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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 AUGUST 2011

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 August 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1108.pdf>

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting to be held on 7 and 8 September will be published on 21 September 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 AUGUST 2011

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 Markets had been unsettled during the month, and had become particularly stressed in the days immediately preceding the Committee's meeting. That partly reflected market participants' concerns about the challenges faced by a number of euro-area countries in improving their competitiveness and the sustainability of their external and internal indebtedness, and the implications of these for banking sectors. Those concerns remained, despite the announcement by the heads of state and government of the euro area and EU institutions on 21 July of an additional support package for Greece and measures to enhance the European Financial Stability Facility and the European Stability Mechanism. Market participants' concerns also reflected uncertainty generated by the process around raising the federal debt ceiling and the medium-term prospects for the growth and fiscal position of the United States. And economic data, both at home and overseas, had on balance been weaker than anticipated.

3 The spread between the yields of the sovereign bonds of several euro-area countries with high government deficits or debt levels and those of German government bonds had remained elevated, and in some cases had risen further. As concerns about the consequences for banks had increased, there had been strains in interbank funding markets and the average tenor of transactions, including those for European banks seeking US dollar funding, was reported to have shortened. The cost of borrowing dollars in forward foreign exchange markets had increased, particularly the premium paid to exchange euros for dollars.

4 Implied market expectations of the point at which Bank Rate would begin to rise had been pushed further into the future. Information derived from overnight index swaps indicated that no change was expected for at least a year, and expectations of increases in Bank Rate in the following

twelve months had fallen. Market expectations of the timing of rises in official interest rates in the United States and the euro area had also been pushed back. Longer-term forward interest rates had fallen somewhat in the United Kingdom, the United States, and in Germany and some other core euro-area countries. Market contacts had suggested that falling yields on these countries' government bonds partly reflected increasing risk aversion by investors.

5 As financial market strains had intensified, the Swiss franc and Japanese yen had appreciated markedly. This had prompted the respective authorities in those countries to intervene to weaken their currencies in the foreign exchange market. The sterling effective exchange rate had risen by 2.3% on the month and was close to its average level during 2011.

6 Equity markets had been volatile: having fallen early in the month, and then risen following the euro-area statement, they had ended the month substantially lower. The FTSE All-Share index had fallen 7% on the month, and the major international markets were also lower. Banks' equity prices had fallen further than the declines in the broader indices.

7 Primary capital markets had experienced relatively low levels of activity. There had been little gross debt issuance by UK private non-financial corporations in July, although issuance in previous months had been proceeding at a relatively high rate. Credit default swap premia on UK banks' unsecured bonds had risen, indicating an increase in the cost of insurance; but UK banks' premia had risen by less than those of many euro-area banks. Wholesale term issuance by UK banks had slowed, although they had already met a significant proportion of their funding needs for the year as a whole in the first part of the year.

The international economy

8 A key question remained the extent to which the slowing in the pace of global activity in recent months was temporary, and the extent to which it would prove to be more prolonged. Both the backward and forward-looking data released during the month had continued to point towards a broadly based slowing relative to earlier in the year. The JP Morgan global manufacturing Purchasing Managers' Index (PMI) had fallen further in July, and the component scores for output, new orders, input prices and employment had all fallen.

9 In the United States, GDP was estimated to have grown by 0.3% in the second quarter and there had been substantial downwards revisions to the data for previous quarters. GDP was now thought to have fallen by around 1 percentage point more during the recession than previously estimated, and growth in the first quarter of 2011 had been revised down from 0.5% to 0.1%. The recent weakness in US activity could be short-lived if it largely reflected the impact of supply-chain disruption associated with the Japanese earthquake and tsunami. But other indicators had suggested that the underlying pace of expansion might be weaker than had previously been thought. These had included the slow rate of growth in employment and real consumption since the spring, and falling consumer and business confidence.

10 Indicators of activity in the euro area had suggested some slowing in the second quarter, although in part that would have reflected supply-chain disruption. Other indicators had suggested that growth might continue to slow into the third quarter: survey measures of euro-area business confidence had fallen; new export orders had fallen, particularly in Germany; and the European Central Bank's latest bank lending survey suggested that growth in companies' demand for credit had slowed in the second quarter.

11 The package of measures announced on 21 July had alleviated the immediate financing pressures on Greece, and in principle made it easier for vulnerable euro-area countries to undertake the necessary structural adjustments. But that process of adjustment was likely to weigh on euro-area demand. There was a risk that concerns surrounding the sustainability of the indebtedness of some members of the euro-area periphery could intensify again, triggering a sharper deterioration in euro-area growth, with possible implications for the functioning of the financial and banking system and for global asset prices and confidence.

12 Chinese GDP was estimated to have grown by 9.5% in the year to the second quarter, broadly unchanged from the rate of growth in the year to the first quarter. Monetary policy in a number of emerging-market economies had been tightened since the beginning of the year, partly in response to inflationary pressures. It was likely that this tighter stance of policy had begun to weigh on the pace of demand growth in these countries.

Money, credit, demand and output

13 According to the ONS's preliminary estimate, GDP had risen by 0.2% during the second quarter of 2011. Underlying growth was, however, likely to have been somewhat stronger: output had probably been reduced by the additional bank holiday associated with the royal wedding in April, and by supply-chain disruption following the earthquake and tsunami in Japan. Construction sector output, which had been more volatile than other indicators of construction activity in recent quarters, had risen by 0.5%. Weak growth in the remainder of the economy had reflected a pickup in service sector growth partially offset by a decline in manufacturing sector output.

14 Business surveys had suggested that this pattern of growth had continued into the third quarter, although with some slowing in the pace of underlying expansion. Manufacturing output growth appeared to have slowed further. In particular, export orders had fallen from the previous quarter, consistent with the softening in global activity. The July CIPS services activity index had picked up to around its long-run average, although the expectations index remained below its historical average.

15 The most recent indicators remained consistent with a subdued pace of consumption growth in the near term. Retail sales volumes (excluding fuel) had risen by 0.8% in June, but this had followed a 1.5% fall in May. The overall volume of sales had been broadly flat for the past year. The CBI's Distributive Trades Survey had weakened further in July. Measures of consumer confidence had remained at low levels.

16 In the judgement of the Committee, after some slowing in the near term, a gradual recovery in the pace of activity was expected over the medium term. The gentle recovery in GDP growth was expected to be underpinned by a recovery in business investment and a gradual rebalancing of the economy towards external demand, with consumer spending growth expected to increase slowly as the drag on real income growth dissipated. Some recovery in investment was expected, given the low investment-to-output ratio, an environment where structural rebalancing could stimulate capital expenditure, and large corporate surpluses. But against that, several investment intentions balances had fallen, and it was possible that the combination of weak output growth and weaker business confidence, perhaps stemming from a further slowing in global growth, could dampen investment. Moreover, indicators of the cost of bank credit to smaller businesses remained elevated and the supply

of credit to them was still restricted. The main risk to a stronger contribution to growth from net trade was whether global demand would continue to grow significantly.

Supply, costs and prices

17 In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 0.6% in July. The rise had mainly reflected higher prices for crude oil and other imported goods. Producer output prices had risen by 0.2% in July.

18 Twelve-month CPI inflation had fallen to 4.2% in June, from 4.5% in May. The most significant contribution to the fall had come from the prices of recreation and culture, and from audio visual equipment. More recent indications had suggested some moderation in food price inflation. But despite the fall in CPI inflation in June, the most likely near-term path of inflation was for a temporary rise to a peak of around 5% as increases in utility bills further raised the contribution of energy prices.

19 The extent to which inflation would subsequently decline would depend, in part, on the inflation expectations of households and companies, and the extent to which they were reflected in wage and price-setting decisions. The YouGov/Citigroup measures of households' inflation expectations one year ahead and five-to-ten years ahead had both fallen in July, having risen sharply in June. But both measures remained above their series averages. The CBI's measure of businesses' inflation expectations one year ahead had fallen back in the second quarter. Measures of inflation expectations derived from financial markets had changed little in July. There remained little evidence to suggest that above-target CPI inflation had begun to feed through into wages. Earnings growth remained subdued.

20 The outlook for inflation would also depend on the extent to which firms attempted to increase their profit margins, which had been squeezed during the recession. Measures based on the national accounts of the margins of private non-financial firms, excluding the oil sector, appeared to be at around average levels. But that aggregate measure probably masked significant differences at the sectoral level. In particular, reports from the Bank's Agents had suggested that margin levels in consumer-facing sectors remained below their pre-recession levels. A recent survey by the Bank's

Agents, however, had suggested that, even in aggregate, margins were below normal, and had fallen further over the past year. But there was little suggestion from the survey that aggregate margins were expected to rise over the coming year.

21 The outlook for inflation remained sensitive to movements in commodity and energy prices. These had changed little over the past month. The near-term softening in indicators of global activity suggested that there was now less risk of further pronounced rises in commodity prices as a result of global demand conditions, although the possibility of disruptions to the supply of commodities remained a risk to the upside.

22 The degree of inflationary pressure associated with the path of demand would depend crucially on the evolution of productivity. Labour productivity had remained well below the level associated with a continuation of its pre-crisis trend, which appeared to suggest a substantial amount of underutilised capacity within companies. That had been in contrast to survey measures of capacity utilisation, however, which had pointed to there being only a small margin of spare capacity. The Labour Force Survey measure of employment had risen by 50,000 in the three months to May, compared with the preceding three months – a slower pace of expansion than earlier in the year. Some survey indicators of employment intentions had also weakened. It was possible that this slowing in the labour market was consistent with an upturn in productivity growth; or it might simply have reflected an anticipation of weaker demand.

The August GDP growth and inflation projections

23 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 10 August.

24 Four-quarter GDP growth had slowed over the past year and was projected to remain weak in the near term, reflecting the continuing squeeze on households' real incomes. Further ahead, growth was likely to recover gradually, underpinned by a recovery in investment, a re-balancing of the economy towards external demand, and a moderate acceleration in consumption as household income growth recovered. But the continuing fiscal consolidation and restrictions on the supply of credit were likely to weigh on demand throughout the period.

25 There were substantial uncertainties around the outlook for output growth. The most significant risks to demand stemmed from abroad. Indicators of global growth had weakened, and it was possible that some of the slowdown would persist. The greatest risk stemmed from the euro area, where several countries faced substantial challenges in improving their fiscal and external debt positions. A significant deterioration of conditions within the euro area, and renewed turmoil in financial markets, could have a material adverse impact on the UK and global economies. But there was no meaningful way to quantify the implications of such risks for the economic outlook, except insofar as they had already been reflected in asset prices, bank funding costs and confidence. Domestically, the strength of the recovery would hinge on how far households had adjusted their spending to the weakness in their real income growth, and on the pace of the recovery in investment from its currently unusually depressed level.

26 There remained a range of views among Committee members about the likely strength of these various factors. The Committee's best collective judgement – on the assumption that Bank Rate followed a path implied by market interest rates, and the stock of assets financed by the issuance of central bank reserves remained at £200 billion – was that growth was likely to pick up gradually, so that by 2014 it was a little more likely to be above its historical average than below it.

27 GDP was likely to remain significantly below the level corresponding to a continuation of its pre-recession trend. Considerable uncertainty surrounded the degree to which that shortfall in output reflected persistent spare capacity in the economy, or alternatively was associated with a lower level of underlying productivity, and so a lower path for potential supply. The Committee's central judgement was that the majority of that shortfall reflected weakness in the level of underlying productivity, but that some margin of slack, particularly in the labour market, was nonetheless likely to persist throughout the next three years.

28 Inflation was judged likely to reach 5% later in 2011, boosted by increases in utility prices, and reflecting the continuing effects of the past increase in VAT and higher import prices. Inflation should then fall back through 2012, as those effects dissipated and downward pressure from slack in the labour market persisted.

29 There remained significant uncertainties around the outlook for inflation. Inflation would continue to be sensitive to fluctuations in global commodity prices. Domestically, there was

substantial uncertainty over: the level of underlying productivity, and so the margin of spare capacity remaining within businesses; the downward pressure exerted on wages and prices by a given margin of spare capacity in the economy; and the upward pressure placed on wages and prices by the sustained period of above-target CPI inflation.

30 There remained a range of views among Committee members over the likely effects of those influences. The Committee's best collective judgement – on the assumption that Bank Rate followed a path implied by market interest rates, and the stock of assets financed by the issuance of central bank reserves remained at £200 billion – was that the chances of inflation being above or below the target were roughly equal in the medium term.

The immediate policy decision

31 The Committee set monetary policy in order to meet the inflation target in the medium term. Inflation had been well above the 2% target as a result of the temporary impact of higher energy and other commodity prices, the increase in the standard rate of VAT and the past depreciation of sterling. CPI inflation had fallen in June, but it was judged likely to rise again temporarily, to reach 5% in the coming months, boosted by further increases in utility prices. The Committee's central view remained that inflation was likely to fall back in the medium term, as the impact of the factors raising inflation diminished and some downward pressure from a degree of slack in the labour market persisted. There were risks to that view, to the upside and the downside.

32 The key upside risk continued to be that inflation would be elevated for longer than the Committee expected. That could be as a result of expectations of above-target inflation becoming embedded in wage and price-setting behaviour; the margin of spare capacity in the economy being less than currently thought; or of further shocks to the price level. Wage growth remained subdued, which suggested that employees had not so far been able to secure higher pay increases in response to the recent squeeze on real incomes. Some measures of the longer-term inflation expectations of households had risen over the past year. But longer-term expectations of professional forecasters and financial market participants had been broadly stable. Overall, most indicators remained close to their series averages. Nevertheless, CPI inflation was expected to reach 5% in the coming months, and it was unclear how medium-term inflation expectations would react. Margin levels in consumer-facing sectors probably remained below their pre-recession levels, and any attempt by those firms to rebuild

their margins could put upward pressure on inflation. The indications that the pace of global growth was moderating suggested that energy and other commodity prices were less likely to continue rising. Import price pass-through from sterling's past depreciation appeared to be more or less complete, although the possibility of further pass-through could not be excluded.

33 The key risk to the downside remained that demand growth would not be sufficiently strong to absorb the pool of spare capacity in the economy, causing inflation to fall materially below target in the medium term. News over the month had generally reinforced the weak tone of indicators of global activity growth over the past few months, which had been particularly notable in data releases for the advanced economies. While some of the slowing would have reflected the impact of continuing disruption to global supply chains, and the effects of the elevated price of oil, the Committee judged it increasingly likely that the global slowdown would prove to be more prolonged than previously assumed.

34 In the United Kingdom, it was likely that underlying growth in the second quarter had been stronger than suggested by the headline number for GDP, but indicators of the evolution of activity in the near term had been subdued, especially for consumption and in the manufacturing sector. Much of the moderation in UK manufacturing output appeared to be related to the slowdown in world activity, and the consequent implications for export orders. Business confidence had fallen, and appeared to be weighing on investment intentions, and perhaps also on employment growth. The lower path for Bank Rate now implied by market interest rates would serve partly to offset this weaker outlook. Evidence of slowing activity, and more particularly concerns about fiscal policy in the United States and the substantial challenges faced by the euro area, had resulted in stressed conditions in financial markets which were reflected in a wide range of asset classes. This had further elevated the funding costs faced by banks. If stress in financial markets persisted, it also had the potential to constrain banks' ability to raise as much term funding as they desired. In consequence, the price and availability of credit to many households and businesses could be adversely affected.

35 The greatest risk to the downside stemmed from the euro area. Concerns about the euro area were likely already to be affecting the economic outlook through their impact on asset prices, bank funding costs and the level of household and business confidence. Reflecting that, the Committee's projections were conditioned on relatively slow growth in the euro area. There were, however, additional risks relating to a significant further intensification of concerns. These could affect the

United Kingdom through a number of channels, including: the impact a further slowing in euro-area activity would have on UK exports; financial and banking sector interlinkages; and possibly, and perhaps most significantly, through a disruption to the functioning of the international financial system more generally – hitting global asset prices, wholesale funding markets, and business and household confidence. Those additional risks were almost impossible to calibrate in terms of their probability or impact. Members of the Committee held differing views about the extent to which those risks should influence the Committee's immediate policy decision. On balance, most members saw little merit in seeking to react to the possibility of these risks crystallising by adjusting monetary policy in advance.

36 There remained substantial risks to inflation in the medium term in both directions. But overall the news on the month had increased the downside risks. Committee members considered the cases for different policy actions.

37 Most members judged that it was appropriate to maintain the current stance of monetary policy at this meeting. The slowing in world demand growth and the heightened tensions in financial markets meant that the balance of risks to the medium-term inflation outlook had clearly shifted to the downside. Some members considered whether there was a case for increasing the degree of monetary stimulus by undertaking a further programme of asset purchases. Those members concluded that the case was not yet strong enough, particularly in light of the lower path for Bank Rate now implied by financial markets. Further asset purchases might nonetheless become warranted were some of the downside risks to materialise. Some other members remained particularly concerned about risks to the upside associated with a sustained period of above-target inflation. For them, plausible outcomes for productivity growth, company margins, the degree of spare capacity in firms, or import price pass-through could also result in inflation remaining elevated. But recent developments had weakened the case for removing some of the monetary stimulus.

38 For one member, the balance of risks to inflation continued to warrant an immediate expansion of the Committee's programme of asset purchases, financed by the issuance of central bank reserves. For that member, the weak pattern of demand domestically and overseas had evolved broadly as expected, although the events of the past month suggested that the downside risks from the euro area had increased. The evidence suggested that there remained a significant margin of spare capacity. It was likely that inflation would fall below the target in the medium term. The stability of measures of inflation expectations and pay growth during a prolonged period in which inflation had been above the

target suggested that it was unlikely that they would begin to drift upwards; and any risk that they might would be further attenuated later in the year if, as the Committee expected, inflation passed its near-term peak and began to fall.

39 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, the Committee voted unanimously in favour of the proposition.

Regarding the stock of asset purchases, eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher, David Miles 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.

40 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
Ben Broadbent
Spencer Dale
Paul Fisher
David Miles
Adam Posen
Martin Weale

Nicholas Macpherson was present as the Treasury representative.