

Publication date: 17 December 2014

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 3 and 4 December 2014

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1412.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 7 and 8 January will be published on 21 January 2015.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 3 AND 4 DECEMBER 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 A significant development during the month had been the continued decline in global long-term interest rates. Ten-year instantaneous forward sterling interest rates had fallen by 30 basis points, euro rates by 25 basis points and dollar rates by over 10 basis points. Since the beginning of the year, sterling ten-year forward rates had declined by 1.6 percentage points. Over this longer period, it was likely that these movements had in part reflected a weakening in market participants' views of global growth trends and factors dampening inflationary pressure – most importantly, the fall in oil prices. More recently, it was also possible that increased expectations of asset purchases by the ECB and Bank of Japan had played a role.

3 Short-term sterling interest rates had also fallen further. One-year sterling rates one year ahead had declined by around 20 basis points during the month. Although part of this decline had accompanied the publication of the Bank's November *Inflation Report*, the majority of the reduction had occurred on days during which there had been no significant UK data releases or monetary policy communications. The same had been true of declines in short rates more generally since the summer, suggesting that other factors, including overseas developments, were at play. At the time of the November *Inflation Report*, overnight index swap prices had implied that Bank Rate was expected by market participants to rise to around 1.8% by the end of 2017. At the time of this meeting, that expectation had become 1.6%.

4 The sterling effective exchange rate index (ERI) had fallen by around ½% during the month, reflecting a 1½% depreciation of sterling against the dollar. The dollar ERI had appreciated by almost 8% since the middle of the year.

5 Equity price indices had risen internationally: by 2½% in the United Kingdom and United States, and by 5% in the euro area. Equity prices had risen by 4% in Japan, following the gains in October associated with the surprise announcements of an increase in the pace of the Bank of Japan's asset purchase programme and the intention of the Japanese Government Pensions Investment Fund to shift its portfolio in favour of equities and foreign assets.

The international economy

6 Oil prices had fallen significantly further during the month. US economic data were generally stronger than expected, but otherwise there had been little news on global activity.

7 The price of Brent crude oil had fallen by 15% in sterling terms since the previous MPC meeting and by 35% since mid-June. There were a number of potential explanations for that reduction relating to developments in both oil supply and demand. Concerns over the geopolitical stability of oil producing regions had eased somewhat since the summer. OPEC supply had increased by over ½ million barrels per day since May, primarily owing to the increase in Libyan production. Iraqi production had not seen major disruption, despite fears to the contrary. And US supply had surprised to the upside. During the month, OPEC had decided not to attempt to stem the fall in prices by cutting member production quotas. At the same time, however, the demand for oil also appeared to have weakened: the International Energy Agency's oil demand forecast for 2014 Q4 had been revised down by around ½ million barrels per day since May. Price reductions associated with positive supply-side developments would act to reduce the global production costs of a wide range of goods and services resulting in a boost to real incomes and a fillip to global demand, including in the United Kingdom. But, to the extent that the price falls were the consequence of weaker global oil demand, then, as well as being a support to the growth of global activity, they were an indicator that it was softer.

8 Market intelligence suggested that, on balance, supply-side factors had probably dominated. If so, this might be one reason why, amongst commodities, the reductions in oil prices had been especially marked. Since June, however, some non-oil commodity prices had also weakened significantly. Agricultural commodity prices had fallen by 9% after good harvests in North America and other parts of the world. Industrial metals prices were, in aggregate, little changed

since June, although they had fallen around 2% during the month, and the fall in the prices of some metals, such as iron ore, had been much larger over recent months.

9 These reductions in the prices of commodities, and especially that of oil, had resulted in further downward pressure on headline inflation rates around the world. Bank staff estimated that the average inflation rate in the United Kingdom's main trading partners, weighted by their importance as a source of UK imports, was around 1% in September. As in the United Kingdom, the persistence of this weak inflationary pressure would depend on the extent to which it had been caused by factors that were likely to be temporary in nature, such as the direct effects of a lower level of oil prices, relative to those that might be longer-lived, such as any deficiency in global demand relative to supply capacity.

10 In the euro area, headline HICP inflation had fallen to 0.3% in November, with a further reduction expected in December. GDP had grown by 0.2% in the third quarter, in line with the expectation of Bank staff. The bounce back in German output following the contraction in Q2 had been more modest than hoped, at 0.1%. Purchasing Managers' Indices (PMIs) suggested that the euro area would continue to grow at a similar pace to that seen in Q3 through the turn of the year, although other indicators of business sentiment in Germany and France had been a little stronger.

11 In the United States, third-quarter GDP growth had been revised up a little to 1%. That figure had been boosted by defence spending and a strong net trade contribution, neither of which seemed likely to persist. Nevertheless, short-term indicators suggested that underlying momentum had been sustained into the fourth quarter. Bank staff expected GDP growth of around 0.6% in Q4, with the risks to that expectation probably to the upside.

12 Japanese GDP was estimated to have fallen by 0.4% in 2014 Q3, a considerably weaker figure than expected, although initial estimates were prone to revision. Adding to the stimulus announced in the previous month by the Bank of Japan, the Japanese Government had postponed a second increase in sales taxes that had been due to take place in the new year. The Prime Minister had dissolved Parliament in advance of an early general election in mid-December.

13 In China, activity had continued to grow at a slower rate than seen on average since the end of the financial crisis. The NBS manufacturing PMI had fallen to 50.3 in November from 50.8 in

October, while the HSBC services PMI had remained broadly flat. The latest indicators suggested that house prices in all but one of the 70 largest Chinese cities had continued to decline, at a pace of around 1% per month on average. In response to both this and lower inflation, the People's Bank of China had cut interest rates for the first time in two years, with the one-year deposit rate reduced by 25 basis points, to 2.75%, and the one-year lending rate reduced by 40 basis points to 5.6%.

Money, credit, demand and output

14 The second estimate of GDP growth in 2014 Q3, at 0.7%, had not been revised. The first estimate of the expenditure breakdown suggested that investment had been weaker than Bank staff had anticipated, while consumption had been stronger. Over the previous four quarters, GDP was estimated to have increased by 3%.

15 Both business and housing investment had fallen in the third quarter. The decline in business investment had been 0.7%, but these data were both volatile and prone to large revisions. Surveys, along with reports from the Bank's Agents, pointed to continued capital spending growth.

16 Housing investment was estimated to have fallen by 0.8% in Q3. This, too, might prove erratic given the recent increase in private housing completions (in England), which in the third quarter had been almost 10% higher than a year previously. Nonetheless, it also appeared broadly consistent with the pattern of a slower housing market seen since the summer. Mortgage approvals for house purchase had declined again in October, by 2,000 to 59,000. Mortgage applications had recovered by around 10% in October, however, so it was possible that the approvals data would also pick up somewhat over the coming months. Mortgage applications and approvals were likely to be supported by the continued declines in fixed mortgage interest rates seen over the second half of the year as market yields more broadly had declined. Two-year fixed rates for new mortgages at a 75 per cent loan-to-value ratio (LTV) had fallen on average by over 40 basis points since June. For 90 per cent LTV products, the average decline was almost 70 basis points. The reduction in the rate of stamp duty for many properties announced in the Chancellor's *Autumn Statement* might also support housing transactions.

17 Consumer spending was estimated to have increased by 0.8% in the third quarter, and by 2.3% over the previous year, the strongest four-quarter growth rate since before the financial crisis. This appeared consistent with the continued high levels of consumer confidence indicators. During the month, the ONS had discovered an error in the calculation of data regarding UK residents' tourism spending overseas. The correction of these data was expected to leave the estimated levels of both consumption and imports higher, with no net effect on the level of GDP. The prospective revisions could, nevertheless, make household consumption spending appear significantly stronger than in the current data vintage, and the household saving ratio commensurately lower. At face value, this implied that growth of aggregate spending over the previous year might have been somewhat less well balanced than it had seemed.

18 Indicators of aggregate output growth in Q4 had been, if anything, a little more upbeat than anticipated, although they remained consistent with a further slowing of growth into the fourth quarter. The composite Markit/CIPS business activity and expectations indices rebounded in November, unwinding almost all of October's fall. That supported the view that the October figures had been temporarily depressed by the impact on sentiment of the financial market turbulence seen in the middle of that month. Bank staff's expectation was for an initial estimate of Q4 GDP growth of 0.6%. Alongside the business survey evidence, the strength of the index of services in September implied that the risks to that expectation were to the upside.

19 On 3 December, the Chancellor's *Autumn Statement*, and the accompanying economic and fiscal projections from the Office for Budget Responsibility, had set out the latest fiscal plans and forecasts. An initial analysis indicated that, in macroeconomic terms, the incremental effects of the changes to the plans announced in the *Autumn Statement* were small by comparison with the fiscal consolidation that was already underway and that had been factored into the MPC's November *Inflation Report* projections.

Supply, costs and prices

20 Twelve-month CPI inflation had risen in October to 1.3% from 1.2% in September, a little lower than had been anticipated by Bank staff at the time of the November *Inflation Report*. The small downside news in the data outturn, along with the 15% reduction in sterling oil prices that had occurred over the past month, meant it was now significantly more likely than not that CPI

inflation would fall below 1% over the coming months, necessitating, in line with the Committee's remit, an exchange of letters between the Governor and the Chancellor of the Exchequer. The expectation of Bank staff was that this was most likely to occur first in the December data as increases in energy prices in December 2013 dropped out of the twelve-month comparison. Those figures would be published on 13 January 2015. It was also thought likely that CPI inflation would remain below 1% for some months after that.

21 The decline in CPI inflation over the previous 18 months could mostly be attributed to a reduction in the contribution from food and energy prices. In the October data, the contribution of these components to twelve-month CPI inflation had been 1 percentage point lower than in June 2013. The appreciation of sterling over the past 18 months was also likely to have borne down on the level of consumer prices. But these factors were not the only reasons that the rate of CPI inflation was below the 2% target. The inflation rate of the most labour-intensive service prices had fallen abruptly in the initial stages of the recession as a margin of spare capacity had opened up and wage growth had fallen back. Since then, such service price inflation had remained consistently subdued by historical standards, driven by weak domestic labour cost growth. The outlook for inflation, therefore, depended crucially both on the impact of movements in food, energy and other imported prices, and on the evolution of the labour market.

22 Employment had risen by 112,000 in 2014 Q3. Compared with the same period a year ago, it had risen by almost 700,000 or 2.3%, a similar proportional increase to that in the total number of hours worked. The unemployment rate had fallen by 0.3 percentage points to 6.0% in Q3. Although the pace at which employment was increasing had remained above historical norms, there were some signs in the official data and from business surveys that both the rate of employment growth and the speed at which unemployment was falling were beginning to slow.

23 It was possible that the modest softening in employment growth reflected an easing in firms' demand for labour as output growth had slowed a little in the second half of the year, and the increase in uncertainty about the outlook for the global economy might have led some firms to begin to scale back their hiring plans. It was also likely to reflect a reduction in the degree of slack remaining in the labour market. The number of job vacancies had continued to increase, and the ratio of vacancies to unemployment had recovered to a level close to its historical average. Information from both the Bank's Agents and business surveys suggested that skills shortages had

become more common in some parts of the economy. Moreover, the short and medium-term unemployment rates had fallen back to leave only the longer-term rate above pre-crisis levels. After accounting for Bank staff estimates of the likely revisions to the GDP data, output per hour worked was estimated to have risen by 0.7% in the third quarter, and by 1¼% by comparison with a year earlier. That either suggested an increase in the intensity of factor utilisation, or provided a very tentative indication that the increase in underlying productivity growth expected by the Committee for some time might be beginning to occur. The average number of hours worked per job had been broadly flat over the past year, whereas some increase might have been expected if capacity pressure had risen significantly.

24 High-frequency measures of wage growth had shown signs of an increase. Seasonally adjusted private-sector regular pay had increased at an annualised pace of around 3% in the third quarter. Compared with a year earlier, this measure of pay had increased by 1.6%. While that pickup was consistent with other signs of a reduction of slack in the labour market, pay growth remained only just sufficient to match the nascent increase in productivity, leaving firms' unit labour costs broadly unchanged over the year to 2014 Q3, well below the rate consistent with meeting the 2% inflation target in the medium term. Survey indicators remained consistent with a further pickup in pay growth, although the most buoyant indicator, from the REC survey, had softened in recent months.

25 Measures of households' inflation expectations had continued to decline. For example, the Bank of England/NOP measures of expectations of inflation one, two and five years ahead had fallen by 0.3-0.4 percentage points between the August and November surveys. These and other measures were generally below their longer-term averages. Households' expectations of future inflation were likely to have been influenced by the recent sharp reduction in CPI inflation itself: households' perceptions of the rate of inflation over the previous year had dropped by 0.6 percentage points over the same time period. It was, therefore, possible that such measures of expectations contained little incremental information beyond what could be gleaned from the CPI data. Nevertheless, it was notable that a range of measures of households' longer-term inflation expectations had fallen back fairly sharply in recent months. Were inflation expectations to decline further, that might lengthen the period of time for which inflation itself would remain below the target, for example if they influenced wage bargaining.

The immediate policy decision

26 The Committee set monetary policy to meet the 2% inflation 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. The Committee's guidance on the likely pace and extent of interest rate rises was an expectation, not a promise.

27 The Committee's full assessment of the outlook for growth and inflation had been published in the November *Inflation Report*. Since then, the news regarding activity had been limited, although near-term activity in both the United Kingdom and United States appeared a touch stronger than previously thought. The outlook for the euro-area remained subdued. And indicators continued to point to a modest, but broadly based, slowing in emerging economies. Although the details were not yet available, it was likely that data revisions would show that UK consumer spending had been stronger than supposed over 2014, offset by weaker imports, and financed by a lower household savings rate. The housing market continued to show signs of softening, although the recent reduction in mortgage rates might cushion that slowing.

28 By far the more significant economic developments during the month had been the continued sharp decline in the price of crude oil and further reductions in market interest rates. Since the former affected the outlook for inflation, at least in the near term, it was possible that it had contributed to a perception that monetary policy normalisation in the United Kingdom would begin later than previously assumed. But it could not easily explain the continued reduction of medium and longer-term interest rates. Rather, these seemed likely to reflect a weakening in market participants' views of global growth trends and, perhaps more recently, an anticipation of central bank asset purchases from the ECB and Bank of Japan.

29 The reduction in the oil price had reflected developments on the supply side as well as, in part, a softening of global demand. In net terms, the Committee judged that the reduction in the oil price would, if sustained, act as a stimulus to growth in the United Kingdom and its main trading partners via its effect on the costs of production and real incomes. The reduction in market interest rates – including some 30 basis points on ten-year sterling forward rates – would also provide support to economic activity and, all else equal, medium-term inflation.

30 In the near term, CPI inflation was expected to dip below 1%, probably in the December data. The expected near-term profile of inflation was somewhat weaker than had been assumed at the time of the November *Inflation Report* because of the further reduction in sterling oil prices. In the medium term, the extent of inflationary pressure, and thus the appropriate path for monetary policy, would depend, as before, on: the persistence of the effects of reduced energy, food, and other imported prices on CPI; inflation expectations; and the evolution of the labour market and, in particular, the degree of slack and consequent growth of wages relative to labour productivity. In light of the degree of uncertainty over all three of these factors, a wide range of outcomes for inflation was possible.

31 For most members, the outlook justified maintaining both the current level of Bank Rate and the stock of asset purchases financed by the issuance of central bank reserves. Inflation in the coming months would be pushed further below the target by the contribution from energy prices and lagged effects of sterling's appreciation, and was set to remain below the target, even after these effects had passed through, for a significant period. Recent signs of a pickup in wage growth were promising. But, as yet, pay growth was only roughly in line with, rather than in excess of, productivity growth. Consequently, domestic cost growth remained lower than would be consistent with the inflation target. Further increases in pay growth, as labour market slack continued to decline, would be required to be consistent with the 2% inflation target in the medium term.

32 There were clear risks to this outlook in both directions. There was a risk that growth might soften further than anticipated and, even absent that, a risk that inflation might persist below the target for longer than expected. This latter risk had, if anything, been exacerbated by the continued decline in oil prices. A premature tightening in monetary policy would leave the economy vulnerable to shocks, with the scope for any stimulus that subsequently became

necessary being limited by the effective lower bound on interest rates. Against this, however, there was also a risk that the degree of spare capacity could be eliminated more quickly than previously assumed, particularly if Bank Rate were to follow the path implied by market yields, which had declined further on the month. This could occur if, for example, there were less spare capacity in the economy than currently believed or if growth in major export markets were stronger than expected. That could result in inflation rising to, and subsequently overshooting, the 2% target. As before, individual members ascribed different probabilities to these risks.

33 For two members, economic circumstances continued to justify an immediate rise in Bank Rate. While CPI inflation was well below the target, this was largely the direct effect of the higher exchange rate and lower raw material prices. Since policy was set in order to deliver the inflation target in the medium term, it was largely appropriate to look through the short-term effects of such price movements. In the view of these members, evidence on the effectiveness of asset purchases suggested that the zero lower bound was not at present a major consideration. The continued fall in the unemployment rate was consistent with the rapid absorption of slack and, even if the rate at which unemployment was falling were to ease markedly, it could nonetheless reach its estimated medium-term equilibrium level by the middle of 2015. Survey evidence of a tightening in the labour market suggested that wage growth might pick up sharply as slack was absorbed. Indeed, although such data were erratic, the most recent information on private sector average weekly earnings raised the possibility that this process was already in train. 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. It was possible that the real rate of interest consistent with stable inflation over the medium term was now rising. 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 any subsequent rises in Bank Rate should be only gradual.

34 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.

35 Prior to its policy meeting, the MPC had been consulted ahead of the decisions by the Bank and HM Treasury to extend access to the Funding for Lending Scheme (FLS) until early 2016 and to focus the incentives in the scheme towards supporting lending to small and medium-sized enterprises. The MPC had concluded that these changes would have no material impact on the stance of monetary policy.

36 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

Sharon White was present as the Treasury representative.