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

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1111.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 7 and 8 December will be published on 21 December 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 NOVEMBER 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 Asset prices had once again been volatile over the month and stress in financial markets had remained acute as concerns about the vulnerabilities associated with the indebtedness of several euro-area economies had further intensified.

3 Following the summit of euro-area leaders on 26-27 October, there had been some immediate narrowing in the spreads between the yields on sovereign bonds of vulnerable euro-area countries and yields on German government bonds. But spreads had widened again in the days after the summit, in some cases to new post-EMU highs, as political uncertainty in Greece and Italy increased. Demand for these bonds had remained very weak and it was possible that this uncertainty might cause a persistent shift in investor appetite for some sovereign debt. Furthermore, to the extent that there were signs investors were increasingly reluctant to hedge sovereign exposures using credit default swaps, because they viewed them as a less useful form of insurance than before, there could be further upward pressure on yields.

4 Bank funding markets had continued to be impaired. Although there had been some secured issuance, the market for term unsecured funding had remained moribund and market contacts had suggested that investor appetite for unsecured bank bonds could be very slow to recover. Three-month Libor-OIS spreads had risen to their highest level since July 2009, though they had remained much lower than in the immediate aftermath of the collapse of Lehman Brothers. Market intelligence suggested that a number of euro-area banks had begun to reduce their lending across a broad range of sectors, particularly overseas. While there were few clear signs of such a sharp reaction in the

United Kingdom, lending to domestic households and businesses had remained subdued and there were limits to how long banks would be able to withstand elevated funding costs without materially tightening credit availability further.

5 Equity markets had been turbulent, but prices had risen over the month as a whole, by around 7% in the United Kingdom and United States and by 4% in the euro area. It was unclear to what extent this reflected holders of equities discounting future earnings at a lower rate, perhaps reflecting changes in risk premia, expectations of higher earnings in the future, or simply month-to-month volatility not linked to fundamental judgements on the economic outlook. Sterling investment-grade corporate bond yields for non-financial firms had fallen, both absolutely and relative to comparable gilts.

6 The yields on longer-term UK government bonds had fallen on the month. Overall, the Committee's decision in October to expand its asset purchase programme by £75 billion had not been much of a surprise to markets. Consistent with that, gilt yields had already fallen prior to the October meeting as expectations of a further round of asset purchases had increased; yields on UK government debt had also fallen relative to yields on German and US government debt. Yields on long-term gilts had decreased by around a further 10 basis points immediately following the October announcement. The spread between gilt rates and overnight index swap (OIS) rates had not fallen significantly in the run-up to, or on the day of the announcement, although they had subsequently narrowed. This was in contrast to the previous round of purchases and might indicate that some of the transmission channels for purchases were different from those in 2009. Discussions with market contacts suggested that direct sales by end-investors into the auctions had been increasing.

7 The sterling effective exchange rate had risen by just under 2% on the month. The Japanese authorities had intervened to limit the appreciation of the yen, while the European Central Bank (ECB) had cut its main refinancing rate by 0.25 percentage points, to 1.25%.

The international economy

8 Euro-area leaders had announced a package of measures, designed in part to relieve funding problems for euro-area governments and banks, comprising: voluntary restructuring of privately-held Greek sovereign debt; plans for the recapitalisation of a number of European banks; an agreement to enhance the efficiency of the European Financial Stability Facility; and measures to strengthen

economic governance. The package should provide more time for vulnerable euro-area countries to undertake the necessary rebalancing, but not all details of the measures had yet been finalised.

9 Data on activity in the euro area had suggested that output growth had been weak in the third quarter and early indications for the fourth quarter were consistent with a decline in GDP. Surveys of consumer and industrial confidence had fallen again in October and the composite Purchasing Managers' Index (PMI) had dropped to its lowest level since June 2009. The October ECB *Bank Lending Survey* had reported a net tightening in credit standards by euro-area banks for non-financial corporations in the third quarter, with a larger net balance of respondents expecting a tightening in the fourth quarter. In the projections it had released before the G20 summit, the OECD had revised down its forecast for euro-area GDP growth in 2012 to 0.3%.

10 In the United States, GDP was estimated to have grown by 0.6% in the third quarter, up from 0.3% in the second quarter and a faster rate of growth than forecasters surveyed by Consensus had expected in September. Much of the pickup had been accounted for by a rise in consumption growth, partly reflecting a stabilisation in automobile sales following supply chain disruption earlier in the year. But the manufacturing and non-manufacturing Institute for Supply Management indices for October had suggested that growth would slow in the fourth quarter, and, taken together, the increases in non-farm payrolls in September and October had been modest. Against a backdrop of falling real personal disposable incomes, surveys of consumer confidence had remained weak and activity in the housing market had continued to be very low. Given the uncertainty surrounding the passing of the Administration's stimulus package, it was not yet clear to what extent the US fiscal stance would change during 2012. Members of the Federal Open Market Committee had revised down their forecasts for growth in the four quarters to the end of 2012.

11 GDP in China had grown by 2.3% in the third quarter, broadly unchanged from 2.4% in the second quarter. Elsewhere in Asia, GDP releases for the third quarter had been mixed, but surveys had pointed to a gradual deceleration in activity in the fourth quarter.

12 Reversing the previous month's fall, oil prices had risen by around \$10 on the month, despite lower forecasts for global activity growth and the ending of the civil war in Libya. In part this reflected market participants becoming concerned about possible disruptions to Iranian production. It was unlikely that other members of OPEC would have the capacity to make up any significant shortfall

in supply. The prices of industrial metals and agricultural commodities had generally risen on the month, but by less than oil prices.

Money, credit, demand and output

13 According to the ONS's preliminary estimate, GDP had risen by 0.5% during the third quarter of 2011. Underlying growth was, however, likely to have been a little weaker: output in the second quarter had probably been reduced by April's additional bank holiday, and by supply chain disruption following the earthquake and tsunami in Japan. Growth in services activity had picked up to 0.7% from 0.2% in the second quarter, while activity in the construction sector had fallen.

14 Over the past two months, the ONS had also published a revised set of national accounts. Abstracting from erratic factors, GDP over the previous 18 months had appeared to have grown at a rate well below its historical average. In part, that slow pace of expansion had been accounted for by falling household real income and the effects of the continuing fiscal consolidation.

15 Forward-looking survey measures of business conditions had fallen in the third quarter and were consistent with output being broadly flat in the fourth quarter. The CIPS/Markit indices for October had also suggested broadly unchanged output in the fourth quarter. The slowdown in underlying activity was in part likely to reflect global developments. For example, some business surveys had suggested a sharp slowing in growth of manufacturing export orders. Growth in domestic orders had also fallen over 2011, although from more modest rates. As well as the indirect effects of weaker export demand, that might reflect the impact of recent financial market stresses and heightened uncertainty on demand. Those factors might also have contributed, in part, to the continued weakness in indicators of service sector output.

16 Measures of whole-economy employment had weakened materially in recent months. Having grown only slowly in the second quarter, the Labour Force Survey measure of employment had fallen by 178,000 in the three months to August, compared with the preceding three months. Slow growth in the second quarter had reflected a sharp decline in public sector employment and lower private sector employment growth. The level of general government employment in the second quarter was around 140,000 below the profile implied by the Office for Budget Responsibility's March projection. That might have been because the reduction in public sector employment had come earlier than anticipated

in that projection, with fewer public sector job cuts to come over the rest of the fiscal consolidation. Alternatively, the total reduction in public sector employment might turn out to be greater than initially projected. Surveys of businesses' employment intentions had been consistent with slower employment growth in the private sector. That could reflect the weakness in output already seen, but businesses might also have modified employment plans pre-emptively in the light of weaker expected growth or delayed hiring decisions due to heightened uncertainty.

17 Signs of slower growth had been less clear from indicators of spending. Although goods exports had fallen by 0.8% in the three months to September, weaker growth prospects, renewed uncertainty and concerns that credit conditions might tighten did not yet appear to have had large effects on investment. Forward-looking survey balances from the BCC and CBI had fallen back in Q3, though they did not imply cuts in investment on the scale seen in the recession. Of those companies responding to a recent survey by the Bank's Agents, most had not revised their investment plans over the previous three months. The latest monthly indicators had indeed suggested that consumption was likely to remain weak in the third quarter. Retail sales volumes had fallen by 0.2% over the quarter and the *CBI Distributive Trades Survey* was consistent with retail sales remaining weak in October. The GfK survey had reported a further fall in consumer confidence. Although property transactions had remained very low compared with historical averages, mortgage approvals for house purchase had risen slightly in the third quarter, indicating a certain resilience in the housing market in face of heightened uncertainty. Taken together, these indicators of expenditure did not imply a faster rate of decline in household spending than seen in the first half of the year.

18 Some support to spending should come from the expansion of the asset purchase programme which would push up asset prices and stimulate expenditure by lowering borrowing costs and raising wealth. Excluding the holdings of interbank intermediaries, broad money had increased by 4.9% on a three-month annualised basis in September, up from 1% growth in June.

Supply, costs and prices

19 Twelve-month CPI inflation had risen to 5.2% in September from 4.5% in August. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 5.0% in October had been provided to the Governor ahead of publication. A detailed breakdown of the CPI data was not available. Also in line with the pre-release arrangements, the Governor informed the

Committee that producer input prices had decreased by 0.8% in October, while producer output prices had been unchanged in October.

20 Energy price rises had contributed significantly to the recent elevated rate of inflation, alongside sizable contributions from VAT and import prices. As these effects began to drop out of the twelve-month comparison, inflation was likely to fall back sharply. In particular, the impact of the rise in VAT was likely to drop out by the first quarter of 2012. And, unless oil prices increased significantly again, the direct contribution of petrol prices to CPI inflation should also fall markedly by early next year. Together, the direct contribution of VAT and petrol prices to CPI inflation was likely to decrease by around 1½ to 2 percentage points between late 2011 and the end of the first quarter of 2012.

21 The pace at which inflation would drop thereafter would depend, in part, on the inflation expectations of households and companies, and the extent to which they were reflected in wage and price-setting decisions. The YouGov/Citigroup measure of households' inflation expectations five to ten years ahead had fallen to 3.4% in October from 3.8% in September. Expectations of professional forecasters and a market-based indicator derived from inflation swaps had continued to be stable and close to their series averages. There remained little evidence to suggest that above-target CPI inflation had begun to generate rapid wage growth – perhaps not surprisingly given the weakening in the labour market. Private sector settlements had remained low, although the twelve-month mean settlement, at 2.2% in September, had risen slightly since the beginning of the year. Regular pay drift – that portion of wage growth not attributable to either bonuses or settlements – had continued to be extremely weak.

22 The outlook for inflation would also depend on the extent to which firms attempted to increase their profit margins. Despite some recovery over the past year, estimates of companies' profit margins had remained below their average level in the years prior to the recession. A further recovery in margins could put upward pressure on prices. And there could be more upward pressure to come if the suppliers of goods and services to the domestic market had still not fully adjusted to the consequences of higher import prices.

The November GDP growth and inflation projections

23 The Committee reached its policy decision in the light of its projections to be published in the *Inflation Report* on Wednesday 16 November.

24 Growth had been weak throughout the past year, reflecting a fall in real household incomes, persistently tight credit conditions and the effects of the continuing fiscal consolidation. More recently growth had also been buffeted by headwinds from the deterioration in the global outlook, heightened strains in financial markets and banking systems, and an accompanying decline in confidence among UK businesses and households. With all those factors continuing to weigh on spending, the outlook for growth over the first year of the forecast was significantly weaker than in the *August Report*, despite the latest projections being conditioned on a lower assumed path for Bank Rate and a larger stock of asset purchases.

25 Growth was judged likely to recover over the second and third years of the forecast period, driven by a moderate recovery in global demand and a resumption in UK private domestic demand growth. Domestic spending should be supported by a gentle recovery in households' real income growth, and the continuing effects of stimulatory monetary policy. Over the second half of the forecast period, the outlook for growth was broadly similar to that in August. But given the weakening in the near-term outlook, the level of output was likely to be lower than projected in August throughout the forecast period.

26 The outlook for growth was unusually uncertain, reflecting in particular the exposure of the UK economy to developments in the euro area. Several euro-area countries faced considerable challenges in improving their competitiveness and ensuring their fiscal and external solvency. A credible and effective policy response that reduced uncertainty would alleviate the drag on global and UK spending. But failure to respond successfully to those challenges would have significant adverse consequences for the world and UK economies.

27 Domestically, there were also uncertainties around the impact of the Committee's asset purchases on nominal demand, and over how much domestic headwinds, including the fiscal consolidation, tight credit conditions and the continuing desire by households and businesses to repair their balance sheets, would restrain spending. There remained a range of views among Committee

members about the likely strength of these factors. Based on the conditioning assumptions described above, the Committee's best collective judgement was that by the second year of the forecast period, growth was somewhat more likely to be above its historical average than below it. The risks around the most likely path for growth were judged to be skewed to the downside in the near term, largely reflecting the risks around the global recovery, but broadly balanced further ahead.

28 GDP was likely to remain significantly below the level corresponding to a continuation of its pre-recession trend. The Committee's central judgement was that a substantial part of the shortfall relative to that pre-recession trend reflected a period of low underlying productivity growth in recent years. And potential supply growth might remain subdued, either because of further weakness in underlying productivity growth, or if persistently elevated unemployment led some people to withdraw from the labour market or lose skills, making it less likely they would be able to find work. Nonetheless, a substantial margin of economic slack was likely to persist throughout the next three years.

29 There were substantial uncertainties, however, over how fast and how far inflation would fall. Inflation would continue to be sensitive to the paths of import prices and global commodity prices, and to the evolution of businesses' profit margins. And there were substantial uncertainties over the degree to which slack in the economy would weigh on prices. That would depend not only on the path of demand, but also on the evolution of potential supply, and on the sensitivity of wages and prices to that spare capacity. There remained a range of views among Committee members over the likely effects of these various influences. On balance, the Committee judged that, based on the conditioning assumptions described above, inflation was more likely to be below the target than above it at the forecast horizon, given continuing downward pressure on pay and prices from some margin of economic slack. Relative to the most likely path for inflation, the risks were judged to be broadly balanced.

30 The inflation projection was lower than in August, reflecting the effects of the lower projected level of output on wages and prices. At the end of the forecast period, there was judged to be a roughly three-in-four chance that inflation would be half a percentage point or more away from the target, but with larger probabilities to the downside than to the upside.

The immediate policy decision

31 The Committee set monetary policy in order to meet the inflation target in the medium term. Although the advance estimate had suggested that twelve-month CPI inflation had fallen in October, at 5% it was still well above the 2% target, largely as a result of the temporary impact on inflation of the increase in the standard rate of VAT, and higher energy and import prices. The Committee's central view remained that inflation was likely to fall sharply by the end of the first part of 2012 as the impact of the factors raising inflation dissipated, although there was greater uncertainty about the pace with which it would continue to fall thereafter.

32 The key upside risk was that elevated inflation would be more persistent than the Committee expected. That could be as a result of companies rebuilding margins more aggressively than anticipated; a greater-than-expected response of wage growth to a gradual increase in productivity growth or to the past squeeze in real incomes; or expectations of above-target inflation becoming embedded in wages and price-setting. There was also some evidence that households expected inflation to be more persistent than envisaged in the Committee's central case. But should inflation continue to fall over the coming months, this could help to influence expectations of future inflation, and wage and price-setting behaviour more generally.

33 The degree of inflationary pressure associated with the path of demand would also depend on the evolution of productivity. Although survey measures of capacity utilisation had fallen in the third quarter, they had continued to point to there being only a small margin of spare capacity within companies. But measured labour productivity remained well below the level associated with a continuation of its pre-crisis trend, which appeared to suggest a substantial amount of underutilised capacity within companies. That might reflect some businesses holding on to employees despite lower activity, due to worries that it would be difficult to recruit suitably skilled staff when demand recovered. Such labour hoarding might have been aided by the low level of Bank Rate, and perhaps by forbearance by banks and other creditors. In that case, there would be scope for the economy to grow more rapidly than usual if demand recovered, without any build-up of inflationary pressure. Such widespread labour hoarding was difficult, however, to square with the relatively broad-based strength of private sector employment growth over 2010 and the first half of 2011.

34 That said, employment had fallen over the summer, and the amount of slack in the economy was likely to increase in the near term. The key downside risk to the medium-term inflation outlook was that demand growth would be insufficient to absorb this slack, causing inflation to fall materially below the target in the medium term. There had been further news on the month about some of the factors influencing demand. In particular, concerns over the sustainability of the public and external debt positions of some euro-area countries had led to increases in the cost of borrowing for those countries and widespread falls in confidence. While the worst risks had not so far crystallised, the threat of their doing so had increased, exacerbating the already severe strains in bank funding markets and financial markets more generally. Once implemented, the package of measures that had been announced by euro-area leaders should provide more time for countries to rebalance their economies and improve their competitiveness. But even so, the process of rebalancing was likely to act as a continuing drag on demand in the euro-area periphery, as fiscal consolidation continued and wage growth was depressed. There was a high degree of uncertainty over how that adjustment process would unfold; failure to tackle successfully the vulnerabilities in the euro area, and any related intensification of financial market stresses, could result in a much weaker external environment.

35 The preliminary estimate of GDP in the third quarter had suggested a rise in output of 0.5%, but underlying growth was likely to have been weaker. Domestic demand over the past year had been held back by falling real household incomes, tight credit conditions and the effects of the continuing fiscal consolidation. More recently, heightened uncertainty associated with international developments and the stresses in financial markets had probably weighed on UK spending. But it was possible that a greater share of the weakness in demand had reflected a desire among households to strengthen their balance sheets for reasons associated with future spending needs rather than uncertainty. If that were so, the recovery in domestic spending could be more subdued, even if uncertainty were to decline. Direct indicators of expenditure were sending mixed signals about the rate of slowing, and the message from output indicators was one of broadly unchanged activity in the fourth quarter rather than a material contraction.

36 The Committee noted that the existing programme of asset purchases would take a further three months to complete and market capacity made it difficult to increase the monthly rate of purchases substantially above what was already under way. During that time the Committee could gather evidence as to the impact of the purchases on asset prices and the real economy. It could also take account of events in the United Kingdom and abroad. Some members noted that the balance of risks

to inflation in the November *Inflation Report* projections meant that a further expansion of the asset purchase programme might well become warranted in due course; anticipation of that might itself have an effect on asset prices and demand. Some other members judged that the risks to inflation around the target were more balanced.

37 Against that backdrop, the Committee agreed that a decision to increase the size of the asset purchase programme was not warranted at this meeting. It was noted that inflation was currently materially above the target and it remained a possibility that it would be slower to fall during 2012 than the pace implied by the Committee's central projections. In the light of the scale of the challenges posed by the domestic and global environments, the likely undershoot of the target was not very large and inflation was in any case projected to be rising towards the end of the forecast period. Given the imprecision with which the appropriate stance of policy could be calibrated at this juncture, there was little merit in fine tuning.

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 continue with the programme of asset purchases totalling £275 billion financed by the issuance of central bank reserves.

Regarding Bank Rate, the Committee voted unanimously in favour of the proposition.

Regarding the stock of asset purchases, the Committee voted unanimously in favour of the proposition.

39 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.