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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING
4 AND 5 MARCH 2009

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 March 2009.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0903.pdf

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 8 and 9 April will be published on 22 April 2009.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4-5 MARCH 2009

1 Before turning to its immediate policy decision, the Committee discussed financial markets developments; the international economy; money, credit, demand and output; and costs and prices.

Financial markets

2 Developments on the month in financial markets had been mixed. The introduction of the Asset Purchase Facility (APF), under which the Bank had so far purchased around £1 billion of corporate commercial paper, had been well received by the market. A number of other assets, including investment-grade corporate bonds, were also eligible for purchase under the APF. Although no purchases had yet taken place, there had been some reduction in the spreads between non-financial corporate bonds and equivalent Credit Default Swaps (CDS), suggesting improvements in liquidity in those bond markets.

3 Details of the terms under which the Royal Bank of Scotland (RBS) would be able to access the Government's Asset Protection Scheme had been made public, and the RBS equity price had risen on the day of the announcement. However, towards the end of February there had been some deterioration in sentiment towards UK and overseas banks. Banks' CDS spreads had picked up, and financial sector corporate bond spreads had widened.

4 The spreads between sterling LIBOR rates and expected policy rates had widened on the month, and the equivalent three-month forward spread had also risen. Those increases in current and forward spreads largely reflected falls in expected policy rates, rather than increases in LIBOR. There was often some lag between movements in expected policy rates and the corresponding changes in LIBOR rates, but those lags were usually a few days, rather than weeks. Moreover, market contacts had reported that inter-bank term lending had reduced over recent weeks.

5 Equity prices had fallen internationally on the month. The FTSE All-Share index had fallen by around 15%, to its lowest level since 2003. Declines in financial sector equity prices had been particularly large, but equity prices across the other main sectors had also fallen. That suggested that

the declines partly reflected a weaker or more uncertain macroeconomic outlook, rather than simply increased concerns about the financial sector.

6 Market expectations of Bank Rate had fallen on the month and a reduction of 50 basis points was expected at the Committee's March meeting. Short to medium term nominal forward rates had also fallen, by as much as 45 basis points. It was likely that this, in part, reflected increased expectations of gilt purchases for monetary policy purposes. The sterling ERI was little changed on the month, although this masked some significant bilateral exchange rate movements. The yen had depreciated sharply against sterling and a range of currencies, following weaker than expected Japanese macroeconomic data. But sterling had weakened somewhat against the dollar.

The international economy

7 The data released over the month had confirmed that output had weakened considerably across a wide range of economies in 2008 Q4. Among the major industrialised economies, Japan had seen the largest contraction in output, with GDP falling by 3.3% – the second largest quarterly decline on record. That weakness had been driven by a sharp decline in exports. A number of other Asian economies had also released data showing particularly large falls in industrial production, output and trade flows.

8 Output was also estimated to have fallen sharply in the United Kingdom's two largest export markets. US output had been revised down, and was estimated to have fallen by 1.6% in the fourth quarter, in part due to a weaker contribution from stockbuilding than previously estimated. Euro-area output was estimated to have contracted by 1.5% in Q4. The largest decline had been recorded in Germany, driven by a 7% fall in exports.

9 Turning to the evidence on global growth in the early months of 2009, the signals provided by Purchasing Managers' Indices (PMIs) had been mixed, following a pickup in many of those indices in January. The JP Morgan Global Purchasing Manager Index for manufacturing had risen slightly in February, with rises recorded in both the US and Chinese indices, although they remained at low levels compared with their historical averages. But the equivalent Global Services Index had fallen in

February. Both the US non-manufacturing PMI and the euro-area services PMI had declined on the month.

10 Over the past month, economic and financial conditions in a number of central and eastern European countries had deteriorated, and there were also concerns about the potential exposure of some western European banks to those countries. Although the direct exposure of the UK economy and banking system to those economies was not large, some of the United Kingdom's trading partners could be more heavily affected.

11 There had been a number of policy developments during the month. The US economic stimulus act had been passed into law, and the US government had announced a new Financial Stability Plan, and a plan to improve conditions in the housing market. The Bank of Japan had announced plans to restart purchases of equities held by banks, to extend its purchases of commercial paper, and to buy highly-rated, short-maturity corporate bonds.

Money, credit, demand and output

12 UK nominal GDP had fallen by 0.8% in 2008 Q4, and was only 0.5% higher than its level a year earlier. If unrevised, this would be the weakest four-quarter growth in nominal output since quarterly data began in 1956. Broad money (M4) had continued to grow strongly in the three months to January. However those high rates of growth were largely explained by the behaviour of the non-bank financial sector, and – within that sector – by increases in intermediation between banks and financial companies belonging to the same banking group. Those large flows were likely to have limited implications for asset prices and money spending. The stock of broad money excluding holdings by non-bank financial corporations had grown by 2.7% on a year earlier in January. This compared with a ten-year average annual growth rate of 7.6%.

13 The expenditure breakdown of real GDP growth in Q4 had been broadly in line with the Committee's expectations. However, de-stocking was estimated to have made an even larger contribution to the decline in output than the Committee had anticipated, accounting for almost two thirds of the entire fall. The Committee recognised that data on stockbuilding were prone to revision.

But these data appeared to chime with evidence from business surveys, that businesses had reacted to a weakening in demand and tighter credit conditions by cutting back on stocks. The data provided some support for the Committee's central projection, in the February *Inflation Report*, of a partial recovery in growth rates over 2009 as the negative contribution to growth from de-stocking lessened.

14 Partly offsetting the drag from de-stocking, GDP was estimated to have been supported in the fourth quarter by a positive contribution from net trade. This support was not due to exports, which had fallen by 5.3%. Rather, net trade had boosted UK growth because of a sharp fall in UK imports, of 5.7% – the largest quarterly decline since 1980. It was likely that the depreciation of sterling had encouraged a switch in spending away from imported goods and services and towards domestically produced output.

15 The news on the month for domestic expenditure in Q1 was mixed. There had been some positive news for household spending. ONS data suggested that nominal retail sales had picked up sharply on the month in January, and had grown by 2.4% on a year earlier. Retail sales volumes were reported to have grown by 3.6% in the year to January, although it was likely that that growth rate would be revised down when the weights underlying the retail sales deflator were updated. Although the CBI *Distributive Trades Survey* pointed to weaker retail sales growth than suggested by the ONS data in January, the responses to the latest survey were consistent with a pickup in twelve-month sales growth in February.

16 There had also been some tentative evidence that activity in the housing market might be beginning to stabilise. A preview of the February Royal Institution of Chartered Surveyors survey had shown modest improvements across most indicators. And according to the Bank's regional Agents, reports of growth in the numbers of enquiries and viewings had become considerably more widespread. But housing market turnover remained exceptionally low, and house prices had fallen by 4.3% in the three months to February, according to the average of the main lenders' indices.

17 The outlook for business investment remained very subdued. In the three months to January, M4 lending to non-financial companies, excluding the effects of securitisations, had grown by only 1.1%

on an annualised basis. And construction orders for new commercial property had fallen very sharply in the fourth quarter, to 40% below their level a year earlier.

18 The news from the surveys for output in the first quarter of 2009 was mixed. The CIPS/Markit output balance for the manufacturing sector had fallen back sharply in February and was at its lowest level since the survey began in 1991. The survey implied a further very significant fall in manufacturing output in the first quarter. In contrast the CIPS/Markit services balance had edged up for the third successive month, although it remained significantly below its series average.

19 Overall, the output surveys continued to point to a broadly similar rate of contraction in output in the first quarter of 2009 to that in the fourth quarter of 2008. To be consistent with the easing in the pace of contraction implied by the February *Inflation Report* central projection, the surveys would need to rise quite significantly over the coming months. The risks to the February central projection remained weighted to the downside.

Costs and prices

20 Conditions in the labour market had continued to deteriorate. Employment had fallen by 45,000 in 2008 Q4, and unemployment, according to the Labour Force Survey measure, had risen by 146,000. Most survey measures of employment intentions had continued to fall. Measures of earnings growth had been broadly stable, but it was likely that earnings would weaken over the first half of 2009, reflecting both lower bonuses and falling settlements. There had been a sizeable pickup in the proportion of companies reporting wage freezes in the January settlements data. That was broadly consistent with reports from the Bank’s regional Agents.

21 The worsening in labour market conditions posed a downside risk to activity, particularly to the extent that it fed back into households’ confidence and willingness to spend. However, the implications for the outlook might be ameliorated somewhat, to the extent that lower settlements reflected increased wage flexibility, dampening the falls in employment.

22 CPI inflation had fallen slightly, to 3.0% in January from 3.1% in December, much as the Committee had expected at the time of the February *Inflation Report*. However, it remained significantly above the 2% target. In part that reflected the continuing impact of past increases in energy and food prices. The lower level of the sterling exchange rate was pushing up energy and food prices, and over time would put upwards pressure on the prices of other imported goods and services. If the current level of the exchange rate persisted, then there would be a positive impact on the price level. But it was uncertain how quickly this would feed through, and so how much it would add to annual consumer price inflation. Offsetting this effect, there were likely to be significant downward pressures on inflation from the growing level of spare capacity in the economy. That was consistent with the results of a special survey on cost pass-through by the Bank's regional Agents, in which, despite the lower level of sterling, many respondents had reported that their variable costs had fallen over the previous six months.

23 Survey measures of near-term inflation expectations appeared to be at levels roughly consistent with inflation meeting the target. The Bank/GfK NOP survey measure of expected inflation over the next twelve months had continued to fall back from its elevated levels in mid-2008, and was now slightly below its average level since the survey began in 1999. The corresponding Citigroup/YouGov survey had picked up further from its recent trough.

The immediate policy decision

24 Activity data for the world economy had continued to be weak. Monthly indicators were consistent with a further substantial contraction of global output in the first quarter of 2009. There had been further measures announced by fiscal and monetary authorities in some large economies which should help to limit the downside risks to global output, and support growth. But the weakness of world demand continued to pose downside risks to the outlook for UK activity and inflation.

25 Data on the UK economy had been consistent with the broad shape of the central projection for activity that the Committee had published in February. The data pointed to a sharp fall in output in the fourth quarter of 2008, and to a similar contraction in the first quarter of 2009. And evidence on lending suggested that credit conditions remained tight for businesses and households. But there were

some signs that the economy remained on track for an easing in the rate of contraction in output over the rest of 2009. Cutbacks in output which companies had undertaken in order to reduce stock levels did seem to have been responsible for some of the severity of the fall in GDP in the fourth quarter. There was evidence that the depreciation of sterling was causing some switching of domestic spending from imported to domestically produced goods and services. House prices continued to fall, but housing market activity, though very subdued, appeared no longer to be weakening further. However even if GDP growth rates were recovering by the end of 2009, this was likely to be taking place against a backdrop of a significant degree of spare capacity, and in particular a high and rising level of unemployment.

26 The current and prospective weakness in nominal demand growth meant that there remained a substantial risk that inflation would undershoot the target in the medium term. CPI inflation had fallen slightly, to 3.0% in January, and the Committee expected further falls over the coming months, as the contributions from energy and food prices declined, and spare capacity pushed down on wages and companies’ margins. These effects would only be partly offset by the impact of higher import prices following the substantial depreciation of sterling over the previous 18 months.

27 The Committee agreed that further monetary easing was required to meet the inflation target, and first discussed whether there should be any additional cuts in Bank Rate. Some arguments were identified for making no further rate reductions. Although the current extremely low level of Bank Rate was providing a substantial stimulus to the economy, the transmission of any further rate cuts through to activity and inflation was likely to be significantly impaired. In particular, the Committee remained concerned that a further reduction could have some adverse impacts on the economy, given its effects on the profits that banks and building societies were able to make through the spread between their deposit and lending rates. Deposit rates could not be reduced much further, and if these institutions were contractually obliged to pass on cuts in Bank Rate to some of their borrowers, that would squeeze their profits further, and potentially reduce lending capacity. In addition, a sustained period of very low interest rates could impair the functioning of money markets, creating difficulties in the future, when interest rates needed to rise.

28 However, there were also arguments in favour of making a further reduction in Bank Rate. First, a cut in interest rates would still have some effects in boosting nominal spending and inflation, for example through the usual exchange rate and asset price channels. Second, a lower level of Bank Rate should increase the effectiveness of the further measures which were likely to be needed to ease the stance of monetary policy. Those measures would lead to an increase in the supply of money in the economy. A lower level of Bank Rate would raise the incentive for investors to find alternative assets to hold, rather than keeping the additional money in bank deposits. Third, concerns about the impact of a low Bank Rate on lending capacity were best met by policy initiatives to stabilise the financial system.

29 The Committee then discussed what further measures it should take to ease the stance of monetary policy. The Committee noted the recent exchange of letters between the Governor and the Chancellor of the Exchequer, in which the Chancellor had authorised the Committee to use the Asset Purchase Facility to purchase up to £150 billion of assets, financed by the issuance of central bank reserves, should the Committee choose to do so for monetary policy purposes. Within that total, up to £50 billion could be in purchases of eligible private sector assets, with the remainder to be made up of purchases of UK government debt in the secondary market.

30 The Committee agreed that such purchases were necessary in order to increase nominal spending growth to a rate consistent with meeting the inflation target in the medium term. Such operations were a natural extension of the Committee's usual monetary policy operations. Given the Bank's role as monopoly supplier of sterling central bank money, the Committee had previously chosen to influence the amount of nominal spending in the economy by varying the price at which it supplied central bank money in exchange for assets held by the private sector. Under the operations now under consideration, the Committee would instead be focusing more directly on the quantity of money it supplied in exchange for assets held by the private sector.

31 By increasing the supply of money in the economy, these operations should, over time, cause nominal spending to rise. Sellers of assets to the Bank would find that their portfolios were now more heavily weighted towards highly liquid, low-yielding assets. To rebalance their portfolios, they would be likely to spend some or all of the proceeds buying other types of asset. This would tend to increase

the relative prices of those assets, and hence wealth, and would, by stimulating the demand for corporate credit instruments, improve the supply of funds to the corporate sector. The purchases would also mean that the banking system would be holding a higher level of reserves in aggregate, which might cause it to increase its lending to companies and households. There could also be positive impacts on expectations and confidence from these operations to increase the money supply, as businesses and individuals became more confident about an eventual recovery.

32 In addition, to the extent that some of the extra reserves were used to finance the Bank's programme of private sector asset purchases aimed at improving the functioning of corporate credit markets, that should make it easier for some types of companies to raise finance, reducing their reliance on the banking sector.

33 There was a high degree of uncertainty over the appropriate scale of purchases necessary to keep inflation at target in the medium term. The Committee noted that their February *Inflation Report* projections suggested that a significant shortfall in nominal GDP was possible over the forecast period. Nominal GDP had grown by, on average, around 5% since the inception of the MPC – a period over which inflation had been close to the target on average. In contrast the Committee's February projections implied a small decline in nominal GDP in 2009, with growth remaining below 5% in 2010. Therefore the projections suggested a shortfall in nominal GDP of at least 5%.

34 A significant programme of asset purchases was likely to be necessary in order to make up this shortfall in nominal spending. The current strains in the financial system, and in particular the pressures on banks to reduce the size of their balance sheets, meant banks were less likely to increase their lending substantially following an increase in their reserves. That would reduce the extent to which a given increase in banks' reserves would generate a correspondingly larger rise in the stock of broad money and credit. It was also possible that the eventual increase in nominal spending might be somewhat smaller than the increase in the stock of broad money resulting from the asset purchases.

35 These considerations suggested that the increase in the level of money balances should be of a similar magnitude to the required increase in nominal GDP. The Committee agreed that reserves should initially be increased by a figure somewhere in the range of £50 billion to £100 billion.

36 Within that range, the Committee discussed the arguments supporting smaller or larger programmes of asset purchases. One factor supporting a figure towards the lower end of that range was the high degree of uncertainty over the precise impacts on nominal spending and inflation of these operations. That might suggest that the Committee should move relatively slowly, while it learnt more about the impact of those operations. Although it would take many months before the full effects became apparent, some indicators would emerge more quickly than that. For example, the Committee would be able to gather some information on how the sellers of the assets were responding to the subsequent increase in liquidity of their portfolios, and would also be able to monitor movements in asset prices.

37 There were also arguments in favour of a programme of purchases towards the upper end of the range. The risks around the inflation outlook were weighted to the downside. As such the costs of doing too little at the start were arguably greater than the costs of doing too much. If the purchases proved too expansionary, the Bank would be able to reduce the degree of stimulus, either by selling back some of the assets, or by raising the level of Bank Rate.

38 In addition, should the first injection prove too small, there was a risk that observers would wrongly infer that such asset purchases were not an effective policy tool. That might dampen the extent to which liquidity premia were reduced, and asset prices boosted, by further purchases. The initial programme of asset purchases needed to be on a scale large enough to demonstrate that the Committee would do whatever was needed to boost nominal spending sufficiently to keep inflation at target in the medium term.

39 Turning to the policy decision, the Committee judged that a further reduction in Bank Rate, of 0.5 percentage points, was appropriate. In coming to that judgement, the Committee noted the changes the Bank’s Executive would make to the operation of the Bank’s Sterling Monetary Framework, which would be set out in a Market Notice to be published later that day. In particular, the rate paid on the Operational Standing Deposit Facility would be reduced from 0.75% to 0%. Consequently, these changes alone would mean that overnight market interest rates would be likely to trade in the range between zero and 0.5%, the new level of Bank Rate.

40 There was a range of views about the desirable size of the initial programme of asset purchases. But Committee members agreed that the differences between their preferred scale of purchases were small relative to the degree of uncertainty surrounding these estimates. On balance, the Committee judged that an initial programme of asset purchases of £75 billion was appropriate.

41 Turning to the type of assets which the Bank should purchase, the Committee agreed on the importance of improving conditions in corporate credit markets. The Committee noted that the Bank would continue with its purchases of private sector assets in order to improve directly the functioning of corporate credit markets. The Committee agreed that these purchases should now be financed through the creation of central bank reserves, rather than through the issuance of Treasury Bills. However, it was likely that the purchases of private sector assets over the coming months would be significantly less than the £75 billion target for overall purchases. In part that was because the size of those private sector asset markets was relatively small. But in addition, the first objective of those purchases was to reduce spreads and to improve the flow of credit. As such, the scale of purchases by the Bank in those markets was not the primary objective. Given these considerations, the Bank would also need to buy substantial quantities of conventional gilts in the secondary market in order to meet the Committee’s objective for overall asset purchases.

42 The Committee noted that these asset purchases were likely to be most effective if they were purchased from the domestic non-bank financial sector rather than from banks. Domestic non-bank institutions were likely to use some of the proceeds from asset sales to buy other assets. The Committee noted that this preference for buying assets from institutions other than banks meant that the Bank would focus its purchases on medium and long maturities, because short-maturity gilts were more likely to be held by banks and overseas central banks. The Bank would also avoid the purchase of very long maturity gilts, given the structure of supply and demand in those markets, and in particular the demand from some institutions such as pension funds to hold those instruments to hedge their liabilities.

43 Finally, the Committee discussed the time frame over which the Bank should aim to complete the asset purchases, and recognised that, given the large scale of asset purchases, it was likely to take more than a month for the Bank to complete the programme. The Committee agreed that it should set

a period of three months over which the Bank should aim to purchase the assets. The Committee would review the appropriate scale of the programme each month.

44 The Governor invited the Committee to vote on the proposition that Bank Rate should be reduced by 50 basis points to 0.5%. The Committee voted unanimously in favour of the proposition.

45 The Governor invited the Committee to vote on the proposition that:

> The Bank of England should finance £75 billion of asset purchases by the creation of central bank reserves. The Bank should seek to make these purchases within the next three months. The scale and timing of purchases would be reviewed at each MPC meeting.
>
> Purchases of private sector assets under the Asset Purchase Facility should now be financed using central bank reserves rather than Treasury Bills.
>
> The Committee noted that, in so far as purchases of private sector assets fell short of the £75 billion target, the Bank of England would buy gilts to fulfil the overall quantity of purchases.

The Committee voted unanimously in favour of the proposition.

46 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
Kate Barker
Tim Besley
David Blanchflower
Spencer Dale
Paul Fisher
Andrew Sentance

Dave Ramsden was present as the Treasury representative.