

Report to the Treasury Committee

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Economy and voting record

When I joined the MPC in July 2017, annual CPI inflation was running well above the 2% target set out in the remit. I judged that the above-target inflation was primarily due to temporarily high imported inflation, driven by the large fall in sterling following the EU referendum. The depreciation led to higher import prices that have, over time, been passed through to consumer prices on import-intensive goods and services. The impact of this pass-through on annual CPI inflation peaked in late 2017 and has been fading since.

Domestic inflationary pressures had been weaker, which suggested to me that the output gap remained in negative territory. Annual wage growth had been just above 2% to mid-2017, which even granted weak productivity outturns, amounted to subdued unit wage cost growth. Other measures of domestic inflationary pressures had been telling a similar story. I judged that weak domestic cost growth, despite a historically low unemployment rate, partly reflected a post-crisis fall in U^* , the equilibrium rate of unemployment. I therefore supported our collective MPC decision in February to lower our forecast estimate of U^* from 4½% to 4¼%.

The evidence over the past year suggests that the output gap has steadily closed as even modest demand growth has been enough to outpace supply. One overarching factor that has weighed on spending via several mechanisms, has been the adjustment of the economy to Brexit. In particular, the hit to real incomes following the rise in import prices has dragged on consumption growth. Subdued price and activity growth in the housing market have also weighed on consumption and housing investment. And for companies, surveys such as the Bank's Decision Maker Panel suggest that uncertainty over the UK's future trading arrangement has reduced the level of business investment.

Acting against that, global activity has been going through a strong cyclical expansion, albeit with some divergence across countries more recently. Adding this to the boost from the fall in sterling, I expected that we would see continued rotation in demand towards net exports and investment in export-producing sectors. And although the data have been volatile, we had seen some signs that this has happened, with business investment and net exports contributing 0.7pp to growth in the year to 2018 Q1, albeit the net trade contribution dropped sharply in the first estimate of GDP for Q2.

Despite relatively modest rates of demand growth, I judge that potential supply has been slightly weaker still. Weak supply growth has been one of the main features of the post-crisis macroeconomic environment in the UK. This has come about due to a far lower rate of labour productivity growth than in the years before 2008. In a speech in January I set out some new

analysis of this fall, pinpointing the finance and manufacturing sectors as the main sources of the productivity slowdown. I suggested that since the post-crisis deleveraging environment may have led finance to drag on productivity growth temporarily, we may expect some recovery going forward. But I also highlighted that other factors were likely to prove a more persistent drag. So productivity growth was unlikely to return to its pre-crisis norm of 2% per year. Smoothing through some of the quarterly data volatility, hourly productivity has grown by just over 0.5% per year over the past 5 years using ONS GDP figures. This is a little higher than its average in the immediate aftermath of the crisis, but has not been enough to prevent the output gap from narrowing over the period.

Over the past year, the narrowing output gap was also reflected in tightening labour market quantities, with unemployment falling to historical lows, strong employment growth and high participation rates. The strength of the labour market in the official data was corroborated by extensive field-work by the Bank agents, as well as a wide range of recruitment and employment surveys.

Taking all this together, when I joined the MPC, I anticipated that a small number of increases in Bank Rate would be required over my three-year term. I expected imported price pressures to fade and judged output remained below potential. But absent some modest tightening in policy, labour market slack looked set to reduce slightly too quickly, resulting in higher domestic cost growth than would be consistent with inflation at target.

The crucial question was on the appropriate timing of Bank Rate rises, where my key uncertainty was initially whether wages would pick up as forecast. On the one hand, despite strong data on labour-market quantities, wage growth at the time remained weak. So I saw value in waiting until we were more confident that wage growth was firming in the data before raising Bank Rate. On the other hand, monetary policy decisions are necessarily forward looking, since any decision to change Bank Rate affects the economy only gradually, with the peak impact occurring some quarters later. So waiting too long would have left it too late to prevent higher wage growth feeding into inflation.

In August and September 2017, with wage growth still weak, I judged that the policy stance prevailing when I joined was appropriate, but that an increase in Bank Rate would be needed if the output gap continued to narrow. As a result, I voted for no change in Bank Rate and the stock of asset purchases.

By November, with labour market slack reduced – evidenced by surveys reporting increasing recruitment difficulties, robust employment growth and record-low unemployment – I felt that removing a small amount of stimulus was justified and voted with the majority of the committee to increase Bank Rate to 0.5%. With domestic cost growth still subdued in the data, albeit expected to strengthen, I felt at the time that this was a finely balanced decision. Ex post, as the labour market has continued to tighten and wage growth has picked up, I think it was the correct choice.

Indeed, developments in the labour market led me to expect that a further Bank Rate increase would be required over 2018; although I also felt at the start of the year that there was time to first monitor the transmission of what had been the first Bank Rate increase in a decade.

Moving further into 2018, the data flow on UK activity in Q1 turned out surprisingly weak. As I discussed in my speech in June, I thought that much of the downside Q1 GDP news was likely to be erratic, but it did increase the possibility of some underlying weakness in demand, particularly when coupled with slightly weaker CPI inflation. Set against that, the labour market had continued to tighten, so I expected this to translate into a pickup in domestic cost pressures. Indeed, annual private-sector regular pay growth had continued to firm, while evidence from the distribution of wage growth also signalled greater strength.

In all, in May and June I thought it was prudent to wait for further confirmation that the weakness in demand was transient. By August, there had been a rebound in activity, as strong services output helped GDP growth recover in April and May, according to the ONS new monthly figures. Alongside this, the labour market continued to tighten and pay growth firmed in line with the MPC forecasts. With inflation still above target, domestic costs building and the output gap almost closed, I felt that an increase of 25 basis points in Bank Rate to 0.75% was required to return inflation to target, and voted for this along with the rest of the MPC.

The Outlook

Conditional on the market-implied interest rate path used in the August *IR*, my central case forecast is for UK demand to grow around 1¾% on average over the next three years as global demand continues to be strong, though somewhat less supportive than last year. In particular, trade tensions have increased and the distribution of global growth has become more uneven.

I expect demand growth to exceed that of supply. Although I continue to see upside risks to the MPC's 1% forecast for potential productivity growth, I share the committee's modal forecast for weaker supply growth than we were used to pre-crisis. That will likely reflect both continued weakness in productivity growth and slower growth of the working-age population. With demand growing faster than supply, I expect the output gap to close over the next year or so.

The reduced slack is reflected in the labour market. The unemployment rate has continued to edge down in recent months, reaching a 43-year low at 4%. Labour-market tightness has translated into a pick-up in wages and the evidence collected by the Bank's Agents as well as surveys of recruitment difficulties, vacancies and earnings are consistent with a further pick up.¹ I expect that a steady increase in pay growth will lead to increasing domestic cost

¹ Private sector regular pay growth (3 month over the same 3 month a year ago) has been above 2.8% from February 2018 until the most recent reading in June 2018. Whole economy regular pay growth has been above 2.7% during the same period. (Measures of total pay growth have been slightly weaker due to a subdued growth in bonuses, which are more likely concentrated in the top end of the pay distribution, particularly in the finance and business sectors).

pressures. These increases will partly offset the waning of external price pressures, resulting in CPI inflation falling only gradually towards the target. Going forward, how much further tightening is needed will depend on whether the economy evolves as in our forecast. The final shape Brexit takes could have a significant effect on the path of the economy. But as the MPC have reiterated a number of times, the appropriate monetary policy response to Brexit will depend on the reaction of households, companies and financial markets.

Brexit aside, while my central forecast is that inflation will remain slightly above target, I think there are some downside risks; in particular, core services inflation might remain soft and unit labour costs might end up below our central forecast (either because pay does not grow as quickly as I expect, or because productivity recovers more strongly). As of now, I think it is prudent to let the effect of the last move sink in and continue monitoring the evolution of the economy.

Explaining Monetary Policy

- I published two on-the record speeches and gave a CBI talk. The first speech addressed the fall in productivity in the UK economy. The second sought to explain to a general audience how I use different models on the MPC for forecasting, for data analysis and for evaluating the effects of monetary policy.
- I made five regional visits (East Midlands, Southern & Central, the North East, Wales and Northern Ireland). They were an invaluable opportunity to learn first-hand about the UK economy through several company visits and seven group discussions.
- I gave three press interviews (Bloomberg, the Sunderland Echo and the Evening Standard).
- I made three school visits.
- I discussed the MPC views with economists, investors and business people at thirteen roundtable discussions (seven of them during regional visits).
- I continued my academic work on monetary policy (some outlets were VoxEU, Nobel Symposium, Central Bank of Ireland as well as publication in academic journals)
- I chaired/hosted a number of academic conferences.
- I gave evidence to the Treasury Committee on the February 2018 Inflation Report as well as during my appointment hearing in October 2017.