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# MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 6 AND 7 MARCH 2013

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1303.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 April will be published on 17 April 2013.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 MARCH 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 month had seen a number of potentially significant events. Reactions to them had been mixed but, on the whole, relatively limited, and the improvements in market sentiment seen over recent months had remained broadly intact. UK asset prices had reacted more to global than domestic events.

3 The longer-term government bond yields of those countries regarded as the most creditworthy remained close to historic lows. Ten-year gilt yields had risen at the beginning of the month but had fallen back following the inconclusive Italian election to end the month broadly unchanged. The downgrade to the United Kingdom's sovereign credit rating by Moody's had been widely expected and had no discernible impact on gilt yields. US Treasury bond yields had moved similarly during the month. There, the activation of automatic spending cuts appeared to have had little effect on asset prices. It was likely that these movements in UK and US government bond yields reflected some modest renewed flows of funds into assets perceived as the safest following the uncertainty in Italy. In the event, ten-year Italian government bond yields had risen by 40 basis points, but around half of that increase had subsequently been reversed as the month wore on.

4 Corporate bond spreads had narrowed fractionally in the United Kingdom and internationally, and equity prices had continued to increase: the FTSE All share index had risen by 2½% during the month, and other major international equity indices had increased by between 2 and 4%. But neither of these classes of assets had shown clear signs of unduly low risk premia. There were some signs that the covenants on loans in the United States had been loosened, but this was less evident in the United Kingdom.

5 There had been a number of UK monetary policy communications during the month: the statement released at the conclusion of the Committee's previous meeting; the publication of both the minutes of that meeting and the February *Inflation Report*; and public evidence given by some MPC members to the Treasury Committee. Against that backdrop, over the month as a whole, forward overnight index swap rates, a proxy for market expectations of Bank Rate, had fallen by 5-15 basis points out to maturities of around four years. Market participants had pushed back their expectations of the timing of the first increase in Bank Rate, so that it was not fully priced in before the end of 2015.

6 The sterling effective exchange rate index (ERI) had fallen by almost 1½% over the month as a whole, largely reflecting a depreciation of sterling against the dollar. In the second half of the month – a period spanning the Italian election and UK sovereign credit rating downgrade – the sterling ERI had been broadly stable.

### **The international economy**

7 The improvement in the global economy had continued to lag behind that in financial markets, especially in the euro area. Globally, indicators of near-term activity in the manufacturing sector had fallen back in February, despite the perceived reduction in economic uncertainty in recent months.

8 In the euro area, GDP had fallen by 0.6% in 2012 Q4. The contraction had been particularly marked in the peripheral economies. But output in the core countries had also fared poorly, with GDP falling by 0.6% in Germany and 0.3% in France. Those falls had perhaps reflected the lagged impact on confidence and activity from the acute financial and political tensions within the area in the first half of 2012. The Purchasing Managers' Indices (PMIs) since the beginning of the year had suggested that the contraction in German output might be short-lived. But the French PMIs, which had been declining below the euro-area average since the autumn, suggested that a further fall in output there was in prospect during the first quarter of 2013.

9 The Italian election on 24-25 February had been indecisive. And, with attempts to form a coalition government continuing, it was unclear how the political situation there would be resolved. Together, parties opposed to further fiscal consolidation had gained a significant proportion of the overall vote. Although it had not crystallised, there remained a risk that these developments might hinder Italy's ability to access government bond markets or agree an official support programme in the event that proved necessary. Negotiations over the form of the support package for Cyprus, and in particular the status of uninsured bank deposits, had continued without conclusion.

10 In the United States, GDP growth, at zero in 2012 Q4, had not been revised. Output had been dampened by bad weather and some erratic weakness in public spending, which seemed unlikely to persist. Moreover, the manufacturing and non-manufacturing PMIs had improved significantly in February, so that a resumption of modest growth seemed likely in the first quarter. Congress had been unable to come to an agreement that avoided triggering \$85 billion of automatic cuts to the annual budget. These had the potential to dampen GDP growth materially over the course of the next two years. But many of the measures would take some time to come into force, and it was possible that they might yet be avoided if a political settlement could be reached as part of the negotiations aimed at avoiding a public spending shut-down that were due to be concluded by the end of March. By comparison with the febrile commentary surrounding the budgetary negotiations around the turn of the year, reaction to the legal implementation of the cuts had, so far, been fairly muted.

11 Indicators had suggested some improvement in Asian activity. Output growth had edged up in 2012 Q4 in Hong Kong, Korea and Singapore, while there had been a smaller contraction in Japan. The Chinese Government had announced a growth target of 7.5% for 2013, unchanged from 2012. It would also aim to achieve a consumer-price inflation rate of 3.5% and to run a slightly larger fiscal deficit.

12 Commodity prices, in general, had fallen back during the month. In dollar terms, the price of Brent crude oil had declined by around 5%.

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

13 The estimated change in UK GDP in 2012 Q4 had been unrevised at -0.3%, with the decline more than accounted for by the unwinding of the temporary boost from the Olympic Games in the third quarter. Indicators of activity growth in the first quarter of 2013 had been mixed: the PMIs for February had suggested that the weakness of services output before the turn of the year might prove short-lived, but they also implied that some of the recent strength seen in the manufacturing sector might unwind. Those indicators taken together, along with the arithmetic effect of the recent monthly pattern of the manufacturing and service sector output data, suggested that GDP was likely to be broadly flat in 2013 Q1, with a roughly 50:50 chance of a further contraction in headline GDP. Further ahead, a modest recovery seemed likely, particularly as the drag on growth from the construction sector seen during 2012 was unlikely to persist. New construction orders had stabilised and ticked up in 2012 Q4 to the highest level since the start of 2011. Contacts of the Bank's Agents

around the United Kingdom had, overall, also become slightly more optimistic about prospects for business activity.

14 Upward revisions to the data for earlier quarters of 2012 meant that headline GDP was now estimated to have grown by 0.2% over the year as a whole, with some signs of slowing towards the end of the year. But, within those aggregate numbers was a picture of relatively steady public and private consumption along with robust investment in the extraction and utility sectors, offset by both weaker capital spending in other sectors and frail foreign demand. As a consequence, final domestic demand had grown by 1.4% during 2012: part of that had been a result of increased real government consumption, leaving private final domestic demand growth of 1%. Net trade had subtracted 0.8 percentage points from GDP growth over 2012. Commensurately, manufacturing output growth had been weak, as had the more export-oriented service sub-sectors.

15 The outlook for business investment depended on prospects for demand and a number of other factors. First, it was likely that elevated levels of uncertainty had been an impediment to capital spending during the second half of 2012. Indicators of business uncertainty had decreased recently, suggesting that increased investment might be in prospect. Secondly, the outlook for credit conditions was important. Historically, most gross business investment had been financed out of depreciation allowances and retained profits. And for companies with access to capital markets, the cost of raising external finance was low by historical standards, with investment grade corporate bond yields close to record lows and a marked increase in equity prices over the past year. But firms reliant on the banking sector for finance could be more constrained. In the past, around 40 per cent of domestic private investment had been undertaken by firms with fewer than 300 employees. Such small and medium-sized enterprises were unlikely to have significant access to capital markets, so, unless those firms could finance capital spending from retained earnings or access to bank credit, investment growth could remain restrained. Thirdly, it was possible that some businesses had reduced their investment plans as a result of pension fund deficits. For businesses with easy access to finance, it was not clear that pension fund deficits would inhibit them from exploiting profitable investment opportunities. But those businesses which had difficulty in raising finance were likely to be affected, and other businesses might respond to concerns over financing future pension fund contributions by hoarding cash.

16 During the month, the Bank had released data on the lending to households and businesses of those banks participating in the Funding for Lending Scheme (FLS). Those data had shown, in aggregate, a small reduction in net lending in the fourth quarter of 2012 of around £2.5 billion. Given

the short time-span of the data, they were not seasonally adjusted, and had very probably been depressed by normal seasonal factors. Looking through that, the picture remained one of broadly flat bank lending to the real economy. Moreover, bank-by-bank analysis revealed that this weakness was largely confined to those banks undergoing significant balance sheet restructuring, much of which reflected plans agreed with the authorities to reduce non-core business. The outlook for new lending to households and businesses appeared more promising than the headline FLS numbers might suggest. The latest intelligence from the Bank's Agents had indicated that improved credit supply had begun to feed through to companies. Other evidence suggested that some lenders had used cashback deals or reductions in fees to pass through the benefits of reduced funding costs to their corporate customers, neither of which would show up in the effective interest rates data for new corporate lending published by the Bank.

17 Perhaps in part as a consequence of the FLS, the housing market had continued to show some signs of thawing. On the average of the main lenders' indices, house prices had risen by over 1% in the three months to February, compared with the previous three months. Housing activity had been comparatively subdued in January, but this may have reflected the impact of the snow.

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

18 Twelve-month CPI inflation had been unchanged at 2.7% in January. It remained likely to pick up to over 3% towards the middle of year as the impact of energy price reductions a year earlier dropped out of the twelve-month comparison. Moreover, the depreciation of sterling during the month, if it persisted, would add a little to inflationary pressures.

19 The Committee reviewed a range of measures of inflation expectations. Measures of households' long-term inflation expectations had remained fairly stable in the first quarter and were roughly in line with, or a little above, their series averages. Measures of longer-term inflation expectations derived from the prices of financial-market instruments had increased a little, but remained in line with their averages over recent years. Inflation itself had been persistently above the 2% target for the past five years, however, so it was not clear how much comfort could be drawn from the fact that these indicators remained close to recent averages. Moreover, long-term measures of inflation expectations might not be informative about whether the perceived persistence of inflation had increased. Evidence from financial-market prices indicated that inflation expectations had shifted upwards, albeit modestly, at short and medium-term horizons following the Committee's February

policy statement, as well as on the publication of the *Inflation Report* and February MPC Minutes. And some measures of households' shorter-term inflation expectations had also risen a little. Although these movements had been only small, the Committee would continue to monitor indicators of inflation expectations closely to ensure that they did not become inconsistent with, or make more difficult, the task of meeting the 2% inflation target in the medium term.

20 Despite above-target inflation, wage growth had remained subdued. According to the AWE measure, private sector regular pay had been 1.4% higher in the three months to December than a year earlier. That was below the rates of around 2% that had become the norm for much of the past two and a half years and much lower than pre-crisis averages. The recent Bank/NOP survey of inflation attitudes suggested that there appeared to be little appetite among employees to press for higher pay awards in response to higher inflation expectations. This had chimed with the message from the earlier Bank Agents' annual pay survey, in which contacts had reported that inflation was not expected to put upward pressure on labour cost growth this year. It was possible that the recent weakness of wages indicated that some firms would be able to rebuild profit margins by bearing down on costs, rather than solely by raising prices. Nevertheless, despite the recent reduction in pay growth, the continued weakness of productivity meant that firms' unit labour costs had increased at above-average rates throughout the past year.

21 The striking strength of employment growth had continued. According to the LFS, employment had increased by 154,000 in 2012 Q4 by comparison with the previous quarter. Over the past year, employment had increased very substantially in excess of the Committee's expectations, unemployment had been lower, and labour-force participation had been considerably higher than seemed probable a year ago. At the same time, pay growth had been more subdued. It seemed likely that a reduction in household expectations of future income growth, coupled with elevated debt levels, social benefit reforms, and concerns about the adequacy of pension income in retirement had caused an increased willingness to work. The participation rate of older workers had increased most significantly. All else equal, an increase in labour supply would be expected to bear down on wage pressures, but the implications that it would have had, and might continue to have, for aggregate levels of labour productivity were more difficult to identify. Normally, businesses might be expected to increase investment in order to take advantage of an increase in labour supply, such that it would have little or no impact on labour productivity in the medium term. In the current environment, however, businesses wishing to avoid irreversible capital spending might instead seek to make their production processes more labour intensive, reducing measured labour productivity.

## **The immediate policy decision**

22 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 news on the month had not changed the outlook materially since the Committee had published its February *Inflation Report*, although the outlook for inflation was a little higher, reflecting some upward movements in retail food prices and the likely impact of the small depreciation of sterling.

23 The estimate of GDP in 2012 Q4 had not been revised, but there were minor upward revisions to previous quarters. Business surveys remained consistent with roughly flat output in the first quarter, with a small increase or decline in activity equally likely. It remained probable that growth would pick up as the year wore on. Construction output – one of the major drags on aggregate output growth during 2012 – had shown recent signs of stabilising, and final domestic demand had grown at around 1½% over the past year. The extent to which global demand would continue to depress output was uncertain, especially in light of continued strains within the euro area. Financial markets had been generally buoyant over the year to date, with increased signs of investors diversifying into risky assets, notwithstanding the seemingly minor retreat in risk appetite that had followed the political events in Italy of the past month. Market interest rates had fallen, sterling had depreciated a little further and equity prices had risen. These factors would tend to add a small impetus to growth prospects.

24 Inflation was more likely to remain above the 2% target than below it for much of the next three years, reflecting the recent depreciation of sterling and the impact of higher administered and regulated prices on the CPI. Underlying domestically generated inflationary pressures remained, on the whole, muted. The level of demand was well below the level implied by its pre-crisis trend and wage growth was low, although the persistent weakness of productivity meant that firms' unit labour costs had grown at rates above average over the past year. The Committee's central expectation was that wage growth would remain subdued and that productivity would pick up gently over the course of 2013.

25 The Committee continued to judge that, as long as domestic cost and price pressures remained consistent with inflation returning to the target in the medium term, it was appropriate to look through the temporary, albeit protracted, period of above-target inflation resulting from higher administered and regulated prices. It also remained appropriate to accommodate the first-round impact on CPI of movements in sterling insofar as those movements reflected real factors, such as the necessity to rebalance the economy towards tradable output, or an unwinding of safe-haven flows, as had appeared

to be the case earlier in the year. Prospective movements in the exchange rate that reflected perceptions that monetary policy would remain excessively loose, or that the MPC's commitment to meeting the inflation target in the medium term was diminished, would be a different matter. As yet, indicators of inflation expectations had remained contained, notwithstanding very small increases in market-based indicators following the Committee's recent policy statements, and wage growth was weak. But the Committee would continue to watch closely for any signs that inflation expectations had risen to a point inconsistent with, or making more difficult and costly, the task of meeting the 2% inflation target in the medium term.

26 Against that backdrop, the Committee examined the cases for either increasing the degree of monetary impetus via further asset purchases, or maintaining it at the current level.

27 Regarding the case for a further extension of the Committee's asset purchase programme: inflation expectations were relatively stable; wage growth remained weak; there remained a degree of slack in the economy; and the potentially positive response of supply capacity to increased demand meant that higher output growth would not necessarily lead to any material increase in inflationary pressure. Output had been depressed, at least in part, because of a reduction in household and business expectations of future income growth, coupled with a desire to reduce debt levels. 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 destruction of productive capacity and increases in unemployment.

28 There were also arguments in favour of maintaining the current size of the asset purchase programme. Monetary policy was already highly accommodative and the benefit of past actions would continue to be felt. Inflation was above the 2% target and was likely to stay above it for an extended period, and there was a risk that could lead to inflation expectations drifting upwards with adverse consequences for wage and price setting behaviour. Further monetary stimulus might increase that risk. It might also lead to an unwarranted depreciation of sterling if it were misinterpreted as a lack of commitment to maintaining low inflation in the medium term. Finally, at the current juncture, there were limits to what further asset purchases could be expected to achieve to support output when some banks and households were reducing their indebtedness, and when the economy needed to rebalance away from public and private consumption towards investment and trade.

29 To varying degrees, all members saw merit in each set of arguments. But members drew different conclusions about the best policy setting to bring inflation back to the target in the medium term while continuing to support output and employment.

30 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.

31 As previously announced, and as described in a market notice of 7 March 2013, the Committee had agreed at its previous meeting to reinvest the £6.6 billion of cash flows associated with the redemption of the March 2013 gilt held in the Asset Purchase Facility.

32 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.