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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 8 AND 9 SEPTEMBER 2010

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These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 September 2010.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2010/mpc1009.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 6 and 7 October will be published on 20 October 2010.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 SEPTEMBER 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 a shift down in the expected paths for official sterling, euro and dollar policy rates over the next two years implied by forward interest rates. The nominal yields on longer-term UK, US and German government debt as well as real UK and US yields had also fallen significantly over the month, and by more than could be explained by the fall in near-term interest rate expectations.

3 The decline in near-term interest rate expectations probably reflected a downward reassessment of near-term growth and inflation prospects and a consequent re-evaluation of the likely future path of policy rates.

4 There were a number of possible explanations for the decline in medium-term yields. They had probably been affected by the decision by the FOMC to reinvest maturing agency debt and mortgage-backed securities in US government debt. That decision had been followed by increased speculation about further interventions in bond markets by the Federal Reserve and, potentially, other central banks. It was also possible that the yields on major government bonds, including those of the United States, United Kingdom and Germany, had been depressed by heightened aversion to risk. Consistent with that, spreads between the yields on the debt of Germany and some high-deficit euro-area countries had risen over the month. In particular, there had been heightened concerns about future developments in Ireland. Finally, the fall in medium-term real yields could also be consistent with market participants having either revised down their view of the distribution of medium-term growth outcomes or having reassessed the likely scale of prospective desired global savings relative to investment.

5 Yields on investment-grade corporate bonds had declined over the month, as spreads over government yields had remained broadly unchanged. Most of the major equity price indices, although not the FTSE All-Share, had declined a little.

6 The Committee noted that asset price movements remained more highly correlated than usual, suggesting that market participants viewed individual asset returns as remaining unusually dependent upon global economic developments. This heightened correlation had been associated with an increased incidence of short-lived, generalised asset price rallies and declines. The transitory nature of some of these changes provided grounds for being cautious about drawing firm signals from monthly financial market developments.

### **The international economy**

7 Aggregate global growth in 2010 H1 had been comparable to pre-crisis averages, but there had been contrasting news over the month in relation to the euro area and the United States. The latest information in relation to emerging Asia had been consistent with continued robust growth.

8 GDP in the euro area had grown by 1.0% during Q2, ahead of market expectations. Within the euro area growth had been quite heterogeneous. Greek output had contracted during the quarter and in a number of peripheral countries GDP had grown only slowly. This had been more than offset by above-average growth in several northern European countries, including a 2.2% expansion in German output, the biggest quarterly rise since re-unification.

9 The exceptionally strong German growth reflected, in part, weather-related volatility in construction investment. Nevertheless, net trade and consumption had also made positive contributions. While the latest monthly data suggested that the pace of expansion was likely to ease in the third quarter, it seemed probable that some of the recent strength in domestic demand would persist.

10 Second-quarter GDP growth in the United States had been revised down to 0.4%. The non-manufacturing Purchasing Managers' Index for August had fallen significantly and pointed to only marginal further expansion, although some other data had been more positive. Other downbeat news included a fall in home sales, albeit in the aftermath of the expiry of the home-buyer tax credit.

The Committee had expected some easing in US growth as the temporary boost from the inventory cycle and the fiscal stimulus waned and given the headwinds to US economic recovery from property markets, high unemployment and constrained credit supply.

11 There had been mixed news in recent months about US credit supply. On the one hand, the incidence of regional bank failures was indicative of continuing strains among small US banks which were an important source of credit to small and medium-sized companies. But on the other hand, the most recent Federal Reserve survey of US senior loan officers had pointed to an easing in corporate credit conditions.

12 The latest data had suggested some moderation in the pace of expansion of some fast-growing Asian economies. This reflected, to some extent, earlier tightening in policy, and growth prospects remained robust.

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

13 Nominal GDP had increased by 1.7% during the second quarter, and had risen by nearly 6% compared with a year earlier. That rate of growth was broadly in line with the post-1997 average, though nominal domestic demand growth was stronger than that. The level of nominal GDP had recovered to around its pre-recession peak. It remained unusually difficult to identify trends in nominal demand from the latest monetary aggregates, given higher-than-normal uncertainty about the seasonal pattern of some financial companies' money holdings. Household money balances had continued to grow slowly, although there had been some pickup in the growth of private non-financial companies' money balances.

14 Credit growth had remained weak. The annual growth of total lending to individuals had remained unchanged at 0.8% in July, and secured lending to households had increased only marginally. A number of indicators had suggested a softening in housing market activity. Despite positive net capital market issuance, private non-financial companies had, in aggregate, repaid funds during July. But there had been some encouraging signs regarding future credit availability. The interim 2010 results of UK banks had generally been stronger than had been expected. Over the year to date, UK banks had raised a significant amount of gross external funding and August had been especially strong relative to previous years. The continuing ability of UK banks to do this, given the

scale of their refinancing needs, as well as the terms on which they achieved this financing, would be an important influence on the price and availability of credit.

15 Second-quarter GDP growth had been revised up slightly to 1.2% and growth in the first half of the year had been at around the long-run average. The expenditure breakdown suggested that investment had fallen back slightly following strong first-quarter growth and that consumption had recovered during the second quarter. Monthly indicators implied that the recovery in consumer spending had probably continued into the third quarter. Goods exports had picked up strongly during the second and third quarters, contributing to GDP growth. Services exports were estimated by the ONS, however, to have fallen. But these data were early estimates and, therefore, might be revised.

16 The manufacturing and construction sectors were estimated to have grown strongly during the second quarter and manufacturing year-on-year growth was now at its highest level for over fifteen years. One explanation for this was that the output of those sectors had declined by most during the recession and it was likely that there was significant spare capacity to accommodate a rebound in demand in those sectors. A related factor was that the manufacturing sector was probably benefiting more than services from the continuing replenishment of inventories and the past depreciation of sterling.

17 A number of indicators suggested that service sector growth might decline during the second half of the year; that would probably also be associated with a slowing in the overall growth rate of the economy. There were a number of reasons why such slowing might materialise. One was that the demand for business and consumer services might have been affected by uncertainty about the impact of the Budget plans ahead of the Spending Review. Another was that discretionary spending on services might have been held back as households responded to an expected squeeze in their disposable incomes. Overseas demand for some exported UK business and financial services might have softened, mitigating the benefit for those exporters from the past depreciation of sterling and recovery in the global economy. It was quite likely that the recovery in the United Kingdom would not be smooth and that growth in some quarters would be relatively slow.

## Supply, costs and prices

18 CPI inflation had fallen to 3.1% in July, as both twelve-month services and goods price inflation had dropped back. Following the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 3.1% in August had been provided to the Governor ahead of publication. A detailed breakdown was not yet available. Also in line with pre-release arrangements, the Governor informed the Committee that producer input prices had fallen by 0.5% in August, reflecting in part lower oil and fuel prices. The annual rate of growth had slowed to just over 8% from a little under 11% a month earlier, the lowest for six months. Producer output prices had remained unchanged in August, though the annual growth rate had been 4.7%.

19 Near-term prospects for inflation remained unusually uncertain and sensitive to the impact of a number of factors whose impact was difficult to evaluate accurately. These included the extent and timing of the pass-through of the rise in the standard rate of VAT to 20% in January; the size and timing of any impact on food prices from the recent increase in world grain prices; and the extent to which the past depreciation of sterling would continue to boost consumer prices. As always, near-term inflation prospects would be sensitive to any unexpected changes in energy prices.

20 Some survey measures of short and medium-term inflation expectations had either remained unchanged or had edged up upon the month. But the Barclays Basix measures of inflation expectations for one, two and five years ahead had fallen substantially – by around 1 percentage point between May and August. These were unusually large declines but it would be unwise to read too much into the movements at present. Medium-term UK breakeven inflation expectations derived from financial prices were unchanged over the month.

21 Pay settlements continued to be subdued. Over the year to date, private sector settlements had been mostly in the 1%-2% range. After stripping out the effect of multi-year deals, public sector settlements had averaged around 0.5% in the year to July. According to the average weekly earnings (AWE) measure, whole-economy total pay had increased by 1.3% in the three months to June compared with a year earlier.

22 The LFS employment measure had risen by 184,000 in the three months to June by comparison with the previous non-overlapping quarter. This reflected in part a rise in the number of full-time

employees, the first three-monthly increase for around two years. The rise in employment was consistent with GDP and a wide range of survey data showing strong growth during the second quarter. Both the LFS and the more timely claimant count measures of the level of unemployment had fallen.

### **The immediate policy decision**

23 The Committee reviewed how the key risks to the medium-term outlook for inflation had changed over the month. The first key risk was that the prolonged period of above-target inflation would lead inflation expectations to drift up, making it more costly to bring inflation back to target. The second key risk was that private demand would not grow sufficiently quickly to replace the waning boost from the working out of the stock cycle and public spending, thus increasing the margin of spare capacity in the economy and causing inflation to fall materially below the target in the medium term.

24 In relation to the first risk, CPI inflation had remained unchanged at 3.1% during August, although pay growth measures had remained subdued. Most indicators of inflation expectations were broadly unchanged. Overall, the Committee judged that the upside risk to inflation expectations, and so the inflation outlook, remained but had not changed materially over the month.

25 With regard to the second risk, developments over the month were on balance consistent with a reduction in growth prospects for the second half of 2010. In the latest vintage of ONS data, private sector final demand had been broadly flat during the first half of the year as a whole. Instead, growth had been accounted for by contributions from stockbuilding and public expenditure, both of which would fall back in due course. Some indicators also suggested that service sector output growth could weaken during the second half of the year. There had, however, been more promising information about the strength of consumption in the third quarter.

26 Overseas developments had been mixed. The latest indicators suggested slowing growth in the United States and that second-quarter GDP growth had been stronger than expected in the euro area. But it was unclear whether this signalled a significant change in the prospects for growth in those regions and so for UK net trade, or was merely a manifestation of the normal volatile pattern of growth

that occurred during recoveries. Financial market participants' perceptions of the risks associated with some euro-area countries had probably risen over the month.

27 International short and medium-term interest rates had declined substantially over the month. Those falls, insofar as they had reflected revised views about the future course of monetary policy, would be likely to stimulate activity at home and overseas. Moreover, the external financing raised by UK banks during August, and over the year as a whole, would contribute to the necessary restructuring of their balance sheets. That restructuring, which would take a long time to complete, was a pre-condition for an eventual normalisation in credit conditions.

28 Committee members differed in their interpretation of these developments for the balance of risks to activity and so inflation in the medium term. A number of members thought there had been either a slight reduction or little change to this risk, with weaker news about the prospects for activity during 2010 H2 and the boost from lower market interest rates acting in opposite directions. Other members thought that recent developments indicated that the headwinds to a recovery in private sector demand in the United Kingdom and overseas were somewhat stronger than previously thought, and that the downside risks to activity had increased. One member was also concerned that the risk of an adverse hit to the supply capacity of the economy had increased in recent months. That would occur if a decline in growth during the second half of the year prompted companies, which had been holding on to underutilised resources in anticipation of a faster recovery in activity, to shed more labour and scrap more capital.

29 On balance, most members thought that the current level of Bank Rate and stock of asset purchases financed by the issuance of central bank reserves remained appropriate to balance the risks to the inflation outlook in the medium term. But both key risks were substantial, and these members stood ready to respond in either direction as the balance of risks evolved. For some of those members, the probability that further action would become necessary to stimulate the economy and keep inflation on track to hit the target in the medium term had increased.

30 One member continued to take a different view. For this member, the data on the month had not changed his assessment that it was appropriate to start to withdraw some of the exceptional monetary stimulus provided by cutting Bank Rate to 0.5% alongside the programme of asset purchases. The strength of global growth and the rebound in domestic demand over the past year suggested that the

recovery would have sufficient momentum to withstand the planned fiscal tightening. And the persistence of inflation above target highlighted the risk of repeatedly accommodating one-off shocks to the price level. In this member's view, a well-communicated policy of gradually increasing Bank Rate would not destabilise business and consumer confidence and would reduce the risk of a sharper jolt to confidence from larger unexpected rises at a later stage.

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.

Eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Spencer Dale, Paul Fisher, David Miles, Adam Posen and Martin Weale) voted in favour of the proposition. Andrew Sentance voted against, preferring an increase in Bank Rate of 25 basis points.

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  
Spencer Dale  
Paul Fisher  
David Miles  
Adam Posen  
Andrew Sentance  
Martin Weale

Dave Ramsden was present as the Treasury representative.