Report to the Treasury Select Committee

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Economy and voting record

Over the past year or so, the UK economy has seen a sharp pick-up in the rate of CPI inflation and a modest slowdown in the pace of GDP growth, as the impact of the decision to leave the European Union has fed through into financial markets and the behaviour of consumers and businesses. This has affected the economy through two channels: the sterling exchange rate and the impact on consumer and business decision-making from uncertainty about the nature of the eventual trading arrangements with the European Union, and whether the transition to those new arrangements will be smooth.

The most immediate impact was delivered via the exchange rate. Following the announcement of the referendum in November 2015, the pound started to weaken, and following the referendum result, fell sharply, such that it is now some 18% below its late 2015 peak. This persistent fall reflects the judgement of the foreign exchange markets about the real adjustment to the economy that is likely to be required. The fall in sterling, combined with a modest recovery in global crude oil prices, has raised the CPI inflation rate from 0.7% in 2016Q3 to 3.0% in September 2017, significantly above the MPC target of 2%. It has also affected demand, in several ways. First, given that nominal wages have grown only modestly through 2017, the rise in inflation has led to a squeeze in household real income, such that growth in consumption has slowed, with the annualised growth rate slowing from 3.4% in 2016H1 to 0.9% in 2017Q2. Second, the fall in sterling has improved the competitiveness of UK exporters, such that an improvement in net exports should be expected, although so far, this has been more apparent in the survey data for export orders than in the official data. Third, given that many capital goods are imported, it will have increased the cost of fixed investment in equipment, and thus probably dampened growth in investment.

The inevitable uncertainty caused by the change in the nature of the trading and investment relationships with the EU after withdrawal has also had an influence on economic activity. Although consumer and business confidence has remained resilient following the sharp dip immediately after the referendum result was announced, elevated uncertainty is having an effect, predominantly in two areas. First, growth in business investment has been somewhat less strong than would be expected given the improving world economy and supportive financial conditions. Second, Brexit uncertainty appears to have contributed to the slight softening in the housing market over the course of 2017.

As a result, quarterly rates of GDP growth have slowed from around 0.5% in 2016H2 to 0.3-0.4% so far in 2017. This has been accompanied by some rotation in the components of demand, with growth in consumer spending slowing and an increased contribution to GDP growth from investment and net trade.

Over the last year or so, there has been further evidence that growth in potential supply is significantly lower than pre-crisis. Measured productivity (output per hour) between 2016Q2 and 2017Q2 fell by 0.2%, continuing the low performance of the past decade. As yet, the causes of this poor productivity performance remain unclear, with no single or simple explanation. In the literature, many different causes have been proposed, and each appears to be able to explain a small proportion of the total shortfall. It is also likely that the contributions of the different factors have varied at different times in the post-crisis decade. While it remains likely that some of the recent low growth in productivity is cyclical, and that annual growth rates should therefore pick up somewhat as demand continues and the labour market tightens, the evidence increasingly suggests that trend growth in potential supply will remain lower than pre-crisis for some time to come.

The other notable developments in the economy relate to the performance of the labour market and wages. The number of those employed has continued to grow strongly, by a quarterly average of 124,000 in 2017H1 (compared with 70,000 between 2000-07 and 75,000 in 2016), while the participation rate and the level of average hours per person have both risen to close to their pre-crisis averages. At the same time, the unemployment rate has continued to fall sharply, to a 42-year low of 4.3%. In early 2017, the MPC revised its estimate of the equilibrium unemployment rate (u*) from the pre-crisis rate of close to 5%, to 4.5%, reflecting changes in the nature of labour supply and replacement ratios. There is some uncertainty around this estimate, which will be reviewed again at the 2018 MPC supply stocktake, but it is clear that the labour market has tightened considerably, and faster than expected earlier in the year.

Nevertheless, growth in private sector regular nominal average weekly earnings has remained at levels significantly lower than the pre-crisis average of 3.9%. In the year to Q3 2017, this measure of AWE grew by 2.3%, in spite of the tightening labour market. This could suggest that the equilibrium rate of unemployment is lower than the reduced estimate of 4.5%, or that other factors have recently been influencing the relationship between unemployment and wages. Indeed, a number of complicating factors do appear to be at work.

- First, growth in AWE will be affected by the composition of new jobs, and the disproportionate number of new jobs in lower-pay occupations over the past year appears to have depressed AWE growth. However, these compositional changes are usually short-lived, and mean-reverting.
- Second, in practice, higher wages are usually generated more through job changes than in-job wage increases, but the level of job-to-job change has until recently remained depressed, relative to pre-crisis levels, as workers seemed to prefer the security of their existing job. More recently, however, the job-to-job change rate has risen, and is now close to pre-crisis levels once shifts in self-employment have been taken into account.
- Third, low levels of productivity growth constrain the rate at which AWE can rise without jeopardising employment. Recent real AWE growth is not out of line with recent productivity performance.

These factors may well be depressing AWE growth at present, but the first two, at least, are likely to unwind over time, driving somewhat faster growth in AWE than recently.

Policy decisions

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 forward-looking, and determined by the outlook for the economy and for inflation over the following two to three years. Throughout the reporting period, the policy judgements for me, and my colleagues, have focussed on the following questions:

- How are both demand and supply evolving, and what is the outlook for the level of slack over the policy horizon?
- What is the balance of inflationary pressure between exchange rate and domestically-driven factors, and hence the profile for inflation over the policy horizon?
- What is the appropriate trade-off between the pace at which inflation should be brought back to target and the conditional requirement in our remit to support output and employment?
- What is the effective degree of stimulus from Bank Rate, given the likely cyclical changes in the equilibrium rate of interest , against which the level of stimulus is judged?

At the start of 2017, I judged that while inflation was likely to exceed our 2% target throughout our normal policy horizon, the degree of remaining slack in the economy justified a degree of tolerance of above-target inflation. That trade-off meant that it was appropriate to lengthen the horizon over which policy would be used to bring inflation back to target (to about three years, rather than the normal two). In addition, at that stage, two other factors contributed to my decision. First, that the inflation overshoot was entirely the result of the fall in the currency, while domestic inflation pressures remained subdued. Second, the risks to demand looked to be on the downside, given the potential impact on spending and investment decisions of the high level of Brexit uncertainty for both consumers and businesses. It was therefore appropriate to maintain an unchanged policy stance, and to remain highly sensitive to the evolution of the economy through the data news.

Through the first half of 2017, my judgement about the balance of the trade-off, and hence my policy position, began to shift, in a number of respects:

- Demand had remained somewhat more resilient than had been feared earlier in the year. Consumers appeared to be “looking through” Brexit uncertainties, and supported by rising employment had offset the impact of some of the real income squeeze on their consumption through changes in the savings ratio.
- Supply growth remained constrained by the persistent poor productivity performance.
- While there remained some uncertainty about the equilibrium rate of unemployment, the sharp falls in measured unemployment, the rising level of vacancies and increased reports of skill shortages indicated that remaining slack might already be very limited, and was being eroded quite quickly.
- After a period of relative weakness in the winter of 2016, caused by a pause in hiring, short term measures of wage growth began to strengthen.
- Further analysis of the impact of a fall in the exchange rate on CPI inflation suggested that the full impact might be slightly larger than estimated in our models.
- Improvements in the outlook for the international economy, combined with the long process of repair to the banking system, were probably reducing the cyclical depressants of

the global real equilibrium interest rate (r*), such that an unchanged Bank Rate was starting to provide an increased quantum of stimulus.

As a result of these judgements, the policy trade-off, for me, began to shift in favour of a less accommodative stance regarding above target inflation, as the level of remaining slack diminished and upside inflation risks to our central *Inflation Report* forecasts became apparent.

By the summer of 2017, the shift in my policy trade-off was sufficient to justify the start of a gradual reduction the level of stimulus provided by monetary policy, such that I began voting for an increase in Bank Rate in June 2017.

This policy stance 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 raised more sharply later, as inflation pressures picked up.

Together, these arguments led me to vote for a rate rise of 25bp in each of the MPC meetings between June 2017 and November 2017.

Economic outlook

The prospects for the global economy currently look better than they have for most of the post-crisis period, suggesting that there may be a period of faster sustained growth than for some time, but there also remain some offsetting downside political and financial risks. The central outlook for the global economy, of solid, broad-based growth, should support the UK outlook.

Nevertheless, it is likely that the decision to leave the EU will continue to exert a marked impact on the evolution of the UK economy, with further impacts on demand, supply and the exchange rate all possible.

- The sterling exchange rate remains very sensitive to Brexit developments, and is therefore likely to continue to exert a strong influence on inflation projections. The degree of pass-through from the depreciation to date will gradually diminish, but Bank analysis suggests that full pass-through (from changes in sterling to import prices, and from import prices to consumer prices) is a lengthy process, such that although existing pass-through effects will diminish, they will continue to influence the path of inflation throughout the forecast horizon.
- To the extent that uncertainty around the nature of the new trading relationship with the EU or the type of transition to that new relationship persists, it is likely to have a continued influence on domestic demand growth.
- Brexit-related constraints on investment and labour supply appear to be reinforcing the slower pace of potential supply growth.

These factors generate a high degree of uncertainty around any central forecast for the economy.

On balance, the MPC central forecast for the UK economy, contained in the November *Inflation Report*, suggests that GDP growth will continue at a modest pace, with subdued growth in domestic demand offset by an increased contribution from net exports. Inflation is expected to peak in the coming months, and then to fall back towards the 2% target, as the pass-through effects of the recent fall in sterling diminish, but domestic inflationary pressures begin to rise, as a tight labour market pushes up nominal wage growth.

Explaining monetary policy

Over the past year, I have communicated my views on monetary policy in a number of ways, ensuring that my personal views, as well as the thinking of the Committee more widely, were communicated to the wider public.

- I have made two public speeches: *The UK Economy: where now? Our emerging understanding of the impact of the referendum to the economic outlook*, Regional visit to Dorset, 20 Dec 2016, and *Twenty years of Bank of England Independence: the evolution of monetary policy,* 38th Robert Warner Lecture, The Worshipful Company of Founders, 5 Oct 2017
- I have made regular speeches and presentations to business groups (Chambers of Commerce, trade associations, 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.
- I have participated regularly on the Drive Time phone-in programme on LBC Radio, explaining and discussing the economy and MPC views on monetary policy. (28 Mar 2017; 6 Jul 2017; 8 Nov 2017)
- On changing my vote in favour of an increase in Bank Rate, in June 2017, I gave an interview to the Times, setting out in detail the reasons for my decision.
- I have also given regular briefings to Reuters and Bloomberg, the newspapers and the BBC, as well as a number of regional media.

I have also made seven regional visits, in order to communicate the views of the MPC on the economy and to discuss with individual businesses in a wide range of sectors across the country how they perceive economic conditions (Central Southern, Nov 2016, Greater London, Jan 2017; West Midlands, Feb 2017; East Midlands, Mar 2017; North East, Jun 2017; Wales, Jul 2017; Yorkshire, Sep 2017).

Throughout my time on the MPC, I have been keen to communicate the work of the MPC to schools and colleges, and in the past year have given a number of talks to school sixth forms.

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