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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 7 AND 8 MAY 2014

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 May 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1405.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 4 and 5 June will be published on 18 June 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 MAY 2014

1 Before turning to its immediate policy decision, and against the background of its latest projections for output and inflation, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and supply, costs and prices.

Financial markets

2 UK short-term interest rates had risen, and the one-year rate one year ahead implied by overnight index swaps was around 20 basis points higher on the month. The fall in the unemployment rate to 6.9%, below the threshold of 7% identified by the Committee in its August 2013 policy guidance, and the strong Markit/CIPS survey releases had been particular influences. Nonetheless, the date at which the first rise in Bank Rate was fully priced in had changed little and remained in the spring of 2015, which was consistent with the expectations of private sector economists polled by Reuters. Over the past few months, falls in the short-term interest rate curve further ahead implied that market participants expected a more gradual pace of Bank Rate rises than earlier in the year.

3 There had been little change in short-term interest rates in the United States or the euro area. The FOMC had, as expected by market participants, announced a further reduction in the pace of its asset purchases. The ECB had left its policy rates unchanged in April. Longer-term interest rates in the United Kingdom, the United States and Germany had fallen modestly on the month. Euro-area periphery countries' sovereign borrowing costs had declined further, and Greece had issued its first sovereign bond since 2010.

4 Market prices had been relatively unaffected by the most recent developments in Ukraine and Russia. In equity markets, the UK FTSE All-Share index had risen by around 2½% and the US S&P 500 index by around 1½%, although the Euro Stoxx index had fallen slightly and some Eastern European indices had declined.

5 There had been a further rise in the sterling effective exchange rate index, which was 0.8% higher on the month and, comparing fifteen-day averages, 1.2% higher than at the time of the February *Inflation Report*. During 2014, the sterling index had risen above the top of the range it had previously occupied in the period since the financial crisis. A number of market contacts had suggested that sterling's appreciation continued to be supported by the strength of demand growth in the United Kingdom relative to other major advanced economies. There had been a small rise on the month in the US dollar's effective exchange rate, and a small fall in that of the euro. The Chinese renminbi had continued to depreciate against the US dollar in April, but had retraced some of that fall in the early part of May.

6 At short horizons, implied volatilities remained relatively low in interest rate, currency, equity and commodity markets. To some extent that could be explained by low realised volatility, and by guidance from central banks about the future setting of monetary policy. Some increase in asset price volatility was likely as monetary policy in the advanced economies was brought back to a more normal setting in future: indeed, at the two-year horizon, UK interest rate implied volatility had risen over the past year. Market intelligence suggested that relatively low implied volatility across asset classes could also have been exacerbated by some investors writing options as they sought to enhance their returns as part of a search for yield. To the extent that that might reflect imprudent risk taking, it could be an amplifying channel in the event of a sharp rise in market volatility.

The international economy

7 Data on the international economy had been mixed, but remained consistent with the Committee's judgement that the global expansion would be sustained in the face of continuing economic and financial challenges.

8 In the United States, GDP in Q1 had been broadly flat, which had been rather weaker than the Committee and most external forecasters had expected. Much of that weakness had seemed to reflect a combination of unusually bad weather and erratic factors, the effects of which should unwind in Q2. That view was supported by the increase of 288,000 in non-farm payrolls and the sharp fall in unemployment to 6.3% in April. Moreover, while the composite Markit PMI output index had fallen very slightly in April, it remained at a level consistent with firm growth.

9 In China, economic data on the month continued to suggest declining momentum. Annual GDP growth had slowed in Q1 to below 7½%, a little lower than the Committee had expected. The PMI surveys had been mixed in April: the manufacturing measures had edged up, but one of the services measures had eased. The rapid growth in credit and the vulnerabilities associated with the shadow banking system remained a risk to the outlook for China's economy.

10 In the euro area, the latest activity indicators had been consistent with growth of around 0.4% in both Q1 and Q2, which was only slightly below its pre-crisis average. That would represent a turnaround of around 0.7 percentage points in quarterly GDP growth relative to the average for 2012. The strengthening of the euro-area economy was likely to have reflected the lower probability of a disorderly adjustment to the imbalances within the area, which had supported an improvement in sentiment and easier credit conditions. Looking ahead, while there might be some scope for a stronger revival in investment and a pickup in real wages, particularly in Germany, confidence measures had returned to their historical averages and savings rates to their pre-crisis levels, so a further boost to growth from the household sector seemed unlikely. Some further improvement in credit conditions was possible, reflecting lower bank funding costs and balance sheet adjustments by banks as a consequence of the Asset Quality Review; but leverage was still at relatively high levels in a number of large euro-area banks, and it remained to be seen whether the forthcoming stress tests would be sufficiently rigorous to boost investor confidence. In terms of fiscal policy, the periphery countries had continued to make progress, and lower sovereign borrowing costs would in time reduce the burden of debt levels, but there was still a long way to go in the adjustment process.

11 Inflation in the euro area had edged up by a little less than expected to 0.7%, well below the ECB's inflation objective. Following its April meeting, the President of the ECB had set out what might lead it to undertake further monetary stimulus and the form it might take.

12 Agricultural commodity prices had risen further on the month, and were around 20% higher than at the start of the year, in part reflecting adverse weather conditions in North and South America. UK wholesale gas prices had fallen on account of unseasonably mild weather and the effect was therefore expected to unwind in due course. A range of commodity prices remained sensitive to political uncertainty in Ukraine.

Money, credit, demand and output

13 GDP had grown by 0.8% in Q1, according to the ONS's preliminary estimate, the fourth consecutive quarter of growth at or above its pre-crisis average. That was slightly weaker than the Committee had expected, however, reflecting the weak estimate of construction output. Estimated growth in the services and industrial sectors had been consistent with the Committee's expectations. In line with the usual pre-release arrangements, the Governor informed the Committee that industrial production had fallen by 0.1% in March; that was stronger than Bank staff had expected, but was not thought to contain material implications for subsequent releases of GDP for Q1. Bank staff's central estimate for the mature Q1 GDP data was 0.9%.

14 The major business surveys had continued to point to strong growth in the near term. The Bank staff's central expectation for final GDP growth in Q2 was 0.9%. Thereafter, the Committee expected growth to ease a little, as the initial fillip from the release of pent-up demand faded.

15 Bank lending to companies had been weaker than expected in Q1. Some of the weakness in bank lending to non-financial companies had reflected erratic factors. Developments in the commercial real estate (CRE) sector also accounted for some of the weakness: the stock of lending to CRE companies had contracted by around 8% in the year to March, whereas the stock of lending to other non-financial companies had been broadly flat. Moreover, the fall in the stock of CRE lending could presage an easing in future credit conditions to the extent that UK banks were more able to free up balance sheet capacity through sales to non-banks and international banks of their legacy CRE portfolios.

16 Even abstracting from these effects, net lending to companies had been weak. There had been no strong evidence to suggest further restrictions in credit supply. The Bank's Agents had reported continuing improvements in credit conditions, including in the terms offered and increased syndicated lending activity. The Bank's Credit Conditions Survey suggested that both spreads and the availability of lending had improved in Q1. Conditions facing small and medium-sized enterprises were tighter than for large companies, but there had been little sign that they had deteriorated in the recent quarter. The evidence on demand for lending had been more mixed. Investment had grown materially during 2013, and investment intentions pointed to a further pickup. But the Bank's Agents had suggested that the demand for bank credit in order to finance investment was likely to be weaker than the Committee

had anticipated. This was, in part, because some firms were likely to prefer to finance investment with their accumulated cash balances rather than with increased borrowing: in that context, many large companies had taken advantage of the opportunity to raise funds in the debt capital markets on favourable terms over the past year. In addition, Agents' contacts reported that, although spare capacity in companies was limited, productivity growth, combined with steady – but not exceptional – increases in capital and labour should be sufficient to meet expected demand.

17 The latest data on mortgage lending had also suggested some softening: mortgage approvals in Q1 had averaged 71,000, around 10,000 a month weaker than the Committee's expectation in February. Housing transactions had fallen in March for the first time in almost a year. In broad terms, however, the conditions for continued momentum in house prices appeared to remain in place, and the forward-looking survey balances remained at historically high levels. It was important to consider whether the recent easing in the activity data was erratic, or whether it was symptomatic of a more persistent slowing in activity.

18 Reforms associated with the Mortgage Market Review (MMR) had recently come into force. A few of the major lenders had reported that they expected the operational implications of the introduction of the MMR to have led to temporary capacity constraints as staff were re-trained and as new IT systems were introduced. The Bank staff's view was that most of these effects would be seen in the Q2 data, and that it was not clear to what extent the MMR could account for the unexpected weakness in approvals in Q1. Once the operational impact had been absorbed, the MMR might have a more lasting effect on the cost and availability of mortgages, but it was too soon to draw conclusions about its medium-term impact. It was also possible that part of the recent slowing in housing transactions reflected a reduction in the rate at which the supply of existing homes came onto the market. That was consistent with the fall in new instructions to sell reported by the RICS survey, and with reports from contacts of the Bank's Agents that concerns over a shortage of properties for sale were becoming more widespread. This might be due to prospective sellers holding out until prices rose further. It might also reflect the fact that non-portable mortgages on advantageous terms were acting as a disincentive to homeowners selling.

Supply, costs and prices

19 CPI inflation had fallen to 1.6% in March, in line with the Committee's expectation. Inflation was expected to pick up a little in April, reflecting petrol price decreases from Spring 2013 dropping out of the annual comparison and higher airfares owing to the later timing of Easter in 2014. The Bank's staff had revised down its short-term projection for inflation in Q2, which reflected both weaker online food price data and a judgement on the effects of the recent news that a major supermarket chain was cutting prices on a large number of items. It was not yet clear how other supermarkets would react, and a significant price response from them would result in a larger downward revision to the profile of inflation over the coming months.

20 Survey measures of households' inflation expectations had fallen since the end of 2013, as CPI inflation itself had continued to decline. In general, the most recent measures of households' inflation expectations had been at or below series averages.

21 The LFS unemployment rate had fallen to 6.9% in the three months to February, below the 7% threshold announced by the Committee in the guidance regarding the future path of monetary policy it had provided in August 2013. Employment had continued to grow strongly, increasing by 239,000 in the three months to February, resulting in a 0.3 percentage point increase in the employment rate. Labour market participation had risen sharply to 63.8% in the three months to February. A range of indicators, including the claimant count, surveys of employment intentions and the number of vacancies, suggested that employment growth had remained strong since February.

22 There had been signs that wages had started to accelerate slightly from the depressed growth rates seen in recent years. The annualised three month on three month growth rate of private sector regular pay had reached 1.8% in February, which compared with an average of 1.4% in 2013 as a whole. Surveys suggested that earnings growth might continue to rise: the CBI measure of businesses' expected salary cost growth over the next twelve months had remained higher than its 2013 average at 2.1% in Q1; and the REC earnings survey balance, which was indicative of growth in the pay of newly recruited employees, was now some way above its pre-recession average.

23 The Committee expected wage growth to pick up gradually as the economy recovered, as productivity improved and as slack continued to be reduced. Since 2012, as output growth had risen,

productivity growth had picked up too, but the recovery in the level of productivity had been far less marked. In the four quarters to 2013 Q4, output per hour had risen by 0.7%, and was still around 4% below its pre-recession peak. It was possible that later vintages of data would reveal that output growth in the past year or so had been stronger than currently indicated, in which case the recovery in productivity growth would also appear stronger. At the current stage in the recovery from the crisis, it was too soon to form confident views about the balance of cyclical and structural influences on productivity growth. Overall, the Committee continued to expect that productivity growth would continue to pick up gradually as the recovery progressed. But there remained considerable uncertainty around the timing and extent of any strengthening.

The May 2014 GDP growth and inflation projections

24 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 GDP growth would ease a little in the near term, as the initial fillip from the release of pent-up demand faded, but would remain relatively steady thereafter. Private final demand in the near term would continue to rise ahead of incomes, supported by the stimulative stance of monetary policy, improved sentiment and easier credit conditions, with household spending, particularly housing investment, projected to grow solidly. Thereafter, the economic expansion would gradually move onto a firmer footing, with a revival in productivity growth supporting real incomes and companies responding to the stronger demand environment by increasing capital spending.

25 The expected easing in the pace of expansion, together with a modest revival in productivity growth, meant that the rate at which spare capacity was absorbed was expected to slow markedly relative to the recent past. In particular, after falling further in the near term, unemployment in the second and third years of the forecast was projected to decline only gradually. On the central projection, the margin of spare capacity was broadly closed only by the end of the forecast period. The path of slack was uncertain, and there was a range of views on the Committee. For a given growth profile, it would depend heavily on the timing and strength of the rebound in productivity growth: the stronger the rebound, the slower the pace at which spare capacity would be absorbed. It would also depend on other developments within the labour market as the expansion took hold,

including the ease with which the longer-term unemployed were able to find work and the extent to which people's desire to work longer hours persisted as incomes increased.

26 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 CPI inflation would rise nearer to the 2% target in coming months as the falls in petrol prices in the spring of 2013 dropped out of the annual comparison. Sterling had increased a little further since the *February Report*; the 10% appreciation over the past year or so should dampen inflation over the first part of the forecast. Having been very weak for over three years, private sector pay growth had begun to pick up, although it remained well below pre-crisis norms. The Committee continued to judge that measures of inflation expectations remained consistent with the 2% target.

27 There were, as always, risks on both sides of the inflation outlook. To the upside, it was possible that slack would be used up more rapidly than anticipated or that companies would use the stronger demand environment to rebuild margins by more than assumed. To the downside, it was possible that the unexpectedly sharp falls in inflation over the past year or so reflected underlying cost and price pressures that were weaker than currently judged.

The immediate policy decision

28 The Committee set monetary policy to meet the 2% inflation target in the medium term, and in a way that helped to sustain the recovery. CPI inflation had fallen to 1.6% in March, but was expected to move nearer to the 2% target in the coming months as falls in energy prices a year ago dropped out of the comparison. Output growth had continued to be robust, but had not yet been accompanied by a material pickup in productivity as employment had continued to increase rapidly. The LFS unemployment rate had fallen below the Committee's 7% threshold in the data for the three months to February. The policy guidance the Committee had provided in August 2013 had therefore ceased to apply. The Committee reaffirmed the subsequent guidance set out in its *February Inflation Report* on how it would seek to achieve the inflation target over the policy horizon. A key feature of the guidance was that, 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.

29 The news on the month had been consistent with a continuation of the gradual firming in the global backdrop. In the euro area, growth was edging higher and the risk of a disorderly adjustment had significantly receded over the past two years. Abstracting from recent bad weather and erratic factors, a steady expansion in the US economy was underway, supported by the highly stimulative stance of monetary policy. Growth in China had eased in recent months, and was expected to slow a little further. Conditions were more stable than a few months ago in other emerging economies, which were likely to grow at around their average historical rates.

30 That essentially benign global conjuncture was one factor contributing to the current compressed level of implied volatility across a range of financial markets. There was a number of downside risks to the outlook, associated with: the tensions between Ukraine and Russia; the rapid growth in credit in China in recent years and the associated expansion of the shadow banking system; and the continuing process of structural adjustment within the euro area. A crystallisation of one or more of those risks could result in a sharp increase in both actual and implied volatility. Moreover, as time passed, some increase in implied volatility was likely as monetary policy in the advanced economies was brought back to a more normal setting.

31 There had been relatively little significant news on the domestic economy. The preliminary estimate of output growth in Q1 had been 0.8%, broadly in line with the Committee's expectation for this vintage of the data. According to present estimates, output had grown at a little above its historical average for each of the past four quarters, suggesting that the recovery had become less fragile. But it was possible that, after the usual cycle of data revisions, output would ultimately prove to have been growing at an even faster rate. That would be consistent with the persistent strength of the business surveys and explain part of the recent weakness in estimates of productivity growth.

32 The easing in the number of mortgage loan approvals and initial signs that fewer properties were coming onto the housing market for sale were noteworthy. These developments were taking place in the context of continuing buoyancy in house prices, which was particularly marked in London. It remained to be seen how much of the fall in approvals was connected with temporary effects associated with the introduction of the Mortgage Market Review (MMR) and with potential sellers

speculating that they might benefit from higher prices if they delayed putting their properties on the market. Moreover, it was unclear what medium-term effects, if any, the MMR might have on the supply of mortgage lending. The Committee noted that the Financial Policy Committee (FPC) would have an opportunity to consider the issues related to the housing market at its June policy meeting.

33 Strong output data, upbeat business surveys and robust employment growth had together been associated with a modest tightening in monetary conditions: the one-year rate one year ahead implied by overnight index swaps had risen by around 20 basis points, and sterling's appreciation had continued. The sterling effective exchange rate index was around 10% higher than its most recent lows about a year earlier, and was above the top of the range it had occupied in the period since the financial crisis; that would put downward pressure on inflation over the next couple of years. As with the upward pressure on inflation in recent years from sterling's earlier depreciation, there was case for the Committee to look through the temporary effects of exchange rate movements. As always, there was uncertainty about the path of import prices and about their likely pass-through to inflation. The Committee's central view was that nearly all of the recent sterling appreciation would be passed into consumer prices over the three-year forecast period, but there was clearly a chance that companies would instead choose to absorb falls in import prices in higher margins.

34 Expectations of inflation were one important influence on price and wage-setting decisions. There had been little news on inflation expectations. Wage growth seemed to have picked up from its depressed rate in recent years; the Committee expected it to continue to rise over the forecast period as productivity growth improved and labour market slack was gradually eroded, although it was expected to remain some way below its historical average rate of around 4½%.

35 Key considerations facing the Committee over the next year or so were the margin of slack and pace at which it was eroded, and the effects of the components of that slack on inflation. The central view of most Committee members was that the margin of spare capacity remained in the region of 1% – 1½% of GDP, although it had probably narrowed a little since February. There was considerable uncertainty around that central estimate, however, and a range of views on the Committee. Among the elements on which members held different views were: the extent of slack remaining within companies; what proportion of self-employment represented a form of labour market slack; and the extent to which increases in employment might at the margin add less to the productive capacity of the workforce than factored into the Committee's projections. On the Committee's central view, the pace

at which slack would be absorbed was expected to slow from the end of 2014 as GDP growth eased slightly and productivity growth picked up. But there was considerable uncertainty around that central path, and a range of views among Committee members. The evolution of slack would depend on the timing and strength of the rebound in productivity growth, and on other developments in the labour market as the recovery continued, including the ease with which the longer-term unemployed were able to find work and the persistence of people's desire to work longer hours as their incomes increased.

36 The outlook for GDP growth and inflation was little changed from February. On the assumption that Bank Rate followed a path implied by market interest rates and the stock of asset purchases stayed at £375 billion, inflation was projected to be close to the 2% target in two to three years time.

37 The economy remained on course to meet the MPC's aim of absorbing spare capacity over the next two to three years, while keeping CPI inflation close to the 2% target. The actual path of Bank Rate would depend on the evolution of the economy, particularly the degree of slack, the prospects for its absorption and the broader inflation outlook.

38 The Committee's February guidance embodied the expectation that when Bank Rate began to rise, it would do so only gradually and to a level materially below its pre-crisis average. Although such a path for policy ran a greater risk of a build up in financial imbalances, particularly in the housing market, the Committee noted that the mitigation of such risks was, in the first instance, the responsibility of the FPC: monetary policy should be only a last line of defence. The case for moving gradually and cautiously was reinforced by uncertainty over the likely impact on the economy of a rise in Bank Rate. It could be argued that the more gradual the intended rise in Bank Rate, the earlier it might be necessary to start tightening policy. Against that, if productive potential were in part related to the level of demand, then the earlier policy was tightened the greater the risk of incurring a substantial cost in foregone output.

39 Committee members placed different weights on these considerations and this was reflected in a variety of views on the appropriate path of monetary policy. The Committee would continue to refine its views as the economy evolved, and for some members the monetary policy decision was becoming more balanced. In terms of the immediate policy decision, however, all members agreed that, in the

absence of other inflationary pressures, it would be necessary to see more evidence of slack reducing before an increase in Bank Rate would be warranted.

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, the Committee voted unanimously in favour of the proposition.

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

41 Finally, on behalf of the Committee, the Governor expressed his appreciation to Spencer Dale for the personal contributions that he had made in establishing the monetary policy framework and to the work of the MPC since becoming a member in 2008.

42 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

The Treasury representatives were James Richardson on 7 May and Dave Ramsden on 8 May.

As permitted under the Bank of England Act 1998, as amended by the Financial Services Act 2012, Dave Prentis was also present as an observer in his role as a member of the Oversight Committee of Court. Anthony Habgood was also present as an observer in his role as incoming Chair of Court.