Report to the Treasury Committee

Gertjan Vlieghe, External Member of the Monetary Policy Committee

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Economy and voting record

Since the autumn of 2016, the demand growth has generally been more resilient than I had expected after the referendum vote to leave the EU in June 2016, while the supply capacity of the economy has been weaker than I had expected.

Indicators of confidence and economic activity initially showed pronounced weakness around the time of the referendum, and led me to vote in a minority for a cut in Bank Rate in July 2016, and to vote with the majority for a comprehensive stimulus package in August 2016. Those same indicators of confidence and economic activity rebounded sharply in the months after our stimulus package. My assessment at the time was that, even though the official GDP data had not shown any slowing in growth in the immediate aftermath of the referendum, I still expected a slowing in the subsequent quarters, accompanied by a modest rise in the unemployment rate. My reasons for expecting the slowing were that, on balance, I thought uncertainty about the UK's future trading relationship with the EU would weigh on investment spending. And I also thought that the exchange-rate driven rise in inflation, to an expected inflation rate of around 3%, would eventually weigh on households' purchasing power and therefore spending.

Around the start of 2017, data started to suggest that the economy was indeed slowing. Retail sales had fallen sharply in the first quarter, housing market indicators suggested some renewed slowing, and car sales weakened sharply in the second quarter. Investment intentions picked up in the manufacturing sector, supported by improving global growth and a weaker exchange rate, but generally remained subdued in the much larger services sector.

The annualised rate of GDP growth in the UK slowed from 1.9% in the second half of 2016 to 1.1% in the first half of 2017. Strikingly, this slowdown occurred at a time when global growth momentum was improving. In the first half of 2017, Euro Area growth accelerated to 2.4% annualised, and US growth accelerated to 2.1% annualised. Such a configuration of slowing UK growth while its trading partners accelerate suggest a UK-specific factor at work that is weighing on UK growth. The uncertainty surrounding Brexit and the associated fall in purchasing power seems to be the most plausible explanation.

However, despite the clear slowing in economic growth, the labour market remained strong. Employment growth continued to grow robustly, and survey evidence of employment intentions also remained high, not pointing to any slowdown in employment that one would normally expect when there is a slowdown in GDP growth. The unemployment rate therefore continued to fall steadily, from 4.9% at the time of the referendum to 4.3% on the most recent data.

During the first half of 2017, despite the continued fall in the unemployment rate, I still did not feel that a rise in Bank Rate was necessary. In my April speech I pointed to the continued weakness in wages, which were still only growing at a pace of around 2% at the time, with no sign of any upward momentum. I also supported the MPC's collective assessment in February 2017 that the natural rate of unemployment was probably lower than we had previously estimated, meaning the unemployment rate could fall further before putting upward pressure on wages.

Headline inflation had started to rise, but the rise was broadly in line with our prior assumptions about the speed and magnitude of the exchange rate effect on inflation. The rise in headline inflation therefore gave us no new information about underlying inflationary pressure – it largely reflected exchange-rate pass-through. And the MPC's remit for monetary policy required us to balance the speed with which we seek to bring inflation back to target with the support that monetary policy provides to jobs and activity. Given my assessment that there was still slack in the labour market, this justified tolerating a somewhat longer horizon over which to return inflation to target.

I did start to point out during the first half of 2017 that I saw the risks to the economic outlook as no longer skewed to the downside. In particular, I highlighted the resilience of consumer credit growth as an indicator that household consumption might slow less than in the central forecast.

As we moved into the second half of 2017, the labour market data still remained strong. Surveys of employment intentions remained high and the unemployment rate continued to fall. Moreover, measures of under-employment, such as the number of people wanting to work more hours, also fell, and generally fell faster than headline unemployment. And data on the type of employment showed that, unlike in some earlier phases of the recovery, employment was now largely accounted for by full-time employees, while self-employment was no longer a significant contributor. Indicators of recruitment difficulties also rose.

Taking all these labour market data into account, a picture was building up of labour market slack being eroded more quickly than I had expected. But given the uncertainties surrounding any evaluation of slack, I also need some confirmation of reduced slack from upward pressure on wages.

Turning to the wages data, there was some tentative evidence of improvement, in contrast to the persistent weakness than had been evident earlier in 2017. Although year over year growth rates of private sector regular pay growth was only slightly above 2%, higher-frequency growth rates were closer to 3%. We had seen such tentative signs of improvement before, and they had subsequently faded again. But a wider range of pay-related indicators also showed improvement, such as the REC survey and the Bank's own Agents' Survey.

Moreover, to assess wage growth in the context of overall labour cost growth, we must make an adjustment for productivity. It is wage growth *relative to productivity growth* that determines labour cost growth. Given the persistent weakness of productivity growth at around ½%, wage growth of 2 ½% would be broadly consistent with meeting the inflation target.

To summarise, despite some slowing in economic growth, evidence continued to accumulate that slack in the labour market was being eroded more quickly than I had expected. That in turn would reduce my tolerance for a prolonged period of above-target inflation.

Over time, reduced slack would result in somewhat higher underlying inflation pressure, even as headline inflation probably falls back next year as the pass-through of the exchange continues, but at a slower pace. An outlook of gently rising underlying inflation pressure brought forward the appropriate time to withdraw some monetary stimulus. I made my change of view clear in a September speech, and voted with the majority for a 25bp hike in Bank Rate in November.

Economic outlook

My central forecast is for growth of around 1 ½% to 1 ¾% over the forecast period, and an unemployment rate that stabilises near current levels. I expect wage growth to rise gradually to around 3%, as productivity growth picks up somewhat from its current subdued pace. I expect CPI inflation to peak in the coming months above 3.0%, before returning to target gradually over the coming years. Such a forecast would be consistent with some modest further tightening of monetary policy over the forecast period.

There are both upside and downside risks to this outlook.

On the upside, consumption growth could be more resilient than I currently expect. Nominal wage growth is expected to pick up, and with inflation expected to fall back, we are entering a period of real wage growth per worker that is likely to be improving from recent deeply negative rates. Moreover, household income is also supported by continued employment growth. This more favourable income outlook, combined with stimulative monetary policy, easy credit availability and low unemployment, could lead households to spend at a faster pace than in our central forecast.

Investment growth also has upside risk, if firms respond positively to a combination of strong global growth, a low exchange rate, and a smooth transition to the UK's new trading relationship with the EU – which continues to be our working assumption.

On the downside, adverse news on Brexit negotiations may lead to expectations that a smooth transition might not take place. That could result in a sharper cut-back in investment spending as firms put spending on hold pending clarity on the new trading arrangements. Alongside such a cut-back in investment spending, we might also see a reduction in hiring, which in turn might lead households to seek to rebuild some precautionary savings by cutting back on consumption.

As I have emphasised before, the key driving force for the economy in the near term is not what the MPC believes will be the long-term economic consequences of Brexit. Rather, what matters is what households, firms and financial markets believe those consequences to be, and in turn how they adjust their behaviour now, in anticipation.

Whether those expectations and beliefs evolve in a favourable or unfavourable direction, the appropriate interest rate response will continue to be driven by the balance of demand, supply and the exchange rate, which ultimately drive inflation. This might lead to some counter-intuitive changes in Bank Rate. It is possible for supply growth to slow, but for demand growth to slow less markedly, which would require tighter monetary policy even as growth slows. Arguably, this has already been happening to some extent. Conversely, supply might rise faster, but if demand does not improve quite as quickly, this would require a more stimulative path for monetary policy even as growth picks up. Developments in unemployment, wages and various measures of underlying inflation pressure will continue to provide important clues on the relative strength of demand and supply. Movements in the exchange rate will continue to have a significant effect on how long inflation is expected to be away from the target.

My interpretation of the current configuration of data is that, with regard to the long-term impact of Brexit, financial markets remain on the pessimistic end of the spectrum, households remain on the optimistic end of the spectrum, and businesses are somewhere in between. That situation has prevailed for more than a year now. At some stage, it is reasonable to think that expectations will converge across these three groups, but it is not possible to say at this stage whether financial markets are overly pessimistic, or households are overly optimistic.

Explaining monetary policy

Since my previous report to the Treasury Committee in September 2016, I have:

- made eight regional visits to meet with businesses around the country
- given 19 talks on monetary policy and the economic outlook to regional business groups.
- given a further 22 talks at universities, schools and to groups of financial market participants
- given three on-the-record speeches on monetary policy and the economic outlook
- given two newspaper interviews

I have appeared before the Treasury Committee in February 2017.