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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

5 AND 6 JUNE 2013

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 June 2013.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1306.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 3 and 4 July will be published on 17 July 2013.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5 AND 6 JUNE 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 Financial asset prices had been volatile over the month. In part, this may have reflected shifting views of the outlook for monetary policy in the United States and Japan, following positive activity indicators and comments by policymakers. The most significant changes had been in sovereign bond markets. In particular, from a low point in early May, ten-year US Treasury yields had risen by around 50 basis points, with UK and German ten-year government bond yields increasing by a little less. In the United Kingdom, most of the increase had been accounted for by higher real yields; longer-term inflation breakeven rates had risen only a little. Euro-area periphery sovereign yields had also picked up, but spreads over equivalent German yields had been broadly unchanged, and both Spain and Italy had begun to issue longer-term debt again in recent months. Japanese government bond yields had risen broadly in line with those of other countries over the month, although volatility had increased.

3 The expected paths for policy rates in the advanced economies had also moved up over the month. In the United Kingdom, overnight index swap (OIS) rates had been consistent with market participants placing less weight than a month ago on the probability of a cut in Bank Rate in the near term. The first rise in Bank Rate was fully priced into OIS rates by late 2015, around nine months earlier than at the time of the May *Inflation Report*. The implied paths of expected official interest rates had also moved up in the euro area and United States, with US rates expected to be above those in the United Kingdom from late 2015. The sterling and euro effective exchange rate indices (ERIs) had changed little on the month; the dollar ERI had risen by around 1.5%.

4 The rise in safe yields had been accompanied by falls in some risky asset prices. In particular, equity prices globally had dropped sharply towards the end of May following speculation that the pace of asset purchases by the Federal Reserve might slow. Those falls had more than offset earlier rises, leaving the S&P 500 and FTSE All-Share indices a little lower than at the time of the MPC's May meeting; the Topix index was 9% lower. There had also been significant falls in the prices of riskier assets, such as emerging market equities. Corporate bond spreads had risen a little on the month.

The international economy

5 Indicators of activity around the world had been mildly positive, but it remained hard to judge whether the recovery in growth would be sustained.

6 In the euro area, output had fallen by 0.2% in 2013 Q1, a slower rate of decline than in 2012 Q4. Output in Germany had been slightly weaker than expected, possibly reflecting an effect from the cold weather that would subsequently unwind. Indicators of euro-area activity had pointed to a stabilisation in output in the second quarter: for example, the manufacturing and, to a lesser extent, services Purchasing Managers' Indices (PMIs) had both risen in May.

7 The speed at which the euro area returned to more normal rates of growth would depend in part on how quickly the periphery economies were able to restructure. In the run-up to the financial crisis, domestic demand in the periphery economies had probably been growing at unsustainable rates. That had put upward pressure on costs in the domestic sector, as illustrated by the significant rise in unit labour costs in the non-tradable sector in Spain relative to those in Germany. In the periphery, domestic demand had since collapsed and it was unlikely that it would grow as rapidly in the future as it had in the past, implying that output growth would be weak unless net exports expanded. To achieve such an expansion, labour would need to move into the traded sector, which would probably require some further wage moderation.

8 The latest data on the United States had, on balance, been positive. Non-farm payrolls had, on average, risen by around 200,000 per month over the six months to April. The latest indicators had suggested healthy rises in durable goods orders, consumer confidence and core retail sales. But growth in total consumer spending had been more subdued. And the PMIs for May had been mixed, with a fall in the manufacturing index and a small rise in the services index. It was possible that the

fiscal consolidation might begin to drag more on growth, but it had been reassuring that increases in payroll taxes at the beginning of the year had appeared, so far, to have had little impact on consumer spending.

9 Japanese output had grown by 0.9% in the first quarter. It was probably too soon for that to have reflected the impact of recent announcements on fiscal and monetary policy. A durable improvement in nominal demand growth would depend in part on the third aspect of the Japanese policy package – structural reform – but there was as yet little detail on the form that that would take. Following the easing in Chinese GDP growth in the first quarter, which had probably been affected by the timing of the lunar new year, activity indicators in the second quarter had not suggested much slowing in underlying growth.

10 Commodity prices had generally been flat on the month and remained lower than earlier in the year. Reflecting that, CPI inflation had fallen back in many countries since the beginning of 2013. One factor influencing energy prices had been the increase in exploitable oil and, more significantly, gas reserves associated with hydraulic fracturing. It was likely that this technique would boost oil and gas production for several years to come. Changes in OPEC production would, however, probably remain a key driver of oil prices. And obstacles to the transportation of liquefied natural gas meant that the newly exploitable gas reserves, which were concentrated in the United States, probably had limited direct implications for UK gas prices.

Money, credit, demand and output

11 UK GDP growth had been unrevised at 0.3% in the first quarter. That estimate was based on output data; the latest release suggested that expenditure had been significantly weaker on the quarter, with little growth in consumption and a fall in investment. The expenditure data were at this stage, however, only partial and particularly subject to revision.

12 The Markit/CIPS activity indices had firmed in May, with the composite output index reaching its highest level in over a year and the manufacturing new orders index picking up strongly. That strengthening was broadly consistent with the assumptions underlying the near-term outlook for growth in the May *Inflation Report*, and the staff's central projection for the preliminary estimate of Q2 GDP growth remained at 0.5%. In line with the usual pre-release arrangements, the Governor

informed the Committee that goods exports had been unchanged in April, and goods imports had fallen.

13 The fall in investment in the first quarter had followed weakness in 2012. Business investment growth had been boosted by expenditure in the energy extraction and utilities sectors but investment elsewhere in the economy had weakened over the course of the year. In particular, in the service sector, investment had fallen by almost 15% in the four quarters to 2012 Q4, despite positive, albeit modest, output growth. The weakening did not appear to have been associated with a marked deterioration in credit conditions or increased uncertainty in the second half of 2012, although companies could still have been responding to earlier adverse developments in demand or the availability of credit.

14 To the extent that tight credit or heightened uncertainty had been bearing down on investment, that drag was likely to lessen if, as expected, credit continued to ease and uncertainty dissipated. Recent strong growth in private non-financial companies' broad money holdings suggested that companies, in aggregate, had ample internal funds that could be used to finance investment, and indicators of business confidence had improved. But, for some companies, the need to reduce pension fund deficits might weigh on investment: around half of the respondents to a survey by the Bank's Agents of some 90 companies with defined benefit pension schemes reported that they had reduced their planned investment as a result of their pension deficit, although a majority of those said that the impact was minor. Surveys of investment intentions suggested some pickup in growth in 2013, but these surveys had not captured the extent of the weakness in 2012.

15 Net lending to households and companies by those lenders participating in the Funding for Lending Scheme (FLS) had been broadly flat in Q1, in line with the aggregate net lending data. In the absence of the Scheme it was likely that lending would have been weaker: prior to the launch of the FLS, Bank staff had judged that UK bank lending had been more likely to decline than increase over the subsequent 18 months. That in part had reflected the fact that several major lenders were in the process of restructuring their balance sheets, in particular running down their so-called non-core assets: for example, some were reducing their exposures to the commercial real estate sector. Part of the recent weakness in lending reflected lower net borrowing by large companies, which tended to be more able to access alternative sources of finance; indeed, private non-financial companies' capital market issuance had been strong in the first quarter.

16 There had been some further improvements in household credit conditions. Twelve-month unsecured loan growth had risen to around 3% in April, its fastest rate since 2009. That was consistent with the strength in private new car registrations, which the Bank's Agents reported had been supported by promotional activity, including finance deals. Quoted mortgage rates had fallen in May, reflecting past falls in bank funding costs. House prices had continued to edge up, although the rate of increase differed across indicators. And most indicators of housing market activity, including survey measures of new buyer interest, had shown signs of improvement, although that had not yet shown up in higher mortgage approvals.

Supply, costs and prices

17 Annual CPI inflation had fallen by 0.4 percentage points to 2.4% in April. That had been 0.2 percentage points weaker than the central expectation at the time of the May *Inflation Report* and 0.2 percentage points below the market consensus expectation. Although the downside news had been broadly based, it was centred in components that were volatile and probably contained little information about medium-term inflationary pressures. As falls in prices a year earlier dropped out of the annual comparison, twelve-month CPI inflation was still expected to pick up again temporarily in the near term, rising a little in May before peaking around 3% in June, and remaining close to 3% throughout the autumn.

18 Earnings growth had remained unusually weak according to the Average Weekly Earnings (AWE) measure. Annual private sector regular pay growth had been just 0.8% in 2013 Q1, and, on that measure, the level of pay had been broadly unchanged since the middle of 2012. The underlying data did not suggest that this weakness reflected a shift towards low paid, low productivity sectors, although such a shift could be happening within sectors or companies. Other indicators of pay growth, such as business surveys and the Bank's Agents' scores, did not show quite as much weakness, although all measures were subdued. Early data were, as always, uncertain, but the more comprehensive measure of wages and salaries per head required tax data, which would not be available for some time yet. In the past, AWE had provided a better early steer on that measure than the surveys, but there had been instances of marked gaps between the path of wages and salaries initially suggested by the AWE and the final estimate.

19 To the extent that it was reliably measured, there were a number of factors that could explain the weakening in pay growth. In part, it had probably reflected a lagged response to past weakness in productivity. It was also possible that there was more slack in the labour market than previously judged, or that slack was pulling down more on wages. For example, recent changes in unemployment, sickness and disability benefits might have encouraged more active job searching by some individuals. Other factors, including a rebalancing of demand between sectors, would, however, suggest a smaller drag on wages from a given amount of unemployment if those who had lost their jobs in one sector had skills that were less suited to working in another; consistent with that, vacancies had risen relative to unemployment. Although the reason for the slowing in pay growth was not clear, it nonetheless represented an easing in domestic cost pressures. Private sector unit labour cost growth had slowed sharply in the first quarter.

20 Employment growth had appeared to be slowing from the rapid rates seen in 2012. In the three months to March, compared with the previous three months, average hours worked and the number of employees had risen a little. Reductions in other categories of employment meant, however, that total employment had fallen by around 40,000. The slowing in employment growth reflected both fewer people moving into jobs and more people moving out of them, with both these gross flows closer to their longer-term averages than they had been in the recent past.

The immediate policy decision

21 The Committee set monetary policy 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 news on the month had not materially changed the outlook since the Committee had published its May *Inflation Report*.

22 The main feature of financial markets over the past month had been increased volatility, partly due to shifting views of policy in the United States and Japan. That had been associated with rises in sovereign bond yields, although these still remained close to historic lows. There was, moreover, the potential for continued volatility. In particular, it appeared that financial market participants had become more sensitive to news about possible changes in the monetary policy stance in the United States: the changes in asset prices over the month had been associated with only small improvements in economic conditions. Moreover, to the extent that past rises in risky asset prices had reflected investors searching for yield in the face of very low rates on safe assets – the risk-taking

channel of monetary policy – the possibility remained of some unwinding in risky asset prices as demand conditions improved and the rates on safe assets rose. The Committee noted that the Financial Policy Committee was actively monitoring whether excessive risk-taking was a threat to financial stability further ahead.

23 Indicators of global activity had pointed to continued moderate growth in the United States and some stabilisation in euro-area output, consistent with the assumptions underlying the May *Inflation Report* projection. But there continued to be downside risks to global activity in the medium term, stemming in particular from the degree of rebalancing needed in the euro area.

24 Although there had been little news on UK real activity on the month, the developments had generally been positive and followed a sequence of small improvements in earlier months. The expenditure breakdown for the first quarter had been superficially disappointing, but there was typically limited information in that breakdown at this stage of the data cycle. The indicators for the second quarter had been positive, with the rises across the board in the Markit/CIPS activity indicators in May particularly striking. Although headline data on employment had weakened, there was not, as yet, any indication that this represented downside news for current activity; indeed the May *Inflation Report* projection had been consistent with a slowing in four-quarter private sector employment growth. Besides, indicators of employment growth from labour market surveys had picked up in recent months. Overall, the Committee judged that recent news was consistent with the slow but sustained recovery in growth over 2013 embodied in the May *Inflation Report*. That recovery was not predicated on a large increase in bank lending, but further improvements in credit conditions, an increase in mortgage approvals and an easing in the pace of contraction of lending to private non-financial companies were anticipated over the rest of the year.

25 CPI inflation had fallen back by more than expected in April, to 2.4%. That followed a number of smaller downside surprises in recent months. The near-term outlook for inflation was little changed, however, and it was still more likely than not that CPI inflation would temporarily rise to around 3% in the summer, remaining close to that level throughout the autumn. The unusual weakness of pay, which had risen by less than 1% in the year to Q1 according to the Average Weekly Earnings (AWE) measure, potentially contained more news about the outlook for inflation. There was some uncertainty around the latest estimates, but there was no reason to discount the AWE. It was likely that the weakness in part reflected companies' response to the past weakness in productivity, although

it was also possible that there was a greater drag on pay from labour market slack than had been previously thought. AWE had suggested that domestic cost pressures would be more favourable in the near term than they had been in recent years. The significance for the medium-term inflation outlook depended on why wages were weak: a lagged response to past productivity weakness would probably have a less persistent effect than a greater drag from slack.

26 Against that backdrop, the Committee considered the case for additional monetary stimulus through further asset purchases. The situation remained one in which above-target inflation was accompanied by a degree of slack in the economy. Under its remit, the Committee had the flexibility to temper the speed at which it sought to return inflation to the target in order to limit the volatility in output, subject to meeting the inflation target in the medium term. The speed at which the Committee sought to return inflation to the target would, however, depend on its judgements about the consequences of its decisions both for the long-term supply capacity of the economy and for public confidence that inflation would be brought back to the target in the medium term. At the current juncture there were therefore two important factors that weighed on the policy decision: the potential impact of weak demand on long-term supply and the potential responsiveness of inflation expectations to continued above-target inflation. As in previous months, different Committee members formed different judgements on these issues. But there had been little news on them over the month.

27 For most members, the current policy setting was appropriate at this time. The modest improvement in activity on the month had been broadly based. This followed a number of months in which the news on activity had been neutral or positive, suggesting that the recovery was becoming more established. The outlook for inflation was also a little more favourable, but it remained the case that inflation was likely to be well above the 2% target for the rest of the year. Although the weakness in pay growth suggested lower domestic cost pressures in the near term, it was still unclear how material the weakness was or how persistent it would prove to be. The effects of the Committee’s previous round of asset purchases were still working through and, together with the Funding for Lending Scheme, should continue to boost activity. Events over the month had demonstrated the sensitivity of financial markets to changes in policy expectations. For some of these members, although an expansion in asset purchases was not warranted at this meeting, those events illustrated the likely effectiveness of asset purchases should they be needed in the future. But for the others, the benefits of further asset purchases were likely to be small relative to their potential costs. In particular,

further purchases could lead to an unwarranted narrowing in risk premia and complicate the transition to a more normal monetary policy stance at some point in the future.

28 For other members the case for more monetary stimulus remained compelling. The news on activity on the month had been reassuring but the outlook was no stronger than had been incorporated into the May *Inflation Report* projections. Those projections implied only a modest recovery in growth and relatively little improvement in unemployment. Moreover, the need to rebalance both at home and abroad was likely to prove a persistent drag on growth. The risks from the euro area remained substantial, especially through their potential effects on the UK banking sector. Commodity prices were lower and domestic cost pressures, as illustrated by very low pay growth, remained weak. An expansion in demand would probably be associated with a strengthening in productivity growth and would be unlikely to be reflected in higher cost pressures; if faster growth in demand boosted productivity sufficiently, cost pressures could even be lower. Additional asset purchases now would allow an earlier normalisation of the monetary stance.

29 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.

30 Finally, on the occasion of the Governor's 194th and final Monetary Policy Committee meeting, Nicholas Macpherson expressed the Treasury and the Chancellor's appreciation of the personal contribution that the Governor had made over several decades to the development of the monetary and

macroeconomic framework in the United Kingdom. Charles Bean, on behalf of members of the Monetary Policy Committee past and present, as well as the Bank's staff, thanked the Governor for his work as the Chairman of the Monetary Policy Committee and for the central role that he had played in establishing both the inflation targeting framework and the Committee itself.

31 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

Nicholas Macpherson was present as the Treasury representative.

As permitted under the Bank of England Act 1998, as amended by the Financial Services Act 2012, Susan Rice was also present as an observer in her role as a member of the Oversight Committee of Court.