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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 7 AND 8 SEPTEMBER 2011

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 September 2011.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1109.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 5 and 6 October will be published on 19 October 2011.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 SEPTEMBER 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 been particularly volatile over the past month and prices of risky assets had generally fallen. There appeared to be three factors underpinning these movements that had interacted with each other: continuing sovereign debt concerns, mainly focused on the euro area, but also in the United States; renewed concerns about banks, both in Europe and the United States; and perceptions that global growth was weakening. Though independent, each of these concerns was likely to have amplified the others.

3 Short-term interest rate expectations had fallen on the month reflecting a growing anticipation that official rates would remain unchanged for considerably longer than previously thought. In the United States and the United Kingdom, expectations were now for policy rates to remain unchanged for around two years, and market participants' view of the likelihood of further asset purchases had also increased. In the euro area, the likelihood market participants attached to the ECB cutting interest rates had been growing. Reflecting both these developments and increasing aversion to risky assets resulting in a flight to safety on the part of investors, longer-term spot interest rates had fallen markedly on the month, with ten-year government bond yields for the United States, United Kingdom and Germany reaching historically low levels. Ten-year forward rates had also fallen substantially this month.

4 In the euro area, sovereign bond yields had been volatile. In the early part of the month, Italian and Spanish ten-year government bond yields had risen to over 6%. Following the ECB's extension of its Securities Market Programme to the purchase of Italian and Spanish bonds, yields had initially

fallen back to around 5%, but they had subsequently risen a little. Both French and German five-year sovereign CDS premia had risen, having roughly doubled since May. That reflected ongoing concerns about the potential consequences of the fiscal problems in Greece.

5 For European banks in particular, short-term dollar funding conditions had been increasingly tight with quantities declining and maturities shortening. One consequence of the turbulence had been the virtual closure of corporate bond and bank term funding markets to new issuance. Since May, there had been no senior unsecured term debt issued by banks either in the United Kingdom or elsewhere in Europe. Over the past month there had been some covered bond issuance around the start of September but this had since stopped. While UK banks had already met a significant proportion of their funding needs for the year, if they were unable to access unsecured term funding markets for much longer they might feel pressure to reduce lending.

6 Internationally, equity markets had fallen sharply on the month, in part reflecting lower growth expectations and the interrelated concerns about the strength of financial systems. The major indices had fallen between 6% and 13% over the month as a whole, with the largest falls seen in the euro area. Banks' equity prices had fallen more sharply than the broader indices. Spreads had widened in corporate bond markets, and yields on financial companies' bonds had increased despite the fall in government bond yields. European corporate CDS premia had also risen sharply.

7 The sterling effective exchange rate had fallen slightly on the month, but had remained close to its average level over the year to date. The effective rates of the major currencies had been little changed. The Swiss authorities had announced a ceiling on the Swiss franc's exchange rate against the euro, at which point they would intervene to prevent further appreciation.

The international economy

8 Global activity indicators had continued to weaken. This had raised the likelihood of a more sustained and synchronised period of weak global growth than had appeared probable earlier in the year.

9 In the United States, the already soft second quarter GDP data had been revised down further. A range of other indicators had also disappointed; most notably, non-farm payrolls had been relatively

weak recently and had been unchanged in August. The ISM manufacturing survey in August pointed to negligible growth. While the non-manufacturing counterpart was firmer, it also indicated weak growth. Consumer confidence balances had fallen further to reach mid-recession levels. Of the shortfall in output relative to its previous trend, a significant part appeared related to the weakness of residential investment but with rather more down to lower consumption, in turn reflecting the weakness in employment and in labour income.

10 In the euro area, output growth had slowed by more than expected in the second quarter to 0.2% and there were now clear signs of growth slowing, even in the hitherto robust core countries. Having weakened in July, the Purchasing Managers' Indices had shown no signs of recovery, with the services activity index broadly unchanged in August and the manufacturing index falling below 50. Other surveys of business and consumer confidence had also weakened. Overall, this suggested negligible euro-area growth in the third quarter. While the German Federal Constitutional Court had rejected the claims that support for the troubled euro-area periphery countries was unconstitutional, considerable challenges remained and it was difficult to see the present uncertainty being resolved quickly. Looking further ahead, additional fiscal consolidation measures announced in some of the larger economies could also be expected to weigh on growth.

11 Survey indicators had continued to point to growth slowing in the major emerging economies, in part reflecting policy measures to reduce inflationary pressures taken earlier in the year. Commodity prices had fallen around the time of the previous MPC meeting but they had since partially recovered. It was perhaps surprising that the prospective slowdown in global growth and the growing likelihood of a resumption of Libyan supply had not had a greater impact on oil prices. It was possible that financial flows into commodity markets during the period of market volatility had helped to support prices, although there was little corroboration for this. Industrial metals prices had fallen on the month, while agricultural commodity prices had risen, reflecting supply factors.

12 On the basis of the recent surveys, it seemed likely that global growth would be weaker than the Committee had assumed in the August *Inflation Report*. The background of heightened uncertainty in financial markets, declining confidence and further fiscal consolidation had added to the sense that the period of weak global growth could be more protracted.

Money, credit, demand and output

13 The ONS's estimate of GDP growth in the second quarter had not been revised at 0.2%, with slightly weaker growth in manufacturing offset by stronger services sector output growth. Underlying growth was likely to have been stronger than this 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. The ONS had not provided an expenditure or income breakdown of GDP for the second quarter to allow for more time to prepare for the major methodological changes in the 2011 *Blue Book*. Manufacturing output had increased slightly in July.

14 Indicators of consumer spending growth had remained weak, consistent with the squeeze on real disposable incomes. Retail sales volumes (excluding fuel) had risen by only 0.2% in July and had been broadly flat over the past year. The August *CBI Distributive Trades Survey* had also pointed to depressed retail sales. House prices had fallen in August although the less volatile three-month on three-month measure had risen by 0.5%, the largest rise for over a year. Mortgage approvals for house purchase had remained low by historical standards.

15 Goods exports in June had been significantly weaker than expected. The weakness had been broadly based across both product and export destination, although some had come from the volatile oil sector and exports to the EU had been especially weak. Forward-looking indicators pointed to increased downside risks. For example, the CIPS/Markit export order index for August had fallen below its long-run average, with firms highlighting weaker market conditions in the United States and Europe. The Bank's Agents had reported that manufacturing and services firms continued to anticipate further modest growth in capital expenditure, although there had been a slight easing in investment intentions in recent months.

16 There had been a marked deterioration in the output surveys over the month, particularly for services. The CIPS/Markit services business activity index had fallen sharply in August and reflected a broadly based decline across sectors. The CBI services survey output balance had also fallen sharply in August, to its lowest level in almost two years. The CIPS/Markit manufacturing output index had declined only slightly in August, but was now at its lowest level since mid-2009. The August *Inflation Report* had already incorporated a material slowing in underlying demand growth in the third quarter which was largely corroborated by these surveys. Although there were few indicators of growth in the

fourth quarter at this stage, the CIPS/Markit expectations indices suggested GDP might be broadly flat in the fourth quarter. Overall, the Committee judged it likely that the period of weak growth would persist for longer than envisaged at the time of the *August Inflation Report*.

17 Much but not all of the recent slowing in GDP growth appeared connected to external developments, with trade linkages, financial markets and confidence as key transmission channels. The slowdown in global growth was already affecting UK exports and orders. So far, however, world trade had moved broadly in line with global GDP and orders were not falling sharply as they had in the autumn of 2008. In financial markets there had been a generalised fall in prices of risky assets and a deterioration in bank funding conditions. Those developments in global demand and financial markets had probably already affected confidence levels, with both business and consumer confidence measures falling this month. While the domestic headwinds to growth remained, including from fiscal consolidation and the weakness of real household incomes, it was not clear that these had intensified in recent months.

18 The recent deterioration in financial conditions could lead to a material tightening in the cost and availability of credit. M4 lending had remained weak and had declined in July, with the weakest monthly flow since April 2010. Twelve-month broad money growth had also stayed low but the three-month annualised growth rate of broad money had picked up to 3.5% in July. This had included a stronger increase in household deposits in the latest month.

Supply, costs and prices

19 Twelve-month CPI inflation had increased to 4.4% in July, 0.2 percentage points higher than in June. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI in August of 4.5% had been provided to the Governor ahead of publication. A detailed breakdown of the latest data was not available. Also in line with the pre-release arrangements, the Governor informed the Committee that producer input prices had decreased by 1.9% in August, mainly due to lower crude oil prices. Producer output prices had risen 0.1% on the month driven by price increases in chemical and pharmaceutical products but partially offset by a fall in petroleum product prices.

20 The increase in CPI inflation in July had included some upside news spread across several components with the largest effect being in clothing and footwear. However, the effect of this news

had been offset by lower energy prices and so the Committee's expectation for the near-term path for inflation had changed little. The ONS advance estimate for twelve-month CPI inflation in August was broadly as expected. The Committee's view remained that the most likely near-term path for inflation was for a temporary rise to a peak of over 5% before the year end, in part reflecting announced utility price changes. Inflation was then expected to fall back sharply in the first part of 2012, with the impact of the change in VAT dropping out of the twelve-month comparison contributing around 1 percentage point to the fall.

21 Beyond the near-term hump, the speed at which inflation declined would be influenced by the behaviour of inflation expectations and the degree of downward pressure from spare capacity. News on inflation expectations had remained mixed. Some measures of households' longer-term inflation expectations had drifted up in August and households' expectations were for inflation to fall more slowly than in the Committee's central forecast. But this pattern was similar to that when inflation peaked in 2008; inflation expectations subsequently fell as inflation itself did. Market-based measures of inflation expectations had changed little on the month.

22 The impact of inflation expectations depended on the extent to which they were reflected in wage and price-setting decisions. The three-month private sector settlement mean had picked up slightly in July but this could be attributed to a single large settlement which was probably affected by the forthcoming increase in the national minimum wage. Whole-economy pay growth had also risen slightly, driven by an increase in bonuses. A continuation of weak productivity growth in Q2 meant that annual unit wage cost growth looked less benign than pay growth, but overall there was relatively little news this month.

23 A key issue was the degree to which the weakening in the demand outlook would feed into employment. Employment growth had slowed in recent months and the unemployment rate had edged up. The broad message from the employment surveys had been that this trend was likely to continue, pointing to broadly flat employment over the next few months. If output growth were to slow sharply there was a risk of a more pronounced shedding of labour.

24 There remained a great deal of uncertainty regarding the amount of spare capacity in the economy and the economy's underlying rate of productivity growth. The latest reports from the Bank's Agents had indicated that manufacturing firms were operating with broadly normal levels of

spare capacity although there remained some slack in much of the services sector. Even if the pattern of demand were to rebalance quickly it would take time for the economy's supply potential to do so. It was also possible that weaknesses in the financial system were limiting the speed at which capital could be reallocated between different activities and that this could impair the economy's underlying growth rate now or in future.

The immediate policy decision

25 CPI inflation had remained well above the 2% target as a result of the temporary boost from higher energy and commodity prices, the increase in the standard rate of VAT and the past depreciation of sterling. The advance estimate of the August data had been in line with the Committee's expectation and inflation was expected to rise further in the coming months to over 5%, boosted by the announced increases in utility prices. The Committee's central view remained that inflation would then fall back to the target in 2012, as the impact of the factors raising inflation dissipated and as downward pressure was exerted by the slack in the labour market. There were risks around how far inflation would fall back and how quickly. The Committee discussed how those risks had evolved since its previous meeting.

26 The key risk to the upside was that the period of elevated inflation would persist for longer than the Committee expected. That could be 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 such as from commodity prices. Recent data on households' and firms' inflation expectations had been mixed but measures derived from financial markets had remained stable. Overall, most indicators of longer-term expectations had remained close to their series averages. Given that CPI inflation was expected to rise further, it was likely that near-term inflation expectations would rise too. But medium-term inflation expectations might also depend on the economic outlook, which had weakened. Wage growth had remained subdued and there was little to suggest that higher inflation expectations were feeding through into wage-setting behaviour.

27 The key risk to the downside was that demand growth would not be sufficient to absorb the margin of spare capacity in the economy, causing inflation to fall materially below target in the medium term. There had been significant downside news on activity over the month, including in the

United States and the core euro-area countries, which had pointed to a synchronised slowing in global growth. In the United Kingdom, there had been a marked deterioration in the business surveys, especially for services. Together they pointed to materially weaker growth in the second half of this year than that assumed in the August *Inflation Report*. Indicators of consumer spending also pointed to continued weakness. Overall, the risk that growth would be insufficient to reduce the margin of spare capacity had clearly increased and this would add to the downward pressure on inflation in the medium term. It was puzzling, however, that oil prices had not fallen back more in the face of the weaker news on global activity.

28 The weakness in the global activity indicators had interacted with renewed concerns about the resilience of financial systems and the risks emanating from euro-area sovereign debt markets. Volatility in financial markets had been high during the month and there had been substantial falls in the prices of some risky assets. If recent conditions in capital markets persisted, European banks could face difficulties obtaining sufficient funding to continue current levels of lending. These conditions could affect UK banks even though they had increased their capital and liquidity levels over the past two years and had already met a significant proportion of their funding needs for the year as a whole. An increase in the price and a reduction in the quantity of funding to banks could lead to slower growth in lending and activity.

29 There remained substantial risks to inflation in the medium term in both directions. While there had been little news on the upside risks to inflation, the downside risks had clearly increased further. In the light of that outlook, Committee members reviewed the range of possible policy actions available to them to loosen monetary conditions were that judged appropriate. One possible action was to restart the asset purchase programme. This programme had been primarily focused on purchases of UK government bonds financed by the issuance of central bank reserves. There was inevitable uncertainty about the precise impact of asset purchases on demand and inflation, but asset purchases were an instrument that would continue to be effective in further loosening monetary conditions in the current context. The Committee also discussed a range of other possible policy options including: changing the maturity of the portfolio of assets held in the Asset Purchase Facility; revisiting the earlier decision not to lower Bank Rate below 0.5%; and providing explicit guidance about the likely future path of Bank Rate beyond the information about the Committee's judgement of the medium-term outlook for inflation contained in the *Inflation Report* and the MPC minutes. At the

current juncture, none of these options appeared to be preferable to a policy of further asset purchases should further policy loosening be required.

30 For one member, the balance of risks to inflation had further strengthened the case for an immediate expansion of the Committee's programme of asset purchases, financed by the issuance of central bank reserves. For that member, the pattern of demand overseas and domestically had suggested an underlying weakness for some time. The news on the month had suggested a further increase in the downside risks reflecting both the change in overseas conditions and the vulnerabilities in the domestic economy. The evidence suggested that there remained a significant margin of spare capacity. Measures of inflation expectations and earnings growth had remained stable and were unlikely to drift upwards. So it was likely that inflation would fall below the target in the medium term without some further monetary policy response.

31 Other members judged that it was appropriate to maintain the current stance of policy at this meeting. The current weakness of demand growth was likely to persist for longer than suggested by the central case in the *August Inflation Report*. This meant that the balance of risks to inflation in the medium term was likely to have shifted further to the downside. Most of these members thought that it was increasingly probable that further asset purchases to loosen monetary conditions would become warranted at some point.

32 Among the members voting to leave the stance of policy unchanged there were a number of considerations. There was some merit in waiting to see how developments evolved in the coming weeks, including the actions of overseas authorities. Some loosening had already been provided by the lower path for market interest rates, although whether that would be sufficient to offset the deterioration in demand prospects was unclear. There were also risks associated with easing policy during a period of sustained above-target inflation and there were concerns about how quickly inflation would fall back to target. Different members placed different weights on these considerations. For most members, the decision of whether to embark on further monetary easing at this meeting was finely balanced since the weakness and stresses of the past month had significantly strengthened the case for an immediate resumption of asset purchases. For some members, a continuation of the conditions seen over the past month would probably be sufficient to justify an expansion of the asset purchase programme at a subsequent meeting.

33 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, the Committee voted unanimously in favour of the proposition.

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.

34 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.