BANK OF ENGLAND

Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 13 July 2016

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These are the minutes of the Monetary Policy Committee meeting ending on 13 July 2016.

They are available at http://www.bankofengland.co.uk/publications/Pages/news/2016/007.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 minutes of the Committee meeting ending on 3 August will be published on 4 August 2016.

Monetary Policy Summary, July 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 13 July 2016, the MPC voted by a majority of 8-1 to maintain Bank Rate at 0.5%, with one member voting for a cut in Bank Rate to 0.25%. The Committee voted unanimously to maintain the stock of purchased assets financed by the issuance of central bank reserves at £375 billion. Committee members made initial assessments of the impact of the vote to leave the European Union on demand, supply and the exchange rate. In the absence of a further worsening in the trade-off between supporting growth and returning inflation to target on a sustainable basis, most members of the Committee expect monetary policy to be loosened in August. The precise size and nature of any stimulatory measures will be determined during the August forecast and *Inflation Report* round.

Financial markets have reacted sharply to the United Kingdom's vote to leave the European Union. Since the Committee's previous meeting, the sterling effective exchange rate has fallen by 6%, and short-term and longer-term interest rates have declined. Reflecting the fall in the level of sterling, financial market measures of inflation expectations have risen moderately at short-term horizons, but only to around historical averages, and have fallen slightly at longer horizons. Markets have functioned well, and the improved resilience of the core of the UK financial system and the flexibility of the regulatory framework have allowed the impact of the referendum result to be dampened rather than amplified.

Official data on economic activity covering the period since the referendum are not yet available. However, there are preliminary signs that the result has affected sentiment among households and companies, with sharp falls in some measures of business and consumer confidence. Early indications from surveys and from contacts of the Bank's Agents suggest that some businesses are beginning to delay investment projects and postpone recruitment decisions. Regarding the housing market, survey data point to a significant weakening in expected activity. Taken together, these indicators suggest economic activity is likely to weaken in the near term.

Twelve-month CPI inflation was 0.3% in May and remains well below the 2% inflation target. Measures of core inflation have been stable at a little over 1%. The shortfall in headline inflation is due predominantly to unusually large drags from energy and food prices, which are expected to attenuate over the next year. In addition, the sharp fall in the exchange rate will, in the short run, put upward pressure on inflation as the prices of internationally traded commodities increase in sterling terms, and as importers pass on increases in their costs to domestic prices.

Looking further forward, the MPC made clear in its May *Inflation Report*, and again in the minutes of its June meeting, that a vote to leave the European Union could have material implications for the outlook for output and inflation. The Committee judges that a range of influences on demand, supply and the exchange rate could lead to a significantly lower path for growth and a higher path for inflation than in the central projections set out in the May *Report*. The Committee will consider over the coming period how the outlook for the economy has changed in light of the referendum result and will publish its new forecast in its forthcoming *Inflation Report* on 4 August.

The MPC is committed to taking whatever action is needed to support growth and to return inflation to the target over an appropriate horizon. To that end, most members of the Committee expect monetary policy to be loosened in August. The Committee discussed various easing options and combinations thereof. The exact extent of any additional stimulus measures will be based on the Committee's updated forecast, and their composition will take account of any interactions with the financial system.

Against that backdrop, at its meeting ending on 13 July, the majority of MPC members judged it appropriate to leave the stance of monetary policy unchanged at present. Gertjan Vlieghe preferred to reduce Bank Rate by 25 basis points at this meeting.

Minutes of the Monetary Policy Committee meeting ending on 13 July 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 There had been large financial price movements over the month following the United Kingdom's vote to leave the European Union. The level of uncertainty in markets had remained elevated following the result, given the lack of clarity over the United Kingdom's future political and trading arrangements. There remained the possibility of further volatility as more information became available and market participants reconsidered their longer-term investment strategies.

3 Sterling had depreciated sharply on 24 June, with the sterling-dollar exchange rate reaching its lowest level in thirty years. The trade-weighted effective exchange rate had ended the period 7% lower than the 15-day average at the time of the May *Inflation Report*. Implied volatilities in sterling foreign exchange options at short horizons had fallen back as the uncertainty about the referendum result itself was removed. But longer-term measures had remained elevated, consistent with greater uncertainty over the longer-term prospects for sterling. Following the result, the price of using options to protect against the risk of sterling depreciation had fallen compared with the price of protection against an appreciation. But it had remained elevated compared to historic levels, implying that market participants still saw the balance of risks as being to the downside.

4 It was likely that asset price movements had reflected perceptions of a weaker UK growth outlook and some concerns about a longer-term deterioration in the United Kingdom's terms of trade and supply capacity. The FTSE All-Share index had ended the period higher than at the time of the Committee's previous meeting, though this had been flattered by the large weight of companies in the index with international activities. The share prices of UK-focused firms within the All-Share index had fallen. The property sector had been particularly affected: share prices of house builders and real-estate investment trusts had dropped sharply, and trading had been suspended in several UK property funds.

5 The share prices of UK banks with a focus on the domestic economy had also fallen sharply, consistent with an increase in investors' concerns about their future profitability. Reassuringly, however, banks' CDS prices and other wholesale funding spreads had risen only relatively modestly, and by less than during other historical episodes of elevated uncertainty. This most probably reflected the increased resilience of the banking sector owing to the substantial capital and liquidity buffers that had been built up in recent years.

6 More generally, the Committee had taken some reassurance from the evidence that markets had continued to function effectively throughout the period. The overall resilience of the UK financial system, and the flexibility of the regulatory framework, had allowed the impact of the referendum result to be dampened rather than amplified. There had been little sign that asset prices had been distorted by impaired market functioning.

7 Short-term sterling interest rates had risen in the run up to the referendum as expectations for a 'remain' vote had increased, but fell sharply in response to the 'leave' outcome, leaving the three-year instantaneous forward OIS rate well below its level at the time of both the Committee's previous meeting and the May *Inflation Report*. Gilt yields had also fallen sharply, with 10-year yields having declined to record lows. One key factor behind the fall in yields was likely to have been the expectation of further monetary loosening: 44 out of 48 respondents to the latest Reuters poll expected the next change in Bank Rate to be a cut. Market contacts had also noted some speculative positioning for further purchases of gilts by the Bank, with some long-maturity gilt yields having fallen by more than equivalent maturity swap rates. There had been no discernible response in gilt yields to the revisions to the United Kingdom's sovereign outlook by credit rating agencies.

8 The referendum result had also had an impact on policy expectations abroad. Short rates had fallen in the United States, with the timing of the next rate increase, as implied by OIS rates, pushed well into 2018. In the euro area there had been increased expectation of further easing via the ECB's asset purchase programmes.

The international economy

9 By and large, there had been less news over the month on global economic developments than in the United Kingdom. The focus of the Committee's discussions was therefore on the potential spillovers from the referendum result to the global economy, particularly to continental Europe. External forecasters' central expectations were that the impact of the result would weaken future growth in world GDP; the Committee would form its own view of the outlook and the balance of risks during its forthcoming forecast round.

10 In the immediate aftermath of the referendum, yields on safe assets had fallen globally, the prices of risky assets had generally declined and some currencies that market participants had traditionally regarded as "safe havens" had appreciated. Some of these movements had since unwound – in particular, global equity prices had ended the period a little higher than at the time of the Committee's previous meeting – but short-term and longer-term interest rates had remained lower, and the prices of some risky euro-area assets had not recovered.

11 Activity in the euro area could be affected through a number of channels. In the short run, the lower sterling exchange rate would act to reduce exports to the United Kingdom, and uncertainty about the United Kingdom's future trading arrangements had the potential to hold back business investment and major household purchases in the euro area. A period of uncertainty might additionally exacerbate some pre-existing vulnerabilities. First, heightened risk aversion could push up borrowing costs on the sovereign debt of vulnerable periphery economies, although there had been only a limited widening in spreads on such debt so far. Second, and more substantively, the equity prices of many euro-area banks had fallen considerably and not yet recovered. With a number of these banks, particularly in Italy, still holding a large fraction of non-performing loans on their balance sheets following the financial crisis, a period of lower growth had the potential further to damage profitability and, at the margin, to hinder credit supply. Finally, unresolved issues around the future institutional arrangements in both the euro area, and the European Union more broadly, might be thrown into sharper relief following the referendum result.

12 Set against that, policymakers in the euro area had a number of tools at their disposal. In particular, the ECB was currently undertaking a programme of purchases of euro-area government and corporate bonds. It was also stimulating credit availability through its targeted long-term repo operations with banks.

13 Elsewhere, direct trade links with the United Kingdom were smaller and the impact on growth, at least through this channel, was expected to be more modest. Perhaps reflecting that, and the supportive effects of lower expected interest rates, the prices of risky assets had generally recovered. Short-term interest rates in the United States had fallen to very low levels, consistent with the next increase in the federal funds rate not occurring until well into 2018, despite an expected rebound in GDP growth in the second quarter and a strong outturn for non-farm payrolls in June.

14 The very muted pace of expected policy tightening in the United States would provide some support to emerging markets, where capital flows were vulnerable to sudden changes in US interest rate expectations. But the further decline in long-run interest rates in advanced economies, coupled with continued disappointment in rates of productivity growth, raised questions surrounding longer-run growth prospects.

Money, credit, demand and output

15 In the United Kingdom, the third estimate of GDP growth for 2016 Q1 had been unchanged at 0.4%. Although the data were prone to substantial revision, it was notable that business investment was still estimated to have declined for the second quarter in succession. Upward revisions to estimates of household income had meant that the savings ratio had been revised higher. Instead of a downward trend to 4% shown previously, it now displayed a stable path at around 6-7% since 2013. The estimated current account deficit, at 6.9% of GDP, was a little lower than the record 7.2% registered in 2015 Q4, but much larger than expected at the time of the May *Inflation Report*. The deficit on income from foreign direct investment had increased to 1.5% of GDP in 2016 Q1, from 1.3% in the previous quarter.

16 Activity indicators for 2016 Q2 had been reasonably solid in the run-up to the referendum, albeit with signs of weakness in particular sectors. In light of some stronger than expected official estimates of output growth across services, industrial production and construction, it seemed likely that Q2 GDP growth would be around 0.5%, stronger than in the May *Inflation Report* projections. Retail sales had risen by 0.9% in May, following an upwardly revised 1.9% rise in April. By contrast, private car registrations had declined by 7% on the quarter on a seasonally adjusted basis and the May RICS survey had indicated an abrupt slowing in reported and expected housing market activity and a marked weakening in house price expectations. The Markit/CIPS composite output index had continued its downward trend in June, with the construction survey pointing to a contraction in activity.

17 The Committee discussed how the vote to leave the European Union might affect UK activity in the near term, and what the information available so far had indicated. The fall in sterling would provide some support to exports, and, together with valuation effects on investment income flows, lead to some reduction in the current account deficit. It would also improve the net foreign asset position. Less positively, any consequent rise in import price inflation was likely to impart a drag on households' real income growth, and so dampen domestic

demand. More generally, a persistent shift in the terms of trade was likely to lead gradually to a reallocation of the United Kingdom's productive capacity between different sectors. As this would take time, it was likely to carry negative implications for productivity.

18 During previous periods when growth had slowed, the effects had often first become apparent in the residential and corporate real estate markets. Uncertainty surrounding the economic outlook was also likely to weigh on business investment more generally, although the effect might be gradual as it took time for any revisions to capital spending plans to take effect. Household consumption was also likely to weaken in response to a weaker housing market and a softer employment outlook, though the timing of such effects was uncertain. The Committee considered each of these transmission channels and would estimate their effects in the August forecast round.

19 Regarding the housing market, a preview of the June RICS survey had pointed to a marked weakening in expected activity and prices following the referendum result. Bank staff had lowered their forecast of housing investment significantly and had revised down the near-term outlook for house prices. The forecast for housing investment had a direct read-across to GDP, while the outlook for house prices was expected to act as a drag on household consumption. Staff were also expecting sizeable falls in commercial real estate prices in the near term. As the Financial Policy Committee had noted, this might affect economic activity by reducing the ability of companies that use commercial real estate as collateral to access finance. On the other hand, investment financed out of retained earnings was unlikely to be directly affected by this.

20 The Bank's macroeconomic uncertainty indicator had risen further, to 1.3 standard deviations above its historical average. Consistent with this environment of heightened uncertainty, market intelligence suggested that some companies had paused or scaled back their investment plans. The Bank's Agents had reported that around one third of business contacts spoken to in the week following the referendum were expecting some detrimental impact from the result on their capital spending over the next twelve months, but there had been no clear evidence yet of a sharp slowing in activity and many firms had only just begun to formulate new business strategies in response to the vote. Nonetheless, the Lloyds Bank Business Barometer for June, which was based on a survey in the week after the referendum, had reported a sharp decline in business confidence, to its lowest level since the euro area crisis. A snap survey by the Institute of Directors immediately following the referendum had found that a third of firms expected to cut investment, with half of these expecting the reductions to be "significant". The latest Deloitte CFO survey had found that 80% of companies expected whole-economy business investment and recruitment to fall over the next twelve months.

21 A snap consumer survey by GfK had reported the sharpest monthly fall in confidence for over two decades. Payment systems data, footfall and department store sales, by contrast, had not shown any material decline, although these indicators had not, historically, been especially reliable signals of household spending. It was possible that any detrimental effect on households would emerge only should broader economic weakness become manifest in employment and pay.

22 In sum, although the data so far had been insufficient to estimate with confidence the quantitative effect on GDP and the precise timing of the slowdown, the uncertainty flowing from the referendum result was likely to be

negative for near-term activity. There had been clear evidence of a weakening in property markets, and measures of consumer and business confidence had fallen sharply; but in terms of the broader activity outlook, much would depend on the degree and timing of any further retrenchment in business investment, and the flow through to households via the labour market. Both of these were likely to take some time to gauge.

Supply, costs and prices

23 Data on the labour market, costs and prices covering the period prior to the referendum had been broadly consistent with the outlook set out by the Committee in its May *Inflation Report*. Unemployment had fallen to 5.0% in the three months to April, and regular pay in the private sector had risen at an annualised rate of around 4% in the six months to April, the fastest rate of growth since September 2014. Whole economy unit labour costs, computed using the Bank's back-cast for GDP growth, had risen by 1.5% in Q1, although much of this increase had reflected a sharp rise in the volatile non-wage component. Nonetheless, in the months prior to the vote, underlying pay growth had strengthened.

24 Few hard data covering the post-referendum period had yet been released and very little survey evidence was available so far. The Committee considered the evidence to hand, drawn from financial markets, from contacts of the Bank's Agents and from business surveys, where available, about the implications of the result for the demand for labour, supply prospects, and inflation.

25 As regards employment intentions, the REC *Report on Jobs* – largely covering the weeks leading up to the referendum – had noted a fall in permanent staff placements in June, leaving the level in Q2 as a whole at its lowest since 2012 Q3. The vacancies balance had also fallen, to its lowest level since May 2013. Since the result, contacts of the Bank's Agents had generally reported that they expected to scale back recruitment plans over the coming twelve months, particularly in the consumer services and construction sectors, although the majority planned to do so only slightly. A quarter of respondents to the survey by the Institute of Directors had said that they planned to freeze recruitment.

26 If maintained, the pause in spending on new investment projects would, over time, begin to hold back the supply capacity of the economy. The longer any period of uncertainty persisted, the larger this impact would be. Some contacts also noted uncertainty about the future funding of research and development, some of which currently came from EU sources. Any reduction in spending on research and other intangible capital in response to heightened uncertainty had the potential, too, to hold back productivity growth. Looking further forward, it was a possible that some, perhaps considerable, reallocation of resources across sectors would follow from the clarification of the United Kingdom's future trading relationship with the European Union. This could be associated with a period of weaker productivity growth as supply chains were adjusted. But businesses would be reluctant to mothball or scrap machinery, equipment or other capital earlier than necessary, and in many sectors it was possible that activity would continue on the basis of existing trading relationships for some time.

27 In the short run, the sharp fall in the exchange rate would put upward pressure on inflation as the prices of internationally traded commodities increased in sterling terms, and as importers passed on increases in their

costs to domestic prices. Although the pace at which this would happen was uncertain, there was no reason as yet to believe that it would happen either more quickly or more slowly than had occurred on average following previous exchange rate depreciations. In the longer run, the path for inflation would also depend crucially on how inflation expectations responded. As yet, there had been no survey data released on how, if at all, households and businesses had adjusted their expectations following the result. Financial market measures of near-term inflation expectations had picked up slightly following the referendum, although only to around historical averages. And measures of longer-term inflation expectations had fallen.

The immediate policy decision

28 The Committee set monetary policy to meet the 2% inflation target, and in a way that helped sustain growth and employment. In its May *Inflation Report*, and again in the minutes of its June meeting, the Committee had made clear that a vote to leave the European Union could have material implications for the outlook for output and inflation. The combination of movements in demand, supply and the exchange rate could lead to a materially lower path for growth and notably a higher path for inflation than in the projections set out in the May *Report*.

29 The Committee would consider over the coming period how the outlook for the economy had changed in light of the referendum result and would publish its new forecast in its August *Report*. It considered at this meeting the early evidence on the impact of the result and the implications this had for monetary policy, in light of the actions already taken by the FPC, the PRA and the Bank.

30 There had been a sharp reaction in financial markets following the announcement of the vote to leave the European Union. Sterling had fallen markedly against the dollar and the effective exchange rate was 6% lower than at the time of the Committee's previous meeting. Although the FTSE All-Share index had risen over the same period, the equity prices of banks focused on the UK economy and other companies exposed to the domestic property sector had fallen. Short-term and longer-term interest rates had declined internationally and there had been falls in the prices of risky assets in the euro area, in some cases exacerbating existing vulnerabilities. Nonetheless, markets had functioned well, and the improved resilience of the core of the UK financial system, and the flexibility of the regulatory framework, had allowed the impact of the referendum result to be dampened rather than amplified, such that there had been little indication that asset prices had been distorted by impaired market functioning.

31 Official data on economic activity covering the period since the referendum were not yet available. The Bank's macroeconomic uncertainty indicator had risen further and there had been preliminary signs that the referendum result had affected sentiment among households and companies, with sharp falls in the Lloyds Business Barometer and in a snap GfK consumer confidence survey. Early indications from surveys by the Institute of Directors and Deloitte, and from contacts of the Bank's Agents, had suggested that some businesses were beginning to delay investment projects and postpone recruitment. Regarding the housing market, the latest RICS survey had pointed to a significant weakening in expected activity. This evidence suggested the uncertainty flowing from the referendum result was likely to depress economic activity in the near term.

32 Twelve-month CPI inflation had been 0.3% in May and remained well below the 2% inflation target. Measures of core inflation had been stable at a little over 1%. This shortfall in headline inflation was due predominantly to unusually large drags from energy and food prices, which were expected to attenuate over the next year. Wage growth had picked up somewhat in the months ahead of the referendum. In addition, the sharp fall in the exchange rate would, in the short run, put upward pressure on inflation as the prices of internationally traded commodities increased in sterling terms, and as importers passed on increases in their costs to domestic prices. In the longer run, the path for inflation would also depend crucially on how inflation expectations responded. Financial market measures of near-term inflation expectations had risen moderately following the referendum, although only to around historical averages. Financial market measures of longer-term inflation expectations had fallen.

33 The Committee took note of the Bank's announcement that it would continue to offer indexed long-term repo operations on a weekly basis until end-September 2016. This was a precautionary step to provide additional flexibility in the Bank's provision of liquidity insurance, complementing banks' ability to draw on their own liquidity buffers. The MPC was aware, too, of the position of the PRA to allow insurance companies to use the flexibility in Solvency II regulations to reduce any immediate pressure on them to sell corporate securities and other risky assets.

34 The Committee noted the assessment of the FPC, published in its July *Financial Stability Report*, that the current outlook for UK financial stability was challenging and that there was evidence that some of the risks to financial stability associated with the referendum had begun to crystallise. It noted, too, that the domestic banking system was much better placed to face this challenging outlook than during earlier periods of stress. Regulators in the United Kingdom and internationally had ensured over recent years that banks had strengthened their balance sheets such that the financial system had become more resilient. The FPC expected that capital and liquidity buffers would be drawn upon as needed to support the supply of credit and in support of market functioning. The MPC noted the actions taken by the FPC at its recent policy meeting to reduce the counter-cyclical capital buffer from 0.5% to zero, which would reduce regulatory capital buffers by £5.7 billion, raising banks' capacity for lending to UK households and businesses by up to £150 billion.

35 The MPC was committed to taking whatever action was needed to support growth and to return inflation to the target over an appropriate horizon. To that end, most members of the Committee expected monetary policy to be loosened in August.

36 The Committee reviewed a range of possible stimulus measures and combinations thereof. It considered the potential interaction between various measures and the financial system, and therefore their influence on output and inflation. Committee members had an initial exchange of views on various possible packages of measures.

37 The exact extent of any additional stimulus measures would be based on the Committee's updated forecast. Their composition would take account of any interactions with the financial system and their effectiveness in supporting the domestic economy. Further detailed analysis across all policy areas of the Bank would be required.

38 Against that backdrop, most members judged it appropriate to leave the stance of monetary policy unchanged at this meeting. For one member, the subdued economic outlook before the referendum had already come close to warranting further stimulus. The early evidence supported the view that demand was likely to weaken further following the referendum. The resulting outlook for medium-term inflation – even taking into account the boost from the lower level of sterling – therefore justified an immediate loosening of monetary policy, to be supplemented by a package of additional measures in August.

39 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, eight members of the Committee (the Governor, Ben Broadbent, Jon Cunliffe, Nemat Shafik, Kristin Forbes, Andrew Haldane, Ian McCafferty and Martin Weale) voted in favour of the proposition. Gertjan Vlieghe voted against the proposition, preferring to reduce Bank Rate by 25 basis points.

Regarding the stock of purchased assets, the Committee voted unanimously in favour of the proposition.

40 The following members of the Committee were present:

Mark Carney, Governor
Ben Broadbent, Deputy Governor responsible for monetary policy
Jon Cunliffe, Deputy Governor responsible for financial stability
Nemat Shafik, Deputy Governor responsible for markets and banking
Kristin Forbes
Andrew Haldane
Ian McCafferty
Gertjan Vlieghe
Martin Weale

Dave Ramsden was present as the Treasury representative.

As permitted under the Bank of England Act 1998, as amended by the Bank of England and Financial Services Act 2016, Bradley Fried and Anthony Habgood were also present as observers for the purposes of exercising oversight functions in their role as members of the Bank's Court of Directors.