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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

5 and 6 March 2014

These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 March 2014.

They are also available on the Internet
http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1403.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 9 and 10 April will be published on 23 April 2014.

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5 AND 6 MARCH 2014

1 Before turning to its immediate policy decision, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and supply, costs and prices.

Financial markets

2 The main events affecting market prices during the month had been, domestically, the publication of the February 2014 *Inflation Report* and, internationally, developments in emerging economies, especially Ukraine.

3 The February *Inflation Report* had set out the Committee's updated macroeconomic projections and further policy guidance that would apply once the 7% threshold for the unemployment rate set by the Committee in August 2013 had been reached. Short-term sterling interest rates had risen following the publication of the *Report*, with market contacts suggesting that this had largely reflected the unexpectedly strong projection for UK output growth in 2014 contained therein. Short rates had fallen back as the month had progressed, partly reflecting international developments, before rising in the days before the Committee's meeting. More broadly, it was notable that, abstracting from short-term fluctuations, the expectations implied by market prices of the date of the first increase in Bank Rate and the likely pace of increases thereafter, as well as the implied volatility of short rates, had changed little since shortly after the MPC's initial policy guidance had been announced in August 2013. Ten-year government bond yields had been stable over the month in the United Kingdom, and had fallen fractionally in the United States and Germany.

4 The sterling effective exchange rate index had appreciated following the publication of the February *Report*, and was up by around 1½% since the Committee's previous meeting. Market contacts ascribed these movements in part to improved optimism regarding growth in the United Kingdom relative to its major trading partners and in part to investors seeking relatively safe assets following the intensification of political tensions between Ukraine and Russia.

5 Notwithstanding those increased tensions, financial conditions in emerging markets had, in the main, stabilised in February relative to the turbulence seen the previous month. Exchange rate movements had been relatively modest, with the currencies of Argentina, South Africa, Turkey and Indonesia all appreciating. The Chinese renminbi had depreciated against the US dollar by around 1½% since mid-January. Market participants believed this depreciation to be an attempt by the Chinese authorities to counter the perception that the renminbi would always appreciate.

6 The UK FTSE All Share index had risen by around 5% over the month. The US S&P 500 index had risen by 7% and the Euro Stoxx index had increased by 6%. There remained little sign that volatility in emerging economies had caused contagion to the euro-area periphery, where long-term government bond yields had continued to fall.

The international economy

7 Developments in the international economy had been mixed. The easing of tensions in some emerging economies had been accompanied by signs of further modest recovery in the euro area. But this had been set against disappointing data releases in the United States and Japan.

8 In the United States, fourth-quarter GDP growth had been revised down by 0.2 percentage points to 0.6%. The increase in non-farm payrolls in January had been subdued. Industrial production and retail sales had both fallen at the start of the year. It was probable that the unusually cold weather had been an important factor behind this weakness, although the extent of that effect was uncertain. The Markit manufacturing Purchasing Managers' Index (PMI) had recovered in February, although the corresponding services survey and the similar ISM index had both weakened sharply. Bank staff expected GDP growth to soften in the first quarter of 2014, before bouncing back in the second. The reduction of the drag on growth from fiscal consolidation, along with the greater certainty afforded by the extension of the federal government debt ceiling, seemed likely to support growth in the year ahead.

9 Data on the euro area had been consistent with continuing modest recovery. GDP growth in 2013 Q4 of 0.3% had been in line with the Committee's expectation, and rates of unemployment had in recent months begun to decline in several periphery countries. The composite PMI had continued to edge up in February, so that Bank staff now expected growth in 2014 Q1 to be slightly stronger than that seen in Q4. In Germany, industrial new orders had risen by 1.2% in January. Area-wide HICP

inflation had remained at 0.8% in January, well below the ECB's target. To the extent that this was a reflection of weak nominal growth in those countries that needed to restore lost competitiveness, then sub-target inflation might persist for some time in the absence of further policy measures. Longer-term measures of inflation expectations had so far remained broadly stable.

10 Japanese GDP had increased by 0.3% in 2013 Q4, which was less than expected. The data in the Asian and other large emerging economies had been mildly encouraging. Indian output had increased by over 1% in 2013 Q4, while Brazilian GDP growth in the same period had been stronger than many had expected at 0.7%. Near-term indicators in China had softened, however. The Chinese authorities had stated that their growth target was around 7½%.

11 The political situation in Ukraine was serious and the economy itself was fragile. The IMF estimated that output had fallen by 0.3% in 2013 and the current account deficit was more than 8% of GDP. The new government had applied for financial assistance from the IMF. During the month, political tensions with Russia regarding Crimea had increased. The direct trade and financial linkages between the United Kingdom and Ukraine were limited, so the most important impact from a more serious deterioration in the situation there would probably come from any general rise in risk premia and via commodity markets – in particular the prices of gas, oil, and grains. Those prices had increased a little in the days leading up to the Committee's meeting as tensions with Russia had escalated.

Money, credit, demand and output

12 Estimated GDP growth in 2013 Q4, at 0.7%, had not been revised in the ONS's second release. On the basis of historical revision patterns, and given the strength of business surveys during the quarter, Bank staff's central estimate for the mature data remained at 0.9%. There had been little news regarding the near-term outlook for output, either. Although some of the latest activity indicators, such as retail sales and vehicle registrations, had been a little softer than expected, the signal from business surveys of activity had remained strong. The Markit/CIPS indices of activity in February had remained at an elevated level, and the CBI survey balance of service sector business optimism had reached a record high. The staff's central expectation of growth in 2014 Q1 remained at 0.9%, with growth in the second quarter expected to be only fractionally weaker than that.

13 The latest GDP release had contained the first breakdown by expenditure component for the fourth quarter, as well as revisions to estimates of component-level growth over the past year. The Committee had been concerned that the recovery had seemed unbalanced to date, being very reliant on household consumption and dwellings investment. The latest vintage of data somewhat reduced that concern. Estimates of growth over the past year had been revised so that the level of consumer spending was ½% lower than the Committee had expected at the time of the February *Inflation Report*, and the level of dwellings investment was 3% lower. This meant that, rather than accounting for all of the demand growth of the past year, consumption and dwellings investment together now accounted for two thirds of total growth – a little less than their combined share in the level of output. By contrast, the level of business investment was estimated to have been 2% higher in the fourth quarter than the Committee had anticipated in February and it had accounted for a quarter of the growth over the previous year. Although early estimates of expenditure data were to be treated with caution, these implied that the broadening of the recovery that the Committee had expected from household to business spending might have already begun.

14 Given the continued buoyancy of the housing market, housing investment remained set to make a substantial contribution to GDP growth over the coming year. Loan approvals for house purchase in January had been over 40% higher than a year earlier and were now back to around 70% of their average level prior to the crisis, although this had not yet translated into a significant increase in net secured lending. According to the average of the main lenders' indices, annualised house price inflation had reached around 10% in the three months to February. The Land Registry index of house prices in England & Wales had, however, risen by much less in recent months, increasing by just over 4% at an annualised rate in the three months to January. The Bank of England/NoP survey conducted during February had included a question regarding households' expectations of house-price inflation over the coming year. The median response had been for a 3% rise – perhaps somewhat lower than might have been expected given the current pace of price appreciation. The outlook for the housing market would depend on the terms and conditions under which banks were willing to expand lending. In part, these would depend on banks' tolerance of any widening in the gap between household lending and deposits, as well as the effect of the implementation of rules on affordability criteria following the Mortgage Market Review.

15 During the month, the Bank had published the final quarter's data regarding the usage and lending for the first part of the Funding for Lending Scheme (FLS). In the final quarter of 2013, participants had lent £5.8 billion in excess of repayments to UK households and businesses. In the

18 months to 2013 Q4, net lending by participants to UK households and businesses had been £10.3 billion, more than accounted for by building societies' lending. Net lending to both households and businesses had been stronger than forecast prior to the announcement of the Scheme, although all of the absolute increase in net lending could be attributed to lending to households. At the end of 2013, the Bank and HM Treasury had announced that the terms of the FLS extension would refocus the Scheme towards business lending in 2014. The 34 groups that had signed up to participate in the FLS extension had initial drawing allowances summing to £32.7 billion.

16 Business investment was estimated to have grown by 8.5% in the year to 2013 Q4. As such, the official data, at least in the second half of 2013, accorded more closely with the strength implied by surveys of investment intentions and intelligence gathered by the Bank's Agents around the United Kingdom. The refocusing of the FLS was expected to support capital spending over the coming year. For some projects, however, such as the development of intellectual property, equity financing was a more natural source of funding than bank loans.

Supply, costs and prices

17 Twelve-month CPI inflation had fallen from 2.0% in December to 1.9% in January, fractionally lower than Bank staff's central expectation. This was mostly explained by movements in prices that were not expected to persist. Consequently, the staff's central expectation for CPI inflation over the coming months was broadly unchanged from that published in the February *Inflation Report*. In that projection, inflation fell a little further over the coming months and then rose back to around the 2% target in April.

18 CPI inflation had fallen by one percentage point since June 2013. Most, but not all, of the fall was explicable in terms of easily identifiable and understandable factors: smaller contributions from tuition fees, airfares, and energy and food prices. Notwithstanding the recent declines, the contributions to CPI inflation of utility prices and tuition fees remained abnormally high – around 0.3 percentage points in excess of their average combined contribution between 2002 and 2005. Moreover, despite sterling's gradual 10% appreciation over the past year, the Committee judged it most likely that the contribution to CPI inflation from imported prices remained slightly positive, reflecting the pass-through of past increases in world prices. Abstracting from those factors implied that the remaining domestic prices had in aggregate been rising at a pace below the 2% target, reflecting the remaining degree of slack in the economy. The MPC expected domestic inflationary

pressures to rise somewhat over the next few years as the degree of spare capacity lessened and wage growth returned to more normal levels. But, as described in the February *Inflation Report*, this was expected to be offset by a waning of external prices pressures, leaving CPI inflation close to the target rate over the next few years.

19 There were many risks to that central expectation, however. Regarding external price pressures, sterling had appreciated by another 1½% during the month, and it was possible that this gradual appreciation would continue if prospects in the United Kingdom continued to be seen as increasingly favourable relative to those of its main trading partners. The degree to which such an appreciation fed through to CPI inflation was uncertain, and would depend on how far it was absorbed within the supply chain. Currently, the Committee assumed that some of the appreciation would be offset by an increase in domestic importers' and foreign exporters' margins. In the other direction, there was a risk that any further intensification of political tensions between Ukraine and Russia might cause a material increase in the international prices of grain and energy supplies.

20 In terms of domestic inflationary pressures, there were risks surrounding the degree of spare capacity in the economy and the resulting outlook for productivity and wage growth. Following several months of declines, the headline LFS unemployment rate had risen to 7.2% in the three months to December, compared with 7.1% in the three months to November. At face value, this implied a slowing in the pace at which spare capacity was being eroded. There were reasons to believe that unemployment would continue to decline over the coming months, however. Vacancies had continued to rise in January and the more timely claimant count measure of unemployment had continued to fall. Surveys of businesses' employment expectations and activity at recruitment consultancies had remained robust.

21 Of the lower than expected 193,000 increase in employment in 2013 Q4, 172,000 had been accounted for by an increase in self-employment. It was possible that some of these individuals were, in reality, underemployed, and so represented spare economic capacity that could be drawn upon as demand recovered without generating upward pressure on wages or prices. In this case, the unemployment rate would be understating the degree of slack in the economy. There was some evidence, for instance, from HMRC data that the pay of the self-employed had worsened relative to that of employees in recent years, perhaps indicative of lower output or fewer hours worked. But, against that, it appeared that self-employment had grown most in those sectors that were estimated to

have seen increases in output at the end of 2013 – for example, the construction sector and a range of service sectors.

22 There were, however, reasons to think that the degree of spare capacity might be smaller than suggested simply by looking at the number of people out of work. For instance, the unemployed, a group in which the young were disproportionately represented, tended subsequently to gain work at lower hourly wage rates than the average of those already in jobs. If that were indicative of lower average productivity levels, then increases in employment might at the margin add less to the productive capacity of the workforce than factored into the Committee's projections. Members of the Committee attached different weights to the pieces of evidence regarding the degree of spare capacity in the labour market.

23 The softening of employment growth in the fourth quarter of 2013, alongside the Committee's GDP backcast, which implied that the concurrent output data would, in time, be revised to show a growth rate of 0.9%, meant that productivity growth appeared to have increased to around its historical average quarterly rate of about ½%. According to the current vintage of data, the growth of productivity now appeared to have recovered gently over the past 18 months from its trough in mid-2012. Whether a recovery in productivity would be sustained, however, remained a key uncertainty.

24 In time, any further recovery in productivity would be likely to feed into real wage growth. The annual growth rate of private sector regular nominal pay had increased a little more than anticipated, to 1.3% in 2013 Q4 from 1.1% in Q3. This was likely to increase further in 2014 Q1, boosted by a small impact on annual regular pay growth of the effect of tax forestalling in 2013. According to the data compiled by Incomes Data Services (IDS), three-month average median wage settlements had increased in January, the beginning of a critical few months for pay settlements. A broader measure of settlements including the IDS data and weighted so as to match the sectoral make-up of the economy, indicated that settlements had remained stable at around 2% in January. During the month, the Low Pay Commission had recommended that an increase in the National Minimum Wage (NMW) of 3% should come into effect in October 2014. The Government had indicated publicly that it was minded to accept that recommendation. Although the NMW directly affected only around 5% of the workforce, previous research had indicated that its adjustment could also influence pay rates further up the wage distribution.

25 As well as the evolution of productivity and spare capacity, pay growth would be affected by expectations of general inflation. Measures of expected inflation derived from prices in financial markets had fallen fractionally over the month. Surveys of households' inflation expectations, however, had seen some reasonably large falls. The Bank of England/NoP survey of inflation expectations one year ahead had fallen sharply in 2014 Q1. And the Citigroup measure had fallen for the fourth consecutive month in February. Looking five years ahead, the Bank/NoP measure had fallen by ½ percentage point in the first quarter. The Citigroup measure of expectations five to ten years ahead had fallen by 0.2 percentage points in February, and by 0.9 percentage points since October 2013. The majority of these survey-based indicators were at or a little below their series averages.

The immediate policy decision

26 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 2013 *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 purchased assets 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).

27 At the time of the February *Inflation Report*, unemployment had remained above 7%, and the Committee had judged that none of the three knockouts had been breached. Therefore, the August 2013 policy guidance had remained operative. Nevertheless, it seemed quite likely that the unemployment rate would fall to 7% during the following few months. In that light, the Committee had judged it appropriate to issue further guidance regarding the setting of monetary policy once the unemployment threshold was reached. That guidance had been described in the February *Report*. The market reaction to that guidance, as well as the updated macro-economic projections contained within the *Report*, had been limited. This suggested that the updated guidance had not been mistakenly interpreted as signalling the prospect of a markedly different monetary stance. Indeed, expectations for the future path of Bank Rate had been relatively stable since the Committee had first announced its

policy guidance in August 2013, and the level of uncertainty around the expected path of Bank Rate over the next year implied by market prices had been historically low.

28 Employment growth had slowed a little in the three months to December such that the LFS unemployment rate had risen fractionally and had remained above the 7% threshold set out in the Committee's policy guidance of August 2013. The Committee's assessment of the outlook and immediate policy decision would therefore continue to be framed with reference to guidance provided in August, including the three knockout conditions specified at that time.

29 Overall, the implications for Committee members' views on the outlook from the news during the month had been fairly limited. Overseas, weaker news from the United States, perhaps related to the weather, had been offset by further signs of a continued modest recovery in the euro area. The financial market reaction to events in Ukraine had, so far at least, been surprisingly muted. Outside Ukraine and Russia, there had been some improvement in financial conditions in emerging markets. UK financial conditions had tightened a little on the month, with a small increase in short-term interest rates and a further 1½ % appreciation of sterling. Realised and implied volatility in a broader range of financial markets remained low by historical standards. Nevertheless, developments in emerging economy financial markets, in particular over the past year, served to highlight the challenges as monetary policy in the advanced economies was brought back to a more normal setting.

30 At home, the latest aggregate GDP data for 2013 Q4 and revisions to previous quarters contained little news. But, at the component level, they suggested that the recovery over the past year might not have been as reliant on the household sector as it had previously appeared. In particular, there were initial signs that the anticipated broadening from household to business spending might have already begun. Even so, there remained some way to go to ensure that the recovery was both balanced and sustainable. Headline inflation had fallen to below the target for the first time in over four years. Wage growth had edged up, although it remained weak relative to both historical standards and the steer given by survey indicators of pay growth.

31 Regarding the knockout conditions, there was a range of views among Committee members over the outlook for inflation in the medium term. But all members agreed that the probability of inflation being above 2.5% in 18-24 months time remained less than 50%. If anything, the appreciation of sterling on the month made that prospect a little less likely than it had been at the time of the

Committee's previous meeting. Moreover, while market-based measures were little changed, the news on survey measures of households' inflation expectations had been to the downside.

32 The FPC had not met since 20 November 2013 when it 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.

33 All Committee members agreed that neither of the price stability knockout conditions that would override the policy guidance provided in August 2013 had been breached; and there had been no change to the FPC judgement that the financial stability knockout had not been breached. With unemployment remaining above the 7% threshold, the Committee's August 2013 policy guidance therefore remained in place and no member thought it appropriate to tighten, or to loosen, the stance of monetary policy at the current juncture.

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 In the light of the Committee's forward guidance, and as described in a market notice of 6 March 2014, the Committee agreed to reinvest the £8.1 billion of cash flows associated with the redemption of the March 2014 gilt held in the Asset Purchase Facility.

36 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.