Report to the Treasury Select Committee for the Period 5th March 2014 to 16th February 2015

Martin Weale, External Member, Monetary Policy Committee

16th February 2015

Voting Record

My voting during this period has fallen into three phases. From March to July 2014 I was voting for no change to Bank Rate. From August to December 2014 I voted for an increase in the Bank Rate to ¾ per cent. In January 2015 I voted for no change to Bank Rate. Throughout the period I voted for no change to our stock of assets.

Underlying this voting is a view that there is less spare capacity in the labour market than the Committee's collective judgement had suggested. That view was informed by work I presented in a speech I gave in March 2014. A high level of unemployment is an obvious source of spare capacity. Two other sources are an "hours gap" (people wanting to work longer hours) and a "participation gap" (people who do not report themselves as looking for work but who would like to work). My view was that the collective analysis overstated the magnitude of all of these.

With unemployment my concern was not focused on the magnitude of the gap between actual unemployment and the level of unemployment below which inflationary pressures were likely to emerge. Rather the concern was that the people returning to work after a spell of unemployment tend to be relatively lowly paid. When the labour market works efficiently, people's relative rates of pay can be assumed to reflect their relative productivity. This suggests that the output per job of formerly unemployed people is likely to be lower than average; a given increase in employment will deliver a less than proportional increase in output.

I also thought there were risks of overstating the hours gap. Using the ONS' Labour Force Survey, I compared what people said in one round of the survey with what they said a year later. I found that, although people, and particularly young people often said they wanted to work much longer hours, a year later many of these were satisfied by much smaller increases in their working week. This suggested to me that a measure based on what people said they wanted was likely to be misleading.

A further issue arose from a comparison of the earnings of people who increased their hours as compared to those who reduced them. People who wanted to increase their hours tended to be relatively poorly paid while those who wanted to reduce them were typically paid more than the average. These effects meant that the extra output to be expected from an increase in hours by the people who wanted to increase them would be less than a count of desired extra hours might suggest.

Finally the estimates of the participation gap concerned me. Like formerly unemployed people, those finding jobs after a spell out of the labour market tend to be low earners. I was also concerned that the Committee was more willing to raise its estimates of "full participation" when actual participation figures rose than it was to reduce them when the participation figures fell.

This belief that there was little labour market slack was reinforced by my visits to businesses throughout the country. It was clear that the way in which they saw recruitment and pay pressures had changed considerably. In light of these considerations I started to vote for a Bank Rate increase in August, more with an eye to what I expected to happen to pay pressures in 2016 than because it was already clear that pay was growing too rapidly to be compatible with the inflation target.

The data in the last few months of last year confirmed my view that pay pressures were building; the ONS measure of Average Weekly Earnings started to show more rapid growth. What increasingly pulled in the other direction, however, was the falling oil price. I am firmly of the view that the Committee should set monetary policy with reference to expected inflation and that it should look through the first-round effects of moves like this. There is, however, an element of persistence to inflation. Low actual inflation may lead to low inflation expectations and these could make it difficult for the Committee to bring inflation to its target. Separately, sequences of “inflation surprises” in the same direction often come together, as they did when inflation was above target; this is a further downside risk to inflation. As the price of oil declined so my concern about these risks increased until, in January, I decided they outweighed developments in the labour market. Accordingly, in January, I voted for no change to Bank Rate.

The Current State of the Economy

Inflation is likely to remain low as the effects of the declining oil price feed through the economy. I am comfortable with the Committee’s forecast that it can be expected to rise to target in early 2017. This is, of course, based on a judgement about the two offsetting risks described above, rather than a sense that the outlook is set fair. Beyond that the prospects are for inflation to edge up further and it seems to me that it may be appropriate to raise Bank Rate rather earlier than financial markets currently anticipate.

It also seems to me that UK economic growth is likely to be sustained. There are, however, obvious risks, most notably from developments over Greece and from the war in the Ukraine.

A noteworthy feature of the UK economy is the balance of payments deficit, now estimated at about six per cent of GDP. The worsening of the deficit is mainly due to declining investment income from abroad. For many years our investment income was more favourable than the balance sheet would have suggested and perhaps it is not a surprise to discover that that was too good to last. Some IMF work suggests that our balance sheet position is such that we should not expect immediate problems. Nevertheless, there is a great deal of uncertainty and, in my view, the risk of a fall in sterling because of concern about the balance of payments position remains substantial.

<u>Martin Weale Activities – from 11 March 2014 to 16 February 2015</u>

Speeches

<u>2014</u>

Thames Valley Chamber of Commerce – 20 March*

CBI Northern Ireland – 18 June*

JSG Wilson Lecture (Hull University) – 15 October

Mile End Club, Queen Mary – 8 December

Inflation Report Briefings

North East Agency – 8 September

Other presentations and discussions

MNI Connect Policymaker Luncheon – 27 March

Eurostat Conference (Luxembourg) – 12 June

Graduate Induction, Bank of England – 7 October

St Catharine's Political Economy Seminar (Cambridge) – 22 October

Magdalene College Economists' Dinner (Cambridge) – 14 November

BoE, CfM and CEPR workshop dinner – 18 December

Interviews and Articles

Der Spiegel – 31 March

Financial Times – 28 May

Economia Magazine – 14 October

Neue Zurcher Zeitung – 14 October

The Telegraph – 15 October

Radio 5 Wake Up to Money – recorded 19 December for broadcast on 22 December

Observer – 15 February

Regional interviews

Trinity Mirror Southern Ltd (Reading Post) – 20 March*

Good Morning Ulster, BBC Radio Ulster – 18 June*

Business Desk (Yorkshire) – 13 November

Business Groups

CBI – 21 March*

CBI London Regional dinner – 15 May

CISI Wealth Management Forum Lunch – 20 May

Credit Suisse Lunch – 21 May

Morgan Stanley – 24 June

PricewaterhouseCoopers – 26 June*

Derbyshire, Nottinghamshire & Leicester Chamber – 27 June*

Deutsche Bank Gilt Market Clients – 17 July

CBI Yorkshire – 13 November*

<u>2015</u>

Grant Thornton and clients breakfast – 15 January*

RICS Norwich lunch – 15 January*

Agency visits

Central Southern England – 20-21 March

Northern Ireland – 18-19 June 2014

East Midlands – 26-27 June 2014

South West – 27-28 August 2014

North East – 9-10 September 2014

Yorkshire & Humber – 13-14 November 2014

Greater London – 11 December 2014

<u>2015</u>

South East & East Anglia – 15-16 January 2015

*Part of Agency visit