Report to the Treasury Select Committee

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Economy and voting record

Over the past year or so, in the face of a series of potential downside risks, the UK economy has remained resilient. Quarterly growth has averaged 0.5%, a sufficient pace to cause unemployment to continue to fall, and by the autumn of 2015, this had fallen to close to 5%, our estimate of equilibrium. Other measures of the level of slack - average hours and participation - also moved closer to equilibrium levels, although the number of part-time workers not able to find a full time job remained above pre-crisis levels. On balance, it became clear that the remaining level of post-recession slack was close to being fully absorbed, such that the output gap had almost closed.

Throughout the period, however, CPI inflation remained well below the MPC's target. It had fallen below 1% in December 2014, remained close to zero for much of 2015, and had picked up gradually through 2016, to a rate of 1% by September 2016. As a result, the Governor, on behalf of the MPC, had been required to write seven quarterly letters to the Chancellor of the Exchequer, explaining the reasons why inflation had moved significantly away from target and the MPC's response.

Throughout this period, the undershoot in inflation was predominantly the result of movements in global energy and food prices, combined with the impact on goods prices more widely of the appreciation of sterling between mid-2013 and mid-2014. Between their peak in mid-2014 and their trough in early 2016, crude oil prices fell by close to 80%, leading to sharp falls in the retail cost of petrol and gas, while the retail price of food and non-alcoholic beverages fell by 6.9% between their peak in 2014 and summer 2016. These factors alone contributed two-thirds of the undershoot in CPI over the period, and some five sixths if the impact on import prices more widely from movements in sterling are also included, leaving only a small contribution from domestic factors.

Given that monetary policy takes some time to work through the economy to influence inflation - with the lag in the peak impact of monetary policy estimated to be some 18-24 months - monetary policy decisions are determined primarily by the outlook for the economy and for inflation over the following two years. The policy judgements for me, and my colleagues, therefore focussed throughout this period on the following questions:

- How temporary were the factors that were driving the inflation undershoot, and how far might they extend into the effective policy horizon?
- How much of the inflation undershoot was due to such temporary factors, and to what extent might these be affecting more persistent elements on inflation such as domestic wage costs?
- What was the trade-off between the pace at which inflation should be brought back to target and output variability?

One of the key features is how each of those policy judgements shifted over the period, in the light of new evidence, and therefore influenced my voting pattern.

Although the period of weakness in global oil and commodity prices was more prolonged than initially thought, with oil prices in particular falling persistently for a period of 19 months, and therefore delivering a more persistent drag in CPI inflation than initially projected, such an impact is still effectively temporary. At a time when the economy was continuing to grow at least in line with its potential, such that the amount of slack was diminishing steadily and underlying domestic inflationary pressures could be expected to pick up over the following 2-3 years, that led me to be cautious about trying to bring the inflation rate back to target too quickly, as such a strategy would, by the end of the forecast horizon, leave inflation pressures higher than consistent with the 2% target, once the temporary impact from low commodity prices had faded. This would then require a sharper tightening of monetary policy, threatening the stability of output.

By August 2015, the available evidence suggested to me that over the course of our policy horizon, and in spite of the short-term outlook for low inflation, underlying inflationary pressures would have built sufficiently to deliver inflation above our 2% target. Unemployment had fallen steadily, and was projected to reach our equilibrium estimate over the course of the following year, demand for labour remained robust and skill shortages were starting to emerge. Following a period of relative weakness, wage trends were running ahead of early year expectations, and private sector wage growth had accelerated to 3.7%, with expectations of a further pick up to come. These trends, to me, pointed to some upside risks to our inflation forecasts. They were also set to deliver an uncomfortable combination – inflation expected to be at, or slightly above target in two years, but only because of a continued drag from import prices, while domestic inflationary pressures would be building to a level inconsistent with the 2% CPI target.

These concerns were sufficient, in my view, to justify the start of a gradual normalisation of monetary policy, in spite of the weakness of concurrent inflation, such that I began voting for an increase in Bank Rate in August 2015. But this policy position was also determined by my views on the preferred pace of tightening once it had begun, and the benefits to the stability of the economy of a very gradual approach. Other things equal, and subject to the primacy of the inflation target, I believe there are merits for the economy in moving interest rates only gradually. Such a strategy minimises the risks of disruption to both consumers and businesses of rapid changes in interest rates. Following a long period in which interest rates had remained unchanged, at historically very low levels, such a strategy might also be more than usually important. As a result, I was keen not to delay the process of policy normalisation, in case it meant that interest rates would have to be tightened more sharply later, as inflation pressures picked up. Together, these arguments led me to vote for a rate rise of 25bp between August 2015 and January 2016.

However, by early 2016, with crude oil prices still weakening and the headline rate of CPI inflation therefore remaining close to zero for much longer than initially projected, it was becoming apparent that the prolonged ultra-low rate of inflation was itself having a marked impact on wage determination. The rise in real incomes for employees driven by the low rate of inflation made it easier for employers to hold nominal wage growth to much lower levels, such that wage settlements into the 2016 wage round averaged only around 2.1%, significantly lower than pre-crisis norms. As a result, the pick-up in nominal wage growth that lay behind my previous voting pattern was likely to be more attenuated, and thus less critical over the policy horizon. Combined with the emergence of increased risks to the growth outlook, stemming from both developments in key emerging markets and the uncertainties around the referendum on membership of the European Union, this led me to return to a “no-change” policy stance in February 2016.

In the most recent period, the outlook for the economy, and hence the policy judgement, has been dominated by the impacts of the referendum on membership of the European Union. The shock to confidence for both financial markets and businesses from the surprise outcome of the vote, combined with the expected deterioration in the medium term outlook for the economy, led me to vote for a reduction in Bank Rate of 25bp in August 2016, although my expectations of the pace and nature of the effects on the economy of the referendum decision (see below) led me to vote against the immediate increase in the programme of government bond purchases. With only limited information about the post-referendum economy, and with an expectation that the slowdown in the economy was likely to take place over a more extended time period than contained in the August *Inflation Report* forecast, I was inclined towards a lesser degree of stimulus, at least until more information became available.

The economic outlook

Over the course of the next couple of years, the international background to the UK economic outlook is expected to improve slightly. Some of the recent drag from key emerging markets is forecast to diminish, partly in response to a modest rise in commodity prices. Meanwhile, the slow improvement in growth prospects in both the US and Eurozone is expected to continue. Nevertheless, global growth is projected to remain at a moderate rate, markedly below that prevailing in the decade prior to the financial crisis. This outlook still contains a number of significant risks, on balance to the downside.

However, the dominant determinants of how the UK economy will fare will be the response, by consumers, business and investors, to the referendum decision for the UK to leave the European Union, and the different ways in which the impacts of this might feed through to the real economy. At this stage, both the magnitude and the timing of each of the potential impacts are extremely uncertain, such that any forecast of the UK economy at present is beset with risks in either direction.

There are likely to be impacts on demand, supply and the equilibrium exchange rate. How these will evolve and interact will only slowly become clearer, but will be critical in determining the path of monetary policy.

- Following the referendum, uncertainty about the future of the economy and future trading arrangements once exit from the EU has been achieved has remained elevated, with uncertainty measures at least as high as during the Eurozone crisis of 2012-13. Such uncertainty is likely to remain elevated for some time, and is likely to have an impact on certain elements of demand. While consumers appear less influenced by this uncertainty, such that consumer confidence and spending have held up since the referendum, business surveys suggest that the elevated level of uncertainty has affected corporate investment intentions, which have weakened. Weaker investment, in both capital equipment and commercial real estate is likely to prove a drag on growth, relative to the pre-referendum period.

- The adaptation of the economy to a post-EU future, with changed trading and investment patterns, will require a reallocation of resources within the UK economy – between tradable and non-tradable sectors, and between sectors whose access to export markets may be changing, and this is likely to affect supply. During the transition period at least, the reallocation of resources is likely to be associated with some reduction in productivity growth and hence a lower rate of growth of economic potential. Both the size and timing of this impact are highly uncertain, and will depend heavily on both the degree of certainty and the nature of the eventual trading arrangements and relationships following exit.

- The nature of the departure from the EU, and the trading relationships that will follow, will also be a major determinant of the equilibrium exchange rate. To the extent that the UK economy becomes less open, the equilibrium exchange rate will be lower than prior to the decision to leave. Adjusting to that new equilibrium will also have a potentially important influence on the economic outlook. To the extent that the exchange rate falls, as it has done since the referendum was announced, inflation will be higher, and by extension, real income growth constrained, relative to a world in which the exchange rate had not moved.

The relative importance of the impacts from these three sources will act to determine the outlook for the economy, and hence for monetary policy, over the next few years. On balance, the MPC's current forecast – contained in the November 2016 *Inflation Report* – portrays an outlook in which growth slows gradually over the forecast period, eroded by a combination of a squeeze in real incomes for consumers combined with slower growth in investment while uncertainty remains elevated. This drag on domestic demand is partially offset by some improvement in net trade, following the decline in the exchange rate.

This is accompanied by a sharp rise in inflation, to a rate markedly above the 2% target for a prolonged period, as a result of the disappearance of the drag from low global oil and commodity prices and the sharp fall in the currency of the last year.

In monetary policy terms, that outlook generates a significant trade off. The MPC will need to judge to what extent to look through the period of above target inflation, in order to provide support for the real economy, or, to put it in other terms, how far it is prepared to tolerate a rise in the output gap in order to keep inflation close to target. Such judgements will be determined on the basis of the relative sizes of the inflation overshoot and the output gap as they evolve, as well as any impact on inflation expectations and hence wage and cost determination of the period of above target inflation. At present, projections for the economy, and hence how these judgements will evolve are subject to significant uncertainty, leaving the future path of interest rate unclear and heavily dependent on the evolution of the economy.

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: *UK business finance since the crisis – moving to a new normal* (Bloomberg, London), *Economic challenges in a changing world* (University of Greenwich), and *Wages, inflation and current monetary policy* (Bank of England, London).
- I have made regular speeches and presentations to business groups (Chambers of Commerce, 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.
- On both occasions in which I have taken a minority position on the Committee, in August 2015 when I started voting for an increase in Bank Rate, and in August 2016 when I voted against the increase in QE, I wrote OpEds in the Times explaining my reasons. My reversion to a "no change" vote in February 2016 was explained in my speech at the Bank of England. I have also had briefing meetings and interviews with the Financial Times, the Guardian, the Wall Street Journal, and the Daily Telegraph, as well as a number of regional media.

In addition, I have made five regional visits, to discuss with individual businesses in a wide range of sectors across the country how they perceive economic conditions and communicate the views of the MPC on the economy.

I have also been keen to continue my ambition to communicate the work of the MPC to schools and colleges, and judged a regional final of the Bank's Target 2.0 competition for schools.

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