Report to Treasury Select Committee

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Voting record

In my previous report, in February 2013, I noted that there had been a marked improvement in financial market sentiment in the preceding months, even though that had yet to be translated into a pickup in the activity indicators. I expected growth gradually to strengthen on the back of that, a further easing in credit conditions, and an improvement in the global environment. Inflation looked likely to remain elevated above the 2% target for longer than we thought but, as that was associated with an unusually large increase in administered and regulated prices, I thought that there were good reasons to look through it, so long as inflation expectations remained anchored.

During the first few months of last year, it was still reasonable to think that further stimulus might be required, though I felt that a combination of an improved growth outlook with above-target inflation, together with doubts about the efficacy of further asset purchases coupled with signs that the Funding for Lending Scheme had improved credit conditions justified maintaining – but not increasing – the degree of stimulus. I therefore voted to maintain the Committee's stock of asset purchases at £375 billion and Bank Rate at 0.5%, and have continued to do so up to and including my final MPC meeting this month.

By the time of the May *Report*, the prospects for output growth looked a little better, while the outlook was for slightly lower inflation. By August, however, there were clearer signs that a recovery was taking hold. At this point, of course, the Committee provided explicit guidance about the future stance of policy by stating that we would not consider raising Bank Rate until the headline unemployment rate – then 7.8% – had fallen to at least 7%, subject to overrides relating to the threats to price and financial stability.

For me, the purpose of this guidance was to emphasise that what mattered for inflationary pressures was not the growth rate, but rather the margin of economic slack, and in so doing head off the risk that market interest rates rose sharply simply because of a return to reasonable growth rates. Moreover, linking policy to unemployment was appropriate because it encoded a link to a key uncertainty, namely whether or not productivity growth would rebound as the recovery proceeded. If productivity did rebound, then unemployment would fall only slowly. But in that case, there would also be more scope to maintain an expansionary policy before inflationary pressures began to rise.

The opposite held if productivity growth remained weak: unemployment would fall faster, but we would also need to begin raising Bank Rate earlier.

Although our August growth projection was already relatively strong compared to other forecasters, the period from then to the February *Report* was characterised by further upside news to growth prospects, while inflation came down rather faster than we anticipated, reflecting downside news on commodity prices and an appreciation of the sterling effective exchange rate. Moreover, productivity rebounded less than expected, so that the headline unemployment rate reached the 7% threshold earlier than expected, in the data release for the three months to February.

The effect of these developments was to bring closer the appropriate time to withdraw some of the exceptional monetary stimulus injected during and after the Great Recession. Nevertheless, I agree with others on the Committee that there is still a sufficient margin of economic slack to keep inflationary pressures in check for some while yet. Consequently, I do not judge that the moment to begin tightening has yet arrived.

The outlook

I think it is now clear that a robust recovery is in train, though the legacy of the financial crisis at home and abroad means that growth is likely to remain subdued in comparison with past recoveries. The key uncertainty is what will happen to productivity: if it recovers strongly, then there will be more scope for output to rise before inflationary pressures build. A strong rebound in productivity would also generate the wherewithal for firms to increase real wages, thus ending the squeeze on household living standards.

Although we are gradually moving towards the point at which it will be appropriate to begin normalising the stance of monetary policy, the exact date will necessarily depend on the evolution of the economy (and productivity in particular). In addition, there are a variety of strategic arguments that may have a bearing on the pace of tightening. First, an overly early withdrawal of stimulus risks foregoing endogenous improvements in productivity, whereas if the exit is left too late then any excess inflationary pressures can be easily dealt with by raising Bank Rate. That points to a late rather than early exit. Second, and against that, continued loose policy may encourage financial vulnerabilities to build, especially in connection with the housing market. In the first instance, they should be dealt with by the Financial Policy Committee, but it is possible that monetary policy may need to act as a last line of defence. Finally, uncertainty about the impact of tighter policy, after a

long period when Bank Rate has been at its effective lower bound, points to the benefits of moving slowly and gradually (though the corollary is that the Committee would in that case need to start the normalisation process earlier).

Explaining monetary policy

Since my previous report, I have given six on-the-record monetary policy speeches (one of these also covered the interaction with the Financial Policy Committee), together with numerous off-the-record presentations to a variety of audiences. I made five regional visits (to Derby, Belfast/Newry, Exeter, Teesside, Cardiff/Port Talbot) involving various meetings and events with local business people. I also attended a variety of events with journalists, City economists and market participants. Finally, as Deputy Governor for Monetary Policy, I also represented the Bank's views in a number of international settings, including the G7, G20, informal ECOFIN and the OECD.