



BANK OF ENGLAND

Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 2 August 2017

Publication date: 3 August 2017

These are the minutes of the Monetary Policy Committee meeting ending on 2 August 2017.

They are available at <http://www.bankofengland.co.uk/publications/Pages/news/2017/005.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 13 September will be published on 14 September 2017.

Monetary Policy Summary, August 2017

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 2 August 2017, the MPC voted by a majority of 6-2 to maintain Bank Rate at 0.25%. The Committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion. The Committee voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion. The Committee voted unanimously to close the drawdown period for the Term Funding Scheme (TFS) on 28 February 2018, as envisaged when the scheme was introduced.

The MPC's overall assessment of the outlook for inflation and activity in the August *Inflation Report* is broadly similar to that in May. In the MPC's central forecast, GDP growth remains sluggish in the near term as the squeeze on households' real incomes continues to weigh on consumption. Growth then picks up to just above its reduced potential rate over the balance of the forecast period. Net trade and business investment firm up, and consumption growth recovers in line with modestly rising household incomes. Net trade is bolstered by strong global growth and the past depreciation of sterling. The combination of high rates of profitability, especially in the export sector, the low cost of capital and limited spare capacity supports investment by UK firms over the forecast period, offsetting the effect of continued uncertainties around Brexit.

CPI inflation rose to 2.6% in June from 2.3% in March, as expected. The MPC expects inflation to rise further in coming months and to peak around 3% in October, as the past depreciation of sterling continues to pass through to consumer prices. Conditional on the current market yield curve, inflation is projected to remain above the MPC's target throughout the forecast period. This overshoot reflects entirely the effects of the referendum-related falls in sterling. As the effect of rising import prices on inflation diminishes, domestic inflationary pressures gradually pick up over the forecast period. As slack is absorbed, wage growth is projected to recover. In addition, margins in the consumer sector, having been squeezed by the pickup in import prices, are projected to be rebuilt. Consequently, inflation remains at a level slightly above the 2% target.

As in previous *Reports*, the MPC's projections are conditioned on the average of a range of possible outcomes for the United Kingdom's eventual trading relationship with the European Union. The projections also assume that, in the interim, households and companies base their decisions on the expectation of a smooth adjustment to that new trading relationship. Other important judgements include: that the lower level of sterling continues to boost consumer prices broadly as projected, and without adverse consequences for inflation expectations further ahead; that regular pay growth remains modest in the near term but picks up over the forecast period; and that subdued household spending growth is largely balanced by a pickup in other components of demand.

Monetary policy cannot prevent either the necessary real adjustment as the United Kingdom moves towards its new international trading arrangements or the weaker real income growth that is likely to accompany that adjustment over the next few years. Attempting to offset fully the effect of weaker sterling on inflation would be

achievable only at the cost of higher unemployment and, in all likelihood, even weaker income growth. For this reason, the MPC's remit specifies that, in exceptional circumstances, the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity. Through most of the forecast period, the economy operates with a small degree of spare capacity and CPI inflation is well above the target. By the end of the forecast, that trade-off is eliminated. Spare capacity is fully absorbed, and inflation remains above the target.

The Committee judges that, given the assumptions underlying its projections including the closure of the drawdown period of the TFS, and allowing for the effects of the recent prudential decisions of the Financial Policy Committee and the Prudential Regulation Authority, some tightening of monetary policy would be required to achieve a sustainable return of inflation to the target. Specifically, if the economy follows a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by the yield curve underlying the August projections.

In light of these considerations, six members thought that the current policy stance remained appropriate to balance the demands of the MPC's remit. Two members considered it appropriate to increase Bank Rate by 25 basis points. All members agreed that any increases in Bank Rate would be expected to be at a gradual pace and to a limited extent. The Committee will continue to monitor closely the incoming evidence, and stands ready to respond to changes in 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 2 August 2017

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 UK short-term interest rates had increased materially since the MPC's previous meeting, responding both to the release of the minutes of that meeting – at which the Committee had voted by a majority of 5-3 to maintain Bank Rate at 0.25% – and to subsequent public comments by MPC members. Although part of that upward move had unwound following the June CPI release, the medium-term path for Bank Rate on which the Committee's latest projections had been conditioned was the highest since the May 2016 *Inflation Report*. Option-implied volatility around the future path of Bank Rate had increased significantly. Longer-maturity yields had also risen.

3 In the euro area, German long-term interest rates had also increased notably since the Committee's previous meeting. This had reflected a sequence of stronger-than-expected euro-area economic data, and commentary by ECB policymakers that market participants had interpreted as bringing forward the time at which monetary stimulus would start to be scaled back. At its 20 July meeting, the ECB Governing Council had left its main policy rates and asset purchase profile unchanged. Most respondents to the latest Reuters poll had expected the ECB Governing Council to announce either a tapering of asset purchases or an extension of purchases, but at a reduced pace, at its 7 September meeting.

4 US Treasury yields had risen only slightly since the previous MPC meeting, in part reflecting weaker-than-expected data on inflationary pressures and adjustments in market participants' views about growth and the path of fiscal policy. At its 13-14 June meeting, the FOMC had increased the target range for the federal funds rate by 25 basis points, to between 1% and 1¼%. The FOMC had also set out its approach to reducing the Federal Reserve's holdings of Treasury and agency securities once normalisation of the level of the federal funds rate was well under way. The FOMC had left monetary policy unchanged at its 25-26 July meeting. Many market participants were expecting a decrease in reinvestment of principal payments received from securities held by the Federal Reserve to begin following the FOMC's 19-20 September meeting. The FOMC's communications on the normalisation of its balance sheet had not, to date, put significant upward pressure on Treasury yields. That may have reflected the relatively gradual expected pace of balance sheet normalisation plans that had been announced. It could also have indicated that market participants expected balance sheet normalisation to act as a substitute for increases in the federal funds rate.

5 There had been significant movements in global exchange rates since the May *Inflation Report*, both before and after the MPC's June meeting. The euro ERI had appreciated by 4% in the run-up to the August *Report* compared with the fifteen working day average used in May, taking it to the highest level since the

beginning of 2015, and reflecting in part the relative strength of euro-area economic data. In contrast, the dollar ERI had depreciated by 3½%, to its lowest level in almost a year. The sterling ERI had been broadly flat since the June MPC meeting – masking relatively large, but offsetting, movements against the euro and dollar – and had remained around 2% lower than in the run-up to the May *Inflation Report*.

6 International equity prices had generally continued to strengthen over the past three months, and non-financial corporate bond spreads had remained at or close to multi-year lows. Measures of implied volatilities in equity markets had also fallen back to historically low levels over recent weeks.

The international economy

7 Since the MPC's previous meeting, there had been indications of continuing strength in the near-term outlook for the global economy. The preliminary estimate of euro-area GDP growth in 2017 Q2 had been 0.6% on the quarter and 2.1% on a year earlier. Although slightly weaker than expected at the time of the MPC's previous meeting, the annual growth rate had been the highest since 2011. High-frequency indicators had suggested that growth would be maintained at a similar rate in Q3.

8 In the United States, GDP growth in 2017 Q2 had risen to 0.6%, after 0.3% in Q1. This suggested that the economy had slowed a little on average over the first half of the year relative to the second half of 2016. Within the Q2 figure, consumption and business investment had accounted for the bulk of growth in demand, broadly as expected. Labour market conditions had remained strong, with non-farm payrolls having increased by 222,000 in June, higher than expected, although labour force participation had also been stronger than expected so that the unemployment rate had risen slightly to 4.4%.

9 Near-term momentum in China appeared to have been strong. According to the official estimate, GDP in 2017 Q2 had grown by 6.9% on a year ago, the same as in the previous quarter, and slightly stronger than expected. Within this, industrial production growth had been robust, which reflected in part rapid export growth as well as infrastructure investment. This had been consistent with the broader resilience of global trade. The three month on three month growth rate of world goods trade had picked up in May, to 1.0%, below the very strong rates seen in Q1 but around the average growth rate seen during the period since the financial crisis.

10 Price developments in advanced economies had been mixed. Core HICP inflation in the euro area had increased slightly to 1.2% in July, and headline inflation had remained at 1.3%. In the United States, core PCE inflation had remained at 1.5% in May and June, lower than the near-2% rates recorded around the turn of the year, while headline PCE inflation had fallen over the past couple of months, to 1.4%. Spot oil prices had increased by 8% since the previous MPC meeting, which market participants attributed largely to supply developments.

11 The Committee discussed wage and price developments in other advanced economies, and considered possible implications for the United Kingdom. As in the United Kingdom, wage growth in the United States and euro area over the past three years had been at least one percentage point lower than their pre-crisis averages. This had partly reflected weak productivity, though unit wage costs had also been weaker than before the crisis.

Across advanced economies, estimates of equilibrium unemployment rates had been lowered. This suggested that slack in the labour market could explain some of the subdued wage pressure. But it was possible that other factors were also at play, including increased global competition, the threat of activity shifting abroad, the effects of new technologies and changing firm structures.

Money, credit, demand and output

12 Growth in economic activity had been sluggish during the first half of 2017. The ONS had reported a preliminary estimate of GDP growth of 0.3% in Q2, following an unrevised estimate of 0.2% growth in the Q1 Quarterly National Accounts. The GDP backcast, which takes into account the revision properties of the official data and information from business surveys, suggested that growth in Q1 had been higher, at around 0.4%. That, nonetheless, implied that quarterly GDP growth had slowed compared with the average rate during the second half of 2016.

13 The Committee discussed recent trends in sectoral output data and their correspondence with aggregate demand. Services growth had risen to 0.5% in 2017 Q2, following a sharp slowdown in Q1. Bank staff estimates had suggested that consumer and business-facing companies' output growth had declined to a similar degree earlier in the year, and that the recent partial recovery had been driven by consumer-facing companies. Retail sales volumes had also rebounded in Q2, and the reported sales balance for retailing in the CBI Distributive Trades Survey had risen to just above its long-run average in July. Other indicators of household spending had been softer, however. Consumer confidence had been little changed in July after a sharp fall in the previous month. House prices had remained broadly flat according to the average of lenders' indices, and the RICS balance of estate agents' expectations of house prices over the next 12 months had declined sharply in June. Lenders responding to the Bank's Credit Conditions Survey had reported that the availability of unsecured credit to households had fallen in Q2, and they had expected a further decline in Q3, although competition between lenders had remained strong.

14 Growth in manufacturing and construction had been volatile, with output declining in both sectors in 2017 Q2 after having risen in the previous two quarters. For manufacturers, that recent weakness had appeared at odds with the strength reported in business surveys, particularly the latest CBI Industrial Trends Survey in which the output volume balance had reached its highest level in over 20 years. There was also evidence from those surveys that export orders had benefitted significantly from the stronger global backdrop and the past depreciation of the exchange rate. Perhaps as a result, investment intentions in the manufacturing sector had appeared somewhat stronger than in the service sector, as indicated in the BCC's Quarterly Economic Survey over recent quarters for example. At the whole economy level, however, the outlook for UK investment had weakened in the latest BCC survey, and was reported to have been weaker than in other major advanced economies in the latest thrice-yearly IHS Markit Global Business Outlook.

15 On balance, the Committee judged that GDP growth was likely to remain at its recent pace into the third quarter. Some surveys of companies' expectations of aggregate business activity had continued to suggest somewhat stronger near-term growth. But the IHS Markit/CIPS composite expectations index in June had fallen

back quite sharply and had recovered only slightly in July, consistent with a softening in growth. A weaker near-term path for business investment or net trade appeared to be the most likely counterpart on the expenditure side to the slightly lower Q3 GDP projection compared with that assumed in the *May Inflation Report*.

Supply, costs and prices

16 Twelve-month CPI inflation had fallen to 2.6% in June, from 2.9% in May, in line with the Committee's expectation at the time of the *May Inflation Report*. The current and prospective overshoot of inflation relative to the target could be wholly accounted for by imported inflation. Pass-through to consumer prices typically took a few years to complete, so it therefore seemed likely that imported inflation would keep CPI inflation above the 2% target for some time yet. The MPC's latest projections were conditioned on the prevailing path for Bank Rate and assumed that households and companies based their decisions on the expectation of a smooth transition to new trading arrangements with the European Union. In those projections, CPI inflation was expected to fall back only slowly towards the target, reaching 2.2% at the three-year forecast horizon.

17 Although imported inflation was the dominant factor driving both recent inflation outturns and the Committee's inflation projection, inflation prospects would also be determined by the pace of domestically generated inflation (DGI). DGI itself was unobservable and, although there was an array of proxy measures, all of them suffered from measurement deficiencies and needed to be interpreted with caution. Looking across a range of measures, the Committee judged that DGI currently appeared to be slightly below the rates that were consistent with the inflation target.

18 Pay growth, a key component of DGI, had remained subdued, with all of the main measures of aggregate average weekly earnings growth around 2% in the three months to May, compared with a year earlier. This had been in spite of the buoyancy of labour market quantities. Employment growth had been 0.6% in the three months to May, driven by rising full-time employment. The unemployment rate had fallen to 4.5%, down by 0.2 percentage points from the previous non-overlapping three-month period, and had now reached the MPC's estimate of the equilibrium rate. Productivity growth had remained low, such that unit labour cost growth in the near term appeared a little higher than had been expected in May.

19 The Committee also discussed the recent evidence on inflation expectations. The MPC monitored a wide range of measures of inflation expectations, covering households, the corporate sector, financial markets and professional forecasters. The clear and common trend had been that these had fallen while headline inflation had been close to zero, but had subsequently recovered to more normal levels as headline inflation had risen and the risks of a prolonged period of deflation had receded. The prevailing levels seemed in line with the MPC's forecasts and consistent with the achievement of the inflation target in the medium term.

The immediate policy decision

20 The MPC sets monetary policy to meet the 2% inflation target, and in a way that supports activity and employment. In pursuing that objective, the main challenges for the Committee had remained to assess the economic implications of the United Kingdom withdrawing from the European Union and to identify the appropriate policy response to that changing outlook, including to the substantial depreciation of sterling that had been associated with the decision. During the negotiation period, those economic implications would be influenced significantly by the expectations of households, firms and financial markets about the United Kingdom's eventual economic relationships with the European Union and other countries and the transition to them. These involved structural economic adjustments over which monetary policy had very little or no influence. Recognising their impact on activity and inflation in the nearer term, it was nevertheless essential to take account of these evolving views in setting monetary policy. The MPC's remit specified that in such exceptional circumstances the Committee must balance any trade-off between the speed at which it intended to return inflation to the target and the support that monetary policy provided to jobs and activity.

21 The Committee considered how the outlook, and the trade-off embodied within it, had changed since the June meeting, and set out its economic projections in the August *Inflation Report*. GDP growth had fallen in the first half of 2017 relative to the second half of 2016. The MPC's central projection was for GDP growth to remain at 0.3% in Q3, before picking up slightly at the end of the year and remaining just above its reduced potential rate over the balance of the forecast period.

22 The growth projection embodied a rotation away from consumption and towards net trade and business investment. Households' real income growth had weakened following the fall in the exchange rate. That weakening in income growth had weighed on consumption. Consumption growth was projected to recover somewhat in the second half of the forecast period, as the pass-through from the depreciation gradually declined, but to remain subdued throughout the next three years. It was possible that there could be a little more momentum in consumption in the near term than assumed in the central case. Retail sales had risen in Q2, reversing the decline in Q1. Although consumer confidence had fallen, it had remained close to its long-run average. Equally, it was possible that consumption could adjust more sharply and the saving ratio could rise, as the housing market had softened further, and new car registrations had been weak.

23 Acting against that, in the forecast, net trade was bolstered by strong global growth and the past depreciation of sterling. The combination of high rates of profitability, especially in the export sector, the low cost of capital and limited spare capacity was expected to support investment by UK firms over the forecast period, offsetting the effect of continued uncertainties around Brexit.

24 In contrast to the fall in GDP growth, employment growth had picked up during the first half of 2017. Such a divergence was relatively unusual. Although indicators of hiring intentions had not shown signs of weakening to date, recent weakness in economic activity was still expected to lead to softer employment growth. Activity and employment data had pointed to weak productivity growth in recent quarters. This might suggest some

margin of spare capacity in the economy, although there was only limited evidence for this in surveys of companies' capacity use.

25 CPI inflation had been 2.6% in June, as projected in the *May Inflation Report*. Inflation remained above the target owing to higher import prices continuing to feed through the supply chain following the depreciation of sterling. This had been offset to some extent by continued modest growth in domestic costs, with wage growth having remained subdued.

26 In the MPC's August forecast, the significant upward pressure on CPI inflation from import prices eased only in the second half of the forecast period. Over the forecast, slack in the economy was absorbed gradually, and wage and domestic price pressures increased as a result. Consumer sector companies rebuilt their margins, which had been squeezed by higher import costs during 2016. Wage growth was expected to recover significantly from its current low level, though less rapidly than previously envisaged. These growing domestic price pressures meant that CPI inflation was projected to remain slightly above the target at the end of the forecast period, even as imported price pressures were falling away.

27 Conditioned on the market yield curve underlying the August projections, which was consistent with two 25 basis point increases in Bank Rate over the forecast period, CPI inflation was forecast to remain around 2¾% until early next year, with some monthly volatility around that path, such that it was projected to peak at around 3% in October. It was then projected to fall back gradually towards the target. The overshoot at the end of the forecast could entirely be accounted for by the effect of higher import prices.

28 Overall, the August projections showed that the economy was expected to operate with a small degree of spare capacity for most of the three-year forecast period, justifying the tolerance of some degree of above-target inflation. Nevertheless, as the Committee had previously noted, there were limits to the extent to which above-target inflation could be tolerated. The Committee discussed the appropriate response of monetary policy.

29 There were arguments in favour of a moderate tightening in monetary policy now. CPI inflation was substantially above the target, and was projected to remain above the target throughout the three-year forecast period. Although household consumption had slowed, recent indicators such as retail sales had not suggested that a sharp downturn was underway. Growth in business investment and net trade, supported by strong global growth, appeared on track to compensate for weaker consumption growth. While the projection for demand growth was modest, growth in potential supply was likely to be materially weaker than over the pre-crisis period throughout the forecast. Employment growth had strengthened, and if it continued to be strong, slack would be absorbed at a faster pace than in the central projection. The withdrawal of part of the stimulus that the Committee had injected in August last year would help to moderate the inflation overshoot while leaving monetary policy very supportive.

30 There were also arguments in favour of leaving the policy rate unchanged. GDP growth had been sluggish and was expected to remain so in the near term. With some business survey expectations balances having weakened, there remained the possibility of a further softening in activity. Weak data on car registrations and the housing market, together with the fall in consumer confidence, could signal weaker consumption than in the central projection. At the same time, increased domestic uncertainty was likely to act as a drag on

investment, and there was a risk that this effect would be larger than had been assumed in the forecast. Inflation expectations appeared well anchored, notwithstanding the overshoot of inflation relative to the target. And, although there had been a few more positive signs on wage growth, there was not yet evidence of the sustained pickup incorporated in the central projection. Also, the extent to which consumer sector firms would be able to increase profit margins in the face of subdued demand was unclear.

31 Different members of the Committee placed different weights on these arguments. On balance, for six members, the current policy stance remained appropriate to balance the demands of the Committee's remit. For two members, the outlook justified an immediate increase in Bank Rate.

32 The Committee judged that, given the assumptions underlying its projections including the closure of the drawdown period of the TFS, and allowing for the effects of the recent prudential decisions of the Financial Policy Committee and the Prudential Regulation Authority, some tightening of monetary policy would be required to achieve a sustainable return of inflation to the target. Specifically, if the economy were to follow a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by the yield curve underlying the August projections. All members agreed that any increases in Bank Rate would be expected to be at a gradual pace and to a limited extent. The Committee would continue to monitor closely the incoming evidence, and stood ready to respond to changes in the economic outlook as they unfolded to ensure a sustainable return of inflation to the 2% target.

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

Bank Rate be maintained at 0.25%;

The Bank of England maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion;

The Bank of England maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion;

The drawdown period for the Term Funding Scheme close on 28 February 2018, as originally envisaged.

Regarding Bank Rate, six members of the Committee (the Governor, Ben Broadbent, Jon Cunliffe, Andrew Haldane, Silvana Tenreyro and Gertjan Vlieghe) voted in favour of the proposition. Two members (Ian McCafferty and Michael Saunders) voted against the proposition, preferring to increase Bank Rate by 25 basis points.

The Committee voted unanimously in favour of the second, third and fourth propositions.

34 Regarding the TFS, the Committee noted that drawings were expected to slightly exceed £100bn by the end of the drawdown period, and that the APF indemnity would be increased to accommodate this expected usage.

35 Consistent with the Committee's forward guidance, and as described in the market notice accompanying these minutes, the Committee agreed to reinvest £10.1 billion of cash flows associated with the redemptions of the August and September 2017 gilts held by the Asset Purchase Facility.

36 Since May 2017 the MPC had voted to maintain the stock of Corporate Bond Purchase Scheme (CBPS) assets at £10bn. Consistent with that decision, the MPC expected to reinvest cash flows associated with any reduction in the stock of CBPS assets back into eligible corporate bonds. That would take place once the required reinvestment had reached a sufficient size to allow an auction programme to be conducted. Based on the current profile of the portfolio, the first such auctions would be expected to take place in 2019 H2.

37 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
Andrew Haldane
Ian McCafferty
Michael Saunders
Silvana Tenreyro
Gertjan Vlieghe

Dave Ramsden was present as the Treasury representative.