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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

9 and 10 July 2014

These are the minutes of the Monetary Policy Committee meeting held on 9 and 10 July 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1407.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 6 and 7 August will be published on 20 August 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9 AND 10 JULY 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 There had been a noticeable increase on the month in UK short-term interest rates and a further appreciation in the exchange rate. One-year overnight index swap (OIS) rates, one year forward, had risen by around 25 basis points, to just above 1.5%, while the sterling effective exchange rate had risen by 2% on the month, to its highest level since October 2008. Both had been rising over recent months, directionally consistent with the relative performance of the UK economy, although the bulk of the increase on the month had occurred in the period immediately following the Governor's Mansion House speech on 12 June. Since that point, short-term interest rates had also shown some signs of greater sensitivity to data developments, although measures of volatility in the near term implied by options prices had generally remained low.

3 An increase in Bank Rate to 75 basis points was fully priced into OIS rates by 2015 Q1, one quarter earlier than at the time of the June MPC meeting. Economists polled by Reuters expected the first increase in February 2015, although they put roughly a 40% probability on it happening during the remainder of 2014. After that first rise in Bank Rate, the market expected a gradual pace of increases of around 20 basis points per quarter for the first year or so. The pace of tightening consistent with the yield curve thereafter was slower and a little more gradual than had been expected last month, such that the level of interest rates expected in four years' time was broadly unchanged.

4 Overseas, the ECB had reduced its main refinancing and deposit rates, the latter to below zero. It had also extended both the scale and the duration of its lending to banks, but that extension was conditional on improvements in bank lending to households and businesses. These measures had been

broadly in line with expectations and the immediate additional impact on euro-area bank funding costs had been relatively small. The euro had depreciated further, by around ½%. The FOMC had continued to reduce the pace of its asset purchases and signalled a modest reduction in its expectation for the federal funds rate in the longer term.

5 There had been some evidence of a reduction in risk appetite on the month, linked in part to tentative signs that the pace of the global recovery was slowing. Equity markets in Europe had fallen back a little, led by declines in bank shares, and, since the ECB's announcement, the spreads of bonds of some highly indebted euro-area countries had widened a little relative to German government bonds. Longer-term forward rates had fallen in the major advanced economies by around 15 basis points. Emerging market asset prices had fared better, however, with equity prices generally higher on the month. As had been highlighted during the month in the Bank's *Financial Stability Report*, the picture more generally remained one of a continuing search for yield across a range of asset classes, together with low levels of asset price volatility.

The international economy

6 On balance, the news about the central outlook for the global economy had been to the downside over the month, and upside risks to activity seemed to have diminished somewhat. This contrasted with the position at the beginning of the year, when expectations for 2014 had generally been for a global growth rate close to the long-term average.

7 In the United States, Q1 GDP had been revised further in the third release, with the economy now estimated to have contracted by 0.7%, the sharpest fall in output since the first quarter of 2009. The harsh winter had almost certainly played a part in temporarily depressing activity and, based on data on household consumption in April and May, Bank staff's estimate of growth in the second quarter was 0.8%. Nevertheless, unless there was a material acceleration in activity in the second half of the year, growth over the year as a whole was likely to fall some way short of public and private sector forecasts that had been made only a few weeks before the meeting.

8 The US expenditure data were out of step with the message from the labour market. Non-farm payrolls had continued to rise, by almost 300,000 in June, and the unemployment rate had fallen to 6.1%. Taken at face value, these data implied a fall in productivity in the first half of the year.

Together with the declines in labour force participation since the beginning of the crisis, and the more recent pickup in measures of consumer price inflation to around 2%, this made any judgement about the supply capacity of the US economy difficult.

9 In the euro area, monthly indicators had remained consistent with GDP growth of around 0.4% in Q2, following the disappointing increase of only 0.2% in Q1. But looking forward, the softening in the Purchasing Managers' Indices (PMIs) in June, particularly those for France and Germany, suggested that growth might be weakening going into the second half of the year and, although the periphery countries had continued to make progress in stabilising public and external debt, the adjustment process there would remain a drag on activity for some time to come. Set against that, the reduction in the ECB's policy rates, together with the measures it had taken to boost lending to households and companies, would in due course provide some support to growth.

10 There had been little news on activity in the major emerging market economies, and indicators for China remained consistent with GDP growth in the second quarter of around 1¾%, a similar rate to Q1. The rapid growth in credit and the vulnerabilities associated with the shadow banking system remained a risk to the outlook for China's economy.

11 Developments in commodity markets had been mixed. Agricultural commodity prices had fallen by 7% due to improving prospects for US grain supply, while industrial metals prices had risen by 5%. Oil prices had also risen during June in response to the conflict in Iraq, a major producer and the potential source for much of the increase in OPEC supply in coming years. But prices had fallen back since the second half of June, leaving them little changed on the month. It was difficult to assess how much this reflected news about the ultimate balance of demand and supply for oil, and, more generally, it was notable that prices had remained in a tight range around \$110 per barrel since the second half of 2012, despite numerous economic and geopolitical risks having emerged over that time.

Money, credit, demand and output

12 The recent trend of activity growth in the United Kingdom at or slightly above longer-term averages had continued, and sustained economic momentum was looking more assured. Given the strength of survey indicators, it remained unclear whether growth would slow modestly in the second

half of the year, as envisaged in the May *Inflation Report*. But there were some indications that a gradual slowing might take place.

13 The third estimate of GDP growth in Q1 had, at 0.8%, not been revised, with four-quarter growth estimated to have been 3%. Within that, there had been revisions to the mix of expenditure, such that growth in Q1 was driven to a greater extent than before by investment and exports. Based on the historical pattern of revisions and the surveys, Bank staff expected the quarterly growth rate in the first quarter ultimately to be revised up to 0.9%.

14 Surveys of activity since then had continued to point to robust growth in the second and third quarters, although there had been some conflicting signals. The Markit/CIPS and British Chambers of Commerce (BCC) output growth indicators had fallen slightly but remained above series average levels. Set against that, the export orders balance from the BCC survey had decreased, perhaps reflecting the appreciation of the exchange rate and weaker data on global activity, and SMMT data on car registrations had weakened. Some indicators had pointed to a moderation in housing market activity. The Index of Production had fallen by 0.7% in May, led by a broadly based fall in manufacturing output; past experience suggested that some part of this might be reversed in June. Bank staff expected the pattern of activity to be very similar to that which had underpinned the May *Inflation Report* projections, with GDP growing by 0.9% in Q2, before slowing modestly into the third and fourth quarters.

15 Within the aggregate picture, the news on the corporate sector had generally been positive. Business investment had grown by 5% in Q1, somewhat stronger than had been expected. Corporate credit conditions had become more favourable, with the twelve-month growth rate of bank lending to private non-financial corporations having turned positive in May for the first time in five years. It was likely that this pickup had been concentrated outside the commercial property sector and to have been driven by larger businesses. Consistent with this, the latest Deloitte CFO survey of predominantly large firms had reported that the cost of credit was at its lowest level, and credit availability close to its highest level, in the survey's seven-year history. Perceptions of economic uncertainty had also continued to fall and surveys of expectations for growth in recruitment and capital expenditure had remained buoyant.

16 The outlook for household spending growth was, however, a little weaker. Growth in real incomes had probably been slower than expected in the first half of the year and any increase in consumer spending was likely to have been financed by a further fall in the savings rate. Bank staff now expected consumption growth of a little less than $\frac{3}{4}\%$ in each of the second and third quarters.

17 The housing market would also be an influence on household spending in the second half of the year and beyond, particularly on housing investment. During the month, the Financial Policy Committee (FPC) had made two recommendations to mitigate risks stemming from the housing market. The first was that, when assessing affordability, mortgage lenders should apply an interest rate stress test that assessed whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be three percentage points higher than the rate prevailing at origination. The second was that the Prudential Regulation Authority and the Financial Conduct Authority should ensure that mortgage lenders limit the proportion of mortgages at loan-to-income multiples of 4.5 and above to no more than 15% of their new mortgages. Both recommendations had been designed and calibrated to provide insurance against a marked loosening in underwriting standards and a further significant increase in the number of highly indebted households, rather than affecting the central outlook for housing activity and prices set out in the *May Inflation Report*.

18 Since the *May Report*, however, indicators had pointed to further moderation in housing market activity. Mortgage approvals for house purchase had fallen again in May, for the fourth consecutive month, to 62,000. This was below the 70,000 monthly average that had been anticipated for Q2 as a whole at the time of the *Report* and represented a 19% drop since the January peak. After controlling for seasonal factors, mortgage applications had also continued to fall from their December peak. Although there had been considerable variation from month to month and across different indices, house prices continued on average to rise at around 1% per month.

19 Weakening housing-market activity might in due course lead to some moderation in house price inflation. But it was also possible that resilient prices suggested some supply-side effect, either acting through the supply of credit, perhaps as a result of the reforms associated with the Mortgage Market Review (MMR), or the secondary supply of houses. Mortgage lenders had indicated that the MMR had been a factor reducing the volume of approvals for both house purchase and re-mortgaging in May. Most had also said that they would be able to return to a normal level of business by the end of July. But the MMR might well have a more persistent impact on the behaviour of some borrowers, by

influencing the terms or the availability of credit. It might take them time to adjust downwards their expectations about what was affordable and to redirect their search. During this time, both transactions and lending would be lower. It was notable that the latest RICS survey of estate agents had shown a slowing in the rate of increase in new buyer enquiries, and an outright fall in London, at the same time as new instructions to sell had begun to increase, suggesting that pressure on house prices might in due course begin to ease. The price expectation balance from the RICS survey had fallen back on the month.

Supply, costs and prices

20 CPI inflation had fallen to 1.5% in May from 1.8% in April. In line with the usual pre-release arrangements, an advance estimate for CPI inflation of 1.9% for June had been provided via the Governor to the MPC ahead of publication. This was around 0.4 percentage points higher than Bank staff's expectations and would require further analysis. Although the full details were not yet available, it seemed possible that a substantial part of the surprise had resulted from unexpectedly strong clothing and footwear prices, perhaps in part reflecting the scale and timing of the summer sales.

21 Employment had continued to increase robustly, both in numbers employed and hours worked, and by more than the Committee had expected at the time of the *May Report*. In the three months to April, the number of people in employment had risen by almost 350,000, the strongest increase on record and one largely accounted for by a pickup in full-time employees. Average hours worked had also risen further. In an accounting sense, this increase in employment had been met by both an increase in labour force participation and a fall in unemployment; the unemployment rate had fallen to 6.6%. When combined with activity growth at or above longer-term averages, this implied further disappointment in productivity, with measured output per hour likely to have changed little in the first half of the year.

22 In contrast to the strength of employment, wage growth had been surprisingly weak. Annual growth in average weekly earnings (AWE) had fallen to 0.7% in the three months to April, from 1.4% in the three months to January. The effect of the timing of bonus payments in 2013 would act to depress annual growth further in May. Regular pay growth had fallen to 0.9% over the same period, around half a percentage point lower than expected at the time of the *May Inflation Report*.

Half a percentage point of the weakness in AWE growth reflected a compositional effect: employment growth over the past year had been concentrated in lower-paid sectors. Perhaps relatedly, recent employment growth had been more heavily skewed towards those in lower skilled occupations.

23 The Committee considered two possible explanations for the contrasting wage and employment data. The first was that the lags between any tightening in the labour market and an increase in wages were longer than the Committee had previously judged. If this were the case, the increase in employment over the past year would in due course feed into higher wages. Consistent with this view, some survey indicators of wage growth had been rising for some time, most notably the REC survey measure of the pay growth of new employees. This had risen to a record high, reflecting firms' reported difficulties hiring suitable workers. This could feed through into average wages as job-to-job churn returned to more normal levels and existing workers demanded commensurately higher pay to prevent them, too, seeking alternative employment as a means of achieving higher income. Growth in measured average pay could then pick up quite sharply. However other measures, including the aggregate data from Lloyds Banking Group on salary payments into customer accounts, were more consistent with the official data. More generally, the Committee noted that these indicators had not been, historically, unerring predictors of AWE growth.

24 An alternative explanation was that the effective supply of labour had increased, resulting in a greater degree of slack and so restraining wage growth. This would be the case if individuals were willing to accept lower hourly wages than before, work increased hours at the same pay rate, or extend their working lives. Such decisions might have been prompted by a number of factors, including concerns about the adequacy of retirement provisions, changes to benefits or the weakness of current levels of income. The labour force participation rate had been remarkably resilient since the onset of the financial crisis, all the more striking in view of the natural demographic factors that would otherwise have been expected to reduce participation rates quite materially over the same period. It was also possible that the composition of labour demand had shifted in such a way as to make the generally lower-skilled and longer-term unemployed better able to compete for available jobs. Although it was unclear what the reason for such a shift could be, if it persisted, then it could bolster the pool of effective labour supply and restrain wage growth for longer than the Committee had assumed. It was possible that elements of both explanations were at play to different extents in

different parts of the labour market. The Committee would consider these and other possible explanations more fully in its preparations for the August *Inflation Report*.

The immediate policy decision

25 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. It remained the case, however, that the actual path for monetary policy, even after the first increase in Bank Rate, would remain dependent on economic conditions.

26 The ultimate strength of the expansion would depend in part on how resilient overseas demand was: if growth were materially stronger in the United Kingdom than in its main trading partners, this could widen the current account deficit. Although the weakness in US activity in the first half of the year might well prove temporary, the fall in productivity and the lower level of labour force participation, particularly when set alongside the adjustment still required in the euro area, highlighted the changes in the global economy following the financial crisis.

27 By and large, however, global financial markets continued to be relatively unresponsive to both economic risks and geopolitical events. Market measures of uncertainty about future asset prices suggested that, for a wide range of assets, it was surprisingly low. Some increase in volatility was likely as the monetary stance became less expansionary in advanced countries.

28 Financial markets continued to expect Bank Rate in three years' time to be around 2½%, materially lower than the pre-crisis average of around 5%. As set out in the February *Inflation Report*, this could reflect a number of structural and demand factors, such as higher credit and risk premia, and the repair of public and private sector balance sheets. Over the month, however, shorter-term interest

rates in the United Kingdom and sterling's exchange rate had risen. Both had been drifting up in recent months, perhaps reflecting the relative performance of the UK economy.

29 There had been some volatility in the monthly indicators, but sustained economic momentum was generally looking more assured. Growth in the first half of the year appeared to have continued at rates at or slightly above longer-term averages, and the mix of expenditure growth had broadened further. Although there were as yet no firm signs, there were some tentative indications that the modest slowing in output growth that the Committee had foreseen would begin to take place in the second half of the year. This was most evident in the housing market. The fall in mortgage approvals, which had extended into its fourth month, suggested that activity in the housing market was slowing. Some of this slowing was probably linked to the impact of reforms associated with the Mortgage Market Review and could well persist. But even if lenders returned to a more normal level of business by mid-summer, the impact on borrowers' behaviour might prove more durable and might slow growth in expenditures associated with moving house. In addition, the FPC had, during the month, made two recommendations to mitigate risks to indebtedness from the housing market. It was too early to tell what impact these would have. The MPC was currently of the view that the measures were unlikely to affect the central projection for housing activity and prices, but they might have an impact on lenders' and borrowers' expectations. Taking all these factors together there was some expectation that, when the Committee came to update its forecast, the outlook for activity in the housing market would be slightly less strong than it had previously thought.

30 CPI inflation had risen unexpectedly to 1.9% in June. This would require further analysis, but it might in part have reflected a change in the timing of summer sales compared with 2013. Further out, the path for inflation would depend in large measure on how quickly spare capacity was absorbed, and the impact this would have on wages and firms' pricing power. The weakness of wages in the face of strong rises in employment was becoming more striking, and there was reason to believe both that reductions in labour market slack were taking longer to affect wage growth, and that the effective supply of labour had increased. Given the contradictory signals from employment and wages, uncertainty about the degree of slack had risen on the month and, in light of this uncertainty, an argument could be made for putting more stress on the expected path of costs, particularly wages, in assessing inflationary pressures. The Committee would have the opportunity to consider in more

depth the signal to take from the various indicators on the labour market during the preparations for the *August Inflation Report*.

31 The Committee considered alternative interpretations of the data that might have different implications for monetary policy. On one interpretation, the risk of a small rise in Bank Rate derailing the expansion and leaving inflation below the target in the medium term was receding as that expansion became more established. Some survey indicators of wage growth had already picked up materially and, although the degree of slack was highly uncertain, it was likely that it was being absorbed more rapidly than had been envisaged in the *May Inflation Report* projection. Because estimates of the level of spare capacity had become more uncertain there was a case for setting policy with some reference to the rate at which it was being used up. A rise in Bank Rate at a time when the economy was growing strongly would facilitate a more gradual path thereafter and would allow the Committee to evaluate the sensitivity of households, firms and financial markets to changes in interest rates, following a long period during which Bank Rate had remained unchanged.

32 On an alternative interpretation, although the domestic economy was growing at or above longer-term average rates, there was little indication of inflationary pressures building and there was uncertainty as to whether there had been a more structural change in the relationship between the labour market and inflation. Moreover, there were early signs that global growth was weakening, and an unexpected increase in interest rates when real wages were not yet rising could lead to an outsized reaction in asset prices and destabilise the recovery. On the central projection from May, conditioned on very gradual increases in interest rates, inflation had been forecast to return to the 2% target only after three years. A premature tightening in monetary policy might leave the economy vulnerable to shocks, with the effectiveness of any further stimulus uncertain.

33 Members put different weights on each element of these interpretations. Members had no preset timing for the first increase in Bank Rate, which would be driven by the data. Against this backdrop, the Committee agreed that no increase was warranted at this meeting, although for some members the decision had become more balanced in the past few months than earlier in the year.

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, the Committee voted unanimously in favour of the proposition.

Regarding the stock of purchased assets, the Committee voted unanimously in favour of the proposition.

35 Finally, on behalf of the Committee, the Governor expressed his appreciation to Paul Fisher for the personal contribution he had made to the implementation of monetary policy, and to the work of the MPC since becoming a member in 2009.

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
Paul Fisher
Kristin Forbes
Andrew Haldane
Ian McCafferty
David Miles
Martin Weale

James Richardson was present as the Treasury representative.