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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 7 AND 8 DECEMBER 2011

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 December 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1112.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 11 and 12 January will be published on 25 January 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 DECEMBER 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.

Financial markets

2 As for some months, against a background of concerns about the vulnerabilities associated with the indebtedness of a number of euro-area governments and banks, financial market prices had been volatile. The spreads between the yields on sovereign bonds of some euro-area countries and those on German government bonds had risen further for much of the period. That had at times included the bonds of those countries whose yields had previously remained relatively close to those on German government bonds. By the time of the Committee's meeting, however, spreads had fallen from their intra-month highs, as financial markets' expectations of the outcome of the European Council meeting on 8 and 9 December became more positive.

3 The yields on longer-term UK government bonds had also been volatile, and on balance had risen slightly over the month. Market intelligence had suggested that investors' appetite for gilts had increased as their concerns about the euro area intensified, and for a brief period within the month the ten-year benchmark gilt yield had been below that on comparable German bunds. Overnight index swaps had indicated that market participants expected UK official interest rates to remain unchanged for around two years.

4 Bank funding markets had continued to exhibit signs of impairment. There had been limited term unsecured issuance in public markets, although banks reported that they had still been able to make private placements of unsecured debt, including of structured notes. A number of banks had, however, issued secured debt in public markets. Three-month Libor-OIS spreads had risen, and although they remained much lower than in the immediate aftermath of the failure of Lehman Brothers

in 2008, the further rise in spreads was indicative of continuing stress in short-term unsecured bank funding markets.

5 For some time, for European banks in particular, short-term unsecured dollar funding conditions had been becoming increasingly difficult. The quantity of funding had reportedly declined, and tenors had fallen. As a result, the cost of borrowing dollars against euros in forward foreign exchange markets had increased. Difficulties in bank funding markets seemed likely to be one of the reasons for the apparently widespread deleveraging by continental European banks, particularly of dollar-denominated assets. There had been a coordinated announcement on 30 November by a number of major central banks of a reduction in the interest rate at which dollars could be borrowed by counterparties in their official operations. That had been intended to mitigate the impact of strains in bank funding markets on the supply of credit to households and companies. Those central banks had at the same time announced that they would establish a network of temporary bilateral liquidity swap arrangements, so that liquidity could be provided in each jurisdiction in any of their currencies should market conditions so warrant. The market premium paid to swap euros for dollars had subsequently fallen, and euro-area banks had increased their participation in the European Central Bank's three-month dollar tender on 5 December.

6 The major international equity indices had again been volatile, and on balance had risen slightly: declines early in the month were reversed as expectations of the outcome of the European Council meeting improved. They were also higher than the recent lows in early August, despite the deterioration in the growth outlook since then. Spreads above government bond yields had widened in corporate bond markets. Nevertheless, market intelligence had continued to suggest increased appetite by some investors for corporate bonds.

7 The sterling effective exchange rate had depreciated by around 1% on the month.

The international economy

8 There had been modest upside news on the near-term prospects for the United States but a further deterioration in euro-area indicators and continued slowing in emerging market economies.

9 Data on activity in the euro area had continued to suggest a period of weakness in the near term. The first estimate of euro-area GDP growth in the third quarter had been 0.2%, the same as in the second quarter. Consumer and business confidence had continued to fall in November, and the composite Purchasing Managers' Index (PMI) was at a level that was consistent with a contraction in euro-area GDP in the fourth quarter. The prospect of deleveraging by European banks, in the face of funding difficulties and a need to increase their capital ratios, was likely to weigh on euro-area activity, although its extent was difficult to calibrate: in part, the impact would depend on the extent to which the deleveraging of assets took place domestically, or from banks' asset portfolios outside the euro area.

10 In the United States, the second estimate of GDP growth in the third quarter had been 0.5%, which had been 0.1 percentage points below the first release. Taken together, the manufacturing and non-manufacturing PMIs during the fourth quarter were consistent with continued modest growth in GDP. Household spending indicators had increased, but it was unclear how sustainable that would be given the weakness in real income growth. Revisions to earlier data had suggested that employment now looked stronger than had been thought, and the unemployment rate had fallen 0.4 percentage points in November to 8.6%. Uncertainty remained about the outlook for fiscal policy in the United States, and the extent to which it would affect the near-term path for growth. The Congressional Committee established in August had failed to agree a package of fiscal measures. In the absence of agreement, spending cuts would be triggered amounting to, on some estimates, around 0.7 per cent of GDP in 2013 and subsequent years. It was also unclear whether the 2010 Tax Act stimulus would be extended.

11 There had been further confirmation that growth was easing in emerging market economies. The manufacturing PMIs for China had fallen on the month, and were consistent with a gradual slowing in activity. Brazilian GDP had been flat in the third quarter. Some of the slowing of activity in the emerging economies had been a consequence of slowing exports to the developed economies, but there were signs that it had also reflected an autonomous slowing in domestic demand. That had been a desired outcome of the monetary policy tightening in a number of countries earlier in the year. In some countries, however, policy tightening had subsequently begun to be reversed: both China and Brazil had eased monetary policy in the past month.

12 Oil prices had changed little on the month, and the spot price of Brent Crude had remained at around \$110 per barrel. The continuing resilience of oil prices seemed to reflect a number of factors, including falling inventories, interruptions to supply, for instance as a result of unplanned maintenance work, and the risk of possible future disruption to supply. The distribution of futures prices was negatively skewed by historical standards, which could be suggestive of lower spot prices to come.

Money, credit, demand and output

13 According to the second ONS estimate, GDP had risen by 0.5% in the third quarter of 2011, unchanged from the first estimate. The initial estimates of the expenditure components had suggested that growth in the third quarter had been driven by government consumption and an increase in inventories; there had been no growth in consumption, investment had fallen, and net trade had made a negative contribution. Moreover, government spending and increases in inventories had contributed around three-quarters of the cumulative increase in GDP since its trough in the second quarter of 2009, and private final demand growth had been subdued. Some business surveys had indicated that stock levels were above normal, and fiscal consolidation was also in train. This suggested that the contribution to growth of these components of demand was likely to moderate.

14 Although a detailed breakdown was not available, the initial estimate of unchanged consumption growth in the third quarter GDP release had been less weak than anticipated. More recent short-term indicators of consumption had been subdued. Consumer confidence remained weak: the GfK headline balance had risen for the first time since May, but was still at a very low level. The volume of retail sales (excluding fuel) had risen by 0.6% on the month in October, and the three-month growth rate had been 0.4%, the first increase since June. But the latest *CBI Distributive Trades Survey* suggested that retail sales volumes had fallen considerably in November, and indicated that retailers had lowered their expectations for December. The Committee continued to expect that households' real incomes would return to growth in 2012, which would provide some support to consumption spending. That would be consistent with the Committee's projection in its November *Inflation Report* for a recovery in activity in the second and third years of the forecast.

15 Business survey measures were consistent with a slowing of output growth in the near term. The CIPS/Markit activity indices for November had provided a further indication that output was likely to be broadly unchanged in the fourth quarter. Their forward-looking components were consistent with

an expectation of broadly flat GDP in the first quarter of 2012 too. In part, the slowdown in activity was likely to reflect global developments, and in particular the slowdown in the euro area.

16 Recent trade data had suggested that underlying export growth to the European Union (EU) had slowed by more than non-EU export growth, although such data were often erratic. In line with the usual pre-release arrangements, the Governor informed the Committee that economic goods exports had increased by 8.6% on the month in October, and the three-month on three-month rate had been 0.3%. Economic goods imports fell by 0.5% on the month in October and by 0.2% on a three-month on three-month comparison. Export surveys within the CIPS/Markit manufacturing index and the *CBI Monthly Trends Enquiry* had been weak.

17 Credit conditions remained an important influence on the outlook for business and household spending. Credit growth had remained weak, and there had been a slight fall in total lending to households and non-financial corporations in the three months to October, continuing the broadly flat pattern of lending since the onset of the crisis. In part, that had reflected flat house prices and very low turnover in the housing market. One key question was whether the weakness in credit growth was consistent with the Committee's expectation for a recovery in activity in the medium term. Given the role that the Committee expected its resumption of asset purchases to play in facilitating some disintermediation of the banking system, and the fact that the corporate sector as a whole had a financial surplus, some reduction in the ratio of bank credit to GDP growth seemed likely.

18 Neither banks' lending rates nor reports from the Bank's Agents suggested that the continuing tensions in financial markets had yet led to a further tightening in credit conditions for businesses and households. But, for some months, conditions had been difficult in bank term unsecured funding markets, with funding becoming more expensive and relatively little issuance in public markets. To some extent, banks had been able to compensate for this by issuing term secured debt, although it was likely that the resulting increase in asset encumbrance would impose a limit on this source of funding at some point. The longer higher funding costs and difficulties in accessing markets persisted, the more likely it would be that banks would restrict the availability of credit, or try to pass higher costs through to businesses and households by raising their lending rates.

19 The Chancellor of the Exchequer had recently announced a package of interventions, including a National Loan Guarantee Scheme, aimed at increasing the flow of credit to businesses that did not

have ready access to capital markets. The Committee also noted the broader package of fiscal policy decisions that the Chancellor had announced in the Autumn Statement. Preliminary analysis suggested the impact on the inflation outlook was likely to be modest.

Supply, costs and prices

20 Twelve-month CPI inflation had fallen to 5.0% in October. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 4.8% in November had been provided to the Governor ahead of publication. Also in line with the pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 0.1% in November, and that producer output prices had increased by 0.2%.

21 Higher energy and import prices and the increase in the standard rate of VAT had all made significant contributions to the recent elevated rate of inflation. Over the next few months inflation was likely to fall back sharply, as the contribution of price rises a year earlier began to drop out of the twelve-month comparison. The extent and pace at which inflation fell thereafter remained uncertain. Monthly inflation rates had not yet fallen back to a level that was consistent with the target, with inflation rates for goods remaining elevated, and import price inflation had been strong in the third quarter.

22 The medium-term inflation outlook depended on both the inflation expectations of households and companies, and on the degree to which they were reflected in wages and prices. Indicators of longer-term inflation expectations, whether in household surveys or derived from financial markets, had changed little on the month and were still close to their historical averages. There had been some evidence from surveys that households' near-term inflation expectations had fallen on the month, but by less than the downward revision to the Committee's own central case for the CPI inflation profile in the November *Inflation Report*.

23 There remained little sign that above-target CPI inflation had begun to generate rapid wage growth. Whole economy total annual pay growth had been just 2.3% in the third quarter. This remained well below pre-crisis rates, although the continued weakness of productivity growth meant that the growth of unit labour costs had been closer to its historical average rate. A substantial proportion of pay settlements were agreed between January and April. The Committee's expectation

was that by then demand would have slowed and inflation would be falling, which might help restrain pay growth.

24 The data continued to suggest further weakening in the labour market. According to the Labour Force Survey, in the third quarter employment had fallen by 197,000, unemployment had risen by 129,000 and the unemployment rate had increased to 8.3%. The rise in unemployment seemed to reflect a small fall in private sector employment, and a continuation of larger falls in public sector employment. Employment surveys had weakened further in November, and pointed to further falls in employment over the next few months.

25 The future evolution of productivity was an important factor in assessing the degree of inflationary pressure associated with the path of demand growth. Measured labour productivity had remained well below the level associated with a continuation of its pre-crisis trend, which appeared to suggest substantial underutilised capacity within firms. For some time, that had been in marked contrast to survey measures of capacity utilisation, which continued to suggest only a small margin of spare capacity. To an extent that might reflect some businesses maintaining employment levels despite lower output, perhaps because they thought that it might prove difficult to recruit suitably skilled staff when demand recovered. Alternatively, the deep recession and the disruption to the flow of credit might have impeded the growth of underlying productivity. Aggregate measures of productivity growth had also masked considerable heterogeneity in sectoral productivity trends.

The immediate policy decision

26 The Committee set monetary policy in order to meet the inflation target in the medium term. Twelve-month CPI inflation had fallen to 5% in October, from 5.2% in September, and the advance estimate had suggested that it fell further in November, to 4.8%. Inflation nevertheless remained well above the 2% target, largely as a result of the temporary impact of the increase in the standard rate of VAT in January, and higher energy and import prices. Inflation was likely to fall sharply in the first part of 2012 as the impact of those temporary factors dissipated. There was greater uncertainty about the pace at which inflation would continue to fall thereafter, but the Committee's central view remained that downward pressure from elevated unemployment and spare capacity would continue to restrain domestically generated inflation.

27 The Committee had initiated a programme of asset purchases in October, which would take a further two months to complete. Assessing the effects of the current programme was complicated by the volatility in financial markets, and the Committee was still gathering evidence on the impact of its purchases on asset prices and on the economy. It was noted that market capacity made it difficult to increase the monthly rate of purchases substantially above what was already under way.

28 The substantial challenges faced by the euro area posed a threat to the outlook for the United Kingdom. The worst risks had not so far crystallised, but the possibility of their doing so was reflected in continuing strains in bank funding markets and volatility in financial markets more generally. Conditions in financial markets had improved somewhat in anticipation of the forthcoming meeting of the European Council on 8 and 9 December.

29 The main upside risk to the medium-term inflation outlook was that, after the impact of the temporary factors diminished, inflation would persist above target for longer than the Committee expected, because of: further upward external shocks, for example to commodity prices; expectations of near-term inflation adjusting more slowly than expected, affecting wage and price-setting behaviour; or the margin of spare capacity in the economy proving to be smaller than previously thought. The oil price had remained resilient to the slowing in global activity, in large part because of risks of interruptions to supply. There was some evidence that households' short-term expectations of inflation had not as yet fallen quite as far as the Committee's own lower central projection, but there was little evidence to indicate that the recent elevated level of inflation had led to higher wages. The weakness in productivity growth had continued, even though the labour market appeared to be weakening.

30 The main risk to the inflation outlook to the downside was that demand growth would be insufficient to absorb the margin of spare capacity in the economy, causing inflation to fall materially below the target in the medium term. Business surveys continued to suggest that the outlook for the fourth quarter and for the first part of 2012 remained one of broadly flat output. The weakening in employment was consistent with that picture. The pace of global expansion appeared to be moderating broadly as the Committee had anticipated. It seemed likely that a contraction in activity was under way in the euro area, although the United States was still experiencing moderate growth. Looking

through the near-term outlook of weak demand, the Committee's central view remained that there would be some recovery in the latter part of 2012.

31 Overall, the Committee judged there had been little change to the balance of risks to UK activity and inflation as a result of developments during the month.

32 Against that background, the Committee agreed that a decision to change policy was not warranted at this meeting. Some members continued to note that the balance of risks to inflation in the November *Inflation Report* projections meant that a further expansion of the asset purchase programme might well become warranted in due course. Of those members, some thought that the outlook had deteriorated somewhat on the month, and noted the further weakening in the labour market and increased concerns for credit supply arising from the continuing strains in bank funding markets. Some other members judged that the risks to inflation around the target were more balanced in the medium term, noting the continued strength in import and goods price inflation, and the risk posed that inflation might be slower to fall during 2012 than implied by the Committee's central projection. Moreover, if productivity growth remained weak, earnings growth might need to fall further from its already subdued rate in order to bring inflation back to the target. All members agreed, however, that given the magnitude of the current uncertainties, in the external environment in particular, relative to the precision with which the appropriate stance of policy could be calibrated, there was little merit in changing the path of asset purchases at this meeting.

33 The Governor invited the Committee to vote on the propositions that:

Bank Rate should be maintained at 0.5%;

The Bank of England should continue with the programme of asset purchases totalling £275 billion financed by the issuance of central bank reserves.

Regarding Bank Rate, the Committee voted unanimously in favour of the proposition.

Regarding the stock of asset purchases, the Committee voted unanimously in favour of the proposition.

34 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

Dave Ramsden was present as the Treasury representative.