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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 AND 4 JULY 2013

These are the minutes of the Monetary Policy Committee meeting held on 3 and 4 July 2013.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2013/mpc1307.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 31 July and 1 August will be published on 14 August 2013.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 JULY 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 Volatility had picked up sharply in financial markets, and there had been falls in the prices of many risky assets and marked rises in short and longer-term interest rates, as participants sought to interpret comments by policymakers about the future stance of US monetary policy and the prospects for an easing in the rate of asset purchases by the Federal Open Market Committee (FOMC).

3 The paths implied by market instruments for policy rates in many advanced economies had moved up sharply. Rates on overnight index swaps (OIS) three years forward had risen by around three quarters of a percentage point in the United Kingdom, and by a little more in the United States, compared with their levels at the time of the *May Inflation Report*. OIS rates were consistent with the first rise in policy rates in the United States and United Kingdom occurring in the middle of 2015, compared, in the case of the United Kingdom, with a date towards the end of 2016 derived from OIS rates as recently as April. Measures of implied interest rate volatility had picked up, albeit from historically low levels. The results of the Thomson Reuters survey of economists' expectations of the UK monetary policy stance had been more stable than market-derived measures in recent months and the bulk of respondents were not expecting a change in the Committee's asset purchase programme at this meeting. In contrast to moves in interest rates, the sterling effective exchange rate index had changed little on the month.

4 Longer-term government bond yields had also risen, to levels similar to those that had prevailed towards the end of 2011; these were nonetheless still very low in absolute terms. From their trough in early May, ten-year US Treasury yields had increased by over 90 basis points, although they had fallen back a little towards the end of June. UK government bond yields had risen by a similar amount,

while German government bond yields had risen by somewhat less. The spreads on Spanish and Italian government bond yields over equivalent German yields had widened modestly. Portuguese and Greek bond spreads had widened more sharply, in part related to heightened political uncertainty in those countries.

5 The rise in UK longer-term rates could be understood if, for example, UK gilts and US Treasuries were viewed by market participants as good substitutes. But the rise in UK short-term interest rates, which were more reflective of expected policy rates, was surprising. UK developments, while broadly positive, had not been enough to warrant such an upward move in the near-term path of Bank Rate.

6 Prices of risky assets had generally fallen on the month and, according to market intelligence, particularly so in markets where leveraged investors had sought to liquidate long positions, such as emerging market debt and equity, and US mortgage-backed securities. Many emerging market economies had experienced sharp falls in their exchange rates and stock markets. Advanced-economy equity markets had performed somewhat better. US equity prices had risen slightly, although the FTSE All-Share index had fallen by 2.5% and the Euro Stoxx 300 index by just over 4%. Measures of bank funding costs had picked up somewhat. There had been a temporary spike during the month in Chinese interbank interest rates, apparently related in part to a temporary shortage of liquidity.

The international economy

7 The focus of financial markets had been on monetary policy prospects in the United States. The real-economy news there had been mixed, but predominantly to the downside. US GDP growth in Q1 had been revised down to 0.4% from 0.6%, with household spending growth looking to have been less resilient than previously thought to the increase in taxes at the beginning of the year. The weaker path for consumption growth had persisted into April and May, and it was likely that GDP growth in Q2 would be a little weaker than in Q1. The signal from the June PMIs was consistent with this, with a rise in the manufacturing index, and a fall in the non-manufacturing index. The activity and new orders sub-indices for the non-manufacturing sector had fallen sharply, partly offset by a material rise in the employment sub-index. Although FOMC participants had made small further downward revisions to their projections for US GDP growth this year, the broader underpinnings of the recovery

in activity were still in place, with measures of consumer confidence at a five-year high, further evidence of a recovery in the housing market, and a slowly improving job market.

8 Data on the euro-area conjuncture released during the month had been mildly encouraging and it was likely that, following six successive quarters of contraction, activity would stabilise or even expand slightly in Q2. There had been increases in both the services and manufacturing PMIs, the latter to a 16 month high, with a notable pickup in indices for Spain, France and Italy. Indicators of consumer confidence had risen. Nonetheless, with further rises in unemployment in many economies, it would take considerable time before activity in the euro area returned to more normal levels.

9 The durability and extent of any return to growth in the euro area would depend on the successful implementation of measures to facilitate the orderly reduction of public and external debt in the periphery to more sustainable levels. Political developments in Portugal and Greece on the month, with changes in the composition of the governments of both, were indicative of the strain this process was placing on these countries. Set against that, there had been further progress on the banking sector aspects of rebalancing. The European Council had agreed a draft directive on banking resolution and recovery, and euro-area governments had finalised the conditions for any deployment of funds from the European Stability Mechanism to support individual euro-area banks. Over the summer, the European Commission would also make proposals regarding the operation of a Single Resolution Mechanism for banks in Member States participating in the banking union.

10 Indicators of activity in the largest emerging economies had, on balance, been disappointing over the month. Data on Chinese industrial production had remained weak, and PMIs in a number of large Asian emerging markets had fallen back. It was particularly difficult to gauge the likely growth of supply capacity in these economies over the medium term and it was possible that the weakening conjuncture reflected in part a gradual re-evaluation by households and businesses of the success of structural reforms in raising future incomes and rebalancing demand. Partly as a consequence of this slowing, there had been falls in the prices of many industrial metals and agricultural commodities on the month. Oil prices had been more resilient, rising slightly, perhaps partly in response to increased political tensions in the Middle East.

Money, credit, demand and output

11 The release of data consistent with the 2013 *Blue Book* had confirmed that GDP had grown by 0.3% in Q1. There was little news in the output breakdown, but the composition of expenditure had been revised since the previous estimate, with private consumption now thought to have grown by 0.5% in Q1, dwellings investment now estimated to have increased substantially, and the contribution from net trade now positive. Set against these upward revisions, the contribution from stockbuilding was now estimated to be negative, and business investment had fallen by 2%.

12 Abstracting from the impact of re-referencing the weights used in the National Accounts to 2010, the level of GDP had been revised down by just over 1½% and the latest vintage of data suggested that activity was 4% below its pre-crisis peak, rather than the 2½% shortfall that the ONS had previously estimated. The revisions had been largely the result of a new method of deflating investment spending; estimates of nominal GDP had changed little. On the new basis, the level of real business investment was 20% lower than previously estimated. The new series for the business investment deflator rose at a similar rate to the consumption deflator. That was puzzling, as business investment was more goods-intensive than consumption, and the price of manufactured goods typically rose more slowly than the price of services, reflecting different rates of technical progress in the two sectors. Business investment growth was also significantly more volatile and the weakness of investment during 2012 looked at odds with other indicators of investment trends.

13 The activity surveys had continued to improve, although at varying speeds. There had been increases in output indicators reported during the month in the Markit/CIPS surveys, in the *CBI Monthly Trends Enquiry* and in the *BCC Quarterly Economic Survey*. Alongside data on service sector output in April, these had led Bank staff to revise up their central projection for the preliminary estimate of Q2 GDP growth by 0.1 percentage points to 0.6%, although the range of uncertainty was still wide. The message from the activity surveys was buttressed by other indicators. The volume of retail sales had increased by over 2% on a year earlier in May and the June REC *Report on Jobs*, which had been provided to the Committee ahead of the meeting, had reported material increases in demand for staff. But some of the surveys of business expectations had suggested relatively weak growth in the second half of the year.

14 Growth in the second half of the year would depend in large part on the behaviour of the household sector. There were some signs that consumer sentiment was improving. The increase in consumption in Q1 looked to have been broadly based, with rises on a year earlier in spending on durables, non-durables and services. And the fall in the household saving rate, although probably exaggerated by some shifting in the timing of income flows to take advantage of the lowering of the top rate of income tax in April, might indicate some reduction in precautionary saving. Credit availability had continued gradually to improve, in part due to the impact of the Funding for Lending Scheme, and there had been further small falls in most household lending rates. This could provide some support to consumer spending as a rise in housing transactions stimulated associated purchases of durable goods. Indeed, indicators of both prices and activity in the housing market had continued to improve: mortgage approvals had picked up sharply in May, albeit from low levels, and both the Nationwide and Halifax house price indices had risen in June. There had been a material increase in the RICS price balances in June, which had been provided to the Committee ahead of the meeting.

15 Set against that, real income growth had remained weak, even abstracting from changes in the timing of income flows, and it was unlikely that consumption growth could continue at its current rate without some rise in real incomes. Although the level of household debt as a proportion of income had fallen back from its peak, it remained high by historical standards and it was probable that households had further to go in adjusting their balance sheets. Moreover the rise in bank funding costs over the month might, if it persisted, slow down the rate at which credit availability would improve.

Supply, costs and prices

16 Annual CPI inflation had risen to 2.7% in May from 2.4% in April and the near-term outlook was similar to that at the time of the Committee's previous meeting. As falls in energy and clothing and footwear prices a year earlier dropped out of the annual comparison, twelve-month CPI inflation was expected to pick up to around 3% in June and to remain close to that level throughout the autumn.

17 Data this month had helped to resolve some of the puzzling recent weakness in average weekly earnings (AWE) relative to other indicators of pay growth. Annual AWE growth had rebounded sharply to 3.3% in April from -0.3% in March. A large proportion of the turnaround was likely to have reflected bonus payments being postponed to April to take advantage of the fall in the top rate of income tax. Annual regular pay growth, excluding bonuses, had also picked up, to 1.3% in April from

0.6% in March. It was likely that some regular payments had also been delayed to take advantage of the tax change, depressing pay in the first quarter and boosting it in April, though it was difficult to quantify this effect precisely. The increase in the top rate of tax in 2010 appeared to have led to around 0.5% of regular pay being brought forward; it was conceivable that an opposite effect of a similar magnitude had been occurring in recent months. Annual growth in the VOCALINK take home pay index, a measure of salary payments of public and private sector organisations, had picked up further in May, perhaps suggesting that not all of the postponed earnings had been paid in April.

18 Nonetheless, the picture remained one in which private sector earnings growth had slowed since the middle of 2012, having, even at that point, only been rising at rates close to 2% per year. The weakening in productivity growth in late 2011 and early 2012 had probably been one driver, and the sectors in which pay growth had fallen the most had seen the largest slowing in productivity growth. But other factors, including the continuing slack in the labour market and the more modest growth in the minimum wage in October 2012 than in previous years, might also have contributed.

19 The persistent weakness of productivity remained difficult to explain. One possibility was that it reflected impairment in the process of capital reallocation. Prior to the financial crisis around half of the growth in aggregate productivity had been accounted for by the reallocation of factors of production across businesses and sectors, rather than by increases in productivity within businesses. There was some evidence to suggest that this process of reallocation had slowed since the financial crisis.

20 The extent to which the low rate of earnings growth would lead to lower inflation would also depend on the desire and ability of businesses to raise their profit margins. A special survey by the Bank's Agents had found that profit margins had increased over the past year at the majority of responding firms. On balance, margins were still reported as being below normal, but the net balance of respondents reporting margins below normal had fallen significantly compared to a similar survey conducted in June 2012. Most of those businesses with margins below normal had expected to make good any shortfall within three years, although in practice this would be likely to depend on the prevailing demand conditions and perceptions of aggregate inflation pressures. Few firms expected to boost margins by raising prices.

The immediate policy decision

21 The Committee set monetary policy to meet the 2% inflation target in the medium term, and to do so in a way that avoided undesirable volatility in output in the short term. There had been further signs during the month that a recovery was in train, but it remained weak by historical standards and a degree of slack was likely to persist for some time. Twelve-month CPI inflation had increased to 2.7% in May and was set to rise further in the near term. Thereafter, inflation was likely to fall back towards the 2% target as external price pressures faded and a revival in productivity growth curbed domestic cost pressures.

22 Developments in the domestic economy had generally been positive and broadly in line with the recovery laid out in the *May Inflation Report* projections. The composition of spending in Q1 looked to have been more favourable than in the previous data release, with larger contributions from consumption, dwellings investment and net trade. The activity surveys had continued to pick up, signalling stronger growth in Q2, and it might well be the case that this momentum would continue into the second half of the year. There were also greater signs that the gradual reduction in uncertainty and improvement in credit conditions over the past year were feeding into household spending, with increases in a wide range of spending categories, some rises in house prices and a pickup in housing transactions. But ONS estimates of business investment had been weak, and looked even more so on the latest vintage of the data. The latest outturns had helped to explain some of the unusual weakness in earnings growth, with some pay likely to have been postponed to Q2 to take advantage of the reduction in the top rate of income tax at the beginning of April. But pay pressures remained muted, and earnings continued to rise more slowly than during the first half of 2012.

23 The news on foreign demand conditions was more mixed. US activity indicators had been a little weaker on the month, but the outlook remained very similar to that at the time of the *May Report*. The slowing in activity growth in the major emerging economies was becoming more apparent and it was possible that this reflected in part a gradual re-evaluation by households and businesses of the success of structural reforms in raising future incomes and rebalancing demand. Activity indicators in the euro area had been a little more encouraging, and there had been further steps taken towards constructing a banking union. But the challenge of reducing debt levels in the periphery economies to more sustainable levels remained daunting, and political developments in Portugal and Greece had

indicated the fragility of the political consensus. The depressed level of activity in the euro area would weigh on the UK recovery for some time to come.

24 Market interest rates had risen sharply internationally and asset prices had been volatile and generally lower. The rise in interest rates in the United States had probably reflected a change in perceptions of the path for monetary policy there, rather than news on the month about the economic outlook. UK gilts were to a certain extent substitutes for US Treasuries. It was understandable, therefore, that movements in longer-term gilt yields might be correlated with those of Treasuries. But it was less clear why shorter-term interest rates had increased in the United Kingdom in tandem with those in the United States. That said, given the volatility in the market, it was not obvious that current forward curves were a fair reflection of market participants' expectations.

25 Taken in isolation, this increase in interest rates represented an unwelcome tightening in monetary conditions that, were it to persist, would risk hampering the emerging recovery. Given that, the Committee agreed that it was important to communicate that the implied rise in the expected future path of Bank Rate had not been warranted by the recent developments in the domestic economy.

26 The latest remit letter to the MPC from the Chancellor had requested that the Committee provide an assessment, alongside its *August Inflation Report*, of the case for adopting some form of forward guidance, including the possible use of intermediate thresholds. This analysis would have an important bearing on the Committee's policy discussions in August, although there was no presumption that this would go hand in hand with a change in the policy stance. Against that backdrop, the Committee considered the case for additional monetary stimulus at this meeting.

27 For most members, the current policy setting was appropriate and the onus on policy at this juncture was to reinforce the recovery by ensuring that stimulus was not withdrawn prematurely, subject to keeping inflation on track to hit the 2% CPI inflation target in the medium term. The recent rise in market interest rates, were it to be maintained, would represent such a premature withdrawal, but the proposed statement from the Committee should help to prevent that. Developments on the month had signalled that the recovery was becoming more firmly established, with further rises in business survey indicators of activity and employment, signs of a greater willingness to spend on the part of consumers, and a continuing recovery in the housing market. The current rate of growth was not yet sufficient to begin to close the economy's margin of spare capacity, but there was reason to

believe that the recovery might gain pace in the second half of the year as confidence improved. There had been little news about the near-term prospects for inflation, which would remain well above the target for some time to come, and the downside risks to pay growth had diminished. Productivity growth continued to be weak and, given the impairment of the financial system, it was by no means clear that productivity growth would match any recovery in demand. For some of these members, asset purchases remained an effective tool with which to inject more stimulus, although an expansion in the purchase programme was not warranted at this meeting. But for others, the benefits of further asset purchases were likely to be small relative to their potential costs. In particular, further purchases could complicate the transition to a more normal monetary policy stance at some point in the future.

28 For the other members, further stimulus was warranted. Domestic activity was recovering as quickly as envisaged in the *May Inflation Report*, but the pace remained too slow to begin to close the economy's margin of spare capacity. Moreover, there remained significant headwinds to growth in the United Kingdom, including the effects of the fiscal consolidation, risks from the euro area and an impaired banking sector. Although the impact of administered and regulated prices meant that inflation was above the target, upward pressures on pay and profit margins were weak, and an expansion in demand would probably initially be associated with a strengthening in productivity growth rather than higher costs. Indeed, if faster growth in demand boosted productivity sufficiently, cost pressures could even be lower. Commodity prices were lower and the downside risks to them had increased with the slowing in emerging economies. An expansion of the asset purchase programme remained one means of injecting stimulus, but the Committee would be investigating other options during the month, and it was therefore sensible not to initiate an expansion at this meeting. Given the already large size of the asset purchase programme, there was merit in pursuing a mixed strategy with regards to the different policy instruments at the Committee's disposal. The Committee's August response to the requirement in its remit to assess the merits of forward guidance and intermediate thresholds would shed light on both the quantum of additional stimulus required and the form it should take.

29 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.

30 The following members of the Committee were present:

Mark Carney, Governor
Charles Bean, Deputy Governor responsible for monetary policy
Paul Tucker, 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, Roger Carr was also present as an observer in his role as a member of the Oversight Committee of Court.

31 On 7 August, alongside the release of the *Inflation Report* at 10.30, the Committee will respond to the Chancellor's request for its assessment of the use of thresholds and forward guidance, as well as its view of the trade off between growth and inflation. Any announcement regarding the implementation of thresholds and forward guidance will be made then, rather than immediately after the Committee's next policy meeting on 1 August.