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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 8 AND 9 FEBRUARY 2012

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 February 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2012/mpc1202.pdf>

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting to be held on 7 and 8 March will be published on 21 March 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 FEBRUARY 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 The improved sentiment in financial markets since the European Central Bank's three-year long-term refinancing operation (LTRO) in December had persisted. Many UK and euro-area banks had issued term debt, including unsecured debt. Spreads on senior unsecured bank debt had been lower than in the second half of 2011, but remained elevated compared to 2010 and the first half of 2011. Short-term bank funding markets had also improved; the cost of borrowing dollars against euros in forward foreign exchange markets had fallen sharply.

3 The spreads between Spanish and Italian government bond yields and those on German bunds had fallen substantially from their highs in late 2011, but remained elevated. While conditions had improved, market intelligence had suggested that investors remained cautious given the continuing concerns about the indebtedness and competitiveness of several euro-area countries. Concerns about Portugal had increased, and yields on its government debt had risen sharply during the month. Uncertainty remained about the negotiations on private sector involvement in Greek government debt re-structuring, and on the prospects for an agreement on a second IMF/EU assistance programme.

4 UK short-term interest rates had changed little on the month, while longer-term rates had risen slightly. Overnight index swaps suggested that market participants expected Bank Rate to remain unchanged for around two years. Market intelligence had suggested that, on balance, market participants expected the Committee to vote to increase the size of its asset purchase programme at this meeting. The sterling effective exchange rate index had changed little on the month.

5 The major international equity indices had continued to rise, particularly in the euro area. The FTSE All-Share and the US S&P 500 indices were around 4% higher on the month, while the DJ Euro Stoxx index had risen by around 8%. It was difficult to explain these movements, but it seemed plausible that they might have reflected a fall in the risk premium investors required for holding equities, perhaps as a result of a reduction in downside risks in the near term associated with the ECB's LTRO. Corporate bond spreads were generally lower on the month and UK gross non-financial corporate bond issuance had been robust.

The international economy

6 There had been upside news on the near-term prospects for global activity. The purchasing managers' indices (PMIs) had generally risen further in January. These were promising signs, although it was unclear what was driving the pickup. It might have been connected with an improvement in confidence following the ECB's LTRO in December, although it seemed unlikely that output would have responded so rapidly. It was also possible that increased output might be associated with an inventory cycle, in which case there was a risk the pickup might not be sustained.

7 In the United States, GDP was estimated to have grown by 0.7% in the fourth quarter of 2011. Both the manufacturing and non-manufacturing PMIs had risen. The labour market data in January had suggested continuing employment growth, and the unemployment rate had fallen by nearly one percentage point in the past year. It was not clear how long that strength in activity would persist, however: nearly three-quarters of the GDP growth in the fourth quarter had been attributable to stockbuilding. There was also a question over the persistence of the strength seen in consumption spending in the fourth quarter of 2011, given the apparent weakness in real income growth. Against that, the improvement in the labour market might be expected to support household spending, and it seemed unlikely that businesses would be expanding employment if they did not expect the recovery to persist.

8 Both the manufacturing and services PMIs had also risen in the euro area in January. While their levels were consistent only with broadly unchanged output in the first quarter of 2012, they at least suggested that euro-area growth had not continued to weaken. While the ECB's actions had reduced the near-term risks from bank funding difficulties, it was likely that continued bank deleveraging would weigh on the availability of credit. Moreover, the concerns surrounding the indebtedness and

competitiveness of some euro-area countries, and the near-term prospects for Greece, in particular, remained downside risks to the outlook.

9 In Asia, the manufacturing PMIs had risen for the second successive month in January, but evidence of tightening credit conditions suggested that domestic activity might continue to slow. Trade spillovers from the advanced economies in 2011 had appeared limited, although it remained possible that deleveraging by European banks in particular might have some adverse impact on the availability of trade finance.

10 The spot price of Brent crude oil had risen by around 5% in the days before the Committee's meeting, which seemed to reflect a combination of the stronger global activity indicators and the recent cold weather in Europe. Industrial metals prices had risen by around 15% since their local lows in mid-December, which had perhaps been a reflection of the stronger prospects for activity evidenced by the global PMIs.

Money, credit, demand and output

11 According to the ONS's preliminary estimate, GDP had fallen by 0.2% in the fourth quarter of 2011, broadly as the Committee had expected. The fall in GDP had reflected shrinking manufacturing, energy and construction output, and flat services output. Overall GDP in 2011 had grown more slowly than had GDP excluding oil and gas.

12 There had been a sharp rise in the CIPS/Markit manufacturing and services surveys in January. Both had risen above their series averages, and stood at their highest levels since March 2011. The forward-looking balances in both surveys had also increased sharply, which suggested that the strength of output was expected to persist into the second quarter. The strength in the CIPS/Markit surveys had not been matched by other survey evidence, however: the CBI and the British Chamber of Commerce survey expectations had both suggested a further contraction in GDP in the first quarter. It was possible that the CIPS/Markit surveys were giving a misleading signal, although past statistical relationships had suggested that they were the most informative individual survey indicators of output growth. Moreover, the UK CIPS/Markit surveys had risen in common with those in many other countries around the world.

13 As for the global PMIs, it was possible that the CIPS/Markit surveys might have reflected an improvement in business conditions following the ECB's LTRO, although it seemed unlikely that it could have led to a sharp pickup in output in such a short space of time. Another possibility, suggested by the Bank's Agents, was that the CIPS/Markit surveys might have reflected an increase in activity as firms now decided to proceed with previously postponed investment or other spending, even though the uncertainty connected with the euro area remained.

14 Taking all these factors together, it seemed likely that growth in the first quarter of 2012 would be somewhat stronger than the Committee had expected at its previous meeting. There had, however, as yet been little evidence from the expenditure indicators to corroborate that. Although they had risen on the month, both the GfK and Mori measures of consumer confidence remained depressed, and suggested weak household spending in the first quarter. Export data for the fourth quarter of 2011 had been strong, but recent surveys had been weaker. Survey measures of investment intentions had been largely flat in the fourth quarter.

15 Money growth had been weak in the fourth quarter of 2011. On an annualised basis, the stock of broad money had fallen by 0.8%, below its average growth rate of 2.1% in the first three quarters of 2011, and the first quarterly fall since the third quarter of 2009. This had followed a relatively robust annualised increase of 5% in the third quarter of 2011. It was not possible to be sure how weak money growth would have been in the absence of the Committee's asset purchases. Moreover, the volatility in the recent money data made it hard to judge how much news there was in any single quarterly outturn.

16 Credit conditions for many households and businesses remained tight, and the intensification of strains in bank funding markets during the second half of 2011 had begun to feed through into further increases in the cost of credit for some borrowers. Bank funding markets had improved since the turn of the year, however, and might be expected to improve further. In time, that should enable spreads on interest rates paid by UK households and businesses over risk-free rates to decline somewhat, although it seemed unlikely that spreads would fall to the levels seen just before the onset of the financial crisis. But the pace at which credit conditions would loosen was uncertain. And there remained a risk that a further period of financial market stress, for example associated with renewed uncertainty over developments in the euro area, would impede any improvement in credit conditions.

Supply, costs and prices

17 Twelve-month CPI inflation had fallen to 4.2% in December. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 3.6% for January had been provided to the Governor ahead of publication. The fall in CPI inflation since its peak in September had largely matched the Committee's expectations. CPI inflation was expected to fall further over the next few months, as the contributions from past petrol and utility price increases, and any remaining effects of the previous year's rise in the standard rate of VAT, dropped out of the twelve-month calculation. Wholesale gas spot prices had risen sharply recently as a consequence of cold weather in the United Kingdom and elsewhere in Europe. Futures prices, which were more important for the setting of utility prices, had risen by far less.

18 The extent and pace of further falls in twelve-month inflation over the course of 2012 remained uncertain. Seasonally adjusted monthly inflation had been close to 2% in the three months to December, suggesting that the instantaneous rate of inflation was now close to the Committee's target.

19 The increases in energy prices in autumn 2011 and the continuing impetus from the prices of imported goods and services made it difficult to form a confident view of the current rate of domestically generated inflation. Key factors determining the future rate of domestically generated inflation were the extent to which productivity would recover, how wages would respond both to future movements in productivity and to labour market slack, and the extent to which consumer-facing businesses sought to rebuild their profit margins.

20 The whole economy employment rate had been broadly flat in the three months to November. While there had been some signs of stronger labour market activity in the monthly CIPS/Markit and REC surveys in January, business surveys of employment more generally had continued to point to weakness in the near term. According to the LFS, the unemployment rate had risen to 8.4% in the three months to November. The extent of downward pressure that those seeking jobs would place on wages would depend on a number of factors, including how transferable their skills were. There was some tentative evidence that companies had been finding it harder to find suitable employees, and in the second half of 2011 the number of vacancies had been broadly stable while unemployment had increased. This could suggest that the unemployed were less able to fill those vacancies.

21 The available indicators suggested that pay growth had remained subdued. According to the average weekly earnings measure, total pay growth had remained well below its pre-recession average, and had fallen back further since the middle of 2011. There had been early indications that pay settlements had picked up a little in January, but at 2.7% they remained well below pre-recession norms. Survey evidence in January from the Bank's Agents had suggested that businesses expected settlements in 2012 to be broadly similar to those in 2011.

22 Although earnings growth was expected to remain modest in the context of a weakening labour market, the behaviour of productivity growth remained puzzling and it was difficult to form a judgement on how productivity growth, and hence unit labour costs, would evolve. The Committee's central expectation was that productivity growth was likely to recover over the next few years. Should productivity continue to grow slowly, however, then a given path for wage growth would be associated with higher unit labour costs and hence increased inflationary pressures. The weakness of productivity growth in recent years had contributed to the relatively low level of businesses' margins, especially in the consumer-facing sector. It was possible that firms might seek to restore margins by raising prices, which would add to inflation, at least temporarily. But with the near-term outlook for demand relatively subdued, firms might instead seek to raise margins by cutting employment or other costs.

23 There had been little significant movement in measures of medium-term inflation expectations on the month. But the YouGov/Citigroup survey measure of households' inflation expectations one year ahead had fallen further in January, which had probably reflected the fall in CPI inflation from its September peak.

The February GDP growth and inflation projections

24 The Committee reached its policy decision in the light of its projections published in the *Inflation Report* on Wednesday 15 February.

25 The slight contraction in output in the final quarter of 2011 had followed a period of sluggish growth, as falling real incomes, tight credit conditions and subdued household and consumer confidence weighed on spending. But monthly indicators for January had pointed to a pickup in output, and households' real income growth was expected to recover during 2012 as inflation fell back. Quarterly GDP growth was likely to be volatile over 2012, given one-off factors including the

additional bank holiday associated with the Queen's Diamond Jubilee. Four-quarter GDP growth was projected to strengthen gradually over the forecast period, as consumption growth picked up and, further ahead, business investment rebounded from its current depressed level. The outlook for growth was judged to be broadly similar to that in the November *Report*.

26 There continued to be substantial uncertainties surrounding the outlook for growth. The most significant threat to the domestic recovery stemmed from developments in the euro area, where there remained concerns about the indebtedness and competitiveness of some member countries. The reforms necessary to deal with those concerns were likely to weigh on euro-area growth throughout the forecast period. But a failure to undertake those reforms could trigger a disorderly outcome and result in sharply lower euro-area growth. That would not only affect UK exports, but would also have substantial depressing effects on UK activity through financial sector linkages and through its effects on confidence.

27 Growth would also depend on a range of domestic factors, including: the extent to which households still had to adjust their spending in response to lower incomes and greater uncertainty; the evolution of productivity; the cost and availability of credit to households and businesses; and the impact of the Committee's asset purchases on demand. There remained a range of views among Committee members about the likely effects of those factors on GDP. The Committee's best collective judgement – on the assumption that Bank Rate moved in line with market interest rates and the stock of purchased assets was held constant at £325 billion – was that by the end of the second year of the forecast, the risks of growth being above or below its historical average were roughly equal.

28 Despite the projected recovery in growth, output was unlikely to surpass its pre-recession level until midway through the forecast period – some five years after the onset of the recession. Since the start of the crisis, the supply capacity of the economy appeared to have grown unusually slowly. Nonetheless, there was likely to be a sizeable margin of spare capacity in the UK economy, largely concentrated in the labour market. That should diminish towards the end of the forecast period, but was unlikely to close completely.

29 As had been expected in November, inflation had fallen from its recent peak, and it was likely to fall further in early 2012, as the effects of past increases in energy prices continued to wane, and the increase in the standard rate of VAT a year earlier dropped out of the calculation. The Committee's

central forecast was for inflation to continue to decline during 2012 to below the 2% target by the beginning of 2013. That partly reflected a further diminution in the upward pressure from past rises in energy and import prices. But it also rested on a reduction in domestically generated inflation, as slack in the labour market continued to restrain wage growth, and productivity picked up. Further ahead, inflation was projected to rise slowly back towards the target, as the margin of economic slack gradually diminished, and businesses continued to restore profit margins that were squeezed during and after the recession.

30 There remained substantial uncertainties around this likely path for inflation. The scale of the factors temporarily raising inflation made it difficult to gauge the strength of underlying inflationary pressure with precision. Moreover, the degree to which inflation fell back would depend on the evolution of companies' costs. Any significant disruption to the supply of oil or gas could lead to further increases in energy prices. Businesses' costs would also depend on the path of productivity, and on the degree to which slack in the labour market continued to hold down wage growth. And inflation would also be sensitive to the timing and pace of any restoration in businesses' profit margins. There remained a range of views among Committee members over the likely impact of those various influences.

31 On balance, the Committee judged that – on the assumption that Bank Rate moved in line with market interest rates and the stock of purchased assets was held constant at £325 billion – inflation was somewhat more likely to be below target than above it for a good part of the forecast period. By the end of the period, however, those risks were judged to be broadly balanced. The inflation projection was somewhat higher than in November, partly reflecting the larger stock of assets on which the forecast was conditioned, but also reflecting a higher path for oil and other commodity prices.

The immediate policy decision

32 The Committee set monetary policy in order to meet the inflation target in the medium term. The advance estimate for January had suggested that twelve-month CPI inflation had fallen further, to 3.6%, from 4.2% in December. That was likely to have been driven by the impact of the previous year's rise in the standard rate of VAT dropping out of the twelve-month calculation. Inflation was

likely to continue to fall over the next few months, as the effects of past increases in energy prices, as well as any remaining impact of the VAT rise, dissipated.

33 The Committee's central view was that inflation would decline further during 2012 as the contributions of energy and import prices continued to wane and as spare capacity weighed on wages and prices. But the speed and extent of the fall remained uncertain, and would depend, in part, on the strength of demand. Growth was likely to be volatile in the near term, given the impact of one-off factors, particularly the additional bank holiday associated with the Queen's Diamond Jubilee in the second quarter. But thereafter growth should strengthen gradually, supported by a recovery in households' real income growth and the expansionary stance of monetary policy. Headwinds from the weak external environment, tight credit conditions and the fiscal consolidation were, however, likely to continue to depress spending, so that some margin of economic slack was likely to persist.

34 There remained substantial uncertainties around the path of inflation in the medium term either side of that central view. To the upside, inflation might fail to fall back as the Committee expected if companies' costs rose further. Any significant disruption to the supply of oil or gas could lead to further increases in energy prices, and tensions remained in the Middle East. Industrial metals prices had risen sharply since the middle of December. Businesses' costs would also depend on the path of productivity, and on the degree to which slack in the labour market continued to hold down wage growth. So far, earnings growth had remained relatively subdued. But productivity growth had also remained low, and it was difficult to know how productivity growth and unit labour costs would develop. The weakness of productivity growth had been a factor in the relatively low level of businesses' margins: the possibility that they might seek to restore margins to more normal levels by raising prices sharply represented an upside risk to inflation.

35 There were also risks to the downside that might result in demand growth being too weak to absorb the pool of spare capacity sufficiently, leading inflation to fall materially below the target in the medium term. Growth appeared to have strengthened in the United States, and the PMIs in many countries, including the United Kingdom, had risen. But they pointed only to broadly flat output in the euro area, the United Kingdom's largest export market. The ECB's LTRO had reduced some of the most immediate risks facing European banks, but concerns remained about the indebtedness and competitiveness of some euro-area countries. In part as a consequence of the ECB's actions, conditions in bank funding markets had been better in the first month of 2012 than in the second half

of 2011. But UK banks' funding costs remained higher than in 2010 and the first half of 2011, and these had begun to feed through into further increases in the cost of credit for some borrowers. Domestically, the extent to which households had completed their adjustment to lower expected real incomes remained uncertain. There was a risk that further adjustment, combined with heightened uncertainty and with tight credit conditions could result in households increasing their saving more substantially as real income growth recovered, so that consumption grew more slowly than income in the medium term. Consumption might also be weaker if businesses sought to cut costs and restore their profit margins by reducing their demand for labour.

36 Against this background, and that of its most recent projections to be published in the February *Inflation Report*, the Committee judged that the weak near-term outlook for growth and the associated downward pressure from slack in the economy meant that, without further monetary stimulus, it was more likely than not that inflation would undershoot the 2% target in the medium term. The Committee recognised that there were substantial risks to inflation in the medium term in both directions, and that it would be some time before the uncertainties around these risks were resolved. There was a range of views among Committee members over the evolution of these risks. For some members, the probability of inflation exceeding the target was slightly higher than shown in the projection to be published in the February *Inflation Report*, and a case could be made for maintaining the stance of policy at this meeting. For others, the case for further easing was more clear-cut.

37 The Committee had announced a programme of £75 billion of asset purchases at its October meeting, and this had recently been completed. While the Committee continued to monitor the impact of its asset purchases, it saw no compelling reason to think that their impact on nominal demand would be materially different than had been anticipated in October. It would keep this under review in judging the policy actions needed to support the recovery and meet the inflation target. In terms of the immediate decision, the Committee considered the arguments for increasing the stock of asset purchases by £50 billion or £75 billion, either of which would be sufficient to put inflation broadly on track to meet the target in the medium term on its central projection. Committee members placed different weights on these arguments.

38 A number of reasons for the smaller increase were advanced. Recent data on the domestic and international economies had on balance been more positive than might have been anticipated towards the end of 2011, pointing to the possibility that growth might be stronger than expected in the near

term. Moreover, the ECB's LTRO had reduced some of the worst immediate downside risks to the outlook stemming from the euro area. Although inflation had fallen back broadly as expected, short-term inflationary pressures remained. The rate was still well above the 2% target and there was a risk that inflation might prove more persistent than in the Committee's central projection, especially if downward pressure from labour market slack was less than expected. An increase of £50 billion in the stock of asset purchases would represent a material monetary stimulus, and it was not clear that a stimulus larger than that was warranted at the current juncture. In addition, given market expectations, a larger increase risked sending a signal that the Committee thought the economic situation was weaker than it was.

39 A case was also made for the larger amount of asset purchases, given the considerable margin of spare capacity remaining in the economy and the extent of deleveraging still likely to be required. There was a risk of a prolonged period of depressed demand causing inflation to fall materially below the target in the medium term. In addition, persistently weak growth might impair the future supply capacity of the economy through hysteretic effects: that risk could be attenuated by a more aggressive loosening of monetary policy in the near term. Should the probability of inflation being above the target in the medium term increase, the Committee could subsequently withdraw some of the monetary stimulus.

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 finance a further £50 billion of asset purchases by the issuance of central bank reserves, implying a total quantity of £325 billion of such asset purchases.

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

Regarding the stock of asset purchases, seven members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher and Martin Weale) voted in favour of the proposition. Two members of the Committee (David Miles and Adam Posen) voted against, preferring to increase the size of the asset purchase programme by £75 billion to a total of £350 billion.

41 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.