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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 JUNE 2012

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These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 June 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1206.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 4 and 5 July will be published on 18 July 2012.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 JUNE 2012**

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**

1 Financial market events had again been dominated by developments in the euro area. Market prices had also been adversely affected by weaker economic data from the United States and emerging economies.

2 The bond yields of several euro-area governments had been elevated and volatile, as market participants reassessed the political situation in Greece and concerns had grown about some other vulnerable European countries. In Spain, ten-year bond yields had reached 6.6% during the month, reflecting market participants' uncertainty over how the previously announced recapitalisation of Bankia, one of the country's largest lenders, would be funded, as well as upward revisions to the estimated size of the fiscal deficit in 2011. By contrast, the yields on UK, US and German government bonds had fallen to new lows, as investors sought assets that were perceived as relatively safe.

3 Bank credit default swap premia had increased internationally, including in the United Kingdom and United States. According to market intelligence, this had reflected both perceived exposures to economically troubled euro-area countries and the possibility of downgrades to US and UK bank credit ratings over the coming weeks. UK banks had continued to access some term funding markets, albeit at an elevated cost. In the interbank markets, sterling LIBOR-OIS spreads had remained elevated and larger than the corresponding euro spread.

4 Consistent with increased perceptions of risk, equity markets had fallen internationally, with the FTSE All-Share index 2.6% lower on the month, and indices in the United States and, especially,

euro area also having fallen. Gross UK non-financial corporate bond issuance had been strong in the first quarter. That issuance had, in aggregate, been accompanied by a reduction in borrowing from banks, suggesting that the terms of bank credit remained less favourable than those of raising funds in the capital markets.

5 Following the IMF's announcement of the conclusion of its Article IV mission to the United Kingdom during the month, market participants' expectations of an expansion of the asset purchase programme, and possibly a small reduction in Bank Rate, had grown a little. But the likelihood of either outcome occurring at this meeting was thought by market participants to be relatively small.

6 The sterling effective exchange rate had fallen by around 1.5%, partly reversing the appreciation seen earlier in the year. That had largely reflected a depreciation against the US dollar. The euro had depreciated by 3.5% against the US dollar over the month, as investors sought to diversify their holdings amid increased tensions in continental Europe.

### **The international economy**

7 PPP-weighted world output appeared to have grown in the first quarter by around 1%. That would be, if anything, slightly stronger than assumed in the MPC's May *Inflation Report* projections. But some indicators for the second quarter had been more subdued, particularly for global manufacturing output.

8 Euro-area GDP was estimated to have been unchanged in the first quarter. Within that, GDP had increased by 0.5% in Germany, which had been more than accounted for by the strength of net trade. By contrast, there had been further falls in output in Spain and Italy. Indicators for the second quarter suggested a weakening in growth. The composite euro-area Purchasing Managers' Index (PMI) had fallen to around a three-year low in May, including large falls in France and Germany. According to the European Commission survey measures, euro-area industrial confidence had fallen to its lowest level since early 2010. These indicators suggested that euro-area GDP would fall in the second quarter.

9 It was highly probable that business sentiment had been affected by the continuing financial and political tensions within the euro area. Market participants' perceptions of the likelihood of a

disorderly outcome had risen again. There remained considerable uncertainty over the likely result of the second Greek election on 17 June. Alongside the upward revisions to the estimated 2011 fiscal deficit in Spain, at the time of the meeting uncertainty remained as to how the Spanish authorities' proposed capital injection into Bankia would be funded and the contribution, if any, from the European authorities. The possibility of some form of European banking union had been raised by the European authorities. But it was as yet unclear exactly what this might involve.

10 In the United States, monthly activity indicators had been consistent with a modest rate of growth in the second quarter. Non-farm payrolls had risen by only 69,000 in May, while the data for April had been revised downwards, although some of that weakness might be attributable to temporary factors associated with the weather and construction activity. Much of the support for spending earlier in the year seemed to have been associated with a temporary boost to inventory accumulation, and household spending on durable goods – especially automobiles. It was unclear how lasting that would prove to be in the face of weaker employment and income growth. This month's data had added to the sense that, as in the previous two years, signs of a more pronounced economic recovery had begun to fade since the spring.

11 Growth prospects also seemed to have softened in some of the emerging economies, with a range of indicators pointing to a further slowing in the second quarter. For instance, the composite PMI had fallen in Brazil in May. In China, industrial production growth had fallen back sharply in April, and the manufacturing PMIs had fallen again in May. So far, those data had been consistent with a gradual deceleration in Chinese activity, rather than an abrupt slowdown. Chinese activity indicators, taken together, had been weakening for a number of months and there remained a risk of a more pronounced slowdown, especially if external demand moderated sharply. The Chinese authorities had responded to the deceleration by loosening policy.

12 Oil and other commodity prices had continued to decline, reflecting among other things the expected drag from tensions in the euro area and signs of weakness in Asia. The spot price of Brent crude oil had fallen to under \$100 per barrel by the time of the Committee's meeting – a reduction in sterling terms of 6.7% over the month. Sterling oil prices had fallen by nearly 20% since the beginning of March. Gas, electricity and industrial metals prices had also fallen during the month, which would put some downward pressure on inflation in the United Kingdom and elsewhere.

## Money, credit, demand and output

13 The ONS had revised down its estimate of UK GDP growth in 2012 Q1 by 0.1 percentage points to -0.3%, with the revision concentrated in construction output. That had left the estimated level of GDP over 4% lower than at the beginning of 2008 and 0.4% lower than 18 months ago. Over the previous 18 months, net trade had contributed 1.3 percentage points to GDP growth. But this had been more than offset by weaker domestic demand, with both investment and consumer spending falling by around 1½% over the period as a whole. Abstracting from erratic factors, such as sharp movements in construction and oil and gas extraction output, and the impact of the royal wedding in 2011 – and in light of the Committee’s judgement that the GDP data might subsequently be revised upwards – it was likely that underlying GDP growth in recent quarters had been somewhat stronger than the headline figures suggested. But it had still been weak.

14 There had been some mildly encouraging recent signs for the near-term outlook for growth. After four quarters of contraction, consumer spending had increased modestly in both 2011 Q4 and 2012 Q1. Although retail sales had fallen sharply in April, they had probably been depressed by the poor weather and an erratic fall in fuel sales after the March spike associated with prospective forecourt shortages. The *CBI Distributive Trades Survey* indicated that retailers expected a recovery in sales in May. And the reduction in commodity and especially oil prices seen over the past two months, if passed through to consumer prices, would moderate the squeeze on households’ real take home pay over time. In addition, stockbuilding had reduced GDP growth by around half a percentage point in each of the two quarters to 2012 Q1. If firms were in the process of making a one-off adjustment to inventory levels, this would depress growth only temporarily: indeed, it might even provide some temporary support to output growth over the coming quarters if companies sought to stabilise the stock-to-output ratio around current levels.

15 But, set against those factors, net trade had reduced growth in the first quarter. The prospective weakening in demand growth in the United Kingdom’s major trading partners and the weakness of the CIPS/Markit export orders index suggested that net trade would continue to be weak in the second quarter. Business surveys were indicative of only broadly flat investment in the second quarter. And the rate of real government consumption growth, which had provided an unexpected boost to GDP in the first quarter, was unlikely to be sustained.

16 Survey indicators of output had also suggested a weaker picture than previously. The CIPS/Markit manufacturing activity index had fallen sharply in May. And, while the service sector counterpart had been broadly unchanged, service sector companies' output expectations had also weakened. Overall, the indicators on the month suggested an increased downside risk to the May *Inflation Report* projection that underlying growth was likely to pick up gradually in the second half of the year.

17 It was possible that the impaired UK banking system, coupled with a heightened perception of risk stemming from the euro area, had been a larger impediment to the recovery of both demand and potential supply capacity than previously thought likely: the weakness of lending, housing market transactions, business investment and productivity growth were all possible symptoms of that. Total lending to households had been growing at an annual rate of at, or under, 1% since the end of 2010. Abstracting from the volatility induced by the temporary Stamp Duty exemption for first-time homebuyers, mortgage approvals had been broadly flat for the six months to April. The Bank's Agents had highlighted the constraints on buyers' access to credit as a material factor affecting housing demand. Mortgage spreads over risk-free rates had increased further on the month, primarily reflecting higher bank funding costs. Moreover, the most recent increases in bank funding costs in the month leading up to the meeting indicated that mortgage rates were likely to increase a little further over the coming months. Bank lending to businesses had continued to fall, with market intelligence suggesting that higher funding costs had led to an increase in the lending rates facing smaller businesses. The proportion of service sector firms surveyed by the CBI citing the ability to raise funds as a factor likely to limit output over the coming year had increased sharply in May.

### **Supply, costs and prices**

18 Twelve-month CPI inflation had fallen to 3.0% in April from 3.5% in March. As expected, the largest contributor to the fall had been a reduction in the contribution of transport prices including airfares – an effect brought about by the differential timing of the Easter school holidays between 2011 and 2012. The contribution from tobacco and alcohol to twelve-month inflation had also fallen, as excise duty increases had a smaller effect on CPI in 2012 than they had in 2011. The recent reductions in commodity prices, especially oil and wholesale gas prices, implied a lower near-term outlook for inflation than assumed at the time of the May *Inflation Report*. In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had fallen by 2.5% in

May, following a reduction of 1.5% in April – the main contributors to the fall had been the prices of crude oil, fuels, imported metals and other imports. Producer output prices had fallen by 0.2% in May, weaker than market expectations.

19 Private sector pay in the three months to March had grown by only 0.3% compared to a year earlier. The recent weakness had been largely accounted for by lower bonuses in the financial sector than a year earlier. This was consistent with the intelligence gathered prior to the bonus season. Private sector annual regular pay growth had remained at 1.9% in the three months to March, having been broadly stable around 2% for most of the previous 18 months.

20 Early indications from commercial data providers and the Bank's Agents suggested that basic pay settlements had fallen materially in April, with a higher proportion of across-the-board pay increases clustered around zero than in either 2011 or 2010. These data were provisional, and might be revised upwards. But April was a key month, with around one-quarter of the private sector typically settling then. At face value, the data suggested that pay pressures might be weaker than the Committee had assumed at the time of the *May Inflation Report*. Alternatively, it was possible that employers had attempted to switch away from basic settlements towards more flexible forms of pay, or that the uncertainty surrounding economic and financial market prospects at the end of 2011 and early 2012 had caused employers to delay any pay increases until later in the year. There had been some evidence of companies delaying pay rises and switching to more flexible forms of pay from contacts of the Bank's Agents, who had reported a continuing gradual weakening in overall pay pressures, rather than a sharp recent reduction.

21 The labour costs faced by companies depended on both pay and productivity. Employment had risen by 105,000 in the first quarter, as increases in the number of part-time employees and self-employment had more than offset a reduction in the number of full-time employees. Provisional data indicated that the increase reflected gains in private sector employment in excess of continued job reductions in the public sector. Business surveys were, on balance, consistent with continued modest employment growth into the second quarter. The combination of continued resilience in employment and the weakness of output growth meant that the stagnation of productivity looked likely to continue into 2012 Q2. If anything, it seemed probable that the level of productivity in the second quarter would be a little lower than a year earlier. That, in turn, implied that private sector unit wage costs, abstracting from the impact of financial sector bonuses, would grow at around pre-crisis average rates

in the first half of the year. On the one hand, this was puzzling, given the likely degree of slack in the economy, and the labour market in particular. But, on the other hand, the recent tentative evidence on weaker settlements had provided some reassurance that spare capacity was continuing to bear down on pay pressures as anticipated.

22 Measures of inflation expectations had given no clear signal on the month. While the Bank of England/GfK NOP measures of households' expectations two and five years ahead were higher in May than February, the Barclays Basix measures at similar horizons had fallen. The YouGov/Citigroup measure of expectations five to ten years ahead had also fallen on the month. Measures of financial market participants' inflation expectations derived from gilt prices had declined during the month, with that reduction accounting for almost all of the decline in nominal gilt yields.

### **The immediate policy decision**

23 The Committee set monetary policy in order to meet the inflation target in the medium term. Twelve-month inflation had fallen to 3.0% in April, from its peak of 5.2% in September 2011. And recent reductions in commodity prices suggested that the near-term outlook for inflation was weaker than the Committee had anticipated at the time of the *May Inflation Report*. Further ahead, the Committee's central judgement remained that inflation would continue to decline gradually, as the impact of past increases in energy and import prices dissipated, and a margin of spare capacity bore down on wage and price pressures.

24 For some time, the Committee had recognised substantial upside and downside risks to that central judgement. Despite the weakness of demand, there was a possibility that inflation might remain more persistently above the target. That could occur as a result of: a re-emergence of external cost pressures – for example from commodity prices; firms seeking to rebuild margins that had been squeezed during the recession more aggressively than expected – particularly in an environment where inflation had been continually above target for several years; or because the financial crisis and recession had caused greater damage to the supply capacity of the economy than assumed. To the downside was the possibility that economic growth might prove insufficiently strong to absorb the pool of spare capacity, so that inflation would fall materially below the 2% target once the impact of past increases in energy and other import prices had passed. In particular, there was a risk of a disorderly resolution of the financial and political tensions in the euro area, and of imported cost



pressures falling materially if global activity slowed significantly. It was also possible that productivity growth would recover more rapidly than assumed, reducing unit labour costs, and that businesses' ability to rebuild margins would be lastingly reduced.

25 The Committee judged that the upside risks to inflation had lessened. The recent fall in commodity prices meant that the near-term outlook for inflation was somewhat weaker than a month ago. This had reduced the risk that inflation expectations might not fall as quickly as anticipated. Moreover, the latest data on settlements, while provisional, tentatively suggested that wage pressures might be less than previously assumed, although the implications for inflation were offset somewhat by the recent weakness of productivity.

26 In addition, the downside risks appeared to have grown. The near-term outlook for UK activity had softened, and output appeared to be slowing in the euro area, United States and some emerging economies. Set against that, short and longer-term market interest rates had fallen on the month and this would provide some stimulus. More significantly, however, the risks to UK and global activity from financial distress and political tension within the euro area had intensified again. The likelihood of a disorderly outcome looked to have increased, and that could, if it crystallised, have a significant effect on global demand and the stability of the banking system, including in the United Kingdom. Even absent a disorderly outcome, it was likely that the ongoing threat of such an event would continue to weigh on economic activity in the United Kingdom, and UK banks' ability and willingness to extend credit.

27 There was a range of views among Committee members about how significant the news on the month had been, but all judged that the balance of risks to medium-term inflation had shifted towards the downside compared to the May *Inflation Report* projections. On balance, most members judged that some further economic stimulus was either warranted immediately or would probably become warranted in order to meet the inflation target. Further stimulus might also help limit any long-lasting erosion of the economy's potential supply capacity. But there were also reasons not to add further stimulus at this meeting. Inflation remained elevated, and there was uncertainty as to how quickly it would fall back to the target. Moreover, there was a series of potentially significant events in the near term – including elections in Greece and France, and the European Council meeting at the end of the month – which could materially affect the outlook. The case for further stimulus depended in part on

how those events unfolded. Different members attached different weights to these factors. In addition, there were questions about the form any economic stimulus should take.

28 The Committee noted that the Financial Policy Committee (FPC) was due to meet towards the end of the month and would be discussing a range of issues relevant to the state of the banking system and its ability to extend credit. It was possible that some of the policy options available to the FPC, if exercised, would affect monetary conditions. Some members suggested further consideration of whether bank liquidity requirements might in effect be operating to increase the demand for reserves, offsetting to some extent the impact on the economy of the Bank's increased supply of reserves as a result of the MPC's asset purchase programme.

29 The Committee first considered the merits of a reduction in Bank Rate. In March 2009, the Committee had judged that a reduction in Bank Rate below 0.5% could have counterproductive consequences, in particular constraining some banks' and building societies' ability to lend. Lenders were, in practice, unable to reduce deposit rates below zero. But they had assets – primarily mortgages – with interest payments contractually linked to Bank Rate. Consequently, a reduction of Bank Rate below 0.5% might squeeze some lenders' interest margins to such an extent that they became even less able to extend new credit. On the one hand, there was some evidence that the proportion of outstanding mortgages contractually linked to Bank Rate had increased since early 2009, as a number of borrowers' fixed rate deals had expired and they had moved to paying pre-set rates linked to Bank Rate. On the other hand, since early 2009, retail deposit rates had increased somewhat. So it was possible that lenders had greater scope than before to absorb a reduction in Bank Rate by cutting deposit rates without adverse cash-flow consequences. The extent to which this would be possible would depend on whether other funding costs also fell in line with Bank Rate. In addition to this, it was possible that, were interest rates to fall further, the functioning of the money markets would become impaired. Overall, the Committee judged that, at the present time, a further reduction in Bank Rate would not have any advantages over an expansion of the asset purchase programme, though it would keep the position under review.

30 The Committee also discussed the possibility of changing the remuneration structure on banks' reserves at the Bank of England by paying Bank Rate on only a proportion of those reserves. There were drawbacks with such a policy. There would be a large degree of arbitrariness involved in setting meaningful reserve requirements for individual institutions in an environment where their reserves

were substantially in excess of the stable norms that had prevailed before the financial crisis. To do so would also change the nature of what was commonly perceived to be meant by Bank Rate, and its relationship with short-term market interest rates.

31 Finally, the Committee discussed further asset purchases. The Committee agreed that asset purchases remained an effective tool for lowering a range of market interest rates, supporting asset prices and so nominal demand. Nevertheless, a significant current impediment to the economic recovery in the United Kingdom lay in the interaction between the financial threats emanating from the euro area, their implications for bank funding costs, and consequently for lending to businesses and households. This might have contributed to the rise in interest rate spreads on mortgages and loans to small and medium-sized businesses in recent months, despite the extension of the asset purchase programme in February. Other complementary policy measures that the authorities might take could be better suited to mitigating these problems than asset purchases on their own, and some members expressed a wish for the MPC to consider additional policy tools. In this context, the Governor informed the Committee that initial discussions were underway with the Treasury on possible measures to ease banks' funding costs and enhance their ability to lend.

32 While acknowledging that further stimulus was likely to become warranted at some point, most members noted that there were several key events occurring over the coming weeks that could have a material bearing on the situation in the euro area and that there was merit in waiting to see how matters evolved there before the MPC reached a conclusion on whether to add any further monetary stimulus. That would also allow time for an assessment of any policy recommendations made by the FPC and for the possibility of other policy tools, designed to ease bank funding costs, to be explored. In any event, the reduction in market interest rates that had occurred over the month had already provided some additional monetary stimulus. And some of these members remained concerned about the possible persistence of inflation at above-target rates.

33 Some other members judged that there was already a sufficiently compelling case for providing a further monetary stimulus in the form of some additional asset purchases immediately.

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 maintain the stock of asset purchases financed by the issuance of central bank reserves at £325 billion.

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

Regarding the stock of asset purchases, five members of the Committee (Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale and Martin Weale) voted in favour of the proposition. Four members of the Committee voted against the proposition. The Governor, David Miles and Adam Posen preferred to increase the size of the asset purchase programme by £50 billion to a total of £375 billion. Paul Fisher preferred to increase the size of the asset purchase programme by £25 billion to a total of £350 billion.

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.