

Bank of England cuts Bank Rate to 0.25% and introduces a package of measures designed to provide additional monetary stimulus

i The MPC voted unanimously to cut Bank Rate to 0.25%. The Committee also voted for a package of measures designed to provide additional support to growth and to achieve a sustainable return of inflation to the target.

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Monetary policy summary

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending 3 August 2016, the MPC voted for a package of measures designed to provide additional support to growth and to achieve a sustainable return of inflation to the target. This package comprises: a 25 basis point cut in Bank Rate to 0.25%; a new Term Funding Scheme to reinforce the pass-through of the cut in Bank Rate; the purchase of up to £10 billion of UK corporate bonds; and an expansion of the asset purchase scheme for UK government bonds of £60 billion, taking the total stock of these asset purchases to £435 billion. The last three elements will be financed by the issuance of central bank reserves.

Following the United Kingdom's vote to leave the European Union, the exchange rate has fallen and the outlook for growth in the short to medium term has weakened markedly. The fall in sterling is likely to push up on CPI inflation in the near term, hastening its return to the 2% target and probably causing it to rise above the target in the latter part of the MPC's forecast period, before the exchange rate effect dissipates thereafter. In the real economy, although the weaker medium-term outlook for activity largely reflects a downward revision to the economy's supply capacity, near-term weakness in demand is likely to open up a margin of spare capacity, including an eventual rise in unemployment. Consistent with this, recent surveys of business activity, confidence and optimism suggest that the United Kingdom is likely to see little growth in GDP in the second half of this year.

These developments present a trade-off for the MPC between delivering inflation at the target and stabilising activity around potential. The MPC's remit requires it to explain how it has balanced that trade-off. Given the extent of the likely weakness in demand relative to supply, the MPC judges it appropriate to provide additional stimulus to the economy, thereby reducing the amount of spare capacity at the cost of a temporary period of above-target inflation. Not only will such action help to

eliminate the degree of spare capacity over time, but because a persistent shortfall in aggregate demand would pull down on inflation in the medium term, it should also ensure that inflation does not fall back below the target beyond the forecast horizon. Thus, in tolerating a temporary period of above-target inflation, the Committee expects the eventual return of inflation to the target to be more sustainable.

The MPC's choice of instruments is based on a consideration of their likely impact on the real economy and inflation. The MPC has examined closely the interaction between monetary policy and the financial sector, both with regard to ensuring the effective transmission of monetary policy to households and businesses, and with consideration for the financial stability consequences of its policy actions.

The cut in Bank Rate will lower borrowing costs for households and businesses. However, as interest rates are close to zero, it is likely to be difficult for some banks and building societies to reduce deposit rates much further, which in turn might limit their ability to cut their lending rates. In order to mitigate this, the MPC is launching a Term Funding Scheme (TFS) that will provide funding for banks at interest rates close to Bank Rate. This monetary policy action should help reinforce the transmission of the reduction in Bank Rate to the real economy to ensure that households and firms benefit from the MPC's actions. In addition, the TFS provides participants with a cost effective source of funding to support additional lending to the real economy, providing insurance against the risk that conditions tighten in bank funding markets.

The expansion of the Bank of England's asset purchase programme for UK government bonds will impart monetary stimulus by lowering the yields on securities that are used to determine the cost of borrowing for households and businesses. It is also likely to trigger portfolio rebalancing into riskier assets by current holders of government bonds, further enhancing the supply of credit to the broader economy.

Purchases of corporate bonds could provide somewhat more stimulus than the same amount of gilt purchases. In particular, given that corporate bonds are higher-yielding instruments than government bonds, investors selling corporate debt to the Bank could be more likely to invest the money received in other corporate assets than those selling gilts. In addition, by increasing demand in secondary markets, purchases by the Bank could reduce liquidity premia; and such purchases could stimulate issuance in sterling corporate bond markets.

As set out in the August Inflation Report, conditional on this package of measures, the MPC expects that by the three-year forecast horizon unemployment will have begun to fall back and that much of the economy's spare capacity will have been re-absorbed, while inflation will be a little above the 2% target. In those projections the cumulative growth in output is still around 2½% less at the end of the forecast period than in the MPC's May projections. Much of this reflects a downward revision to

potential supply that monetary policy cannot offset. However, monetary policy can provide support as the economy adjusts. Had it not taken the action announced today, the MPC judges it likely that output would be lower, unemployment higher and slack greater throughout the forecast period, jeopardising a sustainable return of inflation to the target.

This package contains a number of mutually reinforcing elements, all of which have scope for further action. The MPC can act further along each of the dimensions of the package by lowering Bank Rate, by expanding the TFS to reinforce further the monetary transmission mechanism, and by expanding the scale or variety of asset purchases. If the incoming data prove broadly consistent with the August Inflation Report forecast, a majority of members expect to support a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year. The MPC currently judges this bound to be close to, but a little above, zero.

All members of the Committee agreed that policy stimulus was warranted at this time, and that Bank Rate should be reduced to 0.25% and be supported by a TFS. Eight members supported the introduction of a corporate bond scheme, and six members supported further purchases of UK government bonds.

These measures have been taken against a backdrop of other supportive actions taken by the Bank of England recently. The FPC has reduced the countercyclical capital buffer to support the provision of credit and has announced that it will exclude central bank reserves from the exposure measure in the current UK leverage ratio framework. This latter measure will enhance the effectiveness of the TFS and asset purchases by minimising the potential countervailing effects of regulatory requirements on monetary policy operations. The Bank has previously announced that it will continue to offer indexed long-term repo operations on a weekly basis until the end of September 2016 as a precautionary step to provide additional flexibility in the Bank's provision of liquidity insurance. The PRA will also smooth the transition to Solvency II for insurers.

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