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MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 4 and 5 March 2015

These are the minutes of the Monetary Policy Committee meeting held on 4 and 5 March 2015.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2015/mar.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 8 and 9 April will be published on 22 April 2015.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 4 AND 5 MARCH 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 The month had seen a turnaround in many key UK asset prices, as sentiment appeared to have improved relative to the turn of the year. Short-term interest rates and nominal bond yields had risen, as had equity prices. Credit spreads had fallen. And sterling had appreciated. A key question was whether these movements reflected international developments, domestic factors, or both.

3 Sterling twelve-month forward OIS rates had risen by around 20 basis points since the time of the February *Inflation Report*. A similar increase had occurred in US dollar forward OIS rates, while short-term euro rates had been unchanged. A 25 basis point increase in Bank Rate was fully priced in by March 2016. Although they remained a very long way below historical levels, ten-year nominal sterling spot yields had increased by 45 basis points since the time of the February *Report*. Part of the increase in longer-term sterling rates had been associated with an increase in inflation swap rates, unwinding the movement in the previous month. US ten-year nominal spot yields had risen by around 35 basis points, while those in the euro area had been unchanged.

4 Risky asset prices had also increased across the advanced economies. Investment-grade corporate bond spreads had fallen by 10-20 basis points internationally. The FTSE All Share equity price index had increased by around 1% on the month, while indices in the United States and euro area had risen by 3-5%. Analysis by Bank staff suggested that the equity prices of UK firms whose business activity was domestically focussed had outperformed both the aggregate UK index and the prices of similarly domestically oriented firms in the United States. Implied volatility on equity options had declined during the month.

5 The sterling effective exchange rate index (ERI) had appreciated by around 2½% during the month to reach its strongest level in over six years. As in previous months, that had primarily reflected an appreciation of sterling against the euro, of nearly 4%, but sterling had also appreciated slightly against the US dollar. Intelligence gained from market contacts suggested that upward pressure on sterling might have been stronger still had it not been for the effect of uncertainty surrounding the forthcoming general election.

6 It appeared probable that both international and domestic factors were at play in driving the month's asset price movements. They may in part have reflected the continued effect of the announcement by the ECB of its asset purchase programme. There had also been positive economic data from the euro area and United States, where the payrolls data for January had resulted in a significant impact on UK market interest rates. More generally, US and UK equity and credit market movements had been highly correlated during the month. Domestic factors that might have affected UK asset prices included positive UK business survey data, lower unemployment figures than expected, and the publication of the Committee's February *Inflation Report*.

The international economy

7 Overall, the news on activity in the international economy had been mildly positive. The main focus of the Committee's discussion this month was the extent to which activity growth in the euro area was beginning to pick up.

8 Euro-area GDP had grown by 0.3% in the fourth quarter of 2014, fractionally stronger than the Committee had anticipated. Purchasing managers' indices (PMIs) and other indicators had, taken together, been relatively upbeat moving into 2015, and the ECB's latest *Bank Lending Survey* suggested that credit availability would continue to improve. These factors suggested an upside risk to the near-term euro-area growth assumptions underlying the February *Inflation Report* projections. Within the aggregate, German output had been surprisingly robust at 0.7%, led by healthy consumption growth. Retail sales and survey indicators suggested that momentum had continued beyond Q4. It was possible that this had been a consequence of a more rapid boost to spending than expected from the reduction in oil prices and that confidence had improved as some of the downside risks to German activity resulting from the political situation in Ukraine and Russia had not materialised. During the month, the German metalworkers' union – the country's largest – had agreed a relatively high 3.4% pay settlement, to be implemented in April, which had

reinforced the perception that the economy was strengthening. It also suggested that any deflationary impetus was not becoming entrenched.

9 Elsewhere in the euro area, growth had been mixed. In France, output had expanded by only 0.1% in 2014 Q4, and the INSEE business climate indicator had remained flat since November. More positively, household consumption of goods had increased sharply in December and January to stand 2.6% higher than a year earlier. Fourth quarter growth in Spain, at 0.7%, and Portugal, at 0.5%, had remained relatively strong, and unemployment had fallen in both countries, albeit to a still very elevated level. Output had been flat on the quarter in Italy.

10 Core HICP inflation had remained unchanged at 0.6% in February, and headline inflation had been less negative than expected, at -0.3%.

11 On 20 February, the Eurogroup and the Greek Government had reached an initial agreement that disbursements under the IMF/ECB/EU Greek programme could potentially resume subject to a satisfactory review of the Government's structural reform and fiscal plans. Deposit outflows from Greek banks appeared to have been stemmed by the agreement. No large Greek sovereign debt repayments were due until July but some smaller repayments would need to be made later in March and additional details would still need to be agreed upon. Separately, in the week before the Committee's meeting, the European Commission had set out new rulings on the fiscal plans of a number of Member States: the deadline for the reduction of the French budget deficit had been extended and flexibility had been afforded to the Italian Government regarding compliance with its excessive debt reduction target.

12 In the United States, the estimate of fourth quarter GDP growth had been revised down slightly to 0.5%, reflecting a weaker contribution from stockbuilding. Underlying private demand remained robust. Private consumption had increased by 0.3% in January. Non-farm payrolls had increased by 257,000 in January so that, in net terms, over 1 million jobs had been created over a three month period – the largest increase in the number of people employed since 1997.

13 A range of emerging markets had seen signs of a pickup in growth in the fourth quarter. The Chinese economy was an exception, where the PMIs pointed to a moderation in activity. There, the authorities had cut the main policy rates and reduced the reserve requirement ratio in response to slower growth, falling inflation, and a tightening in monetary conditions caused by capital outflows and the stronger effective exchange rate.

14 The US dollar spot price of Brent crude oil had increased by around 15% since the Committee's previous meeting, although it remained 50% below its peak level in June 2014. Forward oil prices had increased by much less. In part, the rise in the spot price had reflected downward revisions to forecasts for US oil production. Nevertheless, crude oil production was likely to exceed demand for much of 2015 such that inventory levels could be expected to rise further from already high levels. And, with a shortage of onshore storage availability, it was possible that spot oil prices might need to fall relative to futures prices to encourage offshore storage.

Money, credit, demand and output

15 The second estimate of GDP growth in 2014 Q4, at 0.5%, had not been revised. And the business surveys released during the month had been consistent with the near-term pattern of growth anticipated by the Committee at the time of the February *Inflation Report*. The expenditure breakdown contained in the GDP data release, while subject to future revision, had not been as expected. Business investment was estimated to have fallen by 1.4% – the second quarterly fall in a row – compared with Bank staff's expectation of an increase. Consumer spending (excluding non-profit institutions) had grown by 0.5% in Q4, weaker than Bank staff had expected, although close to the average growth seen over 2014 as a whole. The Committee discussed whether these data gave reason for concern about the outlook for private domestic spending, which had been forecast to strengthen further in 2015.

16 A large part of the estimated decline in business investment in Q4 appeared to be related to a drop in capital spending associated with North Sea energy extraction following the reduction in global oil prices. Even abstracting from that, however, Bank staff estimated that business investment had been roughly flat in the fourth quarter and had declined modestly over the second half of the year as a whole. These data sat at odds with more buoyant survey indicators of firms' investment spending. Credit conditions in general remained supportive of investment, with the Bank's most recent *Credit Conditions Survey* indicating a further decline in spreads on lending to large and medium-sized firms. In addition, corporate cash holdings appeared, in aggregate, strong.

17 The Bank's Agents had reported that the forthcoming general election and possible referendum on the European Union had been mentioned more frequently by business contacts. At present, there was little evidence that these issues had affected aggregate capital spending.

18 Another factor that could, in principle, restrain investment plans was the need for companies to make up shortfalls in their defined benefit pension funds. As market yields had fallen, the estimated present value of pension liabilities had increased, leaving funds with an estimated aggregate deficit of £368 billion in January according to the Pension Protection Fund, its largest on record. Previous work by Bank staff had suggested that individual firms had historically been more likely to reduce dividend distributions than cut capital spending in response to increased pension-fund contributions, although a survey by the Bank's Agents in 2013 had suggested that there might be at least some impact on investment decisions for half of the firms whose funds were in deficit. The impact of such an effect on aggregate investment would depend in part on the assets purchased by the pension funds in receipt of the additional cash. The greater the extent to which pension funds invested in the liabilities of domestic companies, rather than, say, gilts or foreign assets, the smaller would be the probable impact on private business investment.

19 The Committee's February *Inflation Report* projections forecast a significant increase in the pace of consumption growth between 2014 and 2015 as real income growth picked up. Near-term indicators were upbeat. Retail sales had been growing at their fastest annual rate in over ten years. On a seasonally adjusted basis, the GfK measure of consumer confidence had risen in February and was at its highest since 2002. The net balance of respondents reporting that it was a good time to make a major purchase had turned positive around the turn of the year. Moreover, credit conditions had eased further over recent quarters, with many mortgage and some unsecured borrowing costs at or around series lows. It was also possible that there might be a small boost to consumer spending growth as a consequence of the new defined-contribution pension rules that would come into effect in April. But, given that accumulated pension pots were in many cases relatively modest in size, this was not likely to result in a significant pick up in either spending or asset prices.

20 One source of uncertainty was the extent to which the increase in households' real incomes resulting from the reduction in energy prices would lead to additional spending or to extra saving. If households were to view the reduction in energy costs as permanent then, in principle, they might be inclined to spend a high proportion, or possibly all, of the additional real income. In their responses to the Bank/NMG Consulting surveys, however, households had previously indicated that they would be likely to save the majority of any unexpected income gains, whether they were considered permanent or not. More broadly, a major source of uncertainty surrounding the outlook for consumer spending was the evolution of wages.

21 Housing investment had increased by around 1% in the fourth quarter of 2014 – largely as expected. Mortgage approvals had been broadly stable in January at 61,000, a level around which the data had hovered since the previous autumn. The RICS survey indicated that estate agents had seen no dramatic change in either demand or supply conditions. The average of the main lenders' indices indicated that house prices had edged down in February. There was little sign of a sustained increase in house-building: although UK private enterprise housing completions had increased by 3% in 2014 Q4, housing starts had fallen by 10%. Mortgage rates had fallen in the second half of last year as market interest rates more generally had declined. Analysis by Bank staff suggested that any boost to housing activity from those falls in mortgage rates would be only just beginning to become evident. It was possible that the reduction in mortgage rates over the past half-year, viewed in isolation, overstated the degree to which mortgage credit availability had improved if changes to credit criteria had excluded some potential borrowers from accessing loans.

22 Net trade had added 0.6 percentage points to GDP growth in the fourth quarter, having subtracted a similar amount in the third. Since the second half of 2013, the external trade deficit had improved by around 1½% of GDP to stand at 1.4% of GDP in 2014 Q4. The current account deficit had widened markedly over the same period, however, to stand at 6.0% of GDP in Q3, the latest period for which data were available. This matched the largest quarterly current account deficit since ONS records began in 1955. The worsening in the current account deficit had been a consequence of weaker foreign income flows – in particular a drop in the income earned on UK foreign direct investments (FDI), especially in the rest of the EU. The latter seemed likely to reflect in part the subdued growth in the euro area of the past few years. It was also possible that the estimated decline in FDI income had been exaggerated by the transactions of a small number of large firms that were not representative of broader experience. The Committee would continue to monitor developments in the current account closely.

23 Overall, the Committee's view was that the news on the month regarding the outlook for demand had been modest, such that the judgements made at the time of the February *Inflation Report* remained reasonable. There remained differences of view among Committee members about the precise balance of risks to the demand outlook, but not ones that had been influenced significantly by the developments over the past month.

Supply, costs and prices

24 Twelve-month CPI inflation had fallen to 0.3% in January from 0.5% in December, as expected at the time of the February *Inflation Report*. In keeping with the recent pattern, the decline had reflected a reduction in the contributions of food and energy prices. Together, these components were subtracting 1.4 percentage points from aggregate inflation, relative to their pre-crisis averages. CPI inflation excluding food and energy prices had remained at 1.5% in January. A range of alternative measures of core inflation also remained clustered around 1.5%.

25 Relative to the fifteen-day average price assumptions underlying the February *Inflation Report* projections, sterling Brent oil spot prices had increased by about 25%, while sterling itself had appreciated by a little over 3%, primarily against the euro. Bank staff estimates suggested that the opposing effects that these developments would have on CPI inflation would be roughly offsetting in the near term, but would leave inflation a little lower further ahead. In the absence of further movements in the sterling exchange rate or price of oil, Bank staff's central expectation was for CPI inflation to fall to around zero in the February data and remain at around that rate for several months. Given the inevitable uncertainty surrounding that central estimate, it seemed more likely than not that CPI inflation would temporarily drop below zero at some point over the coming months.

26 The majority of the deviation of inflation from the target could be explained by unusually weak contributions from energy and food prices, as well as the broader effect on traded goods prices of the appreciation of sterling since the spring of 2013. These factors would have only a temporary effect on CPI inflation. As their impacts began to drop out of the twelve-month calculation towards the end of the year, inflation was likely to rise towards the target. These factors were not the only causes of inflation being below the target, however: the weakness of domestic cost growth had also played a role. A central question, therefore, remained whether pay growth, and so domestic cost pressures, would pick up to a rate consistent with meeting the inflation target in the medium term.

27 The Committee's discussion regarding the outlook for firms' labour costs had in recent months centred on three main issues: to what extent, and how quickly, would the narrowing margin of spare capacity in the labour market cause nominal wage growth to rise; how far would this be supported by a recovery in productivity; and to what degree would the current low rate of

inflation and the history of several years of nominal pay growth below average become ingrained in expectations that became at least partly self-fulfilling.

28 The data released during the month suggested that the labour market had continued to tighten. The LFS unemployment rate had fallen to 5.7% in 2014 Q4 from 6.0% in Q3, a similar pace of decline as had been seen between the second and third quarters of 2014. The claimant count measure, which had over the past year also been declining by around 0.3 percentage points per quarter, had continued that trend by falling to 2.5% in January. The range of short-term forecasting models maintained by Bank staff suggested that the LFS rate might reach 5.3% by 2015 Q2, a little lower than had been assumed at the time of the February *Inflation Report*. The ratio of the number of unemployed people to the number of job vacancies continued to decline in December to 2.6 – not far off the pre-crisis average of 2.5. And the ‘churn’ rate at which employees were moving from one job to another had continued to pick up, suggesting building confidence in job market prospects. The precise degree of spare capacity in the labour market, and economy more broadly, was both uncertain and a matter of some debate between Committee members. The Committee planned to complete a stocktake of its supply-side assumptions as part of the preparation of its May 2015 *Inflation Report* projections. Nevertheless, it was uncontroversial that the degree of slack had been diminishing, and there were signs that earnings growth had begun to pick up as a result.

29 Headline average weekly earnings growth had been a little stronger in the fourth quarter of 2014 than had been expected at the time of the February *Inflation Report* projections. Annual total pay growth had increased to 2.1% in the three months to December and comparable private sector pay growth had increased to 2.5%. The unexpected strength of pay growth reflected stronger bonuses than anticipated across a range of sectors. Private sector regular pay growth had been in line with expectations, growing at an annualised quarterly rate of around 3½% in Q4 and at a four-quarter rate of 2.1%. A range of pay surveys had, on average, been consistent with pay growth of around 3%.

30 A detailed analysis of the micro-data underlying the Q4 Labour Force Survey provided some evidence that the composition of employment growth over the past year had been disproportionately skewed towards individuals with lower educational attainment and in occupations and age cohorts that typically attracted lower pay levels. These composition effects could have subtracted around one percentage point from the measured growth of average weekly earnings. Such a pronounced effect from shifts in the composition of employment was unusual

and unlikely to persist. As it unwound, it was possible that the average weekly earnings measure of pay growth could increase, although, to the extent that such changes were mirrored in productivity, it was not clear that this would have any further implications for inflationary pressure.

31 In total, employment had risen by 103,000 in the fourth quarter, a marginally stronger increase than had been expected at the time of the February *Report*. This, along with minor revisions to the GDP data, led Bank staff to estimate that productivity had risen by only 0.3% during 2014 as a whole, a little weaker than anticipated. As a result, in conjunction with stronger pay growth, firms' unit labour costs had probably increased by rather more in the year to Q4 than the Committee had previously thought likely. The release of the full 2014 Q4 National Accounts would give the Committee the opportunity to examine the data on firms' labour costs in more detail.

32 The Citigroup measure of inflation expectations one year ahead had fallen by a further 0.2pp on the month in February, while the similar Bank/NOP measure had fallen by 0.6pp in the three months to February. The two-year ahead Bank/NOP measure had fallen by 0.4pp on the quarter, compared with a small rise in the February *Inflation Report* projection at the same horizon. Inflation expectations in the Bank/NOP survey were consistent with households expecting inflation to return to the target more slowly than in the MPC's latest forecasts, once those expectations were adjusted for the average wedge between households' perceptions of inflation and CPI inflation itself. Nevertheless, in the Bank/NOP survey, the proportion of people who were 'fairly confident' or 'very confident' that inflation would be within one percentage point of the 2% target in two to three years' time was 49 per cent, its highest since 2011 when the question was first asked. Measures of long-term inflation expectations had been stable in the Citigroup survey on the month, whereas the Bank/NOP survey measure had fallen by 0.2pp in the three months to February. Measures of inflation expectations five to ten years ahead derived from financial market prices had increased on the month. Staff analysis suggested that these longer-term financial market expectations were currently at levels roughly consistent with the inflation target, although that was less clearly the case for household measures of inflation expectations. The latest Bank/NOP survey had also included a new question on households' expectations of their earnings growth over the coming year. The mean expectation of those in employment had been surprisingly low, at 1.2%, although there were no historical data with which to compare that figure.

The immediate policy decision

33 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.

34 In his open letter to the Chancellor in February, the Governor had explained the Committee's view that it would, in the current circumstances, be appropriate to return inflation to the target as quickly as possible after the effects of energy and food price movements had abated. In practice, this meant that the Committee would seek to set monetary policy so that it was likely that inflation would return to the 2% target within two years.

35 Overall, the news on the month had been fairly modest: the broad description of the economic outlook contained within the February *Inflation Report* remained valid. Developments overseas had, if anything, been mildly positive. Indicators in the euro area suggested a pace of growth perhaps fractionally above that envisaged at the time of the February *Report*. Although many obstacles remained, a deal had been reached to avoid a breakdown in negotiations over the Greek support package and potentially allow programme disbursements to continue, subject to a satisfactory review of the Greek Government's structural reform and fiscal plans at the end of April. US employment growth had been brisk.

36 Domestic activity had continued to expand at a solid pace. The expenditure breakdown of GDP growth in 2014 Q4 had given some pause for thought. But there were reasons to remain confident that the continued expansion envisaged in the Committee's February projections was broadly on track.

37 CPI inflation had fallen as expected in January, reflecting movements in energy and food prices. Taken by itself, the combination of the increase in the price of oil and appreciation of sterling that had occurred over the month was expected to leave the path of inflation broadly unchanged in the near term, but a little lower further ahead. Set against that, labour costs looked to be growing slightly ahead of forecast, given the recent evolution of the pay and productivity data. Even so, a further sustained increase in labour cost growth would probably be necessary for inflation to rise to the 2% target in the medium term, after the temporary impacts on inflation of movements in energy and food prices had faded. The outlook for labour costs remained characterised by two opposing forces: on the one hand, the upward effect of a tightening labour market; on the other, the prospect that lower expectations of inflation and wages might persist and become at least partly self-fulfilling. As in previous months, different members placed different weights on the various risks to the outlook for pay and productivity and the implications of them for policy.

38 Arguably the month's most notable developments had been in financial markets. Risky asset prices had risen internationally. Implied volatilities in equity markets had declined. Outside the euro area, short and long-term interest rates had risen, and yield curves had steepened. Sterling had continued to appreciate, primarily versus the euro. Those movements might be a continuing response to the announcement of the ECB's asset purchase programme. But they might also have reflected the reasonably positive UK, US and other international data flow over the past month and, perhaps, a more general improvement in sentiment relative to the turn of the year. Although monetary policy at home and abroad was only one of the many factors that influenced the exchange rate, especially in the near term, there was a risk that divergent monetary policy trends, as well as stronger prospects for growth in the United Kingdom than in the euro area, might continue to put upward pressure on the sterling exchange rate. This had the potential to prolong the period for which CPI inflation would remain below the target and exacerbate the risk that lower expectations of inflation might become more persistent.

39 In light of the relatively limited amount of news for the inflation outlook over the month, all Committee members agreed that it was appropriate to leave the stance of monetary policy unchanged at this meeting, although two members regarded this month's decision as finely balanced. There was a range of views over the most likely path of Bank Rate in future, but all members agreed that it was more likely than not that Bank Rate would increase over the next three years.

40 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.

41 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 on 4 and 5 March as an observer in his role as a member of the Oversight Committee of Court. In the same capacity, Dave Prentis was also present as an observer on 4 March.