BANK OF ENGLAND

Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 10 May 2017

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These are the minutes of the Monetary Policy Committee meeting ending on 10 May 2017.

They are available at http://www.bankofengland.co.uk/publications/Pages/news/2017/003.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 14 June will be published on 15 June 2017.

Monetary Policy Summary, May 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 10 May 2017, the Committee voted by a majority of 7-1 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 also voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

As the MPC observed at the time of the United Kingdom's referendum on EU membership, the appropriate path for monetary policy depends on the evolution of demand, potential supply, the exchange rate, and therefore inflation. Aggregate demand slowed markedly in 2017 Q1, and the MPC's central projection contained in the May *Inflation Report* is now for quarterly growth to remain around current rates, and close to trend. The slowdown appears to be concentrated in consumer-facing sectors, partly reflecting the impact of sterling's past depreciation on household income and spending. The Committee judges that consumption growth will be slower in the near term than previously anticipated before recovering in the latter part of the forecast period as real income picks up.

In the MPC's central forecast, weaker consumption this year is largely balanced by rising net trade and investment. The outlook for global activity continues to improve. Business surveys and Bank Agents' reports imply that business investment growth is likely to be higher in 2017 than previously projected. The stronger global outlook and the level of sterling are providing incentives for many exporters to renew and increase capacity.

Sterling appreciated by 2.5% between the February and May *Inflation Reports*, although it remained 16% below its November 2015 peak. Over the same time period, shorter-term UK interest rates fell, with the sterling yield curve used to condition the forecast close to its lowest level since the start of the year.

CPI inflation has risen above the MPC's 2% target as the depreciation of sterling has begun to feed through to consumer prices. This impact has been offset to some extent by continued subdued growth in domestic costs. In particular, wage growth has been notably weaker than expected. The MPC expects inflation to rise further above the target in the coming months, peaking a little below 3% in the fourth quarter. Conditioned on the market yield curve underlying the May projections, inflation is forecast to remain above the MPC's target throughout the forecast period. The projected overshoot entirely reflects the effects of the falls in sterling since late November 2015 on import prices. This effect is expected to diminish towards the end of the forecast period. With unemployment falling to its estimated equilibrium rate, however, wage growth is expected to recover significantly, and the drag from domestic costs to lessen, over the same period.

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 such 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.

In the MPC's latest projections there is such a trade-off through most of the forecast period, with a degree of spare capacity and inflation remaining above the 2% target. In the final year of the forecast, however, the output gap closes and inflation rises slightly further above the target. This is conditioned on the assumptions that the adjustment to the United Kingdom's new relationship with the European Union is smooth, and that Bank Rate follows the market-implied path for interest rates. At its May meeting, seven members thought that the current monetary policy setting remained appropriate to balance the demands of the Committee's remit. Kristin Forbes considered it appropriate to increase Bank Rate by 25 basis points.

As the Committee has previously noted, there are limits to the extent to which above-target inflation can be tolerated. The continuing suitability of the current policy stance depends on the trade-off between above-target inflation and slack in the economy, as well as the prospects for inflation to return sustainably to target. These projections depend importantly on three main judgements: 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 significantly over the forecast period; and that more subdued household spending growth is largely balanced by a pickup in other components of demand.

In judging the appropriate policy stance, the Committee will be monitoring closely the incoming evidence regarding these and other factors. 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. On the whole, the Committee judges that, if the economy follows a path broadly consistent with the May central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the very gently rising path implied by the market yield curve underlying the May projections.

Minutes of the Monetary Policy Committee meeting ending on 10 May 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 Since the Committee's previous meeting key drivers of financial market movements had been the announcement of the UK general election and the results of the French presidential election.

3 The sterling ERI had risen by 5.0% since the Committee's previous meeting, with a sharp increase on the day the Prime Minister announced her intention to call a UK general election. Market participants had attributed the move to more weight being placed on the probability of a smooth, rather than disorderly, UK exit from the European Union. Consistent with this, implied volatilities in sterling foreign exchange options spanning the Article 50 negotiating period had fallen steadily since the announcement.

4 Financial markets had also responded to the results of the French presidential election, with an increase in the euro ERI and a narrowing of the spread between French and German government bond yields.

5 Advanced economy long-term government bond yields had generally fallen. With gilt yields down only slightly, the larger fall in US yields had meant the divergence between UK and US yields had narrowed slightly since the Committee last met, but remained high by historical standards.

6 Financial market participants had also responded to monetary policy communications from the FOMC and the ECB. The FOMC had made two policy announcements since the MPC's previous meeting, first raising rates and subsequently keeping them on hold. On balance, however, the communications over the period had been seen by market participants as indicating a more gradual increase in policy rates than they had previously anticipated. The ECB had also kept policy unchanged, but again the communications had been taken as signalling a reduced likelihood of rate rises before the completion of their asset purchase programme.

7 UK short-term interest rates had fallen between the February and May *Inflation Reports*, leaving the path for Bank Rate on which the Committee's latest forecast had been conditioned close to its lowest point since the start of the year. Short-term interest rates had risen more recently, however, leaving them overall little changed since the Committee's previous meeting. The latest Reuters survey had indicated that most respondents expected no change in monetary policy before the end of 2018.

8 International equity indices had generally risen since the Committee's previous meeting, with equities in Europe having been notably higher. Euro-area equities had risen sharply following the first round of the French presidential election; and UK-focused equities within the FTSE All-Share had risen, outperforming the broader index, as the appreciation of sterling pushed down on the share price of more internationally focused firms.

9 Measures of market volatility had remained low, with the VIX at its lowest level since before the financial crisis. The Committee noted how this contrasted with indicators of policy uncertainty, which were generally high. The Committee discussed what this implied about market participants' views on the current outlook. Historically, periods of high policy uncertainty had been accompanied by high market volatility. The strengthening of the core financial system and, to various degrees, improvements in corporates' and households' balance sheets in recent years would, however, be likely to provide more insulation against future financial market or policy shocks. Increased use by investors of strategies that sell volatility to increase yields may also have contributed to the reduction in volatility.

The international economy

10 Momentum in global activity had continued to be strong, and this was likely to support UK exports. That said, there had been a divergence in some major countries between survey data, which had been very positive, and official data, which, although still robust, had been less strong overall.

11 In the United States, the advance estimate of GDP growth in 2017 Q1 had been much weaker than expected, at 0.2%. Consumption had slowed sharply to 0.1%, its weakest quarterly outturn since 2009. In part, this weakness is likely to have reflected erratic factors: warm weather had reduced energy consumption, and a delayed tax rebate appeared to have weighed on durables consumption. A large deceleration in inventory accumulation had also played a role, and was expected to contribute to a rebound in GDP growth in the second quarter, to around 0.8%. But even so, growth across the first half of 2017 as a whole was likely to have been much weaker than had been suggested by survey data: the ISM purchasing managers' indices had been consistent with average quarterly growth of nearly 1.0%.

12 In the euro area GDP growth in Q1 had been 0.5%, the same as in the previous quarter, but a touch weaker than Bank staff had expected. Indicators of retail sales and construction had been relatively strong, while industrial production had been little changed from the previous quarter. Survey data for Q2 had suggested continued strength in overall activity, and so Bank staff expected a pickup in GDP growth to 0.6%. Beyond that, strong euro-area growth now appeared likely to be a little more persistent than at the time of the February *Inflation Report*. The flash estimate of headline HICP inflation had been 1.9% in April, up from 1.5% in March, and core inflation had also risen sharply, by 0.5 percentage points to 1.2%, although this partly reflected the timing of Easter and was likely to unwind partially in May.

13 Despite this divergence between official data and surveys in major economies, one reason to suppose that near-term global growth momentum could be sustained was the relative strength of investment, which had been apparent in the US, the euro area and China in 2016 Q4 and 2017 Q1. There were a number of possible explanations for this strength, which had different weights across different countries. The availability of credit had improved and its cost had fallen; the capital overhang built up in the run-up to the crisis now looked much less pronounced; global demand and global trade appeared to have picked up; and some measures of uncertainty had fallen.

14 The prospects for global trade had improved in recent months: the CPB Netherlands Bureau for Economic Policy Analysis measure of world goods trade had increased by 2.7% in the 3 months to February, compared to the previous quarter, and this had been matched by a pickup in global measures of capital goods orders and industrial production. Measured by import growth, the recent recovery in trade had been led by emerging economies, although that had followed a period of unusual weakness of trade growth in those countries. Related to that, near-term momentum in China appeared strong: the official estimate of GDP growth in Q1 had been 6.9% on a year ago, slightly above Bank staff's expectations.

Money, credit, demand and output

15 Domestic economic activity had slowed markedly in 2017 Q1: the preliminary estimate of GDP growth had been 0.3%, a 0.4 percentage point slowdown relative to 2016 Q4. The slowing had been most pronounced in consumer-facing parts of the service sector, with continued solid growth in output for the manufacturing as well as finance and business services sectors. Recent business surveys had pointed to a higher pace of expansion, and the Bank's backcast suggested that this estimate would subsequently be revised up to 0.4%. Nevertheless, a slowdown appeared to be in train, and the MPC was expecting a similarly moderate pace of growth in Q2 and beyond.

16 The Committee discussed what this weakness might imply for activity further ahead. An expenditure breakdown of Q1 GDP growth was not yet available, but the weakening in consumer-facing sectors was consistent with the weak data on retail sales, which in Q1 had registered their largest quarterly fall in seven years. It was possible that the very sharp fall in new vehicle registrations in April might also be a sign of weaker spending growth – although this interpretation warranted some caution, as the monthly pattern of vehicles purchases had been distorted by the introduction of new tax rates, and year-to-date purchases had been strong.

17 There had been growing evidence of a slowing in housing market activity and prices. House price inflation had been somewhat weaker in Q1 than had been expected in February, and this weakness seemed likely to extend into Q2. Housing transactions had been broadly flat recently, while the April RICS survey had reported falls in both new buyer enquiries and new instructions to sell. In the past, such a dip in the housing market had tended to go hand-in-hand with a softening in consumption growth. But it was also possible that the recent slowdown reflected the effect of tax changes on buy-to-let demand, which would probably have less significance for the broader consumer outlook.

18 Additionally, the Bank's most recent Credit Conditions Survey had revealed signs that lenders were tightening some of the terms on consumer credit, with credit scoring criteria for granting both credit card and other unsecured loans reported to have been tightened in Q1, and an expectation that those criteria on credit cards would be tightened significantly further in Q2. As such, unsecured credit was likely to be less supportive of spending than had recently been the case. Taking these factors together with the ongoing weakness in real incomes, it was possible that the slowdown in household spending would prove to be protracted, and the MPC had marked down its forecast for consumption growth during 2017.

19 Other news in the consumer sector had been more positive, however. Consumer confidence had eased only slightly, and remained close to historical averages. Moreover, the Office for National Statistics had indicated that the household savings rate was likely to be substantially higher than was currently being reported, and it was therefore possible that households had scope to maintain solid rates of spending growth even in the face of weak growth in real income.

20 With household demand slowing, the steadier outlook for overall activity growth suggested by the business surveys implied that other components such as business investment and net trade were providing some countervailing support. Business investment had been weak in 2016, but improved responses to surveys of investment intentions suggested that a degree of recovery during 2017 was likely. In particular, the more upbeat global outlook and the fall in sterling since the EU referendum had improved the incentives for exporters to renew and increase capacity. The MPC's central view was that business investment would expand over the next few years, albeit at a pace that was moderate in historical terms. However, investment spending was likely to be sensitive both to the global outlook and to the terms of the United Kingdom's exit from the European Union, and its path was therefore particularly uncertain.

Supply, costs and prices

21 Twelve-month CPI inflation had been 2.3% in March, unchanged from the previous month. This was 0.3 percentage points higher than Bank staff's expectation at the time of the February *Inflation Report*. The MPC expected CPI inflation to rise further above the target in the coming months, with the near-term profile being slightly higher than in the February forecast.

22 Further ahead, the outlook for CPI inflation would depend on the balance between domestically generated and imported inflation. Overall, the MPC expected CPI inflation to remain above the target in the medium term, conditional on the path for Bank Rate based on market yields, which suggested only one 25 basis point rate rise over the next three years, and on the average of a range of possible outcomes for the United Kingdom's future trading arrangements with the European Union. As previously, the transition to any new trading arrangements was assumed to be smooth. Imported inflationary pressures appeared likely to continue to push inflation somewhat higher in the period ahead, fading only gradually over the next three years, although the effect from sterling now looked likely to be a little lower, given its appreciation since February. In addition, the conditioning path for the sterling oil price had been around 10% lower than at the time of the February *Inflation Report*.

23 The expected overshoot of CPI inflation relative to the target could be wholly accounted for by the projected degree of imported inflation. However, the rate of CPI inflation in the medium term would also depend substantially on the prospects for regular pay, non-wage costs and other drivers of domestic inflation. The Committee monitors a wide range of metrics of domestically generated inflation. The Committee judged that although domestically generated inflation had been rising, it was currently below the level broadly consistent with the inflation target. For it to rise in line with the Committee's expectations would probably require a significant increase in wage growth.

24 The MPC discussed the factors that might underlie the notable recent weakness in wage growth, and what it might imply for future domestic cost pressures and inflation. Unit labour cost growth had remained subdued, at 2.0% in the year to Q4, and annual regular pay growth in the whole economy had fallen back further in the three months to February, to 2.2%. Pay settlements in particular had been weak: average annual private sector pay settlements in the three months to March had been 1.2%, down from 3.4% a year earlier. Although labour productivity had been weak, this did not appear to account for the most recent weakness in wages. The recent fall in wage growth could simply reflect volatility in the data. It was, however, possible that it may have been a consequence of companies' uncertainty about the outlook, with some unwilling to raise wages at a faster pace until they had more clarity about their future costs and markets. Weak pay growth may also have reflected firms' attempts to protect their margins in the face of increasing non-wage costs, including the Apprenticeship Levy and pension costs. These influences were judged unlikely to persist throughout the forecast period.

25 The weakness of wages had contrasted with the recent strength of labour market quantities. The unemployment rate had continued to decline, to 4.7% in the three months to February, in contrast to the small increase expected in the February *Inflation Report* forecast, and now looked likely to remain at around its current level in the coming months. Participation in the labour force had also fallen slightly, to 63.5% in the three months to February, and the employment rate had remained stable at 60.5%. Average weekly hours worked had been higher than expected in the three months to February. Much of this strength appeared persistent. Accordingly, total hours worked had also been higher than expected in the February *Inflation Report,* and labour productivity had been lower.

26 Measures of households' and businesses' expectations of inflation in the medium term had generally edged up in line with the increase in headline inflation, although remaining broadly in line with historical averages. But measures of inflation compensation derived from financial instruments had declined since the MPC's previous meeting.

The immediate policy decision

27 The MPC set monetary policy to meet the 2% inflation target, and in a way that helped sustain growth and employment. In pursuing that objective, the main challenges for the Committee had remained assessing the economic implications of the United Kingdom withdrawing from the European Union, and identifying the appropriate policy response to that changing outlook, including the substantial depreciation of sterling that was expected to push CPI well above the 2% target for a period.

28 The sterling ERI had been relatively volatile for a number of months. It stood 15% lower than its peak in November 2015, but had appreciated by 4% since the February *Inflation Report*. The depreciation appeared to have reflected investors' perceptions that a lower real exchange rate would be required following the United Kingdom's decision to withdraw from the European Union. Where the exchange rate would ultimately settle depended substantially on the precise nature of the United Kingdom's eventual trading arrangements both with the European Union and with other countries.

29 The transition to new international trading arrangements, and the movement in the sterling real exchange rate that might accompany it, were structural economic adjustments over which monetary policy had very little or no influence. It was nevertheless essential to take account of such adjustments in the setting of monetary policy because of the impact they had on activity and inflation in the nearer term. In particular, the increase in import prices that had occurred over the past year had pushed CPI inflation above the MPC's 2% target and, in the May central projection, would result in inflation remaining above target throughout the forecast period. This had started to feed through to real incomes and therefore reduce consumer spending. The MPC's remit specified that in such exceptional circumstances the Committee must balance the 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.

30 The MPC had previously noted that the appropriate path of monetary policy following the EU referendum would depend on the evolution of demand, supply, the exchange rate and therefore inflation. The Committee had considered how the outlook for these factors had changed over recent months in the preparation of its May *Inflation Report*.

31 The Committee had expected household demand to slow over time. The recent indicators had provided evidence that this adjustment may have started. GDP growth had fallen markedly in 2017 Q1, and the MPC's central projection was for quarterly growth to remain around current rates. The slowdown had appeared to be concentrated in consumer-facing sectors, consistent with the impact of the fall in the exchange rate feeding through to household income and spending. There had also been evidence of a slowing in housing market activity and prices which, in the past, had been accompanied by a softening in consumption growth. Set against that, indicators of consumer confidence had not shown any sign of deterioration. But, on balance, when combined with the ongoing weakness in real incomes, the Committee judged that consumption growth would be slower in the near term than previously anticipated, before recovering in the latter part of the forecast period as real income picks up.

32 In the MPC's central forecast, weaker consumption this year was largely balanced by rising net trade and investment, with quarterly GDP growth remaining around trend. The outlook for global activity had continued to improve. Business surveys and Bank Agents' reports had implied that business investment growth was likely to be higher in 2017 than previously projected. The stronger global outlook and the level of sterling had provided incentives for many exporters to renew and increase capacity.

33 CPI inflation had been 2.3% in March, up from 1.6% three months ago, driven by higher import prices as the impact of the fall in sterling since 2015 had begun to feed through. This had been offset to some extent by continued subdued growth in domestic costs. In particular, wage growth had been notably weaker than expected. Notwithstanding this, the unemployment rate had continued to decline to 4.7% in the three months to February, in contrast to the small increase expected in the February *Inflation Report* forecast.

34 The MPC expected inflation to rise further above the target in the coming months, peaking only a little below 3% in the fourth quarter. Conditioned on the market yield curve at the time of the May *Report*, which had been close to its lowest level since the start of the year, inflation was projected to remain above the MPC's target throughout the forecast period. The projected overshoot entirely reflected the effects of falls in sterling

since late November 2015 on import prices. This effect was expected to diminish towards the end of the forecast period. With unemployment falling to its estimated equilibrium rate, however, wage growth was expected to recover significantly, and the drag from domestic costs to lessen, over the same period.

35 The continuing suitability of the current policy stance depended on the trade-off between above-target inflation and slack in the economy. In the MPC's latest projections, such a trade-off was apparent through most of the forecast period: there remained a degree of spare capacity and inflation was expected to remain above the 2% target. In the final year of the forecast, however, the output gap closes and inflation rises slightly further above the target. This was conditioned on the assumptions that the adjustment to the United Kingdom's new relationship with the European Union would be smooth, and that Bank Rate followed the market-implied path for interest rates.

36 Seven members considered the current policy stance to be appropriate to balance the demands of the Committee's remit. The actual and prospective overshoot of inflation relative to the target was entirely due to the effects of the exchange rate depreciation, which itself reflected fundamental factors that monetary policy could not affect. This had provided the exceptional circumstances in which the MPC's remit required it to pay close consideration to the trade-off between inflation and slack. For most of the forecast period, the economy was expected to operate with a degree of spare capacity, justifying that some degree of above-target inflation could be tolerated. The output gap was projected to close by the end of the forecast period, reducing the Committee's tolerance for above-target inflation at that point. These members noted that the forecast relied, among other things, upon a significant pickup in wage growth that had yet to materialise and no further slowing in aggregate demand. Some of these members noted, however, that with inflation remaining above the target at the end of the forecast period, and uncertainty about the extent and persistence of the slowdown in Q1, it would take relatively little further upside news on the prospects for activity or inflation for them to consider that a more immediate reduction in policy support might be warranted.

37 For one member, the monetary policy trade-off had continued to justify an immediate increase in Bank Rate. Inflation was already above the target, and pipeline pressures suggested it would continue to increase to uncomfortable levels and remain above the target for over three years. This member felt that the initial estimate of Q1 GDP growth exaggerated the extent of the slowdown. The low unemployment rate, increased recruitment difficulties, and continued momentum in the economy suggested there was no justification for tolerating inflation overshooting the target for such an extended period. Therefore this member felt that an immediate reduction in the substantial stimulus still in place was merited to ensure that the inflation overshoot did not become even more protracted and harder to unwind.

38 The projections described in the May *Inflation Report* depended in good part on three main judgements: that the lower level of sterling would continue to boost consumer prices broadly as projected, and without adverse consequences for expectations of inflation further ahead; that regular pay growth would remain modest in the near term, but pick up gradually over the forecast period, consistent with the Committee's assessment of the remaining degree of slack in the economy; and that household spending growth would remain subdued, and be largely balanced by a pickup in other components of demand.

39 In judging the appropriate policy stance, the Committee would be monitoring closely the incoming evidence regarding these factors, alongside the other judgements underlying the May *Inflation Report*. 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. On the whole, the Committee judged that, if the economy followed a path broadly consistent with the May central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the very gently rising path implied by the market yield curve underlying the May projections.

40 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.

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

Regarding the stock of purchased assets, the Committee voted unanimously in favour of the second and third propositions.

41 The Committee noted that the programme of purchases of sterling non-financial investment-grade corporate bonds had reached the target of £10 billion set out in the August 2016 policy package.

42 The Committee had been updated separately by the Deputy Governor for Financial Stability about recent policy statements made by the Financial Policy Committee.

43 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
Kristin Forbes
Andrew Haldane
Ian McCafferty
Michael Saunders
Gertjan Vlieghe

Dave Ramsden was present as the Treasury representative.