Report to the Treasury Select Committee

Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England

17 November 2017

Economy and Voting record

When I last reported to the Committee we, the MPC, had recently published our August 2016 Inflation Report.

Over the past year, growth has been stronger than forecast in the August 2016 Report. It has been supported by resilient consumer confidence, the stronger world economy, the small loosening in fiscal policy relative to previous plans and the MPC's comprehensive package of measures in August 2016. The economy slowed into the first half of 2017 – growth over the second half of 2016 averaged 0.5% per quarter which slowed to 0.3% per quarter in Q1 and Q2 of this year. This has been due in the main to a squeeze on real income growth from inflation though I think we have also probably seen Brexit-related effects on business investment and perhaps consumption.

I had concerns that the economy might continue to slow into the second half of this year. At present it looks as though we have settled at a steady, but lower, pace of growth of about 0.3-0.4% per quarter. Weak productivity growth since the crisis indicates that the economy's potential growth rate is around these levels. As we were expecting at the turn of the year, there has been something of a rotation in growth – slowing consumption (from 0.5% in Q3 2016 to 0.2% in Q2 2017) offset to some extent by a pickup in exports and business investment. These have been supported by the stronger world economy and, for exports, by the depreciation in sterling.

World growth has been strong and looks set to remain so. In Q3, the Euro Area grew by 0.6% and the US by 0.7% and this year's growth is overall stronger than we had been forecasting. We have repeatedly upgraded our world growth forecast over the past year in contrast to my previous years on the Committee when forecasts for world growth tended to be downgraded. Our current forecast has the Euro Area and US continuing to grow at above potential rates over the forecast horizon and we now judge the risks around the central projection to be balanced, rather than skewed to the downside.

Inflation has risen to 3% – one percentage point higher than our target – which reflects the effects on import prices of the referendum-related fall in sterling. Domestically generated inflation pressure, however, appears low.

Whole economy average weekly earnings grew in the year to September at a rate of 2.2%. Higher frequency indicators suggest a faster rate of growth: 3 month on 3 month annualised AWE growth for regular pay is 2.8%. But wage data are volatile and can mislead. Between 2014 and 2016, the 3 month on 3 month measure annualised AWE gave readings well above 3% which did not translate into sustained higher rates of pay growth.

This weak wage growth comes alongside signals of tightness in the labour market. Unemployment has fallen to 4.3% – its lowest since the mid 1970s and below the Bank's estimate of the equilibrium level. Slack in the labour market has reduced over the year. Labour market indicators such as job to job flows, quit rates, and surveys of recruitment difficulties are also signalling the labour market is tight. Pay growth remains at the same rate we were seeing in 2011 when unemployment was above 8%.

Weak pay, reflecting both weak productivity and below-target consistent unit wage costs, has been a feature of the UK economy since the crisis. This weakness has persisted as the labour market has tightened.

Other measures of domestically generated inflation also appear to be below target-consistent levels. Measuring domestically generated inflation when externally generated inflation pressure is high, as at present, is not straightforward. Higher import prices work their way into the domestic production chain and can appear as domestic inflation.

Bank staff calculations suggest that adjusted for this effect indicators of domestic inflation pressure are below levels consistent with the 2% target.

The outlook

The MPC's November Inflation Report forecast, which is the best collective judgement of the Committee, is for GDP to continue growing at about its current rate through the whole forecast horizon. In the later part of the forecast period, as the impact of externally generated inflation pressure wanes, domestic inflation pressures, particularly pay, rise so that inflation is slightly above the target at the 3 year forecast horizon.

Pay is forecast to rise – to 3% by the end of 2018 and to remain above that for the remaining years of the forecast – because of the tightness we are already seeing in the labour market.

Labour market indicators have been signalling tightness for most of my time on the MPC without translating into pay pressure. Our pay forecasts over the past few years have tended to undershoot and that leads me to be cautious about the forecast and alive to the possibility that the relationship between unemployment and wage growth may have changed over time.

At the November meeting I voted against increasing Bank rate. I did so not because I had a markedly different view to the majority of the right trade-off between output/inflation over the forecast period – or to put it another way, on the limits to tolerance of above-target inflation. In this respect, I share the overall framework of the Committee.

Our framework, however, depends on our estimation of the relationship between labour market slack and wage growth. Where members have different views of this their tolerance for above-target inflation may appear to be different. Given the caution that I have expressed around our pay forecast and the uncertainties around the relationship between labour market slack and wage growth, there is in my view some risk that the trade-off is not as it currently appears.

In my view the low level of domestic pressure on inflation now, the absence of second round effects from the deprecation of sterling, and inflation expectations around their historical averages, make it possible to wait before tightening policy until there is clear evidence that pay growth is responding to the level of unemployment in line with our forecast.

I should of course also speak to how Brexit affects the outlook for monetary policy. While Brexit is a further source of uncertainty, my policy decision does not anticipate any particular Brexit outcome.

Expectations of Brexit - the full and diverse range from the most optimistic to the most pessimistic - are in the UK economy now. Though it is more difficult to measure, expectations about Brexit are also affecting to some degree many of the economic decisions of businesses and households. The full and diverse range of expectations of Brexit and of the path to it cannot by definition all come to pass. Over our forecast period, a specific Brexit and a specific path to it will emerge. The MPC cannot forecast what that outcome will be or how it will measure against the diverse expectations in and between households, businesses and financial markets.

Nor can the MPC forecast how that outcome will affect the adjustment of the paths of demand, supply and the exchange rate, relative to each other. It is that relative adjustment of these variables that will determine the path of inflation and hence whether – and in which direction – policy may need to respond to meet the Committee's primary objective. We can, in my view, only work on what we see in the economy now and stand ready to respond as necessary as Brexit emerges.

Explaining monetary policy

Over the past twelve months I have given six on the record speeches (list below). Of the speeches, two were specifically on monetary policy issues – including one I delivered in Oxford this week. This week I have also been to Liverpool to talk about the work of the Bank of England to schools as part of our 'Future Forum'.

I have discussed my views on the economy in interviews with regional and national newspapers and in radio interviews.

I have given around thirty 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, Northern Ireland, the North East and Wales – to explain the economic and financial outlook to local business leaders and to hear their views on these matters.

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 Bank for International Settlements, the G20 Financial Stability Board and G20 Finance Ministers and Central Bank deputies meetings. I have also maintained extensive contacts with the business and financial communities both here and overseas.

<u>Speeches</u>

3 November 2016	*Challenges for financial markets*
16 November 2016	*Why are interest rates low?*
8 February 2017	*Are firms underinvesting – and if so why?*
22 February 2017	*Global pipes – challenges for systemic financial infrastructure*
29 September 2017	*Ten years on: Lessons from Northern Rock*
14 November 2017	*The Phillips curve: lower, flatter or in hiding?*