**Report to the Treasury Select Committee for the Period 17th February 2015 to 12th February 2016**

**Martin Weale, External Member, Monetary Policy Committee**

**12th February 2016**

**Voting Record**

Throughout this period I have voted for no change to Bank Rate and no change to the stock of assets that the Asset Purchase Facility owns. Just before submitting my previous report I wrote in *The Observer* about a tug of war between "real developments", particularly those in the labour market, and wage and price developments. Since the Monetary Policy Committee has to anticipate developments, and not merely react to them, the combination of a strong labour market and weak price developments made my interest rate decision finely balanced. A year ago I thought it quite likely that I would start voting again for an increase to Bank Rate by the summer.

Developments in the spring of 2015 reinforced this view. Wage growth started to accelerate and a modest recovery in the price of oil meant that the downward pressures on inflation had eased somewhat. In May I presented some results looking at the effects of the oil price fall, but using an approach which took account of fat tails- the fact that large movements in variables like the oil price happen more frequently than standard analysis implies. This work suggested that, while inflation might be depressed a bit more than the collective MPC analysis suggested in the short term, the impact of the oil price on inflation was likely to have faded within about two years after the initial price fall. That of course is not to say that this approach is better than other ways of looking at the effects of oil price change; it simply provides another perspective.

In the early summer there was justifiable concern about how Greece's problems would be resolved. There were major risks to our economy from financial instability on the continent. As this was resolved, two new developments started to take shape. First of all, there were concerns about China. Without wishing to play these down, they do need to be put in a context. China is important, but Bank estimates suggest that the British economy is three times as sensitive to developments in the euro area as it is to those in China. The volatility in financial markets, which began last summer, may have had its roots in concerns about China, but that on its own was not a major influence on my vote; equally, while there were concerns about the depreciation of the renminbni, it was in fact rising against sterling.

For me the material development was a second period of weakness in oil and commodity prices, coming at the same time as wage growth in Britain slowed. Indeed, at an annual rate, private sector regular weekly pay grew by 3.1% in 2015Q2 relative to 2015Q1 and 1.3% a quarter later. It is not possible to say what has caused the recent period of weakness in wages; most economic models have a large unexplained component, and attempts to explain everything can easily result in over-diagnosis. But there is a risk that wages are more sensitive to very low inflation than past evidence might have suggested, and, if that is the case, then the new falls in commodity and oil prices could serve to keep wage costs, and thus inflation below target for longer than would have otherwise seemed likely.

That said, wage costs have been stronger than the weakness in average weekly earnings might suggest. Average hours per week have fallen since the start of last year; production costs of course depend on hourly wages rather than weekly wages. As a result of this, ONS figures show unit wage costs rising by 2.7 per cent in the year to 2015Q3, although the figures for the fourth quarter are likely to be somewhat lower. If import costs were growing in line with the inflation target, then of course this might make a fairly strong case for an early policy tightening, but with import costs also currently weak and with the recent falls only just starting to work their way into the supply chain, I have not seen a case for an increase in Bank Rate.

**The Current State of the Economy**

There are a number of sources of concern about the current economic environment; that is of course normal rather than unusual. The biggest is, I think, the international situation. Anxieties about China's economy and its implications for the rest of the world have been reflected in stock market movements; those probably do not, so far, have major implications for our economy and we have, as far as is possible, taken them into account in producing our February forecast. The much bigger risk is that these market developments will start to affect business and consumer confidence, leading to a reduction in spending. January survey results provide some evidence that that is happening in the euro area. There is also the possibility that, at least in some countries, banks' cost of finance will increase, with the result that lending rates to their customers are pushed up.

At home there has been renewed disappointment with the productivity figures. The data for the first three quarters of the year supported the idea that productivity growth rates were returning to more normal values. But, based on what we already know about hours worked and output, productivity seems likely to have fallen sharply in the fourth quarter. With no clear explanation of the factors behind weak productivity growth overall, it is unlikely that there can be any substantial explanation of these short-term movements either.

In terms of cost pressures, things continue broadly as I have described, with growth in wage costs too low to offset the effects of weak import prices. The Bank's Agents have provided a positive piece of news. They suggest that pay settlements this year are likely to be slightly higher than last year despite a year of no inflation, perhaps putting a limit to the immediate drag on pay from low inflation.

ONS data on rates of return indicate that the return on business capital in the United Kingdom is currently at its highest since the late 1990s; that has to be a positive signal for businesses, especially in the context of low interest rates. A counterpart of this is that the profit share is currently high; indeed a material reduction to this is needed for inflation to match the MPC's forecast of being only slightly above target in two years' time. Or, if this reduction does not happen, money wages need to be appreciably weaker than we have assumed. The economist in me notes that there are good reasons for expecting some sort of return to normality by the profit share, while the statistician has to point out that a good short-term forecast is that it does not change; in other words, inherent in our assumption that the profit share will decline is an upside risk to inflation.

While I am broadly comfortable with the MPC's February forecast, the most likely outcome still seems to me that demand pressures will generate slightly more inflation than the forecast shows. Looking beyond the first year I see the risks to the upside. The risks I have in mind are particularly those stemming from possible profit share movements, but the effects of the tightness in the labour market may also start to show.

# Martin Weale Activities – from 24 February 2015

## Speeches: Text Released

Inflation: Finely-balanced Risks. City & Islington Sixth Form College – 11 March 2015

Telling Tales of Oil and Global Inflation.  AIECE meeting, London – 21 May 2015

Independence and Responsibility: Observations from an External Member of the Monetary Policy Committee. Guggenheim Conference  Geneva – 28 June 2015

Prospects for Supply Growth in Western Europe. University of Groningen – 12 October 2015

What's in a Week's Work? Gatwick Diamond Business – 20 January 2016

## Inflation Report Briefings

Greater Manchester Chamber of Commerce & HSBC corporate clients – 10 November 2015*

## Other presentations and discussions

York Finance Conference – 6 March 2015

Panellist at roundtable - part of CCBS Workshop – 27 May 2015

Workshop on the Eurozone at Clare College – 12 June 2015

British Plastics Federation Council Meeting – 15 July 2015

Oxford University Business Economics Programme – 27 July 2015

Annual International Journal of Central Banking – 23 November 2015

Marshall Society, Cambridge – 27 November 2015

South Cheshire Chamber of Commerce & Industry Lunch meeting – 9 November 2015*

## Interviews

Financial Times – 23 June 2015

Telegraph – 18 December 2015

Bloomberg – 21 January 2016

**Newspaper articles**

Scotland on Sunday – September 2015

Observer – February 2015

**Regional interviews**

Manchester Evening News – 9 November 2015*

**Business Groups**

CBI Dinner organised by Greater London Agency – 18 May 2015

European Macro delegation - organised by | RBC Capital Markets – 22 May 2015

**Agency visits**

West Midlands Agency – 13-14 May 2015

Scotland Agency – 13-14 August 2015

South West Agency – 20-21 August 2015

Wales Agency – 26-27 October 2015

North West Agency – 9-10 November 2015

Central Southern England Agency – 20-21 January 2016

Northern Ireland Agency – 17-18 February 2016

*Part of Agency visit