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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 11 AND 12 JANUARY 2012

These are the minutes of the Monetary Policy Committee meeting held on 11 and 12 January 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2012/mpc1201.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 8 and 9 February will be published on 22 February 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 11 AND 12 JANUARY 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 While the most recent data from the United States had been a supportive influence on financial markets over the month, the main events affecting asset prices had continued to be those in the euro area. The three-year long-term repo operation by the ECB on 21 December 2011 had improved market sentiment and a number of banks had been able to issue public unsecured term debt. Major European banks' issuance in 2012 had already exceeded that in the whole of the second half of 2011. So far it had been the large, more highly rated, banks that had issued, albeit at spreads that had remained elevated. Issuance of secured term debt by banks had also been relatively robust.

3 Banks were reported to have used the long-term repo operation to provide funding for existing bank balance sheets, potentially reducing pressures to de-lever, rather than to expand balance sheets. It was unclear to what extent banks might increase their purchases of sovereign debt of the vulnerable euro-area countries in future, although two-year Spanish and Italian yields had fallen on the month. A second ECB operation would take place at the end of February.

4 Ten-year German bond yields, which had moved erratically during the latter part of 2011, had fallen back below 2%. But government bond yields in many other euro-area countries had remained high. Over the month, ten-year spreads to bunds had widened a little for Spain and substantially for Italy. In the United Kingdom, ten-year gilt yields had fallen to new lows of around 2% in late December. Real long-term yields on gilts had been below 0% over recent months and they had accounted for the larger part of the movements in nominal yields during 2011.

5 Short-term interest rates were little changed in the United Kingdom, but had fallen in the euro area, in part reflecting the ECB's policy rate reduction in December. The euro effective exchange rate index (ERI) had weakened by around 3½% in the past month. Over the same period, the sterling ERI

had appreciated by just over 1%. The skews in options prices continued to imply a balance of risks towards the euro depreciating relative to the US dollar and sterling.

6 Equity markets internationally had fallen before the ECB operation but had rallied subsequently. Over the month as a whole, the FTSE All-Share index was up slightly. It was notable that equity prices had recovered significantly since their very sharp falls in the summer, despite the subsequent downgrades to economic forecasts.

7 Non-financial and financial corporate bond spreads had changed little on the month. 2011 had ended with relatively high gross UK non-financial corporate bond issuance. But new issuance premia had risen during the autumn and liquidity in the secondary market appeared to have been poor. Although bid-offer spreads had widened in recent months, they were not nearly as wide as in early 2009.

The international economy

8 Third-quarter euro-area GDP growth had been revised down slightly to 0.1%. The signs were that the euro area had contracted slightly in the fourth quarter. There remained a difference between the performance of the core and periphery countries, but there was growing evidence of a slowdown in some of the former. Initial estimates of German GDP in 2011 as a whole were, for instance, consistent with a small fall in output in the fourth quarter. The euro-area Purchasing Managers' Indices (PMIs) had edged up in December, although they too continued to indicate contraction. The data suggested manufacturing had been noticeably weaker than services. Consumer and business confidence had continued to decline, although less rapidly than in Q3. The December European Council meeting had made some progress in agreeing a strengthened fiscal framework, but longer-term challenges related to economic rebalancing remained, and near-term financial risks related to the high volume of maturing sovereign debt and the negotiations over Greek debt restructuring continued to cloud the outlook.

9 In the United States, GDP growth looked to have rebounded in the second half of 2011 and the PMIs pointed to expansion. Fourth-quarter growth was likely to be around 0.8%. Only a part of this rebound could be attributed to a recovery from the supply chain disruption caused by the earthquake and tsunami in Japan. Employment had also surprised to the upside and the unemployment rate had fallen to its lowest level in almost three years. The prospects for continued expansion at this pace were unclear. Consumption growth, which appeared to have been the key support to output growth during the second half of 2011, had exceeded income growth by some margin, implying a sharp fall in the

saving ratio. This might reflect growing household confidence about labour market prospects or that the headwinds from household debt and a stagnant housing market were turning out less than had been feared. But this was not corroborated by consumer confidence indicators, which remained depressed, so there was a risk that the recent rate of consumption growth might not be sustained. It was also possible that the income and consumption data might be revised.

10 There had been healthy growth in some of the advanced economies outside the euro area and the United States, with third-quarter growth in the non euro-area countries of Western Europe, Canada, Australia and New Zealand generally around or above 0.8%. In the emerging world, the growth of the larger economies had continued to slow, but there remained few signs of a sharp fall. Activity indicators in China had been broadly consistent with the slowing in the PMIs seen through last year, although the manufacturing measures had risen in December. One risk in China was that the past high rates of investment and credit expansion, including through the shadow banking system, might result in a sharp increase in non-performing loans as economic growth slowed. But there were no signs yet of this risk crystallising.

11 Commodity prices had risen slightly on the month. So far, the impact on oil prices of developments in Iran and the associated threat of sanctions had been relatively limited. But they would continue to pose a potentially serious risk of a sharp price increase.

Money, credit, demand and output

12 According to the most recent ONS estimate, GDP had grown by 0.6% in the third quarter, revised up from the previous estimate of 0.5%. The mix of expenditure in Q3 had also been revised. Investment now contributed positively to growth while government consumption had been revised down. Stockbuilding remained a key driver of growth in Q3. Household consumption data had been revised up implying that the pickup in the saving ratio during 2011 had been smaller than previously thought.

13 The latest quarterly national accounts had also contained revisions to the historical data. GDP growth had been revised back to the start of 2010 with the result that the estimate of the level of real GDP in 2011 Q3 was 0.4% higher than previously reported. The most significant revisions had been in 2010 and suggested a marginally stronger recovery than had been recorded before. But given that these revisions related to the more distant past, their implications for the inflation outlook were probably only modest.

14 The official output data for the fourth quarter were only partial but had been weak. Notably, the index of services had fallen by 0.7% in October. Industrial production had also fallen by 0.6% in November and there had been downward revisions to the October data. Energy output had been a significant drag on industrial production in November, reflecting in part the unseasonably mild weather. Manufacturing output had also fallen slightly in November. Taken at face value this implied a risk that a significant contraction in activity had occurred in the fourth quarter. But the index of services, in particular, was volatile and prone to revision.

15 The recent surveys were more positive than the limited official data. The CIPS/Markit output indices for both services and manufacturing had picked up slightly in December with the services index at its highest level since July 2011. If the output indices were to remain at their December levels over the coming months, this would point to a modest pickup in growth in the first quarter of 2012. But the expectations indices were less positive. The BCC survey for Q4 was also more downbeat: the expectations balances for services and manufacturing had both fallen on the quarter. Taking everything together, there was little to alter the view that output was likely to be broadly flat over 2011 Q4 and 2012 Q1.

16 Turning to the composition of expenditure, the latest indicators of consumer spending growth were mixed. Retail sales volumes and new car registrations implied a strong contribution to consumption growth in Q4. But other indicators such as consumer confidence were still depressed with the GfK balance having fallen in December to its lowest level since February 2009.

17 Although often subject to erratic movements, goods exports had grown sharply in October and had not fallen back as much as expected in November. Exports of goods to the EU appeared to have held up well in the circumstances while, taking the most recent two months' data together, exports to the rest of the world had grown strongly. Although the CIPS/Markit measure of manufacturing export orders had picked up in December, survey indicators of exports more generally had slowed, for example the BCC composite orders balance had fallen in Q4. In any case, there would be a partial offset in the contribution of net trade to GDP because the growth in goods import volumes had nearly matched those of exports in recent months.

18 The way firms responded to the sustained period of weak final domestic demand would affect how quickly the economy recovered. The Bank's Agents had reported a further weakening in investment intentions. The Agents noted that firms still expected to increase capital spending over the coming year but that some investment had been put on hold due to heightened uncertainty. Business

surveys had suggested that the increase in stockbuilding in the third quarter was probably involuntary, so there was a risk it would unwind in the future.

19 Broad money growth had been weak in November and M4 lending excluding OFCs had fallen. It was hard to draw clear conclusions from the latest *Credit Conditions Survey*. Banks had reported that credit availability to both companies and households had remained unchanged or improved, but that the lending spreads to companies of all sizes had increased. As yet, the majority of large UK banks appeared not to have passed through higher funding costs fully into their lending rates. As a result, there remained a risk of a tightening in credit conditions in the near term unless the incipient signs of improved conditions in bank funding markets led funding costs to fall significantly. Lenders also reported that credit demand had remained weak, although the Bank's Agents had found that some smaller companies continued to be wary of approaching banks for loans for fear of triggering changes in prices or conditions on existing facilities.

Supply, costs and prices

20 Twelve-month CPI inflation had fallen to 4.8% in November. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 4.2% for December had been provided to the Governor ahead of publication. Also in line with the pre-release arrangements, the Governor informed the Committee that producer input prices had decreased by 0.6% in December, reflecting lower prices of crude oil, imported chemicals and imported parts and equipment. Producer output prices had fallen by 0.2% on the month.

21 The recent path of CPI inflation, peaking in September and falling subsequently, had largely matched the Committee's central expectation. The Bank's Agents had reported more aggressive discounting by retailers compared with the previous year. But this might just reflect differences in the timing of sales around Christmas. There had been a couple of recently announced reductions in utility prices. If these were followed by other suppliers it would pose a modest downside risk to the short-term inflation outlook. Current developments with regards to Iran, however, could prompt a large increase in energy prices.

22 The broad outlook remained the same as that at the time of the November *Inflation Report*, in which the central case was for inflation to fall by around 2 percentage points between November 2011 and March 2012 and then to fall back to around the target by the end of 2012. Of the initial expected fall, just over 1 percentage point was accounted for by the rise in VAT last January dropping out of the

calculation and a further $\frac{3}{4}$ percentage point or so reflected falling contributions from petrol and utility prices. Part of this fall was evident in the latest data for December.

23 The speed and extent of the fall in inflation in the year from 2012 Q1 onwards was less certain. About half the anticipated reduction was associated with the impact of energy and import prices. The remainder was accounted for by an anticipated reduction in domestically generated inflation. The degree to which this materialised depended in part on whether firms would continue to rebuild their margins by raising prices and the degree to which the growth of unit labour costs might slow. It was difficult to judge what level of margins was sustainable in the long term, although depressed consumer confidence and tough trading conditions might make it difficult for retailers to raise prices. Annualised seasonally adjusted three-month inflation rates were still above the inflation target, but these could be expected to fall given the further disinflationary pressure from the degree of spare capacity underlying the projections in the *Inflation Report*.

24 A key factor determining the degree of inflationary pressure in the medium term was the extent to which slack in the labour market would restrain wage increases. The latest data on employment suggested that the labour market was weakening. The LFS data implied a fall in employment of 63,000 in the three months to October, while the unemployment rate stood at 8.3%, up 0.4 percentage points on the three months to July. With self-employment having increased by slightly more than the decline in public sector employment, the LFS implied that the number of private sector employees had fallen markedly in the third quarter. Other official data painted a different picture of overall labour market conditions. For example, while the LFS data implied total employment had fallen by almost 200,000 in the third quarter, the Workforce Jobs measure showed an increase of over 150,000 jobs over the same period. The claimant count data provided a further cross-check on developments. Earlier in the year, the claimant count had been boosted by people being transferred on to Jobseeker's Allowance from other benefits, but the rise in the claimant count had slowed sharply in recent months. That said, looking ahead, the employment surveys now indicated falls in total employment in the coming months. The surveys also suggested increases in staff availability. Despite weakening, these surveys were nonetheless more resilient than in 2009.

25 There was little evidence to suggest that the period of elevated inflation had begun to generate rapid wage growth. According to the average weekly earnings measure, total pay had increased by 2% in the three months to October compared with a year earlier. Settlements had remained low, although the twelve-month mean private sector settlement, at 2.3% in November, had risen somewhat since the beginning of the year. A substantial proportion of pay settlements were agreed between January and

April. The Committee's central expectation was that the expected fall in inflation and slowdown in demand would continue to restrain pay growth over the coming year. With regard to the amount of slack within firms, the Bank's Agents reported that there were signs of capacity utilisation falling back in recent months in both manufacturing and services. In general, exporters continued to have the highest levels of capacity utilisation.

26 There had been little movement in inflation expectations over the month. The YouGov/Citigroup survey measures of households' inflation expectations one year ahead and five to ten years ahead were broadly unchanged in December. Measures of inflation expectations derived from financial markets were also little changed on the month and remained close to longer-term averages.

The immediate policy decision

27 The Committee set monetary policy in order to meet the inflation target in the medium term. The advance estimate of inflation had suggested that twelve-month CPI inflation had fallen in December broadly as expected. The Committee's central view remained that inflation would continue to fall sharply in the coming months as the impact of the increase in the standard rate of VAT in January 2011, and of higher energy and import prices, dissipated. There was greater uncertainty about the speed and extent of the fall in inflation thereafter.

28 The Committee had initiated a programme of asset purchases in October, which would take until early February to complete. Although the Committee was monitoring the impact of the continuing purchases on financial markets and the wider economy, there was no compelling reason to think that the impact on nominal demand would be materially different from the first round of asset purchases.

29 The Committee discussed how the risks to the medium-term outlook had evolved since its previous meeting. The fact that CPI inflation had been falling in line with the Committee's expectations was encouraging, and reduced the risk that inflation expectations would rise above a level consistent with meeting the target in the medium term. This was reflected in broadly stable inflation expectations from surveys and financial market measures. There was a risk, however, that expectations of near-term inflation might take time to fall back.

30 Elevated inflation could also be more persistent than the Committee had expected because of further upward external price shocks, or due to a stronger contribution from firms' margins or unit

labour costs. There was mixed news on energy prices on the month. Two utility suppliers had announced price reductions and others were likely to follow. But heightened tensions in the Middle East raised the risk of a sharp rise in oil prices. With regards to domestically generated inflation, so far earnings growth had remained modest amid signs of a weakening labour market. But since the behaviour of productivity remained puzzling it was hard to know how productivity growth, and hence unit labour costs, would evolve in future. The accumulated weakness in productivity growth in the past had contributed to the relatively low level of company margins: if firms sought to restore margins by raising prices it would, at least temporarily, add to inflation. On the other hand, with near-term demand and production expected to be flat, firms might seek to restore margins by cutting costs instead, including through reductions in employment.

31 There remained considerable risks to the downside from the global economy. If demand growth in the United Kingdom were insufficient to absorb the pool of spare capacity in the economy it could lead to inflation falling materially below the target in the medium term. On balance, the Committee agreed that there had been some positive developments over the month that had moderated some of the most serious near-term downside risks. The euro area, including the core economies, appeared to be facing a mild contraction in activity and continued to face substantial challenges that were likely to act as a drag on growth for the foreseeable future. But the immediate risk of a more severe dislocation in the euro area arising from banking sector difficulties appeared to have been mitigated by the ECB's actions. These had been accompanied by tentative signs of conditions better than expected in bank funding markets since the start of the year. There had also been a sequence of slightly stronger data from the rest of the world, including the United States. These factors were helping to support financial markets and wider global confidence. In the United Kingdom, there was little to alter the view that output was likely to be broadly flat in 2011 Q4 and 2012 Q1.

32 There remained substantial risks to UK activity and inflation in both directions. While the near-term risks of either a sharp contraction of output or of persistently high inflation appeared to have moderated this month, there was little change to the balance of risks in the medium term. To the extent that inflation continued to fall sharply over the next few months, the upside risk to inflation expectations would be lessened and the Committee could be slightly more confident in its judgements about the recent drivers of inflation. But it would be some time before the uncertainties around the other key risks were resolved. These included: whether euro-area governments would be able to continue to refinance their debts and tackle their economic imbalances successfully; how strongly UK output growth would recover in the second half of 2012; and how far and fast CPI inflation would continue to fall after the first quarter.

33 Against this background, the Committee agreed that a decision to change policy at this meeting was not warranted. The balance of risks to inflation in the medium term had changed little since November. For some members, the risks of undershooting the target meant that a further expansion of asset purchases was likely to be required. Some of those members also noted a downside risk to inflation arising from the possibility that the reduction in the economy's supply potential following the recession had been less, and hence spare capacity greater, than assumed in the *Inflation Report*. But there was no compelling need to increase the scale of the programme of asset purchases before completing those already announced. For other members, the risks to inflation were more finely balanced and it was less clear that inflation would fall below the target in the medium term. Annualised three-month inflation rates were still above the target. Looking ahead, particular concerns included: the risk of price pressures from firms seeking to increase margins; and the fact that even if wage growth were to remain subdued, wages might add to inflationary pressures if productivity growth were also weak.

34 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 £275 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.

35 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.