 24 May to reduce public spending by £6.2 billion within the 2010/11 financial year. More detailed tax and spending plans would be unveiled in the Budget on 22 June. It was not clear how private sector saving would respond to news in the Budget. That would depend in part upon the extent to which the sharp rise already seen in private sector saving had reflected anticipation of future fiscal consolidation.

### **Supply, costs and prices**

21 CPI inflation had picked up to 3.7% in April, mainly reflecting contributions from clothing, food, beverages and tobacco. Following the usual pre-release arrangements, an advance estimate for CPI of 3.4% in May had been provided to the Governor ahead of publication. A detailed breakdown of the May 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 0.6% in May, in part reflecting the fall in sterling oil and commodity prices. But they remained over 11% higher than a year earlier. Producer output prices had risen by 0.3% in May, a slower rate of increase than in the preceding two months.

22 Despite having fallen in May, CPI inflation was likely to take several more months to return to around the target, as downward pressure from spare capacity was offset by the impact on the price level of the past increases in oil prices and indirect taxes, and depreciation of sterling. It remained likely that inflation would moderate later in 2010 as the impact of those temporary factors wore off. But the pace at which it would do so remained highly uncertain.

23 The outlook for inflation in the medium term would depend materially upon the evolution of households' and firms' inflation expectations. The most recent readings from the various household surveys indicated that expectations for inflation one and two years ahead had risen markedly to their highest since 2008. It was likely that these expectations measures had been influenced by the recent outturns for inflation itself. There was less clear-cut evidence from longer-term measures of inflation expectations, which might matter more for underlying inflationary pressure. While the Barclays BASIX survey measure of households' longer-term expectations of inflation had risen, the Bank/NOP and Citigroup measures were little changed. Measures of longer-term inflation expectations inferred from gilt prices had edged down over the month. These measures had shown little clear pattern over recent months and they remained somewhat higher than their averages since 1997, although it was

hard to know to what extent they had been affected by the current condition of financial markets. Measures inferred from derivatives contracts implied that market participants had continued to place more weight on elevated inflation in the medium term than on deflation.

24 The Committee expected pay growth to pick up somewhat but remain subdued, reflecting the significant degree of slack in the labour market. There was a risk that elevated inflation expectations would put upwards pressure on wage growth, but, so far, there was little sign of this. According to the average weekly earnings measure, whole-economy regular pay growth had edged up to 1.9% in the first quarter, picking up by more in manufacturing than services. Total pay had increased by more, reflecting the increased contribution of bonus payments, which was likely to fall back in the second quarter. This would have acted to moderate the decline in unit labour cost growth, which had nonetheless continued to fall as output and productivity had increased.

25 According to the LFS measure, total employment had fallen by 76,000 in the first quarter. Over the same period, inactivity had risen by 121,000 and unemployment by 53,000. The rate of unemployment had edged up further to 8.0% in the first quarter, although the more timely claimant count measure had declined to 4.7% in April, its third consecutive monthly fall. Average hours worked had increased a little in the first quarter.

### **The immediate policy decision**

26 Recent backward-looking indicators suggested that economic activity had continued to recover broadly as the Committee had expected at the time of the *May Inflation Report*. Abstracting from the temporary effects of a number of factors, the evidence pointed towards underlying GDP growth at only a little below its historical average rate during the first half of 2010. The pattern of expenditure in the first quarter had also suggested that the recovery was more broadly based and less associated with a turnaround in the stock cycle than anticipated. This could indicate that there was a greater degree of momentum to demand than previously thought.

27 Two risks to the medium-term outlook for inflation had intensified, however. First, heightened concerns among financial market participants about the sustainability of government deficits and debt levels, particularly in certain euro-area countries, had prompted the announcement of accelerated fiscal consolidation by several governments. In the absence of additional support to demand from elsewhere, it was likely that these events would dampen the prospects for growth in key UK export markets. In

the United Kingdom, the Government had announced measures to reduce public spending by £6.2 billion within the current financial year, and was set to reveal more details about its intended fiscal consolidation on 22 June. Concerns about the exposures of financial institutions to sovereign governments had increased funding costs for many banks, and the risks of further financial fragility had risen. If persistent, these would be likely to reduce further the availability of credit to UK households and firms.

28 Second, this month's data had brought into sharper relief the recent resilience of inflation in the United Kingdom. Although CPI inflation had fallen in May, near-term inflation prospects remained elevated. This followed a period over recent years in which inflation had been above target for a majority of the time. It was likely that inflation would take some time to return to around the target. The near-term outlook for inflation might be further affected by measures announced in the forthcoming Budget, including possible changes to indirect taxes. Against that background, there was a risk that inflation would have a further tendency to remain above the target if the private sector's expectations of inflation over the medium term also rose. That might necessitate tighter policy than would otherwise be the case. Survey-based measures of households' short-term inflation expectations had risen sharply on the month, but the evidence regarding longer-term measures was more mixed. It seemed unlikely that an increase in inflation expectations would raise the medium-term outlook for inflation without also being associated with a sustained rise in pay growth. While total pay growth had picked up, much of this had reflected a contribution from bonus payments that was unlikely to persist. Whole-economy regular pay growth had picked up by much less.

29 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 into the medium term. But there were considerable uncertainties about the margin of spare capacity and the strength of its influence on inflation, and about the extent to which continued above-target inflation would impinge upon the public's expectations in the medium term. The resilience of inflation had raised the possibility that the impact of that spare capacity on inflation might be weaker or operating more slowly than in the past. For some members, the recent downward trends in inflation, excluding energy and food, in the United States and euro area were evidence that a substantial margin of spare capacity would cause inflation to fall back in the United Kingdom as the impact of temporary factors wore off. Other members were concerned by this divergence in inflation outturns.



30 In the light of recent developments, there was a range of views among Committee members about how the balance of risks to the outlook for inflation in the medium term had changed since the time of the *May Inflation Report*. For some members, there was little change in the overall balance of risks, but the probability of inflation being either materially above or below target in the medium term had increased. For some other members, developments in inflation indicated that the balance of risks had moved marginally to the upside. Other members placed marginally more weight on developments in financial markets and, for them, the balance of risks had shifted slightly to the downside.

31 For one member, developments over the past month were consistent with a pattern which had been developing over the past year. Inflation had proved resilient in the aftermath of the recession, casting doubt on the future dampening impact of spare capacity on inflation. Demand had recovered at home and abroad, and the average growth of the main measures of UK nominal demand in recent quarters had been above typical pre-recession rates. Despite current uncertainties, for this member, it was appropriate to begin to withdraw gradually some of the exceptional monetary stimulus provided by the easing in policy in late 2008 and 2009.

32 Other members thought that changes to the balance of risks were insufficient to warrant a change in the stance of monetary policy. For them, the broad weight of evidence provided by a range of indicators of the outlook – including asset prices, the growth rates of money and credit, money spending, wage growth and estimates of spare capacity – continued to support the view that the current level of Bank Rate and stock of asset purchases financed by the creation of central bank reserves remained appropriate to meet the inflation target in the medium term. Furthermore, uncertainty over the nature and scope of the fiscal measures to be announced in the forthcoming Budget would be resolved by the time of the Committee's next meeting.

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

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

Dave Ramsden was present as the Treasury representative.