Report to the Treasury Select Committee for the Period 27 November 2012 to 4 March 2014

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Voting Record

The period falls into two phases. In late 2012 and early 2013 data suggested economic growth was weak, while inflation remained firmly above target, and was expected to stay above target for the next two years or so. Like the other members of the Committee I faced the need to balance the wish to support economic growth against the concern that, with inflation above target, further support might lead to a rise in medium-term inflation expectations. If this were to happen, that could lead, in the long run, to substantial costs arising from the Committee eventually bringing inflation back to target. The trade-off between this risk and the real benefits of further support for the economy is inevitably a matter of judgement; there is little historical evidence which can guide members of the Committee. As a result of these concerns, which eased somewhat as the first half of the year progressed, because the output data started to improve, between December 2012 and July 2013 I voted for no change to asset holdings (with the implication that maturing stock was re-invested) and no change to the Bank Rate.

The Chancellor had, in the Budget of 2013, asked the Committee to prepare a report on monetary policy and *Monetary Policy Trade-offs and Forward Guidance* was published at the start of August. This suggested that there were benefits, for example in terms of increased certainty, of the Committee providing explicit forward guidance about the future path of monetary policy. I thought that the guidance was an inflationary stimulus which, given the prospects for inflation at the time, was undesirable. My key concern was around the inflation 'knockout', which specified that our stated intention not to raise Bank Rate at least until the unemployment rate fell to 7% would no longer apply if there was more than a fifty per cent chance of inflation being above 2 ½ per cent in eighteen to twenty-four months' time. This contrasted with the way that the Committee had described policy in the past, of aiming to bring inflation back to the two per cent target in two to three years, and might lead people to conclude that we were less concerned about the inflation target than we had been in the past, with the risk that could lead to increased expectations of inflation. As a result I voted against adopting the framework. Had I thought there was a significant risk that unemployment would fall as rapidly as it did, that would have been an additional powerful reason for voting against the framework.

Nevertheless, I took the view that my subsequent voting should be set in the framework which eight members of the Committee had supported. Since then data have shown the unemployment rate above the threshold of seven per cent, and the inflation and financial stability knock-outs have not been triggered. I have, as a consequence, voted to keep asset holdings and Bank Rate unchanged. In the Autumn I was concerned about rising inflation expectations and encouraged Bank staff to develop systematic ways of measuring these. But expectations have fallen back slightly as the inflation rate itself has dropped.

I am much more comfortable with the arrangements described on pages 8 and 9 of the February *Inflation Report* and I hope people have found my own thoughts on the factors which influence the path for interest rates helpful. While there are good reasons to expect rates to remain low for some time to come, it is, of course important to stress that we do not know the future and that the Committee can give no guarantees.

The Current State of the Economy

The recovery began in the first quarter of last year. The growth rate, although low, was appreciably higher than had been generally expected and, as a result there was an improvement in business and household confidence. From the second quarter onwards growth has been at close to trend rates. At the same time, partly as a result of the rise in the exchange rate, inflation has dropped to slightly below its target; I had thought inflation would remain above target for rather longer. The strength of the monetary policy framework can be seen from the fact that, while inflation was appreciably above target for most of five years, underlying confidence in the inflation target was sustained. Measures of inflation expectations had shown only a small upward drift.

Of course, the second unexpected development of the last six months has been the sharp fall in unemployment. This has as its counterpart the fact that, over the last six months, productivity growth has been appreciably weaker than it was before the crisis. It is not possible at this stage to say what factors have led to this; indeed even looking at the productivity shortfall which has built up since 2008, the most that can be said is that there is a large degree of uncertainty about both the impact of those factors which can be identified and, more generally, of course, whether there are influences which have not yet been considered. But, with productivity growth highly uncertain so too must be the path of unemployment, even if GDP grows broadly in line with our expectations.

As I stated in the questionnaire for my re-appointment hearing, I do not think it is helpful to work in terms of an aggregate output gap when thinking about inflation prospects. Spare capacity in firms, to the extent that it can be measured, does not seem to have the same sort of impact on inflation as does unemployment. And the Committee has also recently paid attention to underemployment; on balance people would like to extend their working hours. It is not clear how far the rise in underemployment since 2010 is a consequence of weak demand rather than structural changes in the labour market, or how far underemployment affects wage growth. Overall, my best estimate of the amount of spare capacity in the economy is something under one per cent.