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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 NOVEMBER 2010

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1011.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 8 and 9 December will be published on 22 December 2010.



## MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 NOVEMBER 2010

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and supply, costs and prices.

### Financial markets

2 International government bond yields had risen over the month, reversing some of the declines which had occurred since early April. Following the publication of third-quarter UK GDP estimates, which had been stronger than expected, market participants had reduced the probability that they had assigned to the resumption of asset purchases by the MPC at its November meeting. Yields had risen on US Treasury bonds, possibly reflecting a downward revision in the expected scale of further asset purchases by the Federal Reserve. Those expectations had broadly converged on the \$600 billion of further asset purchases announced by the Federal Reserve on 3 November.

3 The expected path for official sterling and dollar policy rates over the next two years implied by forward interest rates had remained roughly unchanged over the month. Euro-area rates had drifted up slightly, reflecting a further reduction in the excess liquidity provided in ECB operations.

4 International equity prices had risen slightly over the month, and were 5%-9% higher than at the time of the *August Inflation Report*. The most recent increases probably in part reflected higher-than-expected earnings, especially for US companies. The spreads on investment-grade corporate debt had declined over the month, roughly offsetting the impact from the increase in government bond yields.

5 There had been a further widening in the yields on Irish and Greek government bonds relative to German government bonds over the month. These developments probably indicated growing market concerns about the fiscal positions of these countries. There had been little change in the spreads on Portuguese, Spanish and Italian debt.

6 The sterling effective exchange rate had depreciated a little compared to its level at the time of the August *Inflation Report* and remained close to its average level for the year to date. Since August, sterling had appreciated against the dollar and depreciated relative to the euro and yen.

### **The international economy**

7 The data released over the month had done little to change the assessment of global economic prospects, which was for a continued, albeit geographically uneven, recovery.

8 The initial third-quarter estimate of US GDP pointed to a small pickup in growth. Consumption growth was estimated to have remained steady, but investment growth had declined. Net trade had subtracted from growth again, while the contribution to growth from inventories had increased. It was possible that some of the growth in inventories over the quarter had been involuntary and might unwind, pointing to somewhat weaker future growth. That said, the manufacturing and non-manufacturing Purchasing Managers' Indices (PMIs) for October had picked up, providing some grounds for optimism about activity during the fourth quarter. Unemployment remained high and seemed unlikely to decline markedly without a more pronounced increase in growth.

9 The dispersion in economic performance across euro-area countries had, if anything, become wider. German industrial production had grown by 1.8% in August, and the manufacturing PMI had picked up further in October. Moreover, it was possible that domestic demand would make an increasing contribution to the recovery. Unemployment had declined further and had fallen by around 1 percentage point since its recession peak. That was particularly striking given the unwinding of measures that had been taken to support German employment during the recession. The recent data also provided signs of robust growth in some of the countries neighbouring Germany. By contrast, the outlook for some of the peripheral euro-area countries remained challenging. In Spain, unemployment had continued to rise, reaching nearly 21%, and Ireland had announced further fiscal consolidation measures.

10 Growth in many emerging economies had remained robust. For example, the annual rate of growth in China had been close to 10% in the third quarter, despite the impact from a tightening in policy earlier in the year, and business surveys had pointed to strengthening growth in some Asian

economies in recent months. These strong growth rates had been accompanied by rising prices for some commodities. For example, metal prices had risen by around one third since July, although oil prices had been more stable over this period.

11 Recent international meetings had highlighted the concerns of some countries' authorities about perceived potential spillovers arising from further asset purchases in the United States and elsewhere. The decision by a number of emerging economies to introduce measures to limit capital inflows in recent months and by some countries to intervene to limit the appreciation of their currencies was symptomatic of those concerns. Without effective co-operation, there remained a risk of competitive currency devaluations, or protectionist trade measures that might harm global potential supply.

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

12 According to the ONS preliminary estimate, GDP had increased by 0.8% in the third quarter, faster than the Committee had expected. Most of the difference was due to the contribution of non-distribution services, where the weak reading from the monthly Index of Services for July had provided grounds for expecting a contraction or only slight growth during the third quarter.

13 According to the official estimates, the fastest-growing sector of the economy had remained the construction sector: output had risen by 4.0% during the third quarter, having increased by 9.5% in the preceding quarter. Even taken at face value, some of that strength might prove temporary. GDP growth over the past year had been quite broadly based, however: even excluding the potentially erratic construction and energy sectors, the economy had grown by 2.4% over that period.

14 Looking ahead, there were a number of important countervailing forces acting on demand. On the one hand, high debt levels of some households, lower incomes, fiscal retrenchment, uncertainty about the economic outlook, possible steps by households to improve their retirement provision, and the reduced availability of credit were all likely to act as restraining influences. On the other hand, the stimulus to private demand from monetary policy and a rebalancing of the economy towards net trade, driven by the strengthening in the global economy and the lower level of sterling, would tend to be supportive.

15 The balance between durables and non-durables goods expenditure was sometimes interpreted as a barometer of household confidence and income expectations. In that context, it was encouraging that durable goods spending had held up relatively strongly compared with non-durables spending since the start of the recession. But housing market activity and prices would also be affected by households' confidence in their future prospects, and they had remained weak. The most recent data pointed to small declines in house prices over the past three months amid continued subdued activity. And survey measures of consumer confidence, which had picked up sharply during 2009, had fallen back since the start of the year. Taken together, it was difficult to draw firm inferences from these disparate indicators about the prospects for household spending.

16 The *Spending Review* had provided more detail on the Government's expenditure plans but had provided little additional news for the macroeconomic outlook relative to the June *Budget*.

17 Real business investment remained 17% below its pre-recession level. It was possible that investment would grow robustly over the next two years supported by the substantial financial surplus in the corporate sector. The latest surveys of investment intentions were consistent with above-average investment growth in manufacturing, but below-average growth in services.

18 Net trade had so far made less of a positive contribution to the recovery than the Committee had expected, reflecting both weakness in the United Kingdom's share of world exports and resilience in import growth. The possibility of further adverse developments in some euro-area countries posed a risk to exports, and to UK activity more generally.

19 The trade-weighted share of UK goods exports had been stable over the past two years, having steadily declined over the preceding decade. The past depreciation of sterling had supported the growth of goods exports and provided some grounds for optimism about the future. In contrast, services exports appeared to have underperformed relative to global demand. That weakness in large part had been driven by sharp falls in the official measure of exports of financial services. Ongoing subdued demand for financial services might cloud the prospects for a recovery in service sector exports.

20 Despite weak money and credit growth, nominal demand growth had returned to around pre-crisis rates. Credit conditions facing large companies appeared to have eased over the past year,

but the cost and availability of credit for small companies and households did not seem to have changed very much and, for them, conditions remained tight relative to pre-financial crisis levels. Following a strong third quarter, debt issuance by banks had fallen back in October, but funding market conditions for them appeared to remain stable.

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

21 CPI inflation had been 3.1% in September, unchanged from August. In line with pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 2.1% in October, with around half of that increase accounted for by higher crude oil prices, though the twelve-month producer price inflation rate had fallen to 8.0%. Producer output prices had increased by 0.6% in October, and their twelve-month inflation rate had increased to 4.0%.

22 In recent quarters CPI inflation had been boosted by the restoration of the standard rate of VAT to 17.5% in January 2010 and the increase in import prices arising from the past depreciation of sterling. But there was considerable uncertainty about the precise impact of these factors on overall inflation, which had generally been slightly higher than the Committee's central expectation. In the near term, inflation would remain elevated on account of the increase in the standard rate of VAT to 20% in January 2011. Some utility price rises for December had also been recently announced: these too would add to inflation in the near term, particularly if other suppliers followed suit and raised prices.

23 Developments in measures of households' inflation expectations had been mixed in recent months. There had been little change in measures derived from financial markets. Overall, inflation expectations remained at levels that appeared broadly consistent with inflation being around the target in the medium term.

24 Nominal pay growth had remained very low relative to its historical average. According to the average weekly earnings measure, regular pay had increased by 2.0% in the three months to August compared with a year earlier. The recent subdued rate of earnings growth was likely to reflect the substantial degree of slack in the labour market and within firms.

25 The latest employment data had pointed to an increase in employment, but the extent of that increase was less clear. According to the Labour Force Survey (LFS), employment had increased by 178,000 in the three months to August compared with the previous non-overlapping quarter. But the less timely Workforce Jobs data suggested a more modest pace of recovery: that measure had increased by 70,000 between March and June, less than half the increase in LFS employment in Q2, but more in line with the evidence from surveys of employment intentions.

26 Measured labour productivity had fallen sharply during the recession, but had begun to recover. Both manufacturing and service sector productivity had recovered towards levels that had been reached in the first half of 2008, before the recession had begun. On the assumption that underlying productivity had continued to grow during the recession, many companies should be able to increase output significantly using their existing workforce and capital. But other signs, such as the modest margin of spare capacity which seemed to be implied by business surveys and the pickup in employment, suggested that their scope to do so might be more limited than that.

### **The November GDP growth and inflation projections**

27 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 10 November. The considerable stimulus from monetary policy, together with a further expansion in world demand and the past depreciation of sterling, should support recovery. Those factors were likely to encourage private sector spending and some rebalancing of the economy towards net trade. But the strength of the recovery was likely to be tempered by the fiscal consolidation and the reduced availability of credit.

28 The outlook for growth remained highly uncertain. The contribution of net trade to growth had so far been weaker than the Committee had expected, and it was unclear how persistent that weakness would prove to be. Private domestic demand could grow rapidly if confidence recovered, and if businesses reinstated investment projects previously put on hold. But there were also significant downside risks to the path of private demand, especially household spending. Some households might not yet have fully adjusted to the forthcoming fiscal consolidation. In addition, there might be a further drag on consumption from weak confidence, higher savings for retirement, and some households' high levels of debt.

29 The range of views among Committee members over the likely effects on growth of these various factors was wider than usual. The Committee's best collective judgement was that GDP growth was a little more likely to be above its historical average than below it for much of the forecast period. Even so, the large fall in output during the recession meant that some spare capacity was likely to persist over the forecast period.

30 Inflation was likely to pick up a little further in the near term, and to remain above the 2% target throughout 2011, boosted by a rebuilding of companies' margins and the forthcoming increase in VAT. The projection over the first half of the forecast period was higher than in the August *Inflation Report*, in part reflecting further increases in import costs. As the impact of those effects on inflation waned, inflation was likely to fall back reflecting the continuing downward pressures on wages and prices from the persistent margin of spare capacity.

31 There were substantial risks to the inflation outlook. Inflation would be affected by future developments in commodity and other traded prices, the degree of spare capacity and its impact on wages and prices, and the evolution of inflation expectations. Continued strong growth in some emerging economies might lead to further upward pressure on the prices of commodities and other imported goods and services, so pushing up companies' costs. The degree of spare capacity and its impact on inflation in the medium term would depend on: the strength of demand; the persistence of the reduction in productivity; the performance of the labour market; and the sensitivity of wages to any labour market slack. Inflation might fall further than expected if the degree of spare capacity was larger or if it had a greater impact. But inflation might remain higher than otherwise if the current period of above-target outturns caused medium-term expectations of inflation to rise, or if the effect of sterling's past depreciation had not yet worked through fully.

32 There was a wider than usual range of views among Committee members over the likely effects on inflation of these various factors. On balance, the Committee's best collective judgement was that, conditioned on the assumption that Bank Rate followed a path implied by market interest rates and that the stock of purchased assets financed by the issuance of central bank reserves remained at £200 billion throughout the forecast period, the chances of inflation being either above or below the inflation target by the end of the forecast period were roughly equal. The most likely outcome was that inflation would fall below target by 2013, but the risks around that most likely path were judged to be skewed to the upside.

## **The immediate policy decision**

33 Third-quarter GDP growth had been surprisingly strong. Although these provisional data were subject to revision, taken together with fairly buoyant survey evidence and employment data, they suggested that the economy had been growing at around or a little above trend during 2010. If this was so, the degree of spare capacity had probably changed rather little.

34 Inflation remained above the 2% target and had generally exceeded Committee expectations in recent quarters. The implications of that for future inflation were far from clear. It was not surprising that the Committee had forecast quarterly inflation outcomes less accurately than previously, given the sequence and scale of the various price-level shocks in recent years and the uncertainty about the degree and pace of pass-through of higher costs to consumer prices. But, at the same time, it was possible that the recent pattern of inflation outturns could persist, and pose an upside risk to inflation expectations.

35 The near-term inflation outlook was more elevated than at the time of the August *Inflation Report*, reflecting in part recent increases in non-energy commodity prices and news about utility prices. But the outlook for inflation further ahead remained unusually uncertain. As in previous months, the policy decision sought to balance two opposing key risks to the medium-term inflation outlook.

36 On the upside, there was a risk that a prolonged period of above-target inflation would cause inflation expectations to drift up, making it more costly to bring inflation back to the target in the medium term. There was little evidence from surveys or financial market prices that medium-term inflation expectations had risen materially, although these measures were imperfect. But some Committee members were concerned that recent inflation outturns and the higher near-term profile meant that the risk to inflation expectations was somewhat greater than previously thought. A related concern was that further strong demand growth in emerging market economies could cause commodity prices to rise further. In addition, it was possible that the upward pressure on prices from sterling's past depreciation could continue or that a stronger-than-expected recovery in demand would reinforce upward pressure on prices and wages. Such developments could extend the period of above-target inflation outturns and would potentially accentuate the risk to inflation expectations.

37 On the downside, there was a risk that private sector demand and thus employment might not grow sufficiently strongly to use up the margin of spare capacity that existed in the economy, resulting in a further underutilisation of resources, perhaps causing inflation to fall materially below the target in the medium term. Although the precise margin of spare capacity was uncertain as productive potential was unobservable it was likely to be material. Despite some positive news about activity, the data were likely to be volatile during the recovery, adding noise to the signal about future activity. Banks still faced a significant challenge in repairing their balance sheets, but funding conditions had eased in recent months, potentially pointing to some moderation in the headwinds to growth from constrained credit supply. And it was possible that some households had not yet fully adjusted spending ahead of the effects of the forthcoming fiscal consolidation.

38 Overall, most members felt that the balance of risks had not altered decisively and that the right action at this meeting was to maintain the current, highly expansionary, stance of monetary policy. For those members, given current policy settings, the balance of probabilities suggested that inflation would fall back close to the target in the medium term. It would be premature to tighten policy while a significant margin of spare capacity remained and medium-term inflation expectations remained anchored, as this implied that the economy could grow for some time at above-trend rates without increasing medium-term inflation pressures. Conversely, it would be premature to loosen policy further without clearer signs that the economy was growing too slowly to use up the margin of spare capacity, especially while inflation was persistently above target and the upside risks to inflation expectations remained. They had differing views on the precise balance of risks to inflation in the medium term, but stood ready to adjust policy in either direction as necessary.

39 One member continued to take the view that it was appropriate to expand the Committee's programme of asset purchases. The recent inflation outturns could be explained by reference to the various price-level shocks that had occurred, which suggested that measures of underlying inflation would be well below the target. The risk to inflation expectations was limited, given muted nominal wage growth, the prospective impact of fiscal consolidation, and the Committee's mandate and independence. In this member's view, international evidence from past recessions suggested that underlying productivity growth was unlikely to have declined by much and there was undoubtedly a significant degree of spare capacity in the economy. The Committee's central projection for growth optimistically assumed only a limited impact of the planned fiscal consolidation on consumption and the risks to growth lay to the downside of that projection. Collectively, these considerations suggested

that further asset purchases would be necessary to avoid inflation falling well below the target in the medium term.

40 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. In this member's view, recent news had strengthened the case for altering policy sooner rather than later: the economy had grown robustly during the third quarter; surveys pointed to continued growth in the final quarter of the year; job creation had continued; and strong global growth was placing upward pressure on commodity prices. According to the Committee's latest projections, even after allowing for the effects of fiscal adjustment, the central projection for economic growth was in the range of 2½% to 3½% per annum, and inflation was set to rise further above the target before falling back. In this member's view, monetary policy should be used to reinforce the expectation that inflation would fall back to the target through a well-communicated policy of gradually increasing Bank Rate.

41 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.

42 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

Dave Ramsden was present as the Treasury representative.