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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 FEBRUARY 2013

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 February 2013.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1302.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 March will be published on 20 March 2013.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 FEBRUARY 2013

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 improved sentiment evident in financial asset prices since the summer had been sustained. In part, that was likely to reflect the continued impact of the exceptionally accommodative policies of major central banks which had encouraged the reallocation of portfolios into more risky assets. It also seemed consistent with financial markets taking the view that the major downside risks had attenuated and, perhaps, that the prospects for a durable recovery in the global economy had improved. Most major equity indices were close to post-crisis highs, and they had risen strongly on the month in the United Kingdom, the United States and Japan. In the euro area the DJ Euro Stoxx 300 index had risen by over 5% over the previous three months, although it had fallen over the past month.

3 The spreads of periphery euro-area government bond yields over those of Germany had on balance changed little over the month, but had narrowed significantly over the previous few months, and there had been successful issuance in January by the governments of Spain, Italy, Portugal and Ireland. Around half of those banks which had participated in the first of the ECB's Long-Term Refinancing Operations (LTRO) had elected to repay some of those funds, in aggregate €137 billion, at the earliest opportunity, which had been greater than market participants had anticipated. The expected path of euro-area short-term interest rates had risen, which seemed to reflect the market impact of the LTRO repayment and reduced market expectations of a further cut in the ECB's main refinancing rate.

4 The expected future path of UK and US short-term interest rates had been stable. Longer-maturity UK government bond yields had changed little since the Committee's previous

meeting although, in common with US government bonds, UK yields had risen by around 60 basis points since the summer. Market intelligence suggested that this had in part reflected some unwinding of safe-haven flows following the reduction of the immediate risks associated with the euro area. In foreign exchange markets, the euro had continued to appreciate and the Swiss franc, often perceived as a safe-haven currency, had depreciated. The Japanese yen had continued to depreciate, reflecting policy developments and statements following the election of the new government. Sterling's effective exchange rate index had depreciated by 4% on the month. The depreciation had been most pronounced against the euro, which suggested that it reflected in part a reaction to financial markets' perception of reduced risk in the euro area, as well as economic developments in the United Kingdom.

The international economy

5 There had been as yet only limited signs of the improvement in financial market sentiment being translated into hard economic data, although there had continued to be some positive developments in Asia and in the United States.

6 In the United States, the small contraction in GDP in the fourth quarter of 2012 had reflected negative contributions from stockbuilding and defence spending, which were likely to be transient; private sector final demand had contributed 0.6 percentage points, its twelfth successive positive quarterly contribution. More timely indicators had reinforced the positive picture: the pickup in housing starts since the middle of 2012 had continued; retail sales and manufacturing output had both risen in December; the labour market had registered another solid increase in employment in January, and past employment data had been revised up; the ISM manufacturing survey for January had risen sharply, although the non-manufacturing survey had fallen a little. Some uncertainty remained about the extent of fiscal tightening. The US Congress had postponed decisions on several aspects of the programmed fiscal tightening until March, and the federal government remained close to its debt ceiling, a limit on government borrowing set by Congress.

7 In Asia, the new Japanese government had confirmed a fiscal stimulus package expected to comprise around 2% of GDP, and the Bank of Japan had announced further asset purchases and an inflation target of 2%. In China, there had been further signs of a resumption of relatively robust growth. GDP growth in the fourth quarter of 2012 had been 2% according to the official estimate, and

the consensus of many external forecasters was that China could sustain annual GDP growth rates of around 8% for some time to come.

8 In the euro area, indicators had suggested that activity had continued to contract towards the end of 2012. More recent survey data had, however, shown tentative signs that the pace of contraction was easing: the area-wide services and manufacturing Purchasing Managers' Indices (PMIs) had risen in January, as had consumer confidence. Concerns about the fiscal position in Cyprus, elections in Italy, and the political situation in Spain illustrated that risks from the euro area periphery remained, even if the chances of disorderly outcomes seemed to have diminished.

9 Oil prices had risen further, by over 4% in dollar terms since the Committee's last meeting and by nearly 10% over the previous three months. The increase had probably reflected improved prospects for the world economy, as well as further declines in Saudi Arabian production. The possibility of further rises, associated with geopolitical developments, could not be discounted.

Money, credit, demand and output

10 GDP had risen only slightly since the middle of 2010, and remained more than 3% below its peak in 2008. In terms of sectors, services output had recently risen above its pre-crisis level, although it remained well below the level implied by a continuation of its pre-crisis growth rate. Output in both manufacturing and construction had remained far below pre-crisis levels. Manufacturing output had initially risen in the aftermath of the crisis, but had slowed in 2011 and had fallen in 2012. The weakness in manufacturing during the second half of 2012 had coincided with a softening in industrial production across a range of countries and disappointing UK exports. That suggested a link to the heightened levels of global uncertainty around the middle of 2012, which now appeared to be abating. Construction output was around 20% below its pre-crisis level. But recent construction industry surveys and reports from the Bank's Agents had suggested that any further contraction in 2013 was likely to be relatively modest. Taking all of this together, the prospect of a modest recovery in GDP growth in 2013 appeared reasonable.

11 According to the ONS's initial estimate, GDP had contracted by 0.3% in the fourth quarter of 2012. That fall could be more than accounted for by the unwinding of the temporary boost from the Olympic Games. The estimate had been slightly weaker than the Committee had anticipated.

Service sector output had been flat, and there had been falls in manufacturing output and in oil and gas extraction, broadly as expected by the Committee. But construction output had been weaker than anticipated and had grown only a little over the quarter, with the ONS having estimated that construction output had fallen sharply in December.

12 The monthly profile of service sector output had also suggested slowing momentum towards the end of the fourth quarter. But more recent survey data had suggested that the weakness might not persist. The Markit/CIPS services activity index had risen in January, and both the business expectations and employment indices had also risen. The falls in manufacturing output in October and November had begun to unwind in December. Combined with the latest Markit/CIPS and British Chamber of Commerce surveys, which had both risen in January, this pointed to a pickup in manufacturing output going into the first quarter of 2013.

13 Bank lending growth to households and non-financial corporations had remained weak. It was likely to take time before the impact of the Funding for Lending Scheme (FLS) on lending flows could be observed. But there had been encouraging signs concerning the effects of the Scheme, which so far appeared to be operating largely as the Committee had anticipated. More generally, the reduction in bank funding costs had been welcome. Fixed-rate mortgage interest rates had continued to fall in January, as had retail unsecured loan rates. There had been some signs of improvement in the housing market: mortgage approvals had increased in the fourth quarter of 2012 and the Nationwide and Halifax indices had suggested that house prices had risen modestly in the three months to January relative to the three months to October. There had been evidence of lower spreads on bank loans to large corporations, and of increased credit availability; those improvements had, however, so far been less marked for small businesses.

Supply, costs and prices

14 Twelve-month CPI inflation had been unchanged in December at 2.7%. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 2.7% for January had been provided to the Governor ahead of publication, although a detailed breakdown of that figure was not available.

15 The Committee anticipated that CPI inflation would rise a little further above the target in the near term, reflecting higher oil prices, the impact of sterling's recent depreciation and, in the second quarter of the year, the effect of the sharp fall in fuel prices the previous year dropping out of the twelve-month comparison.

16 Private sector annual regular pay growth had fallen to 1.5% in the three months to November 2012, slightly weaker than the 2010 to 2012 average of roughly 2%. Regular pay growth had been unusually weak since the crisis, reflecting the effect of elevated unemployment as well as the fall in productivity. Surveys of pay, including information from the Bank's Agents, had suggested that pay growth was likely to be close to 2% during 2013.

17 Employment had continued to grow strongly, rising by 90,000 in the three months to November. The pickup in employment over the past few months had been driven by rising full-time employment, which might point to increased confidence by hiring firms. Surveys of employment intentions had also picked up in recent months, but were nevertheless consistent with a moderation of employment growth in the first quarter of the year, although those surveys had underestimated recorded employment growth recently.

18 Despite the recent weakness of pay growth, the continuing combination of strong gains in employment and weak GDP growth had put upward pressure on unit wage costs. The outlook for inflationary pressure in the medium term depended on the balance between demand and supply capacity, and particularly on the relationship between demand and productivity. In the central view described in the February *Inflation Report*, the expected gentle recovery in output growth was accompanied by a corresponding increase in productivity, lessening unit wage cost pressures. But there remained material uncertainty around that central view. It was possible that stronger demand growth, relative to that central case, might have relatively little effect on the outlook for inflation in the medium term, if it was associated with stronger growth in productivity and so a corresponding increase in the effective supply capacity of the economy. There was also a risk that demand growth could remain sluggish for longer than assumed in the February *Inflation Report* central projection. This would not necessarily reduce inflationary pressure in the medium term if, for example, it were a consequence of deleveraging by the banking system continuing to weigh on productivity by inhibiting a reallocation of capital from less productive to faster-growing sectors of the economy; or, more generally, if weak demand growth were associated with a corresponding weakness of supply.

There was also a possibility that productivity growth might recover to more normal rates in the absence of an increase in demand, if firms shed labour that they expected to remain underutilised, which would result in downward pressure on inflation.

19 Most survey indicators of households' expectations of inflation one year ahead had risen slightly in recent months, but those increases had been similar to the revision to the Committee's own view of the most likely path for near-term inflation. Indicators of households' and professional forecasters' longer-term inflation expectations had remained broadly stable, at around their series averages. Since the spring of 2012, indicators of longer-term inflation expectations derived from financial markets had been affected by the possibility that the formulae used to calculate the retail prices index (RPI) would be changed. Those changes would have reduced the wedge between RPI and CPI inflation, and probably led many market participants to revise down their longer-term RPI expectations. Indeed, market-derived measures of inflation expectations had fallen during May 2012, when speculation about a possible change had begun to emerge. On 10 January, the National Statistician had announced that RPI would not be changed, and market-derived measures of inflation expectations had risen sharply, unwinding their earlier falls; they now stood close to their averages since 2005. The Committee would continue to monitor developments in inflation expectations closely.

The February GDP growth and inflation projections

20 The Committee reached its policy decision in the light of its projections that were to be published in the *Inflation Report* on Wednesday 13 February. The Committee's projections for growth and inflation had been conditioned on the assumption that Bank Rate followed a path implied by market yields, and that the stock of purchased assets remained at £375 billion. That was the same total scale of purchases as in November, and included the intended reinvestment of the £6.6 billion cash flows associated with the maturing March 2013 gilt.

21 GDP growth was likely to remain weak in the near term. But further out, a continued easing in domestic credit conditions and a stronger global backdrop were likely to underpin a slow recovery in both demand and effective supply.

22 Some of the biggest risks to the growth outlook stemmed from overseas. Although recent euro-area policy initiatives had probably lessened the chance that the necessary adjustments to

indebtedness and competitiveness would occur in a disorderly manner, this threat remained. As in previous *Reports*, the Committee's projections excluded these more extreme outcomes, but they assumed that the adjustments were likely to be associated with a prolonged period of sluggish euro-area growth. More generally, the extent to which recent improvements in financial market conditions would persist and spur a strengthening in global demand was uncertain, as was the degree to which UK exporters would be able to capitalise on any such strengthening.

23 Domestically, the strength and sustainability of the recovery would rest on: the extent to which households and companies had already adjusted to the impact of the financial crisis; the degree to which productivity and expectations of future supply picked up alongside demand; the impact of fiscal consolidation; and on whether the recent easing in credit conditions continued and prompted higher lending to the real economy.

24 Taking those risks into account, the Committee's best collective judgement was that the economy was likely to see a slow but sustained recovery over the next three years. The expansion was expected to be weak by historical standards, mirroring the relatively subdued prospects for both demand and the supply capacity of the domestic economy. GDP was likely to remain below its pre-crisis level until 2015.

25 Inflation was likely to rise further in the near term and could remain above the 2% target for the next two years, reflecting sterling's recent depreciation and the persistent contribution from administered and regulated prices. That persistent contribution was likely to be increasingly offset by a gentle moderation in domestic cost growth, aided by a gradual revival in productivity growth, and an easing in external price pressures, such that inflation was likely to fall back to around target by the end of the forecast period. The outlook for inflation over much of the forecast period was higher than in the November *Inflation Report*, reflecting the impacts of administered prices and the lower exchange rate.

26 The Committee judged that demand and effective supply were likely to continue to move reasonably closely together. That implied that some of the uncertainties around the outlook for GDP growth should have only limited implications for spare capacity and hence inflation. Even so, the

evolution of spare capacity in the economy and the extent to which it affected wage and price-setting behaviour were still likely to have an important bearing on inflation.

27 There were a number of other sources of uncertainty affecting the inflation outlook. The extent to which changes in relative prices – including administered and regulated prices – affected the overall inflation rate was hard to predict. Inflation was sensitive to commodity prices and the exchange rate, both of which were prone to move sharply. And the outturn for inflation would depend on the extent to which companies' profit margins were restored through them raising prices rather than reducing costs.

28 There remained a range of views among Committee members regarding the relative strength of these different factors. On balance, the Committee's best collective judgement was that inflation was more likely to be above than below the 2% target for much of the forecast period, but that those risks were broadly balanced by the end.

The immediate policy decision

29 The Committee set monetary policy in order to meet the 2% inflation target in the medium term, and to do so in a way that avoided undesirable volatility in output in the short term. The advance estimate had suggested that twelve-month CPI inflation in January had been 2.7% for the fourth successive month, in line with the Committee's expectation. The Committee discussed its immediate policy decision in the light of developments on the month and its projections to be published in the February *Inflation Report*.

30 The improvement in financial market sentiment in the past few months had continued but it had had mixed effects on the domestic monetary stance: higher gilt yields represented a tightening; the more recent depreciation of sterling's effective exchange rate had imparted an expansionary impetus, but it had also added materially to inflationary pressure in the near term. Alongside this, indicators had continued to suggest that the impact of the FLS to date was largely in line with the Committee's expectations.

31 The news on activity had been mixed. The recovery in the United States appeared to be on track, but the euro area seemed set to remain weak. In the United Kingdom, the fourth quarter GDP data had

been a little weaker than expected. In the course of 2012 there had been considerable volatility in quarterly output growth. Looking through the influence of one-off factors, overall output appeared to have been broadly flat. This had reflected sharp falls in particular sectors of the economy that were unlikely to be repeated in 2013, offset by modest growth in the combined output of the manufacturing and services sectors. Business surveys pointed to a muted pace of expansion in the near term. The weakness in overall output sat in sharp contrast to continued strong employment growth, suggesting that the financial crisis may have had some impact on the effective supply capacity of the economy. The Committee continued to judge that the UK economy was set for a slow but sustained recovery in both demand and effective supply, aided by a further easing in credit conditions – supported by its programme of asset purchases and by the FLS – and some improvement in the global environment. But the risks were weighted to the downside, not least because of the challenges facing the euro area.

32 Inflation had remained above the 2% target. Despite subdued pay growth, weak productivity had meant no corresponding fall in domestic cost pressures. And increases in university tuition fees and domestic energy bills, largely resulting from administrative decisions rather than market forces, had added to inflation more recently. Inflation was likely to rise further in the near term and might remain above the 2% target for the next two years, in part reflecting a persistent inflationary impact from both administered and regulated prices and the recent depreciation of sterling. But the Committee expected inflation to fall back to around the target thereafter, as a gradual revival in productivity growth dampened increases in domestic costs, and as external price pressures faded.

33 The Committee reviewed the range of possible monetary policy instruments other than gilt purchases that might be deployed should further stimulus be warranted. These included: purchases of other assets; a reduction in Bank Rate; and changing the marginal rate of remuneration on banks' reserves at the Bank of England. The Committee had noted drawbacks with each of these options in the past; those drawbacks remained. The Committee would nevertheless continue to examine all of the policies potentially available to it.

34 There was a range of views on the Committee about the marginal impact of a further round of asset purchases at the current juncture, but members agreed that asset purchases remained an effective tool for lowering a range of market interest rates, supporting asset prices. The continuing process of portfolio rebalancing should help to support spending and nominal demand, although the precise extent

to which it would do so was uncertain. All members agreed that the existing stock of asset purchases provided a substantial stimulus, the effects of which were still feeding through the economy.

35 It seemed possible that a further broad-based monetary stimulus would on its own be insufficient to transform the outlook for growth. In that context, the Committee also discussed other potential policy measures that the Bank, together with other UK authorities, might deploy to address particular frictions or market failures that might hamper growth and the rebalancing of the economy. These included measures to increase the flow of credit to the UK economy. The FLS had already been introduced with the aim of supporting the supply of bank credit, and would be kept under review. The Committee noted the recommendation by the Financial Policy Committee that the Financial Services Authority take action to ensure the capital positions of UK banks were prudently stated and, where necessary, the banks took steps to improve the resilience of their balance sheets without hindering lending to the real economy. In addition to improving the supply of bank credit, the Committee thought that consideration of measures to support the flow of credit more broadly, including from non-bank lenders, was also warranted. A number of more targeted interventions to boost demand and the supply capacity of the economy, and to facilitate rebalancing, might be entertained, but many of these fell to other UK authorities.

36 The Committee discussed the appropriate policy response to the combination of the weakness in the economy and the prospect of a further prolonged period of above-target inflation. The Committee agreed that, as long as domestic cost and price pressures remained consistent with inflation returning to target in the medium term, it was appropriate to look through the temporary, albeit protracted, period of above-target inflation. Attempting to bring inflation back to target sooner by removing the current policy stimulus more quickly than currently anticipated by financial markets would risk derailing the recovery and undershooting the inflation target in the medium term. The Committee's remit was to deliver price stability, but to do so in a way that avoided undesirable volatility in output. It judged that its policy stance was fully consistent with that remit. The Committee agreed that it was important to communicate clearly its willingness to bring inflation back to the target over a longer time horizon than usual, and its reasons for doing that. The Committee also agreed that it stood ready to provide additional monetary stimulus if warranted by the outlook for growth and inflation.

37 The Committee then discussed whether further asset purchases were warranted at this meeting. A number of considerations were relevant to its decision, and different members placed different

weights on these. Growth remained subdued and the economy continued to face a number of headwinds squeezing real incomes. But the Committee's asset purchases had already imparted a substantial monetary stimulus. A case could be made that, if further stimulus was required, policy interventions more targeted at particular frictions or market failures in the economy were likely to be more effective in current conditions than further asset purchases. In this context, for example, the Committee continued to monitor the effects of the FLS, which was so far operating broadly as it had anticipated, although it was too early to judge the full effects of the Scheme's impact on bank lending volumes. Inflation was still above the target, and was likely to rise further in the first half of the year, and to remain above the target for the next two years. There was a risk that the prospect of continued above-target inflation could result in a rise in inflation expectations which could affect wage and price-setting behaviour.

38 A case could nevertheless be made for undertaking additional asset purchases at this meeting. Although inflation seemed likely to remain above the 2% target over the next two years, the degree of slack in the economy, and the likely positive response of supply capacity to increased demand, meant that higher output growth would not necessarily lead to any material additional inflationary pressure. Further asset purchases, in part by acting to reduce longer-term interest rates and underpinning the value of a broad range of assets, could help the process of rebalancing the economy, and avoid potentially lasting destruction of productive capacity and increases in unemployment.

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 £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.

40 The Committee noted that the Asset Purchase Facility's holdings of the March 2013 gilt would mature on the day of its March monetary policy decision. In general, the most natural point for the Committee to decide on whether it wished to reinvest the cash flows associated with the redemptions in any particular month was at its meeting immediately preceding those redemptions. But on this occasion, given the coincidence of the date of the Committee's March decision and the maturity of the gilt, it would provide clarity if the Committee indicated its intentions at the current meeting. In the light of its decision to maintain the stock of asset purchases at £375 billion, the Committee voted unanimously that the £6.6 billion of cash flows associated with the redemption of the March 2013 gilt should be reinvested by the Asset Purchase Facility.

41 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.