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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 4 AND 5 APRIL 2012

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 April 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1204.aspx>

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 May will be published on 23 May 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 APRIL 2012

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 Conditions in financial markets had continued to normalise, with less focus solely on euro-area developments and more on a wider range of data. Option-implied volatilities across a number of assets had fallen substantially compared with six months previously. Nonetheless, a negative skew remained evident from the distribution of prices indicating that financial market participants continued to place somewhat more weight on the possibility of downside risks rather than upside risks crystallising.

3 The functioning of bank funding markets had been much improved relative to the second half of 2011 and the term of new issuance had lengthened a little further. The major UK banks had issued £8 billion of debt in public markets in March, close to average monthly issuance during the first half of 2011, and in recent months a growing share of new debt had been unsecured. Secondary market spreads on residential mortgage-backed securities and covered bonds had continued to narrow. There remained risks to bank funding markets, including from the possibility of further ratings downgrades.

4 The fall in short-term bank funding costs had been greater in the euro area, indicating that perceptions of short-term funding risk in euros had fallen considerably, and Euribor-OIS spreads were now below their sterling equivalents for maturities of less than one year. In contrast, ten-year yields on Italian and Spanish government bonds had risen relative to those on German bunds. CDS premia on a number of Spanish banks had also increased relative to those on other banks in the euro area.

5 The path of Bank Rate implied by market prices had remained broadly unchanged on the month, while those for official interest rates abroad had risen marginally. Long-term forward rates had reacted

to statements by the US Federal Reserve and the results of the latest round of US bank stress tests, among other things, and were also slightly higher internationally. Long-term real interest rates remained exceptionally low, however. The sterling effective exchange rate had risen by 1% during March and was 6% higher than in the middle of 2011.

6 Major UK and European equity indices had changed little on the month, while US equity prices had risen by around 5%. UK corporate bond spreads had continued to fall and demand for bonds had been robust. Non-financial corporations had issued new bonds at a record rate during 2012 so far and March had seen the first sub-investment grade issue by a UK company since Summer 2011. But contacts had reported that liquidity across a wide range of secondary markets had remained poor and volumes were said to be low.

The international economy

7 Recent near-term activity indicators had developed broadly as expected and continued to point to a gradual, albeit uneven, recovery in global growth. Data on world industrial production and trade in goods for the beginning of the year had confirmed the pickup seen in JPMorgan's global composite Purchasing Managers' Index (PMI) and were consistent with growth rates similar to those in the first half of 2011 before the slowdown in the second half of the year.

8 In the euro area, the March PMIs continued to suggest a decline in activity in the first quarter, although the signal from measures of business confidence had been slightly less weak. Unemployment had risen to 10.8% in February. There remained wide disparities in labour market performance across the euro area, with the unemployment rate in Spain having risen to 23.6%, but that in Germany remaining stable at 5.7%. The Spanish government had announced further austerity measures during the month. Even so, the weaker growth outlook meant that the government's target for its deficit in 2012 as a share of GDP was almost 1 percentage point greater than previously planned. In Germany, there had been some indication of a pickup in wage settlements, with a deal covering a large number of public sector workers granting a 6.3% increase over two years. A faster pace of wage growth in Germany would help to facilitate rebalancing of the euro-area economy.

9 During the month, an agreement on the restructuring of Greek sovereign debt issued under domestic law had been concluded, and the European authorities had agreed to make available a total

sum of €700 billion through the European Financial Stability Facility and the European Stability Mechanism. Of this, €200 billion had already been committed.

10 Activity indicators in the United States had pointed to a rate of GDP growth in the first quarter of 2012 not far below that seen in the second half of 2011. Real household spending had increased by 0.5% in February and the personal savings rate had fallen. The manufacturing ISM index for March had risen by one point to 53.4, although the non-manufacturing index had dropped back. The signal from the labour market was stronger, with the fall in unemployment since the summer having outpaced the recovery in output growth. This might suggest that the GDP data could be revised up, although it was also consistent with firms returning to more normal rates of labour utilisation having shed workers aggressively during the downturn.

11 Taking data for January and February together, Chinese indicators had generally been consistent with a continuation of the gentle slowing in activity growth seen over the previous year. At the annual meeting of the Chinese National People's Congress at the beginning of March, the authorities had lowered their target for GDP growth in 2012 from 8% to 7.5%. The target for inflation had been left unchanged at 4%.

12 Oil prices had reacted little to speculation surrounding both a possible increase in Saudi Arabian production and a partial release of strategic reserves by some OECD countries. Prices had fallen a little on the month but were still significantly higher than at the turn of the year. The prices of agricultural commodities and industrial metals had generally been stable.

Money, credit, demand and output

13 According to the third ONS estimate, GDP had fallen by 0.3% in the fourth quarter of 2011, 0.1 percentage points weaker than reported in the second release. The ONS had also revised down the path for household consumption during 2011 such that the level at the end of the year was 0.5% lower than previously estimated. Together with an upward revision to households' income, this implied a sizable revision upwards to the estimated household saving rate. This now appeared to have fallen back only modestly since its peak in 2009.

14 In line with the usual pre-release arrangements, the Governor informed the Committee that manufacturing output had fallen by 1% in February and that output in January had been revised down. This was somewhat at odds with the more positive message from the corresponding business surveys. The data on service sector output in January were consistent with solid growth in services in the first quarter of 2012. The CIPS/Markit indices for manufacturing, services and construction had all risen in March and the composite expectations balance had reached its highest level in over a year. The BCC *Quarterly Economic Survey* had recorded rising sales balances for both manufacturing and services in the first quarter. And the Bank's Agents had reported a broad-based, if still modest, pickup in output growth over the previous three months. Consistent with these reports, household and corporate broad money growth had increased in January and February on a three-month annualised basis.

15 For the second month in a row, the ONS had reported a particularly large contraction in construction output, which it estimated to have fallen by around 12% in each of December and January on a non-seasonally adjusted basis. Even if activity were to rise strongly in February and March, measured construction output was likely to show a very sharp fall in the first quarter as a whole. This was at odds with other indicators of construction activity from CIPS/Markit, Experian and the Bank's Agents, which had generally pointed to much smaller declines around the turn of the year. Although construction orders had been weak, the Construction Products Association was expecting only a modest reduction in output during the year as a whole.

16 In the absence of revisions to the latest vintage of data, the contraction in measured construction output was likely to depress measured GDP growth significantly in the first quarter. Indeed, it was possible that the ONS's preliminary estimate for GDP could record a fall in aggregate output. In the second quarter, some activity was likely to be lost because of the extra bank holiday associated with the Queen's Diamond Jubilee celebrations. With output having already contracted in the fourth quarter of last year, the Committee could not rule out the publication of official data showing GDP falling for three successive quarters. Nevertheless, the Committee's judgement was that, abstracting from both the puzzling weakness in measured construction output and the impact of one-off factors, the economy appeared likely to be expanding, albeit only modestly, in the first half of the year.

17 Further out, the speed at which domestic demand growth would recover would depend on, among other things, the availability of credit to the household and corporate sectors. The impact of past increases in costs for UK banks of raising retail and wholesale deposits had been continuing to

feed through into higher borrowing costs for some households and businesses. Respondents to the Bank's latest *Credit Conditions Survey* had expected some further tightening in credit standards for secured borrowing by households, although less so for unsecured borrowing. Some further rise in spreads on loans to businesses had also been expected. In a recent survey of businesses carried out by the Bank's Agents, most companies had not reported a significant worsening in overall credit availability. A sizable minority had seen a rise in the cost of finance, although in most instances this had not led to a material change in investment plans. There had been signs of a greater tightening in conditions for the construction, property development and consumer services sectors, however, and where contacts had reported tighter conditions, they were more likely than other businesses to have lowered capital spending or staffing.

Supply, costs and prices

18 Twelve-month CPI inflation had fallen to 3.4% in February, down from 3.6% in January and its recent peak of 5.2% in September. If anything, the decline in February had been marginally less than the Committee had expected, and seasonally adjusted annualised monthly inflation rates had been somewhat higher than the inflation target. There was a risk that inflation would fall less rapidly in the near term than the Committee had anticipated in its February *Inflation Report* central projection. UK wholesale gas prices had risen by around 5% since then. This, together with the rise in oil prices since the start of the year, would put upward pressure on retail energy and petrol prices. And the additional increase in duties announced in the *Budget* would add around 0.1 percentage points to annual inflation from April.

19 Some statistical projections were pointing to a path for CPI inflation in the coming months higher than would be consistent with the Committee's central path from the February *Inflation Report* projections. But, as with all forecasts, there was a large margin of error around them, and they did not capture all of the forces acting on prices. In practice, the speed and extent of any further fall in inflation would depend on the rate at which external price pressures eased, and how rapidly domestically generated inflation would fall in response to weaker cost and price pressures from a recovery in productivity growth and the margin of spare capacity.

20 Beyond recent rises in oil prices, the impact of external price pressures was difficult to gauge. The contribution of goods prices to twelve-month CPI inflation had fallen back only marginally in

February. This was consistent with a greater degree of pass-through into consumer prices from past increases in import prices, or upward pressure on margins from other sources. But it was also consistent with quicker pass-through, which would imply less upward pressure on consumer prices to come from this source further out.

21 As regards domestically generated inflation, the picture from the labour market had been mixed. Private sector employment had risen by 45,000 between September and December and total employment had been stable in the three months to January. The unemployment rate had risen in recent months to 8.4% and surveys of recruitment intentions had, taken together, continued to point to modest falls in employment. It was probable that a considerable degree of slack would persist for some time in the labour market. That said, contacts of the Bank's Agents did not foresee a major shakeout in private sector employment.

22 Private sector wage settlements seemed to be running at an annual growth rate of around 2.5%. Whole-economy average weekly earnings had risen by only 1.4% in the three months to January compared with the same three months the year before, 0.5 percentage points less than the rise recorded in the three months to December, partly because of a fall in regular pay drift. Labour market slack was acting to restrain nominal wage growth, which was running at rates well below pre-crisis norms. But, alongside this, labour productivity growth had been weak for some time, so that a reduction in unit labour cost growth had been much less evident. Moreover, labour productivity had continued to be weak in the fourth quarter so that, if anything, unit labour costs were likely to have grown faster than in the previous quarter.

23 It was also possible that firms would seek to increase their mark-up over labour costs in setting their prices. The share of profits of private non-financial non-oil companies in GDP was lower than at any time in the previous 25 years. To the extent that demand continued to be slow to recover, firms might seek to restore profit margins only gradually. Set against that, many firms had either less access to credit or access on more unfavourable terms than was the case before the crisis. This might lead them to be less willing to invest in gaining market share by keeping prices low, as they would have less recourse to external sources of funds should they run into cash-flow difficulties.

The immediate policy decision

24 The current challenges facing the Committee as it sought to set monetary policy in order to meet the inflation target in the medium term had been thrown into sharp relief by the downside news on the near-term path of GDP likely to be published by the ONS and by the upside news on the near-term path for inflation.

25 There had been unexpected falls in the ONS's measures of output in manufacturing and, in particular, construction. The sharp falls in construction output in December and January were perplexing, and the Committee was minded not to place much weight on them, particularly given that other indicators of construction activity had suggested far more modest declines. The mechanical impact of the drop in construction output, together with the likely subsequent loss of activity around the Jubilee bank holiday, could lead the ONS to report further falls in GDP in both the first and second quarters of this year. But a wide range of survey indicators pointed to a moderate rate of growth in activity in the first half of the year and this was supported by official data on services output. Underlying aggregate activity growth was likely, if anything, to have picked up since the second half of 2011.

26 Twelve-month CPI inflation had fallen for five successive months, to 3.4% in February from a recent peak of 5.2% in September. This fall had been welcome but had been slightly less than the Committee had expected. That in itself was not a significant cause for concern but, alongside the recent rise in oil and gas prices, as well as the duty changes announced in the *Budget*, it meant that the path for inflation in the short run was likely to be higher than indicated in the most recent *Inflation Report* central projections. The speed at which inflation would return towards target could not be judged with any precision and there were risks on both sides.

27 To the upside, the risk was that elevated inflation might be more persistent than the Committee expected and that the Committee's commitment to achieving the target might be called into question. This risk arose from both external and domestic sources. Further shocks to oil and other commodity prices remained a possibility, and there could be greater external price pressures from other sources, or greater pass-through of these pressures to consumer prices. Domestically, companies could seek to rebuild margins more aggressively than anticipated, perhaps with a view to achieving a target for cash flow in an environment of uncertain credit supply or because the prolonged period of above-target

inflation had enabled them to raise their prices more easily. Against that backdrop, it was notable that seasonally adjusted annualised monthly inflation rates were somewhat higher than the inflation target. The large margin of slack in the labour market was restraining the rate of growth of earnings. But given the continuing weakness in productivity growth, it was possible that nominal wages were nonetheless still increasing rapidly enough that unit labour cost growth was consistent with the inflation target.

28 To the downside, the risk was that demand would not be strong enough to absorb the considerable margin of spare capacity in the economy. In the near term, it was possible that the ONS would report further contractions in output in the first and second quarters. That might further damage household and business confidence, even if the underlying pace of economic expansion were stronger. It was also possible that underlying growth was not as strong as suggested by the business surveys. Further out, it was not easy to assess the speed at which domestic demand growth would return to more normal rates. Although on current plans the pace of the fiscal consolidation was likely to slow, it would still act as a drag on growth for several years. The latest upward pressure on prices was liable to delay the point when real household income would begin to rise again. And, although any desire by households, firms and banks to build up a buffer of savings or to reduce leverage was unlikely to have a permanent effect on the growth rate of activity, it could have a persistent effect whose duration was very difficult to judge.

29 The recovery in activity in the global economy looked to be proceeding broadly as expected. But financial market concerns about the indebtedness and competitiveness of some euro-area countries remained and, if anything, had intensified on the month. Even if the worst risks did not crystallise, the process of rebalancing was likely to act as a persistent drag on the euro-area periphery as fiscal consolidation continued and real incomes were depressed. And, notwithstanding the recent decline in bank funding costs, there remained a high degree of uncertainty over how this rebalancing 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 and more challenging external environment for the United Kingdom.

30 Turning to the policy decision, a number of considerations were discussed. On the one hand there was a risk that inflation would fall more slowly than assumed in the February *Inflation Report* projections, and the recent flow of data provided some support for this view. With underlying activity

recovering, there was a greater chance than before that above-target inflation would persist into the medium term, whether because of elevated external price pressures, a rebuilding of margins or a rise in costs.

31 On the other hand, while the news about the near-term path for inflation was unwelcome, there was little solid evidence yet that the balance of risks to inflation in the medium term had changed. There was a large degree of slack in the labour market, and there was a risk that business and household sentiment could be further dented either by reports of the economy re-entering recession or by deterioration in the situation in the euro area. Moreover, persistently weak growth might impair the future supply capacity of the economy through hysteric effects: that risk could be attenuated by a more aggressive loosening of policy in the near term. Should the possibility of inflation being above target in the medium term increase, the Committee could subsequently withdraw some of the monetary stimulus.

32 Different members put different weights on these arguments. For most members, there was no sufficient reason to change either Bank Rate or the quantity of asset purchases agreed at the Committee's February meeting. Moreover, for them, it seemed sensible to let the current programme of asset purchases run its course while coming to a view on medium-term prospects in the context of the May forecast round. For one member, the balance of risks continued to warrant an expansion of the asset purchase programme this month, although the decision was finely balanced.

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 continue with the programme of asset purchases totalling £325 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, eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher, Adam Posen and Martin Weale) voted in favour of the proposition. One member of the Committee (David Miles) voted against, preferring to increase the size of the asset purchase programme by a further £25 billion to a total of £350 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

Tom Scholar was present as the Treasury representative.