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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

6 and 7 August 2014

These are the minutes of the Monetary Policy Committee meeting held on 6 and 7 August 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1408.aspx>

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting monetary policy 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 September will be published on 17 September 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 6 AND 7 AUGUST 2014

1 Before turning to its immediate policy decision, and against the backdrop 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 Financial markets had remained relatively resilient despite a number of significant events during the month. These included: heightened geopolitical tensions in Russia and Ukraine, and in the Middle East; a technical default on an Argentinian public debt payment; the announcement of public support for a large Portuguese bank; and comments by the chair of the FOMC regarding asset valuations in particular sectors. Although these events had triggered only a fairly modest market reaction, there were some tentative signs in some asset classes of a reduction in risk appetite.

3 Instantaneous twelve-month sterling forward rates derived from overnight index swaps had risen modestly following the release of unexpectedly high June CPI data, but this effect had subsequently unwound so as to leave short rates fractionally lower over the month as a whole. The option-implied volatility of short sterling rates at horizons up to a year ahead had remained at or below pre-crisis norms. Financial market prices suggested expectations of a 25 basis point increase in Bank Rate in the first quarter of 2015. The economists participating in the Reuters survey held a similar view, in general, although a significant minority of the economists surveyed expected an increase in Bank Rate of 25 basis points by the end of 2014.

4 Movements in long rates had been more notable, with ten-year forward rates having fallen by 20-30 basis points during the month in the United Kingdom, United States and euro area. These movements had continued the trend seen since the start of the year, which had been consistent with an increased perception that the interest rates likely to be necessary to balance economic demand and supply in the medium term would be lower than during much of the pre-crisis period.

5 The sterling effective exchange rate index had been broadly unchanged over the month as a whole, but it had appreciated by 2% since the time of the *May Inflation Report* and by 4% since the turn of the year. The levels of implied sterling-dollar volatility at horizons up to a year ahead were at pre-crisis lows.

6 Within the broader context of low actual and implied volatility in financial markets, there were some signs of a modest reduction in risk appetite following the events of the month. High-yield sterling corporate bond spreads had increased by around 50 basis points during the month and those of their dollar equivalents by over 70 basis points. The major advanced economy equity price indices had fallen by between 1% and 5%.

The international economy

7 The news on the international economy had been mixed over the month and, although global growth was likely to be a little stronger in the second half of the year than it had been during the first, the balance of risks, particularly those stemming from the euro area and the political situation in Russia and Ukraine, probably lay to the downside.

8 In the United States, GDP in the second quarter had increased by 1%, slightly stronger than Bank staff had expected, and the fall in output in Q1 had been revised down to 0.5%. Although, since the crisis, strong outturns for quarterly growth had not been a reliable indicator of sustained growth above trend, surveys for July suggested that momentum would be maintained in the third quarter. More broadly, the underlying strength of demand was still uncertain: much of the increase in output in Q2 had been accounted for by a rise in stockbuilding and employment growth had fallen back a little in July.

9 The latest indicators suggested that economic growth in the euro area had not picked up in the second quarter. Although GDP in Spain had risen by 0.6%, there had been a fall in output of 0.2% in Italy. In addition, the timing of public holidays across the region looked to have depressed industrial production in May, and Bank staff's estimate of euro-area GDP growth in Q2 was only 0.2%, the same as in Q1. Purchasing Managers' Indices (PMIs) for July were consistent with an improvement in euro-area output growth in the third quarter, perhaps to around ½%, but, set against that, there had

been a sharp fall in new industrial orders in Germany.

10 The disappointing news on euro-area activity had been accompanied by further weakness in inflation. The flash estimate of twelve-month euro-area inflation for July had fallen to 0.4%. Much of the 2½ percentage point fall in inflation since its peak at the end of 2011 had reflected the mechanical impact of past rises in commodity prices and indirect taxes in a number of countries dropping out of the annual calculation. Inflation excluding these factors had probably been low for quite some time, but it might well have weakened further since the spring. High unemployment, particularly in the periphery, was likely to have been a material restraint on prices and, as activity picked up, it was possible that inflation in these countries would begin to rise. But, with inflation in many core economies likely to stay below 2% and slack still remaining, the process of rebalancing and restoring competitiveness in the periphery might well prove a greater and more persistent drag on euro-area activity.

11 The news on emerging economies had been mixed. Four-quarter GDP growth in China had risen to 7.5% in Q2 from 7.4% in Q1. Since then, surveys of manufacturing output had improved while the HSBC services PMI had fallen back sharply. Nonetheless, it was likely that the large number of targeted stimulus measures implemented by the Chinese authorities since the spring would be sufficient to keep growth close to the government's 7½% target for the rest of the year. The rapid growth in credit and the vulnerabilities associated with the shadow banking system, however, remained a risk to the outlook for China's economy.

12 There had been little change in most commodity prices, notwithstanding the large number of geopolitical risks. The prices of agricultural commodities had generally fallen a little and oil prices were also slightly lower, despite the conflict in Iraq and renewed turmoil in Libya. UK wholesale gas prices had risen by around 5%, however, following the imposition by the European Union and United States of further sanctions on Russia. A further escalation in tensions between Russia and Ukraine could have a material impact on commodity prices, as well as leading to a reduction in trade with many European countries.

Money, credit, demand and output

13 As expected, the ONS's preliminary estimate of GDP growth for the second quarter had been 0.8%, the same rate as in the first quarter. Bank staff continued to expect estimates of growth in Q1 and Q2 to be revised up fractionally, to 0.9%, based on the strength of other surveys of business activity and the historical pattern of data revisions. Thereafter, growth was expected to ease somewhat. The latest survey data suggested that the slowing of growth in the second half of the year was likely to be less pronounced than expected at the time of the May *Inflation Report*. For instance, the composite Markit/CIPS output index had strengthened in July, with the services activity index standing at an eight-month high, although the forward-looking expectations indices had fallen a little. The updated expectation of Bank staff was for an estimate of GDP growth of 0.8% in the mature data for the third and fourth quarters.

14 Although manufacturing output growth had dropped back in the second quarter, there appeared as yet little sign that sterling's recent appreciation had significantly dented export demand. Export surveys had weakened somewhat but remained relatively upbeat. A special survey conducted on behalf of the MPC by the Bank's Agents had suggested that businesses expected export growth to improve over the coming twelve months as overseas demand recovered. The survey suggested that the main impact of the appreciation so far had been to reduce sterling sales values, and so profit margins, rather than volumes. This had partially unwound some of the increase in exporters' average margins seen following the sterling depreciation at the onset of the financial crisis. Some firms anticipated that the impact on export sales volumes would be more pronounced were sterling to appreciate further.

15 Following four consecutive monthly falls, the number of mortgage loan approvals for house purchase had increased by 5,000, to 67,000, in June. The number of applications for mortgages had also picked up a little. Together, these data supported intelligence gained from the major UK lenders that the immediate negative effect on lending activity associated with the implementation of the Mortgage Market Review was beginning to wane. Most lenders expected that its impact would continue to subside in July. Nevertheless, mortgage approvals had been weaker than expected at the time of the May *Inflation Report*, when they had been projected to rise to around 85,000 per month by the end of the year. The recent indicators suggested that a number around 75,000 per month on average in Q4 now seemed more likely. A confidential preview of the RICS survey indicated that new buyer enquiries at estate agents had fallen in July, albeit only slightly, for the first time in 18 months.

In both June and July, by contrast, the number of new instructions to sell properties received by estate agents had risen slightly.

16 Together, the apparent reduction in demand for, and increase in the supply of, homes in the secondary market would act to ease pressure on house prices. The Nationwide house price index had risen by only 0.1% in July and the Land Registry index had been flat in June. The more volatile Halifax index had increased by 1.4% in July, however. The Committee's updated assumption for house price inflation was somewhat softer than that made three months ago, with the pace of price appreciation expected to slow to around ½% per month on average by 2015 Q1. This reflected some unwinding of the relative price increases seen in London in recent years.

17 The stock of broad money had expanded at an annual rate close to 4% in June, a little below the growth of nominal GDP in Q1. Within that, households' M4 had risen at a similar pace. After controlling for the effects of movements in market interest rates, the expansion of households' money holdings since the start of the crisis had been greater than would normally have been associated with the observed increases in nominal spending and wealth.

18 The appropriate signal to draw from the past pace of household money growth depended on whether the apparent increase in the demand for money holdings would prove lasting. It was possible that, following the financial crisis, households would in aggregate desire to maintain a larger buffer of liquid assets than during the preceding years of economic stability. Although surveys indicated that households' confidence in the general economic environment was near record highs, indicators of households' confidence in their own financial situation remained below pre-crisis levels. Set against that, it was also possible that households' desire for liquid money balances would diminish as the expansion progressed and uncertainty over unemployment and income continued to fall. In this case, the money would either be spent or reinvested in less liquid assets, potentially pushing up their prices. In the *August Inflation Report* forecast, the household saving rate was expected to fall a little in the near term as spending exceeded income growth. The switch in the composition of households' money balances away from time deposits and towards instant-access sight deposits seen since mid-2012 was consistent with that judgement. Such a portfolio adjustment was also consistent with the fact that the term structure of interest rates had flattened significantly since mid-2012 as bank funding costs had fallen.

19 Corporate money holdings had grown at an annual rate of almost 9% in June. In the past, increased corporate money holdings had often been an indicator of subsequent periods of higher capital expenditure. The pickup in business investment underlying the Committee's August *Inflation Report* projections was associated with a fall in the corporate financial surplus over the three-year forecast period. The four-quarter growth of bank credit to corporates had only just turned positive in 2014 Q2, although capital market financing had been firm in recent years, and might be expected to remain so.

Supply, costs and prices

20 Twelve-month CPI inflation had risen from 1.5% in May to 1.9% in June, rather stronger than Bank staff and other economists had expected immediately beforehand. Most of the surprise was centred in the prices of clothing and footwear, which had risen between May and June for the first time since the CPI series had begun in 1996. Although it was possible that this partly reflected an unusual delay to the start of the summer sales that normally caused the sub-index to fall in June – a factor which would unwind in subsequent months – there was little firm evidence to suggest that this had occurred. And there were other reasons to suppose that the increase in prices might be more lasting.

21 The BRC and Bank's Agents reported that the clothing sector had recently experienced relatively solid demand. And retailers had suggested that this summer's sales were less widespread than in previous years, reflecting a reduced need to discount prices heavily in order to clear excess stock. In addition, it was possible that the increase in the clothing and footwear CPI sub-index in June had been related to a change in the precise composition of the sample of goods in the basket. Information from the ONS indicated that a high proportion of price quotes had been collected from goods selected as replacements for items that had become unavailable in the shops. Any effect of this kind on the measured price level would be expected to affect the twelve-month inflation rate for a year. Bank staff expected CPI inflation to remain a little below the 2% target over the coming few months.

22 The labour market data for May continued to underscore the strikingly opposing trends of strength in employment growth and weakness in wages. Employment had increased by just over ¼ million in the three months to May compared with the previous non-overlapping quarter. Unemployment had continued to fall, on the LFS measure to 6.5% from 7.2% at the end of 2013. At the same time, according to the AWE measure, private sector annual regular pay growth had edged

down to just under 1%. Total pay growth, as expected, had been weaker, reflecting the impact on the timing of bonus payments of changes to the income tax regime in 2013. Alternative indicators of wage growth from business surveys and recruitment agencies remained stronger than the official AWE data.

23 When combined with the output data, the strength of employment growth implied that hourly labour productivity had fallen back in 2014 Q2 and had probably stood at a level no higher than a year earlier. Indeed, according to the latest data vintage, hourly productivity looked to have grown barely at all over the previous five years. Excluding the years after the two world wars, current data indicated that the recent period had seen the slowest rate of productivity growth over any five years since at least the late 19th century. Even with productivity flat, however, weak wage data implied that unit wage costs appeared to have changed little over the past year.

24 The juxtaposition of strong employment and weak wages was consistent with an increase in households' desired supply of labour. The increase in labour market participation over the past few years had perhaps been the most striking development – all the more so when set against the demographic impact of an aging population which would otherwise have been expected to reduce aggregate participation quite materially. The proportion of the population aged 16+ either in work or seeking it had risen to just under 64% in May: its highest level in 23 years. While it was possible that a part of this reflected a cyclical increase in participation rates as real incomes remained squeezed and more jobs became available, there were also reasons to suppose that higher levels of participation were partly structural. Improved health and longevity, and consequently the ability and need to work longer to provide for retirement, were likely to have boosted labour market participation. Additional contributing factors might have been the recent increase in the state retirement age for women and the planned further increases in state retirement ages, the phasing out of compulsory retirement ages, and changes to disability benefit rules. It was also possible that increased concerns over their debt burdens might have encouraged some people to work later in life, or for more hours per week.

25 In addition, there were reasons to believe that the rate of unemployment achievable without acceleration in wages had fallen back since the depths of the recession. First, the number of long-term unemployed had fallen. Second, after several years where stagnant or falling real wages and productivity had been the norm, workers might be more likely to acquiesce to continued wage restraint. And, third, it was possible that the long-run equilibrium rate of unemployment – determined by the structural characteristics of the labour market – had fallen back over a number of years. This

could reflect the increased incentives to search for work provided by benefit reforms, and technological improvements in job matching, for instance, the increasing prevalence of online job advertising and search.

26 Bank staff would be undertaking further analysis regarding the evolution of labour supply over the coming months.

The August 2014 growth and inflation projections

27 The Committee's central view, on the assumption that Bank Rate followed a path implied by market interest rates and the stock of purchased assets stayed at £375 billion, was that the economy would expand at close to, or a little above, its historical average rate for much of the next two to three years. Growth would ease a little in the near term, as the boost from the pent-up demand released by the easing in credit conditions and lifting of uncertainty faded. Beyond the near term, domestic demand would be underpinned by a gradual recovery in the growth of productivity and household incomes. Consumer spending, housing investment and business investment were all anticipated to make positive contributions to growth throughout the forecast period. The contribution from net trade would be mildly negative, reflecting persistently low growth in the United Kingdom's main export markets, and the lagged effect of the recent rise in sterling.

28 The risks around that central case were judged to be slightly to the downside. That primarily reflected global uncertainties, including the possibility that investors might reappraise their appetite for risk. The outlook for productivity was another key source of uncertainty – productivity growth had repeatedly disappointed, and there was a risk that it would prove weaker still than in the MPC's downwardly revised central view.

29 Unemployment was projected to decline throughout the forecast period, albeit at a slower rate than over the recent past. The outlook for unemployment would be closely linked to that for productivity: for a given GDP profile, stronger productivity growth would tend to be associated with less pronounced declines in unemployment, and vice versa. In the central view, the remaining spare capacity in the economy would be fully absorbed towards the end of the forecast period.

30 The Committee's central view was that inflation would remain close to, but a little below, 2% for the next couple of years, before reaching the target at the end of the forecast period. In part, that was because the anticipated modest expansion in supply capacity would help to slow the rate at which slack was absorbed, thereby limiting the build-up of domestic inflationary pressure. The muted inflation outlook also reflected the dampening effect on import prices of the recent rise in the sterling exchange rate. There were risks on either side of this projection, in particular stemming from labour costs. As labour market slack diminished and productivity growth picked up, wage growth was expected to rise slowly. But wage growth could pick up more sharply than expected, particularly if recruitment pressures broadened and intensified. Against that, it was also possible that wage pressures could remain weaker for longer if labour supply growth remained strong.

The immediate policy decision

31 The Committee set monetary policy to meet the 2% target in the medium term, and in a way that helped to sustain growth and employment. The Committee had given guidance in its February *Inflation Report* on how it would seek to achieve the inflation target over the policy horizon. The central message of that guidance remained relevant: given the likely persistence of headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so only gradually. Moreover, the persistence of those headwinds, together with the legacy of the financial crisis, meant that Bank Rate was expected to remain below average historical levels for some time to come. The actual path for monetary policy, even after the first rise in Bank Rate, would, however, remain dependent on economic conditions. In other words, the Committee's guidance on the likely pace and extent of interest rate rises was an expectation, not a promise.

32 The macroeconomic news regarding the global economy had been relatively limited during the month. The recovery in US growth in the second quarter had been a little firmer than anticipated. By contrast, another quarter of materially sub-trend growth in the euro area seemed likely in Q2, and HICP inflation had fallen further in July. There had been a number of significant geopolitical events regarding the conflict between Ukraine and Russia and also in the Middle East. The Argentinian government had defaulted on a debt payment. And a large Portuguese bank had imposed losses on some creditors and required state support. The prices of some risky assets, such as high-yield corporate bonds and equities, had fallen on the month. Although actual and implied volatilities across a range of asset classes remained low, it was possible nonetheless that these price falls represented the

first steps by investors in a reassessment of risk appetite and a return of asset price volatility to more normal levels. Whether or not such a process would be detrimental to sustaining the expansion might depend on how gradual or abrupt it proved to be.

33 Domestically, output growth had remained firm and employment growth firmer such that productivity had continued to disappoint. Although output growth looked likely to be a touch stronger than previously assumed going into the second half of the year, it also seemed probable that output per worker would recover more slowly, with productivity growth assumed to remain below its pre-crisis rate throughout the three-year forecast contained in the *August Inflation Report*. While employment growth had been strong, wage growth had been weak. This had been a feature of the UK labour market data for some time. One explanation was that it would simply take time for the tightening in the labour market – evidenced by the reduction in unemployment and indications of skills shortages from business surveys – to feed into pay claims, especially if perceptions of job insecurity following the financial crisis remained high. Another, not necessarily inconsistent, explanation was that there had been an increase in the supply of labour that households, especially in older age cohorts, were prepared to offer at a given wage rate. That might reflect increased longevity, recent reforms to state retirement and benefit rules, or concerns about debt levels and pension provision. This would tend to increase the degree to which output and employment could expand without generating inflationary pressure.

34 The Committee's central expectation – assuming that Bank Rate followed the path implied by market yields and that the stock of purchased assets remained at £375 billion – was that inflation was likely to remain close to, but a little below, 2% for the next couple of years, before reaching the target at the end of the three-year forecast period. Inflation would be dampened by the effect on import prices of the recent rise in the sterling exchange rate. And a modest expansion in supply capacity would help to slow the rate at which slack was absorbed, thereby limiting the build-up of domestic inflationary pressure resulting from the pace of output and employment growth. In the Committee's best collective judgement, the degree of slack had narrowed somewhat, and the central estimate was now broadly in the region of 1% of GDP. There was, however, a wide range of views on the Committee – on either side of that central estimate – about the likely extent of spare capacity currently remaining in the economy, and also about its likely impact, and that of its components, on inflation. In the view of some members, the degree of spare capacity had diminished sufficiently that, although

some slack still remained, exactly how much was uncertain enough that estimates of it were becoming a somewhat less informative guide to the appropriate future path of monetary policy.

35 The Committee considered the level of Bank Rate appropriate to meeting the inflation target.

36 For most members, there remained insufficient evidence of inflationary pressures to justify an immediate increase in Bank Rate. These members put forward a number of arguments, on which they each placed different weights. In the central projection contained in the August *Inflation Report*, even with the gradual and limited increases in Bank Rate implied by market rates, inflation was expected to reach the 2% target only at the end of the three-year forecast period. Growth was likely to ease a little as the boost from pent-up demand released by the easing in credit conditions and lifting of uncertainty faded. This would slow the pace at which slack was being eroded. Wage growth remained weak, suggesting that slack in the labour market might have been greater than previously thought. Taking account of flat productivity, unit wage costs were currently growing at a rate well below that consistent with meeting the inflation target in the medium term. Given the risk that an increase in labour supply or persistent concerns over job security would result in weak wage growth continuing for longer, there would be merit in waiting to see firmer evidence that solid increases in pay growth were in prospect before tightening policy. This would allow the expansion to become more entrenched. Even if wage growth were to recover earlier than expected, it appeared that, in aggregate, consumer-facing firms' margins had recovered over the past year and so would be able to absorb some increase in costs before such costs passed through to consumer prices.

37 There were also arguments regarding the current and prospective impact of Bank rate on the economy, on which these members placed different weights. It was possible that, given the strength of the headwinds faced by the economy, even the current extraordinarily low level of Bank Rate was not providing a great deal of stimulus to activity. A premature tightening in monetary policy might leave the economy vulnerable to shocks, with the effectiveness of any further necessary stimulus being limited by the effective lower bound on Bank Rate. In addition, increases in Bank Rate well ahead of any pickup in wage and income growth risked increasing the vulnerability of highly indebted households. Finally, an unexpected increase in Bank Rate might cause sterling to appreciate further, bearing down on inflation and further impeding UK economic rebalancing.

38 That said, a potential over-reaction in financial markets was not necessarily a reason to delay an increase in Bank Rate if that were merited by the economic data. It was also noted that the longer the expansion continued, the less likely it became that some of the downside risks to growth and inflation would appear. This, along with a continued improvement in credit conditions, would in time diminish the need for such a low level of Bank Rate.

39 For two members, in particular, economic circumstances were sufficient to justify an immediate rise in Bank Rate. These members noted that the continuing rapid fall in unemployment alongside survey evidence of tightening in the labour market created a prospect that wage growth would pick up. They noted that it was possible that wages were lagging developments in the labour market to some extent. If that were true, wages might not start to rise until spare capacity in the labour market were fully used up. Since monetary policy, too, could be expected to operate only with a lag, it was desirable to anticipate labour market pressures by raising Bank Rate in advance of them. Moreover, if recent robust GDP growth rates had been underpinned by stimulatory monetary policy, in addition to a release of pent-up demand driven by reduced uncertainty and improved credit conditions, then the erosion of spare capacity would be likely to remain rapid while policy remained expansionary. In the judgement of these members, even after a rise of 25 basis points in Bank Rate, monetary policy would remain extremely supportive, and an early rise would facilitate the Committee's aspiration that the rises in Bank Rate should be only gradual. These members further noted that, while there were always likely to be risks associated with the possible financial market reaction to the first increase in Bank Rate after such a protracted period, it was unclear that these risks would be lessened, and indeed possible they would be augmented, by delaying that increase.

40 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 purchased assets financed by the issuance of central bank reserves at £375 billion.

Regarding Bank Rate, seven members of the Committee (the Governor, Ben Broadbent, Jon Cunliffe, Nemat Shafik, Kristin Forbes, Andrew Haldane and David Miles) voted in favour of the proposition. Ian McCafferty and Martin Weale voted against the proposition, preferring to increase Bank Rate by 25 basis points.

Regarding the stock of purchased assets, the Committee voted unanimously in favour of the proposition.

41 The Committee had an initial discussion of the operating framework appropriate for implementing its monetary policy decisions as the economy began to return to normal. The Committee noted that the current system, under which all central bank reserves were remunerated at Bank Rate, could continue to be used to implement the Committee's decisions on Bank Rate in the near term. The Committee would continue those discussions and provide further information regarding the operating framework in the coming months. Looking further ahead, the framework will be reviewed alongside decisions about the future of the Asset Purchase Facility.

42 The following members of the Committee were present:

Mark Carney, Governor
Ben Broadbent, Deputy Governor responsible for monetary policy
Jon Cunliffe, Deputy Governor responsible for financial stability
Nemat Shafik, Deputy Governor responsible for markets and banking
Kristin Forbes
Andrew Haldane
Ian McCafferty
David Miles
Martin Weale

Nicholas Macpherson was present as the Treasury representative.