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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

3 and 4 September 2014

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 September 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1409.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 8 and 9 October will be published on 22 October 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 SEPTEMBER 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 The prospects for the gradual normalisation of monetary policy in the United States and the United Kingdom, the likelihood of additional stimulus in the euro area, and geopolitical risks in Russia and Ukraine, and in the Middle East, had continued to be major influences on financial markets. Indicators of liquidity premia for corporate bonds in major currencies and of implied volatility across a range of asset classes had remained low.

3 Short-term forward interest rates in the United Kingdom had fallen on the month by around 10 basis points, with much of the decline occurring on the day of the publication of the August *Inflation Report*. A 25 basis point increase in Bank Rate was fully priced into overnight index swap rates by May 2015, a little later than at the time of the Committee's previous meeting, and the median respondent to the Reuters survey had put a 30% probability on there being a rate rise during 2014, down from 40% the previous month. The implied path of Bank Rate after the first increase had become shallower and the level of Bank Rate implied by overnight index swaps in three years' time was a little above 2%.

4 Elsewhere, short-term rates had risen slightly in the United States but had fallen in the euro area. Unsecured overnight interest rates there had turned negative. Following remarks made during the month by the President of the ECB, there were heightened expectations of additional monetary policy measures in the euro area in the coming months, with some chance seen of a cut in policy rates at the

September meeting. The first auction of the ECB's targeted long-term repo operations would be held in September; expectations were that the total size of the operation would be around €340bn.

5 The sterling effective exchange rate index (ERI) had depreciated by around 1½%, in large part accounted for by a fall of around 2¼% against the US dollar. Much of the decline had occurred since the last week of August; market intelligence suggested that this had been partly due to opinion polls indicating greater support for Scottish independence. Sterling implied volatility derived from options prices had also risen sharply. However, the level of the ERI was still 12% above its early 2013 trough.

6 Longer-term interest rates had continued to decline, by 20-25 basis points in the United States, Germany and the United Kingdom. Having risen over the second half of 2013, in large part following a reassessment by market participants of the likely path of US monetary policy, five-year government bond yields, five-years forward, had fallen by around 1¼ percentage points from their December peaks. In the United States and United Kingdom, these interest rates had returned to levels last seen in Spring 2013; in Germany rates were now somewhat lower than that. Most of these falls had reflected declines in real interest rates, with little change in market measures of expected inflation. RPI-based real UK forward rates were now negative across the yield curve. The degree of co-movement in rates across the major economies suggested some common driver, be it lower expectations for policy rates or lower real term premia. Expectations of lower future policy rates might reflect a greater recognition, in part following communication by central banks, of the headwinds facing the global economy in general, and the euro area in particular, or the belief that the balance of global savings and investment flows would require lower interest rates in the medium run. Term premia might have been reduced as a result of the increased use of guidance by central banks about their reaction functions, or of greater demand for long-duration safe assets from certain investors.

7 Perhaps in consequence of declining risk-free rates, the prices of many risky assets had risen further, with international equity indices, for instance, generally rising on the month. Some measures of implied risk premia on equities did not, however, look unusually low and were above pre-crisis levels.

The international economy

8 On balance, the news on the global economy on the month had been to the downside, with weaker outturns in the euro area and heightened geopolitical risks outweighing some upside news on the US economy.

9 Having disappointed in the first quarter, euro-area GDP growth had remained weak in the second quarter. Activity had been flat, somewhat lower than Bank staff expectations of growth of 0.2%. Consequently, growth in the first half of 2014 had been weaker than in the second half of 2013, with the downside news, relative to Bank staff expectations, concentrated in Germany, France and Italy. There was no area-wide expenditure breakdown yet available for the second quarter, though the GDP breakdown for Germany suggested that some of the second quarter weakness there might have been the result of erratic factors. It was therefore difficult to assess the slowdown in the euro area with precision. There had been little news suggesting a change in credit conditions or prospects for fiscal policy, although some surveys had suggested a dampening of business confidence in recent months. The PMIs had continued to point to quarterly growth of close to ½%. It was possible that some of the weakness might be temporary, but a sustained period of very low growth across the euro area would make the process of stabilising public and external debt in the periphery more difficult.

10 It was possible that the weakening in business confidence, particularly in Germany, had partly reflected the heightened tensions between Russia and Ukraine. The direct exposures of most euro-area economies, and indeed of the United Kingdom, to Russia and Ukraine were low. As a result, it was likely that the sanctions announced by the European Union so far, and the counter-sanctions imposed by Russia, would have a limited direct impact on euro-area activity, as would the likely deterioration in the Russian macroeconomic outlook. Nevertheless, it was possible that increased uncertainty would lead some businesses to reassess investment plans or to review the viability of existing investment, particularly in the affected countries. And any sustained disruptions to oil and gas supplies would also have a more material effect.

11 Euro-area inflation had fallen, on the flash estimate, to 0.3% in August, from 0.4% in July. Much of the fall in headline inflation from its peak at the end of 2011 had reflected lower commodity prices, the impact of past rises in the euro exchange rate, and the mechanical effect of past increases in indirect taxes dropping out of the twelve-month calculation. Measures of core inflation had been more

stable at closer to 1%. Nonetheless, euro-area inflation expectations two-to-four years ahead derived from swaps had continued to decline and, during the early part of the month, there had been a significant fall in longer-term expectations, although this had been partially reversed following the speech by the President of the ECB at Jackson Hole.

12 There had been little news in the United States, although the data on the month had been largely positive. The second release of the national accounts for Q2 had shown a higher estimate for GDP growth in the second quarter and activity surveys for August had generally improved. Employment growth had continued at a steady pace: for the sixth month in succession the increase in non-farm payrolls in July had exceeded 200,000, the first time this had happened in nearly twenty years.

13 Agricultural commodity prices had generally continued to fall: the S&P GSCI Agricultural and Livestock Index was now at a four-year low. Oil prices had declined by around 11% since their peak in June, as production levels had if anything surprised to the upside. Options prices suggested that market expectations of a large move in prices from current levels in either direction over the next six months were at twenty-year lows. This was very difficult to reconcile with heightened geopolitical risks in the Middle East and elsewhere.

Money, credit, demand and output

14 The recent trend in the United Kingdom of activity growth at or slightly above longer-term averages had continued, and sustained economic momentum was likely to persist into the third quarter. But there were also some early indications from surveys and other sources that the gradual slowing in the pace of expansion that the Committee had been expecting for some time might occur towards the end of the year.

15 GDP growth in Q2 had, at 0.8% in the second release, not been revised and an expenditure breakdown was not yet available. Bank staff continued to expect the quarterly growth rate ultimately to be revised to 0.9%. Immediately prior to the Committee's meeting, the ONS had released near-final estimates from *Blue Book 2014*, which contained revisions to the National Accounts up to the end of 2012. These would require further investigation, but preliminary analysis showed a shallower trough in GDP during the recession in 2009 and a slightly faster rate of growth thereafter. On the expenditure side, revisions had been concentrated in investment and inventories; on the nominal income side,

a striking portion of the revisions in 2011 and 2012 had been to companies' gross operating surpluses. As expected, the household saving ratio had been revised up, by around 4 percentage points on average for the period 1997-2009. This reflected a change in the treatment of pension contributions, which had led to a corresponding reduction in corporate sector savings rates.

16 Surveys of output in Q3 had continued to be strong overall. The Markit/CIPS services output index had remained near record highs and the construction output index had increased in August. The CBI and BCC output surveys were also above average, although the former had softened slightly in the latest quarter, and the Bank's Agents continued to record robust activity growth across all sectors. The Markit/CIPS manufacturing output index had fallen, however, to 16-month low. On balance, these indicators, taken alongside the strength in the Index of Services for June, had led Bank staff to revise up its expectation of growth in the final vintage of data for Q3 to 0.9%.

17 The early indicators of the pace of activity moving into the fourth quarter were more equivocal. Some indicators of spending continued to be firm. Surveys of investment intentions remained at relatively high levels, in line with the projection for business investment underlying the August *Inflation Report* forecast. Net lending to non-financial businesses had grown at an annual rate of 3½% in the three months to July, perhaps partly underpinned by rising collateral values as commercial property prices increased. Although retail sales in July had risen by only 0.1%, the GfK survey of consumer confidence remained well above its pre-crisis average, and measures of services consumption were strong. Unsecured lending to households had risen by 6% in the year to July. Based on these data, Bank staff expected quarterly consumption growth in Q3 of around 0.6%.

18 Other indicators of activity in Q4, however, were softer and implied a downside risk to Bank staff's expectation of growth of 0.8%. The Markit/CIPS expectations indices for both manufacturing and services had fallen sharply in August, with services moving below its long-term average for the first time in over a year. There were also some early signs that export growth was slowing, perhaps on account of the lagged effect of the earlier strengthening in sterling or the weakening in euro-area activity growth in the first half of the year. For example, the EEF survey of manufacturers suggested that, although firms remained optimistic that export orders would pick up, new orders from overseas had fallen in the second quarter for the first time since 2013 Q1. Set against that, expectations

measures from the CBI services survey had been more positive and remained above series average levels.

19 There was evidence of some slowing in the pace of increase in house prices, and that housing activity had not recovered from the spring dip as fast as expected. ONS house price data for June had shown a 0.5% rise on the month and a 10% rise on the year, and the timelier Nationwide index had risen by 0.8% in August. Nevertheless, several leading indicators, in particular the RICS price expectations balance, continued to point to slowing rates of house price inflation. Mortgage approvals for house purchase had been broadly flat in July at around 67,000, a little lower than Bank staff had expected, and new buyer enquiries, as recorded by the RICS survey of estate agents, had fallen further in August. Taken together, these suggested that the housing market was somewhat weaker than the Committee had envisaged at the time of the August *Inflation Report*.

Supply, costs and prices

20 Twelve-month CPI inflation had fallen to 1.6% in July from 1.9% in June, rather weaker than Bank staff and other economists had expected, as an erratic increase in clothing and footwear prices in June had unwound. Notwithstanding reports from the BRC and the Bank's Agents that the clothing sector had recently experienced relatively solid demand, and thus that summer sales had been less widespread, the CPI data suggested that these sales had merely been postponed, boosting inflation temporarily in June.

21 Looking ahead, Bank staff expected twelve-month inflation to fall slightly further, reflecting the higher exchange rate, lower crude oil prices, and some utility price base effects. It was then expected to pick up a little towards the end of the year. Import price pressures more broadly remained muted. It was possible that the revised data on profits published by the ONS as part of *Blue Book 2014* might have implications for estimates of where companies' profit margins stood relative to longer-run averages, although not all indicators of costs and prices had been revised.

22 Employment had risen by just under 170,000 in Q2. The labour force participation rate had fallen by around $\frac{1}{4}$ percentage point in the three months to June relative to the three months to May. It was likely that this unexpected reduction in participation was erratic: information from the ONS indicated that the newest cohort included in the LFS had sampled more students than usual, who were

more likely to have reported themselves as inactive. If not representative of wider participation trends, this cohort could artificially depress measured employment and participation rates for the five quarters it featured in the LFS, and such effects would have no implications for the Committee's judgements on spare capacity.

23 Surveys indicated that the labour market had continued to tighten, and the LFS unemployment rate had fallen to 6.4%. The AWE measure of pay growth had remained weak, however. In line with expectations, regular pay in the year to Q2 had risen by 0.6% across the whole economy, and by 0.9% in the private sector. Survey measures suggested somewhat stronger pay growth, especially for new recruits. As in previous months, the Committee discussed the continued contrast between strong official employment data and weak wage numbers. The Committee discussed two of the factors that might have held down AWE growth over the recent past.

24 First, during the recession, the pace at which workers had moved from job to job and, more broadly, the voluntary resignation rate had fallen sharply and had remained subdued even after the recovery had begun. This might have reflected lingering risk aversion and a lack of confidence about labour market prospects following the abrupt increase in unemployment after the financial crisis. It was notable, then, that having edged up in the first quarter, job-to-job flows and the resignation rate had increased further in the second quarter. It was possible that further increases in labour market turnover would be reflected in a faster pickup in pay growth than anticipated in the latest *Inflation Report*. The impact on unit labour costs would be offset to the extent that it were the result of individuals finding work in roles that better matched their skills and so boosted productivity.

25 Second, it was probable that part of the recent weakness in the measured increase in average earnings reflected changes in the composition of those in employment. Microdata regarding individuals participating in the LFS suggested that attributes such as educational attainment, tenure, industrial sector, age and occupation were important in accounting for differences in pay. Across the economy as a whole, therefore, changes in the average level of pay would be influenced not just by year-to-year changes in any given individual's wage, but also by the changing composition of the workforce. Estimates by Bank staff suggested that such compositional changes had acted to push up wage growth between 2009 and 2013. Over the past year, however, changes in the average attributes of the workforce appeared to have been pulling down on average wage growth, perhaps significantly. As these effects dissipated over time, measured AWE growth might pick up so as to become more in

line with the message from indicators of pay growth from business surveys, which would be less affected, if affected at all, by such compositional changes.

26 Changes in the composition of the workforce would not necessarily have implications for inflationary pressure, however, if they affected pay and average productivity equally and so had no impact on firms' unit labour costs. There was a range of possible measures of unit labour costs, but overall they had probably risen by around 1% across the whole economy over the past year, considerably weaker than pre-recession norms.

The immediate policy decision

27 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 Bank Rate would follow over the next few years was uncertain, and would depend on economic circumstances. In other words, the Committee's guidance on the likely pace and extent of interest rate rises was an expectation, not a promise.

28 The accumulating evidence of the weakness in the euro area had been the most significant development during the month. GDP growth had disappointed and inflation had fallen further. Even if some of the weakness, particularly in Germany, turned out to be temporary, it was possible that the underlying pace of the recovery in the euro area was slower than the Committee had estimated. Although the direct impact on the United Kingdom of the current phase of disappointing activity might be relatively modest, a prolonged period of poor growth and very low inflation could have a larger impact if it led once again to uncertainty about the sustainability of euro-area public and external debt. This could damage confidence and disrupt financial markets, and, as a result, the downside risks to UK growth in the medium term had probably increased. The President of the ECB had reiterated during

the month that the Governing Council would use all the available instruments needed to ensure price stability.

29 Geopolitical risks had also risen, with renewed tensions between Russia and Ukraine, and in the Middle East. The direct links between the affected regions and the United Kingdom were small and the measures imposed so far were unlikely to have any material direct effect on the outlook. That said, further escalation had the potential to lead to disruption to energy markets and reductions in investor risk appetite and business confidence. Against that backdrop, the continued low level of volatility in a number of financial markets, particularly that for crude oil, remained remarkable.

30 Long-term interest rates had fallen further on the month, to levels last seen in Spring 2013, and the path of Bank Rate expected by markets after the first increase had become even shallower. This might have reflected a greater recognition, in part following communication by central banks, of the headwinds facing the global economy, or a belief that the balance of global savings and investment would require lower interest rates in the medium run. Term premia might have been reduced as a result of the increased use of guidance by central banks, or of greater demand for long-duration safe assets.

31 Domestically, the Committee had for some time been forecasting a moderation in activity growth and it was mindful that on several occasions the data had led it to push back its expectation of the point at which such a slowing was likely to begin. Although growth at a rate at or above long-term averages looked likely to continue in the third quarter, there were early signs from surveys of business expectations, from indicators on manufacturing and exports, and from the housing market that the rate of growth might ease in the fourth quarter. It would be necessary, however, to reassess the domestic outlook in light of the revised National Accounts data that the ONS would release in full as part of *Blue Book 2014*.

32 CPI inflation had unexpectedly fallen back to 1.6% in July and it now seemed likely that June's 1.9% figure had largely reflected a change in the timing of the summer sales for clothing and footwear. The exchange rate had weakened on the month, and volatility had increased as market participants had become more uncertain about the outcome of the referendum on Scottish independence. But the level of sterling was still 12% above its early-2013 trough and this would continue to put downward

pressure on prices in the near term. Bank staff's expectation was that inflation would probably fall slightly further in coming months before rising a little towards the end of the year.

33 There was some evidence that employees were becoming more confident about their labour market prospects: job-to-job flows and resignation rates had picked up further in the second quarter, having been depressed since the beginning of the crisis. This could put upward pressure on wages, as expected in the August *Inflation Report*. Faster turnover might, however, also lead to faster wage growth in a situation where firms were paying more to new recruits than to their existing workforce. But, if this led to people finding jobs that better matched their skills, this would also provide some support to productivity growth, and offset the impact on inflation pressures.

34 Wage inflation on the AWE measure continued to be weak. It was probable that it had recently been depressed by changes in the composition of employment towards individuals with lower wage levels, such as those with fewer qualifications or workers with less tenure. As the impact of these compositional changes waned over time, earnings growth might well rise, perhaps bringing it more into line with some of the surveys. However, these compositional effects need have little impact on labour costs, and so inflationary pressure, if they affected pay and productivity to a similar degree. Labour costs per unit of output were currently rising by only around 1% per year, considerably weaker than was consistent with the inflation target in the long run. The key judgement was whether unit labour costs would rise more or less rapidly than suggested by the August *Inflation Report* projections.

35 The speed at which labour costs would rise depended, among other things, on the evolution of slack in the economy. Here, there had been limited news on the month: with the labour market continuing to tighten, slack continued to be absorbed, and there continued to be a considerable degree of uncertainty about how much remained. Most members observed that it was nonetheless necessary to evaluate the degree of slack in order to assess prospective unit labour cost growth and therefore inflation. Some members remained of the view that, although some slack persisted, the degree of spare capacity had diminished sufficiently that the uncertainty about its level made it a somewhat less informative guide to the appropriate future path of monetary policy. It was noted that the speed with which slack was being used up could nevertheless be a helpful guide to policy setting when the extent of slack was uncertain. Members also discussed other factors that could influence the future path of

wage growth, such as nominal wage rigidities, the rate of labour market churn, and any potential skill mismatch between supply and demand.

36 Against this backdrop, the Committee considered the level of Bank Rate currently appropriate to meet the inflation target.

37 For most members, there remained insufficient evidence of prospective 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. There were more indications, from business surveys, from export indicators and from the housing market that growth was likely to ease a little; and the downside news in the euro area had increased the risks to the durability of the domestic expansion in the medium term. Inflation was below the target and there were few signs of inflationary pressures: import prices were falling, and the depressing impact on prices of past increases in the exchange rate had yet fully to feed through. More significantly, unit labour costs were currently growing at a rate well below that consistent with meeting the inflation target in the medium term. The stimulus provided by a given level of Bank Rate should not be viewed in isolation from the various headwinds facing the economy. Those headwinds were likely to mean that the real rate of interest consistent with stable inflation over the medium term was likely to be lower than in the past, even after slack had been absorbed. Consistent with that, global real interest rates at longer maturities were significantly lower than before the crisis and had fallen further since the turn of the year. A premature tightening in monetary policy might leave the economy vulnerable to shocks, with the scope for any stimulus that subsequently became necessary being limited by the effective lower bound on Bank Rate. In addition, increases in Bank Rate well ahead of any prospective pickup in wage and income growth risked increasing the vulnerability of highly indebted households.

38 For two members, economic circumstances were sufficient to justify an immediate rise in Bank Rate. While CPI inflation was below the target, and was likely to fall further in the near term, this was largely the effect of the exchange rate rise in the first part of the year. Just as the Committee had looked through that effect when it had pushed inflation up, it was appropriate to look through it at present. Meanwhile, the economy continued to grow at a pace consistent with the rapid absorption of slack, and the signs of any easing in growth in Q4 were as yet only tentative. Survey evidence of tightening in the labour market suggested that wage growth might pick up quite sharply as slack was absorbed. Since monetary policy 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, to the extent that recent robust GDP growth rates had been underpinned by stimulatory monetary policy, in addition to reduced uncertainty and an easing in 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 rises in Bank Rate should only be gradual.

39 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.

40 Consistent with the Committee's forward guidance, and as described in a market notice on 4 September 2014, the Committee agreed to reinvest the £14.4 billion of cash flows associated with the redemption of the September 2014 gilt held by the Asset Purchase Facility.

41 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

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, Anthony Habgood was also present as an observer in his role as a member of the Oversight Committee of Court.