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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

8 and 9 January 2014

These are the minutes of the Monetary Policy Committee meeting held on 8 and 9 January 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1401.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 5 and 6 February will be published on 19 February 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 8 AND 9 JANUARY 2014

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

Financial markets

2 Monetary conditions in the United Kingdom had tightened as financial asset prices reacted to further evidence that the domestic recovery was robust and, in particular, news that unemployment was falling more quickly than market participants had expected. Price movements might prove to be transitory, however, as was often the case around the turn of the year when financial market activity was low. Short-term market interest rates had risen: the one-year rate, one year forward implied by overnight interest rate swaps had gone up by 30 basis points, while the first rise in Bank Rate was fully priced in by Spring 2015, a few months earlier than at the time of the December meeting. The shift in the yield curve was also consistent with expectations of a faster tightening of policy thereafter. Respondents to the Reuters survey had brought forward the date at which unemployment was expected to reach the 7% threshold to February 2015, but had not changed their expectation of the date of the first rise in Bank Rate. As a consequence, the interval between the expected date of the threshold being reached and the first rise in Bank Rate had increased.

3 The sterling effective exchange rate had risen a little further on the month and, taking a fifteen-day average, was 2.7% higher than at the time of the November *Inflation Report*. Much of the strength of sterling over this period was against currencies other than the euro and dollar, particularly the yen, and was broadly consistent with movements in longer-term interest rates.

4 The FOMC decision to reduce the pace of asset purchases from January 2014 had come a little earlier than most market participants had expected and had been accompanied by a change in guidance on the date of the first rise in the federal funds rate, which would be ‘well past the time’ that US

unemployment reached the 6½% threshold. Despite this, short-term interest rates in the United States had risen, although the first increase in the policy rate was not fully priced in until Summer 2015. The expected paths of UK, US and euro-area short-term interest rates had continued to diverge, and UK and US ten-year government bond yields had risen on the month to above 3%, over 100 basis points higher than equivalent German government bond yields.

5 Market conditions for the euro-area periphery countries had improved. The spreads on Spanish, Italian and Portuguese government bond yields over equivalent German government bond yields had fallen by an average of around 50 basis points. A €3.75 billion syndicated bond issue by the Irish government, the first since exiting its bailout programme in December, had been four times oversubscribed.

6 Equity prices had risen internationally: the S&P 500 index had risen by 2½%, while both the FTSE All-Share and Euro Stoxx indices were around 4% higher. Unlike in the United Kingdom and the United States, where the main equity price indices were around all-time high levels, euro-area equity prices remained substantially below their pre-crisis peaks.

The international economy

7 There were further signs that global growth prospects had improved as the recovery continued in the United States and became more firmly entrenched in some other advanced economies. It was likely that risks to the outlook had become more balanced, although clear headwinds remained, particularly in the euro area, where growth remained weak and inflation low.

8 The recovery in the United States appeared stronger than previously thought. GDP growth in Q3 had been revised up by 0.3 percentage points to 1%, largely driven by a bigger contribution from stockbuilding. More timely monthly indicators of consumption and investment were consistent with some moderation in GDP growth in Q4, but nonetheless signalled a more rapid pace of expansion than earlier in the year. Consumption had grown by 0.5% in November, employment had picked up further and there had been a marked rise in capital goods orders. The Markit Purchasing Managers' Indices (PMIs) for manufacturing and services for December both pointed to growing activity. Moreover the bipartisan agreement over the 2014 federal budget had eased automatic spending cuts and reduced the

chance of a further government shutdown. That was likely to boost business and consumer confidence even though the direct effect of extra spending would be relatively small.

9 The short-term outlook for the euro area had continued to improve slowly, although growth around the turn of the year was still likely to be only modest. Industrial production had fallen in October but, against that, the composite PMI for December had picked up a little, and was consistent with moderate growth.

10 There had been some signs that the medium-term risks to the euro area had become more balanced as confidence improved, further progress was made towards banking union and momentum built in the global economy. The performance of some of the periphery countries had been better than expected. And the decline in government bond yields in those countries, if maintained, would improve debt dynamics and reduce some of the major downside risks. Against that, inflation in the euro area had fallen back in December to 0.8%; low inflation might make debt repayment and rebalancing more difficult, especially in countries where nominal incomes might need to fall to improve competitiveness.

11 The most recent ECB *Bank Lending Survey* had indicated that credit conditions remained tight. This suggested that a successful conclusion to the ECB's forthcoming comprehensive assessment of euro-area bank balance sheets, whose intention was to restore confidence in the banking system and repair the credit intermediation process, would be important if the euro-area recovery was to strengthen. The agreement in December to establish a Single Resolution Board and Single Resolution Fund for euro-area banks might also reduce the prospect of adverse feedback to the wider economy from banking sector stress. But, set against that, the agreed decision-making process was complex.

12 Growth had slipped back to 0.3% in Japan in Q3, following a stronger performance in the first half of the year. In the emerging economies, indicators of Chinese activity had continued to point to growth of around 2% in Q4. Developments in other emerging economies had been mixed, but overall pointed to further steady growth.

13 Global price pressures had remained subdued. Oil prices had fallen a little, but remained within the trading range of the previous 18 months. Improved harvests meant that agricultural prices were

considerably weaker than they had been in the middle of 2012 and had edged down a little further. Metals prices had risen, but were about 10% lower in dollar terms than a year earlier.

Money, credit, demand and output

14 The estimate for UK GDP growth in the third quarter had remained unchanged at 0.8%. But upward revisions in previous quarters suggested that the recovery had more momentum, with GDP estimated to be 0.6% higher than previously thought. The mix of expenditure in Q3 had also been revised, with higher consumption and business investment offset by lower contributions from net trade and stockbuilding. Exports had fallen by 3% on the quarter and net trade had reduced growth by around 1¼ percentage points.

15 Business surveys had remained strong and pointed to growth of around 1¼% in both the fourth quarter of 2013 and the first quarter of 2014. The Bank staff's central expectation of GDP growth, which also took account of other factors including the ONS monthly output indicators, was a little weaker at just under 1% a quarter over this period. Services activity had been weak in October, albeit offset by stronger-than-expected industrial production. In line with the usual pre-release arrangements, the Governor provided the Committee with an advance estimate suggesting that industrial production had been flat in November, weaker than had been expected. Nevertheless, rapid growth in employment and buoyant survey indicators continued to suggest that there were upside risks to the Bank staff's assessment of growth around the turn of the year.

16 The recovery in growth over the year to 2013 Q3 had largely been driven by household spending. Following the data revisions, quarterly consumption growth over this period was estimated to have averaged 0.7%, in line with its long-term average. With little growth in household income over this period, the growth in household spending had been associated with a fall in the saving ratio from almost 8% to just over 5% of household income. The decline in the saving ratio was likely to have reflected a number of factors including: increased optimism about future incomes; higher asset prices; reduced uncertainty and an associated reduction in precautionary saving; and increased credit availability and lower loan and deposit interest rates. While it was difficult to estimate precisely the relative contributions of these various factors, it seemed unlikely that any would drive a similar fall in the saving ratio over the coming year. Consequently, maintaining the recent rates of consumption

growth would require a sustained pickup in real income growth, preferably underpinned by stronger productivity growth.

17 Timely monthly indicators, such as consumer confidence and new car registrations, suggested that household spending had remained firm in Q4; a survey by the Bank's Agents had reported that spending around Christmas had been a little weaker than expected but still up on a year earlier. House prices had continued to rise, but the mixed signal from different indicators made it difficult to assess the underlying rate of increase with precision. Respondents to the Bank's *Credit Conditions Survey* had reported a further increase in the availability of secured credit to households.

18 The continued recovery was also likely to require a more sustained expansion in corporate spending. Quarterly business investment growth had been revised up to 2% in Q3. And a range of surveys pointed to improving investment prospects. Plant and machinery spending plans recorded in the BCC survey had reached post-crisis highs, above their historic averages, and respondents to the *Deloitte CFO Survey* reported that they were placing greater emphasis on capital spending as uncertainty dissipated.

Supply, costs and prices

19 CPI inflation had fallen to 2.1% in November and, in line with the usual pre-release arrangements, an advance estimate for CPI inflation of 2.0% for December had been provided via the Governor to the MPC, ahead of publication. This was the first month since November 2009 that CPI inflation had not been above the 2.0% target. CPI inflation was expected to remain around 2.0% in the near term, although there was likely to be volatility from month to month.

20 There had been little news about inflation expectations. Both the one year and five to ten year YouGov/Citigroup measures of household inflation expectations had declined in December, and had almost fully reversed the rise in October that had followed the announcement of increases in utility prices. Measures of UK inflation expectations derived from inflation swaps were broadly unchanged over the month.

21 Employment had continued to grow at a faster pace than had been anticipated, with a rise of around 250,000 in the three months to October, according to estimates from the Labour Force Survey (LFS). The biggest increase was in full-time employees, but there were also large rises in the number of self-employed and part-time workers. The increase in employment was spread across industries, with particularly strong increases in construction and real estate activities, according to the latest Workforce Jobs estimates for Q3. A rising level of vacancies and survey evidence of continued strong hiring intentions suggested that recent employment strength would continue. Strong growth in employment, combined with higher-than-expected average hours worked, suggested that total hours worked would be around ½% higher in Q4 than had been anticipated at the time of the November *Inflation Report*.

22 The rapid growth in employment had resulted in a sharper fall in unemployment than had been expected. The unemployment rate had fallen to 7.4% in the three months to October, 0.2 percentage points lower than had been expected by Bank staff prior to the data release. And a range of evidence had suggested that the unemployment rate would continue to fall in the months ahead. In particular, analysis of the monthly samples used to construct the headline three-month unemployment rate had identified sharp falls in unemployment among the same groups of individuals when they were re-sampled. For example, the single-month estimate of the unemployment rate in October had been 7.0%, 0.7 percentage points lower than when the same cohort had been sampled three months earlier. In addition, the more timely claimant count measure of unemployment had fallen by a further 37,000 in November, pointing to a further decline in the headline LFS rate. These, together with the stronger outlook for employment, meant that the unemployment rate was now likely to reach the 7% threshold materially earlier than previously had been expected.

23 Pay growth had remained subdued. Whole-economy total pay had grown by 0.9% in the three months to October compared with the same period a year earlier. The slow pace of wage growth was likely to have reflected the continued and surprising weakness of productivity growth: after picking up to about 0.4% per quarter in the first half of the year, output per hour was reported to have fallen in Q3.

24 Weak pay growth also pointed to the continued existence of slack in the labour market. The unemployment rate remained higher than most estimates of its medium-term equilibrium value. And, while there was considerable uncertainty around such estimates, shifts in the composition of

unemployment had suggested that equilibrium unemployment might be lower than previously thought. In particular, most of the fall in unemployment in the three months to October had come from falls in medium and long-term unemployment. Higher transition rates out of longer-term unemployment had suggested that those affected might have retained a greater attachment to the labour market than had been feared. A tightening in the eligibility requirements for some state benefits might also have led to an intensification of job search. Taken together, this suggested that there could be more downward pressure on pay growth for any given rate of unemployment. The high proportion of part-time workers who said they would prefer a full-time job also provided evidence of continuing slack in the labour market. Against that, contacts of the Bank's Agents and employer surveys had reported an increase in skill shortages and recruitment difficulties in a number of sectors of the economy.

25 There was also considerable uncertainty about the extent of slack within businesses. Survey evidence suggested that, on average, businesses were working at around normal levels of capacity utilisation. It was possible that this understated the extent of spare capacity if, for example, businesses' interpretation of a normal level of capacity utilisation had changed over time as weak demand had persisted. But the strong growth in employment was consistent with there being less effective slack remaining within companies than previously thought. And it was likely that, as a result of the rise in activity through the autumn, the degree of slack had diminished relative to earlier in the year. A key unresolved question was whether there would be a cyclical improvement in productivity as the economy expanded further.

The immediate policy decision

26 The Committee set monetary policy to meet the 2% inflation target in the medium term, but in a way that helped to sustain the recovery. In pursuit of that objective, the Committee had, at the time of its August *Inflation Report*, provided guidance regarding the path of monetary policy. That guidance stated that the Committee did not intend to raise Bank Rate from its current level of 0.5% or to reduce its stock of asset purchases, at least until the LFS headline unemployment rate had fallen to a threshold of 7%, subject to three 'knockout' conditions, relating to: the judged likelihood that inflation would not exceed 2.5% 18 to 24 months ahead; whether measures of medium-term inflation expectations remained sufficiently well anchored; and the impact of the stance of monetary policy on financial stability, as judged by the Bank's Financial Policy Committee (FPC).

27 The domestic recovery appeared to have taken hold, driven largely by household sector spending, as credit conditions loosened and uncertainty dissipated. GDP growth had not been revised, at 0.8% in Q3, and upward revisions to earlier quarters suggested that the recovery had more momentum than previously believed. The recent strength of both the business surveys and employment growth pointed to above-trend growth around the turn of the year. But the precise pace of growth was uncertain and there were upside risks to the Bank staff's estimates of growth of a little under 1% per quarter in the fourth quarter of 2013 and the first quarter of 2014. Even so, the legacy of the financial crisis at home and abroad meant that the domestic recovery continued to face a number of headwinds and its continuation was likely to require a pickup in real income growth, underpinned by a more sustained expansion in corporate spending and an improvement in productivity performance. Net trade had reduced growth in Q3. And while the risks to the global outlook appeared more balanced, it would be difficult for net trade to make a more significant positive contribution to growth as long as activity in the United Kingdom's main trading partners remained subdued.

28 Employment had been growing quickly and, if official output estimates were accurate, at a pace that implied that output per hour had fallen in the third quarter of 2013. The apparent lack, so far, of a significant cyclical improvement in productivity during the recovery was surprising and suggested that there was less slack within businesses than previously believed. While there remained slack within the labour market, the unemployment rate had fallen to 7.4% in the three months to October. It was now likely that the unemployment rate would reach the 7% threshold materially earlier than previously expected. But the relative success of the long-term unemployed in finding jobs suggested that labour market slack might not have been eroded as much as the fall in the headline unemployment rate appeared to imply.

29 Monetary conditions had tightened further following evidence of a strengthening recovery, particularly the news on unemployment. The one-year interest rate, one year forward had risen by around 30 basis points in the United Kingdom and the first rise in Bank Rate was fully priced in by Spring 2015. According to the Reuters survey, there had been an increase in the period between the expected date of the 7% unemployment threshold being reached and the first rise in Bank Rate.

30 Regarding the immediate policy decision, the Committee considered developments on the month in the context of the three knockouts that would override the policy guidance announced in August.

31 The fall in CPI inflation to 2.0% in December, after more than four years above the target, was welcome, and had been accompanied by downside news about the near-term prospects for inflation. Sterling had appreciated a little further and was almost 3% higher than at the time of the November *Inflation Report*. Global inflationary pressures were weak and commodity prices had remained subdued. With continued slack in the labour market and low productivity growth, nominal pay growth had remained weak. In addition, Bank staff had revised down their estimate of the likely contribution of administered and regulated prices to CPI inflation over the next two years, reflecting smaller contributions from utility prices and university tuition fees. Against that, the strong growth in employment was consistent with the degree of effective slack remaining within the economy being somewhat less than previously thought. Overall, the news on the month had reduced the likelihood of CPI inflation being above 2.5% at the 18 to 24-month period relevant to the MPC's 'knockout'.

32 There had been little news about medium-term inflation expectations. Financial market based measures had been broadly flat, and the one household measure released during the month had ticked down. There was, therefore, no reason to alter the Committee's judgement that medium-term inflation expectations remained sufficiently well anchored.

33 The FPC had not met since 20 November 2013 when it had agreed that, in light of its assessment of the current risks to financial stability, the stance of UK monetary policy did not pose a significant threat to financial stability that could not be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

34 All Committee members agreed that neither of the price stability knockout conditions that would override the policy guidance provided in August had been breached; and there had been no change to the FPC judgement that the financial stability knockout had not been breached. With unemployment remaining above the 7% threshold, the Committee's policy guidance therefore remained in place and no member thought it appropriate to tighten, or to loosen, the stance of monetary policy at the current juncture.

35 Looking beyond the immediate policy decision, the Committee noted that while the recovery was becoming more firmly entrenched, productivity growth had been disappointing, and unemployment had fallen faster than expected. Inflation had returned to the 2% target, however, and

cost pressures were subdued. Members therefore saw no immediate need to raise Bank Rate even if the 7% unemployment threshold were to be reached in the near future. Moreover, it was likely that the headwinds to growth associated with the aftermath of the financial crisis would persist for some time yet and that inflationary pressures would remain contained. Consequently when the time did come to raise Bank Rate, it would be appropriate to do so only gradually.

36 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, the Committee voted unanimously in favour of the proposition.

37 The following members of the Committee were present:

Mark Carney, Governor
 Charles Bean, Deputy Governor responsible for monetary policy
 Jon Cunliffe, 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.

As permitted under 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.