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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 JULY 2011

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1107.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 3 and 4 August will be published on 17 August 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 JULY 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 Expectations implied by market prices of the point at which Bank Rate would begin to rise had been pushed back further during the month, partly because economic data, both at home and overseas, had been softer than anticipated. Information derived from overnight index swaps suggested that, on average, financial market participants expected Bank Rate to have increased by 25 basis points by around the middle of 2012. Short-term interest rates had fallen slightly in the euro area as well. Consistent with the pattern of market interest rates, the sterling effective exchange rate index had fallen by about 1%.

3 Longer-term forward interest rates had increased a little in both the United Kingdom and United States, but had been broadly unchanged in the core euro-area countries.

4 Euro-area sovereign debt markets had become more strained, reflecting heightened concerns over some peripheral countries' fiscal positions. The fiscal situation in Greece had remained a key focus for market participants. In the days immediately preceding the approval by the Greek parliament of further fiscal adjustment measures, spreads between the yields of several euro-area countries' sovereign bonds and those of German bonds of equivalent maturity had widened further; CDS premia had also risen and had subsequently remained volatile. The cost of bank funding in wholesale markets had remained elevated internationally, reflecting continued sovereign debt and banking sector strains, including uncertainty over the outcome of the EU bank stress tests. There had been little new funding raised by banks at longer maturities during the month, although that needed to be set against the fact that the major UK banks had already raised around two thirds of their likely funding requirement for 2011 as a whole.

5 Equity prices had risen a little internationally over the month. There had been sizable moves within the month as events unfolded within the euro area. Corporate bond spreads had increased slightly in the United Kingdom and the euro area, but had changed little in the United States.

The international economy

6 The data released during the month had continued to point towards a broadly based easing in the pace of global activity. But it remained unclear whether this slowing would prove to be persistent. JP Morgan's global manufacturing Purchasing Managers' Index (PMI) had fallen in June, reaching its lowest level for almost two years. Some of that weakness was likely to have been caused by the continuing disruption to global supply chains caused by the earthquake and tsunami in Japan in March, and by the contractionary impact of increases in oil prices earlier in the year. It was possible that much of the softening in the pace of global expansion might therefore prove to be temporary. But it was less clear that the disruption to global supply chains could explain recent falls in survey measures of service sector activity in most of the major economies, so the likely persistence of that weakness was hard to gauge.

7 A range of indicators suggested that output growth in the United States had slowed by more than could be explained by supply-chain disruptions. Consumer confidence had fallen and real disposable income growth had remained weak, partly reflecting the impact of elevated energy prices. The business activity balance of the non-manufacturing ISM index had fallen again in June.

8 In the euro area, the picture was one of moderate growth at the aggregate level in the second quarter, but with considerable cross-country variation. Indicators of German growth had remained reasonably firm. But demand growth in some peripheral countries was likely to remain restrained by the need to reduce fiscal deficits and restore competitiveness. And there was a risk that sovereign debt and banking stresses could intensify, perhaps significantly, to the detriment of economic activity and the financial system across the euro area.

9 Notwithstanding OPEC's lack of agreement on production quotas at its most recent meeting, oil prices had fallen slightly on the month, probably reflecting both demand and supply factors. Monetary policy had been tightened further in a number of Asian economies over the past month, partly in response to inflationary pressures. Over time, tighter policy might lead to some easing in the growth

of global demand for oil and other commodities. Some International Energy Agency member countries had also agreed to release additional oil from their emergency stocks in response to the ongoing disruption of supplies from Libya.

Money, credit, demand and output

10 According to the most recent ONS estimate, GDP had grown by 0.5% in the first quarter, unchanged from the previous estimate. Underlying growth was likely to have been somewhat below that, after allowing for the offsetting effects of the apparently erratic falls in energy and construction output in the first quarter, and the recovery in output after the snow-induced weakness in the fourth quarter of 2010. Within that aggregate figure, net trade had contributed a little less to growth than previously indicated, while the contraction in business investment had been less pronounced. The 0.6% fall in consumption had not been revised.

11 Business surveys had pointed towards continued modest underlying economic growth in the second quarter, after allowing for the estimated impacts of the supply-chain disruptions caused by the earthquake and tsunami in Japan, and of the extra bank holiday on the number of working days in April. Industrial production had increased by 0.9% in May, partly reversing the decline in April. But there were early indications that underlying growth might soften in the third quarter, in both services and manufacturing. The CIPS/Markit services business activity index had been broadly unchanged in June, a little below its historic average level, but the more forward-looking business expectations index had fallen sharply. There had also been reductions in both the manufacturing PMI employment intentions and export indices. It seemed likely that these reductions were linked, at least in part, to the concurrent slowdown in global activity.

12 The most recent indicators had pointed towards continued weakness in the near-term outlook for consumption. The volume of retail sales had fallen by 1.4% in May, having risen by 1.1% in April. And consumer confidence survey balances had remained at low levels.

13 The outlook for activity in the medium term would depend in part upon the prospects for consumption and its major determinants. The level of consumption over the past year had been significantly weaker than the Committee had previously expected. Over the same period, households' real post-tax disposable incomes had fallen by more – reflecting the impact of increased VAT, and

higher energy and other commodity prices – and the household saving rate had declined by about 1.5 percentage points. It was possible that households adjusted their spending patterns only gradually, suggesting that the past decline in real incomes could continue to weigh on consumption growth for some time to come and that the saving rate would tend to rise. Alternatively, it was possible that households had already largely adjusted their spending in response to the past shock to their income, in which case there would be less upwards pressure on the saving rate in the future.

14 The pace of the economic recovery in the medium term more broadly would be affected by the price and availability of credit to households and businesses. The spreads on the array of secured and unsecured lending rates to households over riskless interest rates of comparable maturity had remained significantly higher than before the financial crisis. Indicators of the cost of bank credit to a range of firms, particularly smaller businesses, had remained elevated. But larger businesses that were more able to access funds from capital markets faced lower borrowing costs. Broad money and credit growth continued to be weak: M4 excluding the holdings of interbank intermediaries had increased by about 1% on a three-month annualised basis in May and M4 lending had been unchanged on a similar basis.

15 The elevated cost of credit to households and firms had reflected in part the continuing high premium over riskless interest rates charged to UK banks for raising funds in financial markets. The premium had not declined in line with the Committee's previous expectations, despite the actions banks had taken to increase capital and to strengthen their balance sheets. There were several factors that might have weighed against these actions and pushed up investors' perceptions of the risks attached to UK banks' wholesale liabilities. There was uncertainty surrounding the future structure of the UK banking industry and the business models of some of the major banks. Developments in the regulatory environment might have led wholesale investors to infer that the public sector was less likely than before to protect them in the event of a bank default. And the sovereign and banking sector strains in some vulnerable euro-area economies had remained a material threat to the stability of UK banks. While UK banks' direct exposures to the most vulnerable euro-area governments were limited, they had larger claims on the private sectors of some of those economies and credit risks could arise from links with other European banking systems that were more directly exposed. It remained unclear how long it would be before these uncertainties were resolved and to what extent banks' funding costs would decline over the medium term.

Supply, costs and prices

16 Twelve-month CPI inflation had remained at 4.5% in May, unchanged from in April, and broadly in line with the Committee's expectation. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 4.2% for June had been provided to the Governor ahead of publication. A detailed breakdown of the CPI data was not yet available. Also in line with the pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 0.4% in June, mainly reflecting the contribution of elevated crude oil prices. Producer output prices had risen by 0.1% on the month, reflecting increases in prices for both manufacturing products and food.

17 Despite the fall in CPI inflation in June, recent developments in utility and imported food prices had indicated that the near-term peak in CPI inflation would probably be somewhat higher, and would occur sooner, than either the Committee had assumed at the time of the *May Inflation Report* projections or was currently projected by many external commentators. One utility company had announced in June increases in gas and electricity prices that would take effect from August. It was likely, on the basis of past experience, that similar announcements by other utility companies would soon follow. If so, those rises in utility prices would be slightly in excess of what had been assumed in the *May Inflation Report* and would come into effect earlier. But there was considerable uncertainty about the near-term profile for CPI inflation.

18 There remained a significant risk that expectations of above-target inflation would become entrenched, adding to wage and price pressures. The evidence on inflation expectations had been mixed on the month. The YouGov/Citigroup measure of inflation expectations five to ten years ahead had risen sharply in June, to a level a little above its previous peak in 2008. The measure of inflation expectations over the next twelve months had increased by a similar amount. But measures of inflation expectations and inflation uncertainty derived from financial markets had changed little.

19 There was also little clear evidence to suggest that elevated CPI inflation had begun to feed through into wages. Earnings growth had continued to be muted. Private sector regular annual pay growth had been 1.8% in the three months to April, in comparison with 2.1% in the three months to

January. And private sector wage settlements had been subdued at 2.1% in the three months to May. There appeared to be a significant degree of slack in the labour market and that was likely to bear down on earnings growth for some time.

20 The path of productivity would determine what growth rate of earnings was consistent with inflation returning to the 2% target in the medium term. Over the past year, labour productivity growth had been puzzlingly weak and, despite the softness in earnings growth, unit labour costs had consequently grown more strongly than the Committee had expected. The recent behaviour of labour productivity had been more similar to that in some of the core euro-area countries than to that in the United States. It was possible that the underlying growth rate of productivity in the United Kingdom during the recession had slowed, though it was unclear whether this would last.

21 There were signs in the most recent UK labour market data and in some of the employment surveys that the pace of employment growth had begun to slow. It was possible that this heralded an upturn in productivity growth, with firms more able to meet any growth in demand for their goods and services with their existing staff. Alternatively, it could signal that firms had begun to respond to weaker actual or prospective demand by reducing hiring.

The immediate policy decision

22 Inflation had been well above the 2% target as a result of the temporary boost from higher energy and other commodity prices, the increase in the standard rate of VAT and the past depreciation of sterling. Despite the fall in CPI inflation in June, it was likely that inflation would rise further, to over 5%, in the coming months. In the light of recent developments in utility and food prices, the peak in inflation was likely to be a little higher and come sooner than the Committee had previously expected. The Committee's central view remained that a margin of spare capacity in the economy was likely to push down inflation and bring it back towards the target in the medium term, as the impact of the factors temporarily boosting inflation subsided. But there were material risks to that view, both to the upside and to the downside. The Committee discussed how those risks had evolved since its previous meeting.

23 The key risk to the downside was that demand growth would not be sufficiently strong to soak up the pool of spare capacity in the economy, leading inflation to fall materially below the target in the

medium term. The latest indicators suggested that the pace of global activity had slowed, although it was not clear how persistent this would prove to be. Some of the slowing in global activity reflected the temporary impact of the continuing disruption to supply chains caused by the Japanese earthquake and tsunami in March, and the effects of the elevated price of oil. The risks posed by an intensification of the sovereign debt and banking problems within the euro area to the prospects for economic activity and the financial system at home had remained substantial. The funding costs faced by the major UK banks remained elevated, in part reflecting those risks emanating from within the euro area, and were likely to continue to affect the price and availability of credit to many households and businesses adversely. Indicators had pointed towards continued modest underlying UK GDP growth in the second quarter and, more tentatively, to some softening in the outlook for the third quarter. But the implications of weaker activity for inflation would depend on the factors that had caused it. Partly in response to the more downbeat news on the outlook for economic activity, investors had put back their central estimate of when official interest rates would begin to rise and the sterling effective exchange rate had fallen modestly. This was likely, in time, to provide some countervailing stimulus to economic activity.

24 The key risk to the upside was that the period of elevated inflation would persist for longer than the Committee expected. Expectations of above-target inflation could become entrenched in price and wage-setting behaviour; employees might press harder for wage increases in response to recent declines in living standards; or there might be further upward pressure on prices arising from energy and other internationally traded goods prices. According to one survey-based measure, households' expectations of inflation in the medium term had increased markedly, to a little above their previous peak in 2008. But measures of inflation expectations derived from financial markets had been stable. There was no clear evidence that higher inflation expectations had begun to feed through into wage-setting behaviour. Earnings growth had remained subdued. But earnings growth was affected by a range of factors, making it hard to infer clearly what impact inflation expectations might have had. It remained unclear how much comfort to draw from recent labour market developments, given the puzzling behaviour of productivity over the recent past.

25 Overall, the balance between the upside and the downside risks to inflation in the medium term had not changed sufficiently over the month for Committee members to change their views of the appropriate setting for monetary policy. The risks to inflation in the medium term remained substantial in both directions. The Committee set monetary policy to balance those risks around the

2% inflation target. If it were to become clear that one of those risks had crystallised – and the medium-term outlook for inflation had deviated materially from the target in either one direction or the other – the Committee would respond by changing the stance of monetary policy.

26 Most members judged that it was appropriate to maintain the current stance of monetary policy at this meeting. It was likely that the current weakness in activity would persist for longer than previously thought, although the reduction over the month in the exchange rate and in market interest rates would provide some countervailing stimulus to the economy. That weakness, together with the continued subdued behaviour of earnings, reinforced the case that inflation was likely to fall back once the temporary impact of the factors pushing up on it had waned. But there also remained upside risks associated with the sustained period of above-target inflation. There was a range of views on the balance of these downside and upside risks. Overall, however, recent developments had reduced the likelihood that a tightening in policy would be warranted in the near term.

27 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 overseas and domestically had evolved broadly as expected. The evidence suggested that there remained a significant margin of spare capacity. So it was likely that, on the balance of risks, inflation would fall below the target in the medium term. The stability of financial market measures of inflation expectations and of earnings growth indicated that it was unlikely that they would begin to drift upwards.

28 For two members, the argument for removing some of the monetary stimulus at this meeting had remained strong. For them, the upside risks to inflation in the medium term from global pricing pressures and the possibility that inflation expectations could increase continued to outweigh the downside risk that the strength of the recovery would be insufficient to eat into the economy's persistent margin of spare capacity. Recent activity data had weakened both in the United Kingdom and overseas. But it was likely that the factors that lay behind the recent softening had also negatively affected supply conditions, so their impact on medium-term inflation was likely to be muted. It was not clear how much comfort could be drawn from subdued earnings data: it was possible that the rate of wage growth consistent with inflation returning to the 2% target would be lower than in the past, as a result of the continued weakness in productivity growth and the likelihood that businesses would seek to rebuild their profit margins. One of these members felt that a small increase in Bank Rate

would afford the Committee greater flexibility in responding to possible future developments, noting that any increase could be reversed if the need arose.

29 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, seven members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Paul Fisher, David Miles and Adam Posen) voted in favour of the proposition. Spencer Dale and Martin Weale voted against the proposition, preferring 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, 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.

30 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.