Report to the Treasury Committee

Gertjan Vlieghe, External Member of the Monetary Policy Committee

15 February 2019

Economy and voting record

Since November 2017, the two main factors affecting the UK have been the state of the global economy and the impact of changing expectations of, and uncertainty about, Brexit.

During the course of 2017, global growth picked up, became more broad-based, and became more investment led. Global financial conditions, which were already loose, eased further as equity prices rose, corporate bond spreads declined and government bond yields generally remained low.

The impact of Brexit on UK economic growth in 2017 was negative but less severe than expected: business investment growth was around 2 ½ %, weaker than business investment growth in the rest of the G7 which averaged 6%. Consumption growth slowed from 3% to 2%, but remained more resilient than real income growth, that is to say households reduced their savings to maintain consumption growth. Thanks to a positive contribution from net trade, GDP growth ended 2017 around 1 ¾ %, little changed from a year earlier. The UK labour market remained robust, with further declines in unemployment and some tentative evidence of upward wage pressure. This economic backdrop justified the start of a limited and gradual tightening of monetary policy, and I voted for a 0.25 percentage point increase in Bank Rate in November 2017.

During the course of 2018, however, the global economy slowed, and the negative impact of Brexit on UK economic growth intensified.

Global growth slowed in most major areas, with the exception of the US, where growth accelerated in the second quarter, boosted by a significant loosening in fiscal policy. Growth in the Euro Area, China and other emerging markets, however, declined. Several factors contributed to the global slowing.

First, the US fiscal expansion led to US interest rates rising much faster than elsewhere in the world. This was a normal monetary policy response to a stronger economy, and was appropriate for the US. But higher interest rates and a stronger dollar do put a lot of pressure on emerging market countries which borrow in dollars and pay dollar interest rates, and whose economies were not strong enough to withstand such pressure.

The rise in US interest rates also started to affect some domestic borrowers in the US. The premium that corporate borrowers have to pay for market borrowing rose, and this rise came on top of the increase in risk free rates.

Second, the trade war between the US and China escalated as the year progressed, with tariffs rising and covering an increasing range of traded goods. In China, these tariff increases took place against the background of an economy that was already slowing as Chinese policymakers put in place policy measures to reduce financial excesses in the shadow banking sector. This deleveraging process, while welcome from a financial stability perspective, weighed on growth.

Euro Area growth slowed over the course of the year, from 2 ¾ % to 1 ¼ %. I attribute this slowing to a combination of global factors – the slowdown in Chinese demand for Euro Area exports – and domestic factors – e.g. the rising costs of borrowing in Italy as financial market participants became concerned about fiscal sustainability.

In the UK, growth also slowed, due to a combination of weakening tailwinds from the global economy, and intensifying headwinds from Brexit, especially in the second half of 2018.

The negative impact of Brexit on the UK economy intensified as we approached the end of the article 50 negotiation period and are still lacking clarity about the nature of the future trading arrangements, and the transition to such arrangements. The risk of a disruptive “no-deal” outcome, and the uncertainty about the nature of the future trading arrangements, led to firms cancelling or postponing more and more investment. Business investment fell outright in each of the four quarters of 2018, and the falls became larger as the year progressed, even while investment growth in the rest of the G7 remained solid around 5% (four quarters to Q3). This evidence of an intensifying Brexit effect on business investment was also consistent with a range of surveys, such as the Deloitte CFO survey and the Bank of England’s Decision Maker Panel.

Consumption spending, on the other hand remained fairly steady in 2018, with average growth close to 2%, little changed from a year ago. Consumption spending has been supported by rising real income growth. A buoyant labour market has seen unemployment fall to new lows, vacancies rising to new highs, and wage growth picking up steadily. Wage growth, excluding the volatile bonus component, started the year at 2 ¼ % and picked up steadily to 3 ¼ % in the most recently available data.

Monetary policy this year has had to strike a balance between the evidence of slowing growth on the one hand, and further tightening of the labour market on the other. At the August MPC meeting, I thought it was appropriate, on balance, to continue the process of gradual and limited tightening, and I voted for a 0.25 percentage point increase in Bank Rate.

Economic outlook

The outlook for the next few years is unusually uncertain. Different Brexit scenarios could lead to a wide range of outcomes for the economy. Moreover, there is also significant uncertainty about the global economy.

There are some reasons to be optimistic that global growth will soon bottom out and improve a little. In recent months, the anticipated response from the Federal Reserve, reinforced by Fed communications, has resulted in a 70bp fall in the forward policy rate. The expected Euro Area policy rate at the same horizon has fallen by 50bp. Forward rate paths for other central banks have also been revised lower. Chinese policymakers have put in place significant stimulus measures in the monetary, banking and fiscal sphere, and might add more.

But there are downside risks too. The US fiscal impulse is at its peak, and is set to fade from here. Uncertainties about the trade war do not appear to be close a resolution. And the wider political uncertainties that may be weighing on financial market sentiment and investment decisions may well persist for years to come, and could yet worsen.

When I first spoke about the future path of Bank Rate a year ago, I thought one to two quarter point hikes per year in Bank Rate was the most likely central case. But since then, the economic outlook has changed. Global growth has slowed more than expected, and sooner than expected, so will contribute less to UK demand. Domestic growth has slowed somewhat more than expected, especially around the turn of the year. The only significant recent upside economic news has been the government's announcement of increased fiscal spending over the coming years.

And while pay growth has picked up broadly as expected, this has not so far led to any upward pressure on consumer price inflation. For example, services inflation, which is less affected by the exchange rate and oil prices, has remained close to historical lows.

I judge that the net balance of economic news has been to the downside. I therefore consider that the appropriate pace of monetary tightening is somewhat slower than I judged it to be a year ago. On the assumption that global growth does not slow materially further than it has so far, that the path to Brexit involves a lengthy transition period in line with the government's stated objectives, that pay growth continues around its recent pace, and that we start to see some evidence of pay growth leading to upward consumer price pressure, a path of Bank Rate that involves around one quarter point hike per year seems a reasonable central case.

If a transition period is successfully negotiated, and a near term "no deal" scenario is therefore avoided, I would expect the exchange rate to appreciate somewhat. The degree of future monetary tightening will in part depend on how large this appreciation is.

As before, this future rate path is a forecast not a promise, and just as there is considerable uncertainty around the forecast for growth and inflation, there is considerable uncertainty around my forecast for the policy rate path. Given that the data even in the past few weeks are suggesting the slowdown is continuing into the early part of this year, both domestically and globally, a lot needs to go right for this forecast to come to pass. I feel I can probably wait to see evidence of growth stabilising and inflation pressure rising before considering the next hike in Bank Rate.

So far, I have discussed an economic outlook where the path to Brexit is smooth, i.e. involves a lengthy transition period. There is of course, the risk of a no deal outcome. Such an outcome is likely to lead to some economic disruption, which could possibly be severe. This will not be the case for all sectors of the economy, but some are clearly more exposed than others. The risk of a disruptive outcome, not just uncertainty per se, is one of the key factors that are affecting business investment and financial markets. Reducing uncertainty by making a no-deal scenario happen therefore does not produce net economic gains; it results in actual economic disruption.

The question for monetary policy will still be: how do businesses, households and financial markets react to such a scenario? The exchange rate is likely to fall further. That will create a temporary boost to inflation, just as it did after the 2016 depreciation. The MPC's mandate allows the Committee to balance the likely temporary inflation overshoot against the need to support the economy if a margin of slack were to open up. How much flexibility we have depends on how much slack opens up, which is to say, how much demand falls relative to the disrupted lower level of supply. Box 4 in the November 2018 Inflation Report also discusses these issues in some detail.

One can imagine scenarios where households and businesses expect the negative effect on the economy to be quite persistent, so would lower their consumption and investment demand by more than the supply disruption itself, given the extreme uncertainty and the fact that some disruption will actually be taking place, rather than being faced merely with the worry about potential future disruption. Such a scenario would imply that monetary policy should be kept on hold or even eased as long as inflation expectations remain well anchored, and the exchange-rate driven overshoot in inflation can be weighed against the actual or prospective economic slack, in line with the MPC's mandate. One can also imagine scenarios where households and business spending remains robust, if they expect the economic disruptions to be only short-lived, so demand and confidence is affected less. That might imply that monetary policy might have to be tightened.

All of these paths are possible, although not all are equally likely in my view. In the case of a no-deal scenario I judge that an easing or an extended pause in monetary policy is more likely to be the appropriate policy response than a tightening. We will have to judge in real time how well inflation expectations remain anchored, and how households and businesses are reacting to the disruptions. Even if the direction and scale of monetary policy changes are unknown beforehand, monetary policy will do what it needs to do to bring inflation back to target within a horizon that is consistent with our mandate.

Explaining monetary policy

Since my previous report to the Treasury Committee in November 2017, I have:

- given 24 talks on monetary policy and the economic outlook to regional business groups.
- given a further 23 talks at universities, schools and to groups of financial market participants
- given three on-the-record speeches on monetary policy: one on the link between unemployment and pay growth, one on the way QE affects asset prices and the economy, and one on the general economic outlook.
- given one newspaper interview
- made nine regional trips to meet with businesses, charities and schools around the country
    - South West
    - South East and East Anglia
    - West Midlands
    - North West
    - Wales
    - North East
    - Yorkshire & Humber
    - South West
    - Greater London

I have appeared before the Treasury Committee in May 2018.