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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 9 AND 10 FEBRUARY 2011

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 February 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1102.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 9 and 10 March will be published on 23 March 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 FEBRUARY 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 The path expected for official sterling interest rates had moved up over the month, with a 25 basis point increase in Bank Rate fully priced in by early summer 2011. The expected path for official rates in the euro area had also risen. By contrast, expectations of policy rates in the United States had changed little.

3 There had been only small changes in all but the longest-term yields of UK, US and German government debt. The difference between the yields of some euro-area periphery countries' and German government debt had narrowed quite sharply over the month.

4 The improved sentiment in relation to peripheral euro-area fiscal challenges had coincided with a sharp increase in debt issuance in January by European banks, including the major UK banks, although debt issuance typically picked up at the start of each year.

5 The FTSE All Share index had been broadly unchanged over the month, with the main US and euro-area indices increasing by 3% to 4%. Investment-grade corporate-bond spreads had declined slightly.

6 The sterling effective exchange rate was broadly unchanged: sterling had depreciated against the euro but appreciated against the dollar. The appreciation of the euro probably reflected the improvement in sentiment about the fiscal sustainability of a number of peripheral euro-area countries.

The international economy

7 Overall, the most recent data had been consistent with continued buoyant growth in global activity and a pickup in global inflation. There remained considerable differences across countries with regard to both activity and inflation.

8 GDP in the United States was estimated to have grown by 0.8% in the fourth quarter, with final domestic demand also having increased by the same amount, suggesting that the recovery there might have become less reliant on the inventory cycle. On balance, the available evidence suggested that euro-area activity had grown at a rate below its historical average in the fourth quarter, although official estimates had yet to be released. Output growth within many emerging market economies remained robust, with GDP in China continuing to rise at an annual rate of around 10%. The JP Morgan global composite Purchasing Managers' Index had risen in January, with increases in most of its component indices. Drawing these strands together, continued robust near-term global growth seemed likely. Consistent with that view, the IMF had raised its expectation for PPP-weighted global GDP growth in 2011 to 4.5%.

9 The rebound in world demand had been associated with a notable pickup in global inflation, with the IMF's measure of global CPI inflation rising from just over 1% in mid-2009 to almost 4% by the end of 2010. This was close to the post-2000 average, but masked considerable heterogeneity, with inflation in excess of 6% in a number of emerging market countries being offset by lower inflation in the United Kingdom's main trading partners, the euro area and the United States.

10 Much of the rise in global inflation had reflected a rise in commodity prices, many of which had increased by around 50% since the middle of 2010. Temporary supply reductions were likely to have contributed to the increase in the price of some commodities, most obviously agricultural commodities. But in other cases, such as energy and metals, demand increases were likely to have been important. Some commodity prices could rise further if the global economy continued to grow robustly. Especially at risk were commodities for which there were constraints on production or storage capacity. Where available, however, commodity futures prices for delivery in the medium term were generally no higher than current spot prices.

11 The depreciation of sterling had led to substantial increases in UK import prices. More recently, rises in global prices, particularly reflecting higher commodity prices, had added further upward pressure. Accommodative monetary policy in some emerging market economies, particularly where the authorities had been reluctant to permit their exchange rates to appreciate, was likely to have contributed both to the rise in commodity prices and perhaps also to the rise in global prices more generally.

Money, credit, demand and output

12 According to the ONS's preliminary estimate, GDP had declined by 0.5% during the fourth quarter of 2010. The ONS had estimated that GDP would have remained broadly unchanged in the absence of the snow during December. Service sector output had declined and the ONS believed that the adverse weather had materially affected the output of this sector. Construction activity was estimated to have declined sharply during the fourth quarter, and had also been affected by the bad weather.

13 Abstracting from the effects of snow, the weakness in fourth-quarter GDP was consistent with a number of interpretations. First, the data could prove erratic, or simply be revised up. The Index of Production for December, released subsequent to the preliminary GDP estimate, had not by itself pointed to a significant revision, although most of the weakness in activity had been concentrated in the service sector. It was probable that growth in the first quarter would be buoyed to some extent, both as the level of activity returned to normal after the snow, and possibly also by some postponed expenditure. The CIPS/Markit business activity surveys for January, which provided an early indicator of first quarter activity, had been quite strong.

14 Second, growth might have temporarily weakened around the turn of the year. Even without the effects of the snow, the ONS had estimated that the economy slowed sharply in the fourth quarter. And early indicators suggested that, stripping out the effects of the bounce back from the snow-affected levels of activity in December, underlying growth in the first quarter could also be weak. As the Committee had previously noted, recoveries from recessions were rarely smooth, so this would not be unusual.

15 Finally, the data might presage a more prolonged period of weak growth. That could occur, for example, if households chose to increase savings as the fiscal consolidation progressed. Measures of consumer confidence, which had declined sharply in January, might indicate more cautious attitudes towards spending.

16 The increase in the standard rate of VAT at the start of 2011 had created an incentive to bring forward some consumption into the final quarter of 2010. The sharp fall in service sector output and subdued retail sales growth, combined with reports from the Bank's Agents, suggested, however, that there had been significant weather-related disruption to consumption. It was therefore possible that the disruption from snow was likely to have more than offset the VAT effect on the timing of household spending.

17 Exports of goods and services had grown by 7.5% in the four quarters to 2010 Q3, considerably faster than the 2000-07 average. More recent data had been consistent with continued growth, and ONS data suggested that goods exports had grown robustly in the fourth quarter. But import growth had also remained strong, with the result that net trade had continued to make less of a contribution to GDP growth than the Committee had previously expected. It was unclear why import penetration had declined by so little to date, given the substantial fall in sterling. One possibility was that there was a mis-match between domestic productive capacity in certain industries and demand, which would take time to rectify. It was also the case that the trade data were particularly prone to revision, cautioning against drawing firm inferences from the apparent persistence of import penetration.

18 Some indicators of nominal spending continued to grow strongly. Nominal domestic demand had increased by 6.8% in the four quarters to Q3, accompanied by nominal consumption growth of 6.3%, in part reflecting the VAT increase in January 2010. These were both above their average growth rates for the decade before 2007. At 5.1%, overall nominal GDP growth had been somewhat slower and, allowing for the VAT increase, slower still. Broad money growth remained weak. Excluding the holdings of interbank intermediaries, broad money had increased by 3.0% on a three-month annualised basis in December, well below its average growth rate prior to the recession. There were a number of possible reasons, however, why subdued money growth might be consistent with continued robust growth in nominal spending, including if companies relied less than previously on bank credit to fund investment and banks continued to increase their capital.

Supply, costs and prices

19 Twelve-month CPI inflation had risen to 3.7% in December, up from 3.3% in the previous month. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation in January of 4.0% had been provided to the Governor. A detailed breakdown was not available but it seemed likely that increased petrol, furniture and household goods, catering, and alcohol prices had contributed to the rise. More generally, it was difficult to identify how much of the VAT increase had been passed through in January, complicating the interpretation of month-by-month developments in CPI inflation around the turn of the year. The near-term outlook for inflation had risen markedly relative to the November *Inflation Report* following further rises in commodity and other import prices.

20 The available measures of inflation expectations were imperfect and had to be interpreted with care. Surveys of near-term household inflation expectations had risen in recent months, but that was consistent with the change in the Committee's own expectation for near-term inflation. Evidence from firms was more limited, but was also consistent with some increase in their near-term expectations. Some of the survey measures of longer-term household inflation expectations had picked up in recent months. Medium-term inflation expectations derived from financial markets had shown no discernible trend over the past year as a whole. Lack of liquidity obscured the signal from shorter-term financial market measures, but three to five-year measures had moved in line with the longer-horizon measures which the Committee regularly monitored. Overall, there was little evidence that medium-term inflation expectations had risen above a level consistent with the inflation target. That said, financial market measures of uncertainty about medium-term inflation had been elevated for some time.

21 Total employment had fallen by 69,000 in the three months to November, according to the LFS measure, as the number of both full-time and part-time employees had declined. This decline had followed surprisingly strong increases during the summer. Drawing together the evidence from published employment data and surveys, it seemed likely that overall employment had increased gradually during the second half of 2010. Average hours worked had also increased slightly.

22 Evidence about the scale of spare capacity remained mixed. Survey measures of capacity utilisation continued to point to a relatively limited amount of spare capacity and, consistent with this, surveys also suggested that some companies intended to invest to expand their capacity. But the level

of labour productivity remained well below pre-recession trends, consistent with a greater degree of spare capacity than implied by the surveys.

23 Earnings growth had remained subdued. Whole economy AWE regular pay had increased by 2.3% in the three months to November compared with a year earlier, and remained below its pre-recession average. The start of each year was an important period for pay settlements. The Bank's Agents' annual survey of pay intentions suggested that settlements might rise modestly in 2011. In part that could reflect a recovery in productivity. Trends in earnings over the year would depend also on the contributions of bonuses and regular pay drift.

The February GDP growth and inflation projections

24 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 16 February. Expansionary monetary policy, combined with further growth in global demand and the past depreciation of sterling, should ensure that the recovery in the United Kingdom was maintained. But the continuing fiscal consolidation and squeeze on households' purchasing power was likely to act as a brake. Abstracting from the effects of snow, growth around the turn of the year appeared likely to have been somewhat weaker than expected at the time of the November *Inflation Report*.

25 The outlook for growth remained highly uncertain. Private demand could grow rapidly, for example if some businesses chose to use some of their cash balances to increase investment. But there were significant downside risks to private demand, especially to household spending. In particular, uncertainty about the impact of the fiscal consolidation and restrictions on the availability of credit might cause consumption to grow more slowly than real disposable incomes. The improvement in net trade would depend on the vigour of the global recovery and the degree of rebalancing prompted by sterling's past depreciation.

26 There remained a wider than usual range of views among Committee members about the outlook for growth. The Committee continued to judge that relative to the most likely path the risks to growth were skewed to the downside. Taking that skew into account, the Committee's best collective judgment was that GDP growth was about as likely to be above its historical average rate as below it in the medium term. It was likely that some spare capacity would persist throughout the forecast period.

The distribution for the level of GDP was somewhat lower than assumed at the time of the November *Report*.

27 Inflation was likely to pick up to between 4% and 5% in the near term, and to remain well above the 2% target throughout 2011, boosted by the increase in VAT, higher energy and import prices, and some rebuilding of companies' margins. The projection for the first half of the forecast period was markedly higher than in November, due largely to the recent increases in the prices of commodities and other imported goods and services. During 2012, inflation was likely to fall back as those effects waned and the downward pressure on wages and prices from the margin of spare capacity persisted. The extent of that fall was likely to be moderated by companies continuing to rebuild their margins and some upward drift in inflation expectations.

28 The prospects for inflation in the medium term were highly uncertain. Continued strong global growth might lead to further upward pressure on commodity and other import prices. The degree of spare capacity and its impact on inflation would depend on: the strength of demand; the impact of the recession on potential productivity; the performance of the labour market; and the sensitivity of wages to labour market slack. The profile for domestically generated inflation would also depend on the extent and pace of any rebuilding of companies' margins. And inflation would be higher, the more that elevated outturns caused expectations of inflation to rise and that fed through into wage and price setting.

29 There remained a wider than usual range of views among Committee members over the outlook for inflation. On balance, the Committee judged that, conditioned on the assumption that Bank Rate followed a path implied by market interest rates and that the stock of purchased assets financed by the issuance of central bank reserves remained at £200 billion throughout the forecast period, the most likely outcome was that inflation would fall a little below the target in the second half of the forecast period, but that risks around that most likely outcome were skewed to the upside. Taking that skew into account, the Committee's best collective judgment was that the chances of inflation being either above or below the 2% target in the medium term were broadly equal.

The immediate policy decision

30 The near-term outlook for inflation was markedly higher than at the time of the November *Inflation Report* and inflation was likely to be between 4% and 5% for much of 2011. Nevertheless, the Committee continued to expect inflation to fall back thereafter as the temporary impact of various factors waned, and the margin of spare capacity in the economy continued to dampen inflationary pressures.

31 As had been the case for some time, there were two key risks to this broad profile. The first was that weak growth and persistent spare capacity might cause inflation to fall to well below the target in the medium term. The main news about this risk over the past month had been the fourth-quarter contraction of GDP. Even after making allowance for the probable impact of the adverse weather conditions, growth had slowed during the second half of 2010. That apparent weakness could prove temporary, but could also be an early signal of a worsening outlook for growth and hence medium-term inflation. Monthly indicators for January gave conflicting signals: business activity surveys had generally been upbeat, but consumer confidence had declined sharply.

32 The second risk was that the period of elevated inflation would persist for longer than the Committee expected. That could occur if externally generated inflation pressures continued and were not offset by exchange rate movements. One possibility was that the recent further increases in commodity prices, which in many cases had been associated with strong growth in emerging market economies, would continue. Committee members differed in the comfort they drew from the profile of commodity futures prices when assessing the likelihood of that outcome. Second, it was also possible that accommodative monetary policies in emerging market countries could result in higher inflation in those countries. That too could influence UK prices unless offset by exchange rate movements. A third possibility was that there might be further pass through from the past depreciation of sterling.

33 A rise in medium-term inflation expectations could also result in inflation remaining elevated for longer than it otherwise would. Although there was limited evidence that those expectations had risen materially to date, inflation was set to be higher, and above the target for longer, than had been the case at the time of the November *Inflation Report*. The implications of this for inflation expectations would depend on the extent to which households and firms extrapolated from past inflation trends when forming their expectations; and whether they would revise their views about the likely time

horizon over which the Committee would seek to bring inflation back to the 2% target and the extent to which that influenced their price and wage setting. The most recent *Inflation Report* projections were consistent with some upward drift in inflation expectations.

34 Most members agreed that the balance of risks to inflation in the medium term relative to the target had moved upwards in recent months and that the case for withdrawing some of the current exceptionally accommodative monetary policy had consequently been strengthened.

35 For three members, the case for removing some monetary stimulus at this meeting was compelling. For those members, the upside risks to the medium-term inflation outlook from global inflationary pressures and the possibility that inflation expectations would move up outweighed the downside risks to inflation associated with uncertainty about the strength of the recovery and the possibility of persistent spare capacity. In part, this reflected a concern that the level of demand consistent with achieving the inflation target might be lower than previously thought. Two of those members favoured only a small tightening in policy, given the uncertainty about the economic outlook. The third member concluded that a larger reduction in the degree of monetary stimulus had now become appropriate. That member thought that there was mounting evidence that firms were able to pass on cost increases to the prices they set and noted also that nominal domestic demand had been growing for some time at near to the top of its typical range prior to the recession. In that member's view it was significantly more likely than not that inflation would overshoot the inflation target in the medium term.

36 Other members concluded that there was not yet a case for a rise in Bank Rate. They had differing views about the likelihood of the upside risk associated with an increase in inflation expectations materialising. Some thought that this likelihood had grown, given that inflation was set to be higher, and above target for longer, than previously expected. Others considered that the chances of this risk materialising remained limited, given that the change in the near-term outlook could be clearly explained by reference to recent increases in energy, other commodity and world export prices.

37 Of those members not favouring a rise in Bank Rate, some thought that the case for an increase had nevertheless grown in strength. The *Inflation Report* projections implied that inflation was roughly as likely to be above or below target in the medium term, and those projections had been conditioned on a path for market interest rates which assumed an increase in Bank Rate around the

middle of the year. Given the potentially disruptive impact of reversing any immediate change in Bank Rate, there was merit in waiting to see indicators of how the economy performed at the start of the year to help assess whether or not the decline in GDP in the fourth quarter presaged sustained economic weakness. A rise at this juncture could damage household and consumer confidence, which remained fragile.

38 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 to below the target in the medium term. This member believed that the impact of short-term inflation expectations on future prices and wages would be lower than assumed in the MPC's February *Inflation Report* projection, and that consumption also would be lower, both pushing down on medium-term inflation. This member acknowledged that a sustained upward trend in global demand prospects or a shift in sentiment against sterling could outweigh the domestic forces pushing down on inflation. But this member did not see this risk as yet large enough to require a policy tightening.

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, 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.

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

Spencer Dale

Paul Fisher

David Miles

Adam Posen

Andrew Sentance

Martin Weale

Dave Ramsden was present as the Treasury representative.