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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

5 AND 6 OCTOBER 2011

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 October 2011.

They are also available on the Internet http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1110.pdf

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting to be held on 9 and 10 November will be published on 23 November 2011.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5 AND 6 OCTOBER 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 There had been increasingly visible symptoms over the month of rising stress in financial markets as concerns about the vulnerabilities associated with the indebtedness of several euro-area governments and banks had intensified. These symptoms had included continued high levels of volatility in asset prices; a reduction in liquidity across a range of markets; signs of pressure on some individual institutions; and a generalised withdrawal from risk taking, reflected in price falls in an array of markets, including those for emerging-economy assets, commodities and high-yield credit.

3 Stresses had been particularly acute in bank funding markets. Short-term funding had become more expensive and difficult to obtain for European banks, including those in the United Kingdom, and investors had continued to shorten the term of the US dollar funding they provided. Credit default swap premia on banks' unsecured debt had been volatile around elevated levels, and the term unsecured funding markets had remained virtually closed to new issuance. While banks in the United Kingdom had made significant progress in meeting their term debt issuance targets for the year as a whole, there were limits to how long they would be able to withstand elevated funding costs or closure in these markets before lending to the domestic economy would be affected.

4 Equity markets in the United States and Europe had been volatile, with substantial daily and intraday movements. Despite this volatility, prices in these markets had not, on average, fallen substantially further since the large falls in late July and August. There had been larger falls in East Asian equity markets. Spreads above government bond yields had widened in corporate bond markets to around the levels seen before the collapse of Lehman Brothers in September 2008, though they remained well below their peak levels of late 2008.

5 Overnight index swaps had indicated that market participants expected official interest rates in the United Kingdom and the United States to remain unchanged for around two years. And there had been a growing expectation that official rates would be cut in the euro area. With little room for further reductions in official rates, there had been a strengthening expectation of further asset purchases in the United Kingdom. In the United States, the Federal Open Market Committee announced on 21 September that it intended to extend the average maturity of its holdings of securities by buying longer-term securities financed by the sale of shorter-term securities. This programme was intended to put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. Reflecting these developments, and consistent with a generalised withdrawal from risk taking, longer-term interest rates had fallen further on the month, particularly in the United Kingdom and the United States.

6 The sterling effective exchange rate had appreciated a little on the month, as larger opposing moves against the euro and the dollar broadly offset each other. The dollar had appreciated as part of the generalised withdrawal from risk taking and a flight to quality. Conversely, the euro had depreciated, consistent with heightened concerns about some euro-area governments and banks.

The international economy

7 Activity indicators had continued to weaken in some economies and had remained subdued in others, pointing to an increased likelihood of a sustained and synchronised period of weak global growth.

8 In the euro area, the Purchasing Managers' Indices (PMIs) for both the manufacturing and services sectors had fallen further in September, and were now consistent with a small contraction in output in the region as a whole. While much of the weakness was concentrated in the periphery countries, the PMIs in Germany and France had fallen to a level consistent with flat output. Several euro-area economies faced severe challenges in restoring the sustainability of their fiscal positions and their competitiveness. Measures of business and consumer confidence had continued to fall across the euro area.

9 Activity indicators in the United States had been mixed. Both ISM activity indices had risen, but remained consistent with only modest growth. Monthly consumers' expenditure had not grown in

August, perhaps because of weakness in real income growth, and measures of consumer confidence remained weak in September. By contrast, measures of capital spending suggested that investment growth had been robust in the third quarter, consistent with orders and intentions indicators earlier in the year. But those indicators had since weakened, suggesting that the strength of investment might not be sustained. The weakening in the pace of recovery had led the Administration to propose a $450 billion stimulus package, centred around lower payroll taxes. But it was unclear what the package would contain after it had been debated in Congress.

10 Survey indicators had continued to suggest a slowing in the growth of the major Asian economies. A range of monthly indicators had been consistent with a gradual slowing in China. And, while a rebound in output in Japan in the third quarter was likely following the disruption caused by the earthquake and tsunami, recent monthly indicators had been disappointing, with PMIs for both the manufacturing and services sectors consistent with a contraction in output.

11 Global commodity prices had fallen over the month. Oil prices had fallen in dollar terms, with Brent crude down 11%. Industrial metals prices had fallen by 19% and agricultural and livestock prices by 12%.

Money, credit, demand and output

12 According to the most recent ONS estimate, GDP had grown by 0.1% in the second quarter, revised down from the previous estimate of 0.2%. Underlying growth was likely to have been stronger, with output having been temporarily depressed by the extra bank holiday in April and the supply chain disruption following the earthquake and tsunami in Japan. On the expenditure side, the weakness in overall GDP was driven by a sharp fall of 0.6% in consumption and a negative contribution of net trade as exports fell. Opposing these contractionary influences, investment had risen by 1.7% and government consumption had risen by 1.1%.

13 The latest quarterly national accounts had contained substantial revisions to the historical data which could change the interpretation of how the economy had evolved during and after the recent recession. The revisions reflected both methodological changes and new information, including new estimates of past company profits. However, the latest national accounts were partial, with little information on incomes and none on household and corporate saving; a full analysis would not be possible at least until a complete set of national accounts was published later in the month.

14 In the revised data, the downturn had appeared more pronounced than originally estimated and to have been driven more than in previous recessions by the weakness of consumer spending, which was estimated to be only a little higher in the second quarter of 2011 than at its trough two years earlier. Partly offsetting this, there were large upward revisions to net trade. As a consequence, its evolution since the depreciation of sterling in 2007 and 2008 now appeared to be more in line with that seen following previous large movements in the exchange rate.

15 Looking ahead, business surveys had pointed towards only modest underlying economic growth in the third quarter after taking account of the expected recovery from the erratic factors depressing output in the previous quarter. The CIPS/Markit services and manufacturing output indices had both increased in September after weak readings in August. The rise in the services index had only partially reversed its steep fall in August and had continued to point to subdued services growth. The rise in the manufacturing index was reported to have been driven primarily by firms running down existing order books, rather than new demand. Backlogs of work had fallen at their fastest pace since September 2009.

16 The CIPS/Markit output and expectations indices had pointed to unchanged or falling output in the fourth quarter. The service sector index had fallen in September for the second month running, reaching its lowest level for two and a half years. The CIPS/Markit manufacturing new orders index had risen, but at just over 50 it was signalling only a stabilisation in demand. A weakening of consumer confidence had provided some corroboration of a more subdued outlook. The GfK consumer confidence balance had fallen in September to its lowest level since March 2009 and perceptions of household finances over the past year were at their weakest since November 1992.

17 It seemed likely that much of the continuing slowing in underlying growth in the United Kingdom was being driven by the deterioration in the external environment. One of the key channels of transmission was through external trade, where there had been mixed news on future prospects. The CIPS/Markit manufacturing exports index had fallen sharply in September to reach its lowest value since May 2009, and pointed to falling export demand. But a survey on export prospects carried out by the Bank’s Agents in August and September had been more positive, with contacts expecting strong export volume growth over the next year, especially to Asia and the Middle East.

18 Another key channel of transmission of external developments to the domestic economy was through the tensions in financial markets. Even before the emergence of renewed strains in the financial markets, there was evidence that credit conditions had remained significantly tighter than before the financial crisis. Consistent with this, broad money and credit growth had continued to be weak: M4 excluding the holdings of interbank intermediaries had increased by 2.3% on a three-month annualised basis in August and M4 lending had fallen by 4.2% on a similar basis. Part of this decline had been accounted for by sales of securities by banks and so might have exaggerated the weakness of lending to the domestic economy. The housing market remained subdued with house prices and transactions having been more or less flat since the start of 2010.

19 There was little evidence yet that the renewed tensions in financial markets had led to an additional tightening in the credit conditions facing households and businesses. Respondents to the Bank's *Credit Conditions Survey*, carried out in late August, had reported an increase in the amount of secured and unsecured credit made available to households and small businesses and no change in the amount of credit made available to large and medium-sized businesses. And the Bank's Agents had reported that their contacts had seen little evidence so far of a tightening in conditions as a result of the recent financial market turbulence. But the longer that the elevated cost of wholesale bank funding persisted, the more likely it would be that lenders would pass these costs through to households and businesses by raising the cost of credit or restricting its availability. This would add to the domestic headwinds to growth already present, including those from the fiscal consolidation and the weakness of real household incomes.

Supply, costs and prices

20 In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had increased by 1.7% in September. Producer output prices had risen by 0.3% during the month.

21 Twelve-month CPI inflation had risen to 4.5% in August, broadly in line with the Committee's expectation. The Committee's view remained that inflation was likely to rise above 5% in the near term, boosted by already announced increases in utility prices. Inflation was then expected to fall back sharply in the first part of 2012 as base effects from both the earlier VAT increase and higher oil prices dropped out of the twelve-month comparison. More recent signs of intensified competition among

supermarkets were also likely to put downward pressure on inflation in the near term, as would the recent weakening in global commodity prices.

22 There had been little news on inflation expectations over the month, despite a growing expectation of a further relaxation of monetary policy. The YouGov/Citigroup measures of households' inflation expectations one year ahead and five to ten years ahead were broadly unchanged in September. Measures of inflation expectations derived from financial markets had fallen in the United Kingdom and elsewhere, but these measures had been volatile in past periods of stress in financial markets.

23 The Committee had been concerned that elevated CPI inflation might feed through into wage growth. Private sector annual pay growth had been 3.1% in the three months to July, up from 1.8% in the three months to April. But this increase largely reflected strong bonuses, predominantly in the finance and business services sectors. When bonuses were excluded, private sector annual pay growth was 2.2% in the three months to July, compared with 1.9% in the three months to April.

24 A key factor in determining inflationary pressure in the medium term was the extent to which slack in the labour market would restrain wage increases. Labour market quantities had weakened in recent months. The LFS measure of employment had fallen by 69,000 in the three months to July, compared with the preceding three months, and unemployment had risen by 80,000 over the same period. The decline in employment was more than accounted for by a fall in public sector employment. Private sector employment had continued to rise, albeit at a slower pace than earlier in the year.

25 With public sector employment expected to fall further, prospects for the degree of slack in the labour market depended on how private sector employment evolved. That was related to the behaviour of private sector productivity growth, which had been puzzlingly weak during the recovery so far. There were several possible explanations for the productivity slowdown and these had different implications for how the degree of slack in the labour market might develop. One possibility was that companies had been holding on to skilled staff in anticipation of a stronger recovery. Those companies might decide that they could no longer wait for the upturn and could shed labour quickly if it became apparent that economic prospects had worsened. But it was also possible that the productivity slowdown was caused by the impact of the financial crisis on the supply side of the economy. For example, limited access to credit, especially to SMEs, and forbearance by lenders

towards indebted companies, might have inhibited the reallocation of resources towards fast-growing companies, including start-ups, and slowed the rebalancing of the economy. In that case, a renewed slowdown in activity, accompanied by renewed financial market tensions, might be associated with continued low productivity growth, little new labour market slack and so less downward pressure on inflation.

The immediate policy decision

26 CPI inflation had risen to 4.5% in August, remaining well above the 2% target. The elevated rate of inflation primarily reflected the increase in the standard rate of VAT in January and the impact of higher energy and import prices. Inflation was likely to rise to above 5% in the near term, boosted by increases in utility prices already announced. But the Committee's central view was that domestically generated inflation had remained contained. Inflation was likely to fall back sharply in 2012 as the influence of the factors temporarily raising it diminished and downward pressure from spare capacity persisted.

27 The main upside risk to the medium-term inflation outlook was that the period of above-target inflation would persist for longer than the Committee expected as a result of: expectations of above-target inflation becoming embedded in wage and price-setting behaviour; the margin of spare capacity in the economy being less than previously thought; or further upward external shocks to the price level from commodity prices. There had been little further upside news on any of these factors over the past month. Overall, most indicators of longer-term inflation expectations had stayed close to their series averages and there was little evidence of real wage resistance as nominal wage growth had remained subdued. And, having initially remained surprisingly resilient to slowing global activity, commodity prices had fallen from the high levels reached earlier in the year.

28 The main downside risk to the medium-term inflation outlook was that demand growth would be insufficient to absorb the margin of spare capacity in the economy, causing inflation to fall materially below the target in the medium term. There had been significant downside news about the factors influencing the outlook for demand in the two months since the August *Inflation Report* had been published. The pace of global expansion had evidently slackened, especially in the United Kingdom's main export markets. And heightened awareness of the vulnerabilities associated with the indebtedness of several euro-area governments and banks had led to a further deterioration in demand

prospects. While the worst risks had not crystallised, the threat of them doing so had resulted in severe strains in bank funding markets and financial markets more generally. These tensions in the world economy appeared to have already affected consumer and business confidence and could result in a further tightening of credit conditions, posing a threat to the recovery in the United Kingdom.

29 In the United Kingdom, the path of output had been affected by a number of temporary factors, but the available indicators suggested that the underlying rate of growth had moderated and would be close to zero in the fourth quarter. Household spending had been weak for some time and in the second quarter of 2011 had been only marginally higher than at its trough two years earlier. The squeeze on households' real income and the fiscal consolidation were likely to continue to weigh on domestic spending.

30 While the stimulatory monetary stance and present level of sterling should help to support demand, the weaker outlook for, and the increased downside risks to, output growth meant that the margin of slack in the economy would probably be greater and more persistent than previously thought. This made it more likely that inflation would undershoot the 2% target in the medium term, without further monetary stimulus. There had already been some stimulus imparted from the substantial downward movements in interest rates across the term structure over the past two months, although part of that was likely to have been in anticipation of policy rates remaining unchanged for longer than previously expected and further asset purchases by the Committee. Overall, the case for an expansion of the Committee's programme of asset purchases financed by the issuance of central bank reserves was compelling.

31 In terms of the timing of further asset purchases, there were clear arguments for acting quickly and decisively now that the need for further monetary stimulus had become clear. The Committee recognised that there could be some benefit in delaying a policy change until November, when the background could be explained in more detail in the *Inflation Report*. But, on balance, any advantage to delay was thought insufficient to outweigh the arguments for acting immediately.

32 There was considerable uncertainty over the scale of asset purchases necessary to keep inflation at target in the medium term. Depending on developments in the euro area and financial markets, the size of the stimulus could be adjusted in either direction. For some members, the substantial downside risks pointed to injecting a larger monetary stimulus than otherwise in order to place the UK economy in a stronger position were those risks to materialise.

33 Evidence on the impact and transmission channels of the first round of asset purchases, reviewed in the Bank's 2011 Q3 *Quarterly Bulletin*, indicated that, while there was considerable uncertainty about the magnitudes, the earlier asset purchases had had economically significant effects. There appeared to be no strong reason to expect the economic effect of further asset purchases to be materially different, but their impact would need to be kept under review. The size of the asset purchase programme could be adjusted if there were evidence that its marginal effects were different than past experience suggested.

34 The scale of the downward reassessment of the medium-term inflation outlook suggested that substantial further asset purchases were appropriate. In terms of the immediate decision, the Committee considered a range of asset purchases of between £50 billion and £100 billion. Committee members agreed that differences in the impact of asset purchases within this range were, in current conditions, likely to be outweighed by the degree of uncertainty about the outlook for inflation. Moreover, the size of the asset purchase programme would be kept under review in the light of subsequent analysis and events.

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

> Bank Rate should be maintained at 0.5%;
>
> The Bank of England should finance a further £75 billion of asset purchases by the issuance of central bank reserves, implying a total quantity of £275 billion of such asset purchases.

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.

36 It was agreed that the asset purchases would be of nominal gilts, conducted over a four-month period, and spread evenly across residual maturities over three years.

37 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.