Report to the Treasury Select Committee
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This note was finalised on 19 February 2020 and does not reflect any data or developments after that date. My previous annual report to the Treasury Select Committee was submitted in November 2018. Since then, I have provided a written report in May 2019 following my reappointment for a second term on the MPC, and appeared before the Committee in June 2019.

The economy over the last year

Economic growth slowed markedly over the last year, and has been weaker than the MPC (and consensus) expected. Global growth slowed below 3% YoY (PPP-weighted) in 2019, the weakest since 2009. In the UK, quarterly growth in Q4 was zero and the economy has barely grown since the first quarter of last year.

The key factor behind the slowdown has been persistently high policy uncertainty, generated both at home and abroad. Global trade policy uncertainty surged during 2018 and 2019, with a sharp rise in tariffs on US-China trade, actual or threatened tariff hikes on a range of other economies, and a marked increase in non-tariff protectionist measures. In the UK, firms and households also faced a marked rise in Brexit-related uncertainties during 2019, with risks of a possible no-deal Brexit and uncertainties over the UK's eventual trading relations with the EU and elsewhere.

When uncertainty is high, with the possibility that something bad is about to happen, companies and households are likely to defer major spending decisions with large sunk costs.[1] These adverse effects are evident in the data, both for the UK and elsewhere. For the G7 ex UK, the annual growth of real business investment slowed from roughly 6% in mid-2018 to about zero in Q4 2019. In the UK, business investment has shown very little growth over the last year. Indeed, business investment in the UK has risen by only 1.3% in real terms since the Brexit referendum in mid-2016, by far the weakest performance among the G7. World trade volumes fell last year[2], the first decline since 2009, hitting UK exports. Consumers also have turned more cautious. Despite the positive backdrop of rising real wage growth, low unemployment and very low mortgage rates, household spending growth slowed to 1.4% in 2019 (weakest since 2011) from roughly 2½% YoY in 2016-18.

Fiscal policy supported the economy over the last year, with a marked pick up in public spending (especially government consumption). The sum of real government consumption and investment rose by 3-4% YoY in 2019, the strongest gain since 2008. The slowdown in UK growth would have been even sharper had that pickup not occurred. For example, while overall GDP rose 1.1% YoY in real terms in Q4 2019, the ONS measure of market sector output[3] rose just 0.6% YoY, down from 1.8% YoY in Q4 2018 and matching the low seen in 2012.

In recent months, some uncertainties have diminished. In the UK, the general election result has reduced some uncertainties around Brexit and other policies, while there appears to be a truce in the US-China trade war.

With reduced uncertainty, there is less incentive for households and firms to defer spending on major items. As a result, some of the activity that had been deferred over the last few quarters may

[1] See "*Investment and Uncertainty*", speech by BoE Deputy Governor Ben Broadbent, May 2019.

[2] Based on CPB world trade data for January-November 2019.

[3] The National Accounts define market sector activity as that which is undertaken at prices that are economically significant and where the output is disposed of or intended for sale through the market. So this largely excludes the direct contribution to growth from government services.

now be coming through. So far, there is very little hard data for the post-election period, but it seems likely at this stage that the economy will return to positive growth in Q1. Recent business surveys (for January) show a marked rise in business confidence and in firms' expectations for activity over the next year. Consumer confidence also has improved in the last couple of months, with a notable rise in some survey guides to housing activity. However, the survey guides that track activity in the economy, rather just expectations, generally show only a modest improvement and still point to subdued growth. Over recent years, those output surveys have given a better guide to the economy than the expectations surveys, which have been more volatile.

The slowdown over the last year has opened up a margin of spare capacity in the economy. To be sure, the jobless rate has not risen: it remains below 4% and the lowest since the mid-1970s. Nevertheless, business surveys suggest that capacity use in firms has fallen markedly since early 2019.

In the January MPR, the MPC judged that the equilibrium jobless rate is around 4.25% and hence that the jobless rate (currently just below 4%) is somewhat below that equilibrium. My hunch is that the equilibrium jobless rate has continued to decline and probably is close to the current level of the jobless rate. The jobless rate has been below 4.25% since mid-2018, but private sector regular pay growth in Q4 2019 was 3.2% YoY (latest data), similar to a year earlier and a pace that (allowing for the average pace of productivity growth over the last few years, around 0.5% YoY) is roughly consistent with the inflation target over time. The marked decline in structural unemployment over the last 20-25 years has reflected, among other things, changes to the tax and benefit system, improved educational attainment, demographic change, the expansion of less secure forms of work (including self-employment and zero hours contracts), and the establishment of a more credible commitment to low inflation.[4] Many of these factors are still ongoing.[5]

Although the labour market is tight, it no longer seems to be tightening further. The jobless rate has been roughly stable since early 2019. Lead guides to job growth – eg vacancies and surveys of firms' hiring intentions – have weakened over the last year.

Both headline and core inflation have been subdued over the last year and, especially since mid-2019, inflation has been weaker than expected. One factor restraining inflation is that the boost from sterling's mid-2016 depreciation, which pushed up prices of tradable goods and services in 2017 and 2018, has faded. But this is probably not the whole story. Core services inflation, which is less affected by currency swings, also remains subdued and is well below the precrisis pace -- even though unit labour cost growth across the whole economy is roughly back to the pace seen in those earlier years.

Inflation may have been restrained by the recent slowdown in economic growth, which has led to a squeeze on profit margins. The subdued pace of inflation may also reflect a wider story of structural change which, for want of a better phrase, could be called the "amazonification" of the economy. By this I mean the effects of technological change, leading to the shift of spending to online transactions, greater automation, and more efficient use of the capital stock (especially property). This is disinflationary, helping to squeeze margins and costs.

For example, the share of online sales in total retail sales has continued to rise over recent years and, at just below 20% in 2019, is among the highest – if not the highest – of any country. The shift to online retail sales has led to increased price transparency and hence competition that drives

[4] See *Inflation Report* of February 2017 (pages 18-20) and *Inflation Report* of February 2018 (pages 22-23).

[5] The ONS report that the number of people on zero hours contracts rose by 130,000 (15%) over the last year, to reach 3.0% of the total in work, a new high.

down margins: consider Amazon Marketplace and similar price comparison websites, where the cheapest prices are generally from small retailers, many of whom are online only, rather than the long-established department stores. The online model is more labour efficient, and technology is generating additional productivity gains as (for example) self-service checkouts replace shop assistants in stores and robots replace packers in warehouses.[6] ONS data suggest that productivity (output per hour) in the retail sector has surged in the last couple of years, rising more than 6% YoY on average since the start of 2018, far above historic norms (1998-2017 average was 2% YoY). This has been reflected in a sharp drop in labour use, with employment in the retail sector down by 7% over the last two years.[7] Reduced demand for prominent high street space has caused further weakness in rents on retail property, which fell 5% over the last year, a decline that is similar to the worst of the 2008-09 recession, and which takes the level of rents on retail property back to that seen in 2004. All this helps keep down retailers' costs and, assuming at least some is passed on to prices, helps cap inflation.

These disinflationary effects may end eventually. But there is no sign that they will end anytime soon. I would not be surprised if they persist in the next few years even if the economy picks up.

The economic outlook

In the January *Monetary Policy Report*, the MPC's central forecast was for subdued near-term growth, and a pickup in the spring of this year. That forecast was based on the assumption of a quick but orderly transition to a deep free trade agreement between the UK and the EU at the end of this year. It was also based on the prevailing yield curve, which included a 25bp cut in Bank Rate in the next few quarters. The forecast of an economic upturn was driven by two key inflexion points – a recovery in global growth, and a recovery in domestic spending as Brexit uncertainties decline. This outlook implied that slack would rise slightly in the near term, but that faster growth would propel the economy into excess demand two or three years ahead. The MPR projected that CPI inflation would weaken in the second and third quarters of this year because of regulatory-driven cuts in utility bills. Beyond that, the MPR envisaged that the gradual buildup of excess demand and domestic cost pressures would leave CPI inflation slightly above the 2% target three years ahead.

There are substantial risks and uncertainties around that forecast.

Fiscal policy might pose an upside risk. The January MPR forecast was based on the government's prevailing fiscal plans, as laid out in the 2019 Budget and Spending Round. The forecast did not allow for any further fiscal measures that might be announced in the 2020 Budget. It also is possible that consumer spending will recover more quickly than the MPC forecast, if job growth remains stable, given that consumer spending growth has recently lagged real wage growth.

But there also are downside risks to the forecast.

The January 2020 MPR forecast did not include any explicit impact from the Coronavirus outbreak. Recent developments and the experience of the SARS outbreak suggest that the Coronavirus outbreak is likely to have an adverse effect on growth in some countries. The scale and persistence of that impact, and whether it reverses subsequently, are highly uncertain at this stage.

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[6] A recent ONS study suggests that the share of jobs that are at "high risk" of automation is relatively high in the retail sector (23% compared to 7% for the overall economy in 2017). See "*The probability of automation in England: 2011 and 2017*", March 2019.

[7] Latest data are Q3 2019. There has been a similar decline (6%) in the number of hours worked in the retail sector over the last two years.

More broadly, the upturn projected in the January MPR relies on twin inflexion points of stronger global growth and a recovery in domestic spending as Brexit-related uncertainties decline. Either or both might disappoint.

Global growth may well remain subdued amidst high uncertainties over trade policy. Even with the recent roll-back of some tariff hikes, the previous multi-decade trend of falling tariffs on US-China trade has been pretty much fully reversed in less than 25 months. This casts doubt on whether the trend towards globalisation – a key driver of business opportunities and investment over recent decades – remains intact or is starting to reverse, making it harder for firms to decide whether, where and how much to invest.

In the UK, there also are still major uncertainties regarding future trade relations with the EU and other countries, as well as the extent and direction of policy changes in other areas, for example industrial strategy and regulation. The Deloitte CFO survey suggests that, while uncertainty among UK firms has fallen sharply since last autumn, it remains relatively high compared to the years just before the EU referendum. The DMP survey suggests that an increasing share of firms do not expect Brexit-related uncertainty to be resolved until at least 2021.

Moreover, even if and when these uncertainties eventually fade, the recent experience may well, like previous crises, create lasting scars in terms of risk aversion and caution.

It also is possible that, even if growth does pick up in line with the MPR forecast, disinflationary effects from “amazonification” will continue to cap inflation more than expected. This would imply that the economy’s supply side, its potential growth rate, is doing better than expected. Against that, it also is possible that adverse effects from trade frictions (eg the expansion of Customs checks to EU imports) triggered by Brexit will hurt potential growth in coming years by more than expected.

At the January MPC meeting, my view was that, even though economic growth seemed likely to improve from the zero growth rate seen in Q4 2019, risks for the next year or two lay on the side of a more protracted period of sluggish growth and subdued inflation than the MPR forecast. The MPC’s next policy meeting is in late March and my assessment then will, of course, take account of all the information available at that stage.

Monetary Policy Voting Record
I supported the two 25bp interest rate hikes made in 2017-18. In the first half of 2019, I voted for unchanged rates. More recently, I have voted for a 25bp cut in Bank Rate at the MPC meetings of November and December 2019, as well as January 2020.

Those recent votes for a reduction in Bank Rate were chiefly based on the accumulating evidence of slower economic growth and subdued core inflation, and the prospect that a persistent output gap will leave inflation below target 2-3 years ahead. But I also put some weight on risk management considerations. With a low neutral rate and limited monetary policy space, risk management implies that when the economy has an output gap and inflation below target, it is better to err on the side of too much stimulus rather than too little. If the MPC cuts rates, it is possible that the economy will rebound and renewed tightening may eventually be needed. That would be a benign outcome, with time to tighten before excess demand emerges. Conversely, if the MPC defer easing and, in the event of persistent economic weakness, face the need for greater easing later on, then risks of a low inflation trap – which would certainly not be a benign outcome – would rise.

Explaining Monetary Policy
I have done nine regional visits to see businesses around the UK since my previous Annual Report, and a total of 26 such visits since I joined the MPC in August 2016. 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.

I have done five "on the record" speeches on the economic and monetary policy outlook since my last Annual Report, covering effects of demographic change, the transmission of Bank Rate to household borrowing and deposit rates, the changing economic outlook, and to explain my recent votes for a lower level of Bank Rate.

Some effects of demographic change on the UK economy – speech given at the CBI Annual Economic Dinner 2018, Bath, 22 November 2018. (link)

Pass-through of Bank Rate to household interest rates – speech given at Imperial College Business School, London, 06 March 2019. (link)

The economic outlook – speech given at Solent University, Southampton, 10 June 2019. (link)

Shifting balance of risks – speech given at the Barnsley & Rotherham Chamber of Commerce & Institute of Chartered Accountants, 27 September 2019. (link)

Risk management in a sluggish economy – speech given at the South Eastern Regional College, Bangor, Northern Ireland, 15 January 2020. (link)