Report to the Treasury Select Committee
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Voting record

My first meeting as a member of the Bank's Monetary Policy Committee (MPC) was just over a year ago. At that time, the Committee was putting the finishing touches to its November 2013 *Inflation Report*.

We were seeing signs of a strong recovery, with GDP increasing at an annualised rate of over 3% over the middle two quarters of the year. The key drivers of the recovery seemed to be renewed confidence, due in no small part to the de-escalation of the euro crisis and an easing in credit conditions. The squeeze from higher food and energy prices was coming to an end and inflation had just fallen by 0.5 percentage points, the largest fall in over 18 months. With unemployment at 7.6%, there looked to be ample spare capacity in the economy.

The MPC was operating under the 'forward guidance' it had agreed in August last year and to which I had subscribed on joining the Committee. To head off the risk that the market might react too quickly and too simplistically to strong GDP growth numbers and forget the amount of spare capacity still in the economy, the Committee had made clear its intention, through 'forward guidance' not to consider tightening policy at least until there was a substantial reduction in spare capacity as evidenced by a fall in the unemployment rate to below 7%.

In its November 2013 *Report*, the Committee took the view that the recovery would broaden out and move to a more sustainable footing, with business investment becoming a significant driver of growth and a return to productivity growth driving an increase in consumption led by higher real incomes rather than lower saving.

In the event, both business investment and GDP growth came in stronger than forecast, with the ONS data showing GDP growth at 3.2% in the four quarters to the middle of this year, a third of that increase driven by higher business investment. Our productivity forecast proved, however, to be too optimistic, with 4-quarter growth more sluggish than expected at around three-quarters of a percent.

Strong output growth, coupled with weak productivity, made for a record quarterly increase in employment. Throughout this period, and in line with the forward guidance framework under the committee was operating, my view was that the stance of monetary policy should be maintained so as to drive out spare capacity in the economy. I was concerned also that there were major uncertainties about the supply capacity of the economy as a result of possible structural changes due the nature and severity of the crisis and the recession. The failure of productivity to recover and the sharp fall in unemployment during this period of the recovery were possible indications of such changes on the supply side.

By the time of the Committee's May 2014 meeting, the unemployment rate had fallen below the 7% threshold set out in the MPC's forward guidance framework. On the latest data, unemployment stood at 6% in the three months to September.

Surprisingly, despite this substantial and rapid fall in unemployment, nominal pay growth has come in much weaker than expected. On the average weekly earnings measure, annual whole economy regular pay growth was running at just 1.3% in the third quarter. That weakness is more than can be explained by weak productivity. Growth in 'unit labour costs' – pay relative to the output of the average employee – has been negative over the past year. Even after adjusting for what look to be temporary factors, unit labour cost look to be broadly flat and substantially below the 2% rate consistent with inflation target.

This weakness in domestic price pressures has occurred alongside a benign external environment. In part due to the higher level of Sterling, import prices have fallen over the past year. Slower growth in Asia and the Euro-area, together with some positive news on supply, has left oil prices down by around a quarter on their level a year ago. Together, these factors have left inflation at just 1.2% in the latest data.

The weak pay and inflation data, coupled with the strength in participation, have been the key reason why, despite unemployment falling through the 7% threshold in May, I have concluded in subsequent meetings that there remains substantial spare capacity in the labour market. The rate of the fall in unemployment has clearly reduced that spare capacity faster than anticipated as demand has recovered. However, changes on the supply side of the economy have meant that there had been a greater amount of spare capacity in the labour market than we had initially thought.   I have therefore voted to maintain Bank Rate at 0.5% and the stock of asset purchase at £375bn.

That position has, in recent quarters, been reinforced by a weakening in the growth rate of the UK's main trading partners, particularly the euro area. The euro area grew at an annualised rate of less than 1% across the middle of the year. There are signs that, together with some slowing in the housing market, this is feeding through into UK output growth, which appears to have slowed over the second half of the year. The latest ONS data for Q3 showed growth slowing to 0.7%, with business surveys suggest growth may slow further in Q4.

With interest rates already at their effective lower bound and inflation below target, I am more worried about risk of inflation surprising again on the downside than that of an unexpected emergence of inflationary pressure. With greater scope for tightening policy than for loosening, I am more worried about the downside risks to inflation at the moment.

The outlook

The MPC's best collective judgement on the most likely path for GDP growth and inflation over the next three years is set out in its November *Inflation Report* and I share that judgement as a central view.

There are risks either side of those projections.

The evolution of employment, pay and productivity growth will be crucial to my monetary policy decision and, in my view, the debate on the Committee in the coming quarters.

A key area of focus will be on how long unit labour cost growth can remain subdued. It remains to be seen whether the slowing in output growth that looks to be in prospect will translate into a smaller fall in unemployment through the second half of the year and whether, as in the November IR forecast, productivity can contribute a larger amount to output growth than over the recent past. There are tentative signs of that in the latest labour market data, where employment growth eased off relative to the pace seen earlier in the year and where there was an improved picture for productivity, with output per hour growing in the last quarter growing at an annualised rate of over 2%. Although whole economy regular pay growth over the past four quarters has been weak, the annualised rate of growth of the last quarter annualised was around 3%.

If the economy can continue to generate productivity growth of 2% per annum, then there will be room for pay growth to increase further before we reach the point where domestic costs grow at a pace consistent with achieving the inflation target in the medium term. The annual settlements round, in the first quarter of next year, should provide a helpful indication on the extent of domestic inflationary pressure in the economy.

Explaining monetary policy

Over the past year I have given seven on the record speeches and published two articles. Of the speeches, two covered monetary policy issues, with the remainder covering the work of the Bank's Financial Policy Committee and aspects of the international regulatory reform programme. I have given around twenty off the-record talks on monetary policy and financial stability. I have made four visits to different regions of the United Kingdom – the South West, the West Midlands, the North West and Wales. I have had regular meetings with other central bankers and members of the regulatory community, including at the ECB General Council and the European Systemic Risk Board, the European Economic and Financial Affairs Council, the Bank for International Settlements, the G20 Financial Stability Board and G20 Finance Ministers and Central Bank deputies meetings. I have maintained extensive contacts with the business and financial communities both here and overseas.