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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 9 AND 10 MAY 2012

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 May 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1205.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 6 and 7 June will be published on 20 June 2012.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 MAY 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 improvement in sentiment over the first three months of the year had waned and a sense of caution had again become apparent in financial markets. This reflected renewed concerns about the vulnerabilities associated with the indebtedness and competitiveness of several euro-area economies that had intensified after the results of elections in France and Greece. Divergent movements in government bond yields suggested that there had been some flight to safety: yields on ten-year government bonds had fallen to historical lows in Germany and in the United Kingdom, but had risen again in Italy and Spain. Bank CDS premia were higher on the month, especially for Italian and Spanish banks. The partial nationalisation of Bankia, a large Spanish bank, had added to concerns.

3 Equity markets had fallen. The major indices were between 3% and 6% lower in domestic currency terms since the Committee's last meeting, with the largest decline in the euro area. This was likely to have partly reflected disappointing news on economic activity in a number of countries, as well as the re-emergence of fears of a disorderly resolution of euro-area tensions. Non-financial corporate bond spreads were a little higher on the month and gross issuance by UK companies had slowed in April after a strong first quarter.

4 There had been a further appreciation of sterling. In effective terms, sterling had risen by 2% since the Committee's April meeting and was 8% higher than its low point in the middle of 2011. Market intelligence suggested that sterling had benefitted from investors seeking to shift funds into countries with higher perceived credit quality and liquid government bond markets while continuing to diversify their currency holdings. While sterling remained almost 20% lower than it had been five

years earlier, a continuing appreciation could have a material influence on the outlook for growth and inflation in the United Kingdom.

The international economy

5 There had been some signs on the month of a weakening in the pace of expansion in the United Kingdom's main export markets. JPMorgan's global composite Purchasing Managers' Index (PMI) had fallen in April as weaker activity in the service sector more than offset stronger manufacturing.

6 In the United States, GDP was estimated to have grown by 0.5% in the first quarter, broadly in line with expectations. This had been driven by consumption and residential investment. But the near-term activity indicators had pointed to slightly weaker growth in the second quarter: a fall in the non-manufacturing ISM index in April had more than offset a rise in the manufacturing ISM index. Although non-farm payrolls had continued to increase, the relatively small rise of 115,000 in April was consistent with a slowing in economic activity.

7 The latest indicators had continued to highlight the weakness of activity in the euro area. The composite output PMI had fallen in April in both core and periphery countries to around the levels seen the previous autumn, signalling contraction. Business and consumer confidence indicators had also deteriorated. Consistent with this weakness, the euro-area unemployment rate had risen to 10.9% in March. Uncertainty was likely to continue to weigh on euro-area confidence and activity. The Greek election had been inconclusive and this had led to increased speculation that Greece would leave the euro area. And concerns had increased about the Spanish government's ability to deliver the planned fiscal consolidation against a poor economic background and further sovereign and banking sector downgrades. The euro area continued to face fundamental challenges, in particular the need to reduce the indebtedness and improve the competitiveness of some member countries. Market participants' perception of the risk of a disorderly outcome had increased; such an outcome could result in considerably lower output in the euro area and significant disruption to global banking and financial markets.

8 GDP growth in China had slowed a little to 1.8% in the first quarter, but both the manufacturing and services PMIs increased modestly in April to levels similar to those reached in the first half of 2011. In recent years, domestic demand growth had accounted for more of China's output growth and the current account surplus had fallen from a peak of over 10% of GDP in 2007 to a little under 3% of GDP in 2011. In part this had reflected a decline in China's price competitiveness over this period as

its real exchange rate appreciated. This shift in the Chinese current account surplus raised the possibility that a sustainable reduction in global imbalances might be in train, although one counterpart had been an increase since 2009 in the current account surplus of oil exporters reflecting a higher price of oil, rather than a significant reduction in deficits elsewhere in the world.

9 Oil prices had fallen significantly on the month. The price of Brent crude oil had fallen by 8% in dollar terms. This was believed to have been a consequence of strong Saudi Arabian production, reduced risks to supply in the Middle East and a softening of demand prospects in the United States and Europe. Other commodity prices had also fallen back a little over this period.

Money, credit, demand and output

10 According to the preliminary estimate by the ONS, GDP had fallen by 0.2% in the first quarter of 2012, the second consecutive quarter of contraction. That partly reflected an estimated 3% fall in construction output. Growth in the rest of the economy was also estimated to have been weak, with manufacturing and services output both broadly flat. But business surveys, labour market developments and reports from the Bank's Agents had all pointed to somewhat stronger activity in the first quarter, suggesting that the underlying picture was less weak. Domestic demand growth was likely to have remained subdued. While retail sales volumes had risen by 0.8% in the first quarter, the *CBI Service Sector Survey* and consumer confidence surveys had pointed to much weaker consumption growth. And a slowing in growth in the United Kingdom's main trading partners was likely to have contributed to weaker exports. Goods export growth had fallen back to 0.5% in the three months to February from 4.1% in the fourth quarter of 2011. Partially offsetting the weakness of final expenditure on domestic output, goods imports fell by 2% in the three months to February.

11 The headline level of GDP in the second quarter was likely to be affected by the effects of lost output due to the extra bank holiday associated with the Queen's Diamond Jubilee celebrations and the adverse effects on North Sea oil and gas extraction of disruptions at the Elgin platform. Abstracting from that, early indicators suggested that underlying growth would be positive but subdued in the second quarter. The CIPS/Markit activity indices for both services and manufacturing had fallen back in April, but continued to point to an expansion in output. More positively, the *CBI Industrial Trends Survey* reported that companies' expectations of output over the next quarter had reached their highest level since 1996.

12 Broad money growth had picked up in the first quarter of 2012. On an annualised basis, the stock of broad money had risen by 6.4%, though this largely reflected a recovery from the temporary end-year factors that had depressed it in the previous quarter. Taking the two quarters together, annualised growth in broad money over the six months to March had been weak, averaging less than 3%. Nevertheless, this was likely to have been stronger than would have been the case in the absence of the Committee's asset purchases. Moreover, there had been an increase in sterling deposits held by non-residents, which were not included in headline measures of broad money. These might subsequently be invested in other sterling assets. And market intelligence had suggested that some asset managers were beginning to invest the proceeds from sales of gilts into other assets.

13 Credit conditions for many households and businesses had tightened somewhat over the course of the year as interest rates on mortgages and on loans to companies had risen. For example, the average interest rate on a new Bank Rate tracker mortgage with a 75% loan to value ratio was around 50 basis points higher in April than in August 2011. And the renewed sense of caution in financial markets might delay any significant easing in credit conditions. Bank borrowing by companies had fallen sharply in the first quarter. This was associated with robust corporate bond issuance as large companies raised funds from the capital markets rather than the banking sector. Growth in the stock of loans to households had also remained weak. Mortgage approvals for house purchase had remained subdued in March compared with the stronger figures leading up to January, suggesting that some part of the earlier strength might have been due to loans being arranged in time to take advantage of the temporary stamp duty exemption for first-time buyers that expired in March. The Halifax and Nationwide house price indices both fell in April, though they were broadly unchanged on a year earlier.

14 Whole-economy output remained some 4% below its pre-crisis peak. The sluggishness of output growth in the aftermath of the financial crisis reflected the headwinds from weak real income growth, global developments, and the process of balance sheet repair underway in the public and private – particularly the financial – sectors. But the degree of downward pressure on inflation arising from weak growth in recent years had been offset by external pricing pressures and exceptionally weak productivity growth.

Supply, costs and prices

15 Twelve-month CPI inflation had risen to 3.5% in March, a slight increase from 3.4% in February, as a pickup in goods price inflation more than offset cuts in utility prices. In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had fallen by 1.5% in April, somewhat weaker than market expectations, driven mainly by lower crude oil prices. Producer output prices had increased by 0.7% in April.

16 While CPI inflation was well below its peak of 5.2% in September 2011, it was above the 2% inflation target and appeared likely to remain elevated over the near term. The above-target rate of inflation in March largely reflected the effects of past increases in import and energy prices. There had not been strong growth in domestic costs: companies' unit labour costs had increased over the previous year at around their average historical rate. That provided some reassurance that inflation would fall once external price pressures eased. But there remained a question as to why domestic costs were not even weaker given the lacklustre output growth achieved in recent years and the elevated rate of unemployment. The Labour Force Survey measure of unemployment had decreased slightly to 8.3% in the three months to February. But it remained around three percentage points higher than at the start of 2008.

17 Earnings growth had been subdued in 2011 and had declined further at the beginning of 2012. This partly reflected weak pay pressure in the public sector, but even in the private sector regular pay growth had been stable at an annual rate of just under 2% in the three months to February, compared with a rate of around double that in the years before the financial crisis. Despite that, unit labour costs were growing at around average historical rates because of the extreme weakness of productivity growth.

18 Private sector employment had increased by around 450,000 since the middle of 2010, while public sector employment had fallen by around 350,000. Overall employment had picked up in the fourth quarter of 2011, increasing by around 60,000. Since the start of the year, GDP had fallen slightly, while employment had increased further in the three months to February, suggesting that there had been a continuation in the weakness of productivity, which was probably at a level no higher than it had been a year earlier.

19 A key challenge was to understand better why weak economic activity had not generated greater downward pressure on inflation. It was possible that the degree of slack in the economy was having less impact on inflation than assumed. For example, that might be because firms with less access to credit were unwilling to cut prices when there was a risk that they would have less recourse to external funds should they run into cash-flow difficulties. There was also, however, the issue of very weak labour productivity growth. The Committee discussed two possible broad explanations for this that were not mutually exclusive. Both suggested that the supply capacity of the economy had weakened alongside the weakness of demand. First of all it was possible that the weakness in productivity and demand had a common cause, such as the widespread fear of a disorderly resolution of the euro-area crisis. Symptoms would include elevated risk premia that raised bank funding costs and the cost of capital to companies, whether they were reliant on the banking system for finance or not, and weakened physical investment and innovation. The second explanation was that the weakness in productivity had itself been caused by weakness in demand, perhaps because of mothballing of capital or reduced scope for learning on the job. Elements of both explanations seemed to be evident and helped account for low productivity growth and the lack of more substantial downward pressure on domestic costs.

20 The weakness of productivity growth in recent years had contributed to the low level of businesses' profit margins. It was possible that companies would seek to restore margins by increasing their prices, particularly if they thought that their competitors were also behaving in the same way. The latest quarterly CBI surveys suggested that in the first quarter of 2012 there had been an increase of about 0.3 percentage points in the one-year ahead inflation expectations of companies. This was consistent with a similar increase in the Yougov/Citigroup survey of households' one-year ahead inflation expectations.

The May GDP growth and inflation projections

21 The Committee reached its policy decision in the light of its projections published in the *Inflation Report* on Wednesday 16 May.

22 Output was expected to be reduced by the loss of a working day at the time of the Queen's Diamond Jubilee in June, and possibly buoyed by the impact of the Olympics in the third quarter. Four-quarter GDP growth was projected to increase gradually as households' real income growth picked up, supporting a revival in consumer spending.

23 Developments abroad, particularly in the euro area, continued to be a major influence on the UK economy. The projections assumed that euro-area policymakers ensured that the twin challenges facing the periphery countries of regaining competitiveness and reducing indebtedness were tackled in an orderly fashion. Even so, growth in the euro area was likely to pick up only modestly, and to remain below pre-crisis average rates for some time. There were substantial uncertainties around that projection given the scale of the adjustments that were necessary. And, despite recent policy initiatives, there was still a possibility that this process would involve a disorderly adjustment, resulting in sharply lower output in the euro area. The Committee judged it likely that the possibility of such extreme outcomes crystallising would continue to weigh on UK activity for some time, even if those outcomes did not actually occur.

24 The outlook for growth also depended on: the outlook for productivity growth and its impact on household and corporate incomes; how rapidly consumption responded to the recovery in income; credit conditions; and the impacts of the fiscal consolidation and the MPC's asset purchases. There remained a range of views among Committee members about the likely effects of those factors on GDP.

25 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 four-quarter GDP growth was likely to pick up gradually, with growth still a little more likely to be below its historical average than above it two years into the forecast period, but with those risks roughly equal at the end of the three-year forecast period.

26 Given the subdued outlook for growth, output was unlikely to surpass its pre-crisis level before 2014 – some six years after the start of the recession. That weak outlook reflected, in part, continued weakness in the growth of productivity and labour supply, and therefore the economy's supply capacity. That said, the Committee judged that there was a sizable margin of spare capacity, largely concentrated in the labour market. This should diminish over the forecast period, although it was unlikely to disappear completely.

27 Inflation had continued to fall back from its recent peak of 5.2% in September 2011. But it remained well above the 2% target. In the near term, inflation was likely to remain well above the target, a somewhat higher profile than thought likely three months earlier. That change reflected, in part, the impact of higher energy prices and indirect taxes. But it also reflected other pipeline pricing

pressures, including the impact of weaker productivity on companies' unit labour costs and past rises in commodity prices passing through to consumer prices more rapidly than had been previously expected. Inflation was expected to decline towards the end of 2012 as the utility price rises in autumn 2011 dropped out of the twelve-month comparison, the impact of past rises in commodity prices waned, and the higher level of sterling reduced inflationary pressures.

28 The outlook for inflation depended on a number of major influences. There might be further shocks to energy and other commodity prices. Companies' domestic costs would be influenced by spare capacity. And the outlook also depended upon the extent to which, and how quickly, slower growth in costs was reflected in inflation. The precise impact of these influences was difficult to predict. Notwithstanding the difficulty in assessing the precise path of inflation over the forecast period, the Committee judged it likely that inflation would fall back, possibly to a little below target, with the risks to that outlook skewed slightly to the upside. By the end of the forecast period there was roughly a one-in-four chance that inflation would be within half a percentage point of the target, but within that central range the MPC found it difficult to attach relative probabilities to different outcomes with confidence.

29 Overall, the Committee's best collective judgement was that by the end of the forecast period, the risks of inflation being above or below the target were broadly balanced.

The immediate policy decision

30 The Committee set monetary policy in order to meet the inflation target in the medium term. Twelve-month CPI inflation was 3.5% in March, down sharply from its peak of 5.2% in September 2011 as earlier increases in energy prices and VAT had dropped out of the twelve-month rate. But CPI inflation was a little higher than previously had been expected and remained well above the 2% inflation target.

31 The Committee's central view was that CPI inflation would fall a little further from its March level over the course of the year, but remain above the 2% target in the near term. This upward revision to the view it had taken in February reflected both the impact of higher energy prices and indirect taxes, and also a judgement that cost pressures from past rises in commodity prices and weak productivity growth were likely to have a greater impact on inflation in the near term than had been expected three months earlier. But the Committee noted that, despite the changes in the near-term

outlook, the fundamental policy challenges following the financial crisis and subsequent recession remained the same. GDP growth was likely to remain weak in the near term and to strengthen gradually thereafter. Developments in the euro area continued to pose a significant threat to that outlook. And although inflation was likely to remain above 2% for the coming year, it was nevertheless likely to fall back gradually to around the target as a result of a gradual easing in the impact of external price pressures and a continuing drag from economic slack.

32 The prospects for inflation remained highly uncertain. The extent to which inflation slowed in the near term depended on: the pace at which external price pressures eased, and hence on developments in commodity and other global prices and the exchange rate; the growth in companies' domestic costs, which were heavily affected by the pace of productivity growth and the extent to which slack in the labour market limited wage growth; and the degree to which companies sought to restore their profit margins by raising prices.

33 There were possible upside risks to the inflation outlook associated with these factors. Inflation might prove more persistent because tight credit conditions and heightened uncertainty prevented the economy's supply capacity from growing at the pace the Committee expected. There was also a risk that companies would seek to rebuild their margins more aggressively than expected following a period of weak profitability, especially if the experience of a sustained period of above-target inflation raised perceptions of the rate of inflation to be expected in the medium term. This might make businesses more inclined to increase their margins and pass on cost increases, and their customers less likely to resist them. And there was a risk that imported price pressures might not wane as expected.

34 On the downside, there were significant risks to economic activity that might result in inflation falling materially below the 2% target in the medium term. While it was expected to fall less quickly in the near term than previously thought, the underlying forces that had been expected to restrain inflation remained in place and might become more evident once the offsetting influence of external price pressures waned. It was possible that the supply capacity of the economy had not been as adversely affected by factors like tight credit conditions and heightened uncertainty as the Committee had assumed. In that case there might be more spare capacity than currently appeared likely. Moreover, demand growth might be weaker than expected. Economic performance in the United Kingdom had been lacklustre over the past year, so it was possible that the headwinds from the external environment, tight credit conditions and fiscal consolidation might be greater than assumed.

35 The Committee had restarted its asset purchase programme in October and at its February meeting had announced an increase in the size of the programme of £50 billion to a total of £325 billion. This had recently been completed. As yet, there was no compelling evidence that the impact on nominal demand of this additional round of asset purchases would be materially different from previous asset purchases. Recent market intelligence, low gilt yields and a pickup in sterling deposits by both residents and non-residents were consistent with asset purchases working as expected through the portfolio rebalancing channel with a lag. But the Committee would keep this under review in judging the policy actions required to support the recovery and meet the inflation target. In so doing, it would also need to take account of any decisions of the Financial Policy Committee that might have implications for the provision of credit to the wider economy and the pace of the recovery.

36 Against that background, and that of its most recent projections to be published in the May *Inflation Report*, the Committee turned to the immediate policy decision. A number of considerations were discussed. On the one hand, CPI inflation remained well above the target and the near-term outlook for inflation had been revised up materially. The best collective judgement of the Committee was that CPI inflation was about as likely to be above the target as below it in the medium term without further monetary stimulus. That suggested that no further asset purchases were necessary at this point.

37 On the other hand, there was a case for injecting further monetary stimulus. The Committee saw no meaningful way of quantifying the size and the likelihood of the most extreme possibilities associated with developments in the euro area and had excluded them from its assessment of the risks around its projections. These risks had recently resurfaced and there was a possibility that they would weigh more heavily than expected on business and consumer confidence. Alongside this, sterling had strengthened and it was possible that it would rise further. Together with the recent fall in world oil prices, that would help moderate external price pressures. Moreover, output remained significantly below its pre-crisis trend and 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 policy in the near term.

38 Different members put different weights on these arguments. For most members, there was not sufficient reason to change either Bank Rate or the stock of purchased assets at this meeting. The Committee noted that the existing stock of past purchases, together with the low level of Bank Rate, would continue to impart a substantial monetary stimulus to the economy for some time to come. For

several members, the decision not to expand the asset purchase programme at this meeting was finely balanced. The Committee would continue to monitor the outlook each month and further monetary stimulus could be added if the outlook warranted it. For one member, however, the balance of risks already warranted a further expansion of the asset purchase programme this month.

39 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, eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher, Adam Posen and Martin Weale) voted in favour of the proposition. One member of the Committee (David Miles) voted against, preferring to increase the size of the asset purchase programme by a further £25 billion to a total of £350 billion.

40 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.