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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

8 AND 9 JUNE 2011

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 June 2011.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1106.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 6 and 7 July will be published on 20 July 2011.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 JUNE 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 Financial markets had remained generally stable despite a backdrop of increased commentary surrounding the fiscal problems in the peripheral euro-area countries, in particular Greece, and the outcome of the EU bank stress tests. The spreads between the yields of some peripheral euro-area countries' sovereign bonds, particularly those of Greece, and of equivalent German bonds had widened further, and the premia of credit default swaps on those bonds had risen. Market contacts reported increasing doubt that the Greek Government would be able to access private capital market funding by the spring of 2012 as planned.

3 Short-term sterling interest rates had fallen during the month, reflecting the impact of softer-than-anticipated economic data. Information derived from overnight index swap rates had indicated that, on average, financial market participants expected Bank Rate to have increased by 25 basis points by the spring of 2012. Short-term interest rates had also fallen in the United States and euro area, reflecting broader signs of a softening in the pace of global activity. Longer-term interest rates had been broadly unchanged in the United Kingdom, United States and core euro-area countries. The sterling effective exchange rate index was unchanged on the month, although that masked a slight depreciation of sterling against the dollar and appreciation against the euro.

4 Equity prices had fallen internationally during the month. In the United Kingdom and euro area, they had returned to the levels seen at the start of the year, despite upward revisions to expected dividend payments and falls in market interest rates. That suggested that the premium demanded by investors for holding equities had increased since the beginning of the year.

5 Sterling corporate bond spreads had changed little during the month. Gross bond issuance by non-financial companies had been stronger in the year to date than in the comparable period of 2010, or in the years leading up to the financial crisis. Much of that recent issuance had been required to refinance maturing debt, however, so that net issuance had been around its pre-crisis average. UK banks had continued to raise substantial funding, with the major banks raising around £85 billion of wholesale market funding so far in 2011. That issuance represented around two thirds of those banks' likely funding requirement for the year as a whole. The cost of that funding had remained elevated relative to risk-free rates, however.

The international economy

6 The indications of a slowing in the pace of global growth that the Committee had noted in recent months had continued, although the implications for growth in the medium term remained unclear.

7 GDP in the euro area had increased by 0.8% in the first quarter, partly reflecting a recovery in the level of activity following weather-related weakness in the final quarter of 2010. Within that, the contrast between weak activity in many peripheral countries and the resilient economic performance of the core countries, particularly Germany, had continued. First-quarter GDP growth in the United States had been estimated at 0.5%.

8 Indicators for the second quarter had continued to point to a broadly based slowing in the pace of global activity. The JP Morgan global manufacturing PMI, excluding Japan, had fallen again in May, as had the comparable services index, albeit by rather less. Taken together, these surveys indicated that global growth in the second quarter would be weaker than the Committee had assumed at the time of its May *Inflation Report*.

9 On one view, it was possible that the apparent slowdown in activity could be explained simply by the disruption to global supply chains caused by the earthquake and tsunami in Japan, together with the dampening impact of elevated oil prices. The weakness of automotive manufacturing output in the United States and the slowdown in consumer spending growth there could be consistent with that. On that view, unless oil prices rose further, activity might be expected to recover over the coming quarters as supply chains were re-established. Over the past month, the dollar price of Brent crude oil had

fallen by almost 3%, notwithstanding an increase on the first day of the Committee's meeting following OPEC's lack of agreement on production quotas.

10 It was also possible, however, that the softening of global growth would be more sustained. Supply-chain disruption could not explain the apparent weakening in services activity in many countries or, for instance, relatively disappointing US employment and investment indicators. It was possible that private sector deleveraging and fiscal consolidation in many countries would prove more of a drag on growth than anticipated, though it remained too early to draw firm conclusions.

Money, credit, demand and output

11 The ONS's estimate of GDP growth in the first quarter, at 0.5%, had not been revised. It was probable that underlying growth had been only a little below that, after abstracting from the offsetting impacts of the recovery in the level of output from snow-related weakness in 2010 Q4 and seemingly erratic falls in energy and construction output in 2011 Q1. Within that, estimated domestic demand had been weaker than the Committee had expected, while net trade had contributed rather more to growth than expected. That provided some indication that the necessary rebalancing of the UK economy away from domestic consumption and towards external trade was under way. But it remained highly uncertain how strong overall activity growth would be while that rebalancing took place.

12 It was not yet clear from the available data whether the recent weakness in growth would prove to be a temporary soft patch or something more lasting. Despite a possible boost from the recovery from snow disruption at the end of 2010, real consumer spending had been estimated to have fallen by 0.6% in the first quarter. Although the unexpectedly rapid growth in the consumer expenditure deflator suggested that real consumption might eventually be revised upwards, the weakness of real household consumption had been consistent with the sharp reduction in indicators of consumer confidence in the early months of the year. Those indicators had recovered in May, although they remained at a level consistent with further falls in consumption. House prices had remained broadly flat. Housing transactions had remained below the level normally implied by natural market turnover, although there had been some signs that the supply of houses for sale was beginning to edge up. Business investment was estimated to have fallen by around 7% in the first quarter. Some, but not all,

of that weakness was likely to reflect the unwinding of the erratically strong spending on aircraft in the second half of 2010 induced by tax changes at the start of 2011.

13 Net trade was estimated to have contributed 1.7 percentage points to GDP growth in the first quarter – its largest positive contribution since quarterly National Accounts had been introduced in the 1950s. A proportion of that apparent strength would have reflected the unwinding of the erratic strength in aircraft imports, as well as the weakness of import-intensive domestic demand. But, although trade data were often subject to significant revision, the latest data also provided some tentative evidence of expenditure switching towards UK-produced goods and services.

14 The CIPS/Markit manufacturing PMI and services business activity index had fallen in May, and indicated continued subdued growth moving into the second quarter. It was possible that the reduction in the manufacturing PMI in recent months had overstated the slowing in underlying output growth, perhaps as a consequence of the supply-chain disruption caused by the earthquake and tsunami in Japan, and the reduced number of working days in April given the additional bank holiday for the royal wedding. Such sharp falls had not been replicated in other survey measures of activity, including from the Bank's Agents. Overall, the Committee judged it likely that output in the second quarter had grown at an underlying pace similar to that in the first.

15 As in recent quarters, nominal spending indicators had been more robust. Nominal consumer spending was estimated to have grown by over 2% in the first quarter and by 5% over the previous year. This might simply reflect households' unwillingness or inability to alter some of their real spending patterns in the face of higher prices. But it might also provide a positive signal about households' future spending. The Committee noted that the strength of nominal spending in the economy had been possible despite the continued weakness of money and credit growth. Notwithstanding some erratic monthly movements, broad money growth had remained very subdued. And the stock of M4 lending had not grown at all since the beginning of 2010, while lending to private non-financial companies had continued to fall. Given the available data, it was not yet clear whether the reported increase in nominal spending in the first quarter had been associated with a reduction in saving or increased income.

Supply, costs and prices

16 Twelve-month CPI inflation had increased to 4.5% in April, from 4.0% in March, broadly in line with the Committee's expectation. The increase had been driven by higher prices for transport services, as the ONS's collection date for consumer price data had this year fallen in the school holidays, when airfares were typically higher. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 4.5% in May had been provided to the Governor ahead of publication. A detailed breakdown of the May data was not yet available.

17 During the month, one utility company had announced increases in gas and electricity prices to take effect from August. If replicated by other utility companies, those price rises would together be slightly in excess of the assumptions underlying the May *Inflation Report* projections and would come into effect earlier. That might imply that the likely peak in CPI inflation would be slightly higher than assumed in the May *Report*, but that inflation would subsequently fall back a little more quickly.

18 In line with pre-release arrangements, the Governor informed the Committee that producer input prices had fallen by 2% in May, reflecting a reduction in crude oil prices. Producer output prices had risen by 0.2% in May. UK producer output price inflation had been significantly greater than in the euro area between the middle of 2008 and late 2010, most likely reflecting the impact of the depreciation of sterling on manufacturers' costs and pricing decisions. More recently, UK and euro-area producer output price inflation rates had been similar, perhaps indicating that the bulk of the pass-through from sterling's depreciation to domestic output prices was complete. It was also possible, however, that continued pass-through had been offset by other factors depressing UK output price growth.

19 Measures of households' expectations of future inflation had been mixed. The Bank of England/GfK NOP survey had shown a reduction in expectations at short and long-term horizons in May. The YouGov/Citigroup measures of inflation expectations over the next twelve months and five to ten years ahead had increased in May, but remained below their levels at the beginning of the year. The Barclays Basix measures of expectations of inflation in the near and longer term had fallen sharply in May. The Barclays Basix measures had been volatile in the recent past, so it was unclear how much significance should be ascribed to the latest data. Measures of expected inflation implied by financial market prices had remained broadly stable over the past six months. Overall, while it was possible that

expectations would rise further over the coming months as inflation itself rose, there were some signs that the recent upward drift had stopped.

20 There had remained little sign of higher CPI inflation feeding into wage claims. Private sector regular annual pay growth in the three months to March had been 1.9%, a little weaker than in the three months to December. And private sector wage settlements had remained subdued at 2.1% in the three months to April. A key question for the MPC was over the rate of pay growth that was likely to be consistent with inflation returning to the 2% target in the medium term. That would depend upon the future path of productivity, which had so far barely grown at all during the recovery. It would also depend on the extent to which businesses sought to rebuild profit margins that had been compressed during the recession, as the level of productivity had fallen sharply.

21 Survey measures of capacity utilisation had suggested that some spare capacity remained in the service sector, although less than a year ago, while capacity utilisation in the manufacturing sector appeared at around normal rates. On the one hand, this appeared broadly consistent with the price trends seen in the manufacturing and service sectors, after abstracting from the estimated impacts of changes in VAT, energy and import prices. On the other hand, it was puzzling that measures of spare capacity had narrowed to such an extent, given the very substantial fall in output during the recession, coupled with the sluggish demand and very weak productivity growth that had followed during the recovery. While cross-country evidence suggested that it was typical for recoveries after recessions accompanied by financial crisis to be slow, the weakness of productivity growth observed in the United Kingdom over the past year had been abnormal and had reflected stronger-than-anticipated employment growth. The Committee had for some time thought it possible that the official output data during the recession and recovery would be revised upwards. An upward revision, with commensurate changes to estimated productivity growth, would resolve some of that puzzle in the published data.

The immediate policy decision

22 CPI inflation had remained well above the target, boosted by the temporary impacts of the increase in the standard rate of VAT, higher energy and other commodity prices, and the past depreciation of sterling. It remained likely that inflation would continue to rise in the near term – probably to above 5% – before subsiding as the temporary impacts of those factors dissipated. The Committee's focus was to set monetary policy so as to balance the risks of inflation being either above

or below the 2% target in the medium term. It discussed both the upside and downside risks to medium-term inflation.

23 The primary upside risks flowed from: the possibility that above-target inflation would become engrained in expectations and subsequently in wage and price-setting behaviour; and the possibility of further upward shocks to the price level, particularly from global prices. The Committee judged that the likelihood of these risks materialising, while substantial, had changed little over the month. Oil prices had remained volatile, but had fallen slightly during the month. And the sterling effective exchange rate index had been broadly stable since the beginning of 2009, suggesting that its earlier depreciation had been a step adjustment to the real consequences of the financial crisis and the necessity for economic rebalancing. Taken together, measures of household and financial market participants' inflation expectations had not moved materially. And the latest wage and settlement data had remained subdued, even if, looking ahead, the rate of pay growth consistent with inflation returning to the target was uncertain. Inflation was likely to continue to run above the target for some time. That raised the likelihood that such inflation might come to be regarded as the norm. The relative stability of inflation expectations could, however, suggest that they were more firmly rooted than might have been expected.

24 The key downside risk was that the strength of demand would prove insufficient to eliminate the current margin of spare capacity, leading to inflation falling below the target in the medium term. GDP growth, and especially consumer spending, had been weak. And the latest indicators suggested that, abstracting from erratic factors, growth would remain below its historical average in the middle of the year. Moreover, there was continued evidence of a softening in the pace of global output growth, although it was possible this had primarily been caused by the supply-chain disruption resulting from the Japanese earthquake and tsunami, and the elevated level of oil prices. While activity in the euro area as a whole had remained resilient, sovereign debt and banking problems could intensify, perhaps significantly, to the detriment of economic activity and the financial system. More positively, UK net trade had surprised to the upside and there were signs that the necessary rebalancing of the economy was under way. The medium-term outlook for demand remained extremely difficult to judge. It was possible that official estimates of demand during the recession and recovery would be revised upwards, and some allowance for that was already incorporated into the May *Inflation Report* projections. Beyond that, the array of erratic factors affecting measured output made any assessment of the current underlying state of the domestic and global economy highly uncertain. More

fundamentally, it was unclear how strong aggregate UK output would be as the necessary rebalancing of the economy from domestic demand towards net trade took place. It was also unclear what the consequences would be for the economy's supply capacity, and therefore inflationary pressure, if the recent weakness of demand persisted. For example, it was possible that some businesses would scrap capital or leave markets and that some unemployed people might lose skills or quit the labour market. Notwithstanding that uncertainty, on balance, the Committee judged that the downside risks to the prospects for medium-term inflation had increased over the month.

25 Most members judged that it was appropriate to maintain the current stance of monetary policy at this meeting. The current weakness of demand growth was likely to persist for longer than previously thought. Moreover, the fiscal challenges in the euro-area periphery highlighted the potential for further adverse shocks to demand. For some of these members, it was possible that further asset purchases might become warranted if the downside risks to medium-term inflation materialised. For others, there remained a substantial upside risk to medium-term inflation stemming from the possibility that inflation expectations might rise significantly, compounded by the potential for further upward shocks to global prices. Although there was no sign that this risk was materialising as yet, that did not preclude it from doing so in the future.

26 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, it was likely that inflation would fall below the target in the medium term. The stability of measures of inflation expectations and pay growth during a prolonged period in which inflation had been above the target suggested that it was increasingly unlikely that they would begin to drift upwards. For this member, the weak pattern of demand both in the United Kingdom and overseas had evolved broadly as expected.

27 For two members, the argument for removing some of the monetary stimulus at this meeting remained strong, although both acknowledged that the data on the growth outlook during the month had been weak. The recent data on productivity and employment suggested that the margin of spare capacity might be less than previously thought. The prospect of further increases in CPI inflation in the near term, perhaps to a level higher than implied by the central projection of the May *Inflation Report*, increased the risk that households and businesses would come to expect above-target inflation in the future, possibly leading to higher inflation itself. Moreover, although pay growth had remained

low, measured productivity growth had been abnormally weak so that unit labour costs had risen relatively briskly. For them, it was possible that the rate of wage growth consistent with inflation returning to the 2% target would be lower than it had been in the past, reflecting the prospect of continued weakness in productivity growth and the likelihood that businesses would seek to rebuild their profit margins following the sharp drop in productivity during the recession. One of these members also felt that a small increase in Bank Rate would afford the Committee greater subsequent flexibility in responding to possible future developments.

28 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.

29 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.