Report to the Treasury Committee

Mark Carney, Governor of the Bank of England

8th September 2015

Economy and voting record

Around this time last year, the United Kingdom was experiencing annual growth of around 3% and a rapid fall in unemployment. Despite robust momentum and a tightening labour market, however, wage growth had been exceptionally weak and was only just beginning to pick up. Moreover, having been close to the 2% target around the middle of 2014, by September inflation had fallen to around ¾ of a percentage point below the target.

Since then, these trends have continued. Private final domestic demand growth has been robust and overall momentum solid. Unemployment has continued to fall, as has inflation.

The most striking development in the UK in the past year has been the fall in annual headline CPI inflation to around zero for the bulk of the year. Because inflation has been more than 1 percentage point below the target, I have written three in a likely sequence of open letters to the Chancellor explaining the reasons why this has happened and outlining the MPC's strategy for returning inflation to the target in a timely and sustainable manner.

Mechanically, around three quarters of the deviation of inflation from the 2% target reflects unusually low contributions from energy, food, and other imported goods prices.

The most important single reason for below-target inflation is the sharp drop in energy prices during the second half of last year. This reflects the large fall in the price of oil globally, partly driven by an increase in its actual and prospective supply. However, food prices have also been falling by around 3% year-on-year, reflecting both lower world prices and fierce competition amongst domestic retailers. Finally, and of particular importance from a monetary policy perspective, the appreciation of sterling of close to 20% since March 2013 has imparted a drag to imported goods prices.

The remainder of the inflation undershoot reflects the past weakness of domestic cost growth, particularly low wage growth. This is gradually beginning to change. Wage growth has picked up to around 2 ½ % in the latest data from around 1% this time last year, though it remains substantially below its pre-crisis average rate of around 4 ¼ %.

Moreover, unit labour cost growth, which matters particularly for inflation, remains modest. In tandem with wages, measured productivity growth has also recently picked up. Although I regard it as prudent to exercise caution in interpreting this given the UK's disappointing post-crisis productivity performance, renewed productivity growth does nonetheless mean that, for the economy as a whole, labour costs have not accelerated to the same extent as wages. In fact, unit labour cost growth was likely to have been only around 1 ¼ % in the second quarter of 2015, some 1 ½ percentage points below its pre-crisis average rate.

Finally it should be noted that the coincident pick-up in wage and productivity growth likely reflects in part an abatement of the effects from the changing composition of employment. A cyclical recovery in the employment of people with lower than average skills, experience and qualifications served to reduce both measured average wage growth and measured productivity growth during 2014. It seems likely that the net of these two effects was broadly neutral for overall unit labour costs, which ultimately matter for monetary policy.

The combination of modest domestic cost growth and very weak imported goods prices is evident in subdued core inflation, which strips out the direct effects of volatile components of the CPI on annual inflation. On a range of measures, core inflation is currently around 1%.

Taken together, these considerations have underpinned my votes to maintain the level of Bank Rate at ½ % and the stock of asset purchases over the past year. In my view, this policy stance over the past year was consistent with providing the necessary stimulus to return inflation to target in a timely fashion in the absence of further shocks.

Returning inflation to the target

With underutilised resources remaining in the economy and with inflation below target, the Committee is setting monetary policy to ensure growth is sufficient to absorb the remaining economic slack and to generate the rise in firms' costs needed to return inflation to the target within two years. That strategy needs to balance two large gross effects: domestic strength on the one hand and disinflationary forces from the combination of the exchange rate and global weakness on the other.

The MPC's policy stance is supporting continued robust domestic demand growth. The combination of strong employment growth, the recovery in wages and the one-time boost from low food and energy costs is supporting robust household spending. Consumer confidence is at its highest level in over a decade and retail sales are growing at well above past average rates. Business investment has been robust and surveys suggest this is likely to continue.

Domestic strength is needed to offset the headwinds to growth and inflation from abroad. While activity in our major trading partners has recently begun to recover, particularly in the euro area, the Committee expects global growth to continue at rates between ¼ - ¾ percentage point below past averages over the forecast horizon. The

August *Inflation Report* also highlighted downside risks to global growth. These risks have increased further since that *Report*. Actual headwinds to UK growth could grow if a potential further material slowing of growth in China and more broadly in emerging markets materialises. If coupled with material and persistent depreciation of those economies' exchange rates and a tightening of global financial conditions, there could be further significant imported disinflationary pressures in the UK over the policy horizon.

However, these are possibilities, not certainties, and their evolution needs to be closely monitored. In the absence of sustained crystallisation of these risks, as I remarked in recent speeches in Lincoln and Jackson Hole,[1] the prospect of sustained momentum in the UK economy and the gradual firming of underlying inflationary pressure will likely put the decision as to when to start the process of gradual monetary policy normalisation into sharper relief around the turn of this year.

The path of Bank Rate is much more important than the precise timing of the first increase, however. As I have stressed for the past two years,[2] given the likely persistence of the headwinds facing the economy, I expect Bank Rate increases, when they come, to be gradual and limited to a level below past averages. That is because the combination of steady-not-spectacular global growth, the marked appreciation of sterling, ongoing fiscal consolidation and higher intermediation spreads implies that the 'equilibrium' real rate of interest – the rate needed to keep the economy operating at potential and inflation on target – will continue to be lower than on average in the past. It also seems likely that the equilibrium interest rate, having been sharply negative during the crisis, will move only slowly back up towards historically more 'normal' levels. Everything else equal, that suggests a prospective tightening cycle that, once it starts, will be longer and shallower than those of the past.

There are several reasons why the actual path for Bank Rate will not be mechanical, linear or pre-determined. First, shocks to the economy could easily adjust the timing and magnitude of rate increases. Second, we will learn more about the sensitivity of household balance sheets as interest rates rise. Third, given the importance of the exchange rate for UK inflation and activity, monetary policy must be carefully calibrated. All of these dynamics will need to be monitored.

Given these considerations, the MPC will have to feel its way as it goes, monitoring a wide range of indicators and adjusting policy as it learns about the effects of higher interest rates on the economy. Different factors will become worthy of particular attention as the economy evolves in informing the timing, pace and degree of likely Bank Rate increases. In my view, at the current juncture, three stand out.

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[1] See Carney, M (2015), "From Lincoln to Lothbury: Magna Carta and the Bank of England", Lecture at Lincoln Cathedral, 16 July; and Carney, M (2015), "Inflation in a globalised world", remarks given at the Economic Policy Symposium hosted by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 29 August.

[2] See Carney, M (2013), "The spirit of the season", Speech at the Economic Club of New York, 9 December.

First are the prospects for sustained momentum in economic activity to wring out any remaining slack. This will depend heavily on continued robust domestic demand. Second, domestic costs need to continue to firm. The extent needed depends on what is happening to other costs. In the decade prior to the crisis, labour costs grew by around 2 ½ per cent each year on average, with wages and salaries per head growing at around 4 ¼ per cent and productivity at around 2 per cent. Inflation averaged 2 per cent, however, because import prices rose by only around ¼ per cent each year at the same time.[3] That points to a third important consideration: the need to monitor developments in firms' costs other than labour. The sum of these is evident in so-called 'core' inflation which, by virtue of the UK's openness, is significantly influenced by developments in the exchange rate and the cost of imports. Core inflation needs to increase further to have a reasonable expectation that, in the absence of additional shocks, overall CPI inflation will return to 2 per cent within the MPC's stated objective of two years.

The uncertainty surrounding these developments means there is a wide distribution of possible outcomes around any expected path for Bank Rate, reflecting the inevitability that the economy will be buffeted by shocks and that monetary policy will have to adjust accordingly in order to return inflation to target.

Explaining monetary policy

In the past year, the MPC has implemented changes to the monetary policy process following the recommendations of the Warsh Review. In August, for the first time, we published the *Inflation Report* and Minutes of the MPC's deliberations simultaneously, ending the drip feed of information around a single monetary policy decision. The new approach allows the MPC to set out its assessment of recent economic developments and future prospects in a comprehensive fashion. The sum of the major reforms implemented in light of the Warsh Review brings the Bank of England to the forefront of international best practice in monetary policy transparency. I believe this further enhances our accountability to Parliament and the people of the United Kingdom, while making monetary policy more effective.

Over the past year, I have delivered six on-the-record speeches covering aspects of monetary policy (in addition to six other on-the-record speeches covering other issues relevant to the Bank of England's responsibilities) and given four *Inflation Report* press conferences (in addition to two press conferences on the *Financial Stability Report*).

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

[3] CPI inflation was around 2% on average prior to the crisis after adjusting for the mis-measurement of clothing and footwear prices. See Bank of England (2011), *Inflation Report*, box on page 39, February.

In response to concerns raised by the Treasury Committee, I have written letters on migration, MiFID, the use of Agency intelligence in monetary policy, foreign exchange reserves, and the MPC's Code of Conduct.

I have given fifteen national television, radio and print interviews, five regional print and broadcast interviews, and three international media interviews.

I have reiterated the Bank's public messages and heard the perspectives of a range of professional associations and business groups, including Pro Bono Economics, the British Bankers' Association, London Chamber of Commerce, Heart of the City, IOSCO, ISDA, Group of Thirty, and the Advanced Manufacturing Research Centre.

In addition, I have made seven visits around the United Kingdom over the past year, building on visits to each home nation and region of the United Kingdom during my inaugural year as Governor. These involved numerous company meetings, events with local business people, and speaking engagements. The visits provide an important regional perspective to monetary policy, as well as the opportunity to explain the MPC's decisions.

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