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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 8 AND 9 MAY 2013

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 May 2013.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1305.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 5 and 6 June will be published on 19 June 2013.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 MAY 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 There had been a number of domestic and international policy announcements on the month, some of them substantial, to which markets had on balance reacted positively. By and large, there had been little change in prices of safer assets, but the prices of riskier assets had generally continued to rise.

3 There had initially been marked volatility in Japanese asset prices in response to the Bank of Japan's 4 April announcement of a material increase in its asset purchase programme with the aim of doubling the monetary base within two years and raising inflation to its 2% target. Once markets had settled, and continuing the trends that had begun with the election of the new Japanese government in December, some measures of medium-term inflation expectations had risen, there had been large rises in equity prices and the yen had fallen further. As had been widely expected, the ECB had announced a 25 basis point cut in its main refinancing rate and that it was starting consultations on initiatives to improve lending to the euro-area economy.

4 At home, the first rise in Bank Rate was not priced in until the end of 2016, and there had been little expectation of an increase in the Committee's Asset Purchase Programme at this meeting. Sterling had risen by around 1½% on the month, largely on the back of a preliminary release of Q1 GDP growth that had been at the upper end of expectations.

5 Longer-term government bond yields for highly rated sovereigns remained exceptionally low, but had changed little on the month. Yields on the government bonds of some highly indebted

euro-area countries had continued to fall. For example, ten-year yields on Italian government bonds were close to their post-crisis trough. Measures of European bank funding costs had decreased and were particularly low, by recent standards, in the United Kingdom. Some continental banks had raised new capital. Both investment-grade and sub investment-grade corporate bond spreads had continued to fall, and equity prices had risen further internationally, by between 2% and 5% on average. The S&P 500 index was above its previous nominal peak, while the FTSE All-Share index was also close to its 2007 highpoint. Euro-area stock markets generally remained below previous peak levels.

6 This improvement in risky asset prices came at a time when the underlying risks to the global economy remained material. Much of the increase could be attributed to lower rates on safe assets, such as some government bonds, which raised the current value of future flows of income from risky assets. These low rates, in turn, reflected both a global mismatch between strong desired savings and weak investment plans, and the policies undertaken by various central banks to underpin nominal demand and meet their inflation targets. At some point, higher prices of risky financial assets would in all probability make investing in the real economy a more attractive proposition, leading to higher aggregate demand. A sustained rise in demand would, in due course, mean a rise in interest rates on safe assets and, potentially, some unwinding of the rise in risky asset prices.

The international economy

7 Developments in the euro area, the United Kingdom's largest trading partner, remained central to the domestic outlook. April had seen some positive steps to facilitate orderly rebalancing. A new government had been formed in Italy. The European authorities had agreed an extension in the maturity of loans by the European Financial Stability Facility to Ireland and Portugal. And the package of measures to aid the Cypriot economy had been approved by the parliament there. There had been few signs that banking systems in the rest of the euro area had seen a material withdrawal of deposits. That said, there might still be a perception that the euro-area authorities were now more committed to shifting the burden of future bank restructurings from governments to uninsured private creditors. As a result, euro-area banks might now be more vulnerable to withdrawals of uninsured deposits, were their solvency to be called into question.

8 Data on the euro-area conjuncture had been disappointing. Activity indicators for Q1 were consistent with a smaller contraction in output than the 0.6% fall seen in Q4. Nonetheless, there had

been few signs that the euro-area economy would improve in the near future, with falls in retail sales and industrial confidence, though the composite PMI had edged up. The German composite PMI for April had fallen, although other indicators of the German economy had been less weak. Euro-area inflation had declined by 0.5 percentage points in April to 1.2%, reportedly reflecting a reduction in the contribution from energy prices and an erratic drop in the prices of package holidays due to the timing of the Easter break.

9 Elsewhere, the recovery in the United States was continuing at a moderate pace. Output had increased by 0.6% in the first quarter, a faster rate of expansion than had seemed likely a few months ago. Lower government spending had been offset by resilience in household consumption in the face of January's increases in payroll and income taxes. It was likely that GDP growth would slow in the second quarter as the impact of government spending cuts began to be felt; indeed there had been some moderation in the ISM surveys. Set against that, there had been a 165,000 increase in non-farm payrolls in April and upward revisions to the March figure. It continued to be the case, however, that the lion's share of the fall in the unemployment rate in the United States since the depths of the crisis had been accounted for by a fall in the proportion of the population active in the labour market. Indeed, despite an estimated 165,000 rise in the working-age population since January, the labour force had fallen by over 400,000.

10 In Japan, it was too early to assess the effects of the material loosening of monetary policy on the economic outlook, although household real consumption had risen sharply in March, and commentators had generally increased their forecasts for growth and inflation since the new government had come to power. Direct spillovers to the United Kingdom were likely to be limited, reflecting the small share of UK exports that went to Japan. But Japan remained one of the world's largest economies and the indirect effects could be significant. It was possible that the impact of Japanese asset managers adjusting their portfolios in response to the new measures might be felt more widely.

11 Chinese GDP growth had eased in the first quarter, but that had been affected by the timing of the lunar New Year and it was likely that there would be some catch-up in the second quarter. Over a longer time period, the Chinese economy was likely to rebalance away from investment spending and towards private consumption. This process might well be accompanied by somewhat lower growth

than had been seen in recent years, although the resulting configuration of Chinese demand might be a more favourable one for UK exports, which were not heavily weighted towards capital goods.

12 The moderation in Chinese growth had contributed to a fall in oil and metals prices on the month. At one point, Brent oil prices had fallen below \$100 per barrel for the first time in almost a year but had risen somewhat towards the end of the month.

Money, credit, demand and output

13 The preliminary release of Q1 GDP had shown a 0.3% increase, all of which had been accounted for by the services sector. In line with the usual pre-release arrangements, the Governor informed the Committee that industrial production had risen by 0.7% in March, on the back of a 1.1% increase in manufacturing output. The level of production in February had been revised down, however. Nonetheless, the pattern of growth over Q1, together with the increase in the April CIPS/Markit indices, suggested that the level of overall activity at the beginning of the second quarter was likely to have been higher than the Committee had previously anticipated, and Bank staff's projection for the preliminary estimate of Q2 growth was 0.5%, although there was a sizable margin of error around such a forecast. Looking further forward in 2013, there was the possibility of a stabilisation in oil production in the North Sea and in the output of the construction sector.

14 Recent indicators of expenditure had been broadly positive. Retail sales had risen on the quarter and, accounting for seasonal factors, there had been a 16% increase in new private car registrations in the three months to April compared with the previous three months. Broad money holdings of the corporate sector had increased by around 10% at an annual rate in Q1, perhaps as a prelude to greater business investment. And, in line with the usual pre-release arrangements, the Governor informed the Committee that both imports and exports of goods had risen strongly in March.

15 During the month, the Bank and HM Treasury had announced an extension to the Funding for Lending Scheme (FLS) that provided institutions with access to funding until early 2015, as well as expanding the Scheme to cover lending involving financial leasing and factoring corporations, alongside mortgage and housing credit corporations. One motivation for the extension was to provide confidence to Scheme members expanding their lending to the real economy that they would continue to have access to cheap funding, even if stresses in bank funding markets were to re-emerge. Another

was that, thus far, improvements in credit conditions had been more pronounced for secured household borrowers and large businesses than for smaller businesses. The extension had been designed to encourage lending to smaller businesses in the remainder of 2013 and 2014. Participants' initial access to the extended scheme would be determined by increases in their weighted net lending between 2013 Q2 and 2013 Q4, with the weight attached to lending to smaller businesses being ten times greater than other types of lending. Similarly, in 2014, additional access would also be linked to increases in weighted net lending, with the weight attached to lending to smaller businesses five times greater than other types of lending.

16 The projected pace of activity growth over the next few quarters was not predicated on a large increase in bank lending. Nonetheless, net lending to the real economy had been weak during 2012, and some improvement over this year and next would support the recovery. That said, private non-financial corporations had increased their use of sources of finance other than bank lending over the past few years: despite lower borrowing from banks, UK companies had raised £8.5bn of net external finance in Q1, the most since late 2008, with sterling bond issuance particularly strong. Credit conditions facing households had continued to improve, although quoted interest rates on mortgages had not fallen in recent months as much as the Committee had anticipated at the time of the February *Inflation Report*. The scale of the pickup in lending would depend on how households responded to the improvement in credit supply. The loosening of credit conditions for secured household borrowing had not fed through into a pickup in mortgage approvals in Q1, although other housing market indicators did point to a pickup in housing market activity. House prices appeared to have increased slightly over the past six months and, taken together, the Nationwide and Halifax house price indices had pointed to a further modest rise in April.

Supply, costs and prices

17 Twelve-month CPI inflation had remained unchanged in March at 2.8% and the near-term outlook was similar to that at the time of the Committee's February meeting, as the impact of lower oil prices was likely to be offset by news about the path for other prices. Inflation might well fall slightly in April before picking up to around 3% in the middle of the year.

18 Pay growth had weakened further. Having risen by around 2% during 2012, the ONS measure of private sector regular pay had grown at an annual rate of around 1% in the three months to

February. A fall in the contribution of bonuses had meant that average weekly earnings in the private sector had fallen by around 0.5% in the year to February, although the negative bonus contribution was unlikely to persist. It was difficult to assess the significance of the slowdown. On the one hand, surveys of pay had not indicated any slowing in the rate of increase in recent months and contacts of the Bank's Agents, on the whole, had not reported a material reduction in wage growth. Settlements in the private sector were continuing to run at around 2%, although fewer companies now made use of an across the board settlement. On the other hand, regular pay growth as measured by the ONS had been slowing for some time, so it was difficult to dismiss the fall as erratic.

19 One driver of the slowdown in pay growth might have been the weakening in productivity growth in late 2011 and early 2012: in the past, sharp movements in productivity growth had tended to be associated with changes in regular pay growth about one year later. But other factors might also have contributed. In particular, the elevated level of unemployment might have made employees reluctant to seek higher wages and, although indicators of slack in the labour market had not increased, it might take some time for the full impact on pay to come through.

20 The weakness in earnings would, other things equal, put downward pressure on inflation, although how long this downward pressure persisted would depend on the outlook for labour costs more broadly. If the impact of labour market slack was greater than previously thought, then it was reasonable to think that pay growth might remain subdued for some time. If instead, the impact of weak productivity was the dominant influence, then earnings growth might stay weak if productivity continued to disappoint, but this would not be associated with further downward pressure on inflation. If productivity growth were to recover, earnings growth would be able to rise somewhat without necessarily putting upward pressure on inflation.

21 The pace at which inflation fell back from its current rate would also depend, in part, on movements in inflation expectations and how they affected the behaviour of those setting prices and wages. Survey measures of expectations of inflation one-year ahead had changed little in Q1. There was evidence that expectations, including at long horizons, derived from financial markets had become a little more sensitive to short-term news on inflation in the past year than they had been previously, which could indicate that some market participants believed that the Committee had become more tolerant of inflation returning to the target more slowly. But there were few signs that inflation

expectations had triggered changes in price and wage-setting behaviours that would lead elevated inflation to persist for longer.

The May GDP growth and inflation projections

22 In the Committee's central view, the UK economy was set for a modest and sustained recovery in both demand and effective supply – aided by the low level of Bank Rate, the Committee's programme of asset purchases, the extended FLS and the impact of the recommendations of the Financial Policy Committee. The scale of repair and adjustment necessitated by the financial crisis meant that the recovery was likely to be subdued by historical standards. As in February, there was a range of views on the Committee about the outlook for output growth. But, in the Committee's best collective judgement, the balance of risks was weighted to the downside, reflecting the possibility that the repercussions of the crisis weighed on demand to a greater degree than assumed in the central view.

23 Compared with February, the central view for activity was a little higher. That in part reflected developments in the conditioning paths for asset prices: both the market yield curve and the assumed path for the sterling ERI were a little lower than three months previously. But it also reflected a judgement that participation in the labour market was likely to be higher than previously assumed. This modest uprating in the central projection for GDP growth, combined with recent GDP revisions by the Office for National Statistics, meant that the central estimate of the level of output ended the three-year forecast period around 1% higher than was the case in February.

24 In the Committee's best collective judgement, domestic cost pressures were likely to ease over the forecast period as productivity growth gradually revived. Medium-term inflation expectations were assumed to remain anchored on the target. And external pricing pressures were assumed to fade. Overall, those assumptions meant that inflation was set to fall back gradually over the forecast period. Even so, inflation was more likely than not to be above the 2% target for much of the next two years.

25 There was a range of views on the Committee on the outlook for inflation. But, in the Committee's best collective judgement, the risks were judged to be broadly balanced around the 2% target in the latter part of the forecast period. Compared with February, the outlook for inflation was a little lower. In part, that reflected a modest reduction in the assumed path for world prices. It also

reflected a weaker path for nominal wage growth, in part due to the upward revision to the assumed labour force participation rate.

The immediate policy decision

26 Between meetings, and in line with agreed procedures, members had been consulted on proposals to extend access to the Funding for Lending Scheme (FLS) until early 2015 and to include lending involving certain other financial intermediaries providing credit to the real economy; lending to smaller businesses would also carry a significantly larger weight in calculating access limits in the extended Scheme. Members had supported the proposed extensions. They had noted that these extensions were in line with the options discussed at their April meeting and should help to boost both the supply of credit and aggregate demand, though the overall impact was likely to be relatively modest on account of the small share of lending to smaller businesses in the total stock of lending.

27 The Committee discussed its immediate policy decision in light of this, and in the light of developments since its previous meeting and its projections to be published in the *May Inflation Report*. News on the month had on balance been favourable and it was likely that the level of output at the end of Q2 would be 0.7% higher than the Committee had expected three months ago. By and large, asset prices had continued to rise, but the outlook for the global economy remained subdued, and the risk of a more severe crisis in the euro area remained a major potential impediment to the domestic recovery. Commodity prices had fallen and the recent weakness in earnings growth would lessen upward pressure on inflation, at least in the short run. For the first time since the February 2007 *Inflation Report*, the Committee had revised up its projections for output over the next three years, while revising down its projections for inflation. Nonetheless, the outlook for growth remained poor by historical standards, and it was likely that inflation would rise a little further in the short run and remain above the target for a further two years.

28 The nature of the shocks affecting the UK economy in recent years – which had weakened output growth, but raised inflation – had posed substantial challenges for monetary policy. In particular, such shocks meant that the Committee faced a trade-off between the speed with which inflation was returned to the target and the support that monetary policy could provide to output and employment. As set out by the Chancellor in his March 2013 *Budget*, the MPC's latest remit required that it promote understanding of the short-run trade-offs inherent in the setting of monetary policy.

29 The Committee had always recognised such short-run trade-offs. In particular, under its remit, the Committee had the flexibility to temper the speed at which it sought to return inflation to target in order to limit the volatility in output, subject to meeting the inflation target in the medium term. This consideration had been central to the Committee's policy discussion in February, for example. When judging the appropriate speed with which to return inflation to the target, the Committee had particular regard to the likely medium-term consequences of its decisions both for the long-term supply capacity of the economy and for confidence in the achievement of the inflation target over the medium term, which allowed the Committee to respond effectively to shocks in the future.

30 The Committee agreed that, subject to medium-term price stability being maintained, the nature of the shocks affecting the UK economy meant it was appropriate to bring inflation back to the target more slowly than had been the case for much of the period prior to the financial crisis. But different Committee members placed differing weights on likelihood of the various risks to growth and inflation materialising. There might therefore be differences of view over the speed with which it was appropriate to return inflation to the target.

31 Against that backdrop, the Committee considered the case for additional monetary stimulus through further asset purchases at this meeting.

32 For most members, the current policy setting was appropriate at this juncture. GDP growth in the first quarter had been faster than expected and the outlook for activity was stronger than at the time of the February *Inflation Report*. The effects of the Committee's previous round of asset purchases were still coming through and, together with the extended FLS, should continue to boost activity. Although pay growth had weakened, it was likely that, at least in part, this reflected the lagged response to past weakness in productivity and to that extent had fewer implications for domestic cost pressures; there was a range of views as to how far this was the case. Inflation had been above the target for a considerable period and there was tentative evidence that measures of medium-term inflation expectations were becoming more sensitive to short-term news in inflation. Moreover, financial markets were not expecting further asset purchases at this meeting and might, at the margin, reassess the Committee's tolerance of elevated inflation should additional stimulus be injected. Monetary policy was already exceptionally accommodative, and further purchases could contribute to

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

33 For other members, the case for additional monetary stimulus was more compelling. Although the persistently large contribution of administered and regulated prices to inflation meant that domestic costs needed to grow more slowly than normal to bring inflation back to the target, there was currently a large margin of spare capacity in the labour market. Output growth was unlikely to be rapid enough to allow this margin to start to close over the forecast period. Moreover, at least some of the loss of supply capacity in the economy was likely to be temporary and further stimulus could lead to a recovery in effective supply, alongside demand, which would mean that cost pressures need be no higher even if growth was somewhat stronger. Rebalancing was proving a greater drag on output in the euro area than previously thought, and persistent weakness there might lead to upward pressure on sterling. Earnings growth had fallen and there was little sign of any de-anchoring of inflation expectations. Further asset purchases now would facilitate an earlier normalisation of the monetary stance when that became appropriate. Against that backdrop, it was appropriate to reduce labour market slack more quickly than was envisaged in the Committee's central projections. The impact of such a policy on inflation was uncertain. The initial impact of faster demand growth might be to reduce cost pressures by improving productivity.

34 The Governor invited the Committee to vote on the propositions that:

Bank Rate should be maintained at 0.5%;

The Bank of England should maintain the stock of asset purchases financed by the issuance of central bank reserves at £375 billion.

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

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

35 The following members of the Committee were present:

Mervyn King, Governor

Charles Bean, Deputy Governor responsible for monetary policy

Paul Tucker, Deputy Governor responsible for financial stability

Ben Broadbent

Spencer Dale

Paul Fisher

Ian McCafferty

David Miles

Martin Weale

Dave Ramsden was present as the Treasury representative.

In accordance with the Bank of England Act 1998, as amended by the Financial Services Act 2012, David Lees was also present as an observer in his role as a member of the Oversight Committee of Court.