Report to the Treasury Select Committee
Ian McCafferty, External Member, Monetary Policy Committee
12 September 2013

Voting record

When I joined the Committee, in September 2012, the economy was showing little or no growth, although a modest recovery through 2013 was anticipated. The asset purchase programme had been increased by £50bn in July, and the Funding for Lending Scheme had recently been announced. I initially felt it appropriate to see how these recent policy changes affected the outlook before voting for further policy change.

Early this year, I began to argue that the economy was beginning to show the early signs of a more marked recovery. It was against that background that I maintained my position not to ease policy further. As the news on the real economy improved, however, I became concerned that households, businesses and financial markets might over-react, pushing up their expectations for market interest rates and reducing the effective level of monetary stimulus prematurely; it was to help prevent such an over-reaction from stifling the recovery that I voted in favour of providing explicit forward guidance on the intended path of policy in the August meeting.

Sentiment in financial markets improved in part as a result of initiatives on the part of a number of Central Banks. First, the possibility of a catastrophic break-up of the eurozone currency area was perceived to have receded, in part as a result of the Outright Monetary Transactions programme initiated by the ECB; second, the creation in the UK of the Funding for Lending Scheme capped UK bank funding costs, and third, the US economy started to benefit from the additional asset purchases by the Federal Reserve.

In the real economy, this helped restore business and consumer confidence, ending the "paralysis of decision making" triggered by the eurozone crisis, which had caused the UK economy to struggle throughout 2012. Nevertheless, uncertainty about the outlook remains elevated. In such circumstances, there are significant risks that financial markets over-react to short term data and misinterpret the intended future path of monetary policy, and that businesses and consumers lack the certainty to increase spending.

I believe that the MPC has an important role in supporting the recovery in activity by delivering a policy stance that assists that restoration in confidence and minimises the risks of premature increases in market interest rates. Consequently, in the current circumstances, I see merit in providing more explicit guidance about the intended path of policy, even though such an approach is not without risk to the MPC's credibility should circumstances change. Given that there are significant uncertainties about the degree of spare capacity and the extent to which productivity will pick up in response to stronger demand, it is necessary that such guidance is couched in terms of economic conditions rather than a specific time-frame.

It is also critically important that forward guidance does not compromise the primary objective of the MPC, to deliver medium term price stability. CPI inflation has persistently exceeded the 2% target since the start of 2008, so that, while inflation expectations and price-setting behaviour have so far remained consistent with medium term price stability, there are still material risks that they become de-anchored. The design of the inflation knockout is therefore critical to the success of the guidance policy. To be fully credible, and prevent inflation expectations from being raised, it needs to be sufficiently close to our 2% target to demonstrate the MPC's determination to deliver medium term price stability, and operate over a period shorter than our normal two-three year horizon. The final design of our guidance policy provided sufficient emphasis on these principles for me to vote in favour.

The outlook

As long as the recent restoration in business and consumer confidence can be maintained, the recovery is likely to prove sustainable. However, the risks facing the UK economy remain elevated, albeit somewhat lower than a year ago. The key risks to the UK economy now stem primarily from the global economy (e.g. further disruption in the eurozone; financial disruption triggered by changes in the monetary stance of the Federal Reserve, in particular in emerging markets; politically-driven spikes in the oil price). Disruption from any of these would still hit confidence severely.

If the more extreme downside risks to the outlook can be avoided, the recovery should gain strength over the next couple of years, in line with the forecast in the August *Inflation Report*. Nevertheless, the legacies of the financial crisis suggest that the pace of the recovery will remain modest by historical standards for some time yet.

The August *Inflation Report* forecasts a gradual decline in CPI inflation to hit the 2% target over the course of the forecast period. While the degree of spare capacity in the economy and the diminishing impact of imported commodity prices should help inflation decline over the next two years, I remain concerned that there are upside risks, which would cause inflation to decline more slowly than expected:

- Administered and regulated prices (e.g. university fees, rail fares and energy tariffs) are already generating disproportionate inflation pressures, but increases in future years may prove even greater than currently expected in the August IR.
- The fact that inflation will by 2014 have exceeded the MPC's target for close to seven years risks raising inflation expectations and changing price- and wage-setting behaviour.
- Even if productivity recovers strongly as demand picks up, the benefit may not fully be passed through to lower CPI inflation. Businesses may use the fall in their costs to restore profit

margins rather than reduce prices, or employees may receive higher wages to compensate them for the recent period of falling real incomes.

Explaining monetary policy

During the course of the year, I gave three public speeches, setting out my views on issues central to my voting record: on the productivity puzzle and the functioning of the labour market, on the improving outlook for the economy and on the risks of inflationary pressure as the economy recovers. I gave interviews to the Sunday Times, the Times, the Yorkshire Post, Bloomberg, and Dow Jones, as well as background briefings to a number of national journalists. On regional visits, I was also interviewed by a number of regional media outlets.

Given my background, I consider it important to maintain good contact with business, both to explain the thinking of the MPC and gain understanding of the economic conjuncture and the issues – the availability of credit, business sentiment and investment intentions – faced by the corporate sector. I have undertaken six regional visits (to Wales, the North West, Yorkshire & the Humber, West Midlands, Southern & Central and London), involving numerous company visits and presentations and discussions with business representative groups.

On my appointment, I said that I was keen to communicate the work of the MPC to schools and universities. I took part in the Henley College Lecture series, delivering a lecture on "Economic Challenges in a Changing World", spoke to students at Bedford Modern School and was keynote speaker at the EBEA annual conference. I also acted as judge in the national final of the Bank's Target 2.0 competition for schools.

I also met with a number of banks, pension funds and brokers and representatives from foreign embassies in London to explain the MPC's views on the economy and our policy position.