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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

4 and 5 June 2014

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 June 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1406.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 9 and 10 July will be published on 23 July 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 JUNE 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 Financial markets had been relatively insensitive to political and financial events over the month, including the European elections. Implied volatility remained low across a range of assets, especially at short horizons, and there was mounting evidence of investors searching for yield.

3 UK short-term interest rates had been sensitive to data outturns and MPC communications, but had ended the month little changed from their levels at the time of the May meeting. One year overnight index swap (OIS) rates, one year forward had, for example, risen early in the month before falling on the back of a combination of weaker-than-expected wages data, smaller-than-expected revisions to the outlook in the *May Inflation Report* and falls in shorter-term rates internationally.

4 The first rise in Bank Rate was fully priced into OIS rates by 2015 Q2, with economists polled by Reuters expecting the first rise in Q1, a little earlier than in May. Analysis of options prices suggested that market participants put only around a 15% chance on a rise in Bank Rate by the end of 2014. Once Bank Rate began to rise, market expectations were consistent with a steady pace of increases of around 20 basis points a quarter over the following 18 months or so, unchanged since Autumn 2013.

5 Longer-term interest rates remained well below historical averages. Ten-year spot rates were little changed on the month in the United Kingdom and United States, although rates had fallen slightly in Germany. Since the turn of the year, medium-term rates were lower in all areas: US and UK five-year forward rates had fallen by around ½ percentage point, for example. Those falls largely

reflected lower real rates rather than lower inflation expectations. Surveys of market participants carried out by the Federal Reserve Bank of New York suggested that lower longer-term real policy rate expectations and falls in term premia had both played a role in the United States.

6 The sterling ERI was broadly similar to its level at the time of the May meeting, although it had reached a post-crisis high during the month. The dollar ERI had risen by a little under 1%, and the euro ERI had fallen by a similar amount, in part reflecting comments by the President of the European Central Bank (ECB) on its policy options.

7 Equity markets had strengthened globally, with the Euro Stoxx, S&P 500 and MSCI emerging markets indices all up around 2½%. The FTSE All-Share index had continued to underperform a little, being broadly flat on the month; the recent underperformance contrasted with the better relative performance of the UK economy. UK net equity issuance had been strong in March and April. Demand for corporate and bank debt were robust, with yields on that debt having fallen since the start of the year.

The international economy

8 There had been modest downside news on global activity in the first quarter, with growth in the euro area below expectations, and growth in the United States revised down a little. That downside news appeared largely to reflect temporary factors, however, and did not change the Committee's judgement that the global expansion would be sustained.

9 In the euro area, output grew by 0.2% in 2014 Q1, 0.2 percentage points lower than incorporated in the May *Inflation Report* projections. That weakness was partly accounted for by large falls in energy output in the Netherlands following unusually warm weather, although the mild winter had probably also boosted construction output a little in some countries. Output growth in France and Italy had also been weaker than expected. The manufacturing PMI had fallen in May but the composite indicator in April and May was, on average, above its Q1 level. Overall, surveys suggested that growth would rise in Q2, to just under ½%, broadly in line with expectations a month earlier.

10 Euro-area inflation had also been lower than expected, with the flash estimate of annual HICP inflation falling 0.2 percentage points to 0.5% in May. Within that aggregate figure, German inflation

had fallen ½ percentage point to 0.6%. Although a complete area-wide breakdown of the latest data was not available, it seemed unlikely that all of the weakness reflected temporary influences, and so might prove more lasting.

11 The developments in the euro area had been associated with a growing expectation that the ECB would take action to support the recovery and counter deflationary pressures. In particular, financial market participants expected the ECB to cut its refinancing and deposit rates. And according to a Reuters poll, financial markets placed some weight on the possibility of operations aimed at boosting lending. As some policy action was already factored into financial asset prices, the impact might be more evident in measures of household and business confidence and, over time, access to finance.

12 In the United States, output was estimated to have fallen by 0.2% in the first quarter, lower than the initial estimate of no growth. The revision was accounted for by stockbuilding, which was consistent with a drag from bad winter weather even greater than had been built into the initial estimate. Evidence for the second quarter – including both official data and survey indicators – pointed to a sizable bounceback in growth. Bank staff projected that growth would rebound to around 1% in Q2. The housing market had weakened, however, with a 1 percentage point rise in mortgage rates since Summer 2013 associated with a 7% fall in house sales over the past year. Although house prices were rising at around 10% a year according to the Case-Shiller index, they remained well below their previous peaks.

13 Chinese growth had remained subdued. Twelve-month growth in investment, retail sales and industrial production had all slowed in April. Housing starts and sales were lower in Q1 than they had been a year earlier, with house prices falling in a number of cities, but the People's Bank of China had recently taken steps to support the housing market.

14 In Japan, growth in Q1 had been much stronger than expected at 1.5%. But that partly reflected a pickup in household spending growth that would prove temporary if it reflected more bringing forward of spending ahead of the April consumption tax increase.

15 Oil prices had ended the month a little higher. Agricultural commodity prices fell, partly reflecting upward revisions to expectations of the US wheat harvest.

Money, credit, demand and output

16 The second estimate of Q1 GDP growth remained at 0.8%. That was the fourth consecutive quarter of growth around or above its pre-crisis average rate. Business surveys, including those produced by CBI and Markit/CIPS, pointed to growth continuing around these rates, or even picking up a little, in the middle of the year. The optimism balances in the CBI survey of consumer, business and professional service companies had risen in May to their highest levels since the survey began in 1998. Overall, Bank staff continued to expect growth of 0.8% in the initial estimate of Q2 GDP, with a final estimate of 0.9%. The strength of the business surveys suggested upside risks to Bank staff's expectation that quarterly growth would ease back to 0.7% in Q3.

17 The GDP release provided the first official data on the expenditure breakdown for Q1. Household consumption and business investment had both grown robustly, in line with expectations. Government investment had, however, fallen by 10%. And housing investment, although up 1.7%, had been below expectations for the third quarter in a row. Although data on housing starts suggested scope for greater rises in investment, housing completions had been somewhat weaker than starts so far.

18 More generally, housing market activity appeared to have weakened since the start of the year. Most notably, mortgage approvals fell for the third consecutive month in April and were 17% below the January 2014 peak. It was therefore possible that Q2 approvals would fall short of the 70,000 monthly average that had been anticipated at the time of the *May Report*. There had also been signs of weakness earlier in the housing market chain: data provided through the Financial Conduct Authority suggested that mortgage applications had been falling and the RICS new buyer enquiries balance, although still suggesting rises, was well off its recent highs. A key issue was, therefore, why activity had weakened.

19 Reforms associated with the Mortgage Market Review (MMR) had probably played some role in the recent weakening. Information from the major lenders suggested that MMR implementation had had adverse operational effects as staff training continued, new IT systems were brought on stream and interview times lengthened. Such effects should be only temporary, but it was possible that the MMR could act as a more enduring drag on lending. In particular, some borrowers might no longer qualify for any mortgage products. And for others, the terms on which credit would be available could lead

them to reduce the size of loan applied for or delay taking out a loan until their incomes were higher. In that case, transactions and approvals should return to more normal levels over time, although the effect on the value of loans issued would be permanent.

20 It was possible that the weakening in activity reflected factors other than the MMR. There were signs of weaker housing supply: the RICS new instructions to sell balance continued to point to falls in the number of properties coming onto the market, and the Hometrack survey suggested that those houses that were on the market were selling more quickly than last year. Such a supply story would be consistent with the continued rise in house prices, which were up a little over 2% in the three months to May, according to the average of the Halifax and Nationwide indices. It was also possible that demand had weakened independently of the MMR, for example, if some potential homebuyers viewed current house prices as too expensive.

21 The weakening in housing activity was not representative of household demand more broadly. On average, consumption had grown by 0.5% a quarter – contributing 0.3 percentage points to quarterly GDP growth – in the year to 2014 Q1, in part funded by a falling saving rate. Indicators suggested robust consumption growth in the second quarter: retail sales growth in April was the strongest for ten years, with volumes rising 5% in the three months to April relative to the same period a year earlier, and the CBI Distributive Trades survey pointed to continued strength in May. Consumer confidence had also remained buoyant and was consistent with a reduction in uncertainty. Within the GfK measure of confidence, which was above its historical average, it was notable that consumers were particularly confident about the general economic outlook compared with past experience, and unemployment expectations were at their lowest level since 1998. Easing credit conditions may also have supported consumption: the stock of unsecured loans grew by more than 5% in the year to April.

Supply, costs and prices

22 CPI inflation had picked up to 1.8% in April, as petrol price falls a year earlier began to drop out of the annual comparison and the change in the date of Easter this year pushed up the inflation rate of airfares and other travel prices. Although the headline April outturn was in line with the *May Report* projection, the temporary impact of the date of Easter on transport costs appeared a little greater than expected, offset by weakness in other components. Reflecting that weakness, staff had revised their

short-term inflation forecast down a touch, such that inflation in Q2 as a whole was expected to be 1.7%.

23 One factor that was likely to bear down on CPI inflation in Q2 was the price cuts announced by a major supermarket chain. The impact of these, which would appear in the CPI from May, was uncertain and their wider implications would depend on the extent to which other retailers followed suit. More generally, a balance of companies surveyed by the Bank's Agents had reported that their profit margins had fallen over the past year, but that they expected to rebuild margins a little over the coming twelve months. The reported narrowing of margins over the past year seemed at odds with aggregate data on consumer prices, and companies' labour and non-labour costs. But the expectation for next year was consistent with the assumption built into the *May Inflation Report* projection that consumer-facing companies' margins would rise over the forecast period.

24 Inflation expectations had remained subdued. In the 2014 Q2 Bank/GfK NOP survey, inflation expectations had fallen over the quarter by around 0.3 percentage points at the one-year, two-year and five-year horizons.

25 There had been little news in labour market quantities. The LFS unemployment rate had edged down to 6.8% in the three months to March, and was only marginally higher than expected. Average hours had ticked up on the month, and employment had continued to grow robustly. There was consequently little news in the data on hours worked to alter the MPC's view of the degree of labour market slack. There were, however, some signs of increasing tightness in other indicators. In particular, survey measures of recruitment difficulties had been rising, particularly for more highly skilled employees. And job to job moves had picked up: such increased churn might be associated with increased bargaining power on the part of existing staff.

26 According to official data, however, wage growth remained subdued and had been surprisingly weak in the latest release. Private sector average weekly earnings (AWE) growth had been expected to rise sharply in the twelve months to March, to over 4%, because bonus payments and earnings had been deferred in March 2013 ahead of the reduction in the top rate of income tax in April of that year. The twelve-month growth rate of private sector AWE instead fell back to 1.6%. Within that, regular pay growth was 1.1%. The underlying path of AWE was uncertain as it was possible that some people had postponed bonuses and pay this year too.

27 The picture on earnings remained clouded by the stronger message given by a range of surveys. Most notably, the REC survey continued to point to strong pay growth for new employees, although the index for permanent placements fell back a touch on the month, which could feed through to average wage levels as churn returned to more normal levels. Other surveys also pointed to faster rises in pay than did the official data.

28 Overall, unit labour cost growth had remained weak. The Committee continued to expect some recovery in pay growth. A key issue remained whether that would be accompanied a rise in productivity growth, with few implications for inflationary pressure. It was possible that a rise in pay growth could predate a pickup in productivity: in particular, pay restraint during the crisis had allowed companies to hold onto staff, but a pickup in pay pressures could encourage companies to economise on labour to some extent. It was also possible that entrenched expectations of low wage growth might mean that wage growth lagged a revival in productivity growth.

The immediate policy decision

29 The Committee set monetary policy to meet the 2% target in the medium term, and in a way that helped to sustain the recovery. 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. It remained the case, however, that the actual path of Bank Rate would reflect economic developments.

30 There had been little change in financial market prices over the month as a whole, although there had been some notable movements during the month in response to domestic data releases and MPC communications. In general, financial markets continued to be characterised by low volatility, especially at short horizons, and a strengthening search for yield.

31 Internationally, activity had disappointed in the first quarter in the United States and the euro area. The unexpected weakness in both regions probably reflected temporary factors. In the United

States, output growth was expected to bounce back to around 1% in the second quarter. In the euro area, the recovery remained fragile. Surveys continued to point to a pickup in growth in the second quarter, but to less than ½%. And inflation had fallen back. The path for growth and inflation further ahead would in part depend on the impact of any policy actions by the European Central Bank, which were widely anticipated. Overall, the news on the month did not change the Committee's judgement that the global expansion would be sustained, but the UK outlook remained sensitive to changes in the pace of that expansion.

32 Domestically, it was difficult to know how persistent the slowing in housing market activity, apparent across a range of indicators, would be. It was likely that operational factors, associated with the Mortgage Market Review (MMR), were weighing on mortgage approvals. It was also possible that the MMR could have a longer-lasting effect on approvals, especially in value terms, and on net secured lending, if it constrained the amount that some potential homebuyers could borrow. The slowdown could also reflect other factors. Past rises in prices may have started to weigh on housing demand: growth in new buyer enquiries was slowing. Or activity could be constrained by a shortage of properties for sale, perhaps because homeowners were delaying selling in the expectation of further house price rises. A lack of supply would be consistent with the continued rises in house prices. There was uncertainty about the relative importance of these factors and their persistence. 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 Output growth continued apace, in line with expectations at the time of the February and May *Reports*. Consumption had continued to grow at a reasonable pace and business investment had picked up. It appeared therefore that the recovery had broadened and become more sustainable. Survey indicators of output growth remained strong, reinforcing the expectation that growth would remain at around recent rates in the second quarter. Bank staff continued to expect a modest slowing in quarterly growth rates in the second half of the year, but the latest surveys suggested some upside risk to that assumption.

34 As expected, CPI inflation had picked up a little on the month, but the short-term outlook had again been revised down marginally. Non-labour cost growth remained more benign than in recent years; indeed, the appreciation of sterling over the past year or so meant that import prices were probably starting to pull down CPI inflation. Companies seeking to rebuild margins might do so by

maintaining prices as their imported costs fell. It was possible, however, that the weakness in inflation elsewhere, especially the euro area, contained information about underlying global inflationary pressures that might yet become evident in the United Kingdom.

35 Average Weekly Earnings (AWE) growth had slowed unexpectedly in March. There was some uncertainty around the precise trends owing to the effect of the reduction in the top rate of income tax in 2013. Further work was needed to investigate the differences between the official data and a range of survey indicators, which were significantly stronger. It was possible that weak AWE outturns reflected entrenched expectations of modest pay increases following the considerable period of restraint or that the weakness in wages indicated that substantial labour market slack remained. Unemployment had continued to fall.

36 Most members' central view of spare capacity was that it remained in the range of 1% to 1½% of GDP in 2014 Q2. There was considerable uncertainty around the current level of slack, and a range of views on the Committee. That uncertainty had been reinforced by the contrasting trends in the economy since August 2013, when the Committee had set out its forward guidance strategy. On the one hand, output growth had been stronger, and unemployment had fallen faster, than had been anticipated by the MPC and most other forecasters. On the other hand, wage growth and inflation had been weaker. One possible explanation was that the effective labour supply was greater than previously thought.

37 The point at which slack would be fully absorbed would depend not only on its current level, but also on the speed at which it was used up. In the *May Report* projections, output growth moderated and productivity growth recovered gently, such that slack was absorbed only slowly: that was apparent in the projected flattening in the unemployment profile from late 2014. One indicator that slack had been eroded would be a sustained rise in real wages. There was, however, a risk that growth would not slow in the second half of the year so that, without a corresponding rise in supply, slack would be absorbed more quickly than had previously been expected. In that context, the relatively low probability attached to a Bank Rate increase this year implied by some financial market prices was somewhat surprising.

38 Overall, there had been little news on the month to change the view encompassed in the *May Inflation Report* central projections that, under market interest rate expectations, the economy

remained on course to meet the MPC's aim of absorbing spare capacity over the next two to three years, while keeping inflation close to the 2% target. It still seemed likely that when Bank Rate began to rise, it would do so gradually and to a level below its pre-crisis average rate. While the low level of Bank Rate could encourage financial imbalances, particularly in the housing market, the mitigation of such risks was best addressed using the macroprudential tools available to the FPC in the first instance. The case for raising Bank Rate gradually and cautiously was reinforced by uncertainty over its likely impact on the economy, following the long period at 0.5%, although it could be argued that the more gradual the intended rise in Bank Rate, the earlier it might be necessary to start tightening policy. If policy were tightened prematurely, however, that could be associated with considerable costs in terms of lost output. That was particularly important when the starting point was one from which interest rates could not easily be reduced.

39 The economy was starting to return to normal. Part of that normalisation would be a rise in Bank Rate at some point. The precise timing of the rise would depend on the outlook for inflation. That, in turn, would depend on the data flow, and in particular what that implied for the degree of slack, the prospects for its absorption, and the broader outlook for wages. For some members, the policy decision had become more balanced in the past couple of months than earlier in the year. 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 being absorbed 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 the occasion of his 166th and final meeting, the Governor, on behalf of Committee members past and present, thanked Charlie Bean for his contributions to the work of the MPC since becoming a member in 2000 and his personal contribution in establishing the monetary policy framework.

42 In order to accommodate some members' attendance at international meetings in Washington DC on 9 October, the MPC's policy meeting scheduled for 8-9 October will take place on 7-8 October. The decision will still be announced at the originally scheduled time of 12.00 on 9 October.

43 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
Paul Fisher
Andrew Haldane
Ian McCafferty
David Miles
Martin Weale

Dave Ramsden was present as the Treasury representative.