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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 APRIL 2011

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These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 April 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1104.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 4 and 5 May will be published on 18 May 2011.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 APRIL 2011**

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. The Committee noted a letter from the Chancellor (attached as an annex) setting out the remit for the Committee over the following year, in accordance with Section 12 of the Bank of England Act.

### **Financial markets**

2 Despite several disturbances to the global economy over the past month – including the earthquake and tsunami affecting Japan, continuing political turmoil in the Middle East and North Africa, and the Portuguese government’s request for the activation of European financial support mechanisms – movements in asset prices had been limited and normal trading conditions had returned quickly in most financial markets. This was in contrast to conditions in early 2010 when, for example, bank funding markets had been more persistently affected by global events.

3 Short-term sterling interest rates had changed little over the month as a whole and had continued to indicate that market participants expected Bank Rate to increase by 25 basis points around the middle of the year. Within the month, however, yields had reacted to a range of data releases and news.

4 The sterling effective exchange rate had depreciated slightly over the month, although it remained close to its average rate for 2010. The euro had appreciated against most currencies, possibly because expectations had grown among market participants that official euro-area interest rates would be increased on 7 April. The yen had appreciated, most likely in response to news about the possible economic impact of the events in Japan, which had prompted co-ordinated sales of yen by the G7 authorities.

5 Long-term interest rates were little changed over the month and measures of uncertainty about them derived from options prices had remained elevated. It was possible that market participants

believed that the distribution of future disturbances to inflation, and hence nominal interest rates, was wider than during the period before the financial crisis. But this view was hard to reconcile with the movements in options-based measures of uncertainty about other asset prices, which had not similarly increased.

6 Euro-area sovereign debt markets had remained strained, reflecting continued concerns over some peripheral countries' fiscal positions, and this was reflected in CDS premia and government bond yields. The eventual announcement by the Portuguese government on 6 April that it would seek financial assistance from the European Union had limited impact on bond yields.

7 Over the month, equity prices had fallen sharply in response to the news from Japan, but had subsequently recovered in most markets: the FTSE All-Share index had increased by nearly 2%, while equity indices in the United States and euro area had risen by less. Equity prices had fallen by around 11% in Japan. UK, US and euro-area corporate bond prices had changed little, and bond issuance by UK businesses had been strong. Debt issuance by UK banks had also continued at a steady pace.

### **The international economy**

8 The data released during the month had remained consistent with firm growth in the world economy, though possibly at a slightly slower pace. Even excluding the contribution of the Japanese indices, JP Morgan's global composite Purchasing Managers' Index had fallen a little in March.

9 Economic recovery appeared to have continued at a steady pace in the United States and the euro area. In the United States, output was estimated to have grown by 0.8% in the fourth quarter of 2010 and more contemporaneous data on employment had also been encouraging. Uncertainty remained about the medium-term sustainability of the recovery, however. In the euro area, the picture continued to be one of reasonable growth at an aggregate level, but with considerable cross-country variation. Business surveys had pointed to output in the euro area growing at a little above its historic average rate in the first quarter of 2011, and indicators of German growth had remained firm. Demand growth in some peripheral countries was likely to be restrained over the next few years by the need to reduce fiscal deficits and restore competitiveness.

10 The impact that the earthquake and tsunami would have upon activity in Japan was uncertain. It was likely to depend upon how significantly business confidence had been affected, by how much power and utility supplies had been impaired, and how quickly reconstruction activity would begin. But exports to Japan accounted for only a small fraction of UK trade, so the direct impact on UK activity was likely to be small.

11 The latest indicators of activity in emerging markets had suggested continued rapid growth. There were, however, some signs of a slowing in the pace of growth, notably in China, possibly in response to recent policy tightening. Monetary policy had been tightened further in a number of Asian economies over the past month. Over time this might lead to some easing in the growth of global demand for oil and other commodities.

12 Headline measures of inflation had picked up further in a number of economies. Twelve-month US CPI inflation had reached 2.1% in February and the preliminary estimate for euro-area CPI had increased to 2.6% in the year to March. In part this had reflected the impact of the higher prices of oil and other commodities.

13 The price of crude oil had remained elevated over the month, reflecting both the continuing strength of global demand, particularly in emerging economies, and concerns about the impact on oil supply of political events in the Middle East and North Africa. The price of Brent crude oil had risen by a further 8% since the previous MPC meeting. But it was possible that the most recent increase would prove to be short-lived because it appeared to have been caused by a variety of supply factors, whose impact was likely to be temporary.

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

14 According to the most recent estimates, output had fallen by 0.5% in the fourth quarter. The ONS continued to estimate that the level of activity would have been broadly flat in the absence of the bad weather in December. UK GDP at basic prices had increased by 1.4% over 2010 as a whole. Services output had contributed around one half of that growth. The most significant expenditure counterpart of the growth in GDP had been an increase in the contribution of inventories. Final domestic demand had also contributed positively. But the contribution of net trade to growth had been negative in 2010.

15 Indicators of activity in manufacturing and services pointed to a resumption of growth in the first half of 2011. Manufacturing output had increased by 1.1% in the three months to February compared with the preceding three-month period. And while the CIPS/Markit survey index for manufacturing activity had weakened in March, it remained above its historic average level. The equivalent index for service sector activity had increased sharply, although much of the pickup was attributable to other consumer services, such as recreational and cultural services. Taken together with other surveys, the evidence pointed to some strengthening in service sector growth since the middle of 2010. First-quarter GDP growth was likely to be pushed down, however, by the impact of large falls in energy and construction output that were unlikely to be repeated.

16 The prospects for consumption would have an important bearing on the outlook for activity. Consumer spending was estimated to have fallen during the second half of 2010 and to have been broadly flat over the year as a whole, consistent with stagnant real household income growth over that period. The near-term prospects for consumption had weakened further over the month. Survey-based measures pointed to weak consumption of services in the first quarter. The volume of retail sales had been broadly flat for some months. And surveys of consumer confidence had remained far below their historic average levels.

17 A key question was whether this softening in measures of household spending indicated that the medium-term outlook for consumption was weaker than the Committee had previously expected. The continuing squeeze on households' real incomes, as a result of subdued post-tax pay growth and the elevated rate of near-term inflation, was likely to dampen consumption materially over the next year or so if some consumers had not yet fully adjusted their spending. It was also possible that some people might seek to increase their rate of saving if, for example, they perceived future income prospects to be more uncertain. Alternatively, the weakness in consumption growth might be temporary, due to factors such as the rise in the standard rate of VAT. Output growth was typically uneven during the early stages of economic recoveries, so some unevenness in consumption growth would not be surprising.

18 One way to reconcile in part the more downbeat indicators emanating from the household sector with the evidence of greater optimism among businesses was that the necessary rebalancing of activity towards net trade was under way. Surveys had continued to point to strong export growth and the recovery in the world economy remained on track. But it was puzzling that import growth had

remained so robust, despite the substantial depreciation of sterling. It was possible that domestic substitutes for some imported goods and services were not available. It was also possible that UK firms in some industries lacked the plant or capacity to expand production rapidly in response to the past depreciation of sterling and it would take time for them to install it. Consistent with that, responses to a special survey by the Bank's Agents suggested that a lack of domestic alternatives had been a significant factor restraining substitution away from imported goods and services.

19 Nominal GDP had increased by 4.2% in 2010 and nominal domestic demand had risen by 5.6%. Nominal consumption had grown by 5%, close to its historic average rate. This might provide a positive signal about households' and businesses' willingness to spend. But higher nominal spending might simply have been a mechanical consequence of tax changes and other factors that had raised prices. Broad money and credit growth had remained weak, with M4 excluding the holdings of interbank intermediaries increasing by 0.5% on a three-month annualised basis in February and M4 lending rising by 2% on a similar basis. Subdued money and credit growth could nevertheless remain consistent with more robust nominal spending growth if companies continued to become less reliant on bank credit to fund investment.

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

20 Twelve-month CPI inflation had risen to 4.4% in February from 4.0% in January. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 4.0% in March had been provided to the Governor ahead of publication. A detailed breakdown of the CPI data was not yet available, but changes in the prices of food and beverages, and recreation and culture were reported to have contributed to the fall on the month.

21 Also in line with the pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 3.7% in March. That increase had mainly reflected higher crude oil prices. The twelve-month inflation rate had fallen to 14.6%. Producer output prices had increased by 0.9% in March, causing the twelve-month inflation rate to increase to 5.4%. Increases in petroleum prices had accounted for much of the rise on the month.

22 Despite the fall in CPI inflation in March, recent developments in the prices of energy, imported commodities and other goods indicated that the most likely near-term path of inflation would be higher

than the Committee had thought at the time of the February *Inflation Report*. Recent developments in wholesale gas and other energy prices pointed towards further likely increases in utility prices later this year. These factors represented disturbances to the price level whose direct impact on inflation should abate over time. But it would be a source of concern if import prices were to continue rising rapidly. Moreover, it was possible that there were further effects from the past depreciation of sterling still to come. Near-term developments in inflation were also a source of concern to the extent that businesses were finding it easier than might have been expected to pass on cost increases.

23 A key risk remained that expectations of above-target inflation would become entrenched, adding to wage and price pressures. The evidence from surveys about households' medium and longer-term inflation expectations had been mixed. Implied measures of inflation expectations derived from financial market prices had shown no consistent pattern on the month. Options-based measures of uncertainty about the level of inflation in the United Kingdom, United States and euro area five to ten years ahead had remained elevated relative to the period before the financial crisis, but had not risen much further. It was possible that this reflected a view among market participants that the shocks affecting inflation would be larger or more persistent than before.

24 One important channel through which an increase in inflation expectations could lead to a sustained increase in inflation was through a pickup in wage growth. Pay settlements and total earnings had risen over the past year, but remained below pre-recession averages. The data on private sector wage settlements agreed so far in 2011 remained limited, but the additional evidence over the month had suggested that the underlying level of settlements remained muted. The contribution to pay growth of bonuses and regular pay drift had also remained subdued; annual whole-economy regular pay growth had been 2.2% in the three months to January. But there was a risk that pay growth could rise further in response to elevated inflation. And the sustainable rate of wage growth consistent with meeting the inflation target depended upon the growth rate of labour productivity, which had also remained weak in the latest data.

25 The evidence from published employment data and surveys of employment intentions had remained consistent with gentle growth in employment and the total number of hours worked. The LFS employment measure had increased by 32,000 in the three months to January by comparison with the previous non-overlapping three-month period and average hours worked had increased by around 1%. It was possible that the growth in employment over recent months indicated that underlying

demand in the economy had been stronger than suggested by the official data. To the extent that it indicated that firms were less able to meet demand from existing resources, it might also be a sign that the degree of spare capacity in the economy was less than the Committee had assumed.

### **The immediate policy decision**

26 Inflation had risen to well above the 2% target as a consequence of higher energy and other commodity prices, increased VAT and the impact of the past depreciation of sterling. It was likely to remain well above the 2% target for much of 2011. Nevertheless, the Committee's central view remained that a substantial margin of spare capacity in the economy was likely to persist for some time and would bear down on inflation in the medium term, as the impact of the factors temporarily boosting inflation waned.

27 The Committee set monetary policy to meet the inflation target in the medium term. As for some time, there were sizable opposing key risks to the medium-term prospects for inflation. The key consideration for the Committee this month was whether recent events had altered the balance of those risks.

28 On the downside, the key risk was that private final demand would not pick up sufficiently strongly to offset the impact on aggregate demand of the fiscal consolidation, and that the resulting margin of spare capacity would cause inflation to fall materially below the target in the medium term. Data on output during the month had been mixed and did not provide clear guidance about the extent to which activity had recovered since the slowdown in growth at the end of 2010. Indicators of output in the manufacturing and services sectors pointed to reasonably healthy growth. But weak output in the construction and energy sectors was likely to depress GDP growth in the first quarter of 2011, and assessing the outlook for economic activity as a whole was likely to be complicated by the volatility in these sectors.

29 Demand developments had also been mixed. Indicators of household spending and measures of consumer confidence had both remained weak. The extent to which these signals presaged an even weaker profile for spending growth than the Committee had expected depended on the extent to which households had adjusted their spending in response to the recent and prospective reduction in their real disposable incomes and on their desired rate of saving. In contrast to domestic demand, the evidence



suggested that export growth had remained buoyant. That was consistent with continuing recovery in the world economy, which was unlikely to be significantly affected by the disturbances in different parts of the world over the past month. But import growth remained puzzlingly strong.

30 On the upside, the key risk was that the period of elevated inflation could persist for longer than the Committee expected if there were further pass-through from the past depreciation of sterling; if externally generated inflation pressures continued to raise CPI inflation; or if expectations of higher future inflation became entrenched, leading households and businesses to set higher wages and prices. The price of oil had risen further during the month, but this was likely to have been influenced by temporary supply disruptions. CPI inflation had fallen sharply in March, but until more detail became available it was hard to know how to interpret this. In the light of recent developments in the prices of energy, imported commodities and other goods, the near-term path of CPI inflation was likely to be higher than in the February *Inflation Report*. And there remained a significant risk that inflation would exceed 5% in the near term. Survey-based measures of inflation expectations from household surveys had been mixed, while those derived from financial markets had been little changed. It was encouraging that the data on pay settlements suggested that wage growth had remained muted. There was a risk, however, that the rate of wage growth consistent with hitting the inflation target in the medium term could be lower than the Committee had previously assumed if labour productivity growth remained weak.

31 The risks to medium-term inflation in both directions were substantial. It was possible that medium-term inflation would deviate from the target in one direction or the other, perhaps materially. Overall, however, the balance between the upside and downside risks to the outlook for inflation in the medium term had not changed sufficiently over the month for Committee members to change their views of the appropriate stance of monetary policy.

32 For three members, the argument for removing some of the monetary stimulus at this meeting remained persuasive. For them, the upside risks to the outlook for inflation in the medium term from global inflationary pressures, and the possibility that inflation expectations would increase, continued to outweigh the downside risk that the strength of the recovery would be insufficient to eat into the economy's persistent margin of spare capacity. So some tightening in the stance of monetary policy was required to balance the risks to medium-term inflation around the target. Developments over the month had, on balance, not been sufficient to alter that view. There remained a material chance that

the prolonged period of above-target inflation could cause companies and households to expect inflation to come back to target only slowly and this could become embedded in wage and price-setting. Waiting for this risk to crystallise before beginning to tighten monetary policy could be costly. Moreover, the continuing growth in employment suggested that the degree of spare capacity could be less than the Committee had assumed and that the degree of downward pressure on prices could be commensurately lower. Two of those members regarded the matter as finely balanced and favoured only a small tightening in policy, given the weakness of the real economy and the uncertainty facing the outlook. The third member concluded that a larger reduction in the degree of monetary stimulus remained appropriate. For that member, the likely strength of imported inflationary pressures and the resilience of services price inflation implied that the balance of risks around the inflation target in the medium term remained significantly to the upside.

33 Other members concluded that an increase in Bank Rate was not yet appropriate. The risk that increased inflation expectations might become entrenched in wage and price-setting was material, but there was no evidence yet of that crystallising. Wage growth remained low. It was still too early to know whether the slowdown in growth towards the end of 2010 had been temporary, or whether the weakness in the contemporary indicators of household spending heralded a more protracted weakness in consumption growth. But the news over the month about demand and activity had probably been to the downside. An increase in Bank Rate in current circumstances could adversely affect consumer confidence, leading to an exaggerated impact on spending. Although the global recovery remained solid, it was not clear yet that a boost to growth from net trade was under way. And there remained significant risks to UK activity from developments within the euro area. Although there remained differences of view about the likelihood of the risks to inflation expectations crystallising, there continued to be merit in waiting to see how the various factors evolved before adjusting the stance of monetary policy.

34 For one member, the balance of risks to inflation continued to warrant an expansion of the Committee's programme of asset purchases, financed by the issuance of central bank reserves, because it was likely that inflation would fall below the target in the medium term. For that member, the data over the month had remained consistent with the view that the impact of inflation expectations on wages and prices would be less than assumed in the central projection of the February *Inflation Report*, and that consumption spending would also be lower. These factors would push down on medium-term inflation. This member recognised the risk that a persistent increase in inflation expectations or global

price pressures could outweigh the forces pushing down on inflation, but did not see this risk as material.

35 The Governor invited the Committee to vote on the propositions 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.

Regarding Bank Rate, six members of the Committee (the Governor, Charles Bean, Paul Tucker, Paul Fisher, David Miles and Adam Posen) voted in favour of the proposition. Three members of the Committee voted against the proposition. Andrew Sentance preferred to increase Bank Rate by 50 basis points. Spencer Dale and Martin Weale preferred to increase Bank Rate by 25 basis points.

Regarding the stock of asset purchases, eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Spencer Dale, Paul Fisher, David Miles, Andrew Sentance and Martin Weale) voted in favour of the proposition. Adam Posen voted against the proposition, preferring to increase the size of the asset purchase programme by £50 billion to a total of £250 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.