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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 4 AND 5 MAY 2011

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 May 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1105.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 8 and 9 June will be published on 22 June 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 MAY 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 Markets had generally been stable on the month, against a backdrop of relatively thin trading conditions during the holiday periods.

3 Implied market expectations of the point at which Bank Rate would begin to rise had been pushed back, partly in response to data releases, notably the March CPI outturn. Information derived from overnight index swaps indicated that the market yield curve had fully priced in a 25 basis point increase in Bank Rate by early 2012. The ECB had raised its official short-term interest rate by 25 basis points in April and market participants expected further tightening in coming months. Consistent with that, and with the lower expected path for Bank Rate, the sterling effective exchange rate had fallen by 1.4%.

4 Longer-term forward interest rates had fallen internationally by around 15-25 basis points. In the United Kingdom the fall had primarily reflected lower breakeven inflation rates.

5 For some countries in the euro area, sovereign debt markets had become more strained, reflecting concerns over their fiscal positions. The differences between the yields of some peripheral euro-area countries' sovereign bonds and those of German bonds of equivalent maturity had widened over the month as a whole. There had been little immediate reaction to the news of the support package agreed by the Portuguese government with the European authorities and IMF.

6 Oil prices had been broadly stable over the month prior to the meeting. But the prices of many other commodities had decreased, with sharp falls at the beginning of May in the prices of some precious metals. There had been little movement in other asset prices. The FTSE All-Share index had been broadly unchanged over the month, while there had been small rises in equity prices in the United States and euro area. Bank and corporate funding markets had continued to function smoothly.

The international economy

7 The IMF's April *World Economic Outlook* projected global growth to continue at slightly above pre-crisis average rates during 2011 and 2012. Nonetheless, the data released during the month had pointed to a moderate slackening in the pace of expansion. JP Morgan's global manufacturing Purchasing Managers' Index had fallen for the second month in a row in April, even omitting the contribution of the Japanese index, where activity had been affected by the impact of the earthquake and tsunami. And surveys of activity in the service sectors of the United Kingdom's main trading partners had also generally weakened, with the business activity balance of the US non-manufacturing ISM index falling sharply to 53.7 in April from 59.7 in March.

8 In the United States, GDP was estimated to have grown by 0.4% in the first quarter, down from 0.8% in the fourth quarter. The slowdown in growth had been spread across expenditure components, with modest consumption growth and sluggish growth in investment. It was plausible that some of this weakness would be temporary, but that would depend on the extent to which private final domestic demand growth gathered pace. The housing market had remained weak. And the strength of US household spending would hinge on whether the outlook for employment continued to improve. Members of the Federal Open Markets Committee had revised down their forecasts for growth in the four quarters to the end of 2011. Twelve-month CPI inflation had risen to 2.7% in March from 2.1% in February.

9 Indicators of activity in the euro area had continued to be consistent with growth at or above historical average rates, with GDP in Belgium, often a good early signal of output growth in its neighbours, growing by 1% in the first quarter. Euro-area business and consumer confidence indicators had fallen back slightly, however. Twelve-month HICP inflation in the euro area had risen to 2.8% in April from 2.7% in March.

10 Industrial production in Japan had fallen sharply in March following the earthquake and tsunami. It was still too early to know how persistent the interruption to output would be and little was known yet about the likely pace of reconstruction work. Some dislocation in global supply chains had been reported, particularly in motor vehicles and electronics manufacturing. It was possible that this could become more pronounced. But firms outside Japan could be expected to seek alternative sources of supply should the disruption persist.

11 Monetary policy had been tightened further in several emerging economies during the month, in response to rising consumer and asset price inflation. There were some signs that the pace of output growth was slowing and, were this moderation to continue, it might lead to some easing in the growth of global demand for oil and other commodities. IMF projections for GDP growth in emerging economies as a whole nonetheless remained robust and these countries were likely to continue to be the main engine of global activity. Indeed, it was possible that policymakers in those economies might decide that a more rapid pace of tightening was necessary to address incipient signs of overheating.

Money, credit, demand and output

12 According to the ONS's preliminary estimate, GDP had risen by 0.5% during the first quarter of 2011. Excluding the impact of the snow in December, underlying output was estimated by the ONS to have been broadly unchanged during the fourth and first quarters. Construction output had fallen by 4.7% in the first quarter, but official construction output data had continued to be very volatile compared to other indicators of construction activity and a continuing fall of this magnitude was unlikely. Output in the rest of the economy had grown moderately: abstracting from the effects of the snow, the combined output of the manufacturing and service sectors had risen in the first quarter by about 0.5%.

13 A key question was how long the current weakness in demand and output was likely to persist. Some indicators were consistent with the economy having entered a period of sustained weakness. The GDP data for the first quarter had been weaker than the Committee had expected at the time of the February *Inflation Report*. And a greater proportion of demand growth during 2010 had come from stockbuilding than previous vintages of the data had suggested. Lending to companies and individuals had remained weak, notwithstanding some signs of a slight easing in credit conditions. And, against the backdrop of a broadly flat level of household spending over the previous year, the GfK measure of

consumer confidence had fallen further, to its lowest level since March 2009. Any additional increases in energy prices would further reduce real personal disposable incomes. Moreover, the Bank's Agents had reported anecdotal evidence of pressures on consumers: an increasing concentration of retail sales around pay days; shoppers making smaller, more frequent purchases; and a shift away from spending on discretionary items.

14 Other indicators had pointed to stronger growth. The Labour Force Survey showed that employment had picked up and this was supported by business surveys of employment and recruitment intentions. And, although the CIPS/Markit business activity surveys of manufacturing and services had fallen in April, they remained in line with the pace of growth seen during the middle of 2010. It was possible that real household spending growth had been temporarily held back at the turn of the year given the rise in the standard rate of VAT, and retail sales volumes had risen slightly in March. Surveys of investment intentions suggested that a period of above-average spending growth on capital goods might be in prospect. And surveys of export orders in manufacturing remained solid and in services continued to pick up, consistent with the improvement in the trade balance seen in the official data for January and February.

15 Business confidence surveys pointed to a pickup in underlying growth in the near term. But growth was likely to continue to be temporarily affected by special factors. In particular, the royal wedding and supply chain disruptions following the earthquake in Japan were likely to dampen GDP growth in the second quarter and boost it in the third.

Supply, costs and prices

16 In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 2.6% in April. Increases in crude oil prices had accounted for most of the rise on the month. Producer output prices had risen by 0.8% in April. That increase had mainly reflected higher prices for tobacco and alcohol, clothing and footwear, and petroleum products.

17 Twelve-month CPI inflation had fallen to 4.0% in March from 4.4% in February. The most significant contribution to the fall had come from the prices of food and non-alcoholic beverages. There were signs in clothing, footwear and food prices that retailers might have been reacting to

weakness in demand by limiting price increases. It was possible that this response to demand conditions would continue, at least in the near term.

18 Despite the fall in CPI inflation in March, the most likely near-term path of inflation was markedly higher than at the time of the February *Inflation Report*. That largely reflected the impact of recent further rises in energy prices, including the likelihood they would result in substantial increases in electricity and gas prices over the next year.

19 The outlook for inflation remained sensitive to movements in commodity and energy prices. It also depended in the medium term on the extent of domestic price pressures. Prices could be pushed up if employers and employees agreed wage increases that were higher than were consistent with increases in labour productivity. It could also be affected by any upward drift in inflation expectations that fed into price-setting. Set against that, the slack that remained in the economy – both within the labour market and within companies – should act as a countervailing influence on inflation.

20 An assessment of the path of labour productivity over the past and how it would evolve in the future was a key component of any judgement on the margin of spare capacity within firms or the sustainable rate of wage inflation. The latest employment and output data suggested that private sector output per head had been broadly unchanged since the middle of 2010, while output per hour had actually fallen. This was substantially weaker than the Committee had expected at the time of the February *Inflation Report*. Measured labour productivity growth had been surprisingly weak for some time. Wage growth had remained moderate, with whole-economy regular pay increasing by 2.2% in the three months to February compared with a year earlier. But the weakness in labour productivity meant that it was possible that the modest rate of wage growth was consistent with a rate of underlying inflation higher than previously thought.

21 There were several explanations for this weakness. The output or employment data might be mismeasured. Alternatively, the path of underlying structural productivity before or during the recession might have been lower than previously thought. For instance, financial crises in other countries in the past had often been accompanied by sustained shortfalls in output relative to its pre-crisis trend. Both of these explanations were consistent with there being limited spare capacity within firms currently. That also chimed with the message from survey indicators of businesses' employment intentions and their assessment of spare capacity, both of which were broadly in line with

their long-run averages. A third explanation for the weakness in labour productivity was that some businesses had been retaining or taking on staff in anticipation of a recovery in demand. In that case a margin of spare capacity within firms probably remained and might have increased further over the past year. Were that recovery in demand not to materialise, firms might reduce capacity and lay staff off. It was possible that each of these explanations had contributed to the observed weakness, but none was fully convincing by itself and, given it was not yet clear how much weight should be put on each, any assessment of spare capacity within firms remained uncertain.

The May GDP growth and inflation projections

22 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 11 May.

23 Abstracting from the volatility associated with heavy snow in December, output appeared to have been broadly flat over the previous two quarters. The Committee's central judgement was that some pickup in underlying growth was likely during 2011 – albeit less than judged probable in February – driven by a continuing recovery in business investment and a positive contribution from net exports. But temporary factors, such as the effects of the additional bank holiday associated with the royal wedding and supply chain disruption from the Japanese earthquake and tsunami, were likely to add some volatility to quarterly GDP over the coming quarters.

24 There remained substantial uncertainties, and a wider than usual range of views among Committee members, regarding the outlook for growth. Households might have much further to adjust to the significant squeeze on real incomes. In that case growth could remain sluggish. There was also uncertainty over the extent to which net exports would support growth and the pace at which that support would materialise. But the corporate sector continued to run a substantial financial surplus: that suggested there was scope for higher investment spending, or possibly greater support to consumption if more of the surplus were to be distributed to households. Overall, the Committee's best collective judgement was that by the second half of the forecast period, the chances of four-quarter growth being either above or below its historical average rate were broadly equal.

25 The projection for growth implied a lower level of GDP than was judged probable in February. Given the observed weakness in productivity over recent quarters, the Committee judged that the

outlook for productivity, and so for the supply capacity of the economy, was also weaker than in February. The Committee continued to judge it likely that some margin of spare capacity, although diminishing, would persist throughout much of the forecast period.

26 There was a good chance that inflation would reach 5% later in 2011 and it was more likely than not to remain above the target throughout 2012, boosted by the increase in the standard rate of VAT, higher energy and import prices, and some restoration of companies' profit margins. As the impetus from external price pressures dissipated and the increase in VAT dropped out of the annual comparison, inflation should fall back. But the precise timing and extent of that decline in inflation were uncertain, and would be sensitive to the extent of any further pass-through from the past depreciation of sterling, and the evolution of energy and commodity prices: for example, plausible alternative paths for domestic utility prices would have significant implications for the outlook.

27 Inflation would also depend on the balance between two other substantial, but countervailing forces. To the downside, persistent spare capacity was likely to weigh on wages and prices for much of the forecast period. The extent of that downward pressure would depend on the strength of demand, but also on the evolution of productivity and the performance of the labour market, and therefore the path of potential supply. But to the upside, the protracted period of above-target inflation might lead to further upward pressure on prices, if households and businesses came to expect elevated inflation to persist, or if the recent and prospective squeeze on households' real incomes led to higher pay growth.

28 The range of views among Committee members over the outlook for inflation was, as in recent months, wider than usual. In the current uncertain environment, modest differences in judgements regarding the factors described above could have a material impact on the outlook. The Committee's best collective judgement was that, assuming Bank Rate moved in line with market interest rates, the chances of inflation being above or below the target were, as in February, broadly equal in the medium term.

The immediate policy decision

29 The Committee set monetary policy in order to meet the inflation target in the medium term. As had been the case for the previous few months, the Committee was confronted with two key questions in reaching a view on the outlook for inflation: how prolonged the current weakness in demand would

be; and how persistent the impact on inflation of increases in VAT, energy and import prices would be, either directly or via second-round effects.

30 On the first of these questions, there was a risk that demand would not grow sufficiently strongly to eliminate the current margin of spare capacity, leading to inflation falling below the target in the medium term. The probability of that risk crystallising was hard to evaluate, in part because there were mixed signals from indicators of business and consumer confidence, the interpretation of which was further complicated by the impact of the snow in December and erratic movements in construction output. The level of household spending had been stagnant over the previous year. And, against the backdrop of the continuing fiscal consolidation and the likely intensification of the squeeze on real disposable incomes from the current high level of energy prices, consumption growth was likely to remain weak for some time. But, set against that, activity balances from business surveys were consistent with continuing modest underlying growth in the bulk of the economy in the near term and firms were indicating that they intended to recruit and invest at around long-run average rates.

31 One way to reconcile these factors was if businesses' expectations of stronger activity growth were based on buoyant overseas demand for their goods and services, greater competitiveness compared with foreign suppliers of the UK market, and the need to undertake some investment projects postponed during the recession. If that were to prove correct, overall demand would be sufficient to justify their output, investment and employment decisions, providing some support to household incomes and facilitating the necessary rebalancing of the UK economy. There were signs that global growth had eased in the first quarter, but variability was not unusual at this stage of the cycle.

32 Alternatively, it was possible that domestic consumer spending would fall further or that external demand would disappoint. Surveys indicated that households' confidence in their own financial positions was low and the latest data had shown a further fall. Some euro-area periphery countries continued to face substantial fiscal and competitiveness challenges and additional weakness in these economies could weigh on UK demand. And, notwithstanding the improvement in the trade balance since the turn of the year, the contribution to the recovery in demand from net trade remained disappointing. If businesses came to revise down their view of the likely demand for their output, this could lead them to shed staff, curtail investment plans and reduce capacity.

33 On the second question, there was a risk that the period of elevated inflation could persist for longer than the Committee expected. Although they had been broadly flat over the month, oil prices had risen substantially since the February *Inflation Report* and the near-term outlook for inflation was higher. Continued robust growth in emerging economies, or an intensification of political instability in key oil-producing regions, might put further upward pressure on the prices of energy and other commodities. The sustained period of above-target inflation might cause expectations of inflation to drift upwards. To the extent that people placed weight on past outturns in forming their expectations, it might then take time for inflation expectations to decline again, even as inflation itself fell back. Moreover, the further squeeze in households' purchasing power might result in some upward pressure on nominal wages to the extent that workers sought to maintain real living standards. Thus far, however, there had been few material signs of the period of high inflation having fed into elevated medium-term inflation expectations or higher wage demands.

34 Overall, the balance between the upside and downside risks to the outlook for inflation in the medium term had not changed sufficiently over the month for Committee members to change their views on the appropriate stance of monetary policy. The pace of recovery was more likely than not to pick up from its recent soft patch. It was likely that there would be some continued recovery in business investment and that exporters would continue to benefit from the global recovery and the past depreciation of sterling. The near-term outlook for inflation had worsened further since February, primarily reflecting renewed increases in energy prices. But, under the assumption that Bank Rate rose in line with market yields, inflation was still likely to fall back in the medium term, as the temporary impacts of the factors currently raising inflation diminished and some downward pressure from a margin of spare capacity persisted.

35 Against that backdrop, for three members, the argument for removing some of the monetary stimulus at this meeting remained strong, and the projections in the May *Inflation Report* had reinforced that judgement. For them, the upside risks to the outlook for inflation in the medium term from global price pressures, and the possibility that inflation expectations would increase, continued to outweigh the downside risk that the strength of the recovery would be insufficient to erode the economy's margin of spare capacity. So some tightening in the stance of monetary policy was required to balance the risks to medium-term inflation around the target. Given the volatility in output expected in the second and third quarters, it was unlikely that the uncertainty over the strength of the recovery in demand would be resolved soon, so there was little benefit from waiting before tightening

policy. Were output to surprise on the downside, that could be a sign of a weakening in the supply capacity of the economy as well as weakening in demand. Moreover, beginning to withdraw some stimulus at this juncture could facilitate a more gradual return to a more neutral stance of policy in the medium term. Two of these members regarded the matter as finely balanced and favoured only a small tightening in policy, given the weakness of the real economy and the uncertainty facing the outlook. The third member concluded that a larger reduction in the degree of monetary stimulus remained appropriate. For that member, the likely strength of imported inflationary pressures, together with upside risks to inflation expectations, implied that the balance of risks around the inflation target in the medium term remained significantly to the upside.

36 Other members concluded that an increase in Bank Rate was not yet warranted. There was little evidence that elevated inflation expectations were becoming entrenched in wage and price-setting. Nonetheless, that risk remained material given the elevated near-term outlook for inflation. It was still too early to know whether the softening in activity was temporary and, notwithstanding the expected unevenness in output growth, the coming months could be revealing about the underlying strength of demand. Even though the overall extent of spare capacity in the economy was uncertain, high unemployment was likely to persist for some time. In time, some withdrawal of stimulus would become necessary. But the *May Inflation Report* projections implied that this did not need to occur immediately. An increase in Bank Rate in current circumstances could adversely affect consumer confidence, leading to an exaggerated impact on both spending and firms' perceptions of their desired productive capacity. And, were the downside risk to household spending to materialise, a path for policy weaker than that implied by market prices might become appropriate.

37 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 below the target in the medium term. For that member, the path of consumption spending would be lower and the margin of spare capacity in the labour market would be larger than assumed in the *May Inflation Report*, even allowing for the possibility of an upward revision to the level of output. Moreover, the impact of inflation expectations on wages and prices would be less than assumed in the central projection. Given the elevated path inflation would be likely to follow in the near term, this member recognised the risk that a persistent increase in inflation expectations or global price pressures could outweigh the forces pushing down on inflation, but did not

see this risk as material. That member saw the flatness of consumption over the past year and the weakness of pay growth as indicators consistent with this judgement.

38 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.

39 Finally, the Governor expressed his appreciation to Andrew Sentance for his contribution as a member of the Committee.

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.