Report to the Treasury Select Committee

Mark Carney, Governor of the Bank of England

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Economy and voting record

A little more than a year ago, inflation was around 3% and had been above target for most of the previous five years. Unemployment and underemployment were elevated. Firms were operating below full capacity. There were signs that a modest recovery was underway, but it was still early days and confidence remained fragile.

It was in this context that, in August 2013, the MPC committed not even to consider raising Bank Rate from historic lows at least until unemployment had fallen back to 7%. That threshold-based forward guidance was consistent with seeking to return inflation to the 2% target over a three-year period, using the flexibility in our remit to avoid unnecessary volatility in output.

The guidance encouraged businesses to hire and spend, and helped keep expected interest rates low, even as the economy recovered strongly.

Growth has exceeded the MPC's projections made a year ago, even though those were at the top end of forecasts for the UK economy. Business investment played an important role in driving that unexpected strength of demand. At the same time, productivity growth has not accelerated as we had expected alongside the recovery in output. As a result, the unemployment threshold was reached in February and, consistent with our guidance, that prompted a broader assessment by the MPC of the state of the economy. That assessment was published in the February *Inflation Report*.

At that time, inflation had fallen faster than expected to a little below the 2% target and the MPC noted that, with inflation expectations well anchored, the inflation target would be achieved in the medium term only if the margin of spare capacity in the economy were to be eliminated. In February, the Committee judged there to be spare capacity of 1 – 1½% of GDP, concentrated in the labour market, although it cautioned that there was considerable uncertainty around that central estimate

In the light of that assessment of the state of the economy, the MPC evolved its guidance. The second phase of guidance made clear that:

- The Committee was seeking to eliminate the margin of spare capacity in the economy.
- There remained scope to absorb spare capacity further before raising Bank Rate.
- Increases in Bank Rate, when they came, were expected to be gradual and limited.
- The Committee would defer sales of assets at least until Bank Rate reached a level from which it could be cut materially.

Like the first phase of guidance, this provided clarity about our intentions and our expectations for the economy. My impression from visiting businesses around the country is that the MPC's efforts to make clear its expectation that interest rate increases will be limited and gradual are supporting the expansion.

I have considered it appropriate to maintain the stance of monetary policy at each meeting since the second phase of our guidance was introduced. It is my judgement that, consistent with the guidance and our forecast, as the economy has continued to normalise, we have moved closer to the point at which Bank Rate will need to start to rise in order to achieve the inflation target.

As the MPC has stated repeatedly, there is no fixed path for Bank Rate. The actual level of Bank Rate will depend on what we learn as the expansion proceeds and the inflation outlook evolves.

Taking a step back, in the past, monetary policy could be informed largely by developments in the demand side of the economy. On historic relationships between output growth and changes in interest rates, the MPC would have raised Bank Rate on a number of occasions by now. In my judgement and that of the Committee, that would clearly have been mistaken. In part that is because the economy began its recovery with a wide margin of spare capacity. It is also because, given the potentially large cyclical and structural changes, the MPC has also needed to monitor closely, learn about, and respond to, developments not just in aggregate demand but also to aggregate supply.

In that regard, we have learned that productivity growth has remained anaemic while employment and hours worked have risen sharply. Wage growth has been much weaker than we would have expected at this rate of unemployment. Unit labour cost growth is soft.

Part of the more recent weakness in wage and productivity growth seems to reflect the changing composition of the workforce over the past year. But this explains neither the magnitude of the weakness in wages and productivity nor the softness of unit labour costs.

The full range of signals from the labour market can be explained by a marked expansion in labour supply. People have effectively been pricing themselves into work and the proportion of people in the UK who are active in the labour market is at its highest level for 25 years. These developments tell us that, although slack is being used up at a faster pace than anticipated, there was more slack in the first place. Once again, they reinforce the need for a balanced, detailed examination of developments and prospects for aggregate supply as well as in aggregate demand.

Those developments are incorporated into the Committee's August *Inflation Report* projections for unemployment, growth and inflation. The Committee is now more cautious about the prospects for productivity growth, but over the past year has also revised up its view of the sustainable levels of labour force participation, employment and hours worked.

The latest projections, which are conditioned on a path of Bank Rate that begins to rise by the spring and thereafter rises very gradually, are consistent with the guidance that remains in place because slack is eliminated and inflation gradually returns to the target over the forecast horizon.

As we continue to learn about both the strength of demand and developments on the supply side, those projections will be updated.

As an aside, the November projections will incorporate the recent revisions made by the ONS to GDP data up to and including 2012. Although these revisions show that the peak-to-trough fall in GDP was a little smaller and that growth since then has, on average, been stronger than previously estimated, the new estimates are by themselves unlikely to affect the outlook for inflation materially. They do not point to there being less slack in the economy but instead suggest that the underlying productive potential of the economy was a little higher and expanded slightly faster than previously estimated.

Even though our projections will be updated, our guidance remains constant: we are seeking to eliminate spare capacity in order to return inflation to the target and, when Bank Rate begins to rise, we expect it will do so only gradually and probably to a level materially below its historical average. As always, we caution that this is an expectation, not a promise.

Explaining Monetary Policy

Over the past year, I have delivered nine on-the-record speeches covering aspects of monetary policy and given five *Inflation Report* press conferences.

I have given evidence to the Treasury Committee regarding monetary policy on four occasions (in addition to four other evidence sessions) and I have appeared before the House of Lords Economic Affairs Committee.

I have given four post-speech press conferences, sixteen national television, radio and print interviews, eleven regional print and broadcast interviews, and six international media interviews.

I have privately addressed a range of professional associations and business groups, including the EEF, the Association of British Insurers, British Retail Sector chairs, challenger banks, and FTSE chief executives and chairs.

In addition, I have made at least one visit to each home nation and region of the UK during my first year as Governor. These involved numerous company meetings, events with local business people, and speaking engagements. Taken together, I have engaged with a thousand business leaders from across the country. The visits provide an important regional perspective to monetary policy, as well as the opportunity to explain the MPC's decisions.

Over the past year, I have also attended many meetings of various different international bodies – the G7, G20, IMF, FSB (as Chair), ESRB (as Vice-Chair), BIS and the World Economic Forum.

In response to concerns raised by the Treasury Committee, I have initiated a review of the merits of publishing transcripts of MPC meetings. Kevin Warsh, a former member of the Board of Governors of the Federal Reserve System, is conducting the review and will report back by the end of the year. In the coming year I also expect the MPC to consider the optimal timing and sequencing to be considered of MPC meetings, minutes, transcripts and publication of the *Inflation Report*.

Co-ordination with Macroprudential responsibilities

I outlined the case for, and our commitment to, co-ordination of macroprudential and monetary policy in the Mais Lecture in March. As Chairman of both Monetary and Financial Policy Committees, I have established joint briefings of the two Committees, together with regular in-depth discussions pertaining to particular policy issues.

From the monetary policy side, co-ordination began in August 2013 with the first phase of forward guidance. The MPC made clear that guidance would cease to hold if the FPC were to judge that the stance of monetary policy posed a significant threat to financial stability that could not be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

Similarly, the MPC's February guidance made clear that, while monetary policy may have a role to play in mitigating risks to financial stability, it would only do so as a last line of defence if those risks could not otherwise be contained by the substantial range of policy actions available to the FPC and other regulatory authorities.

I have also described how the FPC's exercise of its macroprudential tools allows monetary policy to focus on its primary responsibility of ensuring price stability. In short, taking macroprudential action means that monetary policy does not need to be diverted to address sector-specific risks, such as those arising from the housing market.

There is a continuing need for the MPC, FPC and PRA to work closely together. Working as One Bank, we will continue that approach in future because we recognise that it is by using our policy tools in concert that we can best meet our respective policy responsibilities.