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Report to the Treasury Committee
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Economy and voting record

This is my first report to the Treasury Committee since I had the privilege of joining the Monetary Policy Committee (MPC) in September 2018.

In August 2018, just before I joined the MPC, the Bank of England published its regular *Inflation Report* outlining its view of the economy. The MPC, conditional on a gently rising path of Bank Rate implied by market yields at the time, expected GDP to grow by an average of around 1 ¾ % per year over the forecast period. This was slightly above the UK potential rates of growth. Global demand was also projected to grow above its estimated potential rate over the forecast and financial conditions remained accommodative at the time. CPI inflation was 2.4% in June 2018. The MPC expected domestic costs to push up on inflation as external cost pressures from the effects of sterling's previous depreciation and higher energy prices waned. In order to achieve inflation at target by the end of the third year, this warranted a gently rising path for Bank Rate as implied by market yields at the time.

When I joined I agreed with this view. But since then there have been significant developments, both in the UK and globally, that resulted in increased uncertainty and lower growth. Some of the downside risks that I worried about over the past year have, I regret to report, materialised.

The world economy has seen a significant and broad based slowdown in growth since late 2017. Annual global growth reached a peak of 3.9% in 2018Q1 in PPP-weighted terms and has since slowed to around 3.2% in 2019Q1. Currently, only around one sixth of the global economy is thought to be growing above trend, down from four fifths at the start of 2018. Growth in the UK's major trading partners such as emerging markets, China and the Euro area has declined. The exception is the United States where growth has been supported by fiscal stimulus.

The slowdown in the world economy since late 2017 has been associated with two factors: tightening in financial conditions and trade tensions.

Regarding financial conditions, the withdrawal of monetary stimulus in the United States, warranted by the domestic economy, had resulted in an increase in US interest rates. But in the rest of the world, particularly in emerging markets, this had caused an increase in interest rates, too. This is because they borrow in US dollars and higher US interest rates lead to a tightening of financial conditions. This had partly contributed to a slowdown in growth. More recently, though, US interest rates along with interest rates in other countries have fallen leading to looser financial conditions and supporting growth.

[1] This report was finalised on the 9th of August, 2019 and does not include information and data published since then.

But another important factor behind decline in global growth are trade tensions. Over the past year, trade tensions have increased. The US and China have implemented higher tariffs on their trade. This is likely to both directly lower growth, through lower trade, as well as to indirectly decrease growth through lower business confidence and increased uncertainty about economic policy. Indeed, there is some evidence that during 2018 falls in business confidence were correlated with a slowing in business investment growth across advanced economies. I have been concerned that downside risks, such a further escalation of trade tensions, might materialise. Some of these events have occurred. For example, after the August 2019 *Inflation Report*, the US announced 10% tariffs on the remaining $300 billion of Chinese imports effective from September 1. This is likely to have further decreased confidence and increased uncertainty.

Turning to the UK economy, it has also seen slower growth since 2018. Quarterly GDP growth had been around 0.4% during most of 2017 and 2018. But as we entered 2019 growth has become more volatile, largely due to Brexit-related effects, and the underlying pace of growth slowed. After growing by 0.5% in 2019 Q1, GDP declined by 0.2% in Q2. This can partly be accounted for by Brexit-related volatility: stockbuilding and car production shutdowns that were brought forward. Survey-based evidence and trade data suggest that firms had been building up their inventories in Q1 which pushed up on growth in that quarter and subsequently dragged on growth in Q2. Similarly, a decline in car production contributed to the weak Q2 GDP figures as some firms brought forward their usual summer shutdowns for maintenance to April, in order to mitigate the effect of any Brexit disruption. Once these erratic factors are accounted for, underlying quarterly growth is likely to have been around 0.2% in 2019, lower than in 2018.

The slowdown in the UK economy reflects the influence of global factors, such as the decline in growth discussed above, and domestic factors such as the rising Brexit-related uncertainty. The recovery in business investment since 2008 was broadly in line with previous recoveries but since the EU Referendum Act was passed in 2015 investment growth had been weak. The Bank's Decision Maker Panel (DMP) survey suggests that the level of nominal investment may be between 6%-14% lower than in the absence of Brexit uncertainty. UK business investment growth was also weaker than most other G7 countries since 2016 pointing to UK-specific factors, such as the rise in uncertainty, that may be at play. As we moved through 2019, both the DMP survey and my personal conversations with firms on my site visits, suggested that firms were increasingly worried about Brexit and I believe this has further dragged on business investment growth.

But household consumption growth, a significant part of UK GDP, has remained relatively steady despite the increase in uncertainty. Consumption grew by 0.6% and 0.5% in 2019 Q1 and Q2 respectively. Consumer confidence, which tends to correlate with consumption growth, has held up. The Bank's NMG and the GfK/EC surveys suggest that households' expectations are around their average historical levels despite the fact that their expectations of the general economic situation have deteriorated since 2015. This remains somewhat of a puzzle to me and since joining the MPC I have been worried about possible sharp falls in consumption growth should households re-evaluate their beliefs about their expected future income.

So far, though, a robust UK labour market has supported consumption growth. Since 2018, employment has been strong and has grown at around 0.3%, similar to the 1997-2007 pre-recession period. The unemployment rate in the three months to May 2019 stood at 3.8%, the lowest since

1974Q4. The tightness of the labour market has been associated with higher wage growth. Whole economy average weekly earnings growth, excluding bonuses, grew at 3.6% in the three months to May 2019. All else equal, this should exert upward pressure on inflation. But this may not necessarily happen if companies adjust their margins and allow them to temporarily absorb higher costs. A range of measures of firms' margins suggests they have been decreasing from their peaks seen around 2015-2016. They are currently around their normal levels and could decrease further particularly if firms find it difficult to raise prices in the current environment.

Different measures of core and domestically generated inflation do not point to higher inflation. Some measures based on unit labour costs are currently towards the top of their target-consistent ranges. But CPI excluding food, energy and VAT has been around 2% since mid-2018. Other measures, such as core CPI services inflation are towards the bottom or below their target-consistent ranges.

Monetary policy has had to balance slower world and UK growth as well as higher uncertainty against resilient consumption and a tightening labour market. Since joining the MPC in September 2018, I judged that the balance of news has been negative for the outlook on inflation and, in line with this view, I considered no change in the monetary policy stance appropriate for meeting the inflation target in the medium-term.

Economic outlook

Monetary policy is necessarily forward-looking as there are lags in the monetary policy transmission mechanism. The outlook for the coming few years is extraordinarily uncertain. Brexit might take the economy in different directions and the prospects for the global economy are uncertain.

My expectation is that global growth is likely to stabilise over the next couple of years. But the key question is whether growth might weaken further before doing so. Higher frequency indicators are pointing to weaker growth. For example, the latest global PMI survey balances now point to a contraction in manufacturing and suggest a faster pace of slowing in the service sector. But forward-looking surveys such as the manufacturing export orders index have remained at a similar level over the past three months. Furthermore, as recent moves in financial markets might suggest, trade-related uncertainty could exert more downward pressure on the world economy than traditional trade models would suggest. As in the August *Inflation Report*, I now expect global growth to be a little weaker at 3.1% in 2019, in PPP-weighted terms, before recovering to 3.3% in 2020 and 3.4% in 2021. But I am less certain that growth will stabilise in the near-term. Downside risks have increased. There may be further trade tensions between the US and China and we have already seen further evidence of this. There is also the potential for tariffs on autos following a report to the President of the US in May this year suggesting that auto trade had national security implications. We could also be understating the extent to which uncertainty is bearing down on global growth.

While the outlook for the global economy may be uncertain, my view is that the outlook for the UK economy is particularly uncertain. Assuming a smooth transition to new trading arrangements, I would expect a modest pick up in UK growth. As uncertainty subsides, I would expect business investment to bounce back. But, as I outlined in my speech in March at the University of Birmingham, I believe that Brexit is process and not an event. There has been a sharp rise in Brexit-related uncertainty since I joined the MPC and the level of uncertainty in the UK has remained

elevated. It now looks like some of that might be more persistent. According to the latest DMP survey, taken between 5-19 July, 30% of firms now take the view that uncertainty will not be resolved by 2021 and beyond. Therefore, I remain cautious about any increase in growth. That said, it is likely that some of strength in household consumption growth and further wage growth might result in increased inflationary pressure. In that case, a gently rising path of interest rates would be consistent with achieving the inflation target in the medium-term. I will be monitoring the data closely for any signs of inflationary pressure.

Of course, in a no deal scenario the response of monetary policy might be different. It will depend on the balance of the effects of supply, demand and the exchange rate on inflation. But I am even less certain that we can be confident in the direction of monetary policy before such an event occurs.

In my view, it is not clear what shape a no deal outcome might take. A withdrawal from the EU without an agreement would result in economic disruption. The exchange rate is likely to depreciate further which would push up on inflation. Going further than this, though, it is much less clear to me what might happen. One can imagine a state of the world in which aggregate demand falls sharply as uncertainty increases and confidence drops while the supply capacity of the economy adjusts more slowly to the new trading relationship with the rest of the world. But, equally, one can imagine a world where aggregate supply does not move slowly, as is usually the case, but the severity of the disruption leads to a sharp and fast decline in the production capacity of the economy. In this case, the decrease in supply could be greater than the decrease in aggregate demand if spending by households and businesses remains robust.

The appropriate response of monetary policy, that is, whether policy should be loosened or tightened depends on the relative size and speed of each effect and the precise shape of a no deal scenario. In my view, it is very difficult to know in advance in which state the economy will be. But should we find ourselves in such a scenario I will be closely monitoring the data to inform my decisions. In that regard, the work done by the ONS to improve our ability to monitor the economy is invaluable and I hope the TSC will support the ONS in their efforts to harvest timely data, particularly that held across government.

So far, Brexit has commanded a lot of the MPC's attention since I joined, and rightly so, but we also need to think about monetary policy in the context of longer run structural changes in the UK economy. The shift away from manufacturing towards services; the increased flexibility of the labour market; the rise of intangible investment and digitalisation are all trends that are changing how the UK economy works. This might potentially affect monetary policy transmission, too. I hope that when the dust of Brexit settles more time will be available to consider these issues.

Explaining monetary policy

Since joining the MPC in September 2018, I have:

- given nine talks on the economic outlook to regional business groups and financial market participants
- given a further five talks to schools and at universities including two on-the-record speeches on uncertainty and investment at the University of Birmingham and on the knowledge economy at the University of York (attended by a number of local schools).
- made three regional visits to meet with businesses and schools in:
    - North West;
    - Yorkshire & Humber;
    - Wales.
- given one on the record interview to the Financial Times and eight off-the-record interviews to the Wall Street Journal, Bloomberg, Trends, Financial Times, The Guardian, Big Ideas/Future Tense, and The Times.
- Continued with duties and responsibilities as a non-Executive Director at the UK Statistics Authority.
- Continued pursuing academic research on productivity, investment and innovation with a view to better understanding how it affects the economy, monetary policy and the transmission mechanism. To that effect, I attended several workshops and conferences at HMT, BEIS, ESWG, NIESR, the European Investment Bank, CEPR, Royal Economics Society, and the European Central Bank.

I gave evidence before the Treasury Committee on the *Inflation Report* in February 2019 as well as during my appointment hearing in June 2018.