Report to the Treasury Select Committee

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Voting record

In the last year I have voted to hold Bank Rate at 0.5%. In October of last year, and in February of this year, I voted to increase the size of the Bank's asset purchases. From March 2012 onwards I have been in a minority voting to further extend the size of asset purchases beyond £325 billion.

The economic situation remains difficult. Output has barely grown for a year and a half and is estimated to have contracted slightly in the first two quarters of this year. Having dropped substantially from its peak of 5.2% in September 2011, inflation has still remained above the inflation target and was 3.0% in April 2012. Despite above-target inflation, I have consistently voted for a very expansionary monetary policy stance. Let me explain why.

Most of the rise in inflation over the past few years, and much of its more recent fall, has reflected: increases in energy and other commodity prices, in VAT, and the depreciation of sterling. These have a temporary – though nonetheless quite long-lasting – effect on inflation; they do not reflect underlying domestically generated inflation pressures. The impact of these temporary forces on inflation is already waning. Monetary policy should not attempt to fully offset these sorts of temporary inflation pressures because output would become too volatile. This is recognised in the MPC’s remit.

Inflation might have been even higher had domestic price pressure not been weak. The reason for weak domestic price pressure was that a substantial degree of spare capacity opened when GDP declined during the banking crisis. Unemployment has risen substantially and investment has been weak.

I had expected this downwards pull on inflation from spare capacity to be somewhat stronger than it turned out to be. One reason may be that the economy’s capacity has been damaged by more than I had thought. This is what surveys of firms suggest. Another may be that there is indeed significant spare capacity, but that it has had less impact on inflation. There is probably some truth in both explanations.

If spare capacity has a more limited impact on inflation, a lot of spare capacity is needed to reduce inflation quickly – and a lot of spare capacity means underutilisation of capital and more unemployment. But at the same time stimulating demand will put less pressure on inflation. So the price of bringing above-target inflation back down quickly is high, while the cost of more expansionary policy – which means a slower trajectory of inflation coming back to target – has fallen.

There is another reason behind my votes for a more expansionary monetary policy. The longer output lies below potential, the more likely it is that potential output itself declines – perhaps permanently. Workers lose some of their skills during long spells in unemployment. Long-term unemployment has already picked up during the crisis. The pool of qualified labour from which firms can hire then risks shrinking. In a situation where weak demand is likely to be having a negative impact upon productive capacity the cost of having a tighter monetary policy to bring inflation back to target fast will be some long lasting damage to incomes.

I do not feel comfortable with the prolonged and substantial overshoot of inflation above its target level. But that does not mean bringing inflation back to target very rapidly is or would have been the best thing to do.

The outlook

There are reasons why demand should recover. Monetary policy remains very expansionary. Households' real income should stop declining as inflation falls further. Both the household and business sectors have reduced their financial leverage, and once they have reached their targeted leverage ratios, saving ratios could fall back, boosting investment and consumption growth.

But there are very substantial risks that demand stays weak. Deleveraging may still take some time. Domestic demand faces headwinds from the external environment, tight credit conditions, and the fiscal consolidation. The possibility of a significant economic and financial disruption within the euro area continues to pose the greatest threat to the UK recovery.

The MPC's central forecast, which I believe is plausible, is for demand growth to remain subdued in the near term, and for an only gentle recovery afterwards. If so, the degree of spare capacity in the economy would continue to pull down on prices, so that CPI inflation is likely to fall back to the MPC's target.

We continue to face the problem of balancing risks: risks that we overestimate the degree of spare capacity in the economy and that inflation remains above target for longer, versus the risk of prolonging the recession and undershooting the inflation target if monetary policy is not sufficiently expansionary.

There is a risk that a protracted period of high CPI inflation could lead to higher inflation expectations becoming entrenched. But even if inflation expectations rise, wage growth might not pick up in the presence of high unemployment.

Explaining monetary policy

Since I presented my previous report last year, I have given six public speeches, focusing on the challenges monetary policy is facing and discussing the interaction between monetary policy and the real economy. Their messages were widely reported.

To present my views on monetary policy to the wider public, I have given several interviews (to *Dow Jones, The Orcadian in the Orkney Islands, The Times, BBC Radio Cumbria, Cumberland News & Star, ITN, Reuters and Reuters Insider, CNBC and Bloomberg*).

I have met numerous investors from banks, pension funds and insurance companies to obtain first-hand information on the effectiveness of asset purchases.

In the last twelve months I have made visits to many of the regions of the UK, including Scotland, North West England, Yorkshire & the Humber and the West Midlands, where I spoke to many companies.

I have spoken at a number of schools and universities to explain how monetary policy in the UK is being set.

I also published a Discussion Paper on Demographics, house prices and mortgage design.