Report to the Treasury Select Committee

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Economy and Voting Record

The last year has seen a mild slowdown in economic growth, with real GDP growth edging down from 1.8% YoY in Q3-2016 to 1.5% YoY (first estimate) in Q3 2017. The change in pace is small, and well within margins of error of revision to the UK GDP data. In particular, the ONS data for construction output in Q2 and Q3 look quite soft compared to business surveys and may well be revised up at some stage. At the same time, CPI inflation has risen from 1.0% YoY in Sep-2016 to 3.0% in Sep 2017 (latest data available at the time of writing).

Compared to the MPC's expectations of late-2016, real economic growth has slowed less than expected, while inflation has turned out higher than expected. Key factors behind the resilience of real economic growth include the low cost and relatively favourable availability of credit, the improvement in household and corporate balance sheets over recent years, stronger world growth, sterling's depreciation and changes to monetary and fiscal policies.

The recent pace of growth is modest by historic norms, but probably is slightly above the economy's relatively low pace of potential growth. The average of the estimates of the IMF and OECD is that potential growth is running at about 1½% YoY, versus roughly 2½% YoY over the period 1997-2007, reflecting lower productivity growth. In practice, potential growth may now be even lower than this, with Brexit already hitting workforce growth via reduced inward migration. Over the last five years, all the growth in the UK workforce has reflected people born outside the UK and hence probably driven by inward migration. With the participation rate already at historically high levels and inward migration from other EU countries to the UK now slowing, workforce growth is down from 1.4% a year ago to just 0.3% now, the lowest for over five years. So far there has been no offsetting boost to potential growth from higher productivity growth, with output per person in Q2 up just 0.5% YoY, and output per hour worked down 0.3% YoY.

In recent years, the economy was able to grow above its subdued potential pace without generating significant domestic inflation pressure, because of the overhang of spare capacity after the 2008-09 recession. However, that spare capacity has now been largely used up. Moreover, spare capacity has fallen faster than expected in recent quarters, partly reflecting the better growth outturns (compared to the MPC's forecasts of late 2016) but also lower-than-expected growth in productivity and labour supply. For example, the jobless rate has repeatedly undershot MPC (and other) forecasts and, at the time of writing, is down from 5.0% a year ago to 4.3% -- the lowest since 1975. Under-employment (measured for example by the net balance of people seeking to work more/fewer hours, or the net balance of extra/fewer hours desired) has also continued to fall steadily. The number of people that would like to work but are not counted in the official workforce total has fallen to a record low. The BoE agents survey indicates that labour availability has worsened over the last year, and that recruitment difficulties are high by historic norms. There is little evidence of significant spare capacity in firms, and indeed capacity use in manufacturing is the highest since the 1990s.

Consistent with this, domestic cost pressures also have gradually picked up. In contrast to the subdued trends from 2009 to 2015, CPI-based measures of DGI are now within the margins of error around a target consistent pace. Unit labour cost growth also has been around a target-consistent pace over the last two years, although this is a volatile series and I would not want to put too much emphasis on its behaviour from quarter to quarter.

To be sure, YoY average earnings growth ex bonuses has been fairly stable at just above 2% YoY in the last few quarters. But this reflects a slight underlying pickup offset by unusually large downward composition effects. Such composition effects have tended to prove fairly temporary in the past and in any case do not imply downward pressure on unit labour costs. So in my view the recent pay data do not at present argue for a major reduction in our 4.5% U* estimate, although I could easily accept that it is 4¼% or so. Either way, with the jobless rate at 4.3% now and likely to edge lower in coming months, this would imply limited slack.

I joined the MPC just after the August 2016 meeting, which announced a major easing package that consisted of a 25bp rate cut, £70bn of asset purchases, the Term Funding Scheme and a statement indicating a bias to ease further, depending on data: "If the incoming data prove broadly consistent with the August Inflation Report forecast, a majority of members expect to support a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year."

I voted for unchanged policy from September 2016 to May 2017, including votes to fully implement the asset purchase program announced in August 2016 but not to further expand asset purchases once that program was complete. The major theme behind my votes in this period (as discussed in the speeches of October 2016 and January 2017), was the judgement that the economy would probably not weaken as much as projected in the August 2016 Inflation Report, chiefly reflecting the support from the low cost and favourable availability of credit, as well as the low pound. As a result, I judged that the economy did not need extra stimulus at that stage. At the same time, with the jobless rate still above its likely equilibrium, I judged that there was no urgent need to raise rates.

More recently, I voted for a 25bp rate hike at the meetings on June, August, September and November 2017. I supported the 25bp hike that was made at the November 2017 meeting. As discussed in the speeches of April and August 2017, these votes have chiefly reflected the judgement that, with the labour market tightening more than expected, spare capacity in the economy is now small, and the remaining spare capacity would continue to shrink faster than projected by the central forecast in the Inflation Report. As a result, the prospective tradeoff between above-target inflation and spare capacity has been beyond my limits of tolerance. Accordingly, I have judged that a 25bp rate hike was needed to help bring inflation back to target over time, while still providing significant support to output and jobs, consistent with our remit.

Economic Outlook

CPI inflation is likely to rise a little above 3.0% YoY near term, lifted by recent increases in energy prices, along with the continued pass through to consumer prices from sterling's depreciation. There are early signs in lead guides (for example, output prices and the BoE agents survey of prices of imported finished goods) that this currency-driven boost to consumer prices will soon start to decline a little, bringing CPI inflation a little lower from late this year. Nevertheless, the pass through from sterling's depreciation over the last 18 months is far from over, and is likely to keep CPI inflation above target throughout the next 2-3 years -- even if there is no pick up in domestic cost growth.

Business surveys suggest the economy will continue to grow steadily in the near term, at roughly 1½%-2% YoY, with subdued consumer spending growth, buoyant exports and modest investment growth. Household real incomes have been squeezed markedly by rising inflation, but spending has been supported by gains in employment as well as the low cost and relatively easy availability of credit, along with the boost to consumer confidence from gains in asset prices. That squeeze on real incomes is set to ease slightly in coming quarters as the boost to CPI inflation from sterling's depreciation declines. Even so, the adjustment to the recent squeeze on real incomes will probably continue to cap consumer spending for a while. At the same time, sterling's depreciation has markedly improved the profitability and competitiveness of UK exports, especially exports of goods. Over time, the low pound may also prompt import substitution in supply chains, although this process may be hindered by the tight labour market. For example, the CBI report that, among manufacturers of intermediate goods, the share of firms reporting skilled labour shortages is the highest since at least 1980. Surveys of firms' investment intentions are around their longrun average overall. Business surveys and discussions with businesses highlight a range of positive factors for investment spending, including the high return on capital, low cost of debt, high corporate liquidity, and relatively high capacity use balanced to an extent by Brexit-related uncertainties.

As noted, GDP growth of 1½% to 2% YoY is modest compared to pre crisis trends, but probably is slightly above the current rate of potential growth. Consistent with this, surveys of firms' hiring intentions suggest that labour demand continues to run well ahead of labour supply. As a result, I suspect the labour market will tighten further, with the jobless rate falling a little below the central forecast in the Inflation Report over the next few quarters, alongside further declines in under-employment. In turn, the tightening labour market is likely to push up pay growth a bit in the year ahead. Risks around our 2018 forecast of roughly 3% average earnings growth are two sided in my view, and pay growth could well – for once -- surprise on the upside if composition effects unwind and underlying pay growth picks up further.

If the economy plays out broadly in line with this outlook, I consider it likely that – broadly consistent with market pricing -- interest rates will need to rise further over time. To be clear, this is not meant to endorse the exact path of interest rates projected by markets, rather the general sense that some further tightening would be likely over time. I do expect that any further tightening will be limited and gradual.

The economy is always subject to a range of uncertainties. At present, two key uncertainties in my view are: (1) the nature of the UK's eventual trading relations with the EU after Brexit, and any transition to that end-state; (2) the extent of remaining spare capacity in the economy, and the impact of changes in spare capacity on labour cost growth and domestic inflation pressures.

The UK economy at present is highly globalised, via inward and outward investment, trade and migration flows. On balance, this openness has probably increased markedly the overall level of living standards in the UK, by increasing competition and innovation, and allowing the UK to specialise in sectors in which it has a clear competitive advantage, eg IT and communications services, business and financial services. It is unclear whether the longrun impact of the UK's exit from the EU will be to reduce or increase the economy's openness: much depends on what kind of trade agreements are eventually established with the EU and other countries. However, in the near term, Brexit is likely to reduce the economy's openness. This is because any decline in openness with the EU is unlikely to be immediately offset by similarly extensive trade deals elsewhere. And, in any case, previous experience suggests that it takes time for businesses to adjust fully to new trading opportunities, with considerable stickiness in business relationships over time[1]. All this is likely to

[1] See, for example, "Investigation into the extensive and intensive margins of growth in the value of UK exports and the role of SME exporters", Mion and Muuls, report commissioned by the UK Trade and Investment (UKTI, published January 2014

affect both actual and potential growth over time. These effects remain highly uncertain at this stage.

Of course, what matters for the economy is the collective expectations of households, business and financial markets. But the sense that Brexit will probably have modest adverse effects on the economy's future growth is evident in business and consumer surveys, and also is implicit in sterling's depreciation. This is also broadly consistent with the views of the IMF and OECD[2].

Anticipation of these longrun effects seems to be already having some adverse impact on economic activity, especially business investment. At the same time, the Brexit-related depreciation of sterling is lifting inflation and hence squeezing consumers' real incomes, while also giving a considerable near term boost to exports. The lower pound, along with uncertainties over the future status of EU nationals working in the UK also seems to be reducing inward migration from other EU countries, reducing both labour supply and economic growth. The net effect at present probably is to reduce both actual and potential growth somewhat.

As and when there is greater clarity on the UK's eventual trading relations with the EU, and any transition, there may be significant effects on business and consumer confidence, migration, and asset prices including the exchange rate. These could go either way. Consistent with our remit, the MPC has said that any resultant monetary policy implications would not be automatic and would depend on the balance between changes in supply, demand and the exchange rate and their implications for the economic outlook.

On the second key issue, as noted above, a range of indicators currently suggest that the overall extent of spare capacity across the economy currently is small. Nevertheless, estimates of spare capacity are inevitably uncertain, and estimates by the IMF and OECD of one such measure – the output gap – have tended to be revised quite markedly over time. Moreover, uncertainty over the extent of spare capacity has been highlighted by the repeated undershoots in pay growth during 2013-16 even while unemployment fell faster than expected. A range of factors probably lay behind this shift in the relation between the jobless rate and pay growth, including greater labour market flexibility and insecurity, extra labour supply, increased under-employment, broader educational attainment, and changes to the tax and benefit system.

Reflecting these and other factors, the MPC cut its estimate of the equilibrium jobless rate (U*) from 5.0% to 4.5% in early 2017. Since then, trends in pay growth (allowing for composition effects) and domestic costs have not undershot expectations. I consider it quite possible that the equilibrium jobless rate is slightly below our 4.5% estimate, but probably only slightly. The MPC will review this and other issues in our annual "supply stocktake" ahead of the February Inflation Report.

Explaining Monetary Policy

Over the past year I have given four on-the-record speeches on the economic outlook and prospects for monetary policy. Two of these were in London (Resolution Foundation and Federation of Small Business), two were on regional visits (Manchester and Cardiff). For three of them, I recorded a short video summary, released alongside the speech on the BoE website and social media.

I have done three major press interviews (FT, Guardian, Evening Standard), as well as some regional press.

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[2] See IMF "World Economic Outlook" of April 2017 and October 2017, and OECD "Economic Survey of the UK", October 2017

Since joining the MPC, I have made 10 regional visits around the UK to explain the Bank's thinking and to hear first-hand about economic prospects. These have covered almost every region of the UK. Each regional visit is usually for two days, including meetings with companies, small firms and start-ups, charities, regional development bodies and so forth. As part of these, I have made more than 20 off-the-record speeches. I have also been a judge at one of the regional finals for the Bank's Target 2.0 schools competition.

I have also appeared before the TSC twice, one for my confirmation hearing and the other to discuss the November 2016 Inflation Report.

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