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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 12 AND 13 JANUARY 2011

These are the minutes of the Monetary Policy Committee meeting held on 12 and 13 January 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1101.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 February will be published on 23 February 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 12 AND 13 JANUARY 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 was typical during the Christmas and new year period, the level of activity in financial markets had been relatively low. So the asset price movements that had occurred within the month were to be interpreted with some caution.

3 Over the month as a whole, expectations of the point at which Bank Rate would begin to rise had been brought forward. Information derived from overnight index swaps indicated that market participants expected that Bank Rate would increase by 25 basis points by around August. By contrast, longer-term interest rates in the United Kingdom were little changed, having increased in the month leading up to the previous MPC meeting.

4 Euro-area sovereign debt markets had remained strained, reflecting continued concerns over some countries' fiscal positions. The difference between the yields of many peripheral euro-area countries' sovereign bonds and those of equivalent German government bonds had increased. Credit default swap premia on both peripheral and German sovereign bonds had increased over the month.

5 Having been subdued during December, activity in bank funding markets had picked up since the start of the new year. Consistent with the movements of sovereign bond yields, market contacts had reported increased discrimination by investors across the banking sector debt of different European countries, with funding for peripheral euro-area country banks becoming more costly. Non-financial corporate bond yields had been broadly unchanged during the month.

6 Equity prices had increased by around 4% in the United Kingdom and United States during the month, and by a little less in the euro area. The FTSE All-Share index had recovered to stand around 10% below its peak in June 2007, while equity indices in the United States and euro area had remained

further below their pre-crisis peaks. That may have, in part, reflected the depreciation of the sterling exchange rate. Much of the recovery of UK equity prices over the past year could be accounted for by expectations of stronger earnings and dividend growth. It may have also reflected financial market participants' perceptions that the likelihood of a sustained period of very weak economic growth had lessened as the global recovery had progressed.

7 The sterling effective exchange rate index had been little changed over the month as a whole, despite some volatility around the turn of the year. It had ended the month modestly above its 2010 average, but sterling had remained relatively stable, moving within a small range, since the beginning of 2009.

The international economy

8 The data released during the month had remained consistent with continued firm growth in the global economy, albeit uneven across countries. And, as in previous months, there were continued signs that global demand was putting upward pressure on commodity prices.

9 There were some signs that the recovery in the United States was becoming more firmly rooted. The ISM non-manufacturing business activity index had reached 63.5 in December, its highest level since 2005, while the manufacturing PMI had remained broadly unchanged. These business surveys pointed to growth in the fourth quarter at a little above its historic average, consistent with the signal from monthly indicators of consumer and business spending. And the recently announced additional fiscal measures, as well as the resumption of large-scale asset purchases, were likely to support activity in future. Set against that, it was possible that unemployment would fall only slowly; non-farm payrolls had increased by 103,000 in December, below the pace of employment growth that would probably be necessary for a sustained fall in unemployment. And the continued weakness of the housing market would most likely remain an impediment to construction sector activity for some time.

10 In the euro area, the picture remained one of moderate growth at an aggregate level, but with considerable cross-country variation. Third-quarter GDP growth had been revised down fractionally to 0.3%, and the business surveys and other indicators remained consistent with similar or slightly stronger growth in the fourth quarter. Industrial production was estimated to have increased by 1.2% in November, following an increase of 0.7% in October. Indicators of German growth had remained strong. But demand growth in some peripheral countries was likely to be restrained over the next few

years by actions to reduce fiscal deficits. Moreover, there was a risk that an intensification of concerns over fiscal sustainability could result in disruption to bank funding markets and weaker growth.

11 Indicators had remained consistent with robust growth in emerging economies, which provided almost a quarter of UK goods imports. China and some other countries had tightened monetary policy during the month, in response to heightened inflationary pressures, which could feed through to higher export prices. Unless offset by a movement in the sterling exchange rate, such heightened inflationary pressures could lead to higher UK import prices.

12 Oil prices had risen by almost 8% in sterling terms since the Committee's previous meeting, while industrial metals prices had also risen. Since July 2010, oil and other commodity prices had risen by around a third or more. It was possible that demand and supply pressures could lead to further increases in the prices of some commodities and exert further upward pressure on UK import prices.

Money, credit, demand and output

13 Estimated GDP growth in 2010 Q3 had been revised down by 0.1 percentage points to 0.7% during the month. Within that, a downward revision to the measured contribution of net trade to growth had been offset by stronger business investment. But revisions to the data for previous quarters implied that the level of GDP in the third quarter was broadly unchanged from that implied by the previous data release.

14 On balance, business surveys had remained consistent with some slowing in the pace of growth in 2010 Q4. The impact of the snowy weather in December and the increase in the standard rate of VAT in January were likely to inject some volatility into output around the turn of the year, making the data difficult to interpret. The sharp fall in the CIPS/Markit services business activity index was consistent with some negative impact on activity from the bad weather, as it appeared to be centred in the consumer-facing service sectors; the equivalent construction activity index had also fallen. That matched reports from the Bank's Agents.

15 Although output had evolved broadly as the Committee had anticipated, there remained downside risks looking forward. It was likely that some households had not fully adjusted their behaviour in response to the prospective fiscal consolidation. And the growth in households' real incomes was likely to be held back by the elevated level of near-term inflation and by subdued pay

growth. These factors had the potential to dampen household spending. Moreover, house prices had fallen by 0.4% in December according to the average of the Halifax and Nationwide indices, while mortgage loan approvals had remained at a low level in November.

16 Prospects were also uncertain for net trade, which had reduced GDP growth by 0.1 percentage points in 2010 Q3. There had been some encouraging news in recent quarters. The recovery of the world economy had continued. UK goods exports had increased at an average quarterly rate of almost 3% for the past five quarters, although exports of services had been considerably weaker. And there had been further strong increases in survey measures of export orders during the month. Nevertheless, in recent quarters net trade had generally reduced GDP growth in part because of the strength of import growth. The growth in imports was associated with a recovery of domestic demand, but it was disappointing that net trade had not yet improved by as much as expected given the past depreciation of sterling and the growth of world trade. And there remained a downside risk to export growth stemming from the financial tensions within the euro area, the United Kingdom's largest trading partner.

17 The latest data indicated that broad money and credit growth had remained subdued relative to pre-crisis rates, with M4 excluding the holdings of interbank intermediaries rising by 1.4% in the year to November, and M4 lending on a similar basis falling by 0.8%. But nominal GDP was estimated to have risen by around 5% in the year to 2010 Q3, close to its historical average. And nominal domestic demand had increased by almost 7%. That pattern might have reflected a reduced reliance on the banking system during the recovery, given the tightening in bank credit conditions. This trend might persist if businesses were to rely increasingly on existing cash balances and capital markets, rather than bank lending, to finance investment in future. The relative weakness of broad money growth might also reflect banks increasing their capital bases in advance of the introduction of higher regulatory capital standards. To the extent that these factors persisted, money and credit growth could remain weaker than nominal spending growth for some while.

Supply, costs and prices

18 CPI inflation had risen to 3.3% in November from 3.2% in the previous month. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 3.7% in December had been provided to the Governor ahead of publication. A detailed breakdown of the

inflation data was not yet available, but increased food, petrol and utility prices were likely to have contributed to the increase on the month.

19 Also in line with the pre-release arrangements, the Governor informed the Committee that producer output prices had risen by 0.5% in December, causing the twelve-month inflation rate to rise to 4.2%. An estimate of producer input prices had also been provided, showing a rise of 3.4% in December, an increase materially larger than the average market expectation: the twelve-month inflation rate had risen to 12.5% from 9.2% in November. Increases in food and energy prices could account for the majority of the rise on the month.

20 Recent developments in the prices of imported commodities and other goods indicated that the most likely near-term path of CPI inflation might be higher than the Committee had thought at the time of the November *Inflation Report*. It appeared likely to rise above 4% in coming months. The latest reports from the Bank's Agents suggested that it was also possible that the pass-through into consumer prices of January's VAT increase would be greater than previously expected. These factors represented further shocks to the price level whose direct impact on inflation should dissipate over time. But they were a source of concern if imported price pressures were to remain elevated or if businesses were more able or willing to pass on cost increases than might have been expected given the shortfall of demand relative to supply capacity. They were also likely to exacerbate the risk that expectations of above-target inflation would become engrained, affecting wage and price pressures.

21 Survey measures of households' expectations of future inflation had generally drifted up in recent months. This month, data from the Citi/YouGov survey indicated that households' expectations of both near and longer-term inflation had increased again in December. Measures of businesses' expectations of future inflation had appeared more stable through most of the year, although it was difficult to know how much weight to place on the limited survey information that was available. Implied measures of inflation expectations derived from financial market prices had shown no clear pattern on the month. The expectations implied from inflation swaps had been broadly stable since the middle of 2010.

22 Annual regular pay growth had increased to 2.3% in the three months to October, compared with 1.6% in the three months to July. The LFS employment measure had fallen by 33,000 in the three months to October, compared with the three months to July. But it had risen substantially over the preceding year – by almost 300,000 in the year to 2010 Q3. The Workforce Jobs measure of

employment had fallen over the same period, however, making it more difficult to judge the pace of job creation and productivity growth.

23 Taken at face value, the strength of employment growth shown by the LFS data over the past year or so had been surprising. Given the large reduction in productivity relative to its pre-crisis trend that had occurred during the recession, businesses might have been expected to be able to increase output during the recovery without taking on many additional employees. If the LFS measure was accurate, then the past strength of employment growth might indicate that the degree of spare capacity in the economy was less than the Committee had assumed, or else was more unevenly spread across different businesses and sectors. The downward pressure on prices stemming from the margin of spare capacity would then be commensurately less. But in that case, consideration would also need to be given to the implications for income and spending growth. The Committee would seek to analyse this issue further in the context of the projections prepared for its February *Inflation Report*.

The immediate policy decision

24 Inflation had generally exceeded the Committee's expectations in recent months. But the key consideration for monetary policy was the likely rate of inflation, and the balance of risks around it, in the medium term. The Committee discussed how the balance between the opposing key risks had altered over the past few months.

25 The first key risk was that the growth of private demand might be relatively weak, and that the margin of spare capacity would cause inflation to fall below the target in the medium term. Overall, there had been little change in this risk since the Committee's previous meeting. The recovery in the United Kingdom and overseas had continued broadly as expected. Abstracting from the likely effects of the snow in December and the VAT rise in January, the data had remained consistent with UK growth at around its historical average in the second half of 2010 and early 2011. And, if anything, it was possible that near-term growth in the United States would be a little stronger than the Committee had previously assumed. But there remained significant downside threats to UK growth. Those stemmed primarily from: the risk of a sustained rise in the household saving rate, possibly in response to the UK fiscal consolidation; the possible impact on the United Kingdom and the international banking system of an intensification of sovereign debt concerns within the euro area; and the continuing funding challenge for UK banks.

26 The second key risk was that inflation might remain above the 2% target for long enough to cause expectations of future inflation to move up and that this would in turn lead to higher increases in future wages and prices, so making it more costly for the Committee to bring inflation back to the target further ahead. Commodity prices had risen further, and it was probable that the near-term path of inflation would be materially higher than the Committee had thought at the time of the November *Inflation Report*. The extent to which these developments affected inflation expectations would be hard to gauge, given the imperfect and partial nature of the available indicators. Survey measures of household inflation expectations for both the short and medium term had risen. But measures derived from financial market prices, and measures of businesses' inflation expectations, which were likely to be more immediately relevant to the setting of wages and prices, had remained more stable. And wage growth had remained moderate, especially when compared to productivity growth.

27 Even without a generalised increase in inflation expectations, there was a risk that inflation would remain above the target in the medium term for three reasons. First, the recent increases in commodity prices might continue. Some members thought it was likely that robust growth in emerging economies would continue to put upward pressure on commodity prices, but for other members the best forecast was embodied in futures prices, which were lower. Second, more general inflationary pressures in emerging economies could lead to higher UK import prices. In the event of either of those risks crystallising, lower domestically generated inflation would be needed to hit the inflation target. Third, there was a risk that the prices of the domestically produced goods and services that competed with imports would rise further in the aftermath of sterling's depreciation as the economy recovered.

28 The Committee considered the case for an increase in Bank Rate at this meeting. The domestic and global recovery had proceeded at least as well as expected. And the most likely prospect was for continued growth, despite the downside risks that remained. For most members, the balance of risks to medium-term inflation relative to the target had moved upwards over the past few months, reflecting the recent and prospective buoyancy of import prices and the possible impact of higher near-term inflation on public inflation expectations. That would suggest that a lower level of demand might be consistent with hitting the inflation target in the medium term, and so might argue for a withdrawal of some of the current monetary stimulus. Moreover, an increase in Bank Rate at the current juncture might lessen the risk that a larger increase became necessary at a later stage if inflation persisted above the target. Members noted that a small increase in Bank Rate at this meeting would still leave

monetary policy highly accommodative, and would not preclude the Committee from increasing the policy stimulus in future if that became necessary.

29 The Committee also considered the arguments for maintaining the current level of Bank Rate. Inflation had been boosted by the past depreciation of sterling, and increases in VAT and energy prices. These effects were large and – in the view of many members – could more than account for the current deviation of inflation from the 2% target. This suggested that the margin of spare capacity had exerted downward pressure on inflation, and would continue to do so while demand growth remained insufficient to reduce that margin materially. Moreover, material downside risks to demand remained. The impact of the fiscal consolidation on spending was uncertain. And euro-area sovereign debt problems remained capable of delivering a significant jolt to UK export demand, as well as to the international banking system and confidence more generally. In addition, while Bank Rate had been reduced to an exceptionally low level, the effective stimulus had been offset by the reduced supply of credit: since the onset of the financial crisis the interest rates faced by many households and businesses had fallen by less than Bank Rate, and in some cases had increased. On this view, the balance of risks continued to suggest that inflation would fall back to around the target once the impact of the factors boosting it had dissipated.

30 Some members also noted that an increase in Bank Rate at this meeting might be misinterpreted as a signal that the Committee would attempt to bring inflation back to the target excessively rapidly, which could cause expectations of a relatively sharp tightening of monetary policy that could have a detrimental impact on confidence and activity.

31 There was a spectrum of views among Committee members about how much weight to place on the arguments for and against a change in the policy stance.

32 For most members, recent developments implied that the risks to inflation in the medium term had probably shifted upwards. For some of those members, the decision this month was finely balanced. The analysis that fed into the forthcoming February *Inflation Report* projections would provide an opportunity to assess fully the developments since the previous *Report*, and to evaluate more thoroughly the risks to inflation in the medium term. The publication of the *Report* would also give the Committee the opportunity to explain fully its assessment of the outlook and its policy decisions.

33 For two members, the evidence suggested that the balance of risks was already sufficiently clear to warrant an immediate increase in Bank Rate. The continued elevated rate of inflation, which was forecast to persist, posed a significant risk to inflation expectations and hence to the medium-term outlook for inflation. This made more powerful the case which had been building for some time for a gradual rise in Bank Rate.

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 to below the target in the medium term. This member acknowledged that a sustained upward trend in commodity prices or 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.

35 The Governor invited the Committee to vote on the proposition that:

Bank Rate should be maintained at 0.5%;

The Bank of England should maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

Six members of the Committee (the Governor, Charles Bean, Paul Tucker, Spencer Dale, Paul Fisher and David Miles) voted in favour of the proposition. Three members of the Committee voted against the proposition. Andrew Sentance and Martin Weale preferred to increase Bank Rate by 25 basis points and to maintain the size of the asset purchase programme at £200 billion. Adam Posen preferred to maintain Bank Rate at 0.5% and 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.