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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

4 and 5 December 2013

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 December 2013.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1312.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 January will be published on 22 January 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 DECEMBER 2013

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 Developments in UK financial markets had reflected reactions to the continuation of data suggesting that the domestic recovery remained robust with diminishing inflationary pressure. There had been little change overall in the expected path of UK official interest rates, although the short end of the yield curve had steepened slightly: the one-year rate, two years forward implied by overnight interest rate swaps had risen by eight basis points. The first rise in Bank Rate was fully priced in by mid-2015, similar to last month, while respondents to the Reuters survey had, on average, brought forward by one quarter their expectation of the first rise, to August 2015. Most respondents expected the first rise to take place one to three quarters after the 7% unemployment threshold had been reached. The Bank's and HM Treasury's announcement of changes to refocus the FLS to support business lending, by removing the direct incentives to expand household lending in 2014, had had little impact on market interest rates.

3 Elsewhere, on the day of the Committee's last policy decision, the ECB had cut its main refinancing rate by 25 basis points to 0.25%. In the United States, the most likely date at which markets expected the FOMC to begin to reduce the pace of its asset purchases had remained March 2014. Taken together, the effect of recent developments was that the expected paths of UK, US and euro-area short-term interest rates now diverged more than earlier in the year. Longer-term interest rates had risen on the month - UK and US ten-year spot rates by around 20 basis points, and equivalent German rates by around ten basis points.

4 There had been some divergence in equity indices in the major economies over the month: the S&P 500 index had risen by 1.3%, while the FTSE All-Share and DJ EuroStoxx indices had fallen by 3.1% and 1.9% respectively.

5 The sterling effective exchange rate index had risen further, by around 2% on the month, and now stood close to the top of the range it had occupied since early 2009. Sterling had appreciated by 1.6% against the dollar and by 1.4% against the euro. In commenting on exchange rate developments, market contacts had tended to emphasise the more positive news about the UK economy relative to the economic and policy outlook in the United Kingdom's major trading partners.

The international economy

6 The activity indicators had largely confirmed the existing international pattern of growth, and of declining inflation in many of the advanced economies. The latter in part reflected the impact of lower commodity prices. But core measures of inflation had also fallen over the past year which, given the moderate scale of the current global expansion, could well be symptomatic of the effects of underlying slack.

7 Growth in the euro-area had remained weak. GDP was estimated to have risen by only 0.1% in Q3, slightly lower than previously expected, reflecting unexpectedly slow growth in Germany and France rather than in the periphery. Prospects for Q4 had remained subdued: the euro-area composite Purchasing Managers' Index (PMI) for November had declined slightly by 0.2 points to 51.7, while the Italian and French indices had each fallen by 2.5 points to 48.8 and 48.0 respectively. CPI inflation in the euro area had fallen by just over a percentage point in the past year and, according to the flash estimate, stood at 0.9% in November. Lower commodity and food prices and euro appreciation had contributed to the decline in inflation, but it was likely that the effects of economic slack had also been important. Slack was particularly concentrated in the periphery, where unit labour costs had been flat compared to growth of a little over 2% per year in the core. Such divergence in unit labour cost growth within the euro area was necessary to facilitate internal rebalancing. Reflecting the subdued outlook for inflation, the ECB had reduced its main refinancing rate by 25 basis points to 0.25% at its November meeting, and most commentators and market participants continued to expect further measures from the ECB in the coming months to ease monetary conditions in the euro area.

8 In the United States, the data had suggested that moderate expansion had continued. GDP growth in Q3 had been 0.7%, stronger than the Committee had expected. Much of that surprise had

reflected rapid stockbuilding, which might suggest that growth would ease in Q4. The November PMIs had been mixed: the manufacturing measure had risen by 0.9 points to 57.3, but the non-manufacturing measure had fallen by 1.5 points to 53.9. Non-farm payrolls had risen by over 200,000 in October, which was above recent levels, despite coinciding with the partial government shutdown. But the rate of employment growth nevertheless remained well below that seen in previous recoveries. US GDP growth was likely to pick up in 2014 as the impact of fiscal tightening diminished.

9 In Asia, Japanese GDP growth had slowed to 0.5% in Q3, weaker than the Committee had expected. While still strong by recent standards, it raised a question about whether the pickup in activity was sufficiently well entrenched to withstand the increase in consumption taxes scheduled for 2014. Recent data had pointed to slightly greater near-term strength in Chinese growth than the Committee had expected. Medium-term prospects in China depended to a large extent on the ability of the authorities to set out and implement policies to liberalise and rebalance the economy. While it would take some time for detailed measures to emerge, the Central Committee's Third Plenary Meeting had sketched out significant reforms in several areas.

Money, credit, demand and output

10 The Committee had been briefed on the fiscal policy measures to be announced by the Chancellor in the Autumn Statement. Preliminary analysis had suggested that their impact on the macroeconomic outlook over the Committee's forecast horizon was likely to be small.

11 The second estimate of GDP growth in Q3, at 0.8%, had not been revised. As always, the Committee treated the first estimate of the expenditure breakdown with caution. But on the face of it, it suggested an unexpectedly rapid pickup in consumption growth, from 0.3% in Q2 to 0.8%, the strongest rate of growth since the second quarter of 2010. Business and dwellings investment had been weaker than expected. A strong contribution from stockbuilding had been offset by a large drag from net trade. Overall, the divergence between domestic demand and net trade had been larger than expected, and emphasised the difficulty of achieving a rebalancing of domestic and external demand at a time when the outlook for activity in the United Kingdom's major trading partners was subdued.

12 In a longer context, the current account deficit had roughly doubled over the past two years and could have been around 3½% of GDP in Q3. Exports had been broadly flat since late 2011 as the United Kingdom's share of world export markets had continued to decline gradually, despite the

earlier substantial depreciation of sterling. Much of that weakness had been concentrated in exports of financial services, but some could also be attributed to exports of goods and non-financial services. The pattern of global demand growth had contributed to the weakness of UK exports: growth had generally been weaker in the United Kingdom's main export markets, especially the euro area. The United Kingdom's net international investment position was close to balance, and had changed little in the past two years, but net investment income had fallen. That had been a major contributor to the widening in the current account deficit, and had appeared to be driven partly by low income on euro-area assets. The weak outlook for the euro area made it unlikely that external demand would provide a significant contribution to the UK expansion. Moreover, if income on euro-area assets remained low, a significant narrowing of the current account deficit in the near term seemed unlikely.

13 In terms of the immediate outlook, the business surveys pointed to growth rates of around 1¼% in both the fourth quarter of 2013 and the first quarter of 2014. The Bank staff's central expectation for growth remained below the steer given by the surveys, however, at 0.9% for the fourth quarter of 2013. In part that judgement reflected more recent signs of softness in some of the consumer spending data: retail sales had fallen by 0.7% on the month in October, while private car registrations, the CBI distributive trades and the GfK consumer confidence surveys had also weakened a little recently. Data from the Halifax and Nationwide indices had been consistent with the Committee's assessment that house prices were currently rising at around 1% per month for the United Kingdom as a whole, and there had been a further increase in mortgage approvals for house purchase.

14 Beyond the near term, it seemed likely that, for the recovery to be sustained, a pickup in business spending would be necessary. The initial ONS data had suggested that business investment had risen in Q3, although by less than the Committee had expected. Such early estimates were prone to revision, however. Moreover, there had been recent signs that a recovery in business investment might be underway. The CBI service sector survey for November had suggested that investment intentions had picked up across all investment categories, alongside growing business confidence and receding demand uncertainty. The latter had been supported by other surveys and by the Bank's Agents' reports that business contacts were increasingly confident of future demand.

Supply, costs and prices

15 Twelve-month CPI inflation had fallen to 2.2% in October, reflecting smaller contributions than anticipated from university tuition fees and from airfares. Since the Committee's previous meeting, the government had announced the removal of around £50 of policy costs from annual household

energy bills. If all of that reduction were passed through by the utility companies, it would reduce CPI inflation by 0.15 percentage points relative to the profile that had incorporated the utility price rises previously announced and taking effect around the turn of the year. The precise timing of the change was uncertain, but if it was implemented early in 2014 it would contribute to a short-term outlook in which inflation fell to around the 2% target over the next few months.

16 Measures of UK inflation expectations derived from inflation swaps had on balance risen slightly over the month. Five-year and ten-year forward inflation rates were a touch higher than their averages for the period January 2008 to July 2013. There had been mixed signals from survey-based measures of inflation expectations. Having risen sharply in October in the wake of the announcement of rises in energy utility prices, the YouGov/Citigroup measures of inflation expectations one year and five to ten years ahead had both fallen back in November. On the other hand, the latest quarterly Bank of England/GfK NOP survey of public attitudes to inflation had shown a pickup in expectations at both the short and medium-term horizons. Abstracting from the high frequency moves in individual measures, summary measures of the common signal contained within the various indicators of inflation at different maturities had suggested that while medium-term inflation expectations had picked up a little over the past year, they nevertheless remained close to pre-recession levels.

17 There had been no signs of higher inflation expectations contributing to larger wage increases. Whole economy average weekly earnings excluding bonuses had risen by 0.8% in the three months to September compared with a year earlier. That had reflected flat public sector earnings and private sector earnings growth of around 1%. The latter remained below its post-recession average, and well below its pre-recession average of around 4%. The usual concentration of annual pay agreements in the first few months of 2014 would provide the Committee with an important reference point on the strength of pay pressure.

18 The LFS measure of headline unemployment had fallen to 7.6% in the three months to September, as an increase in the size of the labour force had been more than offset by the increase in employment. Employment had risen by more than 175,000 in the third quarter, quite a bit more than the Committee had expected. Reflecting an increase in average hours, the quarterly increase in hours worked had been even stronger at 1%.

19 As a result, measured productivity per hour had fallen by around 0.2 percentage points in the third quarter. That had continued the trend of very weak productivity growth in the current upswing, which was at odds with the experience during previous recoveries. It was possible that output growth

had been stronger than the current vintage of official data suggested, and that productivity growth was correspondingly higher. After previous recessions, estimates of output growth in the early phase of expansion had subsequently been significantly revised up, which suggested that measurement was particularly difficult at turning points in the cycle. But real wage growth had remained extremely weak, which was less consistent with productivity having picked up significantly; and survey measures had suggested rising and near-normal levels of capacity utilisation in many firms. Contacts of the Bank's Agents had indicated that some of the factors that had been holding back productivity persisted. These included the extra resources required to win orders in thin markets and to expand into new markets. Contacts expected those constraints to ease as the recovery continued, in which case productivity would pick up as demand increased.

The immediate policy decision

20 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).

21 The news on the month had continued to suggest a burgeoning recovery in the United Kingdom. The second estimate of GDP growth in the third quarter had been unrevised at 0.8%. Business surveys pointed to growth rates of around 1¼% in each of the next two quarters, and although Bank staff took a more cautious view they nevertheless expected growth of 0.9% in the fourth quarter of 2013. The recent data suggested that the recovery was being driven by consumption and stockbuilding, with both investment and net trade weaker than expected, although the Committee treated first estimates of the GDP expenditure breakdown with considerable caution.

22 A sustained recovery was likely to require a pickup in investment growth as well as consumption, and some rebalancing from domestic to external demand. The prospects for continued robust consumption growth would depend on productivity gradually increasing and supporting a strengthening in real incomes. There had been some signs of softness in recent consumer spending

data and confidence surveys. However, there were increasing signs from business surveys and the Bank's Agents that investment might be rising as expectations of a continued recovery in demand became entrenched. The net trade data had been weak over the past couple of years, reflecting in part demand conditions in the rest of the world. In the euro area, only a very weak recovery was in prospect and inflation remained materially below 2%, but a moderate expansion appeared to be underway in the United States and there were signs that growth in the emerging economies had bottomed out. It would be difficult to achieve a better balance of domestic and external demand as long as activity in the UK's main trading partners remained subdued.

23 In financial markets, there had been a slight tightening in monetary conditions, with UK longer-term market-implied interest rates rising by around 20 basis points and sterling appreciating by around 2% on the month. These developments were likely to reflect the relatively strong UK data. The sterling effective exchange rate index was near the top of the range it had occupied since early 2009, and had risen by around 9% since its recent trough in March 2013. Although the extent of the final pass-through to domestic prices was uncertain, that appreciation would contribute to disinflationary pressure. But any further substantial appreciation of sterling would pose additional risks to the balance of demand growth and to the recovery.

24 The LFS unemployment rate had fallen to 7.6% in the three months to September, and so remained above the Committee's 7% policy threshold. There remained something of a puzzle in relating the official output data to the strength in employment. It seemed possible that either or both of the official output and employment data were giving misleading signals. Weak productivity had been a feature of the UK economy since the recession, however, and it was surprising that since the start of 2013 there had appeared to be almost no cyclical recovery in productivity despite measured output having grown by around 2%. Contacts of the Bank's Agents continued to expect that some of the factors that had held back productivity would ease as the recovery continued. It was, however, too soon to draw firm conclusions on the responsiveness of effective supply to stronger demand. The Committee would continue to assess the data and outlook against its central judgement in the November *Inflation Report* that productivity was likely to increase gradually as the economy recovered.

25 Regarding its 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.

26 Twelve-month CPI inflation had fallen to 2.2% in October. Since then there had been further downside news to the inflation outlook in the form of the government's announcement on reducing energy costs associated with environmental regulation. As a result, inflation seemed likely to remain at around its current level in the final part of the year and to fall towards the 2% target in the first quarter of 2014. Sterling's appreciation should reduce inflation further out. Pay growth remained muted at present. Overall, the probability of CPI inflation being at or above 2.5% 18 to 24 months ahead was judged to be lower on the month.

27 Market-derived measures of UK medium to long-term inflation expectations based on inflation swaps had on balance risen slightly over the month, and there had been mixed signals from survey-based measures of inflation expectations. But while there were some signs that inflation expectations had picked up a little over the past year, there were no indications that this had had much impact on wage growth. The twelve-month rate of CPI inflation was now close to the target, after a long period of inflation above target. In the absence of further shocks, the Committee's central view was that it was likely to remain at or close to the target over the coming months. Notwithstanding some near-term volatility associated with changes in utility prices, that outlook, if realised, should itself serve to anchor inflation expectations. Overall, the Committee judged that medium-term inflation expectations remained sufficiently well anchored.

28 At its meeting on 20 November 2013, the FPC 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. This had been communicated to the MPC. Prior to its policy meeting, the MPC had been consulted ahead of the Bank's and HM Treasury's decision on changes to the FLS, and had concluded that they would not materially affect monetary conditions. Moreover, by removing direct incentives for banks to expand residential mortgage lending in 2014, the changes to the FLS provided support to the MPC's policy guidance by reducing the risk of triggering the financial stability knockout.

29 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 the FPC had judged that the financial stability knockout had not been breached. A recovery in output appeared to be under way, and inflation had fallen and was expected to remain close to the 2% target. With unemployment remaining above the 7% threshold, the Committee's forward guidance remained in place and no

member thought it appropriate to tighten, or to loosen, the stance of monetary policy at the current juncture.

30 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.

31 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, Bradley Fried was also present as an observer in his role as a member of the Oversight Committee of Court.