Report to the Treasury Committee

Mark Carney, Governor of the Bank of England

2nd September 2016

Economy and voting record

Context

After the longest and deepest recession since the Great Depression, the United Kingdom's expansion finally took hold about three years ago. It was driven initially by sharp declines in economic uncertainty and significant improvements in credit conditions. These helped restore confidence and unleash pent-up household demand.

The nascent recovery was reinforced by a more resilient banking system and accommodative monetary policy, with the MPC's forward guidance reassuring households and businesses that Bank Rate was not going to rise at the first signs of growth, thereby creating the confidence to spend, hire and invest. The recovery was supported by a large, positive supply shock – particularly a notable increase in the labour force participation rate.

With time, the boost from lower uncertainty faded, pent-up demand was largely spent, and consumption growth became increasingly supported by greater hours worked, a sharp pickup in real wages (largely due to commodity price falls), and lower saving rates. Business investment rose with demand and continued improvement in financial conditions. Trade and fiscal policy continued to drag on growth.

By early last year, growth had begun to slow as the labour supply shock had largely run its course and supply growth became more reliant on modest and somewhat erratic growth in productivity. By the second half of last year, though still near the top of the G7, growth had settled at around 2%, about the rate of potential supply growth the MPC estimated at the time.

Such continued, solid growth, and the gradual firming in domestic cost pressures it heralded, together with the outlook for an eventual lessening of the effects of past sharp falls in commodity prices, suggested a sustainable return of inflation to the target was in prospect. This led me to vote to maintain Bank Rate at 0.5% and the stock of asset purchases at £375 billion at each MPC meeting prior to the EU referendum, with the expectation that, when increases in Bank Rate did become appropriate, they would, in all likelihood, be limited and gradual in nature.

The referendum

As a result of the decision of the people of the United Kingdom to leave the European Union, the UK will redefine its openness to the movement of goods, services, people and capital.

Some of the adjustments to this new reality may prove difficult and many will take time. The UK can handle change, however. It has one of the most flexible economies in the world; benefits from a deep reservoir of human capital, world-class infrastructure and the rule of law; and its people are admired the world over for their strength under adversity.

The future potential of the UK economy and its implications for jobs, real wages and wealth are not the gifts of monetary policymakers. The MPC cannot immediately or fully offset the economic impacts of a large structural shock. However, monetary policy can support the necessary adjustments of the UK economy during a period of heightened uncertainty.

That is why, in August, I voted for an exceptional package of measures comprising:

- a 25 basis point reduction in Bank Rate to 0.25%;
- a new Term Funding Scheme (TFS) to reinforce the pass-through of the cut in Bank Rate to the borrowing rates actually faced by households and firms;
- a new programme of private sector asset purchases with up to £10 billion of UK corporate bonds; and
- a £60 billion expansion of gilt purchases.

I voted for these measures because, in my view, the economic outlook has changed markedly, with the largest revision to our GDP forecast since the MPC was formed almost two decades ago. By acting early and comprehensively, the MPC can reduce uncertainty, bolster confidence, blunt the slowdown, and support the necessary adjustments in the UK economy.

As I said prior to the referendum, following a vote to leave the EU "the implications for monetary policy would not be automatic; its direction would depend on the relative magnitudes of the demand, supply and exchange-rate effects."[1] The degree and composition of the stimulus we have implemented is largely determined by our assessment of these effects.

Demand

Beginning with demand, the 10% depreciation of sterling since the referendum will boost exports and weigh on imports. However, even though the MPC expects the current account deficit to halve over the next three years, improvements in the external sector are not expected to offset fully the drag from substantially weaker private domestic demand.

The MPC expects several factors to weigh on investment in the near term and on employment and consumer spending over time. These include a protracted period of heightened uncertainty, weaker activity in residential and commercial real estate markets, and a higher cost of capital for UK-focused firms.

[1] *Inflation Report* Press Conference, Opening Remarks, 12th May 2016.

Some of these effects are beginning to manifest in surveys of investment intentions, business activity, and the housing market. These indicators fell sharply in the wake of the referendum result, in most cases to levels last seen in the wake of the financial crisis, and in some cases to all-time lows.

The MPC has been conservative in its interpretation of these data, however, and expects some recovery in investment intentions and activity expectations after initial sharp falls. As a result, in August the MPC produced a stronger growth forecast than historical relationships would imply. Nonetheless, we expect aggregate demand to grow only a little for the next few quarters before picking up to rates that remain below those projected in May.

Supply

The extent to which this lower path for aggregate demand is likely to be accompanied by a lower path for aggregate supply is a key determinant of the inflation outlook and the ultimate determinant of the UK's prosperity.

The weakness in demand will itself weigh on supply as a period of low investment restrains growth in the capital stock and productivity. There could also be more direct implications for supply from the decision to leave the European Union. The UK's trading relationships are likely to change, but precisely how will be unclear for some time. If companies are uncertain about the future impact of this on their businesses, they could delay decisions about building supply capacity or entering new markets. In addition, in anticipation of the UK's new trading arrangements, a period of resource reallocation could be necessary as some sectors of the economy expand and others contract. As a result of these factors, the MPC expects supply growth to remain well below past average rates throughout its forecast period.

The combination of these demand and supply factors means that cumulative GDP growth is expected to be around 2½% lower by the end of the forecast period than was the case in May. On balance, even after stimulus, a margin of spare capacity is expected to open up and the unemployment rate is expected to rise from its current level of 4.9% to around 5½% over the next two years.

Exchange rate

The fall in sterling will push up on import and consumer prices notably over the next three years. Indeed, despite the much weaker outlook for activity, CPI inflation in two years' time is projected to be higher than expected in May, reaching 2.4% at both the two and three year points of our forecast.

Policy trade-off

The MPC's Remit recognises that when the effects of shocks persist over an extended period, the MPC is likely to face an exceptional trade-off between returning inflation to target promptly and stabilising output. When this is the case, the Remit requires the

MPC to explain how it has balanced that trade-off, including the horizon over which it aims to return inflation to target.

Fully offsetting the persistent effects of sterling's depreciation on inflation would require exerting further downward pressure on domestic costs, implying even more lost output and a total disregard for higher unemployment. In my judgement, such outcomes would be undesirable in themselves and, moreover, would be unlikely to generate a sustainable return of inflation to the target beyond the MPC's three-year forecast period.

As a result, in order to mitigate some of the adverse effects of the shock on growth, I judge it appropriate to set policy so that inflation settles at its target over a longer period than the usual 18-24 months.

Policy response

To achieve this balance, I voted for a timely, coherent and comprehensive package of measures in August.

First, the response is timely because the combination of the markedly weaker outlook for the economy and the lags in the transmission of monetary policy dictate the need for stimulus now. For example, cutting Bank Rate will immediately ease financing conditions for households and firms, thereby supporting activity. Around half of mortgagors have floating rate contracts and more than four-fifths of bank loans held by firms are at floating rates; lower interest rates will be felt immediately in the economy.

Second, the package of measures is coherent. I recognise the risk that, when interest rates are very low, Bank Rate cuts might not be fully passed on to the interest rates actually faced by households and firms. There have been examples overseas of interest rates on loans increasing when official policy rates have been reduced from very low levels. The MPC is determined that the stimulus the economy needs does not get diluted as it passes through the financial system. That is why I supported the launch of a new Term Funding Scheme. The TFS will reinforce the transmission of cuts in Bank Rate to the interest rates actually faced by households and firms.

Compared to the old Funding for Lending Scheme, the TFS is a pure monetary policy instrument that is likely to be more stimulative pound-for-pound. Specifically, it reinforces Bank Rate cuts, reduces the effective lower bound of Bank Rate to close to but a little above zero, charges a penalty rate if banks don't lend, covers all types of lending, and is funded by central bank reserves. UK banks and building societies could borrow up to £100 billion over the next year at rates that neutralise the effects that could otherwise cause them not to pass on the new lower Bank Rate to end borrowers.

The coherence of the MPC's stimulus package is further enhanced by a joined-up approach across the Bank, including:

- The FPC's decision today to amend the leverage ratio framework for UK banks by excluding central bank reserves. This gets a regulatory constraint out of the way of monetary policy operations without compromising financial stability;
- The FPC's earlier action to increase the availability of credit by up to £150 billion by cutting the counter-cyclical capital buffer rate to zero and emphasising that banks' liquidity reserves are usable; and
- The PRA Board's decision to use regulatory flexibilities to smooth insurers' transition to new regulatory standards in a very low interest rate environment.

Third, the package is comprehensive. The cut in Bank Rate, the new Term Funding Scheme, the new corporate bond purchases and the expansion of gilt purchases work through multiple channels, are mutually reinforcing, and more powerful as a result. In the absence of these actions, output would have been lower, unemployment higher, and slack greater over the forecast period, and the return of inflation to the target would have been less sustainable.

The purchase of up to £10 billion of UK corporate bonds will support the real economy by directly affecting financing conditions for companies that make a material contribution to UK economic activity. By supporting investment, this action should improve the monetary policy trade-off with inflation. By acting in capital markets, it will be complementary to the TFS which reinforces the bank lending channel. And by lowering credit and liquidity premia, corporate bond purchases are an efficient means of providing stimulus.

Expanding the stock of gilts held in the Asset Purchase Facility by £60 billion will reinforce the transmission of lower Bank Rate to longer-term market interest rates. In addition, by triggering a process of portfolio rebalancing among sellers of long-dated gilts, gilt purchases will transmit to other risky asset prices, easing financial conditions and providing additional stimulus directly.

Conclusion

The MPC has worked closely with the Bank's other committees to understand how conventional and unconventional monetary measures interact with the financial system. We have tailored our approach to avoid unintended consequences. This joined-up approach, using multiple channels, will ensure that stimulus will have maximum impact on the real economy.

By acting now, the MPC is supporting the necessary adjustments in the UK economy and ensuring a more sustainable return of inflation to the target in the medium term. The package of measures I supported in August is timely, coherent and comprehensive. It is appropriately sized given the scale of the shock, uncertainties about the degree of the adjustment, and relatively limited data.

All of the elements in this package have scope to be increased. There is scope to lower Bank Rate, increase the size of the TFS, and expand the scale or variety of assets held in the Asset Purchase Facility.

The Bank continues to stand ready to take whatever action is needed to achieve its objectives for monetary and financial stability as the UK adjusts to new realities, and moves forward to seize new opportunities, outside the EU.

Explaining monetary policy

Over the past year, I have delivered five on-the-record speeches covering aspects of monetary policy (in addition to ten on-the-record speeches covering other issues relevant to the Bank of England's responsibilities) and given four *Inflation Report* press conferences (and two press conferences on the *Financial Stability Report*). I have also given ten other talks on monetary policy to other stakeholders. I have given evidence to the Treasury Committee regarding monetary policy on five occasions (in addition to four other evidence sessions) and have also given evidence to the House of Lords Economic Affairs Committee.

In addition, as required by the Bank's monetary policy remit, I have written four open letters to the Chancellor on behalf of the MPC explaining the reasons for continued low inflation. I also wrote to the Chancellor requesting an extension of the indemnity for the Asset Purchase Facility in light of the MPC's August monetary policy decision. All of these letters are in the public domain.

In response to questions raised by the Treasury Select Committee, I have written letters on topics including liquidity conditions, the size of the Bank's balance sheet and the UK's membership of the EU.

Over the past year, I have attended meetings of various different international bodies to explain the monetary policy position in the UK. This includes speaking at the G7, G20, IMF, FSB (as Chair), ESRB (as Vice-Chair), BIS and the World Economic Forum. I have also participated in roundtable events in China, the US and the EU to allow more in-depth engagement with stakeholders. I have held bilateral meetings with numerous central bank governors and finance ministers from around the world over the course of the year to continue engagement on the MPC's decisions.

Over the past year I have engaged in numerous activities to promote public understanding of monetary policy and to hear directly from stakeholders. This year, I have made seven visits around the United Kingdom to hear perspectives on the economic outlook first hand. These included on-site company visits, roundtable events with local business people, third-sector stakeholders and talks to local schools.

I have also reiterated the Bank's public messages and heard the perspectives of a range of professional associations and business groups, including the British Retail Consortium, Financial Sector Forum, Business Advisory Group and the World Business Council, as well as having a wide range of *ad hoc* meetings with industry groups, from farming to FinTech, to hear directly their perspectives on economic developments.

This past year, the Bank launched the ‘Open Forum’ which brought together policymakers, financial market participants and users, academics, media representatives and the general public to discuss the role of markets in society.

I have further corresponded with many members of the public, MPs and their constituents in response to letters that they have sent me about the MPC and monetary policy. The Bank’s enquiries team has received and responded to almost 1000 letters to the Bank about monetary policy from members of the public.

Finally, I have given 21 national television, radio and print interviews, three regional print and broadcast interviews and two international media interviews.