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

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1207.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 1 and 2 August will be published on 15 August 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 JULY 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 Several potentially significant events had occurred, and financial markets had responded to them in a more benign way than had seemed likely at the time of the Committee's previous meeting. Nevertheless, the prevailing theme from contacts in financial markets had remained one of caution and aversion to risk.

3 The yields on the long-term government debt of troubled euro-area countries had been volatile, particularly in Italy and Spain. Overall they had fallen over the month, despite some upward drift in the days immediately before the Committee's meeting. At the time of the meeting, Spanish government bond yields had been around 6½%, having peaked at over 7% during June. Independent auditors had estimated that the Spanish banking system's probable recapitalisation requirements were less than the €100 billion that had been earmarked by the authorities. And the results of the Greek election had been greeted with cautious optimism: political parties broadly in favour of fulfilling the conditions of the EU/IMF support package had been able to form a coalition government.

4 Market sentiment had been supported by the outcome of the European Council meeting at the end of June. The agreement there had involved plans for: a single euro-area bank supervisory mechanism; the European Stability Mechanism (ESM) to recapitalise banks directly, rather than via commitments to individual euro-area governments – and without those claims becoming senior to private ones; the European Financial Stability Fund and ESM to purchase the bonds of troubled euro-area countries without additional conditionality; and budgetary measures equivalent to 1% of EU GDP to support economic growth. While many details of the package remained to be decided, the

initial reaction had been positive. Market expectations of a reduction in the ECB's main refinancing rate at its July meeting had also grown.

5 In continental Europe, improved sentiment towards the end of the month had led to some improvement in bank funding markets, with issuance of unsecured debt by some banks. In the United Kingdom, downgrades to the credit ratings of banks had been less marked than expected. Sterling funding market conditions had seemed to improve following the announcement earlier in the month of the creation of a Government and Bank of England Funding for Lending Scheme (FLS) and the activation of the Bank's Extended Collateral Term Repo Facility (ECTR). Sterling three-month LIBOR had fallen by around 10 basis points since those announcements and market expectations of three-month LIBOR in six months' time had fallen by around 20 basis points. Although the controversy surrounding the investigation into the manipulation of LIBOR had so far not had a broad effect on market prices or conditions, there was a risk it might do so in future.

6 Following the release of the Minutes of the June MPC meeting and public comments by some MPC members, as well as weaker economic data for the United Kingdom, short-term sterling interest rates had fallen. Forward overnight index swap rates, a proxy for market expectations of Bank Rate, had fallen further below the current Bank Rate of 0.5% at maturities out to at least two years. Nearly all of the economists polled by Thomson Reuters expected an expansion of the MPC's asset purchase programme at this meeting.

7 Longer-term interest rates had seen less movement during the month. In the United Kingdom, ten-year gilt yields had been stable at around 1¾% compared with around 2½% in the middle of March. That had seemed to reflect market participants seeking to invest in assets perceived as the safest in the face of the continued financial and political uncertainties in the euro area. The spread between ten-year gilts and equivalent German government bonds had narrowed from around 45 basis points in mid-April to 25 basis points by the time of the Committee's meeting. More broadly, investors had continued to seek to acquire assets in the most liquid and deep markets.

8 Equity prices had risen internationally with the FTSE All-Share index up by around 5% over the month, and European indices up by more. This had probably reflected both an increased market expectation of supportive economic policies from the authorities and a perceived reduction in the immediate economic threats stemming from the euro-area financial crisis. Exchange rates between the

major advanced economies had changed little during the month.

The international economy

9 Recent indicators had continued to suggest a weak near-term outlook for global activity. In the euro area, the composite Purchasing Managers' Index (PMI) had risen fractionally in June, but remained at a level consistent with a further contraction in area-wide output in the second quarter. The forward-looking service sector business expectations index had fallen sharply, suggesting that such weakness could continue into the third quarter. It was possible that some of the weakness in the activity surveys had been influenced by the heightened climate of uncertainty ahead of the Greek elections and European Council meeting, and so might unwind in subsequent months. But, while the package announced following the Council meeting had been welcomed, very substantial challenges remained. There had been some progress towards reducing the imbalances within the area. But that had in large part come at the expense of severe recessions and high unemployment in some countries. And it was possible that there would be further fiscal consolidation in several member states.

10 There had been little major news about the United States. Activity and employment indicators had remained consistent with the modest continued expansion of output that the Committee had assumed at the time of the *May Inflation Report*. The manufacturing ISM index for June had fallen sharply to just below 50, indicating flat or declining output in the sector. Within that, the new orders index had fallen significantly, suggesting that the weakness could persist. There remained uncertainty about how the political negotiations towards the end of the year over the pre-programmed budgetary tightening would be resolved. Little progress was expected before the Presidential elections in November.

11 Evidence on prospects in emerging economies had been mixed. There had been further signs of a slowing in China, with the HSBC services PMI falling again in June. So far, the slowdown had been gradual, broadly in line with the Committee's expectations, although the risk of a sharper slowdown remained if global demand growth continued to moderate. The Chinese authorities had responded by loosening monetary policy. The HSBC composite PMIs in both Brazil and India had increased in June, possibly in part reflecting past policy easing. But, overall, the picture had remained one of a gradual reduction in the pace of growth in the emerging economies as a whole.

12 In part reflecting weaker global demand, oil prices had continued to decline for much of the month, before rising a little towards the end of June and in early July following the European Council meeting. The sterling price of Brent crude oil had fallen by around 2% over the month as a whole, and by 9% since the time of the *May Inflation Report*. As well as the slowing in global demand, this probably reflected supply factors such as robust production in Saudi Arabia and Libya. To the extent that oil-producing nations tended to save a greater proportion of their incomes than oil importers, the net effect of the reduction in oil prices and the resulting support to real incomes in the oil-importing countries would probably help cushion the decline in global demand.

Money, credit, demand and output

13 The ONS's updated estimate of the change in GDP in the first quarter, at -0.3%, had not been revised. The latest data release, consistent with the forthcoming ONS Blue Book, had contained only modest revisions to the historical data, and so had few implications for the interpretation of UK economic developments over the past few years. In the most recent data, however, revisions to the expenditure components of GDP had been unfavourable. The contribution to GDP growth from net trade in the first quarter had been revised down to -0.4 percentage points. Consumer spending was now estimated to have fallen slightly. And business investment growth had also been revised down. Offsetting this, government spending – particularly on investment – had been revised up significantly, but such strength was unlikely to persist.

14 Perhaps more significantly, business survey indicators of activity had been weak. Although the CIPS/Markit manufacturing activity index had recovered in June from the very sharp fall in May, this had been more than offset by a reduction in the service sector activity index, as presaged the previous month by a sharp fall in the service-sector activity expectations index. The latter had fallen sharply again in June, which had added to the sense from the previous month that underlying growth in the second half of the year was likely to be weaker than the gradual pickup expected at the time of the *May Inflation Report*.

15 It was possible, however, that these surveys of business output had been temporarily affected by the impact of the the Diamond Jubilee public holidays and heightened uncertainty about the euro area, and so might recover over the coming months. Moreover, the available indicators of domestic spending did not, in general, show a marked weakening. The most recent retail sales and *CBI*

Distributive Trades survey data remained consistent with an increase in consumer spending. And survey measures of business investment intentions had been relatively stable, albeit at subdued levels. Indicators of exports were, however, weak. Aggregate goods exports had fallen by 7.7% in April, with reductions in exports to both EU and non-EU countries. Within the EU, exports had fallen to several of the core euro-area countries – most notably Germany. The trade data were extremely volatile from month to month. But the CIPS/Markit survey indicator of new export orders in June had also indicated further contraction. This, along with the continuing weakness of demand in the euro area, suggested that some of the weakness of export growth was likely to persist.

16 The annual growth rate of bank lending to households had remained at 1% in May: indeed the growth rate had changed very little since the middle of 2009. The stock of loans from UK banks to UK private non-financial businesses had fallen by £1.7 billion in May, after a small increase in April; in total, it had fallen by 3% over the twelve months to May. Interest rates charged on mortgages and loans to small and medium-sized companies had risen since the beginning of the year. And the Bank's *Credit Conditions Survey* indicated that further increases in spreads over reference rates were expected. Broad money growth had remained subdued, with the twelve-month growth rate standing at 3.1% in May, although this was around half a percentage point stronger than the growth rates seen at the turn of the year.

17 During the month, the Government and Bank had announced the creation of the FLS. The Committee had discussed the details of the scheme, which were shortly to be announced publicly. The FLS would offer funding to banks significantly cheaper than was available in the market together with embedded financial incentives to encourage them to increase lending above that already planned. An initial analysis by Bank staff had suggested that this would more than offset the tightening in credit conditions that had occurred since the *May Inflation Report* had been finalised. It was also possible that the scheme would alleviate some of the credit constraints on households and firms that wished to borrow, but had been unable to. Given that the FLS involved the injection of a substantial quantity of liquid, risk-free Treasury Bills into the economy, it might also be associated with a variety of portfolio-balance effects.

18 Overall, there were reasons to believe that the scheme would provide a material economic stimulus. But it was too early to judge with any precision what the economic impact would be and when it might be felt. That would depend on: the take-up by eligible institutions of the favourable

funding provided by the scheme; whether that put downward pressure on other costs of funding and the extent to which banks passed on lower funding costs into the rates charged to household and business borrowers or relaxed non-price loan terms; the impact of those changes in interest rates on the demand for loans; the magnitude of any portfolio-balance effects; and the extent to which banks were capital-constrained. The Committee would monitor the evidence closely over the coming months.

19 In addition to the FLS, the Bank had activated its ECTR facility, auctioning liquidity against a broad range of collateral at a minimum of Bank Rate plus 25 basis points. Following the announcement three-month LIBOR had fallen by around 10 basis points and market expectations of three-month LIBOR in six months' time had fallen by double that. This would reduce the interest payments of businesses who were servicing loans with terms linked to those rates. As well as these initiatives, the Bank's Financial Policy Committee (FPC) had at its June meeting recommended that the FSA make clear to banks that they were free to use their regulatory liquid asset buffers in the event of liquidity stress. The FPC had also recommended that the FSA consider whether adjustments to microprudential liquidity guidance were appropriate, in light of the additional liquidity insurance provided by the ECTR. The implementation of those recommendations was a matter for the FSA. But the FPC judged it important to send a clear signal of liquidity guidance having been loosened. The effect of a loosening of such guidance might well vary from bank to bank and its impact on the rest of the economy was difficult to judge. It was possible that some banks might use the funding currently supporting such liquid assets to finance greater lending to households and businesses.

20 In sum, a range of policy initiatives had been implemented or announced that would be likely to provide a potentially significant stimulus to economic activity via the banking system. These would help to offset the recent downside news about the near-term prospects for output growth.

Supply, costs and prices

21 Twelve-month CPI inflation had fallen to 2.8% in May from 3.0% in April. The largest single contributor to the reduction had been a decline in the contribution of fuel prices. In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had fallen by 2.2% in June, mostly reflecting a reduction in crude oil prices. And producer output prices had fallen by 0.4%, largely caused by a fall in the price of petroleum products.

22 The reduction in global energy prices, as well as the announcement by the Government of the postponement to the planned increase in fuel duty, meant that the near-term path of inflation would probably be substantially lower than assumed at the time of the *May Inflation Report*. While these factors did not directly affect the outlook for inflation in the medium term, they had reduced the risk that public expectations of inflation would begin to drift upwards and that the commitment of the Committee to meeting the inflation target would be called into question.

23 Some other factors also pointed to a weakening of medium-term inflationary pressure, not least the probable lower near-term outlook for output growth and the associated increase in the margin of spare economic capacity. Private sector twelve-month regular pay growth had remained subdued at around 2% in April. And within that, across-the-board pay settlements data for April had remained very weak, although it was possible that lower settlements would subsequently be offset by increased pay drift if productivity began to recover. Moreover, the prospective slowing in global demand would be likely to dampen pressure on commodity prices. In addition, it was possible that, in the face of weaker than expected demand, the anticipated rebuilding of firms' price margins might be slower than assumed. A special survey by the Bank's Agents suggested that the majority of businesses anticipated rebuilding their profit margins over the next one to three years. Recent staff work indicated that the squeeze on firms' margins had been most acute in the intermediate sectors further up the supply chain, which might suggest that any rebuilding of margins would be evident in CPI inflation only slowly. Furthermore, aggregate data on the rate of return on corporate capital, relative to some measures of the cost of capital, did not suggest that, on average, profit margins needed to be rebuilt.

24 But, set against those factors, private sector productivity had continued to fall. Despite the reduction in demand so far in 2012, employment had increased by 166,000 in the three months to April by comparison with the previous three months, as gains in private sector employment had more than offset public sector job cuts. Job gains over the past year had been concentrated among the self-employed, those in more highly skilled occupations and those with high educational attainment, which made the continued reduction in the level of productivity all the more puzzling. Overall, it seemed that the level of productivity had weakened further. Combined with the stability of private sector pay growth, this suggested that the wage costs incurred by firms, per unit of output, had been rising by around 2% year-on-year so far in 2012, similar to pre-crisis norms. Underlying the *May Inflation Report* projections was a reduction in unit labour cost growth to below average rates.

The immediate policy decision

25 The Committee set monetary policy in order to ensure that CPI inflation was on track to meet the 2% target in the medium term, and so considered how the medium-term outlook had evolved over the month, and since the time of the *May Inflation Report*.

26 The near-term outlook for GDP growth had weakened. It now seemed possible that output would be roughly flat over 2012 as a whole, implying a period of two years where there had been little or no economic growth – a near-term picture somewhat weaker than had been expected at the time of the *May Inflation Report*. Some of that evidence had begun to emerge before the Committee's previous meeting. But the survey data had continued to weaken this month. This suggested that a further margin of spare economic capacity would open up. Global demand had slowed, and the near-term outlook was weaker than the Committee had assumed in May, largely due to the impact of the euro-area financial crisis. And, notwithstanding the initial positive market reaction to the political developments within the euro area, very substantial risks there remained. These could, if they crystallised, have a considerable impact on economic activity in the United Kingdom and the stability of the global banking system. There were increasing signs that the threat of a disorderly resolution of the financial tensions in the euro area was affecting growth at home. Information during the month suggested that export prospects had weakened, which would further impede the UK economy's rebalancing away from domestic demand towards net exports.

27 Inflation had fallen slightly faster than the Committee had expected at the time of the *May Inflation Report*. In large part, that was because of the reduction in global energy prices that had occurred since then. It was unlikely, therefore, that those developments had a very significant bearing on the outlook for underlying inflationary pressures in the medium term. But, with inflation now likely to continue to fall modestly during the rest of the year, it had become less likely that expectations of elevated inflation would become ingrained in wage and price setting behaviour.

28 In light of the change in the risks to the outlook for inflation since the time of the *May Inflation Report*, all members of the Committee judged that further economic stimulus was required in order to meet the inflation target in the medium term. A potentially significant, but hard to calibrate, additional stimulus would come from the FLS, the prospective relaxation of regulatory liquidity requirements,

and the activation of the Bank's ECTR facility. These policies could affect the level of aggregate demand, as well as the economy's supply capacity. The key question for the Committee was whether an additional stimulus was required over and above these initiatives.

29 At the previous month's meeting, the Committee had considered the case for a reduction in Bank Rate below 0.5%, and had judged that such a policy continued to have drawbacks that made it less attractive than an extension of the asset purchase programme. The arguments for and against a cut in Bank Rate at this meeting were the same as before. But the impact of the FLS and other policy initiatives might, in time, alter the Committee's assessment of the effectiveness of such a rate reduction. The Committee could review this option again when the impact of the FLS and other policy initiatives was more readily apparent; that was unlikely to be for several months.

30 All members expected the recently announced policy initiatives to boost the supply of credit and provide a fillip to economic activity. Most members felt that the case for adding to this by undertaking further purchases of gilts, financed by the issuance of central bank reserves, at this meeting was nevertheless compelling and stronger than at the previous meeting. For them, while there were risks to medium-term inflation in both directions, developments since the previous meeting meant that the upside risks had declined and the possible cost of erring on the side of providing a greater stimulus was less than that of providing too little. Those members discussed the case for undertaking additional asset purchases, of either £50 billion or £75 billion. On balance, and in light of the potential stimulus provided by the other recent and prospective policy initiatives, these members judged that an additional £50 billion of asset purchases was appropriate at this meeting in order to balance the risks to inflation around the 2% target in the medium term.

31 In the judgement of other members, the balance of risks around the outlook for inflation in the medium term had shifted less since the time of the *May Inflation Report*. While inflation had fallen, and was expected to fall further, this was very largely a consequence of temporary price-level effects resulting from the reduction in oil prices. Moreover, they expected the policy initiatives announced during the month to have a sufficiently large impact on the supply of credit and on economic activity that no further stimulus was warranted at this meeting. The extent of that economic support could be assessed over the coming months.

32 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 £375 billion of such 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, Paul Fisher, David Miles, Adam Posen and Martin Weale) voted in favour of the proposition. Spencer Dale and Ben Broadbent preferred to maintain the stock of asset purchases, financed by the issuance of central bank reserves, at £325 billion.

33 The Committee agreed that the additional asset purchases should take place over a period of four months.

34 Earlier in the month the Committee had been consulted over the size and terms of the ECTR, in advance of the first monthly auction on 20 June.

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.