



BANK OF ENGLAND

Minutes of the Monetary Policy Committee meeting 7 and 8 May 2015

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

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2015/may.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 27 May, 1 and 3 June will be published on 17 June 2015.

Minutes of the Monetary Policy Committee meeting held on 7 and 8 May 2015

1 Before turning to its immediate policy decision, and against the backdrop of its latest projections for output and inflation, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and supply, costs and prices.

Financial markets

2 After falling in March, long-term interest rates had increased markedly on the month in the United Kingdom, the United States and the euro area, returning almost to levels seen around the time of the November *Inflation Report*. There had so far been limited spillovers from those moves to other UK asset prices.

3 Yields on UK, US and German ten-year government debt had increased by between 30 and 45 basis points on the month. Despite the increase on the month, real yields on ten-year UK government bonds continued to be negative and both real and nominal yields remained unusually low. While yields on ten-year Greek government debt had fallen on the month, spreads between the government debt of other periphery economies and German government bonds had widened.

4 Market contacts were not able fully to explain the sharp upward movement in long-term interest rates in major advanced economies: the data flow had, if anything, been a little softer than expected in several of the major economies. It was possible that the upward movement in oil prices on the month had led to an easing in concerns about deflationary pressure. Consistent with that, ten-year instantaneous forward UK and US breakeven inflation rates and euro-area inflation swap rates had risen on the month. It was also possible that the upward move in long-term interest rates had been exacerbated by market participants anticipating less need for the ECB to purchase long-dated securities as the yields on a greater volume of shorter-dated securities rose above the ECB's deposit rate. It might also represent the correction of an overshoot in yields in response to those same asset purchases.

5 Short-term interest rates had also increased somewhat in the United Kingdom on the month. Based on information from OIS rates, an increase in Bank Rate to 0.75% was now fully priced in by May 2016, around one quarter earlier than at the time of the April MPC meeting. The median expectation of economists responding to the May Reuters poll continued to be for an earlier increase in Bank Rate, in 2016 Q1. The short end of the UK yield curve had also steepened a little on the month. Some of those upward moves had come on the day of the release of the minutes of the Committee's previous meeting, although it was likely that other factors had also played a role over the course of the month.

6 The sterling effective exchange rate had fallen slightly since the previous MPC meeting. At the start of the Committee's meeting it was down by 0.7%. Nevertheless, sterling remained just over 2% higher than at the time of the February *Inflation Report* and 16% above its trough in March 2013. Options prices continued to suggest that greater weight was being put on a further depreciation of sterling than on an appreciation. Subsequent to the beginning of the meeting, and after the data cut-off for the May *Inflation Report*, the sterling effective exchange rate had appreciated by 1.7% on 8 May following the announcement of the unexpectedly

decisive results of the general election. On the month, equity prices had fallen by 4.5% in the euro area, but UK and US equity prices had been broadly unchanged.

The international economy

7 International data for the first quarter had been mixed: while there had appeared to be continued upward momentum in euro-area activity, US and Chinese GDP data had been disappointing. Furthermore, several of the global output surveys had weakened in April. A key question was whether this weakness was likely to be temporary or more persistent.

8 Indicators of output in the euro area continued to point to a pickup in GDP growth to 0.4% in Q1, slightly stronger than had been anticipated at the time of the February *Inflation Report*. Growth in France and Italy was expected to rise in Q1.

9 Looking further forward, euro-area output and confidence surveys had eased back a little in April after increasing for several months in a row. The recent data flow in Germany had also been a little weaker, suggesting some easing in momentum into the spring. Despite that, Bank staff expected euro-area growth to increase further to 0.5% in Q2. Although oil prices had risen somewhat on the month, the decline in prices in the second half of 2014 and the depreciation of the euro would continue to support growth during the coming months. Credit conditions had continued to improve – as reflected in rising credit growth and responses to the Q1 ECB *Bank Lending Survey* – and the ECB's asset purchase programme was likely to support GDP growth throughout 2015.

10 In the United States, the advance estimate of Q1 GDP growth of 0.1% had been a little weaker than Bank staff expectations of 0.2% immediately ahead of the release, and much weaker than the 0.6% expected at the time of the February *Inflation Report*. Furthermore, trade data for March had shown a large decline in net exports, suggesting that this advance estimate of GDP was likely to be revised down. Various factors were likely to have contributed to the weakness in Q1 GDP growth: severe winter weather in the North East was likely to have dampened activity there, and an extended West Coast port strike would have disrupted trade flows. These effects were likely to be temporary, pushing up on growth in Q2: Bank staff expected growth of 0.7%. However, the decline in investment in the mining and extraction sector had been even greater than expected and it was possible that both this decline and the drag on exports from the dollar's recent appreciation would intensify. There was a risk, therefore, that these data were signaling more underlying weakness than was factored into the May *Inflation Report* projections. Cost pressures had picked up somewhat and there was now some evidence that recent falls in the unemployment rate were starting to feed through into pay growth, with the Employment Cost Index rising by 0.7% in Q1. Unit labour costs had risen by 1.2% over the same period, which in part reflected a weakening of productivity growth as well as higher hourly compensation growth.

11 Four-quarter Chinese GDP growth had slowed to 7% in Q1, a little weaker than expected in the February *Inflation Report*, and annual growth in industrial production had fallen to 5.6% in March. The Chinese

authorities had responded to this softening in growth with a 100 basis point cut in the reserve requirement ratio for banks.

12 Brent crude oil prices had risen to \$64 per barrel, a rise of around 16% on the month. A reduction in the perceived likelihood that Iranian sanctions would be lifted in the second half of the year, unexpectedly protracted hostilities in Yemen, and lower than expected US crude inventory data had likely contributed to this increase. But oil prices remained around 40% lower than their peak in mid-2014. OPEC production in March had recorded its largest monthly increase since September 2012 and the level of OECD oil inventories remained high, suggesting that the short-term risks to oil prices might remain to the downside.

Money, credit, demand and output

13 In the February *Inflation Report*, the Committee had expected a modest reduction in the growth of UK activity at the start of 2015 to closer to its long-run average rate. However, the first official estimate suggested that the slowdown had been more marked than expected. Although there was a risk that some of the weakness might prove persistent, it was judged more likely that much of the slowing of growth in Q1 would be temporary.

14 GDP growth was estimated by the ONS to have moderated from 0.6% in 2014 Q4 to 0.3% in 2015 Q1. This was 0.1 percentage points weaker than Bank staff had anticipated immediately before the data release, and 0.3 percentage points weaker than the February *Inflation Report* projection. Service sector output growth had slowed to 0.5% in Q1, compared with 0.9% in Q4, while manufacturing output growth had eased a little from 0.2% to 0.1%. Construction output had continued to contract in Q1.

15 Survey indicators had suggested a faster rate of output growth than in the first release of the ONS data. That divergence was particularly evident for the construction sector where the surveys had pointed to a healthy expansion, rather than a contraction in output on the quarter. Based on those surveys, Bank staff expected GDP growth for Q1 eventually to be revised up to 0.5%.

16 Looking further ahead, the composite Markit/CIPS output index had weakened a little in April: falls in the manufacturing and construction series had outweighed a rise in the services component of the index. The composite expectations index had also fallen in April and was now broadly in line with its series average. The message from the CBI Industrial Trends survey had been broadly similar. Overall, the surveys remained consistent with growth at around its historical average rate in Q2, and Bank staff projected GDP growth of 0.7% in the final vintage of data.

17 Turning to the likely composition of expenditure, Bank staff's projection was that consumption had grown by 0.7% in Q1, up from 0.4% in Q4, supported by the fall in oil prices in the second half of 2014. The GfK/EC consumer confidence index had risen for the fifth month in a row in April, reaching its highest level since late 2002. Growth in retail sales volumes had been robust in Q1, with rises in spending on food and petrol, as well as on more discretionary items, although they had fallen back in March driven by a sharp drop in fuel sales. Even excluding fuel sales, growth in retail sales had been modest at 0.2% on the month.

18 Mortgage approvals for house purchase had remained broadly flat, at around 61,000 per month in 2015 Q1. The average of the lenders' house price indices had increased by 1.3% in April, a bigger rise than had been expected. Provisional data from the RICS survey for April had indicated that secondary housing market supply had continued to fall relative to housing demand. The net balance for new buyer enquiries had risen and that for new instructions to sell had fallen. This could indicate upside risks to house prices in the second half of 2015.

19 Bank staff's projection was for growth in business investment of around 1% in Q1, following the reported contraction of 0.9% in Q4. Initial estimates of business investment were volatile and prone to revision, making it hard to draw a signal from the decline in the second half of 2014. The pickup in growth in Q1 was consistent with both fairly robust survey indicators and an improvement in credit conditions for most firms over the previous two years. That said, surveys of investment intentions had eased a little and there was likely to be a continued drag from investment in the extraction sector in the coming quarters, pointing to weaker business investment growth than had been assumed in the February *Inflation Report* projections.

Supply, costs and prices

20 Twelve-month CPI inflation had remained at 0.0% in March, necessitating a further open letter from the Governor to the Chancellor of the Exchequer, to be published alongside the May *Inflation Report*. Both the extent of the fall in annual CPI inflation over the previous three months and the reasons for that fall had been as anticipated at the time of the previous open letter and *Inflation Report* in February. Consequently, Committee members' views on the outlook for inflation had remained essentially unaltered.

21 Around three quarters, or 1½ percentage points, of the 2 percentage point deviation of inflation from the 2% target in March had been related to unusually low contributions from movements in energy, food and other goods prices. Despite a recovery from its trough in January, the sterling price of crude oil had been 44% lower in March than in the middle of 2014. Wholesale gas prices had also declined and most of the major utility companies had reduced the retail price of gas, by an average of 4% in Q1. Overall, the energy components of the CPI had accounted for around 0.9 percentage points of the deviation of headline inflation from the target in March. Lower food price inflation had subtracted about 0.5 percentage points, influenced by lower wholesale prices, the appreciation of sterling relative to the euro and competition among retailers. And the appreciation of sterling had also weighed on the prices of other imported goods and on the prices of goods with a sizable imported content. In the absence of further falls in energy prices or sharp movements in the exchange rate, inflation rates close to zero would be unlikely to endure for very long. As the impact of past movements in energy prices and the exchange rate faded from the twelve-month calculation, CPI inflation was likely to rise notably towards the end of the year.

22 The remaining one quarter, or ½ percentage point, of the deviation of inflation from the target reflected the modest pace of increase of domestic costs, particularly wages. Annual whole-economy total pay growth on the AWE measure had risen by 1.7% in the three months to February, slightly weaker than expected in the February *Inflation Report*, partly as a result of the pattern of bonus payments. Abstracting from that volatility,

private sector regular pay growth had increased to 2.2%, slightly weaker than expected in the February *Inflation Report*. These growth rates remained well short of the growth rates of total pay of 4% to 4½% seen on average in the years before the financial crisis.

23 The labour market indicators had, on balance, continued to tighten in the latest data. The LFS unemployment rate had fallen to 5.6% in the three months to February, and the timelier claimant count measure had fallen by 0.1 percentage points to 2.3% in March. In contrast, however, the average number of hours worked per week had fallen back in the latest data.

24 Stepping back, and as part of the preparation of the May *Inflation Report* projections, the Committee had taken stock of its assumptions regarding the supply side of the economy, including: the outlook for labour supply, productivity, the degree of spare capacity within the economy and, therefore, the outlook for domestic costs, and wages in particular. That assessment would be described in more detail in the May *Inflation Report*.

25 This stocktake had not painted a substantially different picture of the overall degree of slack remaining in the economy from the one underlying the February *Inflation Report* projections, although it had perhaps offered some reassurance that the Committee's previous assessment remained a reasonable baseline assumption. The best collective judgement of the Committee was that the degree of slack had narrowed substantially over the course of the past two years and currently stood at around ½% of GDP, although there was considerable uncertainty around those estimates and a range of views across the Committee. It was not likely that there was much scope for a further material cyclical recovery in the labour market participation rate. In contrast, there remained more material underutilisation of labour resources in the shortfall between the number of hours employees would ideally like to work and those that they actually did. Although it remained above its assumed long-run sustainable level, the LFS unemployment rate had fallen close to the 5.3% level that the Committee had assumed to be its medium-term equilibrium.

26 Despite the apparent tightening of the labour market, wage growth had been weaker than expected over the past eighteen months, only recently showing tentative signs of a modest recovery. Over and above the restraining influences on pay of the remaining degree of slack and several years of lacklustre underlying productivity growth, wage growth appeared to have recently been depressed by the impact of a shift in the composition of employment growth. In particular, employment growth since the end of 2013 had been disproportionately concentrated among employees in occupations that tended to attract lower average pay rates, and on average with fewer qualifications. Moreover, increased employment growth and job churn meant that average tenure in role had been declining a little. These compositional shifts would tend to push down on average pay growth while they were taking place. If past relationships were a guide, their impact could account for around 1 percentage point of the recent weakness in average annual earnings growth. But because these factors were likely to have influenced average labour productivity to a degree commensurate with their effect on pay, their overall impact on unit labour costs faced by firms, and hence inflationary pressure, was likely to be limited.

27 The impact of these cyclical shifts in the composition of employment on wage growth and productivity was likely to dissipate, resulting in a pickup up in both. The Committee thought it probable, however, that these factors would be more persistent in the short run than had been assumed in the February *Inflation Report* projections. Partly as a consequence, wage and productivity growth were projected to be somewhat weaker during 2015 than had been thought likely in February.

28 Looking further ahead, there remained grounds for believing that productivity, and therefore real wage, growth would continue to pick up over time. The improvement in credit conditions should in due course facilitate an improvement in the allocation of capital across sectors, and the past and prospective recovery in business investment would add to productive potential, especially if it aided the diffusion of technological improvements into production processes.

29 The Committee's best collective view was that, as in February, whole-economy total pay growth would increase gradually over the three-year forecast period, averaging 4% from mid-2016. Members differed in their views on the balance of risks around the speed with which pay growth was likely to pick up. On the one hand, it was possible that unemployment would continue to fall and the labour market to tighten to a greater degree than envisaged in the central projection of the *May Inflation Report*, supporting a more robust pickup in wages in the near term. On the other, it was possible that part of the recent weakness of wage growth had been a consequence of the low level of inflation influencing wage expectations and settlements. If that were the case, the pickup in wage growth might be somewhat more restrained than assumed in the nearer term.

30 Indicators of inflation expectations had been mixed on the month. Measures of inflation expectations five to ten years ahead derived from financial market prices had increased slightly, while the average of professional forecasters' two year ahead inflation expectations from the Bank's latest survey of external forecasters had been unchanged in Q2 and remained broadly in line with the Committee's projection for inflation at the same horizon. In contrast, distributive trade sector companies' one and two year ahead expectations for price increases in their own markets, as measured by the CBI survey, had fallen by 0.5 percentage points and 0.3 percentage points respectively in 2015 Q1. And, having picked up in March, household inflation expectations, as reported in the Citigroup/YouGov survey, had fallen back again at both short and long-term horizons in April. On balance, the Committee judged that inflation expectations remained broadly consistent with the 2% inflation target.

The May 2015 growth and inflation projections

31 The Committee's central view, on the assumption that Bank Rate followed a path implied by market interest rates and the stock of purchased assets stayed at £375 billion, was that GDP was likely to grow at or just a little below historical average four-quarter rates throughout the forecast period. Domestic demand growth was likely to be supported initially by lower energy and food prices; further out productivity growth was projected to recover and wage growth to pick up. Net exports were projected to detract slightly from growth. The central outlook for GDP growth was a little weaker than in February, reflecting a higher Bank Rate path and higher exchange rate, together with a downward revision to the outlook for housing investment and a weaker

productivity projection. Considerable uncertainty about the outlook, stemming in particular from global developments and domestic supply growth, remained. The Committee judged that the risks around the central projection were skewed slightly to the downside for much of the forecast period, reflecting the possibility of a disorderly outcome to the current Greek negotiations, rather than balanced as in February.

32 Inflation was judged likely to remain close to zero in the very near term, reflecting past falls in energy, food and other import prices and some continued drag from domestic slack. Further out, the impact of those past price falls began to drop out and declines in slack were associated with a rise in four-quarter unit labour cost growth. Conditional on the market path for Bank Rate, CPI inflation was judged likely to return to the 2% target by the two-year point and to move slightly above the target in the third year of the forecast period. Considerable risks remained around that central projection. On the downside, the factors pulling inflation down currently could prove more persistent than expected or a period of low inflation could be reflected in weaker wage pressures. On the upside, further falls in unemployment, and a pickup in the rate of turnover in employment could lead to a faster pick up in average wages. Taking into account the central projection and the risks around it, the MPC's best collective judgement was that inflation was as likely to be above as below the 2% target in early 2017, with the likelihood of inflation being above the target rising a little further into 2018. That outlook was very similar to the projection in February, despite a higher assumed path for Bank Rate and higher exchange rate, as the resultant downward revisions to the demand outlook had been offset by a downward revision to the path for productivity.

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 more gradually 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 Long-term interest rates had risen on the month across a range of developed economies, unwinding some of the falls seen since the start of 2014. While there were some candidate explanations for that move, none seemed persuasive on its own. Beyond the three-year forecast horizon, the yield curve had flattened over the past year. There was uncertainty about the reasons for this. Given that uncertainty, there was a risk that longer-term yields would go back up over time.

35 The global economic data had been mixed on the month. There were reasons to think that upward momentum in the euro area would continue: although the output surveys had weakened in April, the ECB's asset purchase programme was likely to continue to boost growth. There was also a good chance that the

sharp drop in US GDP growth in 2015 Q1 would be temporary and that at least some of the lost output would be recovered in Q2. Set against that, Chinese growth had softened and, although the authorities had taken action in response, it was likely that more stimulus would be needed to bring growth back to their target of around 7%. It was also possible that US GDP growth would be revised down in Q1 and that some of the weakness in labour productivity growth would persist. And there remained downside risks to the euro area given the possibility of a disorderly outcome of the Greek debt negotiations.

36 UK GDP growth had slowed further in the first estimate for 2015 Q1, but survey indicators continued to suggest that the pace of growth was faster than that, and it was more likely than not that the Q1 data would be revised upwards in future releases. The Committee judged that GDP growth would pick up in Q2 to close to its historical average rate, supported by the boost to real incomes from the fall in food, energy and other import prices, and would continue to grow at, or just a little below, historical average rates throughout the forecast period. Members noted, however, that the weakness in the first quarter had been common across several countries. This could reflect spillovers from a temporary global shock, or indicate a risk of a more persistent global slowdown than anticipated in the May *Inflation Report* projections.

37 The Committee's review of the supply potential of the UK economy had led it to make some small revisions to its estimates of slack and the outlook for productivity growth. Slack in the labour market was judged to be similar to that in the February *Inflation Report* projections. The composition of that slack was now thought to be somewhat different, though: it was likely to be more concentrated in the shortfall between the number of hours per week employees would ideally like to work, and the number that they actually did. There was also estimated to be less slack from labour force participation being below its trend rate. Statistical estimates of potential supply that included nominal indicators, such as wages, suggested that slack could be greater than an assessment of the bottom-up components would imply. But the degree of uncertainty around those estimates was large and there was a range of views on the MPC as to how much weight to place on them. Overall, the Committee's best collective view was that slack was currently broadly in the region of ½% of GDP and was likely to be fully absorbed within a year. There was considerable uncertainty around that judgement, however, and there was a range of views on the Committee about both the current degree of slack and how quickly it would narrow.

38 The Committee judged that productivity growth would pick up a little more gradually than expected at the time of the February *Inflation Report* as the continuing impact of changes in the composition of employment exerted a drag over the next few quarters. Beyond that, there were risks on both sides, but overall, there remained reason to believe that productivity growth would gradually return towards its pre-crisis average growth rate over the coming years.

39 There was a range of views about the degree to which the changing composition of employment growth, alongside the remaining degree of slack and weak productivity growth, could explain the weakness of wage growth over the past eighteen months, or whether there were additional factors at play. While the compositional effects were likely to continue to push down on wage growth in the very near term, the unwinding of those effects would probably result in some upward pressure on both wages and productivity thereafter and, as a

result, the consequences for unit labour costs, and therefore inflationary pressures, were likely to be limited. It was probable that diminishing labour market slack would also cause wage growth to pick up over the forecast period. For some members, there were upside risks to the central projection for wage growth as unemployment continued to fall towards its long-run equilibrium rate and some other labour market indicators approached pre-crisis averages. Other members placed greater weight on the risk that subdued wage growth would be more persistent than envisaged in the *May Inflation Report*, reflecting a greater degree of economic slack, a more persistent downward effect on wage settlements from continued low inflation, or weaker-than-expected productivity growth.

40 CPI inflation had been zero in March. In accordance with the MPC's remit, that would necessitate a second successive open letter from the Governor to the Chancellor of the Exchequer to be published alongside the *May Inflation Report*. Over the past three months, CPI inflation had evolved in line with the Committee's February *Inflation Report* projection. While it was more likely than not that inflation would briefly turn slightly negative in the near term, the MPC's best collective judgment was that this weakness would prove temporary. Around three quarters of the deviation of inflation from target could be accounted for by unusually low contributions from movements in energy, food and other goods prices. Although it was likely that low inflation would necessitate further open letters during the course of the year, the Committee's central view continued to be that, in the absence of further falls in commodity prices, inflation rates close to zero were unlikely to endure for very long. The Committee's central expectation was that CPI inflation would pick up notably towards the end of the year.

41 The appropriate horizon for returning inflation to the target would depend on the trade-off between the speed with which inflation returned to target and the consequences of that speed for output and employment. That trade-off appeared quite similar to how it had looked three months previously: inflation remained below the target while unemployment was still somewhat above its long-run sustainable rate. Eliminating the remaining economic slack, and so returning output to its sustainable level, should reduce the drag on domestic costs and prices, helping to return inflation to the target. The Committee therefore judged it appropriate to set monetary policy 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 would be likely that inflation would return to the 2% target within two years.

42 In light of that aim, and the Committee's latest set of economic projections, all Committee members agreed that it was appropriate to leave the stance of monetary policy unchanged at this meeting. For two members, the immediate policy decision remained finely balanced between voting to hold or raise Bank Rate. While there was a range of views over the most likely future path for Bank Rate, all members agreed that it was more likely than not that Bank Rate would rise over the three-year forecast period.

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, the Committee voted unanimously in favour of the proposition.

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

James Richardson was present as the Treasury representative on 7 May and Dave Ramsden was present on 8 May.