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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 7 and 8 January 2015

These are the minutes of the Monetary Policy Committee meeting held on 7 and 8 January 2015.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2015/jan.pdf>

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 4 and 5 February will be published on 18 February 2015.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 7 AND 8 JANUARY 2015

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 pick-up in volatility and sizeable moves in some asset prices, partly reflecting greater political uncertainty associated with elections in Greece, more evidence of very low global inflation, and the consequences of further falls in oil prices for oil-exporting countries, particularly Russia.

3 Short-term interest rates in the United Kingdom and the United States had diverged. Whereas the one-year sterling rate one year ahead had declined by close to 20 basis points, the equivalent US dollar rate had risen by around 5 basis points. The timing implied by OIS rates of the first policy rate increase in the United Kingdom was now about 8 months later than that in the United States, and the date at which OIS rates reached 2% was around 8 years later. There had been little movement in short-term euro interest rates, which remained at very low levels.

4 The divergent expected paths of short-term interest rates in the major economies had been reflected in foreign exchange markets, where the US dollar effective exchange rate index (ERI) had appreciated by a further 3% on the month to a level 10% higher than a year earlier. The sterling ERI had fallen by 1% during the month, reflecting a 4% depreciation of sterling against the dollar. The sterling ERI was around 2% higher than a year earlier, 11% higher than its trough in 2013, and still close to the top of the trading range established since its large depreciation in 2008.

5 There had been significant further falls in longer-term nominal interest rates. Ten-year government bond yields had fallen by 30 to 40 basis points in the United Kingdom, United States and Germany, with the German rate moving below 0.5%. Reflecting greater political uncertainty, Greek ten-year government bond yields had risen by close to 300 basis points, though there had been negligible contagion to other euro-area periphery countries.

6 A significant part of the falls in longer-term nominal interest rates in the major economies had reflected lower compensation for expected future inflation: the UK five-year RPI inflation swap rate five years forward had fallen by 25 basis points, a similar decline to that seen in equivalent US and euro-area swap rates. Historically, at least in the US, these measures of inflation expectations had been correlated with changes in oil prices. But the UK RPI inflation swap rate of 3.2% remained close to its average over the preceding ten years, whereas the US and euro-area inflation swap rates, at 2.2% and 1.6% respectively, were both around 70 basis points below their ten-year averages.

7 It was not clear whether medium-term UK inflation expectations had genuinely held up more than elsewhere or whether there were market factors that had distorted the signal about inflation expectations that could be extracted from inflation swap rates. One possible reason why US inflation swap rates were correlated with changes in oil prices was that traders might prefer to deal in the most liquid inflation instruments which, in the United States, tended to be at longer maturities. If so, recent moves might have exaggerated the decline in medium-term inflation expectations in the United States. On the other hand, the activities of liability-driven investors might have pushed up implied inflation rates as they sought to hedge their inflation exposure. This would have particularly affected UK markets where defined-benefit pension funds were dominant and might help to explain why market-based measures of UK inflation expectations had not fallen further. While there was no hard evidence concerning hedging flows, market intelligence suggested that they had picked up towards the end of 2014.

8 Surveys of households did suggest that UK medium-term inflation expectations had fallen below past averages, although most surveys had relatively short historical time series. According to the YouGov/Citigroup survey, households' inflation expectations five-to-ten years ahead had fallen to 2.7% in December, 0.7 percentage points below the average since the series began in 2005. There was evidence that companies' inflation expectations had also fallen.

9 Members put different weights on the contrasting signals from household and market-implied measures of medium-term inflation expectations. The balance of evidence pointed to inflation expectations remaining well anchored to the 2% inflation target over the medium term. There was some concern about the recent pace of decline in all measures of inflation expectations, in the United Kingdom and internationally, especially as there could be more downside news on inflation to be digested. All members agreed that different measures of inflation expectations across major countries needed to be monitored closely in the months ahead.

10 Equity price indices had been volatile internationally, and had ended the month lower by 3.6% in the United Kingdom, 2.3% in the United States, and 5.8% in the euro area. Declines were more pronounced in the oil and other energy producing sectors.

The international economy

11 Oil prices had fallen further during the month. The spot price of Brent crude oil had fallen to \$50 per barrel, down \$20 on the month and \$32 lower than at the time of the November *Inflation Report*. The consequences of a lower oil price for the global economy would depend on the cause of the decline and how long it persisted.

12 It was likely that the majority of the fall in oil prices since the summer had been a reaction to news about global oil supply and changes in the behaviour of key oil producers, although lower-than-expected oil demand was also likely to have played a significant role. In recent months, higher global oil production had been driven by greater Libyan and US output, supplementing a more generalised longer term rise in supply that had raised oil inventories. While this had put some downward pressure on oil prices, it was likely that the strategic decision by Saudi Arabia and other OPEC countries not to cut production had been more significant. The dominance of such supply factors was likely to explain why the sharp fall in oil prices had not so far been replicated more generally in the prices of other commodities, as would be the case if softer global demand had been the key driver of lower prices. Since the start of 2014 the S&P GSCI metals US dollar price index had fallen by 8% and agricultural commodity prices had fallen by 1%. Iron ore prices had fallen by up to 50%, but that was thought largely to reflect strong competition among major mining companies rather than weak demand, and the decline had occurred earlier than the drop in oil prices.

13 The effect of lower oil prices would also depend on how long they persisted. The futures curve was upward sloping and consistent with prices rising to around \$70 per barrel by the end of 2017. In sterling terms this represented a 30% decline on average across the first three years of the futures curve since June 2014.

14 Sustained lower oil prices, to the extent they were driven by increased supply, were likely to boost global growth and dampen inflationary pressure. Estimates from a range of sources suggested that a supply-driven 10% fall in oil prices tended to boost world GDP by around 0.25%, with around 0.1-0.2 percentage points coming through within a year. If the fall in prices since June had been entirely supply-driven, Bank staff calculated on the basis of these estimates that it would add almost 1% to world GDP by the end of 2017. The impact on inflation would depend on the monetary policy response in each country but was likely to come through quickly and was already clearly visible.

15 In the euro area, the flash estimate of headline HICP inflation had fallen to -0.2% in December, slightly lower than market expectations and the first negative reading since October 2009. Core inflation was stronger than expected at 0.8%. There had been little news on euro-area activity: the composite Purchasing Managers' Index (PMI) had picked up a little in December but, taken together with other indicators, continued to point to growth of 0.2% in Q4, the same as in Q3.

16 The recovery in the United States appeared a little stronger than previously thought. GDP growth in Q3 had been revised up to 1.2%, largely driven by a larger contribution from consumption. Bank staff's estimate of growth in Q4 had also been revised up a little to 0.7%. Non-farm payrolls had increased by 321,000 in November while the unemployment rate had remained steady at 5.8%. Inflation, measured by the private consumption deflator, had fallen to 1.2% in November, partly reflecting lower oil prices.

17 In China, a wide range of indicators had on balance suggested growth would stabilise at a quarterly rate of around 1.8% in 2014 Q4, although individual sectors relating to investment and construction were materially weaker. There were tentative signs of stabilisation within the property sector. In Japan, GDP had been revised down and was estimated to have fallen by 0.5% in 2014 Q3.

Money, credit, demand and output

18 New estimates of UK economic activity suggested that growth was proceeding at a steady pace, rather than slowing from an above-trend rate as had previously seemed likely. The third estimate of GDP growth in 2014 Q3, at 0.7%, had not been revised. But downward revisions to earlier quarters had led to four-quarter GDP growth being revised down from 3.0% to 2.6%. Bank staff estimated that output had continued to expand at a similar pace around the turn of the year with GDP growth in the final vintage of data expected to be 0.8% in Q4 and 0.7% in 2015 Q1. This was broadly consistent with evidence from a range of indicators, although these had been somewhat divergent. The composite CIPS output index in December had fallen to its lowest level since May 2013, while the activity balances in the Q4 BCC survey had picked up to close to their post-crisis highs.

19 The mix of expenditure in Q3 had been revised, with higher consumption and a larger contribution from net trade offset by lower business investment and government consumption. Consumption growth had been revised up to 1% in Q3, its fastest rate since 2010 Q2, with an unusually large contribution from spending on vehicles. Upward revisions to household income meant that the saving ratio had been 7.0% in Q3, 1 percentage point higher than had been expected at the time of the November *Inflation Report*. Given the scope for future revisions, it was important not to over-interpret trends in the most recent vintage of National Accounts data. On the face of it, however, it no longer appeared that the pickup in consumption growth since the beginning of 2013 had been financed by a fall in saving. While the trade deficit had narrowed to 2% of GDP in Q3, the current account deficit had widened to 6% of GDP, driven largely by an increase in the primary income deficit from 1.8% to 2.8% of GDP. The balance of direct investment income had turned negative for the first time since 2008.

20 Near-term indicators suggested that household spending growth had remained strong. Retail sales volumes had grown by 1.6% in November, above Bank staff's expectations, though it was not clear to what extent this increase represented spending being brought forward as a result of 'Black Friday' discounts, rather than underlying growth. According to contacts of the Bank's Agents, retail sales over the Christmas period had appeared solid. There had been a strengthening in consumer credit growth to 8.3% in November on a three-month annualised basis, perhaps driven in part by a loosening in the supply of unsecured credit. Lenders responding to the Bank's

Credit Conditions Survey had reported that credit scoring criteria had loosened significantly and the proportion of loan applications being approved had increased in Q4.

21 The buoyancy of consumer spending was in contrast to the pattern of a slower housing market seen since the summer. Mortgage approvals for house purchase had remained below expectations at around 59,000 in November, and there was evidence from the Halifax and Nationwide indices that the rate of increase in house prices had slowed to an underlying pace of about 0.3% per month. While the housing market would be supported by recent declines in fixed mortgage interest rates, there was evidence from the Bank's *Credit Conditions Survey* that the demand for secured lending for house purchase in Q4 had fallen sharply.

22 There was mixed evidence on business investment trends. Official data showed that business investment had weakened, with growth being revised down to -1.4% in Q3. Intelligence collected by the Bank's Agents indicated that business investment intentions had eased, more so in manufacturing than services. But investment data tended to be volatile and prone to future revision, and other business surveys had continued to point to strong growth in capital spending with investment intentions in the BCC survey picking up in Q4. One factor pushing down on investment in coming months would be the likely reduction in capital spending in the North Sea in response to lower oil prices.

Supply, costs and prices

23 Twelve-month CPI inflation had fallen to 1.0% in November, its lowest rate since September 2002, and, in line with the usual pre-release arrangements, an advance estimate for CPI inflation of 0.5% for December had been provided via the Governor to the MPC, ahead of publication. In line with the Committee's remit, this would necessitate an exchange of letters between the Governor and the Chancellor of the Exchequer.

24 The fall in CPI inflation to 0.5% in December was in line with Bank staff's expectations immediately before the data release, but 0.5 percentage points lower than expected at the time of the November *Inflation Report*. Although the full details were not yet available, the fall in CPI inflation on the month was likely to have largely reflected lower fuel prices and utility price increases in December 2013 dropping out of the annual comparison. CPI inflation was expected by Bank staff to reach a trough of around zero in March, as lower oil prices fed through to petrol

prices, with a roughly even chance that it would temporarily dip below zero at some point in the first half of 2015.

25 A full analysis would be possible only once the detail behind the December figure had become available. It seemed likely, however, that the majority of the deviation of inflation from the target related to unusually low contributions from energy and food prices, as well as some downward impact on goods price inflation as the effects of sterling's appreciation between Spring 2013 and Summer 2014 passed through to consumer prices. In addition to those factors, Bank staff's central estimate was that around ½ percentage point of the deviation of inflation from the target reflected the weakness of domestic cost growth, a key element of which was wages.

26 Over much of the past year, pay growth had been subdued such that unit labour costs had grown by only 0.5% in the four quarters to 2014 Q3, the latest period for which data were available. During the month, however, there was further evidence that the pace of pay growth had been picking up recently. Annual growth in whole-economy total pay had been 1.4% in the three months to October. Private sector regular pay had grown by 2.0% over the year and at an annualised rate of 4.3% in the three months to October. Pay growth at that rate was likely to be significantly higher than current rates of productivity growth, suggesting that unit labour cost growth had picked up toward the end of the year.

27 The outlook for pay would depend on the pace at which the degree of slack remaining in the labour market was absorbed. Employment had continued to increase at the end of 2014, both in numbers employed and total hours worked, albeit at a slower pace than at the start of that year. In the three months to October, the number of people in employment had risen by 115,000. The unemployment rate had fallen to 6.0%, with short-term unemployment particularly low relative to its pre-crisis average, and the timelier claimant count measure of unemployment had fallen by 27,000 to 900,100 in November.

28 Pay growth might also depend on the development of inflation and inflation expectations over the coming months. Around 40% of pay settlements would be agreed in April when, according to Bank staff's latest estimates, twelve-month CPI inflation was likely to be around zero, so there was a risk that any pickup in pay growth might be delayed. There had been an increase in Q4 to around 20% in the proportion of respondents to the quarterly *Deloitte CFO Survey* of large companies who expected CPI inflation to be less than 1.5% in two years' time.

The immediate policy decision

29 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 2014 *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, and more slowly than in previous cycles. 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.

30 There had been a number of significant developments since the November *Inflation Report*. Oil prices had fallen further: the spot price of Brent crude oil had dropped to \$50 per barrel, down \$20 on the month and \$32 lower than at the time of the November *Inflation Report*. CPI inflation had fallen to 0.5% in December, 0.5 percentage points lower than had been expected in November, and was now expected by Bank staff to reach a trough of close to zero in March, as lower oil prices fed through to petrol prices. There was, therefore, a roughly even chance that CPI inflation would temporarily dip below zero at some time during the first half of 2015. Inflation had also fallen abroad and was negative in the euro area. Market interest rates had declined as the expected pace and extent of future UK monetary policy tightening had been scaled back. The one-year sterling rate one year ahead had fallen by close to 20 basis points and was 40 basis points lower than at the time of the November *Inflation Report*. By comparison, there had been relatively little news on activity. Growth remained solid in the United Kingdom and United States, but subdued in the euro area and was slowing modestly in the emerging economies.

31 The Committee considered how these and other developments since the November *Inflation Report* had affected the balance of risks to the medium-term outlook for growth and inflation and hence the appropriate stance of monetary policy. As before, this would depend on factors such as: the persistence of the effects of reduced energy, food, and other imported prices on CPI; inflation expectations; the pace of aggregate demand growth; 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 these and other factors, a wide range of outcomes for inflation was possible. The Committee's full assessment would be carried out over the coming month and published in the February *Inflation Report*.

32 It was important to distinguish between factors affecting inflation in the very near term and those affecting it at medium-term horizons where monetary policy was more effective. The expected near-term profile of inflation was weaker than had been assumed at the time of the November *Inflation Report*. This was largely the result of the further sharp reduction in sterling oil prices that had taken place over the previous two months, and inflation in food and core goods prices being lower than expected, possibly reflecting slightly faster exchange rate pass-through than previously had been assumed. The downward effect on inflation was likely to be temporary if oil prices stabilised at around their current level or rose, as the oil price futures curve implied. The downward effect from exchange rate movements in 2013 and early 2014 could also begin to fade over the year. Over the medium term, inflation would predominantly reflect growth in domestic costs. These had also been subdued, but recently there had been signs of a pickup in pay growth as the amount of slack in the labour market was absorbed and the pace of economic activity continued to grow at around trend rates. Sustained pay growth, at rates materially higher than in recent years, would be required to be consistent with the 2% inflation target in the medium term.

33 There were a number of developments since the November *Inflation Report* that might push down on inflation in the medium term. In particular, it was possible that the fall in near-term inflation might become more persistent if it lowered inflation expectations, pay and other cost growth in a way that became self-perpetuating. Inflation had fallen globally and was expected to reach its trough in the United Kingdom in the early part of the year when a large proportion of pay claims were settled. It was therefore possible that the pace of nominal wage growth would be weaker than otherwise and that this would feed into lower subsequent price inflation. In addition, the continued decline in oil prices was likely to contribute to a reduction in capital investment in the UK oil industry. Alongside these developments, it appeared that downside risks to the euro area had increased. Together, these factors could result in inflation persisting below the target for longer than previously expected.

34 But there were also several developments since the November *Inflation Report* that might push up on aggregate demand relative to supply in the United Kingdom, and so result in inflation

pressures being somewhat higher in the medium term. First, the Committee judged that the lower 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. One early manifestation of this was that nominal incomes were likely to have been growing at a significantly faster rate than consumer prices in the second half of 2014. Second, market interest rates had fallen sharply and were already passing through to lower fixed rate mortgages. Demand would be stimulated further were Bank Rate to follow the path implied by market yields, although inflation expectations had also fallen so the effect on real interest rates was smaller. Third, the early signs of a pickup in private sector average weekly earnings growth tentatively suggested that slack was either lower or being absorbed more quickly than previously thought. Each of these factors could result in inflation bouncing back sharply once the near-term effects of lower oil prices had passed through.

35 In the view of all 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. It was possible that the risks to CPI inflation in the medium term might have, if anything, shifted to the upside, but all members were also alert to the downside risk of current low inflation becoming entrenched. Monetary policy could and would be adjusted at the appropriate time to ensure that CPI inflation was on track to meet the 2% target in the medium term.

36 For the two members who had voted in the previous month for an increase in Bank Rate, the decision this month was finely balanced. They believed that the sharp fall in inflation to below the 2% target was probably driven largely by temporary factors and was unlikely materially to affect the behaviour of households and businesses in such a way that it became self-perpetuating. They also noted the most recent evidence that wage growth was more buoyant than they had expected. Nevertheless they noted the risk that low inflation might persist for longer than the temporary factors implied and concluded that this risk would be increased by an increase in Bank Rate at the current juncture.

37 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.

38 Consistent with the Committee's forward guidance, and as described in a market notice on 8 January 2015, the Committee agreed to reinvest the £4.35 billion of cash flows associated with the redemption of the January 2015 gilt held by the Asset Purchase Facility.

39 In order to accommodate Bank officials' attendance at the G20 Meetings in Istanbul, the publication of the February 2015 *Inflation Report* and the accompanying press conference will be moved back one day to Thursday, 12 February.

40 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.

As permitted under the Bank of England Act 1998, as amended by the Financial Services Act 2012, Anthony Habgood was also present as an observer in his role as a member of the Oversight Committee of Court.