Written evidence submitted by Michael Saunders

Report to the Treasury Select Committee
Michael Saunders, External Member of the Monetary Policy Committee, Bank of England
9 November 2018

Economy and Voting Record
This note was finalised on 9 November 2018 and does not reflect any data or developments after that date.

Economic growth during 2018 so far has been modest and fairly close to expectations a year ago, with some volatility from quarter to quarter because of erratic factors including the weather. The MPC's central forecast for real GDP growth in 2018 was 1.3% YoY in the latest Inflation Report, versus 1.6% in the Inflation Report of November 2017. But the difference is within the usual range of revisions to these numbers. Indeed, the "backcast" estimate for 2018 GDP growth, which attempts to allow for such revisions, remains unchanged at 1.6% YoY.

Within the mix of growth, consumer spending has been stronger than expected so far in 2018, with weaker business investment and less of a boost from net trade. The official data on business investment are often revised up over time, but the picture of soft investment is consistent with the mood of caution over Brexit I have encountered from businesses on regional visits across the UK. The weakness in net trade in the first half of this year in official data appears to have been somewhat erratic and at odds with trends in business surveys. Notwithstanding signs of softer global growth, export volumes have rebounded in recent months.

CPI inflation has slowed from 3.0% YoY in Q4-2017 to 2.4% in September this year (latest data at the time of writing), similar to the forecast in the late-2017 Inflation Report. The boost to inflation from sterling's 2016 depreciation has diminished, as expected. Among other components, core services inflation has been a bit weaker than expected, while petrol prices have picked up.

It appears that potential growth has been a little lower than expected, as in 2016 and 2017. For example, even without upside surprises in economic growth, spare capacity has been used up faster than expected over the last year. The jobless rate has fallen from 4.3% in Q3 2017 to 4.0% in June-August this year, whereas a year ago the MPC expected only a marginal decline to 4.2% in Q3 2018. Similarly, under-employment has continued to fall, and job vacancies have continued to rise. Productivity growth remains subdued. Moreover, with lower inward migration, the contribution to workforce growth from foreign workers has diminished markedly. As a result, workforce growth has slowed slightly in the last couple of years even with the sizeable boost to participation rates from the increases in the female State Pension Age.

With economic growth having been above potential for six or seven years, the spare capacity created by the recession has now probably been used up. There is a range of capacity use guides, none of which is perfect. But taken as a whole, they suggest to me that supply and demand in the economy are now broadly in balance.

In the labour market, the jobless rate is the lowest for more than 40 years and (at 4.0% in June-August) slightly below the MPC's estimate of equilibrium (4.25%). Under-employment has fallen markedly over recent years, with the net balance of desired extra working hours now around zero. The number of involuntary part-time workers (IVPT) remains above the pre-crisis average (as a share of the workforce), while the number of people that would like to work but are not counted in the workforce (ie marginally attached to workforce) is at a record low. Overall, a U6-type underemployment measure (which combines unemployment, IVPTs and the marginally attached) has fallen to 11.8% of the workforce in June-August from 12.6% a year ago and is the lowest since data began in the early 1990s.

With the labour market tightening, business surveys suggest that recruitment difficulties (eg CBI, British Chambers of Commerce, BoE Agents) are at or around the highest levels recorded in recent decades. The growing difficulties companies face in recruiting suitable staff have been a regular theme in recent regional visits.

In turn, underlying pay growth (measured by private sector average weekly earnings excluding bonuses) has picked up from 2-2½% a year ago to about 3% in June-August. This is close to a target-consistent pace, given the subdued trend in productivity growth.

I do not believe the economy has already over-heated, and it is notable that measures of domestically generated inflation based on the ONS CPI data (eg core services inflation) remain subdued. However, some of the weakness in core services inflation reflects recent weakness in rents, which may be due to idiosyncratic (and possibly rather temporary) factors relating to the housing market rather than general slack across the economy. Moreover, core services inflation tends to lag changes in capacity use by about a year, and hence may not fully reflect the rise in capacity use since then. But it is worth keeping an eye on such measures as a cross-check to other capacity use guides.

I supported the 25bp rate hike of November 2017. I voted for unchanged rates for a few months after that, but noted in January this year that, with the labour market tightening, interest rates would probably need to rise further over time if the economy played out as expected. I voted for another 25bp rate from March this year, outlining the case for higher rates in a speech in April. I supported the 25bp hike in August this year. I have voted for unchanged rates since then.

Economic Outlook

It seems likely that economic growth in Q4 2018 and perhaps Q1 2019 will slow from the strong gain (0.6% QoQ) recorded in Q3. That is partly because Q3 growth itself benefited from erratic gains in some areas, for example construction, after earlier weakness. Moreover, there may be some adverse effects on exports from the slowdown in global growth. But, at the time of writing, it also appears that Brexit uncertainties have risen recently and that these uncertainties are having a bigger impact on business confidence – which has fallen markedly in various recent business surveys. With these uncertainties, firms may be tempted to defer some investment and possibly also hiring, to a greater extent than in recent quarters.

So far, there is little evidence of precautionary stockbuilding ahead of possible disruptions to transport around the scheduled time of EU exit (March 2019). But this may become more of an issue if Brexit uncertainty remains high as that date approaches. To the extent that any such stockbuilding reflects imports, it may have little effect on UK GDP either way.

Since the EU referendum, the MPC’s forecasts have been conditioned on the assumption that the economy adjusts smoothly to an average of Brexit end states. Conditioned on that assumption, the latest Inflation Report projects that economic growth will pick up a little from early 2019 and again slightly outpace potential, so that the economy moves into excess demand over the next year or two. As a result, assuming that smooth adjustment to Brexit, the MPC as a whole judged in that Inflation Report that some further rises in interest rates probably will be needed over time, in order to return to a more neutral policy stance and thereby return inflation sustainably to target. I agree with that broad outlook, conditioned on the Brexit assumptions.

At least some of these Brexit uncertainties might be resolved quite soon. Either there will be a withdrawal agreement and transition period or not. If there is a withdrawal agreement then the range of options for the possible Brexit end state also may narrow. Any such resolution of Brexit uncertainties may change the economic outlook, perhaps substantially. But the monetary policy implications of different Brexit outcomes could go either way, depending on the effects on supply, demand and the exchange rate.

For example, a smooth transition to a relatively close economic relationship with the EU would probably boost business confidence, with pent-up demand propelling investment and hiring. The same factors might well cause sterling to appreciate. The net effect would probably be higher growth and lower inflation than the central forecast of the recent Inflation Report. But it is unclear whether it would be appropriate to tighten monetary policy more or less than implied by the yield curve underpinning that forecast (or indeed not adjust policy at all, or to loosen): this would depend on the balance between potentially inflationary effects from stronger growth (relative to supply) and disinflationary effects from a stronger pound.

Conversely, an early move to WTO trading rules with no transition would probably see weaker business confidence and higher uncertainty, hitting investment and hiring. There might also be further adverse effects on potential growth, for example through a rapid shrinkage in high productivity sectors with heavy reliance on exports to the EU, migration flows, and disruption to transport. For the same reasons, sterling would probably depreciate, with the resultant boost to inflation reinforced by any extension of tariffs and increases in transport costs. The net effect would probably be higher inflation and lower growth. It is not possible to predict with any certainty the magnitudes of swings in prices, growth and potential growth. Indeed, if this scenario were to occur, it may be hard to judge in real time whether any weakness in growth exceeds the possible deterioration in potential growth. The monetary policy implications of this scenario could go in either direction. In particular, the MPC might well face a different tradeoff between the prospects for inflation and spare capacity than after the mid-2016 EU referendum, given that (unlike then) the output gap is now closed and inflation is already slightly above target.

Monetary policy cannot prevent the necessary adjustment in the economy to EU exit. What it can do is to ensure that adjustment is not complicated by an erosion of the low inflation culture built up over recent decades.

Explaining Monetary Policy

I have done two "on the record" speeches on the economic and monetary policy outlook so far this year. One was in London, the other in Glasgow. The first speech focussed on prospects for the labour market ("The Outlook for Jobs and Pay", London, 17 Jan 2018). The second focussed on prospects for monetary policy ("Why Raise Rates? Why "Limited and Gradual"?", Fraser of Allander Institute, 20 Apr 2018).

[The Outlook for Jobs and Pay]

[Why Raise Rates? Why "Limited and Gradual"?]

Another speech is scheduled before yearend. I have also done a live TV interview on CNBC.

I have done seven regional visits to see businesses around the UK so far this year, and a total of 17 such visits since I joined the MPC two years ago. Each regional visit is usually for two days, including meetings with, for example, large and small companies from a range of industry sectors, startups, third sector groups, regional trades union officials, schools or further education institutes. Another two regional trips are scheduled before the end of this year. I have appeared before the TSC once so far this year, in May.