

Publication date: 20 October 2010

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 OCTOBER 2010

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1010.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 November will be published on 17 November 2010.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 OCTOBER 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 Having declined markedly in recent months, short and longer-term interest rates had been little changed since the previous MPC meeting, so that they remained close to historic lows. There were several possible explanations for the recent reduction in government bond yields: market expectations of additional asset purchases by central banks; a belief that policy rates would remain low for an extended period; heightened aversion to risk; and a prospective shortfall in global investment relative to desired saving. It seemed likely that all of these explanations had at their heart the prospect of softer growth in parts of the world economy than previously anticipated by market participants, and the authorities' possible reaction to it. So the impact of those supportive asset price movements needed to be set alongside the likely evolution of the growth outlook.

3 Speculation over the probability of further asset purchases by the US Federal Reserve and by the MPC had intensified during the month. Towards the end of the month, the Bank of Japan had announced an additional asset purchase programme, alongside other monetary easing measures.

4 Equity prices had increased internationally – by around 5% in the United Kingdom and United States, and by less in the euro area – although prices remained below their April peaks. Corporate bond yields had fallen slightly. Those asset price movements, which would tend to boost activity, might have reflected financial market participants' expectations of further policy stimulus by the authorities.

5 The sterling effective exchange rate index (ERI) had declined by almost 3% and the dollar index by a little more, while the euro had appreciated by over 6%. The sterling ERI had ended the month at

around its average level since the start of the year. During the month, Japan and some other countries had intervened in the currency markets. On an effective basis, the yen had depreciated by 2% since the previous MPC meeting.

The international economy

6 The data released during the month had done little to change the assessment of global economic prospects. By comparison with its July projections, the IMF had revised its expectations of global output growth slightly upward for 2010 and fractionally downward for 2011. Growth was expected to remain considerably more robust in the developing and emerging economies than in the industrially advanced ones. In aggregate, the IMF projected growth in 2010 and 2011 at above the average over the decade leading up to the crisis.

7 Global growth during the first half of the year had generally been stronger than many commentators had anticipated six months ago, though there were signs of a more recent easing in the pace of expansion. Consistent with that, the monthly JP Morgan global all-industry Purchasing Managers' Index (PMI) had continued to edge down. Such a softening was probably to be expected given the fading boost to growth as the stock cycle ran its course – albeit at different paces in different regions. The key question, as in the United Kingdom, was the extent to which final demand would pick up sufficiently to erode spare economic capacity as the boost from the stock cycle and fiscal policy dissipated.

8 In the United States, where the contribution of stock building to growth had already fallen back, the second quarter GDP growth estimate had been unrevised at 0.4%. The PMIs and data on shipments of capital goods had pointed to continued modest output growth in the third quarter.

9 US consumer spending had been comparatively resilient, growing by 0.5% in 2010 Q2. Monthly data suggested a similar rate of growth was probable in the third quarter. But there remained doubts over the extent of any further acceleration in consumer spending. Notwithstanding that some of the dramatic weakness in housing starts and sales in July had been reversed in August, the US housing market remained fragile. And it was unclear how US unemployment would evolve as the economy recovered, in light of evidence of increasing mismatch and duration of joblessness in the US labour market.

10 Euro-area data for GDP growth in 2010 Q2 had been unrevised at 1.0%. The recent PMI data had pointed to some easing in the pace of growth in the third quarter. The growth experience of different countries remained diverse. German growth in the second quarter had been 2.2% and, given the continued fall in unemployment, it was possible that some of the pickup in consumer spending growth might be sustained in the third quarter. Activity indicators in a number of peripheral euro-area countries had remained weak, and there had been further evidence of differentiation by financial market participants between them.

11 The first release of Irish GDP data indicated that output had fallen by 1.2% in the second quarter, which had added to concerns over the health of the Irish banking sector. During the month, the Irish Government had announced that further substantial capital support for Irish banks would be required, and the acceleration of the transfer of some of their weaker assets into the National Asset Management Agency. The Government also announced that there would be further budgetary tightening measures.

12 Indicators in emerging Asia remained consistent with buoyant growth. Chinese industrial production had risen almost 14% in the year to August, and both manufacturing PMIs had increased in September, although the services PMI had fallen. Indian industrial production had increased by nearly 14% in the year to July. As Committee members had previously noted, there was a risk that continued robust growth in the emerging economies might cause global commodity prices to rise. The dollar price of Brent oil had increased by almost 9% during the month, and the prices of several other commodities had risen too.

Money, credit, demand and output

13 In the United Kingdom, estimated GDP growth in 2010 Q2 had been unrevised at 1.2%. But within that, estimates of private investment had been revised sharply upward. Final domestic demand was estimated to have increased by 0.9% on the quarter, and by 1.8% over the past year. Moreover, having increased by 0.7% in the second quarter, a number of indicators suggested that consumer spending might continue to increase in the third quarter. Although indicators of services output were weak, retail sales volumes had risen by 1.4% in the three months to August by comparison with the previous three months. And the retail sales balance in the CBI Distributive Trades survey for September had increased for the fourth consecutive month. These would be promising signs for both near and medium-term demand prospects if they implied that the headwinds to private sector spending

from tight bank credit supply and the forthcoming fiscal consolidation were less powerful – or were receding more quickly – than previously thought.

14 Bank credit availability remained tight, reflected in the continued weakness of money and credit data. But there had been some indications of a more general improvement in credit availability for larger businesses with access to capital markets. The number of UK companies issuing corporate bonds for the first time had risen, with an increasing proportion of sub-investment grade and unrated companies issuing debt. And a survey by Deloitte of the Chief Financial Officers of over 100 of the largest UK companies indicated that a majority described credit as easily available for the first time since the survey began in mid-2007. A separate survey of businesses conducted by the Bank's Agents found that a majority – particularly of larger businesses – viewed their corporate cash holdings as above normal, and in aggregate planned to reduce them next year by both paying down existing debt and making capital expenditures. It was therefore possible that many firms would be able to finance additional investment if they desired.

15 Households and small businesses unable to access capital markets and dependent on bank finance had seen less, if any, improvement in credit conditions. But it was mildly encouraging that September had been another month of strong bank term-debt issuance.

16 Nevertheless, there were also reasons to be less optimistic about demand prospects. In the near term, part of the recent strength of final domestic demand was estimated to have been driven by abnormally strong construction output. Such strong growth appeared at odds with reports from the Bank's Agents, and was unlikely to persist for long. And timely business surveys mostly indicated that growth in the second half of the year would be likely to ease somewhat, particularly relative to the strong growth seen in the second quarter.

17 Regarding medium-term prospects, consumer spending had recovered despite weak income growth, so that the household saving rate had been falling since 2009 Q3. It was possible that some households may not yet have adequately adjusted their spending behavior to the likely squeeze in future income resulting from the forthcoming fiscal consolidation. Such an adjustment might, therefore, occur at some point in the future. The relative resilience of employment during the recession had helped to support household spending during the recovery. The outlook for the labour market would be a key influence on future spending.

18 It was possible that the anticipated boost to activity from sterling's depreciation would take longer or be weaker than previously assumed, or that the drag to UK trade from the weak demand for exports of financial services might be more pronounced. Net trade was estimated by the ONS to have subtracted from GDP growth in the second quarter, and had yet to add convincingly to growth despite the substantial past depreciation of sterling. Exports of services were difficult to measure, however, and survey evidence on them remained more positive than the official data.

Supply, costs and prices

19 Twelve-month CPI inflation had remained unchanged at 3.1% in August. Within that, the price of airfares had risen by almost 25% over the previous year, contributing almost ½ a percentage point to aggregate CPI inflation, perhaps reflecting higher fuel costs and capacity pressures within the industry. Following the usual pre-release arrangements, an advance estimate of CPI inflation for September, also of 3.1%, had been provided to the Governor ahead of publication.

20 In line with pre-release arrangements, the Governor informed the Committee that producer output prices had risen 0.3% in September, so that the twelve-month inflation rate had eased back a little to 4.4%. Producer input prices had risen by 0.7% in September, taking the twelve-month inflation rate to 9.5% from 8.7% the previous month. Much of the increase on the month had reflected increases in the prices of imported materials. Upward revisions to the implied import price deflator in the National Accounts, along with monthly data, suggested that imported costs might have risen more rapidly than the Committee had assumed at the time of the August *Inflation Report*, so that CPI inflation in the near term might be higher.

21 Money growth had been weak, as had earnings growth, consistent with subdued medium-term inflationary pressure. According to the average weekly earnings measure, whole-economy regular pay had increased by 1.8% in the three months to July compared with a year earlier. Moreover, most survey and financial-market based measures of inflation expectations had changed little in recent months.

22 Judging the impact of the recession on unobservable supply potential was exceptionally difficult. Past international experience of the subdued economic recoveries that tended to follow banking crises had suggested some long-lasting reduction in productive capacity. And consistent with that, survey measures of the margin of spare capacity within firms generally pointed to a smaller degree of slack

than was implied by the scale of the recent reductions in the level of output and labour productivity. Several of those surveys were only indirect indicators of spare capacity, however, and it was possible that the reduction in potential supply they implied was overstated.

23 It was also likely that many firms had suspended production capacity during the recession in a way that might prove only temporary and that could be re-activated if demand recovered sufficiently. These factors might imply there was a larger-than-perceived pool of effectively spare resources that could be called upon to meet any future increase in demand. The way in which meeting such additional demand would affect business costs and hence inflation would depend on how quickly and at what cost firms could re-deploy underutilised labour and capital.

24 The sharp reduction in labour productivity during the recession had been accompanied by a reduction in real wages. This meant that some businesses might have been able to retain more labour than necessary to meet current output, in an attempt to avoid the costs associated with recruiting new – perhaps less suitably skilled – workers when demand conditions improved. If that was the case, then output might be able to grow without causing significant price pressure as long as wage demands remained commensurate with the real wage warranted by productivity and other economic factors. If demand conditions did not improve sufficiently quickly, however, there was a risk that business would begin to shed labour and scrap capital or leave the market, further prolonging the period of subdued activity and income growth. There was, as yet however, little sign of that occurring: corporate liquidations had remained lower than during previous recessions, and unemployment had stabilised. On balance, the evidence suggested that there was significant spare capacity in the economy, so that increases in demand would bring forth more output rather than higher inflation.

25 The LFS employment measure had increased by 286,000 in the three months to July, by comparison with the previous non-overlapping three-month period, including a 121,000 increase in full-time employment. The employment rate had increased by 0.5 percentage points to 58.5% over the same period. That strength was consistent with the robust output data in the second quarter. Taken at face value, these data seemed to challenge the view that firms had retained significant excess labour during the recession. However, the less timely Workforce Jobs measure of employment had increased by rather less than the LFS measure in the three months to June.

The immediate policy decision

26 The news during the month had done little to alter the near-term growth outlook. Global activity data had been broadly as expected, and were consistent with a modest deceleration as the support from the inventory cycle faded. In the United Kingdom, activity had continued to recover from its depressed level. But that recovery seemed to be weaker in the second half of the year than it had been in the first.

27 CPI inflation had remained unchanged at 3.1% in September. The prospective increase in VAT in January 2011 would affect measured CPI inflation for twelve months, and would probably keep inflation above the target for a period. The temporary impact of higher energy and import prices on inflation remained hard to calibrate. But it was likely to have been accentuated by recent movements in the prices of oil and other imported costs. CPI inflation in the near term could be higher than the Committee had previously expected. The Committee's central view remained that, as the impact of temporary factors dissipated, the persistence of weak underlying price pressures was likely to cause CPI inflation to fall back towards the target.

28 What was crucial for the policy decision was whether recent developments had affected the Committee's view of the balance of risks to the prospects for inflation in the medium term. As in previous months, there were two opposing key risks: on the one hand, whether the prolonged period of above-target inflation would cause inflation expectations to drift up, making it more costly to bring inflation back to target; and, on the other, whether private demand would grow insufficiently rapidly to replace the waning boost from the inventory cycle and public spending, resulting in a persistent underutilisation of resources that could cause inflation to fall materially below the target in the medium term.

29 The potential upside risk to inflation expectations did not seem to have changed substantially since the previous MPC meeting. Most measures of inflation expectations had moved little in the past few months. And earnings and money growth had remained weak. But recent increases in commodity and measured import prices, the 3% sterling depreciation over the past month, and their likely impact on CPI inflation in the near term had the potential to exacerbate this risk.

30 It was possible to draw different inferences about the medium-term prospects for private demand growth from the latest data. On one view, the recent recovery in private final demand, and particularly

consumer spending, was encouraging. It was a possible indication that the headwinds to the economic recovery from the fragility of the banking sector and the forthcoming fiscal consolidation – while substantial – might weigh slightly less on activity than previously thought likely. That view was supported by the recent evidence on the access to credit of large firms, and on bank funding conditions. Recent asset price movements, including lower medium-term interest rates, and the most recent depreciation of sterling and recovery of equity prices, should also act to bolster demand.

31 On an alternative view, however, real disposable income growth had been weak and the apparent recovery in consumer spending might be dampened as the impact on household incomes of the fiscal consolidation became more readily apparent. Moreover, the continued absence of a noticeable positive contribution to growth from net trade might indicate that the tailwind to growth from sterling's depreciation would be less pronounced than assumed in the recent *Inflation Report* projections. Recent asset price movements might simply have reflected market expectations that further intervention by the authorities might be necessary.

32 Committee members differed in the significance they ascribed to these developments on the overall balance of risks to the medium-term outlook for activity and inflation since the August *Inflation Report*. Most members felt that the balance of risks had not altered sufficiently to warrant a change in the policy stance at this meeting. On the one hand, they continued to believe that the economy contained a considerable margin of spare capacity and, therefore, that demand could expand significantly before widespread capacity constraints put upward pressure on inflation. On the other hand, there were concerns about the risks to inflation expectations from the persistent and prospective above-target inflation outturns. The risks to inflation in either direction remained great, and these members stood ready to alter the policy stance in either direction as the balance of risks became more decisively tilted in one direction or the other. Some of those members felt the likelihood that further monetary stimulus would become necessary in order to meet the inflation target in the medium term had increased in recent months. But, for them, the evidence was not sufficiently compelling to imply that such a course of action was necessary at present. The analysis and projections prepared for the November *Inflation Report* would give the Committee an opportunity to re-evaluate more thoroughly the outlook for activity, the margin of spare capacity and inflation in light of all the news.

33 For one member, the accumulated evidence since the Committee had completed its £200 billion programme of asset purchases suggested that a further expansion in that programme was now

warranted. In this member's view, the current degree of spare capacity in the economy was sufficiently large that monetary policy could afford to encourage more rapid growth without risking an undesirable increase in underlying inflationary pressures. Absent such additional stimulus, inflation would fall well below the target in the medium term. And the stability of measures of inflation expectations and wages over several months indicated that the likelihood of their rising sufficiently to cause an overshoot of the inflation target in the medium term was smaller than previously feared. For this member, an increase in the size of the asset purchase programme at this meeting would reduce both the risk of inflation falling materially below the target after the temporary factors that were boosting it had dissipated, and also the risk that a period of subdued growth would have a self-reinforcing effect diminishing the supply capacity of the economy.

34 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. Although some slowdown in growth might be occurring in the United Kingdom and overseas, this had to be seen alongside the strong momentum of growth in the first half of the year. The pace of growth was bound to be variable at early stages of the recovery. Meanwhile, inflation remained above the target and could increase further with upward pressure from a higher standard rate of VAT and rising oil and other commodity prices. In the view of this member, by failing to respond to persistent above-target inflation, which was forecast to continue for some time, the Committee risked a loss of credibility that would be damaging to business and consumer confidence over the medium term.

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 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 an increase in Bank Rate of 25 basis points, and to maintain the size of the asset purchase programme at £200 billion.

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

Martin Weale

Dave Ramsden was present as the Treasury representative.