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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 MARCH 2010

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 March 2010.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1003.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 April will be published on 21 April 2010.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 MARCH 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 There had been sizable changes in a range of financial asset prices over the course of the month, in part reflecting increased uncertainty on the part of investors about the economic and fiscal outlook for a number of countries, particularly for some of those within the euro area.

3 Near-term interest rate expectations had fallen. In the United Kingdom, one year ahead overnight index swap (OIS) rates had decreased by about 15 basis points, in part following the publication of the Committee's February 2010 *Inflation Report*. Interest rates expected one year ahead had also fallen in the euro area and the United States, reflecting some unexpectedly weak macroeconomic data.

4 Yields on UK government bonds had risen. Ten year ahead nominal forward rates had increased by around 30 basis points, while real forward rates had risen by rather less. Uncertainty about UK fiscal prospects could have contributed to that rise. The suspension of the MPC's asset purchases had not had much impact on the gilt market.

5 The sterling effective exchange rate index had fallen by nearly 5% on the month, mostly accounted for by a weakening against the dollar and the yen. This took the cumulative nominal depreciation of sterling since its peak in the summer of 2007 to over 25%. Against the backdrop of market concerns about the UK fiscal position and of more generalised uncertainty among investors, the very recent weakness of sterling might have reflected an increase in the risk premium attached to sterling-denominated assets. Sterling had moved by less against the euro, which could have been consistent with an increase in the risk premium attached to euro-denominated assets too, in response to heightened concerns about the fiscal positions of a number of governments in the euro area, notably Greece.

6 In contrast to the pattern of recent months, there had been little new issuance of corporate bonds and equity by UK firms in capital markets. It was not clear whether this indicated a change in underlying demand or supply conditions, or just temporary factors. The main UK banks had also issued little debt in the run-up to the release of their annual results. Although equity prices were little changed on the month in both the euro area and the United States, they had risen by about 5% in the United Kingdom.

The international economy

7 Output growth had slipped back to 0.1% in the euro area in the fourth quarter of 2009. It was possible that slower growth was due to short-term factors. Temporary fiscal measures may have led some domestic spending and production decisions to have been brought forward to earlier in the year, while business surveys were consistent with moderate growth in the first quarter of 2010. But it was also possible that there would be more persistent weakness in demand and activity. German consumption was estimated to have fallen by almost 2% during the second half of 2009 and lending data had continued to point towards further weakness in business investment.

8 There was also a need to rebalance the composition of demand within the euro area. Some euro-area economies needed to consolidate their fiscal positions and improve competitiveness. This was likely to weigh on demand prospects for the euro area as a whole, unless those countries with trade surpluses boosted domestic demand at the same time.

9 GDP in the United States had risen by 1.4% in the fourth quarter of 2009, driven by strong contributions from inventories and consumption. In spite of tight credit conditions, durable spending, excluding cars, had been stronger than might have been expected. But it was not clear how strong the underlying recovery was. The manufacturing Purchasing Managers' Index fell a touch in February, but the non-manufacturing index had increased. Together, they continued to point towards further growth in activity in the first quarter of 2010.

10 Growth in the emerging Asian economies had continued to be robust, with industrial production recovering close to the level implied by its pre-crisis trend. In China, the authorities had taken steps to tighten policy. Business surveys there had ticked down in February. In Japan, output was estimated to have risen by 1.1% in the fourth quarter, though the data were prone to revisions.

Money, credit, demand and output

11 Broad money growth, as measured by M4 excluding holdings by interbank intermediaries, had remained weak in January. Over the past three months, the money holdings of other non-bank financial companies – primarily institutional investors and securities dealers – had fallen, possibly reflecting the continuing impact of their purchases of long-term debt and equities issued over that period. In contrast, the three-month annualised growth rates of households' and non-financial companies' money holdings were around 3% and 4% respectively in January.

12 The latest data from the ONS suggested that nominal GDP had grown by 1.1% in the fourth quarter. In the past, these data had been subject to sizable revisions, but this rise was similar to that recorded in the previous quarter, reducing the likelihood that the pickup in nominal demand growth was erratic. Taken at face value, that was encouraging given that the MPC's policy actions were aimed at increasing nominal demand sufficiently to meet the inflation target. But it was a concern that the pickup in money spending was largely associated with a rise in the GDP deflator rather than in real activity.

13 The ONS had revised its estimates of the pattern of GDP growth during 2009, but had not materially changed its view of the level of activity at the end of 2009. This included an upward revision to the recorded growth rate of GDP in the fourth quarter from 0.1% to 0.3%. The expenditure breakdown had suggested that a continuing turnaround in the stock cycle and public and private consumption were the main factors supporting growth. Monthly data suggested that the pace of expansion had been rising towards the end of the final quarter of the year. Some business surveys had softened in January and then picked up again in February, suggesting that some of the weakness recorded in January's figures may have been associated with the bad weather. Nevertheless, the impact of the weather and of other temporary influences, such as the restoration of the standard rate of VAT to 17½% and the ending of stamp duty relief on housing, would make it hard to interpret the activity data at the end of 2009 and during the first few months of 2010.

14 Looking ahead, the path of the recovery in economic activity was uncertain. Lending growth to households and businesses had remained weak, reflecting both demand and supply factors. Although there were some signs that the supply of credit to households and firms had started to ease, it was likely to remain constrained until the banking sector had completed the process of balance sheet

restructuring and the refinancing of its own funding maturing over the coming years. During the month, the major UK banks had reported their annual results for 2009. These results had, on balance, been broadly as expected and contained little news about the pace of banks' balance sheet restructuring.

15 Business investment was estimated by the ONS to have fallen sharply in the fourth quarter. This could indicate that the impact of restricted access to bank credit was larger than had previously been thought. The business investment data, however, were volatile and were subject to frequent revision. Moreover, it was possible that private sector investment would lag behind the broader recovery, as firms delayed investment decisions until there was greater certainty over the economic outlook.

16 Private consumption was estimated to have grown in both the third and fourth quarters of 2009, following the substantial falls seen over the previous five quarters. While retail sales had dropped sharply in January, the strong reading of the CBI's *Distributive Trades Survey* in February suggested that the previous month's weakness may have been related to the unusually cold weather. Following recent rises in asset prices, the ratio of households' net financial wealth to income had increased substantially, taking it back towards levels last seen in early 2007. And although the latest data from the housing market were somewhat softer on the month – probably also affected by the cold weather as well as the ending of stamp duty relief – indicators of house prices, demand and activity had increased significantly over the course of 2009. It was therefore possible that the pressure for households to rebuild their balance sheets had dissipated somewhat, suggesting that the recovery in consumption growth might be more durable than previously thought.

17 Net trade was estimated to have again reduced GDP growth in the fourth quarter. In time, the depreciation of sterling, and the resulting increase in the competitiveness of UK firms, would most likely induce a rebalancing of production towards net trade. And it was reassuring that business surveys pointed to strong demand for UK exports. But the latest reports from the Bank's Agents indicated that few exporters were yet anticipating large reductions in their foreign currency prices, suggesting that it might take some time before the depreciation boosted exports significantly. To date, the degree of import substitution in response to the depreciation of sterling had remained limited.

Supply, costs and prices

18 CPI inflation had increased to 3.5% in January. The Governor's open letter to the Chancellor had identified three factors driving up the CPI measure of inflation temporarily. First, the restoration of the standard rate of VAT to 17½% had raised prices relative to one year ago. Second, over the past year, oil prices had increased by around 70%. That was pushing up petrol price inflation, which, in turn, had raised overall CPI inflation. And third, the effects of the sharp depreciation of sterling in 2007 and 2008 were continuing to feed through into consumer prices. The depreciation of sterling since the start of the year was likely to put additional upwards pressure on inflation over coming months.

19 It was likely that inflation would moderate during the course of 2010, but the pace and degree of that moderation was highly uncertain. And further sharp movements in the exchange rate and energy prices could introduce additional significant near-term volatility. At a time when the stance of monetary policy was accommodative, there was a risk that the public's inflation expectations might rise. Measures of inflation expectations derived from household surveys and financial asset prices had so far remained broadly consistent with the inflation target.

20 The near-term outlook for inflation depended partly on how much further prices would rise in response to the past depreciation of sterling. In the medium term, the prospects for inflation would be heavily influenced by the way in which firms responded to the substantial degree of spare capacity in the economy. Business contacts of the Bank's Agents reported that a combination of credit constraints, weak cash flows and uncertainty about the economic outlook had made them wary of cutting prices so far.

21 Earnings growth had remained weak. It was likely that there would be some increase in the growth rate of earnings in the first quarter of 2010 as a result of a rise in financial sector bonuses, but this effect was likely to be temporary. Despite the weakness in earnings growth, unit wage cost growth had been high during the recession: measured labour productivity growth had fallen sharply, possibly as firms had retained workers in anticipation of a resumption in economic activity. It was possible that a recovery might be associated with relatively little job creation, as labour productivity increased. The impact of increased labour productivity on wage growth would depend upon the degree of slack in the labour market and the extent to which pay negotiations within firms were influenced by

external pressures, such as the rise in unemployment, rather than internal factors, such as capacity utilisation and profit margins.

22 Labour market activity had remained broadly stable. According to the LFS measure, employment had fallen by 12,000 in the three months to December, compared with the previous non-overlapping quarter. The LFS measure of the unemployment rate had remained constant in the fourth quarter at 7.8%. The claimant count unemployment rate had remained at 5% in January for the fifth month in succession. The rise in unemployment over the past 18 months meant, however, that the amount of slack in the labour market was likely to be substantial.

The immediate policy decision

23 Over the past three years, inflation had been more volatile than in the preceding ten years, reflecting the impact of short-run factors. CPI had risen to 3.5% in January, driven up temporarily by three influences: the restoration of the standard rate of VAT; the effect of higher oil prices on petrol price inflation; and the impact of the past depreciation of sterling on import prices. If it persisted, the recent further depreciation of sterling was likely to put additional upwards pressure on inflation over the next few quarters. So it was increasingly likely that CPI inflation would remain well above the target over the months ahead.

24 Against that background, there was a risk that the public's expectations of inflation over the medium term might begin to rise. The Committee would keep under close review the extent to which these shocks to the price level were feeding through into inflation expectations. But so long as expectations remained broadly consistent with the 2% inflation target, the key determinant of the medium-term outlook for inflation would be the balance between money spending and the economy's supply capacity.

25 The most recent indicators of activity had painted a mixed picture. The latest vintage of ONS data had suggested little change to the level of economic output in the fourth quarter of 2009. But revisions to the data had made the trough in activity earlier in the year more pronounced, and the recovery in output growth in the fourth quarter was estimated to be somewhat stronger than previously thought. The profile for growth over the past year was more in line with those seen in other advanced economies. Business and consumer confidence surveys in February had picked up, suggesting that the

momentum in growth may have been sustained into the first quarter. But, given the various erratic factors affecting activity at present, including the impact of the recent cold weather, the restoration of the standard rate of VAT and the ending of stamp duty relief, it was likely that the data would be volatile and hard to interpret for some time.

26 It was nevertheless clear that output was and was likely to remain well below capacity for an extended period. The pace and sustainability of the recovery in activity would depend upon the interplay of several factors, some of which were likely to remain a powerful constraint on growth. The banking sector remained impaired, holding back the growth of both broad money and credit. A significant fiscal consolidation was needed in the United Kingdom, the precise nature and pace of which remained uncertain. And a weakening in the prospects for growth in some of the United Kingdom's main trading partners, amid growing concerns about the fiscal position in some countries, particularly in the euro area, would weigh on the outlook for UK exports.

27 The significant degree of policy stimulus and the substantial past depreciation of sterling were two factors supportive of growth, and both the expected near-term path of official interest rates and the exchange rate had fallen further over the month. The scale and timing of the impact of the monetary stimulus remained highly uncertain. Some boost to net trade was likely as a result of the depreciation. However, it was not obvious, against the backdrop of increased uncertainty about demand growth in some of the United Kingdom's main exports markets, how quickly this would happen.

28 In the light of those factors, Committee members agreed that, on balance, there was little evidence to suggest a significant change on the month to the balance of risks to the outlook for activity in the medium term. And given that outlook, Committee members continued to expect that a significant margin of spare capacity in the economy was likely to bear down on inflation, once the temporary impact of shocks to the price level had worn off.

29 As the February *Inflation Report* had made clear, considerable uncertainties around the outlook for inflation remained. On the one hand, if the economic recovery gathered momentum and upside pressures on inflation from energy prices and the exchange rate continued, there was a risk that the current period of above-target inflation would be more prolonged, with a potential knock-on effect on inflation expectations. On the other hand, the prospect of a substantial and sustained margin of spare capacity in the economy and downside risks to demand implied a risk that inflation might fall

persistently below target in the medium term. Members drew different inferences about how the balance of risks to inflation was evolving. Some members considered that the upside risks to inflation had increased slightly over the month; others felt that the balance of risks had not changed materially.

30 Although different inferences could be drawn from recent data, all Committee members agreed that the monetary stance should be left unchanged at this meeting. That would allow the Committee to continue to assess the effects of the cumulative loosening of monetary policy since September 2008, alongside emerging evidence on the upside and downside risks to inflation.

31 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.

The Committee voted unanimously in favour of the proposition.

32 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

Dave Ramsden was present as the Treasury representative.