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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 APRIL 2013

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 April 2013.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1304.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 8 and 9 May will be published on 22 May 2013.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 APRIL 2013

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. The Committee noted a letter from the Chancellor setting out the remit for the Committee over the following year, in accordance with Section 12 of the Bank of England Act.

Financial markets

2 For much of the month, financial market attention had been focused on the progress of negotiations to resolve the banking sector crisis in Cyprus, and their implications for the rest of the euro area. The agreed outcome had included a €10 billion loan by the European Stability Mechanism and IMF to the Cypriot authorities, the temporary imposition of capital controls, and the resolution of the two largest Cypriot banks, with losses borne by their bondholders and uninsured depositors. An initial proposal to impose losses on insured depositors by way of a levy on all bank deposits had been rejected by the Cypriot parliament.

3 The market reaction to these developments had been relatively limited, with only small moves in most market prices, perhaps reflecting a perception that the situation in Cyprus was contained or unique. Nevertheless, some market moves could be interpreted as suggesting that the Cyprus bailout had demonstrated a greater commitment by the euro-area authorities to shift the burden of future banking sector restructurings from governments to private creditors. Consistent with that, government bond yields had fallen in Italy and Spain, as well as in Germany. And bank CDS premia had risen, especially for banks operating in the euro-area periphery countries; bank equity prices had generally fallen.

4 The Financial Policy Committee (FPC) had announced that major UK banks and building societies should achieve a risk-weighted capital ratio, on a full Basel III basis with adjustments for expected losses, of 7% by the end of 2013, with the Prudential Regulation Authority to examine the

needs of individual banks. Against that benchmark, UK banks and building societies had a collective capital shortfall at the end of 2012 of around £25 billion. This shortfall was at the lower end of external commentators' estimates and there had been little impact on market prices. Equity markets more generally had continued to be buoyant, with some major international equity indices trading around all-time highs in nominal terms.

5 There had been little change in short-term monetary conditions in the United Kingdom, and policy was expected to remain highly stimulatory for some years. A majority of economists polled by Reuters had expected further asset purchases at some stage. And the first increase in Bank Rate was not fully priced into OIS rates before 2016, broadly in line with the implied timing of the first policy rate increase in the euro area and a little after that in the United States. The sterling effective exchange rate had risen by 1% on the month. It had earlier fallen to its lowest level since July 2011, but had then firmed following events in Cyprus, the publication of the minutes of the March MPC meeting, and comments by the Governor.

6 Longer-term nominal yields had declined further in the United Kingdom, with the ten-year government bond yield falling by around 20 basis points to 1.9%. There had been little reaction to the news that Fitch had placed UK government debt on negative watch. The fall in nominal yields was associated with greater falls in real yields; breakeven inflation rates had drifted up in recent months. Three-year inflation rates implied by swaps had risen by more than in the euro area or the United States, consistent with expectations of UK inflation returning to target more slowly. And the market implied measure of inflation in five years' time had risen by a further 30 basis points since the sharp correction in mid-January when the National Statistician had announced that the RPI formula would not be changed.

7 Ahead of the MPC's policy decision, the Bank of Japan had announced on 4 April a set of highly stimulatory measures aimed at meeting its 2% inflation target at the earliest possible time. These included the intention to double the monetary base by the end of 2014 and increase purchases of Japanese government securities across the maturity spectrum. The immediate market reaction to these announcements had been strong, with the yen depreciating by 3% and ten-year Japanese government bond yields falling sharply.

The international economy

8 There had been further evidence of a gradual recovery in global growth, with early signs that both world trade and investment had picked up a little in the first quarter. But the pattern of that growth remained uneven, with a lack of momentum in the euro area contrasting with a stronger outlook for the United States and much of Asia.

9 In the euro area, the earlier tentative signs of an improvement in business and household surveys had not been maintained. The area-wide services and manufacturing Purchasing Managers' Indices (PMIs) had both fallen in March and remained at levels consistent with further contraction in activity. At the country level, the composite PMIs fell in both Germany and France, suggesting little positive momentum even in the core economies. It was possible that elevated event risk, associated with continued political uncertainty in Italy and the handling of the Cyprus bailout, would weigh further on confidence in the euro area.

10 The latest data for the United States had been more positive and suggested a return to moderate economic expansion following a near standstill in the fourth quarter of 2012. Consumer spending had appeared robust, the housing market had strengthened further, and employment had risen strongly in February, with non-farm payrolls increasing by 236,000. Both the manufacturing and non-manufacturing PMIs had fallen in March, unwinding the improvement seen earlier in the year, but continued to point to positive growth. Fiscal policy had become more restrictive. Government funding levels had been agreed for the remainder of the fiscal year, thereby averting a federal government shutdown, but the \$85 billion of sequestration cuts to the annual budget had been left in place.

11 There had been further evidence of expansion in Asia. The PMIs had risen in China in March. And business confidence had improved in Japan amid expected and realised announcements of monetary and fiscal policy stimulus from the Japanese authorities.

12 Commodity prices had fallen a little during the month. There had been a sharp fall in corn prices following a revision to estimates of US stock levels. In dollar terms, the price of oil had fallen by around 4%. UK wholesale gas prices had been very volatile, reflecting supply constraints and a lack of available storage, and had ended the month 7% higher.

Money, credit, demand and output

13 There had been relatively little news in the latest ONS estimates of income and expenditure in the fourth quarter of 2012. GDP had fallen by 0.3%, unrevised from previous estimates, with the decline more than accounted for by the unwinding of the temporary boost from the Olympic Games in the third quarter. GDP was 0.2% higher than it had been a year earlier. Within that, net trade had subtracted 1.2 percentage points from GDP growth. But final domestic demand growth had been more robust at 1.7%. Household consumption had grown more strongly over the year than previously estimated and, with the re-emergence of a real income squeeze, the saving ratio fell back to 6.7% in the fourth quarter. Business investment growth had slowed in the second half of 2012, despite robust investment in the extraction and utility sectors.

14 Official indicators of activity in the first quarter of 2013 had been mixed, with a fall in manufacturing output in January offset by a 0.3% rise in the output of the service sector. Oil and gas extraction had fallen by 4.3% in January as output continued to be adversely affected by repair and maintenance. Survey indicators, while somewhat diverse, had been mildly encouraging. The Markit/CIPS services activity PMI for March was higher than in the autumn and winter, although the manufacturing output PMI remained weak.

15 There had been further evidence of an improvement in the supply of credit following the fall in lenders' own wholesale and retail funding costs since the middle of 2012. Some, but not all, of this reduction in funding costs had been passed through to loan rates. Mortgage rates had fallen sharply over this period, although the pace of decline had eased in March. Effective new business rates on loans to companies had fallen by about 25 basis points since June. Some lenders had also used cashback deals or reductions in fees to pass through the benefits of reduced funding costs to their smaller corporate customers. The Bank's inaugural *Bank Liabilities Survey* had suggested that lenders expected to reduce further their transfer prices – the cost charged to business units to fund the flow of new loans – in the following three months. And the Bank's *Credit Conditions Survey* had indicated that lenders were expecting to reduce spreads further on secured loans to households and loans to businesses.

16 Surveys of businesses taken in the first quarter had also suggested that there had been some easing in credit conditions, although significant differences continued to be reported in access to

finance between large companies, especially those with access to the capital markets, and small companies. There was evidence that investment by companies with access to capital markets, accounting for roughly half of UK business investment, had risen strongly. Given the aggregate behaviour of UK business investment, this would imply that investment by those without access to capital markets might have fallen on average.

17 Despite significant improvements in the price and availability of credit, there had been little sign so far of any significant pickup in net lending to businesses. That may have reflected the usual transmission lags, but it could also point to a more fundamental change in the structure of credit markets. Some contacts of the Bank's Agents had reported a continuing lack of trust between banks and small businesses, and fears that applications for new lending facilities might result in the terms of existing facilities being reappraised. Nevertheless, lenders surveyed in the Bank's *Credit Conditions Survey* had reported expectations of a pickup in the demand for bank credit in the next three months. And a special survey by the Bank's Agents had found that businesses that reported that credit conditions had loosened over the past year were expecting to increase their demand for credit over the next twelve months. In contrast, businesses reporting tighter credit conditions were expecting to reduce their demand. More generally, business surveys had pointed to a slight pickup in investment intentions, consistent with a possible building in the demand for finance.

18 There were some signs that the improvement in the supply of credit had been passing through to the housing market. Housing transactions had risen by over 5% in February, consistent with the growth of loan approvals seen at the end of 2012. The three-month annualised growth rate in net secured lending to individuals had picked up to 0.7% in February. But loan approvals for house purchase had fallen in January and February, possibly affected by the cold weather. Additional measures to support housing market activity had been announced in the *Budget*, although details of the mortgage guarantee component of the Help to Buy scheme had not yet been finalised. Compared with the previous three months, house prices had risen by about 1% in the three months to March on the average of the main lenders' indices.

19 The three-month annualised growth rate in unsecured lending had picked up to 5.5% in February, with positive net lending in both credit cards and other loans and advances. Retail sales had grown by 2% in February, consistent with further growth in consumption in the first quarter of 2013.

Supply, costs and prices

20 Twelve-month CPI inflation had risen by 0.1 percentage points to 2.8% in February, in line with market expectations. Although changes to duties announced in the *Budget* and lower sterling oil prices would dampen the expected increase over the coming months, inflation still appeared likely to pick up to around 3% in the middle of the year. And the recent cold weather had increased the risk that further rises in seasonal food prices would push up CPI inflation in the months ahead.

21 Pay growth had continued to be weak: annual growth in private sector regular pay in the three months to January was 1.2%, a fall of around 1 percentage point since the middle of 2012. Indeed, the level of average weekly earnings in January, at £470, was lower than it had been the previous April. The continued weakness of pay pressure was likely to reflect both resilient labour market participation rates and sluggish productivity growth.

22 Employment had increased in the three months to January by 131,000, continuing the upward trend seen since the middle of 2011. Unemployment was broadly unchanged at 2.52 million, down 136,000 from a year earlier. Labour market participation had appeared more resilient than previously expected. In contrast to previous recessions, where flows into inactivity had increased and outflows fallen, there had been little sign that those without jobs had reduced their attachment to the labour market. In addition, the participation rate of older workers had continued to increase. Further, the number of economically inactive people classified as long-term sick had fallen by around 145,000 following changes to incapacity benefits introduced in October 2008. This increase in labour supply might have contributed to the weakness of pay growth.

23 Productivity had continued to fall in the fourth quarter of 2012, with employment increasing as output fell, adding further to the longstanding productivity puzzle. Information on the output and employment of individual businesses from the 2011 *Annual Business Survey* and the 2012 *English Business Survey* had suggested that there might have been unusually high labour retention by businesses whose output had fallen: 20% of all employment in the sample had been in businesses whose output was falling but whose employment was nevertheless broadly flat, double the share immediately prior to the crisis. In previous recessions, which were often associated with tight monetary policy, such businesses might have failed completely. The relatively low rate of company

failure in this episode might therefore be one of a number of factors explaining why aggregate productivity had been lower relative to its pre-crisis trend than in previous recessions.

24 There were likely to be two broad explanations of why business failures had been lower in recent years than would have been expected on the basis of their previous relationship with output growth. First, low nominal interest rates had alleviated the financial pressure on indebted businesses, thereby helping them to survive, in contrast to previous recessions which had been associated with tight monetary policy. Second, forbearance by lenders had provided some indebted businesses with the opportunity to continue trading when they might otherwise have failed. It was also possible that the changes resulting from the Enterprise Act 2002 made it easier for businesses in difficulty to carry on trading in current circumstances. Forbearance might have occurred because lenders had been unwilling to write off, or make provisions for, bad loans when their own capital position was weak. But, were forbearance to cease, it was not obvious that the resources currently used by struggling businesses would necessarily be re-employed in healthy businesses. It was possible that less forbearance would lead simply to more company failures, higher unemployment and lower output. Policies to strengthen the UK banking system, such as those recommended by the FPC, together with policies to encourage lending, such as the Funding for Lending Scheme, were intended to bring about a normalisation of credit conditions that would allow capital to flow to where it could be used most efficiently.

The immediate policy decision

25 The Committee's new remit, as set out by the Chancellor of the Exchequer at the time of his latest *Budget*, reaffirmed that monetary policy should be set to meet the 2% inflation target but in a way that avoided undesirable volatility in output. The new remit also confirmed that the Committee should continue to look through temporary, even if protracted, periods of above-target inflation where it judged that cost and price pressures were consistent with inflation returning to the target in the medium term.

26 The outlook for activity and inflation remained broadly in line with that set out in the February *Inflation Report*. After only weak growth in 2012, business surveys suggested that the pace of expansion in the UK economy was likely to remain muted during the first half of 2013. Employment had continued to rise in spite of the weakness of output growth. Retail sales growth had been strong in

February and suggested that the pickup in consumers' expenditure over 2012 might have been sustained. But there had been only tentative signs of a generalised pickup in business investment other than by utilities and in the North Sea oil industry. The impact of the euro-area debt crisis, together with the fiscal consolidation and tight credit conditions at home, were likely to continue to weigh on demand. The reaction of financial markets to the events in Cyprus had been relatively muted, although the risk that bank depositors might also face losses or capital controls in a future crisis might have increased the fragility of the euro area and the associated downside risks. The stimulus from the Funding for Lending Scheme (FLS) and the asset purchase programme were likely to support a gradual recovery, although there had been some signs on the month that the pace of improvement in credit conditions had eased and net lending had so far remained subdued.

27 Inflation had risen to 2.8% in February, in line with market expectations. It was still expected to pick up to around 3% in the middle of the year. But changes to duties announced in the *Budget* and lower sterling oil prices had offset upside news from the previous month and meant that the overall outlook for inflation was similar to that published in the February *Inflation Report*. While pay growth had been subdued, the impact of this on unit labour costs had been offset by weak productivity growth. And administered and regulated prices were likely to make unusually large and sustained contributions to inflation over the next two years or so.

28 In line with its remit and to avoid undesirable volatility in output, the Committee had previously judged that it was appropriate to look through the impact of these prices on inflation provided that indicators of cost and price pressures were consistent with inflation returning to the target in the medium term. The Committee continued to expect CPI inflation to fall back to around the target in the medium term as a gradual revival in productivity growth dampened increases in domestic costs, and as external price pressures faded. The pace at which inflation was expected to return to the target was determined by monetary policy; this needed to balance supporting the recovery with bringing inflation back to the target promptly. The short-run trade-off between output growth and inflation meant that the Committee could return inflation to the target more quickly than currently expected only by taking policy actions that would provide less support to output. In responding to this trade-off, the Committee was setting policy in broadly the same way that it had done since its formation.

29 The Committee took note of the recommendations of the Financial Policy Committee that sought to improve the capital adequacy of the major UK banks and building societies by the end of 2013. The

Committee agreed that a well-capitalised banking system was essential to improving the supply of credit and the supply capacity of the economy in the medium term. The Committee also saw merit in possible extensions to the FLS that would boost lending further.

30 Against that backdrop, the Committee examined the cases for either increasing the degree of monetary stimulus through further asset purchases, or else maintaining it at the current level.

31 There continued to be a case for a further extension of the Committee's asset purchase programme to support other policies that were being deployed: wage growth had weakened further, consistent with there being a significant degree of slack in the economy; the prospects for growth remained subdued, especially given the continued weakness in the euro area; despite their recent rise, market-implied medium-term inflation expectations remained broadly consistent with meeting the target; and the Committee should look through temporary, even if protracted, periods of above-target inflation. Moreover, it was possible that higher demand would itself push up productivity and, if that were the case, higher output need not be associated with a material increase in inflationary pressure. Further asset purchases, by lowering longer-term interest rates and supporting a range of asset prices, could facilitate a smoother path towards the economy's new equilibrium, help prevent a more persistent reduction in spending, and thereby avoid potentially lasting damage to productive capacity.

32 There were also arguments in favour of maintaining the current size of the asset purchase programme. Monetary policy was already highly stimulatory and the benefit of past actions would continue to be felt: the first rise in Bank Rate was not fully priced into market rates until well into 2016. Inflation was above the 2% target, was likely to rise further later this year, and was expected to remain elevated for an extended period. Medium-term inflation expectations had drifted upwards in recent months, and a further easing might exacerbate this movement and prompt renewed weakness in sterling, with implications for wages and prices. In addition, the extent to which supply capacity would respond to greater demand would depend on how quickly capital and labour could be redeployed from declining to growing businesses. This issue was better addressed by policies to improve the working of credit markets.

33 All members saw some merit in each set of arguments, but weighted them differently in forming their view about the best monetary policy setting to bring inflation back to the target in the medium term while continuing to support output and employment.

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 £375 billion.

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

Regarding the stock of asset purchases, six members of the Committee (Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Ian McCafferty and Martin Weale) voted in favour of the proposition. Three members of the Committee (the Governor, Paul Fisher and David Miles) voted against the proposition, preferring to increase the size of the asset purchase programme by a further £25 billion to a total of £400 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
Ian McCafferty
David Miles
Martin Weale

Dave Ramsden was present as the Treasury representative.