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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 9 AND 10 JANUARY 2013

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 January 2013.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1301.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 February will be published on 20 February 2013.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 JANUARY 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.

Financial markets

2 The improvement in sentiment evident in asset prices since the middle of 2012 had been sustained over the past month, although, as ever, it was difficult to draw strong conclusions from financial markets around the turn of the year. Nevertheless, market developments in the first week of January had been consistent with greater confidence that some of the major tail risks facing the global economy had been reduced.

3 Markets had reacted positively to the agreement on New Year's Day to moderate the programmed fiscal contraction in the United States. Global equity indices had risen sharply on the news and both the S&P 500 and the FTSE All-Share indices had risen by just under 4% on the month, the latter reaching a four and a half year high. Government bond yields in the United Kingdom and the United States had also risen after the US fiscal news and nominal ten-year forward rates had gone up by between 25 and 50 basis points on the month in these countries. Most of this increase had reflected higher real yields rather than higher breakeven inflation rates, although this had been difficult to disentangle in the United Kingdom in advance of the outcome of the ONS consultation on options for improving the Retail Price Index (RPI). In the event, ten-year breakeven inflation rates rose by 35 basis points on the morning of 10 January immediately following the announcement by the National Statistician that no change would be made to the RPI calculation. Investment-grade corporate bond spreads had tightened a little on the month, with more substantial falls in non-investment grade spreads.

4 There had been relatively little market reaction to the announcement by the Federal Open Market Committee (FOMC) that it had agreed at its December meeting to extend its asset purchase

programme and change its forward guidance regarding the federal funds rate. The minutes of that FOMC meeting had surprised the market by suggesting that more participants than anticipated were expecting asset purchases to be halted in 2013.

5 Periphery euro-area government bond yields had fallen further on the month: since July benchmark ten-year government bond yields had fallen by around 200 basis points in Spain, Italy and Ireland, with larger falls in Portugal and Greece. The Irish government had raised €2.5 billion by tapping an existing five-year maturity bond at a yield of 3.3%, its first syndicated deal since 2010.

6 Sentiment towards the banking sector had also improved further following the announcement by the Basel Committee on Banking Supervision of revised liquidity requirements. UK bank equity prices had risen sharply following the announcement and, for some banks, were about 15% to 20% higher on the month. UK bank CDS premia had fallen. There had been little further change in other measures of wholesale funding costs, such as covered bond and unsecured bond spreads, although these remained significantly lower than in the middle of 2012.

7 There had been little change in short-term monetary conditions in the United Kingdom. Sterling interbank interest rates had been flat and three month LIBOR-OIS spreads remained close to pre-crisis levels. The median expectation of the final total of asset purchases in the Reuters survey of economists had stayed at £375 billion. The sterling effective exchange rate index had changed little on the month.

The international economy

8 There had been some evidence of a modest improvement in global growth prospects, with activity indicators picking up a little, especially outside of the euro area. There had also been further policy developments that had reduced some of the more extreme tail risks.

9 In the United States, activity indicators had suggested that the growth rate might be returning towards its long-run average. Both the manufacturing and non-manufacturing ISM indices had picked up materially in December. Employment growth had continued in line with expectations and outturns in previous months, with non-farm payrolls increasing by 155,000 in December. The recovery in the US housing market had continued and gradually rising house prices had reduced the estimated proportion of households in negative equity. While the agreement to moderate the programmed fiscal

contraction that was due to take place early in the New Year had removed some of the most extreme downside risk, some fiscal tightening was nevertheless being implemented, largely through higher payroll taxes. And decisions on programmed spending cuts and the debt ceiling had been postponed only until March. These, together with uncertainty about the longer-term fiscal position, were likely to continue to weigh on economic activity.

10 In the euro area, a number of indicators had suggested that activity had continued to contract towards the end of 2012. Industrial production had fallen by 1.4% in October, following an even sharper decline of 2.3% in September, with reductions in Germany, France and the Netherlands suggesting that economic weakness was not confined to the periphery countries. Nevertheless, some recent indicators had improved. For example, capital goods orders had picked up in October and the area-wide composite Purchasing Managers' Index (PMI) output index had risen somewhat in December, although that was still consistent with further contraction. Some of the tensions within the euro area had eased following the further disbursement of official sector funds to Greece and as more progress was made towards a banking union. Less positively, growing unease about resolving the fiscal position in Cyprus and prospective elections in Italy could lead to renewed uncertainty.

11 Weak economic data and the outcome of the general election had increased the likelihood of further policy easing in Japan. The Bank of Japan had increased the size of its asset purchase programme in December. As well as seeking to alter the Bank of Japan's mandate to target 2% inflation, the new government was reported to be planning a fiscal stimulus worth 2% of GDP. There had been further evidence that growth in China had stabilised with the composite PMI rising in December.

12 Oil prices had risen by about 3% on the month, while food prices had fallen back a little. Nevertheless, most agricultural stocks remained below long-run average levels, increasing the vulnerability of prices to future shocks to demand and supply.

Money, credit, demand and output

13 According to the most recent ONS estimates, GDP had grown by 0.9% in the third quarter, slightly lower than the previous estimate of 1.0%, although there had been upward revisions to earlier quarters. The mix of expenditure in the third quarter had also been revised. Household consumption growth had been revised down to 0.3%. When combined with upward revisions to household incomes

this implied a pickup in the saving ratio to a little under 8%. Business investment was estimated to have grown by 3.8%, broadly in line with the previous estimate. Most of this investment growth had been concentrated in the extraction and utilities sectors and so did not signal a broad-based recovery. Net trade had contributed 0.5 percentage points to GDP growth as imports fell.

14 The underlying state of the UK economy in 2012 had been difficult to gauge on account of a number of one-off events, such as the Olympic Games and the additional bank holiday for the Diamond Jubilee, as well as volatility in the output of the construction and extraction industries. Following revisions to the historical data, and abstracting from the impact of those one-off events, growth in manufacturing and services output was estimated at around 0.3% per quarter for the first three quarters of the year. But GDP growth had been weaker, largely reflecting the fall in construction output from 2011 levels.

15 The strength of the economy in the fourth quarter could not be judged with precision. Contrary to expectations, service sector output was estimated to have edged up in October suggesting a slightly stronger underlying performance than previously expected. And construction output had grown by 8.3% in October. But other official data had pointed to a weaker outlook. The index of production had fallen by 0.8% in October and, in accordance with the usual pre-release arrangements, the Governor had informed the Committee that it had risen by only 0.3% in November, a smaller increase than had been expected. The major business surveys had given unusually diverse steers on the state of the economy at the turn of the year. While the British Chambers of Commerce survey had suggested that the economy was continuing to grow in the fourth quarter, with the output and orders balances rising in both the manufacturing and service sectors, the Markit/CIPS survey had pointed to a weaker outlook. Its services activity index had fallen in December to its lowest level since April 2009.

16 There had been a similarly diverse pattern in the money and credit data for the fourth quarter. Official data covering lending by all UK-resident banks and building societies continued to be weak. The stock of loans to businesses had fallen every quarter since mid-2009. The annual growth rate in the stock of secured lending to individuals had fallen to 0.6% in November, broadly in line with its average since mid-2009. By contrast, the monetary data had been more positive. Broad money growth had picked up to an annual rate of 4.5% in November, driven largely by an increase in households' money holdings.

17 Despite the recent weakness of credit growth, there was growing evidence that credit supply conditions had improved as the Bank's Funding for Lending Scheme (FLS) gained traction and as sentiment in financial markets improved more generally. In addition to the decline in UK banks' wholesale funding costs, there had been a reduction in many retail deposit rates as banks had less need to bid for retail funds. Lower funding costs had started to pass through to lower loan rates. Rates on new fixed-rate mortgages had continued to fall in December, with rates on two-year fixed rate mortgages at a 90% LTV ratio falling by over 30 basis points. The Bank's 2012 Q4 *Credit Conditions Survey* had indicated that spreads on new lending for medium-sized and large businesses had fallen significantly in the fourth quarter, although spreads on new lending to small businesses had changed little. Looking forward, respondents to the *Credit Conditions Survey* expected that the availability of credit to all sectors would increase further in 2013 Q1. Consistent with the increase in credit availability, spreads on lending to the secured household and corporate sectors were expected to fall further, with the exception of lending to small businesses.

18 Alongside the view from lenders of improving credit supply conditions, surveys of companies had provided corroboration. A survey by the Federation of Small Business suggested that, while credit conditions for small companies remained tight, perceptions of both the cost and availability of credit had improved a little. And the Deloitte Chief Financial Officer (CFO) survey reported that very large companies had healthy balance sheets and were benefiting from benign financing conditions. CFOs had rated credit as being cheaper than at any time since the survey started in 2007 Q3. As had been the case since the middle of 2009, corporate bond issuance was perceived by CFOs to be the most attractive form of finance when compared with bank borrowing and equity issuance. Separate evidence had suggested a change in the use to which the funds raised by bond issuance had been put. Whereas the majority of companies that had issued bonds between 2009 and 2011 had also repaid bank loans in the same year, in 2012 there had been an increase in the proportion of companies issuing bonds that had not then repaid bank loans. That might suggest that they had raised funding in anticipation of future business expansion, consistent with a slight pickup in investment intentions in other surveys. But the Deloitte CFO survey had indicated that, while a larger proportion of CFOs than a year earlier saw increasing capital expenditure and acquisitions as priorities for the next twelve months, their main emphasis had remained on defensive strategies such as reducing costs and increasing cash flow.

19 The contribution of net trade to UK economic growth since the large depreciation of sterling in 2007 and 2008 had continued to be disappointing. While it had contributed 0.5 percentage points to GDP growth in the third quarter, net trade had made a small negative contribution over the preceding year as a whole. The lack of a more significant improvement in the trade performance of the UK economy could partly be explained by slow growth overseas, although there was little evidence that UK exporters were disproportionately reliant on more slowly growing markets. It was also the case that measures of the real exchange rate had appreciated since the end of 2008 as UK costs and prices had risen by more than in other countries and the nominal exchange rate had appreciated somewhat. Receipts of net property income from abroad had weakened and the latest estimates suggested that the current account deficit had been 3.3% of nominal GDP in 2012 Q3. The existence of a significant current account deficit at a time of depressed activity and considerable spare capacity could imply that the sterling real exchange rate was higher than the level compatible with external balance.

Supply, costs and prices

20 Twelve-month CPI inflation had been unchanged at 2.7% in November. Within this, annual goods price inflation had been 1.5% and annual services price inflation had been 4.2%. In line with the usual pre-release arrangements, an advance estimate for twelve-month CPI inflation of 2.7% for December had been provided to the Governor ahead of publication. This was broadly as expected, although a detailed breakdown was not available.

21 Among the factors that had raised CPI inflation in recent months were higher food prices. Twelve-month food and non-alcoholic beverage inflation had been 3.9% in November, somewhat higher than its long run average, driven largely by higher agricultural commodity prices. There was a concern that recent poor weather was likely to affect future harvests and push up further on food prices. But the effect of higher agricultural commodity prices on food price inflation was likely to be relatively muted so long as the costs of food processing and distribution remained stable. Agricultural commodity prices had fallen a little in recent months, although they remained high and vulnerable to further shocks.

22 A number of administered and regulated prices were set to add to CPI inflation in 2013. These included the impact of higher university tuition fees, domestic energy prices, water and sewerage charges and rail fares. Together, increases in these prices were expected to contribute about

one percentage point to CPI inflation in 2013, compared to an average of 0.5 percentage points in the decade prior to 2008. For CPI inflation to fall back to the target in the face of continued upward pressure from administered and regulated prices, other prices in the economy more exposed to market forces would need to rise less quickly.

23 According to the Average Weekly Earnings measure, annual private sector total pay growth had edged down to 1.7% in the three months to October. The sustained period of modest pay growth was consistent with evidence that real product wages had largely adjusted to the weakness in productivity growth seen in recent years.

24 Employment had continued to grow, rising by 40,000 in the three months to October, compared with the three months to July, despite only a modest increase in underlying activity. There remained a considerable shortfall in productivity relative to the level implied by a continuation of its pre-crisis trend. Understanding the factors behind that shortfall, which had built up to around 15% of the level of productivity since the onset of the crisis, and was outside past experience, remained a key challenge. The international evidence suggested that the shortfall was larger in the United Kingdom than most other developed countries. A central policy issue was whether productivity would pick up, and the shortfall get smaller, as aggregate demand expanded. Intelligence concerning the business services sector from the Bank's Agents had indicated that some of the productivity weakness might indeed dissipate if demand picked up. Contacts had suggested that one of the reasons that employment had remained buoyant was that companies found winning and delivering work was more resource intensive in an environment of persistently weak demand. Some companies had retained staff in the light of persistent expectations of a return to more normal demand growth. Both of these factors were likely to dampen the amount by which employment would need to increase when demand eventually picked up, suggesting that some of the productivity shortfall was likely to be temporary. Nevertheless, contacts had identified other factors, such as client expectations of higher service levels and more frequent tendering for work, that were likely to persist, so that not all of the productivity shortfall was expected to be recouped when demand eventually recovered.

25 Overall, the near-term outlook remained in line with the Committee's projections in the November *Inflation Report*, with inflation likely to remain a little above target for the next year or so. The latest evidence from the Yougov/Citigroup survey had suggested that households' short-term and medium-term inflation expectations had remained in line with their series averages.

The immediate policy decision

26 The Committee set monetary policy in order to meet the 2% inflation target in the medium term. The advance estimate had suggested that twelve-month CPI inflation in December had been unchanged at 2.7% for the second successive month. This had been broadly in line with expectations. The Committee's central view, described in the November *Inflation Report*, was that CPI inflation would remain a little above 2% in 2013 before falling back towards the target as external price pressures waned and a pickup in productivity caused domestic cost pressures to lessen.

27 International developments over the month had been, on balance, positive as some of the international tail risks that had weighed on sentiment and activity appeared to have become less acute. That included the agreement to moderate the programmed fiscal tightening in the United States and evidence of a modest improvement in global growth prospects outside of the euro area. And while recent indicators suggested that growth in the euro area had weakened by more than expected in the fourth quarter, the tensions associated with the imbalances within the euro area appeared to have eased further. These developments had contributed to better financial market sentiment and generally higher asset prices. While uncertainty was likely to continue to weigh on economic activity, a further month of relative calm, without negative headlines and unusual market volatility, was welcome.

28 It continued to be difficult to get a sense of the underlying strength of growth in the United Kingdom. Employment growth had remained firm and revisions to official statistics had suggested that growth in manufacturing and services sector output, abstracting from the impact of one-off events, had been relatively stable at around 0.3% per quarter during the first three quarters of 2012. But recent information from both monthly official data and business surveys had been conflicting. Moreover, the unwind from the Olympic Games was expected to depress headline GDP growth significantly in the fourth quarter.

29 There had been some evidence that credit conditions were easing as lower bank funding costs began to pass through to lower loan rates. These developments were broadly in line with expectations of how the Funding for Lending Scheme (FLS) would operate in its early stages. And the Bank's *Credit Conditions Survey* had pointed to expectations of a further easing that could help support lending and demand over the course of the year. There had been evidence of a slight improvement in investment intentions that might herald a more broad-based pickup in business investment.

30 Nevertheless, substantial headwinds to recovery remained, including the drag to activity from fiscal consolidation, a further squeeze in household real incomes, and the deterioration in UK competitiveness over the past couple of years. Indeed, the existence of a significant current account deficit at a time of subdued activity and spare capacity suggested that the sterling real exchange rate might be above the level compatible with the necessary rebalancing of the economy.

31 As with activity, there had been little news to cause the Committee to revise its view of the outlook for inflation. Inflation was a little above the 2% target, and was likely to remain so in the near term. Wage growth had remained subdued and, while productivity growth was also weak, the Committee's central view remained that productivity growth would pick up as the economy expanded. But there remained a question as to whether this would put sufficient downward pressure on unit labour costs and market price inflation to offset the effect of rising regulated and administered prices. Intelligence concerning the business services sector from the Bank's Agents had found some grounds for expecting productivity growth to pick up as the economy recovered. But there was a risk that any recovery in productivity would result in higher wage demands, rather than lowering firms' costs, and so would not deliver the necessary downward pressure on market price inflation.

32 The Committee discussed how further monetary stimulus could be delivered, should it be warranted, and the effectiveness of additional asset purchases. While it was too soon to assess the full impact of the FLS in supporting lending and wider economic activity, the early signs within the banking sector were encouraging. There was also considerable further scope for asset purchases to lower long-term yields on government and corporate debt and support other asset prices. But there remained uncertainty about their impact on nominal demand, and they might prove less effective in boosting real output when resources needed to be shifted between sectors and while the banking system was constrained.

33 Developments on the month had been modestly positive, increasing the confidence of most members that the outlook was broadly as described in the November *Inflation Report*. While these developments had not substantially altered the balance of risks associated with maintaining and increasing the size of the monetary stimulus, they had strengthened the belief of some of these members that no further asset purchases were required at the current juncture. Inflation remained above target at 2.7% and some of the factors currently contributing to higher inflation, resulting from administered or controlled sources, were likely to persist through the current year and beyond. There was a risk that the prospect of continued above-target inflation could result in an erosion of credibility

in the monetary policy framework which could affect wage and price setting behaviour. Against that, growth remained subdued and the economy continued to face a number of headwinds that would squeeze real incomes. Moreover, there was likely to be some excess capacity and some members put weight on the possibility that output could be expanded without generating much additional inflationary pressure. On balance, most members judged that it was not necessary at this meeting to change either Bank Rate or the size of the asset purchase programme in order to meet the inflation target in the medium term.

34 For one member, the case for undertaking additional asset purchases at this meeting was nevertheless strong. Although inflation seemed unlikely to fall very substantially below the 2% target in the medium term, the degree of slack in the economy, and the likely positive response of supply capacity to increased demand, meant that it was probably possible to achieve higher output growth without causing any material inflationary pressure. An easing of monetary policy, in part by discouraging any further appreciation of sterling, could help the rebalancing process and avoid potentially lasting destruction of productive capacity and increases in unemployment.

35 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, eight members of the Committee (the Governor, Charles Bean, Paul Tucker, Ben Broadbent, Spencer Dale, Paul Fisher, Ian McCafferty and Martin Weale) voted in favour of the proposition. One member of the Committee (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.

36 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 December 2012.

37 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

Tom Scholar was present as the Treasury representative.