Report to the Treasury Select Committee

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Economy and voting record

Over the past twelve months, the UK economy has grown by 3.0%, employment has risen strongly and the unemployment rate has fallen from 7.6% to 6%. Much of this has been driven by a recovery in domestic demand growth, as the rest of the world and in particular the eurozone, our main trading partner, have continued to grow at only relatively sluggish rates. Nevertheless, the latest vintage of ONS data suggest that the recovery in domestic demand has been more balanced than originally thought, with a strong rise in business investment accompanying the pick-up in consumer spending growth.

Over the same period, inflation has fallen more sharply than expected, from over 3% to below our 2% target. While some of the fall can be attributed to the effect of slack on the economy, much has been due to the effects of movements in the exchange rate and, more latterly, sharp falls in international commodity prices.

For monetary policy makers, the key judgement over this period has been the extent to which the considerable spare capacity that existed at the start of the recovery some eighteen months ago is being absorbed, and the implications of that narrowing in the output gap for future inflationary pressures. The lags inherent in monetary policy (it takes some twelve to eighteen months or more for the full effects of any change in interest rates to feed through the economy) require the members of the MPC to consider how the economy will be performing, and the likely degree of inflation pressure, at that horizon.

Estimates of spare capacity, in firms and within the labour market, can never be precise, and depend heavily on judgements about the supply side of the economy, which cannot be observed directly. Three key elements relating to labour supply – the equilibrium level of full employment, the equilibrium level of participation in the labour force and the desired number of hours people wish to work – may well have changed since the financial crisis, as a result of either the resulting recession itself or longer term demographic factors. Estimates of each have had to be revised over the course of the recent recovery, as data have become available. Furthermore, the likely rate of productivity growth as the expansion continues is difficult to estimate, given that the recent trend has been far from previous experience. Assessing the exact level of spare capacity, and exactly when full capacity is likely to be reached, is currently subject to considerable uncertainty.

However, with GDP growth markedly above potential in recent quarters, and unemployment falling sharply, it is clear that spare capacity has been absorbed quite rapidly. Over the next two years, it is expected to continue to decline, even with a more moderate pace of growth expected in coming quarters. The sharp falls in unemployment of the past year are only now starting to influence growth in average wages, which have been held down recently by unusually fast growth of employment in lower-paid jobs. Nevertheless, there are signals – from survey data and the Bank's

Agency network – that skills shortages in some sectors have begun to emerge, and that starting wages and salaries for those changing jobs – marginal wages – are picking up more sharply. This, combined with the recent increase in the rate of job turnover, suggests that a broader pick-up in wage growth should be not long in coming. At a time of only modest growth in productivity, a significant rise in labour costs over the next year or so would threaten to push up underlying inflation pressures above those consistent with our 2% target.

My judgement about these emerging risks to medium term inflation explains my voting record over the past year. Initially, in order to provide support to the recovery, particularly in its early stages, I voted for no change in policy. I supported the MPC decisions to provide more explicit guidance about how it would respond to changes in the economic environment. The messages of both Guidance 1 – that the MPC would not consider raising rates until slack had been materially absorbed, as measured by the level of unemployment, and of Guidance 2 – that there were good reasons why the future path of interest rates, as they increased, would be gradual and limited, were beneficial in supporting business and consumer confidence, which remained fragile for much of the early stage of the recovery.

However, as the recovery became more sustainable, and as spare capacity was absorbed, I began to believe that the level of monetary stimulus provided by a Bank Rate of 0.5% was starting to introduce risks of underlying inflationary pressures emerging over the course of 2015 and 2016. As a result, since August, I have been voting for a rise in Bank rate to 0.75%.

Starting to raise Bank Rate before inflation pressures become more acute makes it more likely that the increase required over coming years to deliver our inflation target can be kept gradual and limited. Such gradualism is important, in allowing consumers and businesses to adapt to the tightening of monetary policy with minimum disruption, thus supporting the economic expansion.

The current inflation undershoot does not, in my view, negate the need for a modest rise in interest rates. The sharp fall in headline inflation has been driven primarily by falling commodity prices and a rise in the exchange rate. In inflation terms, these are one-off effects, and, as with the inflation overshoot in 2011-12, there are good reasons to look through their impact, at least partly. Allowing (possibly temporary) weaker global prices to mask a pick-up in domestic inflation pressures would risk unbalancing the economy, requiring a more rapid policy response later on.

The Outlook

The MPC's latest forecast shows that the UK economic expansion now underway is likely to continue, albeit at a slightly slower pace than has been recorded over the past year or so. This I find plausible. The pace of expansion is still sufficient that slack will continue to be absorbed. The central forecast suggests that the output gap may not be closed until the end of the forecast horizon, but this projection relies heavily on estimates of changes to equilibrium participation and desired hours, which are inherently uncertain, such that I believe there is a risk that effective full capacity will be reached somewhat earlier than suggested in the central forecast.

The central forecast also shows that after a further period in which inflation remains below target, largely due to weaker import prices and the recent appreciation of sterling, it returns to the 2% target over the remainder of the forecast horizon. This profile comprises a modest increase in domestic inflationary pressure, as the drag from slack diminishes, coupled with an end to the downward pressure from import prices. To the extent that the level of spare capacity is less than the Inflation Report central estimate, or that effective full capacity is reached earlier than anticipated, there are upside risks to this inflation profile.

There are a number of risks, and a high level of uncertainty, surrounding the latest MPC central forecast, in particular from the international environment. Activity in the global economy remains weaker than pre-crisis, and in the eurozone in particular the recovery of earlier in the year has recently faltered. While some of that may be due to erratic factors, it may signal a more prolonged period of very sluggish growth at best. If this were to lead to concerns in financial markets as to the debt sustainability of any of the Eurozone members, it would hit the UK through not only the trade channel but also financial market volatility and a loss of business and consumer confidence. On the upside, however, if the recent decline in global oil and commodity prices, driven primarily by expanding supply, were to persist, it would provide a boost to global activity.

Explaining monetary policy

Over the past year, I have communicated my views on monetary policy in a number of ways.

- I have made three public speeches: *Achieving a sustainable recovery: where next for business investment* (Nottingham Business School), *Slack, pricing pressures and the outlook for policy* (Northern Ireland), and *The UK productivity puzzle – a sectoral perspective* (London).
- I have made regular speeches and presentations to business groups (Chambers of Commerce, Institute of Directors, CBI), as well as having regular meetings with banks, pension funds and brokers to explain the views of the MPC on the economy and on policy issues.
- Having started to vote for a rise in Bank Rate, I wrote an OpEd for the Sunday Times, explaining my reasons. I have also had briefing meetings and interviews with the Financial Times, the Times, the Guardian, the Independent, the Daily Mail, the Evening Standard and the BBC, as well as a number of regional media. I have also represented the MPC on three occasions on a radio phone-in programme on LBC.

In addition, I have made nine regional visits, to discuss with individual businesses in a wide range of sectors across the country how they perceive economic conditions.

I have also been keen to continue my ambition to communicate the work of the MPC to schools and colleges. I gave a lecture at the annual EBEA Teachers and School Students Conference on *The post-crisis monetary policy landscape: moving to a new normal*, and judged both a regional final and the national final of the Bank's Target 2.0 competition for schools.