BANK OF ENGLAND

Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 14 December 2016

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These are the minutes of the Monetary Policy Committee meeting ending on 14 December 2016.

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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 minutes of the Committee meeting ending on 1 February will be published on 2 February 2017.

Monetary Policy Summary, December 2016

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 14 December 2016 the Committee voted unanimously to maintain Bank Rate at 0.25%. The Committee voted unanimously to continue with the programme of sterling non-financial investment-grade corporate bond purchases totalling up to £10 billion, financed by the issuance of central bank reserves. The Committee also voted unanimously to continue with the programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion, financed by the issuance of central bank reserves.

In the November *Inflation Report*, the Committee set out its projections for output, unemployment and inflation, conditioned on average market yields. Output was expected to grow at a moderate pace in the near term, but slow from the beginning of next year. In part that reflected the likelihood that household real income growth would slow and hence weaken household spending. It also reflected uncertainty over future trading arrangements, and the risk that UK-based firms' access to EU markets could be materially reduced, which could restrain business activity and supply growth over a protracted period. The unemployment rate was projected to rise to around 5½% by the middle of 2018 and to stay at around that level throughout 2019. Largely as a result of the depreciation of sterling, CPI inflation was expected to rise to around 2¾% in 2018, before falling back gradually over 2019 to reach 2½% in three years' time. Inflation was judged likely to return to close to the target over the following year.

Since November, long-term interest rates have risen internationally, including in the United Kingdom. In part, this reflects expectations of looser fiscal policy in the United States which, if it materialises, will help to underpin the slightly greater momentum in the global economy evident in a range of data since the summer. At the same time, however, the global outlook has become more fragile, with risks in China, the euro area and some emerging markets, and an increase in policy uncertainty.

Domestically, data released since the Committee's previous meeting continue to indicate that activity is growing at a moderate pace, supported by solid consumption growth. Forward-looking components of business surveys are weaker than those regarding current output, however, suggesting that some slowing in activity is in prospect during 2017. The timing and extent of this slowing will depend crucially on the evolution of wages and how resilient household spending is to the pressure on real incomes from higher inflation.

Twelve-month CPI inflation stood at 1.2% in November, up from 0.9% in October and 1.0% in September. Looking forward, the MPC expects inflation to rise to the 2% target within six months. Since the Committee's previous meeting, sterling's trade-weighted exchange rate has appreciated by over 6%, while dollar oil prices have risen by 14%. All else equal, this would result in a slightly lower path for inflation than envisaged in the November *Inflation Report*, though it is still likely to overshoot the target later in 2017 and through 2018.

The MPC's Remit requires that monetary policy should balance the speed with which inflation is returned to the target with the support for real activity. The lower level of sterling since the vote to leave the European Union has adversely affected that trade-off. Sterling's effect on CPI inflation will ultimately prove temporary and fully offsetting it would require exerting further downward pressure on domestic costs, including wages, and would therefore involve lost output and higher unemployment. The Committee continues to judge that such outcomes would be undesirable and, consistent with its Remit, that it would therefore be appropriate to set policy so that inflation returns to its target over a longer period than the usual 18-24 months.

Equally, there are limits to the extent to which above-target inflation can be tolerated. Those limits depend, for example, on the cause of the inflation overshoot, the extent of second-round effects on domestic costs, the evolution of inflation expectations, and the scale of the shortfall in economic activity below potential. Inflation expectations at medium-term horizons had been somewhat below their past average levels, reflecting the period of below-target inflation, although some measures have risen more recently. The Committee continues to monitor the evolution of these expectations closely.

In light of these developments, and in keeping with its Remit, the MPC at its December meeting agreed unanimously that Bank Rate should be maintained at its current level. It also agreed unanimously to continue the previously announced asset purchase programmes, financed by the issuance of central bank reserves.

Earlier in the year, the Committee noted that the path of monetary policy following the referendum on EU membership would depend on the evolution of the prospects for demand, supply, the exchange rate, and therefore inflation. This remains the case. Monetary policy can respond, in either direction, to changes to the economic outlook as they unfold to ensure a sustainable return of inflation to the 2% target.

Minutes of the Monetary Policy Committee meeting ending on 14 December 2016

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 Financial market movements since the Committee's previous meeting had been dominated by reaction to the US election result, although other global events, and market participants' continuing assessment of domestic prospects following the vote to leave the European Union, had also featured.

3 Following the election, US short-term and long-term interest rates, equity prices and the dollar had all risen. This was consistent with a re-evaluation of US growth prospects, perhaps in expectation of more stimulatory fiscal policy on the part of the new administration. The composition of equity price movements, with sectors more exposed to any cyclical upswing doing better, had added weight to this view. In addition, the macroeconomic news in the United States had been broadly positive since the summer and it was possible that, with the election now out of the way, markets had re-evaluated the outlook.

4 Although there remained a gap between the two, the rise in short-term US interest rates had brought the forward curve more into line with the interest rate expectations of the median FOMC member published in September, and markets were pricing in a very high chance of an increase in the federal funds rate at the December meeting. Nonetheless, the scale of the increase in market interest rates, particularly at the long end, suggested that it also reflected other factors. Market participants might now be placing less weight on the possibility of a prolonged period of very low nominal growth. Consistent with this, market measures of longer-term inflation expectations in the United States had picked up towards historical averages.

5 Equity prices and longer-term interest rates had also risen in other advanced economies. Market intelligence suggested that some of this had reflected increased expectations of more stimulatory fiscal policy outside the United States, although concrete steps had as yet been taken in only a small number of countries. Oil prices had risen sharply in response to the confirmation by OPEC that it would cut production.

6 Relative to the conditioning assumptions underlying the Committee's November projections, sterling had risen by over 6% and UK three-year forward OIS rates had risen by around 35 basis points. Long rates had also risen materially. Although break-even rates had increased, inflation swaps – which were likely to be a more reliable measure of inflation compensation – had been little changed. The sterling exchange rate, in particular, might have been influenced by evolving expectations of the United Kingdom's longer-term relationship with the European Union and the possible implications this would have for the economy.

The international economy

7 Since the Committee's previous meeting there had been further confirmation of a modest improvement in the global conjuncture and there was a possibility of an additional boost from some loosening in US fiscal policy. But downside risks in China, other emerging markets and the euro area had probably intensified.

8 In the United States, headline data on the macroeconomy had continued to be more buoyant than during the first half of the year. GDP growth in the third quarter had been revised up to 0.8% and the unemployment rate had fallen to 4.6% in November, although underlying momentum had probably been a little more even throughout the year than the pattern of headline GDP and unemployment numbers had indicated. Bank staff had revised down their expectation for growth in the fourth quarter to 0.4% following weak data on trade flows in October. Nonetheless, in several respects the US economy looked to be running with little slack. Looking further forward, the outlook would crucially depend on the size and composition of any fiscal stimulus package, and on the policies of the new administration more broadly.

9 The Committee also considered the impact of the US election result on emerging market economies. In response to the stronger dollar and higher US market interest rates, emerging markets had seen considerable gross capital outflows. On some measures these had been on a par with the 'taper tantrum' period in the second quarter of 2013. The currencies of a number of major emerging markets had depreciated since the election, in some cases by over 10%, equity prices had fallen and sovereign bond spreads over US Treasury yields had widened in a number of countries. This would lead to a tightening in financial conditions and make servicing dollar-denominated debt more expensive. Relative to 2013, however, emerging markets generally seemed better placed to weather these capital outflows, and, taken over the year as a whole, net capital inflows had remained positive. Current account deficits had fallen in some large economies, inflation was lower and activity growth looked to have bottomed out. To the extent that the dollar had strengthened in anticipation of looser US fiscal policy, emerging markets would benefit from stronger export demand.

10 The Chinese renminbi had depreciated a little against the US dollar against a backdrop of renewed capital outflows and further falls in foreign exchange reserves. Domestically, although activity looked likely to meet the authorities' target for GDP growth in 2016 of between 6.5% and 7%, house price inflation was running at very rapid rates in the larger cities, and credit growth continued to outpace nominal GDP growth by some margin. Given very high and rising levels of debt, and some incipient signs of inflationary pressure, the challenges facing the authorities were considerable as they sought to rebalance the Chinese economy.

11 Euro-area GDP had grown by 0.3% in 2016 Q3 and Bank staff expected growth rates of 0.4% in Q4 and 2017 Q1. Inflation remained significantly below target, but was likely to pick up in coming months, reflecting higher commodity prices. Against this backdrop, the ECB had announced a continuation of its asset purchases until December 2017, albeit at a slower pace from April onwards. There had been some modest increase in sovereign bond spreads in Italy, Portugal and France in the run up to the constitutional referendum in Italy, although they remained much lower than in 2011 and 2012. A high level of non-performing loans continued to affect perceptions of the long-term profitability of the Italian banking system.

Money, credit, demand and output

12 UK GDP growth in 2016 Q3 had been unrevised in the second estimate, at 0.5%. The expenditure breakdown had shown an increase in business investment of 0.9%, in contrast to the Committee's forecast of a modest fall. Although this could be interpreted as upside news for demand, possibly indicating less of a drag from uncertainty than had been expected, it was probably unwise to take a strong signal from it as early estimates were prone to significant revision. More generally, growth appeared to have been remarkably stable during 2016: although the staff nowcast for Q4 was 0.1 percentage points lower than growth in Q3, the fall was more than accounted for by erratic movements in extraction output that had boosted growth in Q3 and would depress it in Q4.

13 The central projection in the November *Inflation Report* had contained a slowing in demand during 2017, and the Committee discussed what signs there had been to support this expectation. The resilience of demand growth in 2016 had been largely due to household spending, and most of the recent consumption indicators had remained solid: retail sales had been buoyant, with annual growth in October at its strongest in fourteen years; car registrations had been relatively steady; and housing market data had continued to surprise on the upside, with mortgage approvals and house price inflation both picking up more strongly than expected and the latest RICS survey continuing to point to further strengthening in prices and activity. There had, however, been a notable decline in consumer confidence, including households' reported likelihood of making a major purchase. It was possible that expectations of faster increases in retail prices over the coming months, with an attendant dampening in real income growth, had begun to weigh on sentiment, if not yet on spending. Nevertheless, consumer confidence remained around long-run average levels.

14 Other activity indicators had also shown signs of moderation. Industrial production had dropped sharply in October, with a notable fall in manufacturing output having reinforced the decline in extraction. The Markit/CIPS composite expectations index had weakened in November, with firms considerably less optimistic about the coming twelve months than they had been prior to the EU referendum. Expectations of service sector firms in the CBI survey had also deteriorated. And, on balance, investment intentions had remained below pre-referendum levels. All in all, although recent experience had highlighted the uncertainties inherent in reading across from the high-frequency indicators of both activity and expectations to the official outturns, a slowing in activity in 2017 still appeared to be a reasonable central case.

15 The Autumn Statement had provided some upside news for demand relative to the conditioning assumptions underlying the November *Inflation Report* projections. The OBR had revised up its forecast for public sector net borrowing by around 1½% of GDP per year. Roughly half of this revision was accounted for by lower expected GDP growth while the remainder resulted largely from a combination of discretionary measures to support economic activity and downward revisions to projected tax receipts relative to GDP. The second two factors would reduce the extent to which fiscal policy would act as a headwind to aggregate demand over the next few years, although the precise quantitative effect was highly uncertain, not least because it was likely that the strength of fiscal measures to support growth might vary with the prevailing economic environment. The

introduction of the National Productivity Investment Fund was likely to be positive for aggregate supply, but from the perspective of monetary policy the effects seemed likely to be quantitatively modest in the near term.

Supply, costs and prices

16 Official data suggested that labour demand had remained healthy during the second half of the year, commensurate with the stability of output and demand growth. The LFS unemployment rate had declined by 0.1 percentage points to 4.8% in the three months to October, while the claimant count measure had held steady at 2.3% in November. The number of job vacancies had been roughly stable since early 2016 at historically high levels. And the number of people moving directly from one job to another had risen in the third quarter. The Committee expected output growth to slow in 2017, and it remained probable that the unemployment rate would rise somewhat over the coming year.

17 Annual private sector regular pay growth had been 2.8% in the three months to October, an increase on the previous three months, but nevertheless within the range of 2 to 3% or so that it had occupied since the autumn of 2014. Indeed, it was striking how stable pay growth had been over the past few years even as the unemployment rate had declined from 8½% to less than 5%. Over a number of years, the Committee's expectations for some recovery in pay growth had been confounded. In part, this was likely to have reflected serial disappointment in the rate of productivity growth and, more recently, the influence of very low headline consumer price inflation. Given the prospect of a fairly sharp pickup in price inflation as a result of the depreciation of sterling since the start of the year, some recovery in pay growth still seemed a reasonable central expectation. But it remained to be seen how quickly and to what extent this would occur.

18 On the one hand, it was possible that firms would seek to restrain pay increases in order to mitigate the impact of both higher imported costs and only moderate productivity gains on final retail prices – and that employees, taken as a whole, would continue to accept historically weak pay growth rather than risk job losses. Such pay restraint seemed consistent with behaviour in the labour market following the financial crisis, during a period of stagnant productivity growth and above-target consumer price inflation. The Committee's November projections expected this restraint to persist, with the rate of CPI inflation expected to overtake that of pay growth marginally during 2017. On the other hand, however, it was possible that pay growth might be more responsive to the prospective increase in consumer prices, at least in the near term, than had recently been the case – perhaps especially now that the unemployment rate had fallen to around its pre-crisis low.

19 Assessing these forces was particularly challenging because the historically typical relationship between pay growth and the unemployment rate appeared to have altered over the past few years. The main difficulty had been in identifying the causes of that change. Potential explanations included weaker productivity growth, more flexible pay bargaining, a greater decline in the equilibrium unemployment rate, and the sensitivity of wages to recent low inflation rates. Although something might be learned about the responsiveness of wages to the pickup in inflation during the traditional pay settlement period at the start of next year, it was probable that many of these settlements would be determined against a background of below-target headline inflation figures.

20 Twelve-month CPI inflation had been 1.2% in November, in line with Bank staff's expectation for that month's outturn at the time of the November *Inflation Report*. In between, CPI inflation had dipped back to 0.9% in October, thus necessitating an open letter from the Governor to the Chancellor of the Exchequer to be published alongside the release of these MPC *Minutes*. Recent volatility in CPI inflation appeared in large part related to movements in the prices of clothing and footwear. These might have been connected to an unusual pattern of seasonal discounting in 2016. A range of measures of domestically generated inflation had continued to edge up, although they had remained below historical average rates and those relating more directly to final consumer prices had risen by less.

21 The sterling effective exchange rate index had appreciated by 6% since the time of the November *Inflation Report* such that the overall depreciation of sterling since its peak in November 2015 had been around 16%. This recent move would imply somewhat less of a boost to CPI inflation from imported costs than had been factored into the November projections and, taken in isolation, somewhat less of an overshoot of inflation relative to its target during the next three years or so. To date, the responsiveness of measures of import prices to the lower value of sterling had been in line with what the Committee had anticipated. It was too early to tell whether the pass-through from imported costs to final retail prices would evolve as expected. This might become clearer over the next few months. More broadly, further volatility in asset prices, including the sterling exchange rate, was likely over the coming months and this had the potential to affect the outlook for inflation materially in either direction.

22 As the Committee had previously stressed, one of the critical factors in determining the appropriate policy response to the prospect of a period of above-target inflation would be the extent to which it caused expectations of inflation in the medium term to rise. Indicators of this were being closely monitored by the Committee. Measures derived from swaps of the compensation required for inflation in the medium term had been fairly stable since the time of the November *Inflation Report*, following the sharp rise in early October, although break-even rates had risen. The YouGov/Citigroup measure of households' inflation expectations over the next five to ten years had increased slightly to 2.8% in November, having gradually drifted up from 2.4% in July. The Bank of England/TNS measure of expectations five years ahead had been roughly unchanged in Q4. Both the comparable measure of household expectations two years ahead and the equivalent figure from the Barclays BASIX survey had increased relatively briskly, although by no more than would have been warranted given the likely impact of sterling's recent depreciation. The balance of respondents to the GfK survey expecting inflation to increase over the next twelve months had increased sharply in November.

The immediate policy decision

23 The Committee set monetary policy to meet the 2% inflation target, and in a way that helped sustain growth and employment. Since the vote to leave the European Union, the main challenge for monetary policy had been to balance a likely period of above-target inflation following the large depreciation of sterling with supporting activity and employment in the face of lower real income growth and uncertainty over future trading arrangements. The Committee considered how developments since its previous meeting had affected this trade-off.

24 Long-term interest rates had risen internationally, including in the United Kingdom. In part, this reflected expectations following the US election of looser fiscal policy there. If that materialised, it would help to underpin the slightly greater momentum in the global economy evident in a range of data since the summer and reduce further the remaining risk of persistently low inflation. The currencies of some emerging market economies had depreciated against the dollar, but by and large most were in a better position to weather such asset price movements than they had been during a similar period in 2013. In China, however, vulnerability to capital outflows had increased and risks had arguably become more pressing, as debt and house prices had risen rapidly and growth had become more reliant on credit expansion. In the euro area, while activity growth had remained steady and the ECB had announced an extension of its asset purchase programme, risks surrounding the banking system remained elevated. Taken together, the central outlook for the global economy had probably improved, but, notwithstanding low levels of financial market volatility, fragilities had become more evident and policy uncertainty had increased.

25 Domestically, data released since the Committee's previous meeting had confirmed the remarkably steady path of activity during 2016, and a range of indicators pointed to GDP growth of around 0.4% in Q4. Forward-looking components of business surveys were weaker than those regarding current output, however, and reported investment intentions remained below pre-referendum levels. Some slowing in activity was therefore in prospect during 2017.

26 The timing and extent of this slowing would depend crucially on the evolution of wages and how resilient consumption growth would be to the pressure on real incomes from higher inflation. Household spending had underpinned recent GDP growth and there had been little sign of weakness in near-term indicators: consumer confidence had fallen but was still around historical averages, consumer credit continued to grow rapidly, and housing market activity had been relatively resilient. Media references to uncertainty had picked up again, but it was unclear what impact this would have on sentiment in the absence of any tightening in credit conditions or increase in job insecurity. Nonetheless, real incomes were likely to slow as higher imported costs pushed up on domestic inflation.

27 Twelve-month CPI inflation had been 1.2% in November, up from 0.9% in October and 1.0% in September. Looking forward, the Committee expected inflation to rise to the 2% target within six months, boosted in part by the recent increase in oil prices. The sterling effective exchange rate had appreciated by 6%, since the time of the November *Inflation Report*, however, in part reflecting evolving expectations of the United Kingdom's longer-term relationship with the European Union and the possible implications this would have for the economy both in the near term and further out. This appreciation would imply somewhat less of a boost to CPI inflation from imported costs than had been factored into the November projections and, therefore, in isolation somewhat less of an overshoot of inflation relative to its target during the next three years or so. Further volatility in asset prices, including the sterling exchange rate, was possible over the coming months and this had the potential to affect the outlook for inflation materially in either direction.

28 Indicators of inflation expectations were being closely monitored by the Committee. Although break-even inflation rates had increased, inflation swaps – which were likely to be a more reliable measure of inflation

compensation – had been little changed. The balance of respondents to the GfK survey expecting inflation to pick up over the next twelve months had increased sharply in November.

29 The Committee took note of the recent policy statements made by the FPC. In particular, it noted that the financial system had not amplified recent shocks despite the challenging outlook for financial stability. The UK banking system had in aggregate remained well capitalised in the stress tests the FPC and PRA had conducted, requiring no new macroprudential measures, although the FPC had kept in place its tools for mitigating risks from the housing market.

30 Against this backdrop, the Committee agreed that no change in policy was warranted at this meeting. A slowdown in growth remained likely, but there had been little news since the time of the November *Inflation Report* about domestic activity and, although the near-term global outlook had improved, this was counterbalanced by more elevated risks. The sterling exchange rate had appreciated and this would by itself point to less of an overshoot in inflation relative to the target in the medium term, though month-to-month volatility was to be expected as market participants' views on the United Kingdom's future relationship with the European Union continued to evolve. The Committee would continue to monitor domestic costs and indicators of inflation expectations closely. Earlier in the year, the Committee noted that the path of monetary policy following the referendum on EU membership would depend on the evolution of the prospects for demand, supply, the exchange rate, and therefore inflation. This remained the case. Monetary policy could respond, in either direction, to changes to the economic outlook as they unfolded to ensure a sustainable return of inflation to the 2% target.

31 The Governor invited the Committee to vote on the propositions that:

> Bank Rate be maintained at 0.25%;
>
> The Bank of England continue with the programme of sterling non-financial investment-grade corporate bond purchases totalling up to £10 billion, financed by the issuance of central bank reserves;
>
> The Bank of England continue with the programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion, financed by the issuance of central bank reserves.

The Committee voted unanimously in favour of all three propositions. For Kristin Forbes and Ian McCafferty, who had opposed the increase in asset purchases in August, the current outlook still did not fully warrant the additional stimulus that they generated. However, given the potential costs to the economy of reversing the programme underway, they would not vote against the continuation of the programme.

32 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
Michael Saunders
Gertjan Vlieghe

Dave Ramsden was present as the Treasury representative.