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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 OCTOBER 2012

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These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 October 2012.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2012/mpc1210.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 7 and 8 November will be published on 21 November 2012.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 OCTOBER 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 Globally, there had been several policy developments that had affected financial markets over the month. As anticipated, the ECB had announced a programme to counteract the perceived risk of currency redenomination incorporated into some euro-area countries' sovereign debt yields. This programme of Outright Monetary Transactions (OMTs) would be focused on secondary market purchases of short-dated sovereign bonds of countries that agreed to enter a European Financial Stability Fund/European Stability Mechanism programme. In the United States, the Federal Reserve had announced that it would purchase \$40 billion of agency mortgage-backed securities per month, in addition to reinvesting funds from maturing assets, until there had been a sustained improvement in labour market conditions. And the Bank of Japan had announced a further ¥10 trillion of government bond purchases.

3 Yields on short-term government bonds in Spain and Italy, which had begun to fall in anticipation of the ECB's policy meeting, had fallen further once the OMT programme had been announced; longer-term interest rates had fallen too. Although the initial reaction had faded a little over the month, the comments of market participants suggested that they thought that the OMT programme had removed some near-term tail risks. Contacts suggested that safe-haven flows into the United Kingdom had lessened. But ten-year gilt yields remained at historically low levels. Four fifths of respondents to the Reuters survey of economists expected a further expansion of the Committee's asset purchase programme at some stage. The sterling effective exchange rate index had changed little on the month as the euro continued to appreciate against the dollar.

4 Equity prices had been volatile but had generally been rising since early summer. The FTSE All-Share index, for example, had risen by around 10% since May, and indices globally were around 3% higher on the month. Corporate bond yields in the United Kingdom had remained low, reflecting both the low level of government yields and a decline in the spreads over those yields. That was likely to reflect an increased demand for risky assets on the part of investors, in part prompted by the Bank's purchases of gilts. There had been very strong gross issuance in non-financial corporate bond markets, although in the United Kingdom these markets continued to be accessed by a relatively small number of companies.

5 Banks' funding costs had continued to fall on the month. In part, that probably reflected the perception that the near-term risks emanating from the euro area had moderated. But secondary market spreads on senior debt had fallen by more for UK banks than for banks in other European countries, which was likely to reflect the impacts of the Funding for Lending Scheme (FLS) and Extended Collateral Term Repo Facility (ECTR). That fall in funding costs could put downward pressure on the interest rates charged on existing loans as they were refinanced, as well as on new lending over the FLS drawdown period.

### **The international economy**

6 Output growth had remained soft across many advanced and emerging economies, and world trade had grown only slowly in recent quarters. The JPMorgan global composite Purchasing Managers' Index (PMI) for September had suggested that growth in output and new orders had risen on the month, but those indices also continued to point to below-average growth rates.

7 The European authorities and IMF had not yet completed their latest review of the Greek programme, which would determine whether Greece would be eligible to receive the next tranche of support funds. The ECB's announcements of conditional sovereign bond purchases had provided reassurance to financial markets, but longer-term structural adjustments were still required. Despite falls in unit labour costs in many of the peripheral economies relative to those in Germany, there were still considerable differences in levels of competitiveness. Survey data had pointed to a further slight contraction in GDP in 2012 Q3. In particular, the area-wide composite PMI output index had edged down a little in September and the new business index had fallen by more.

8 In the United States, employment growth had been weaker than at the start of the year. With political negotiations over the substantial pre-programmed fiscal consolidation in 2013 unlikely to make progress until after the US elections in November, uncertainty was probably still weighing on activity. There had, however, been a marked improvement in the manufacturing and non-manufacturing ISM indices for both output and new orders in September. There were also some tentative signs of an improvement in the US housing market – homebuilders’ sentiment had begun to rise in recent months, the overhang of unsold properties was declining, house prices had increased a little and construction companies’ equities had outperformed those of other US companies since the middle of the year.

9 There had been little news on the emerging economies, where growth remained below past averages. In China, the official estimate of GDP growth had softened a little in recent quarters, as had a range of other indicators. Those indicators suggested that external demand had slowed more sharply than domestic demand. The manufacturing PMIs for major emerging economies had generally increased a little in September but remained below pre-crisis averages. Although the most likely outlook remained one of continuing growth in the emerging economies, albeit at below-average rates, there remained a risk of a sharper slowdown. Should that risk materialise, however, the impact on the United Kingdom would probably be tempered by an associated fall in the demand for, and prices of, commodities.

10 Oil prices had fallen a little on the month, but remained higher than at the time of the August *Inflation Report*. The fall on the month probably reflected assurances by the Saudi Arabian authorities that they stood ready to boost production in response to the backdrop of heightened political tensions elsewhere in the Middle East. Industrial metals prices, which appeared to have been less affected by supply shocks than oil or agricultural commodities, had risen by nearly 10% on the month. This was difficult to reconcile with the news on global activity.

### **Money, credit, demand and output**

11 The ONS had revised up its estimate of the change in GDP in the second quarter by a further 0.1 percentage points to -0.4%. Activity in that quarter had been distorted by the additional bank holiday in June associated with the Diamond Jubilee: monthly data for manufacturing and services in June and July suggested that the holiday could have depressed quarterly output by up to 0.5%. The

related bounceback in activity in July, together with a possible boost from the Olympics, meant that published growth rates would most probably turn around markedly in the third quarter. The underlying picture, however, was little changed: survey indicators were consistent with broadly flat underlying output in the third quarter. And, with the Markit/CIPS activity and new orders indices remaining weak in September, the modest pickup in underlying activity in 2012 Q4 anticipated at the time of the August *Inflation Report* now seemed likely to take longer to come through.

12 In the 2012 Q2 National Accounts, the drag from net trade in the second quarter, which reflected strong import growth as well as weak exports, had been revised down a little. Although surveys of export orders remained weak, the lower value of sterling, relative to its pre-crisis level, was still supportive of net exports. A majority of the exporting companies responding to a special survey by the Bank's Agents expected to expand their overseas business over the next twelve months. Business investment growth in Q2 had been revised up, but investment intentions remained weak.

13 The latest data had suggested that consumption had grown a little in both 2011 Q4 and 2012 Q1 and had fallen by only 0.2% in Q2 despite a likely drag from the Jubilee holiday. That growth, which followed falls earlier in 2011, had probably reflected some easing in the significant squeeze in real income growth that had been associated with previous rises in import and energy prices and VAT. Since 2008, however, households' spending had fallen relative to income, such that the savings rate had risen to a level similar to that seen in the early 2000s. The available household-level data up to 2010 suggested that those households with the lowest saving ratios and those with the largest debts before the crisis had subsequently reduced spending by more than others.

14 The twelve-month growth rate of the stock of household credit had been less than 1% over the past two years, compared with an average growth rate of over 10% in the years leading up to the recession. And the stock of loans to businesses had been falling since mid-2009. Against that backdrop, the FLS had been designed to increase the incentive for banks to lend to UK households and companies. There had been some early positive indications of the impact of the Scheme. As of 24 September, thirteen lenders, accounting for nearly three quarters of lending to the UK private sector, had signed up for the FLS. Banks' funding costs had fallen significantly and, since the Scheme had been launched, reductions in some mortgage rates had been announced and a number of major UK lenders had announced new products aimed at companies, particularly smaller ones.

15 The Bank's 2012 Q3 *Credit Conditions Survey* gave the first aggregate read on banks' response to the Scheme. On the household side, that response had been positive: mortgage availability was reported to have increased markedly in the third quarter and was expected to increase further in the fourth quarter. Moreover, the improvement was particularly pronounced for loans at loan to value ratios (LTVs) over 75%. It was too soon, however, to expect to see any impact on lending flows. The responses in the *Credit Conditions Survey* had been less positive for corporate lending: loan availability was reported to have been broadly unchanged in Q3. But some lenders had suggested that this response in part reflected the fact that they did not expect to see a significant increase in companies' demand for credit even at lower rates. For a number of reasons it seemed probable that it would take longer for the FLS to feed through to corporate lending than household lending. Before the crisis, secured household net lending flows had been much larger than those to small and medium-sized companies, so banks wishing to increase their net lending to maximise their access to the FLS might target mortgage lending first. In addition, corporate loans were less standardised than mortgages, so expanding corporate lending would tend to take longer.

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

16 Twelve-month CPI inflation had fallen to 2.5% in August, from 2.6% in July. There had been little news on the near-term outlook for inflation on the month. But higher oil prices and likely rises in domestic energy prices and some foodstuffs meant that inflation might remain broadly flat over the rest of the year, rather than gently falling as expected at the time of the August *Inflation Report*. Private sector average weekly earnings growth had remained stable at around 2%.

17 Employment had continued to grow strongly despite little change in underlying activity, rising by 236,000 in the three months to July, compared with the three months to April. Data on temporary employment suggested that only a part of that rise was associated with the Olympics. With average hours worked remaining robust, the shortfall in productivity per hour relative to the level implied by a continuation of its pre-crisis trend had increased in the second quarter. Understanding the factors behind that shortfall, which had built up to over 10% since the onset of the crisis and was unusually large relative to previous recessions, remained a key challenge.

18 The GDP data could be revised up a little, especially over the past few quarters, as more information became available to the ONS but this was unlikely to change the broad picture

substantially. It was also the case that productivity had been dampened by a secular decline in domestic output of oil and gas, but this too could resolve only a modest amount of the puzzle.

19 It was unlikely that any one factor could explain all of the remaining productivity shortfall. Indeed different factors had probably been in play at different times. In the initial stages of the recession, productivity had fallen sharply as employment fell less than output. But since mid-2010, productivity had fallen back a little with employment rising despite virtually no growth in output. Some of that initial weakness in productivity was likely to reflect spare capacity within companies that had been holding on to staff in anticipation of a recovery. But, taken at face value, more recent survey readings had been consistent with limited spare capacity remaining, suggesting that underlying productivity might have weakened alongside demand.

20 The international evidence suggested that past financial crises had been associated with pronounced and persistent reductions in productivity. One likely channel was via tighter credit conditions. Constraints on the cost and availability of working capital could have reduced the efficiency of production processes. And tighter credit, as well as general economic uncertainty, was likely to have borne down on productivity via lower investment in physical and intangible capital, training and innovation.

21 Firm-level data from company accounts suggested that the reduction in productivity had been largely centred in small and medium-sized companies. That could have been because of the reliance of smaller companies on bank finance for growth, coupled with the impaired flow of bank credit. But there could be other factors depressing their measured productivity. For instance, it was likely that it was impractical for small firms to reduce their workforce below a certain level in the face of weak demand.

22 It was also possible that the disruption to the flow of credit, or some other factor, had hindered the reallocation of capital towards more productive sectors. The rate of new company formation was low. And recent company exit rates had been below those in the 1990s recession, despite the proportion of companies running at a loss being higher. Some companies may have been able to remain in operation during the recession as a result of forbearance from their lenders, the low level of interest rates and initiatives such as HMRC's Time to Pay Scheme. This, in turn, might have limited job losses and reduced measured productivity.

23 It was particularly difficult to explain the recent strength of job creation. But evidence from the Bank's Agents suggested that there had been a wide variety of experiences across companies. Companies that had been expanding may have been doing so primarily via increasing headcount rather than physical capital, possibly because the latter was more costly to reverse and the outlook was unusually uncertain. It was also possible that a lack of bank credit had limited investment.

24 Overall, there were many factors that could help explain the weakness of productivity growth. The key questions facing the Committee were how persistent that weakness would be and the extent to which productivity would pick up as demand recovered, such that the economy could grow without generating inflationary pressure.

### **The immediate policy decision**

25 The Committee set monetary policy in order to meet the 2% inflation target in the medium term. Output had been broadly flat since mid-2010 and recent business surveys were consistent with broadly flat output in the remainder of 2012, a weaker path than the Committee had anticipated at the time of the *August Inflation Report*. The implications of that for inflation would depend in part on whether activity remained subdued thereafter or began to rise gradually. That would depend on the persistence and strength of the headwinds that had constrained growth in the past: the real income squeeze; the fiscal consolidation; global activity and the challenges facing the euro area; and the banking system.

26 There had been signs that the lessening of the real income squeeze that had been associated with previous rises in import and energy prices and VAT had begun to feed through to household spending growth: abstracting from the Jubilee effect in Q2, consumption had started to pick up, although very modestly. Looking ahead, movements in energy, utility and agricultural commodity prices implied that short-run measures of inflation might pick up again later in the year. Offsetting this, employment growth had been much stronger than expected but it was unclear how long that strength would last.

27 There had been little news on the fiscal consolidation, which was likely to continue to weigh on activity over coming years. The Chancellor's Autumn Statement was scheduled for 5 December.

28 Slowing activity in the rest of the world had been a drag on UK exports and had hampered the rebalancing process. Although that was a cause for concern, recent international policy



announcements had reduced the risk of a sharper slowdown. In particular, the ECB's OMT announcement had contributed to a material decline in banks' funding costs, including in the United Kingdom.

29 The decline in UK bank funding costs was also likely to reflect the introduction of the FLS. The signs from the mortgage market, and in particular the increases in the availability of loans at higher LTV ratios reported in the *Credit Conditions Survey*, were encouraging. If greater availability were to feed through into higher housing market activity, that could directly support output and could indirectly support household spending. There were good reasons why it might take longer for lower funding costs to feed through into business lending, although there had been some announcements of new products, predominantly for smaller companies, by major UK lenders in recent months.

30 Inflation was a little above the 2% target, and was likely to remain so in the near term. The outlook for inflation further out would depend not only on whether demand recovered but also on whether that was accompanied by a recovery in productivity. On the one hand, it was possible that a lack of demand had been restraining productivity in some sectors, and that uncertainty about the demand outlook had led companies to step back from investing. In that case, stronger demand could in itself lead productivity to recover quite sharply and would not necessarily add to inflationary pressures. On the other hand, it was possible that constraints on the supply of credit from the banking system were the dominant factor – either by preventing some companies from investing in productive technology or by hindering the reallocation of resources towards more productive companies and sectors. In that case, more buoyant demand in itself might not be sufficient to bring supply back on stream without a material improvement in credit conditions.

31 There were, as ever, limits to what monetary policy could be expected to achieve. The Committee discussed the likely effectiveness of further asset purchases, should they be required. Some members felt that there was still considerable scope for asset purchases to provide further stimulus. Other members, while acknowledging that asset purchases had the scope to lower long-term yields further, questioned the magnitude of the impact that lower long-term yields on corporate debt and equity would have on the broader economy at the present juncture.

32 The Committee discussed whether it was appropriate to modify or continue with the programme of asset purchases that it had agreed at its July meeting and that would be completed ahead of its

November meeting. Although it now seemed likely that the pickup in activity would come through a little later than anticipated at the time of the *August Report*, there had been little news on the month to change the balance of risks to growth or inflation in the medium term. There were some differences of view between members about the outlook and the likelihood that further easing in policy would be required. But there was agreement that there was little to be gained at this meeting in changing the current programme of asset purchases. The Committee would have the opportunity to gauge the impact of past and prospective policy actions at home and abroad over the next month, in the context of preparing its forecasts for the November *Inflation Report*.

33 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 £375 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.

34 Since the Committee's previous meeting, it had been consulted over the size and terms of the Bank's ECTR Facility, in advance of the monthly auction on 19 September.

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  
 Ian McCafferty  
 David Miles  
 Martin Weale

Dave Ramsden was present as the Treasury representative.