



BANK OF ENGLAND

Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 2 November 2016

Publication date: 3 November 2016

These are the minutes of the Monetary Policy Committee meeting ending on 2 November 2016.

They are available at <http://www.bankofengland.co.uk/publications/Pages/news/2016/011.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 December will be published on 15 December 2016.

Monetary Policy Summary, November 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 2 November 2016 the Committee voted unanimously to maintain Bank Rate at 0.25%. The Committee voted unanimously to continue with the programme of sterling non-financial investment-grade corporate bond purchases totalling up to £10 billion, financed by the issuance of central bank reserves. The Committee also voted unanimously to continue with the programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion, financed by the issuance of central bank reserves.

At the time of the August *Inflation Report*, the Committee announced a package of supportive measures that it judged was appropriate to balance the trade-off that had emerged in the economic outlook. On the one hand, economic activity was expected to weaken and unemployment to rise, given the period of uncertainty likely to follow the referendum on EU membership. On the other hand, inflation was expected to rise to a rate above the 2% target, for an extended period, as a result of the depreciation of sterling that had accompanied the referendum result. At the August meeting, a majority of Committee members also expected to support a further cut in Bank Rate at one of the remaining MPC meetings of 2016 if the outlook remained broadly consistent with the one set out in the August *Report*.

In the three months since then, indicators of activity and business sentiment have recovered from their lows immediately following the referendum and the preliminary estimate of GDP growth in Q3 was above expectations. These data suggest that the near-term outlook for activity is stronger than expected three months ago. Household spending appears to have grown at a somewhat faster pace than projected in August, and the housing market has been more resilient than expected. By contrast, investment intentions have continued to soften and the commercial property market has been subdued.

In financial markets, the past three months have been characterised by two phases. In the first, the sterling exchange rate stabilised for a period following its initial post-referendum depreciation. Supported by the measures announced by the MPC in August and more positive activity indicators, financial conditions and other asset prices recovered from the deterioration seen straight after the referendum, accompanied by a sharp increase in corporate bond issuance. However, in the period since the beginning of October, the sterling effective exchange rate index has depreciated further. Market intelligence attributes these latter movements to perceptions that the United Kingdom's future trading arrangements with the EU might be less open than previously anticipated, requiring a lower real exchange rate to improve competitiveness and support activity. Longer-term gilt yields have risen notably, as have market-implied expectations of medium-term inflation.

The Committee's latest projections for output, unemployment and inflation, conditioned on average market yields, are set out in the November *Inflation Report*. Output growth is expected to be stronger in the near term but weaker than previously anticipated in the latter part of the forecast period. In part that reflects the impact of lower real income growth on household spending. It also reflects uncertainty over future trading arrangements, and the risk that UK-based firms' access to EU markets could be materially reduced, which could restrain business activity and supply growth over a protracted period. The unemployment rate is projected to rise to around 5½% by the middle of 2018 and to stay at around that level throughout 2019.

Largely as a result of the depreciation of sterling, CPI inflation is expected to be higher throughout the three-year forecast period than in the Committee's August projections. In the central projection, inflation rises from its current level of 1% to around 2¾% in 2018, before falling back gradually over 2019 to reach 2½% in three years' time. Inflation is judged likely to return to close to the target over the following year.

The MPC's Remit requires that monetary policy should balance the speed with which inflation is returned to the target with the support for real activity. Developments since August, in particular the direct impact of the further depreciation of sterling on CPI inflation, have adversely affected that trade-off. This impact will ultimately prove temporary, and attempting to offset it fully with tighter monetary policy would be excessively costly in terms of foregone output and employment growth. However, there are limits to the extent to which above-target inflation can be tolerated.

Those limits depend, for example, on the cause of the inflation overshoot, the extent of second-round effects on inflation expectations and domestic costs, and the scale of the shortfall in economic activity below potential. In the MPC's November forecast, the inflation overshoot is the product of a perceived shock to future supply, which has caused the exchange rate to fall, alongside a modest projected shortfall of activity. Inflation expectations have picked up to around their past average levels and domestic costs have remained contained. Given the projected rise in unemployment, together with the risks around activity and inflation, and the potential for further volatility in asset prices, the MPC judges it appropriate to accommodate a period of above-target inflation. That notwithstanding, the MPC is monitoring closely the evolution of inflation expectations.

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

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

Minutes of the Monetary Policy Committee meeting ending on 2 November 2016

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 there had been significant movements in UK asset prices, most notably a large sterling depreciation. The Committee considered the factors behind the recent moves, as well as market expectations for domestic policy action.

3 The sterling trade-weighted effective exchange rate index had depreciated by 6% since the Committee's previous meeting, leaving it 7% lower than the 15-day average at the time of the *August Inflation Report*. Market contacts had attributed the recent movements to perceptions that the United Kingdom's future trading arrangements with the European Union might be less open than previously anticipated, requiring a lower exchange rate to maintain competitiveness and support activity. Implied volatilities in sterling foreign exchange options had risen, with one-year implied volatility reaching a level similar to that seen immediately after the United Kingdom's vote to leave the European Union. Consistent with views from market participants that there remained downside risks to sterling, the price of options offering protection against the risk of further sterling depreciation had increased compared with the price of protection against an appreciation.

4 Gilt yields had also risen notably over the period, and by more than long-term government bond yields in other economies. Ten-year gilt yields had increased by 40 basis points relative to the time of the *August Inflation Report*. The bulk of the move had occurred alongside the depreciation of sterling, with a further increase following the release of stronger-than-expected UK GDP data. Much of the rise in gilt yields had appeared to reflect an increase in the inflation compensation component. Shorter-term inflation compensation measures had picked up, consistent with an expectation that the depreciation in sterling would push up on inflation in the near term. Longer-term inflation compensation five-to-ten years ahead had also risen to levels around their past averages.

5 Short sterling rates had risen since the *August Inflation Report*, and only a very low implied probability of a cut in Bank Rate was priced into the sterling OIS curve by the end of the year. The latest Reuters poll of economists had also shown a shift in Bank Rate expectations, with 30 per cent of respondents expecting a cut by the end of the year, compared with 81 per cent in the previous survey. The same survey had revealed little expectation of any further extension to the other elements of the MPC's August package over the next twelve months.

6 Reflecting the exchange rate depreciation's impact on the sterling profits of multinationals, the FTSE All-Share index had risen relative to other advanced economy benchmark equity indices. In contrast, the equity prices of domestically focused UK firms within the FTSE All-Share index had fallen. Sterling non-financial

investment grade corporate bond spreads had also increased a little, widening relative to dollar and euro spreads. Although sterling corporate bond issuance had picked up markedly following the announcement of the MPC's Corporate Bond Purchase Scheme in August, it had slowed in October.

7 Internationally, market implied measures suggested a majority view that the US FOMC would increase rates at its December meeting, in line with broadly positive US data outturns and communication from FOMC members. While the ECB had left policy unchanged at its October meeting, market expectations were for further easing at a subsequent meeting. The Bank of Japan's communications on its monetary policy framework had been seen by market participants as reducing the likelihood of further aggressive stimulus.

The international economy

8 The news on the global outlook since the MPC's previous meeting had been slightly to the upside, and growth in the second half of 2016 was expected to be a little higher than that in the first half. Nevertheless, the Committee's forecast of medium-term growth of a little over 2% per year in UK trade-weighted terms was subdued by historical standards.

9 In the euro area, GDP had been estimated to have grown by 0.3% in 2016 Q3. This was in line with what had been expected at the time of the *August Inflation Report*, though slightly weaker than the signal from recent monthly indicators. Early indications from business surveys had suggested a pickup in the pace of growth in Q4. The ECB had left policy unchanged in October, but market expectations of further loosening meant that monetary conditions continued to be supportive of growth into 2017.

10 In the United States, the advance estimate of Q3 GDP growth had been 0.7%. This represented a pronounced pickup from the 0.4% rise in Q2, driven by a turnaround in stock-building. The near-term outlook for consumption remained solid, supported by continued improvement in the labour market. There appeared to have been little evidence that uncertainty about the outcome of the presidential election had weighed on economic activity. Inflation had picked up a little, with twelve-month core PCE inflation at 1.7% in August and September, up from 1.6% in July.

11 The official estimate of Chinese Q3 GDP growth had been 1.8%. This had been in line with expectations and showed continuing signs of some rebalancing away from manufacturing and investment towards services and consumption. Debt growth had remained rapid, however, with mortgage lending having risen by 30% in the year to Q3. The Chinese authorities had recently announced new restrictions on home purchases in more than 20 cities and had introduced a range of measures designed to curb property developers' access to debt and equity financing.

12 The price of oil had risen to around \$50 per barrel on a 15-day average basis, about 12% higher than at the time of the *August Inflation Report*. Oil prices had increased following the OPEC meeting in late September, at which members had agreed to cut production. If implemented, these production cuts were expected to take the oil market from close to balance at present to a state of excess demand.

Money, credit, demand and output

13 UK GDP had increased by 0.5% in 2016 Q3, according to the preliminary estimate, notably stronger than the expectation incorporated in the August *Inflation Report* projections. Growth during the quarter had been more than accounted for by the service sector, where output had expanded by 0.8%. Manufacturing and construction output had both contracted. Business surveys had provided mixed signals, with some having recovered sharply from their weakness immediately following the EU referendum result, while others had remained subdued and consistent with a modest slowing in near-term activity. However, official estimates of activity had diverged from the signals provided by the main business surveys, with the latter pointing to materially weaker growth in the recent past. This suggested that a degree of caution was warranted in interpreting the data.

14 The strength in services output in Q3 appeared consistent with other indications that consumer demand had remained relatively robust: the distribution sector, hotels and restaurants, and the film industry had all made noteworthy contributions to output growth during the quarter. Consumer confidence had stabilised at a little above its long-run level and housing market activity and prices had proved somewhat more resilient than expected. The latest household survey conducted by NMG on behalf of the Bank had shown little evidence of increased uncertainty about income and employment prospects following the EU referendum.

15 By contrast, there had been further evidence that corporate investment spending was likely to experience some drag from uncertainty about the economic outlook. Investment intentions surveys, including reports from the Bank's Agents, had, by and large, failed to recover from their post-referendum declines. The Bank's new Decision Maker Panel, a survey of around 500 firms designed to gauge company expectations and uncertainty, had pointed to elevated levels of uncertainty among a sizable minority of firms, with negative implications for their year-ahead investment spending.

16 Growth in broad money had strengthened during 2016, with the four-quarter growth rate in Q3 having reached its highest level since the financial crisis. It was possible that at least part of that strengthening of money growth for both households and some financial companies had reflected a switch out of other, riskier, assets into sterling deposits for precautionary reasons. The rise in financial companies' deposit holdings could also in part be a consequence of the Bank of England's asset purchases.

17 Overall, activity during the middle of 2016 had been more resilient than the Committee had expected in August. It remained likely that demand would slow during 2017 as rising costs of imports and tradable items weighed on real incomes, but that slowing might be more gradual than previously thought, not least because the recent fall in sterling should provide further support to exports. This assessment remained tentative, however, as uncertainty about the outlook remained unusually high, and shifts in sentiment among households, companies and financial market investors had the potential to generate marked changes in the economic outlook.

Supply, costs and prices

18 Twelve-month CPI inflation had increased by 0.4 percentage points to 1.0% in September, slightly higher than the figure expected by Bank staff. Conditional on the market yields prevailing at the time of the latest November *Inflation Report*, CPI inflation was expected to continue to rise, reaching around 1½% at the turn of the year and rising further to around 2¾% in mid-2018 before beginning to fall back gradually thereafter. This anticipated pickup in inflation was primarily a result of two factors. First, the combined effect of reductions in global energy prices a year earlier dropping out of the twelve-month calculation and the more recent increase in global energy prices, especially in sterling terms, pushing up on fuel prices over the coming months. The second factor was the more general impact of the depreciation of sterling on the prices of imported and tradable goods and services.

19 Sterling's depreciation had occurred in three phases: the persistent decline in value between mid-November 2015 and April 2016; the more abrupt depreciation immediately following the referendum on the United Kingdom's membership of the EU in June; and the marked decline that had happened around the start of October. In total, sterling had depreciated by 21% since the November 2015 peak, and by 7% since the time that the Committee's August *Inflation Report* projections had been finalised. Reflecting the earlier phases of the depreciation, sterling goods import prices, excluding oil, had increased by around 7½% between November 2015 and August 2016. There was uncertainty over the extent and speed with which this increase in imported costs would be passed through into final consumer prices. Given the size of the fall in sterling, and its association with a weaker outlook for supply, it was possible that pass-through to CPI inflation would be relatively brisk. The movement in the sterling exchange rate had been sufficiently large to push projected inflation above the 2% target for an extended period. In the central projection to be published in the November *Inflation Report*, the contribution to CPI inflation from the prices of imports (other than energy) and tradable items was expected to rise to over 1 percentage point, falling back to around ¾ percentage points by the end of 2019 and toward zero over the following year or so.

20 Regarding domestic cost pressures, wage growth had remained moderate and roughly in line with expectations at the time of the August *Inflation Report*. The annual growth of regular pay in the three months to August had been 2.4% in the private sector and 2.3% in the economy as a whole. It remained to be seen to what extent pay growth would rise with headline inflation, and to what extent it would continue to be restrained by subdued productivity growth. Also important would be the margin of slack likely to result from the softening of demand growth described in the November *Inflation Report* projections.

21 Employment growth and labour market participation had been stronger than expected at the time of the August *Inflation Report*. The employment rate had increased to 60.6% in the three months to August, its highest in over 40 years, and the number of vacancies in official data and posted online had remained at relatively elevated levels. Most surveys had suggested that jobs growth would be likely to slow a little in the near term. Combined with the prospect of only moderate output growth in 2016 H2, this meant that the growth of labour productivity, expressed as output per hour worked, was expected to average around 0.4% per quarter in the second half of the year. This, in turn, suggested that aggregate unit labour costs were expected to grow

in annual terms by around 2% – roughly one percentage point lower than had been the norm in the decade before the financial crisis. A range of other measures of domestic cost pressures – such as the GVA deflator, the service sector producer price index and estimates of 'core' service sector CPI – had picked up in recent quarters, but remained below pre-crisis historical norms.

22 During the month, the YouGov/Citigroup survey had indicated that households' expectations of inflation one year ahead had picked up sharply from 1.7% in September to 2.5% in October, a likely reaction to the effect of the depreciation of sterling. The comparable expectation for inflation five to ten years ahead had increased only a little, to 2.7% in October. By contrast, measures of investors' required inflation compensation in the medium term derived from financial market prices had increased notably. Although these measures had risen from relatively low levels to around their past averages, the scale of their rise was noteworthy, and the MPC would be watchful for the possibility of further increases.

The immediate policy decision

23 The Committee set monetary policy to meet the 2% inflation target, and in a way that helped sustain growth and employment. In keeping with its Remit, at the time of the *August Inflation Report*, the Committee had announced a package of supportive measures that it judged was appropriate to balance the trade-off that had emerged in the economic outlook. On the one hand, economic activity had been expected to weaken and unemployment to rise, given the period of uncertainty likely to follow the referendum on EU membership. On the other hand, inflation had been expected to rise to a rate above the 2% target, for an extended period, as a result of the depreciation of sterling that had accompanied the referendum result. At the August meeting, a majority of Committee members had also expected to support a further cut in Bank Rate at one of the remaining MPC meetings of 2016 if the outlook remained broadly consistent with the one set out in the *August Report*. Three months later, the key question was how the economic outlook, and therefore the policy trade-off, had changed.

24 Since the time of the *August Inflation Report*, indicators regarding the near-term outlook for growth had been stronger than expected. Nonetheless, sterling had depreciated considerably further. The Committee discussed these developments.

25 The preliminary estimate of GDP growth in the third quarter had been 0.5%, materially stronger than the Committee had expected three months previously. Survey indicators of activity had generally recovered from their troughs immediately following the referendum, albeit to differing degrees. As a whole, these business surveys had pointed to weaker growth than the official data, even allowing for their recovery after July. Importantly, a discernible pattern had become evident, with indicators relating to household sentiment and spending noticeably stronger than those relating to the corporate sector. Retail sales, indicators of consumer confidence and the housing market data had been resilient, as had consumer services output in the preliminary Q3 GDP data. By contrast, indicators of businesses' investment and employment intentions had generally continued to soften and the commercial property market had remained subdued.

26 In financial markets, the further depreciation of sterling had been the most notable aspect of a three-month period characterised by two phases. In the first phase, the sterling exchange rate had stabilised for a period following its initial post-referendum depreciation. Supported by the measures announced by the MPC in August and more positive activity indicators, financial conditions and other asset prices had recovered from the deterioration seen straight after the referendum, accompanied by a sharp increase in corporate bond issuance. However, in the period since the beginning of October, and despite the continuation of a relatively positive flow of UK economic data, the sterling effective exchange rate index had depreciated further taking the total depreciation since sterling's November 2015 peak to 21%. Market intelligence had attributed the most recent movements to perceptions that the UK's future trading arrangements with the EU might be less open than previously anticipated. That could result in weaker longer-term prospects for income growth and require a lower real exchange rate to improve competitiveness and support activity.

27 At face value, the decline in sterling seemed at odds with the more optimistic picture implied by the resilience of household spending. Any such difference in view between households and financial market investors about the probable long-run consequences of the United Kingdom's withdrawal from the EU would be resolved over time as the nature of future international trading relationships, and their consequences for demand and supply, became clearer. Meanwhile, however, a wide range of potential outcomes remained possible, and both the economic outlook and asset prices remained susceptible to shifts in sentiment in one direction or the other. For instance, it was possible that sterling might appreciate at some point in the future if investors' assessment of the outlook for income growth became more positive. Conversely, it was possible that households' spending would slow reasonably significantly, perhaps prompted initially by the negative impact of sterling's sizeable depreciation on their real incomes.

28 The depreciation of sterling had been accompanied by a notable increase in longer-term gilt yields, which had exceeded the increases in the yields of overseas government bonds. Much of this appeared to reflect an increase in the compensation that investors required for future inflation. Both near-term and medium-term inflation break-even rates had increased materially. In the near term, an increase in expectations of inflation seemed a natural response to the likely impact of sterling's depreciation on the price level. It was less straightforward to attribute the increase in medium-term measures of inflation compensation to recent movements in sterling, however. The Committee noted that, during the recent period in which CPI inflation had fallen below the target and in which domestic cost growth had remained subdued, both short and medium-term forward inflation compensation measures had fallen. The recent parallel increases in short and medium term inflation compensation measures had so far only returned them to around past average levels. The MPC would nevertheless remain watchful for the possibility of further increases in measures of inflation compensation in financial markets, as well as in surveys of households' and businesses' inflation expectations.

29 The net result of the developments since the August *Inflation Report*, and particularly the depreciation of sterling, had adversely affected the trade-off between the outlook for inflation and real activity that the MPC was required by its Remit to balance. The Committee's updated projections for output, unemployment and inflation, conditioned on average market yields, were described in detail in the November *Inflation Report*. Output growth

was expected to be stronger in the near term, reflecting the resilience in particular of indicators of household spending and sentiment. But it was expected to be weaker than previously anticipated in the medium term. In part that reflected the impact of lower real income growth on household spending as a consequence of the depreciation of sterling. It also reflected persistent uncertainty over future trading arrangements, and the possibility that UK-based firms' access to EU markets could be materially reduced, which could restrain both business activity and supply growth. The unemployment rate was projected to rise to around 5½% by the middle of 2018, and to stay at around that level throughout 2019 – a little lower in the near term than in the August *Inflation Report* projections, but slightly higher further ahead. Largely as a result of the depreciation of sterling, CPI inflation was now expected to be higher throughout the three-year forecast period than in the Committee's August projections. In the central case, it rose from its September level of 1% to around 2¾% in mid-2018 before falling back gradually over 2019 to reach 2½% by the end of the three-year forecast period. Inflation was judged likely to return to close to the target over the following year.

30 The Committee considered the appropriate policy response to the more challenging trade-off that these projections implied. The impact of sterling's depreciation on CPI inflation would ultimately prove temporary and, in the Committee's judgement, attempting to offset it fully with tighter monetary policy would be excessively costly in terms of foregone output and employment growth. However, there were limits to the extent to which above-target inflation could be tolerated. These limits depended, for example, on the cause of the inflation overshoot, the extent of second-round effects on inflation expectations and domestic costs, and the scale of the shortfall in economic activity below potential. In the MPC's November forecast, the inflation overshoot was the product of a perceived shock to future supply, which had caused the exchange rate to fall, alongside a modest projected shortfall of activity. Inflation expectations had picked up to around their past average levels and domestic costs had remained contained. Given the projected rise in unemployment, together with the risks around activity and inflation, and the potential for further volatility in asset prices, the Committee judged it appropriate to accommodate a period of above-target inflation. That notwithstanding, the MPC would monitor closely the evolution of inflation expectations.

31 In light of the developments of the past three months, all MPC members agreed that that the guidance it had issued following its August meeting regarding the likelihood of a further cut in Bank Rate had expired. As the Committee had noted earlier in the year, the future path of monetary policy would depend on the evolution of the prospects for demand, supply, the exchange rate, and therefore inflation. 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.

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

Bank Rate be maintained at 0.25%;

The Bank of England continue with the programme of sterling non-financial investment-grade corporate bond purchases totalling up to £10 billion, financed by the issuance of central bank reserves;

The Bank of England continue with the programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion, financed by the issuance of central bank reserves.

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

33 The following members of the Committee were present:

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

Dave Ramsden was present as the Treasury representative.

As permitted under the Bank of England Act 1998, as amended by the Bank of England and Financial Services Act 2016, Anthony Habgood was also present on 27 and 31 October 2016 and David Prentis was present on 31 October 2016 as observers for the purposes of exercising oversight functions in their roles as members of the Bank's Court of Directors.