

Publication date: 22 October 2014

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING

7 and 8 October 2014

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 October 2014.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1410.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 5 and 6 November will be published on 19 November 2014.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 OCTOBER 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 combination of generally weaker news on the global economic outlook and continuing geopolitical risks in a number of regions had weighed on market sentiment and pushed down on risky asset prices.

3 In the United Kingdom, moves in short-term interest rates and in the sterling exchange rate ahead of the referendum on Scottish independence had largely unwound. Short-term interest rates had ended the month slightly lower and the date at which a 25 basis point increase in Bank Rate was fully priced into overnight index swap (OIS) rates had shifted out by around two months to July 2015. This was later than expected by the majority of respondents to the Reuters survey who thought that the first rise in Bank Rate would be in the first quarter of 2015. After the first increase, the path of Bank Rate implied by OIS rates had remained shallow and the implied level of Bank Rate in three years' time was a little under 2%.

4 Short-term interest rates had increased a little in the United States: the one-year OIS rate one year forward had risen by around 10 basis points. This was partly in reaction to the release of strong non-farm payrolls data towards the end of the month, but it also followed a slight upward revision of the federal funds rate projections of Federal Open Market Committee participants in September. The timing implied by OIS rates of the first policy rate increase in the United States was now only two months later than in the United Kingdom.

5 Following its September meeting, the Governing Council of the European Central Bank (ECB) had announced further reductions of 10 basis points in its main refinancing, marginal lending and deposit rates alongside plans to purchase asset-backed securities and covered bonds. These asset purchases were intended to complement the targeted longer-term refinancing operations (TLTROs) that had previously been announced. Take-up of that scheme in the first auction in September had been a little over €80 billion, lower than market contacts had expected but within the range of values expected by the ECB. Short-term interest rates in the euro area had fallen following the ECB rate cuts and the forward OIS curve was negative out to late 2016.

6 The divergent expected paths of short-term interest rates in the major economies had been reflected in foreign exchange markets. The US dollar effective exchange rate had appreciated by 2.8%, while the euro had depreciated by 1.9%. Sterling had fallen ahead of the referendum on Scottish independence, but had subsequently risen to end the month 0.5% higher in effective terms, still close to the top of the trading range established since its large depreciation in 2008.

7 There had been some further falls in longer-term nominal interest rates. Since the beginning of the year, five-year government bond yields, five years forward, had fallen by between 130 and 140 basis points in the United States, Germany and the United Kingdom. Around 20 to 50 basis points of this decline reflected a reduction in implied inflation rates, but the main part of the fall was accounted for by lower real interest rates. This in turn appeared mainly to reflect lower term premia rather than reductions in medium-term policy rate expectations, which appeared to have fallen by less.

8 Risky asset prices had fallen on the month, despite continuing reductions in risk-free rates, and equity market volatility had increased. Equity prices had fallen internationally, with the major indices lower by between 3%, in the United States, and 5%, in the United Kingdom and emerging markets. It was likely that those falls had reflected a modest downgrade of the most likely outcome for global growth, although they could also have reflected a more pessimistic view of the tail risks and some reduction in risk appetite. A reduction in risk appetite might also help account for lower term premia on some government bonds. High-yield US dollar corporate bond spreads had increased by over 50 basis points during the month; equivalent sterling spreads had risen by 40 basis points.

The international economy

9 Once again, the news on global activity and inflation had, on balance, been modestly to the downside, particularly in the euro area, Asia, and the emerging economies. Indicators of manufacturing output had weakened in many economies.

10 There was growing evidence of continued weakness in euro-area activity. For example, there had been further broadly based declines in the purchasing managers' indices (PMIs) in September to a level consistent with only modest growth. Bank staff's forecast of average quarterly growth in the second half of 2014 had been shaded down to 0.2%.

11 Within the euro area, the loss of momentum was especially notable in Germany. Quarterly growth had averaged only 0.3% in the first half of the year, less than Bank staff had previously expected, with the weakness associated with lower-than-expected exports and strong import growth. German industrial production had fallen by over 4% in August. Given its export-focused economy, Germany was more vulnerable than many other countries to shifts in global demand. It was likely that German exports and imports had been affected to some extent by continuing rebalancing in the euro-area periphery countries and the slowdown in growth in the emerging economies. The direct effect on Germany of trade sanctions imposed between Russia and the European Union, and any deterioration in the Russian macroeconomic outlook, was likely to be limited. But, while goods exports to Russia represented only a small share of German exports, it was likely that there had been a larger indirect effect on German business confidence, which had deteriorated in recent months. That, together with a weaker export outlook, was likely to dampen the prospects for fixed investment and domestic demand more generally.

12 Euro-area inflation remained very low and had fallen, on the flash estimate, to 0.3% in September, from a revised 0.4% in August. Core inflation had fallen to 0.7%. Euro-area inflation expectations implied by financial markets had continued to drift down and longer-term forward inflation rates remained below 2%.

13 The news on emerging economies was a little to the downside. Annual growth in Chinese industrial production had slowed to 6.9% in August, the lowest rate since December 2008, and GDP growth in Q3 was likely to be a little weaker than had previously been expected. It was unclear how

the outlook would be affected by political unrest in Hong Kong. In other emerging economies, tighter monetary policy since the start of the year had weighed on the growth outlook.

14 Data outturns in the United States had been more positive than in other countries. Q2 GDP had been revised up further in the third release, with the economy estimated to have grown by 1.1%. Bank staff's estimate of growth in Q3 had also been revised up a little to 0.8%. But the Q3 revision had largely reflected news on inventories and net trade, both of which were erratic, and it was possible that this pace of expansion would not be maintained. Non-farm payrolls had grown by 248,000 in September, continuing the steady rate of employment growth seen through most of the year. This had been associated with weaker productivity growth, which might mean that the sustainable growth rate of the US economy, already expected to slow on account of demographic changes, would be a little lower than previously thought.

15 There had been further significant falls in the US dollar prices of commodities: industrial metals prices had fallen by around 5%, and oil prices had fallen by close to 10%. Lower oil prices appeared to reflect subdued global demand against a background of rising supply. The upward-sloping oil price futures curve was consistent with some of the weakness in oil prices being expected to be temporary.

Money, credit, demand and output

16 In contrast to much of the global economy, activity in the United Kingdom around the middle of the year had continued to grow at a pace slightly above its long-term average. But there were increasing indications that the slight slowing in the pace of expansion towards the end of the year that the Committee had been expecting for some time would indeed occur.

17 A substantial amount of new data had been released by the ONS in the 2014 *Blue Book*. As had been previously highlighted by the ONS, this contained significant revisions to the UK National Accounts, mostly relating to years before 2013. The new data contained relatively little news concerning the recent path of GDP growth. The third estimate of GDP growth in Q2 had been revised up a little to 0.9%, and upward revisions to growth in earlier years meant that the level of GDP was estimated to be 2.7% higher than its pre-crisis peak.

18 Bank staff continued to expect GDP growth in the final vintage of data for Q3 to be 0.9%. This was consistent with a range of monthly indicators. The composite CIPS output series had fallen in

September to its lowest level since mid-2013, but remained high. There had also been an easing in BCC activity balances that was more pronounced in manufacturing than services. Industrial production had been flat in August, following growth of 0.4% in July.

19 The slight loss of momentum in the monthly indicators in September and a fall in some of the survey expectations balances were consistent with Bank staff's expectation that GDP growth in the final vintage of data for Q4 would slow to 0.8%. It was possible that this would be associated with some slowing in UK export growth, consistent with a marked weakening in export orders across the manufacturing business surveys. While the relationship between the official trade data and the surveys was not strong, contacts of the Bank's Agents had also reported a slowing in manufacturing exports growth in response to a softening in global demand, adverse geopolitical developments and the higher value of sterling.

20 The news on the corporate sector had generally been positive. Some of the positive news was due to revisions in the 2014 *Blue Book* suggesting that both the profit share and investment growth in recent years had been higher than previously thought: business investment was estimated to have accounted for almost one third of GDP growth since the trough rather than 6% in the previous vintage of data. The revised pattern of investment growth was now more consistent with a range of business investment survey indicators that had remained strong throughout the period. Other news had pointed to a further improvement in corporate credit conditions, especially for large companies. The latest *Deloitte CFO Survey* of predominantly large firms had reported that the cost and availability of credit had become more favourable. Gross bank lending to small and large businesses had picked up strongly in the year to date, although net lending had remained subdued reflecting continued high levels of debt repayments. Improved credit conditions, together with the stronger pace of capital accumulation in the revised data, could increase confidence in the Committee's August *Inflation Report* projections that business investment would continue to support growth. Recent discussions with corporate treasurers of large UK companies also suggested that access to finance was not considered to be a barrier to investment. But, to the extent that investment in the recent past had been higher than previously thought, it was also possible that there might be less need for as much investment in the future. On that argument, the 2014 *Blue Book* revisions might have slightly increased the downside risks to the business investment forecast.

21 The outlook for the housing market had weakened on the month. Having risen strongly in the second half of 2013, mortgage approvals for house purchase had turned down in the early part of 2014

and had since failed to recover. At 64,000 in August, they were again weaker than Bank staff had expected. The Bank's *Credit Conditions Survey* had pointed to a temporary reduction in the availability of secured credit in Q3, partly attributable to operational issues associated with the implementation of the Mortgage Market Review that were reported to have largely dissipated by July. Some lenders had also reported some effect from the Financial Policy Committee's recommendation limiting lending at high loan to income ratios, although the effect on mortgage approvals was likely to have been small. The continued weakness in approvals was now thought likely to reflect more persistent factors in the mortgage market that reduced the availability of credit to some borrowers. This might have made it more costly or difficult for some mortgaged homeowners to move house. Consistent with this, the RICS survey for September had shown a negative balance for both new buyer enquiries and new instructions to sell. House price data had also weakened by more than expected. The Nationwide house price index had fallen by 0.2% in September. While the more volatile Halifax index had risen by 0.6%, after being flat in August, the three-month on three-month growth rate of the average of the lenders' indices had dropped below 2% for the first time in over a year. The weaker outlook for the housing market was likely to lead to some softening in the prospects for housing investment.

22 The measured level and past profile of the household saving ratio had been revised substantially in the 2014 *Blue Book* with possible implications for the likely future path of household spending. The revised saving ratio was 6.7% in Q2, closer to its pre-crisis low than in the previous vintage of data. Whether households would be willing to allow saving to fall appreciably further was unclear, and would depend in part on whether the effect of higher uncertainty on precautionary saving was offset by the effect of low interest rates on bank deposits in discouraging saving.

23 The 2014 *Blue Book* had also contained a large downward revision to the United Kingdom's estimated net international investment position. Instead of being broadly balanced, the net international investment position had been revised down to a net liability position of around 20% of GDP on the official basis using historic cost valuation of FDI assets, with much of the deterioration now evident since the beginning of 2013. While this was consistent with recent large current account deficits, changes in the valuation of assets and liabilities meant that the Bank staff's estimate of the net international investment position at market value had not deteriorated and remained strongly positive. Nevertheless, there was a considerable margin of uncertainty around such estimates.

Supply, costs and prices

24 CPI inflation had fallen to 1.5% in August, from 1.6% in July. In line with the usual pre-release arrangements, an advance estimate for CPI inflation of 1.2% for September had been provided via the Governor to the MPC ahead of publication. This was 0.3 percentage points lower than Bank staff's expectations at the time of the meeting and 0.5 percentage points lower than incorporated into the *August Inflation Report* and would require further analysis. Although the full details were not yet available, the fall in inflation was reported to have been broadly based.

25 Employment had continued to increase, both in numbers employed and hours worked, but by less than the Committee had expected at the time of the *August Inflation Report*. In the three months to July, the number of people in employment had risen by 74,000, with part-time workers accounting for 68,000 of the increase. The unemployment rate had fallen by a little more than expected to 6.2% and the more timely claimant count measure of unemployment had fallen by 37,000 to 967,000 in August, its lowest level since August 2008. But there was other evidence suggesting that the pace at which slack was being absorbed might have slowed. The labour force participation rate had increased strongly in recent years, but it had fallen in the three months to July. That fall meant that participation was now a little further below the estimated potential level underlying the *August Inflation Report* projections, suggesting there was slightly more spare capacity in the labour market than previously thought.

26 There was no news in earnings growth in the recent data. Annual growth in whole-economy total pay had been 0.6% in the three months to July, as expected. Within this, public sector pay growth had been particularly weak. Private sector regular pay was growing at an annual rate of 1.0%, and remained lower than alternative measures of pay growth inferred from surveys and recruitment agencies, although these had shown little change on the month. Contacts of the Bank's Agents had reported that recruitment difficulties had broadened as the economy had strengthened and that there were increasing signs of churn in the labour market that might be associated with upward pressure on pay.

27 The Committee considered the signal that could be taken from a number of different possible measures of underlying inflation: inflation expectations; unit labour costs; and measures of costs and prices that stripped out the effects of import price inflation.

28 A broad range of measures of inflation expectations was broadly in line with the inflation target and suggested little sign of future inflationary pressure. According to the YouGov/Citigroup survey, households' median inflation expectations had ticked down in September to 1.9% at the one-year horizon, their lowest level since December 2009, and 3% at the five to ten year ahead horizon, below their pre-crisis average. Around 80% of respondents to the *Deloitte CFO Survey* of large companies expected CPI inflation to be between 1.5% and 2.5% in two years' time.

29 Unit labour costs for the whole economy were estimated to have fallen by close to 2% in the year to Q2. This measure had been distorted by a decline in the volatile non-wage component of labour costs as well as by base effects associated with tax forestalling. After stripping out estimates of these effects, unit labour costs had been broadly flat over the year to Q2. But, on any measure, growth in unit labour costs had been materially below the inflation target and their average growth rate since inflation targeting had been introduced in 1992.

30 Underlying inflationary pressure in the United Kingdom was being obscured to some extent by the effect of low import price inflation, itself driven by falling commodity prices, weak global inflation and the effects of the appreciation of sterling over the past year and a half. Nevertheless, measures of core inflation that attempted to strip out such effects had remained stable at subdued rates. There was also little sign of domestically generated inflationary pressure in the prices of goods and services that were less directly affected by import price inflation.

The immediate policy decision

31 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. In other words, the Committee's guidance on the likely pace and extent of interest rate rises was an expectation, not a promise.

32 While the pace of the recovery in the United Kingdom and the United States had been maintained, pessimism about the global economic outlook had increased over the month. Partly this was a reflection of geopolitical risks in the oil-producing regions of the Middle East and continuing tensions between Russia and Ukraine. It was also due to the steady accumulation of evidence that the outlook for the global economy had weakened, particularly in the euro area and many emerging economies. Greater pessimism had been reflected in risky asset prices and long-term interest rates, which had both fallen on the month. Oil prices had also fallen further, despite the tensions in the Middle East.

33 There was mounting evidence of a loss of momentum in the euro area, including in Germany, where growth appeared to have stalled and industrial production had fallen sharply. Euro-area inflation remained very low and had fallen to 0.3% in September. Implied inflation expectations had fallen further on the month and remained at low levels. The Governing Council of the ECB had announced new stimulus measures following its September meeting, including cuts in policy rates and asset purchases. Short-term forward interest rates in the euro area had fallen following the ECB rate cuts and the forward OIS curve was negative out to late 2016.

34 In contrast to the euro area, short-term interest rates had risen in the United States and, after some volatility ahead of the referendum on Scottish independence, had fallen only slightly in the United Kingdom. OIS rates implied that the timing of the first rise in Bank Rate had been pushed out by two months to July 2015, two months earlier than the implied first rise in the federal funds rate. Consistent with the direction of moves in the expected paths of short-term interest rates in the major economies, the US dollar had appreciated by 2.8% and the euro had depreciated by 1.9%. Sterling had ended the month 0.5% higher in effective terms, but still 1.7% lower than its recent peak in July.

35 Activity in the United Kingdom around the middle of the year had continued to grow at a pace slightly above its long-term average. Upward revisions to investment in the 2014 *Blue Book* suggested that GDP growth was more balanced than it had appeared in the previous vintage of data. But there were signs of a slight loss in momentum from a number of indicators, including from the housing market and surveys of business expectations, consistent with the modest slowing in the pace of expansion that the Committee had been expecting for some time. The loss of momentum was especially pronounced in the traded goods sector where contacts of the Bank's Agents had reported a slowing in export growth in response to a softening in global demand, adverse geopolitical developments and the higher value of sterling. This highlighted the risk that it might be difficult for

the United Kingdom to grow much more quickly than its major trading partners for a prolonged period without a rising trade deficit.

36 CPI inflation had fallen back unexpectedly to 1.2% in September, 0.5 percentage points lower than the Committee had expected at the time of the August *Inflation Report*. While the fall in CPI inflation on the month would require further analysis, its low rate was consistent with currently weak price pressures: wage growth remained low; unit labour costs had fallen; and import prices were falling, driven by lower commodity prices, weak global inflation, and the higher level of sterling. This weakness in inflation also corresponded to similar downside surprises to inflation in some other countries.

37 Set against the evidence of weak inflation in the backward-looking data, the amount of slack in the economy had been diminishing and this was expected in due course to lead to a gradual pickup in inflation back towards the 2% target. But there continued to be a considerable degree of uncertainty about the amount of slack in the economy and the rate at which it was being used up. The unemployment rate had fallen by a little more than expected in the most recent data. Despite this, the labour force participation rate had also fallen and it was now estimated to be a little further below its potential level than previously thought. Analysis by Bank staff suggested that the output gap, while continuing to fall, was estimated to be slightly larger in the second half of the year than had been previously expected.

38 Against this backdrop, the Committee considered the level of Bank Rate currently appropriate to meet the inflation target.

39 For most members, there remained insufficient evidence of prospective inflationary pressure to justify an immediate increase in Bank Rate. These members put forward a number of arguments on which they each placed different weights. CPI inflation was 1.2% in September, partly reflecting lower import prices. While it was appropriate for policy to look through the near-term effects of lower import prices on CPI inflation when indicators of cost and price pressures remained consistent with inflation returning to the target in the medium term, CPI inflation had fallen relative to an already weak outlook. In the central projection contained in the August *Inflation Report*, CPI inflation was expected to reach the 2% target only at the end of the three-year forecast period even with the gradual and limited increases in Bank Rate implied by market rates.

40 For these members, there remained few signs of inflationary pressure in the UK economy, even after looking through the effects of a stronger sterling exchange rate. In particular, unit labour costs had fallen over the past year. Pay growth, which was likely to remain subdued in the public sector, was lower than was consistent with meeting the inflation target in the medium term. Household inflation expectations had fallen a little, although they continued to be well anchored to the inflation target. While the economy had been growing sufficiently quickly to absorb some of the slack in the economy, there were some signs that the pace of growth was beginning to ease. The housing market appeared to be cooling with house price growth slowing to a more sustainable pace. Further downside news in the euro area had increased the risks to the durability of the UK expansion in the medium term.

41 Set against this, the level of Bank Rate remained exceptionally low. But, in the view of these members, the stimulus that it provided could not be viewed in isolation from the various headwinds facing the economy. Those headwinds were likely to mean that the real rate of interest consistent with stable inflation over the medium term was likely to be lower than in the past, even after slack had been absorbed. Consistent with that, global real interest rates at longer maturities were significantly lower than before the crisis and had fallen further. A premature tightening in monetary policy might leave the economy vulnerable to shocks, with the scope for any stimulus that subsequently became necessary being limited by the effective lower bound on Bank Rate.

42 For two members, economic circumstances were sufficient to justify an immediate rise in Bank Rate. While CPI inflation was well below the target, this was partly the effect of the higher exchange rate and lower raw materials prices. Just as the Committee had looked through the first-round effects of external price pressures when they had pushed inflation up, it was appropriate to look through them at present when they were pushing inflation down. Keeping Bank Rate at its current level for too long to offset these effects risked unbalancing the recovery. While growth in the euro-area economy had been disappointing, so far, in contrast to 2011, the United Kingdom had not been affected by damaging financial contagion. 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 would nonetheless reach its estimated medium-term equilibrium level by the middle of 2015. Survey evidence of tightening in the labour market, including from the Bank's Agents, suggested that wage growth might pick up quite sharply as slack was absorbed. 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.

43 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.

44 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

Dave Ramsden was present as the Treasury representative.