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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 1 AND 2 AUGUST 2012

These are the minutes of the Monetary Policy Committee meeting held on 1 and 2 August 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1208.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 5 and 6 September will be published on 19 September 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 1 AND 2 AUGUST 2012

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 Market participants had been focusing on changes, and prospective changes, in policy in the major economies. Short-term interest rates derived from six-month overnight index swaps (OIS) had decreased by around 10 basis points in the United Kingdom to 0.3%, which appeared to reflect expectations that the Committee might at some point reduce Bank Rate further. But they were still higher than equivalent rates in the United States and, especially, in the euro area, reflecting in part the decision earlier in the month by the European Central Bank (ECB) to cut its deposit rate to zero. Official interest rates in the advanced economies were expected by market participants to remain exceptionally low for several years to come.

3 There had been some further divergence in government bond yields. Longer-term interest rates in the United Kingdom had fallen over the month as a whole – reflecting further safe-haven flows in part. The yield on ten-year UK government bonds had dropped to 1.7% and that on 30-year government bonds was below 3.5%. Spreads over equivalent German government bonds had also fallen. In contrast, yields on Spanish and Italian government debt had risen during the first half of the month, particularly for bonds of maturities between two and five years. These increases had largely unwound following comments by ECB Governing Council members regarding the scope for the ECB to deploy additional policy instruments if needed.

4 Sterling had appreciated further, particularly relative to the euro. In trade-weighted terms, sterling had risen by almost 1% since the Committee's July meeting and was 3.5% higher than at the start of the year. Although sterling remained over 15% lower than it had been five years earlier, it was

around 5% higher than its average in 2011. A continuing appreciation could have a material influence on the outlook for growth and inflation in the United Kingdom.

5 Libor rates had fallen further relative to OIS rates. That would reduce lending rates for businesses with floating-rate loans linked to Libor. The details of the Bank of England and Government Funding for Lending Scheme (FLS) had also been issued during the month and the drawdown window had opened. In response, a number of banks had already announced reductions in the rates on certain mortgage and small-business loans. It would take a while, however, before it would be possible to assess with any confidence the impact the Scheme was having on lending.

6 The major equity indices had been volatile but had ended the month largely unchanged. Compared to the beginning of the year, UK equity prices were little changed, those elsewhere in Europe had generally fallen, and US prices had risen – perhaps reflecting views about relative economic prospects. Notwithstanding continued strong demand for corporate debt, bond issuance by UK non-financial companies had slowed somewhat. Although the number of companies that had raised finance through issuing bonds was considerably greater than before the financial crisis, small and medium-sized businesses generally still did not have access to bond markets.

The international economy

7 Recent data had continued to suggest a weak near-term outlook for global activity. In the euro area, monthly indicators had remained consistent with a fall in output in the second quarter and there had been no improvement in the composite Purchasing Managers' Index (PMI) for July. With the forward-looking business expectations index for services having fallen for two successive months, and with respondents to the ECB's latest Bank Lending Survey having reported an additional tightening in credit conditions, a further contraction in GDP was probable in the third quarter.

8 The European authorities had approved the use of the European Financial Stability Fund (EFSF) and, prospectively, the European Stability Mechanism (ESM) to recapitalise the Spanish banking system. Reports during the month had suggested that several regional administrations in Spain would apply to the central government's Regional Liquidity Fund, raising concerns that targets for Spanish fiscal consolidation might not be met and that the country might need to seek further financial assistance. That would place strain on the remaining resources available under the EFSF/ESM.

The European authorities were due to decide during the autumn whether Greece would be eligible to receive the next tranche of funds under its programme.

9 There had been little significant news about the economic situation in the United States. GDP had increased by 0.4% in the second quarter, broadly confirming the signal from previous activity indicators of a modest rate of expansion. Employment growth had continued to be weak, with the average monthly increase in non-farm payrolls having slowed to 75,000 in the second quarter from around 225,000 in the first quarter. There had been mixed signals from the consumer confidence surveys, with some reports that uncertainty over the size of the prospective fiscal contraction at the beginning of 2013 was beginning to weigh on demand. Congressional leaders had agreed a Continuing Resolution to fund the federal government until the end of March 2013, but there seemed little prospect of an agreement before the Presidential elections in November on the size and speed of the consolidation thereafter.

10 Four-quarter growth in Chinese GDP had fallen back to 7.6% in the second quarter, but both the HSBC manufacturing and services PMIs had risen. Nonetheless, the underlying picture of a deceleration in activity had continued. Policymakers in a number of Asian economies had loosened monetary policy further, with cuts in official interest rates in both China and Korea. Notwithstanding these cuts, the level of official interest rates in the major emerging markets was generally much higher than in the advanced economies, implying there was scope for further loosening in the stance of policy should that become warranted.

11 In spite of the continuing slowing in the emerging economies, commodity prices had generally risen on the month, particularly for oil and agricultural commodities, which were both 7% higher. In both cases, supply factors had probably been the principal driver: production stoppages in the North Sea had held oil production back, while the drought in the United States had led to a sharp rise in corn prices in particular.

Money, credit, demand and output

12 According to the preliminary estimate by the ONS, UK GDP had fallen by 0.7% in 2012 Q2, the third consecutive quarter of contraction, including a significant decline in construction output. While GDP had been rather weaker than median expectations, it was broadly in line with what the

Committee had anticipated at the previous meeting. It was probable that around half a percentage point of the fall had been accounted for by the additional bank holiday for the Diamond Jubilee. Manufacturing and services output was estimated to have decreased by over 2% in June, similar to the decline associated with the Golden Jubilee in 2002.

13 Some of the reduction in construction output might also prove temporary, but this was unlikely to explain much of the 10% fall in activity that the sector had seen since the beginning of the year. Surveys of construction output and orders had indicated a much more moderate pace of decline over recent months. The data on new orders did not suggest further large declines in activity were probable, but neither did they indicate much likelihood of a strong bounceback.

14 Measured GDP could be expected to rise sharply in the third quarter as the Diamond Jubilee effect unwound. Set against this, the Markit/CIPS manufacturing output index had fallen by nine points in July, its largest ever monthly fall. The Committee continued to judge that underlying activity had expanded very modestly in the first half of the year, but it was possible that it would be flat in the third quarter.

15 Looking back over a longer period, the recovery had stalled at the end of 2010, following a period of growth from the middle of 2009. Output had been broadly flat since then, a considerable shortfall compared to expectations formed at the time. It was possible to point to factors that could plausibly account for much of this disappointing performance. The rise in commodity prices and other import prices, and the increase in VAT, had depressed real incomes and household spending. Government spending on goods and services had recently been lower than planned. The recovery in overseas demand for UK goods and services had been weak, particularly in the euro area, where the outlook remained fragile and unusually uncertain. Funding conditions for banks had worsened, again in part as a result of the deterioration in the situation in the euro area, and credit conditions had tightened.

16 The impact of some of these factors, such as the drag on growth from commodity and other import prices, had begun to wane. The recent expansion of the asset purchase programme, together with the FLS and other policies that aimed to boost bank lending, would act to underpin activity. It was probable, therefore, that GDP growth would begin to pick up somewhat; indeed four-quarter growth in broad money had already increased to 3.5% in the second quarter, having been growing at

less than half of that pace at the end of 2011. But other factors, such as the uncertainty over the evolution of the euro-area crisis, were unlikely to dissipate quickly and so would continue to dampen demand growth. More broadly, many previous financial crises had been associated with sustained periods of weak output; it was by no means clear when the effects of the recent financial crisis would cease to restrain the recovery.

Supply, costs and prices

17 Twelve-month CPI inflation had fallen to 2.4% in June from 2.8% in May. The reduction in inflation had been concentrated in goods, where prices were rising much less rapidly than in the second half of 2011. Much of the decrease in goods price inflation had been accounted for by falling prices for food and energy. The rise in oil and agricultural commodities on the month had meant that there was unlikely to be much further near-term downward pressure on prices from this source. But prices for other goods were also rising less rapidly. There had been a large drop in the contribution of clothing and footwear prices to aggregate inflation in June, due partly to summer sales having been brought forward relative to 2011. This was likely to have reflected in part unusually wet weather and so would not be expected to persist. But it might also be indicative of weaker underlying demand pressures or the impact of higher import prices waning.

18 The labour market had continued to be surprisingly resilient in the face of the contraction in activity. The unemployment rate had fallen to 8.1% in the three months to May and employment was estimated to have risen by 181,000, with increases in the numbers of both full-time and part-time employees. Despite recording a large fall in the output index for July, the Markit/CIPS employment index for manufacturing had risen. During the month, the ONS had published the first results of the 2011 Census for England and Wales. These had revealed a larger population than previous estimates, due in part to net immigration higher than previously assumed. But, by and large, the new estimates had simply confirmed the message from direct indicators of migration flows, such as air passenger numbers, and so did not change the Committee's understanding of the labour market to any great extent.

19 Employment growth had outpaced the growth in output over the previous two years meaning that measured productivity had fallen. Strong hiring could indicate that activity was stronger than currently measured, although the measurement error would have to be unusually large to account for most of the

productivity shortfall. While it was possible to identify factors that had contributed to the weakness in activity, there was as yet no clear explanation as to why at the same time employment had continued to increase and why productivity had therefore been so weak.

20 On the one hand, the weakness could reflect a persistent slowing in underlying productivity growth. Problems in the banking system might have prevented some companies from obtaining finance to expand their operations, while others might have found their production constrained by restricted access to working capital. Contacts of the Bank's Agents had reported that some companies had increased their professional staff devoted to risk and compliance.

21 On the other hand, the weakness in productivity might be cyclical. Some companies might have needed to retain a certain minimum level of staff to continue operating, and depressed trading conditions could mean that employees had to work harder to generate new business. In addition, companies might have maintained or taken on new employees in the expectation of an increase in demand, either domestically or overseas, depressing measured productivity in the interim. Should that increase in demand fail to materialise, they could be forced to reduce staffing again, perhaps significantly. But equally, some might be taking advantage of the lower exchange rate and the rebalancing of global demand by seeking to enter new markets. The process of reorienting production and shifting labour accordingly could be quite long and drawn out, during which time measured productivity might increase only slowly, but might nonetheless be fruitful in the longer run.

22 Wage pressures had remained muted. Private sector regular pay in the three months to May had grown by 2.1%, relative to the same period a year earlier. And data from commercial providers and the Bank's Agents had continued to suggest that basic pay settlements were lower than in the previous year, with a proportion of pay increases clustered around zero. The weakness in output and strength in employment meant, however, that the level of productivity had been lower than a year earlier. That, in turn, implied that private sector unit wage costs had grown at around or above pre-crisis average rates in the first half of the year.

The August GDP growth and inflation projections

23 The Committee reached its policy decision in the light of the projections published in the *Inflation Report* on Wednesday 8 August.

24 GDP had fallen over the first half of 2012, in part due to unusually large falls in measured construction output and the additional Jubilee bank holiday in the second quarter. But abstracting from such distortions, underlying GDP growth remained very subdued. Weaker world growth had pulled export growth down. And although the squeeze on real income growth was lessening, it continued to weigh on consumption growth. That squeeze was expected to continue to ease and, alongside the policy stimulus announced since May, spur a gradual recovery in GDP growth.

25 The external environment, and in particular developments in the euro area, would remain a key influence on UK activity. Several euro-area countries needed to rebuild their competitiveness and reduce their indebtedness. The Committee's projections assumed that the euro-area authorities took sufficient steps towards fiscal, financial and political integration to boost confidence, and, over time, allow these countries to make the necessary adjustments in an orderly manner. Even so, that adjustment process was likely to weigh heavily on euro-area activity, with growth likely to remain weak for much of the forecast period.

26 Higher bank funding costs – in part reflecting euro-area developments – had put upward pressure on lending rates for households and businesses. The recently introduced FLS should reduce those lending rates, encourage more lending and support demand, but there was uncertainty around its impact.

27 The Committee judged that four-quarter GDP growth was likely to pick up gradually. Growth was judged likely to reach a similar rate to that expected in the *May Report* in 2013 Q3, as the downside news on the global backdrop was offset by the greater policy stimulus. Further out, however, the growth profile was somewhat lower than in May. On the assumption that Bank Rate moved in line with market interest rates and the stock of purchased assets was held constant at £375 billion, growth was now judged more likely to be below than above its historical average rate in the second half of the forecast period. That weaker outlook in part reflected the possibility that the factors contributing to the weakness of growth since the financial crisis might persist. But the

continued experience of weak output and productivity meant that the Committee was particularly uncertain about the demand outlook, and had widened the growth distribution to reflect that. To the extent that there was a common component to the risks to demand and supply, those risks had fewer implications for the outlook for inflation.

28 Even with the recovery in growth, the level of output was not likely to rise above its pre-crisis level until 2014. Although much of the past fall in output had been accompanied by supply weakness, it was likely that a sizable margin of spare capacity existed at the start of the forecast, largely concentrated in the labour market. That was likely to close somewhat over the forecast period.

29 CPI inflation had continued to fall, reaching 2.4% in June. The decline over the previous three months in part reflected lower commodity prices, but broader inflationary pressures also appeared to have been somewhat weaker than previously thought. Largely reflecting that news, inflation was now judged likely to fall back further this year, a profile lower than three months ago. Inflation would be sensitive to developments in commodity markets. It would also depend on domestic inflationary pressures.

30 Wage growth had remained weak, in part reflecting downward pressure from elevated unemployment. But that had not been enough to outweigh the weakness in productivity growth and companies' unit wage costs had been growing at close to average rates. The path of inflation would depend, in part, on the extent of the recovery in productivity and how quickly wages reacted to that. Inflation would also depend on the extent to which companies, especially those in the consumer-facing sector, raised prices relative to their costs, thereby restoring margins.

31 On the assumption that Bank Rate moved in line with market interest rates and the stock of purchased assets was held constant at £375 billion, the Committee judged that inflation was a little more likely to be below the target than above it for much of the second half of the forecast period. At the forecast horizon, those risks were broadly balanced, but there remained a three-in-four chance that inflation would be more than half a percentage point away from the target. Beyond the near term, the most likely path for inflation was similar to that in May. But the risks around the central projection were judged to be more evenly balanced, as the risk that elevated expectations would put upward pressure on inflation had waned.

The immediate policy decision

32 The Committee set monetary policy to ensure that CPI inflation was on track to meet the 2% target in the medium term. Inflation had decreased from a peak of 5.2% in September 2011 to 2.4% in June, and it was likely that it would return to rates close to the target in the coming months. The Committee considered the factors that would affect inflation thereafter.

33 The key uncertainty surrounded the outlook for demand, the path for supply capacity that would accompany it and the impact of any slack on inflation. GDP had contracted by 0.7% in the second quarter, the third successive quarter of falling output. Around half a percentage point of this fall could probably be attributed to the impact of the additional bank holiday for the Diamond Jubilee, and much of that was likely to be recovered in the third quarter. Nonetheless, output growth in manufacturing and services, excluding the impact of temporary factors, had been weak and indicators over the month had suggested that it would remain so in the third quarter. This would continue the disappointing pace of recovery in GDP, which had been broadly flat since the second half of 2010.

34 There were reasons to believe that demand growth would begin to pick up, however. Much of the weakness in activity over the recent past could be accounted for by factors whose influence was now waning. Commodity and other import prices were no longer dampening real income growth and this boost to growth in household purchasing power should encourage some increase in spending. Since the time of the *May Inflation Report*, market interest rates over the next three years had fallen by an average of around 50 basis points and the asset purchase programme had been expanded. And the FLS had opened, which would lead to lower funding costs for banks and encourage lending. Although it was far too early to come to any sort of assessment of the impact of the FLS, it was encouraging that a number of banks had decided to cut rates on some mortgage and small-business loans. Indeed it was possible that the impact of the Scheme might be somewhat greater than the relatively cautious assumptions embodied in the *August Inflation Report* projections.

35 Set against that, other factors restraining demand were likely to remain in force or could even worsen. The global economy had continued to slow and very substantial risks remained in the euro area. These could, if they crystallised, have a considerable impact on the stability of the global banking system and on economic activity in the United Kingdom. Even if a disorderly outcome were avoided, it was probable that the continuing threat of such an event would weigh on domestic

economic activity for some time to come. Indeed, some banks had been planning to cut their lending to the UK economy in the coming months, before the details of the FLS had been announced. The Committee also noted the gradual appreciation of sterling, particularly against the euro, which weakened the prospects for a rebalancing of demand towards net exports.

36 Even though it was possible to identify factors that had limited the recovery in activity, the conjunction of weak output and moderate growth in employment that had prevailed over the past two years was more difficult to understand. Measured productivity had continued to fall substantially short of its pre-crisis path, with little immediate sign of any lost ground being clawed back. On the one hand, this might reflect the nature of the rebalancing process the economy was undergoing, as companies entered new sectors and markets in response to the lower exchange rate and the opportunity to win new customers. In due course this might lead to a recovery in both demand and productivity. On the other hand, a combination of persistent uncertainty about future demand prospects, a desire to reduce leverage, elevated risk aversion, and a higher cost of capital, might, as in many previous financial crises, be an enduring impediment to growth. In this case, prospects for demand would remain poor, with this weakness being at least partially accompanied by weak supply growth. Distinguishing between these possibilities was particularly challenging, and it was unlikely that any one factor could satisfactorily explain the conjunction of output weakness and relative strength in employment growth. The likely path of output was as a consequence unusually uncertain.

37 To the extent that there was a common component to the risks to demand and supply, those risks had fewer implications for the outlook for inflation. But the recent rise in the exchange rate and the increase in commodity prices on the month served as a reminder that inflation was still susceptible to external price shocks that could push it materially away from the target in either direction.

38 The Committee discussed whether it was appropriate to expand or continue with the programme of asset purchases it had agreed at its previous meeting. Inflation was still slightly above 2% but likely to remain close to the target in the coming months. The level of underlying activity was perhaps not as weak as the GDP data for the second quarter had suggested and, with the squeeze on real incomes beginning to ease, some recovery in spending was probable. The FLS had the potential to improve funding conditions for banks materially and to encourage lending, thus providing some support to both demand and supply. These effects might be particularly marked if the FLS allowed some households and companies to borrow who had previously been unable to obtain bank credit. Set against that, the

FLS might prove less effective if uncertainty and risk aversion among households and businesses were the dominant factors holding back spending in the current environment. These same factors might also limit the effectiveness of additional asset purchases.

39 Against that backdrop, all members agreed that it was appropriate at this meeting to continue with the asset purchase programme announced at its previous meeting. For most members, the decision this month was relatively straightforward. Over the coming months, the Committee could take stock of the impact of the FLS and the implications this had for other potential policy options. For some members the decision was nevertheless more finely balanced, since a good case could be made at this meeting for more asset purchases. For those members who had voted against the expansion of the programme at the previous meeting, there were potentially costs to reversing the previous month's decision.

40 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 £375 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.

41 Earlier in the month the Committee had been consulted over the size and terms of the Bank's Extended Collateral Term Repo Facility, in advance of the monthly auction on 18 July.

42 Finally, the Governor expressed his appreciation to Adam Posen for his contribution as a member of the Committee.

43 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

Nicholas Macpherson was present as the Treasury representative.