Report to the Treasury Committee

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Economy and voting record

Context

My previous report to this Committee was sent on 2 September 2016, and focussed on the MPC's decision to loosen policy following the referendum. In what follows, I will reflect on developments over that whole period, not just the past twelve months.

To provide some context, the MPC had said ahead of the referendum that, in the event of a vote to leave, sterling would fall, perhaps sharply, inflation would rise and growth would slow, due to the squeeze on real incomes and elevated uncertainty weighing on household consumption and investment.

That is, by and large, what has happened.

The exchange rate fell by over 10% in the wake of the vote and remains some 16% below its level before the referendum came into prospect in late 2015. That largely reflects the judgements of financial market participants about the likely impact of Brexit on the United Kingdom's relative economic prospects. This is evident in other asset prices, such as UK-focused equity prices, which have significantly underperformed international indices by around 35pp. Risk premia on UK-focused equities have risen by 300 bps relative to the S&P500. Implied volatilities on sterling currency pairs also continue to be higher than for other major currencies.

As expected, the fall in the exchange rate has pushed inflation above the target. CPI inflation was 3.0% in December 2017 and is expected to fall back gradually as the effects of the depreciation diminish. Exchange rate pass-through has a substantial and prolonged effect in the UK. Based on past experience, around 60% of changes in the exchange rate tend to be passed through to non-energy import prices, which account for around 30% of the CPI basket. On average, less than half of the overall amount of pass-through comes through within the first year, and it takes around four years in total for pass-through to complete. Thus far, that judgement looks broadly on track.

Activity has, however, proved stronger than anticipated in August 2016.

In part, that reflects a stronger global economy. The global economy began picking up, ultimately quite robustly. Global growth is now stronger, broader and healthier than it has been for some time. The global economy is growing at its fastest pace in seven years, with 90% of the world growing at above-trend rates. The global expansion is also being increasingly driven by investment.

The stronger world economy is supporting UK activity through demand for our exports, and easier financial conditions. Whereas it usually drags on growth, net trade is currently contributing substantially.

Uncertainty has also weighed less on demand than expected – both because it fell back from elevated levels immediately after the referendum and because what uncertainty there was had a smaller effect, particularly on household spending.

In part, that might be because financial conditions decoupled from uncertainty. This partly reflects decisive actions taken by the Bank. The MPC's August 2016 policy package was complimented by actions taken by the FPC (reducing the countercyclical buffer for banks) and the PRA (to help banks manage liquidity around the referendum).

The lower-than-expected impact of uncertainty was particularly evident in the response of households. Perceptions of job security remained strong. Nominal wage growth remained at around the same modest pace as at the start of 2016. Credit remained available and competitive. And consumer confidence held up.

Households have also reacted more to changes in their current real income, and less to possible changes in their future long-run income than the MPC had anticipated in August. Nevertheless, consumption growth has slowed in response to the squeeze in real incomes, halving since the referendum. Overall, real wages are 3½% lower and consumption around 2% weaker than projected immediately before the referendum, in the May 2016 *Report*.

Business investment has been stronger than projected in August. That reflects the support from strong global growth, high rates of return, the low cost of capital and supportive financial conditions. Nevertheless, business investment is being restrained by Brexit-related uncertainties. Our most recent Decision Maker Panel survey, that surveys 2,400 businesses, estimates it reduced investment by 3-4% last year. This remains the shallowest UK investment recovery in more than half a century.

Fiscal policy has been loosened relative to expectations at the time of the August 2016 projections.

Nevertheless, despite that support and the stronger world economy, UK output was around 1% lower at the end of 2017 than projected in May 2016 – the MPC's forecast made immediately prior to the referendum, which was conditioned on remaining within the EU (the Government's policy at the time). That shortfall is expected to increase to closer to 2% by the end of this year.

Policy trade-off and policy response

The biggest influence on, and source of uncertainty about, the economic outlook remains Brexit.

In such exceptional circumstances, the MPC's remit specifies that the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably back to the target and the support that monetary policy provides to jobs and activity. The Committee has long emphasised that the effects on inflation of the Brexit process would be the product of its impact on demand, supply and the exchange rate. And it has consistently stressed that as a result, the implications for monetary policy would not be automatic.

Chart 1 provides a simple framework for illustrating how the MPC has been managing the monetary policy trade-off that has emerged since the referendum. The red lines illustrate the potential trade-offs that the Committee could strike: mapping the size of the inflation overshoot that it could be prepared to tolerate for a given amount of spare capacity, and vice versa. The flatter the line, the less weight the Committee places on output stabilisation and the more it is willing to tolerate large output gaps in order to eliminate small overshoots in inflation.

Chart 1 also demonstrates how the expected trade-off has evolved in successive MPC forecasts since the referendum. It shows the MPC's central projections at Year 2 for CPI inflation on the vertical axis against those for spare capacity (the opposite of excess demand) on the horizontal axis from successive *Inflation Reports* since August 2016. The projections are conditioned on the market yield curves prevailing at the time the forecasts were made.

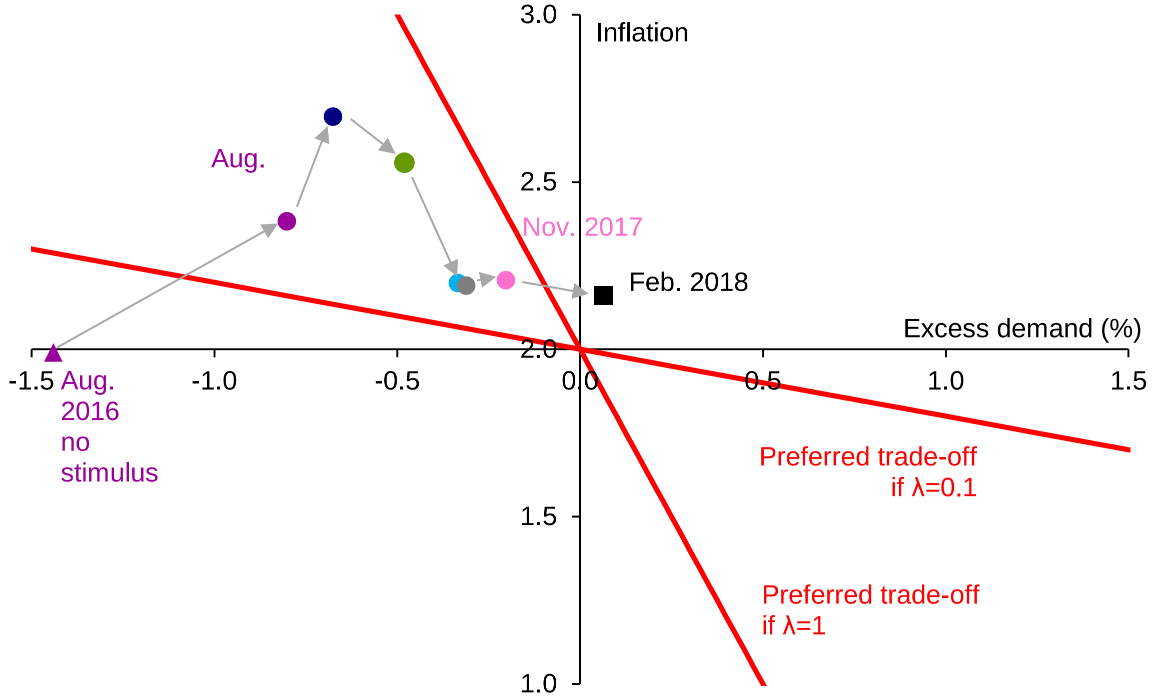
Following the vote to leave the European Union, there remained a significant margin of slack in the economy and, consistent with its remit, the MPC implemented a package of easing measures to balance that trade-off.

Since then, the Committee has managed policy to diminish steadily the trade-off, increasing employment, using up the expected degree of spare capacity in the economy, and reducing the expected overshoot of the inflation target.

Accordingly, over the course of last year, a steady absorption of slack – evident in the dots showing the successive *Inflation Report* projections in Chart 1 – has lessened the trade-off facing the MPC and reduced the degree to which it was appropriate to accommodate an extended period of inflation above the target. This is evident in Chart 2 where the economy was forecast in November 2017 to move into small excess demand at Year 3 while inflation remained above target (the pink dot).

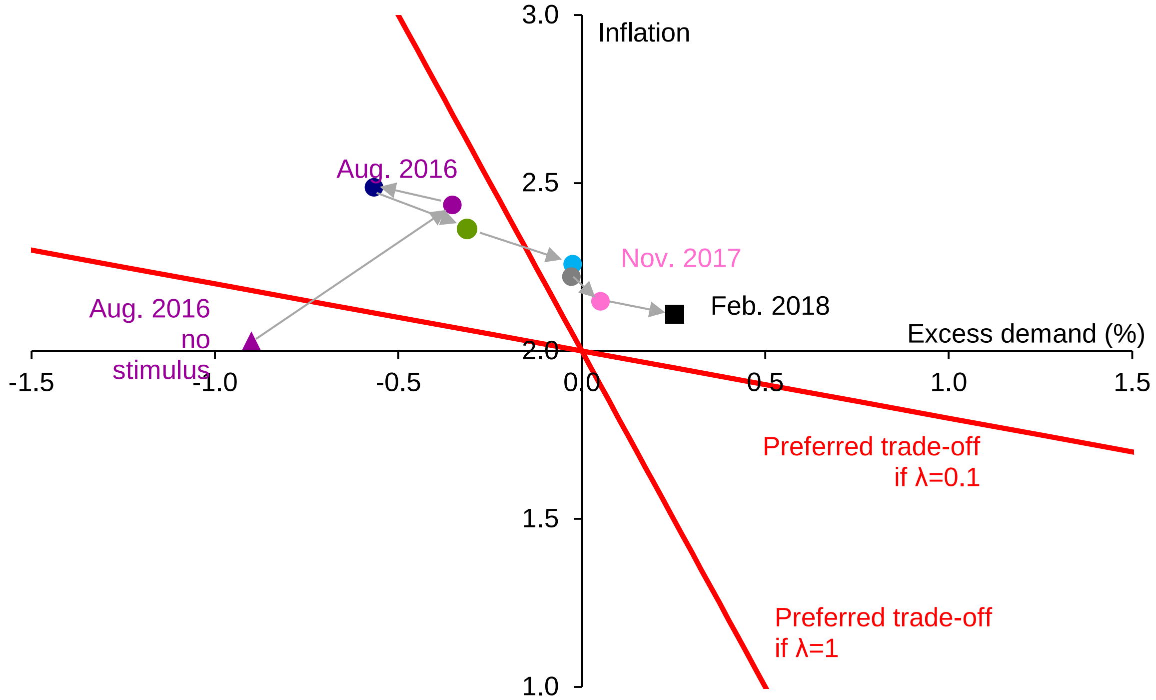
Consequently, at the MPC's November 2017 meeting, I judged it was necessary to tighten modestly the stance of monetary policy in order to return inflation sustainably to the target, and voted – along with the rest of the Committee – to raise Bank Rate by ¼ percentage points to ½%.

Chart 1: The trade-off in successive Inflation Report forecasts at Year 2



Notes: Each observation shows the central projection for spare capacity or excess demand at the end of the second year of the forecast period (the 'Year 2' point) on the horizontal axis against the central projection for four-quarter CPI inflation at Year 2 on the vertical axis from successive *Inflation Reports*. The left-most observation (labelled "Aug. 2016 no stimulus") is a counterfactual version of the August 2016 *Inflation Report* forecasts with the effect of the MPC's Bank Rate cut, Term Funding Scheme and Asset Purchases removed. See the "Lambda" speech of 16th January 2017 for further details and discussion.

Chart 2: The trade-off in successive Inflation Report forecasts at Year 3



Since November, the prospect of a greater degree of excess demand over the forecast period and the expectation that inflation would remain above the target have further diminished the trade-off that the MPC is required to balance (see the black squares in Charts 1 and 2). It is therefore appropriate to set monetary policy so that inflation returns sustainably to its target at a more conventional horizon.

As a consequence, the Committee now judges that, were the economy to evolve broadly in line with the February *Inflation Report* projections, monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November *Report*.

At its February policy meeting, all members thought that the current policy stance remained appropriate to balance the demands of the MPC's remit. The outlook for growth and inflation was likely to require some ongoing withdrawal of monetary stimulus. All members agree that any future increases in Bank Rate are expected to be at a gradual pace and to a limited extent. The Committee will monitor closely the incoming evidence on the evolving economic outlook, and stands ready to respond to developments as they unfold to ensure a sustainable return of inflation to the 2% target.

Explaining monetary policy

To ensure that our policies are effective, the Bank needs to be understood, credible and trusted. We do this by being transparent about what we do and why we take policy decisions so that people can hold us to account.

This means communicating to members of the public, businesses, and market participants.

To communicate with markets and technical audiences, I have continued to explain monetary policy and my voting record through traditional existing approaches, including through speeches, press conference and committee appearances, meetings with businesses and regional outreach visits.

Since September 2016, I have participated in 119 speaking engagements about the Bank's work, including five on-the-record speeches covering aspects of monetary policy and given six *Inflation Report* press conferences (and three press conferences on the *Financial Stability Report*).

I gave evidence to the Treasury Committee four times before the Committee was suspended ahead of last year's general election and twice after it was subsequently reformed (once in a hearing that covered all aspects of the Bank's work and once in an evidence session on the Bank's November 2017 *Financial Stability Report*). I have also given evidence to the House of Lords Economic Affairs Committee on two occasions since my last report.

In addition, as required by the Bank's monetary policy remit, I have written two open letters to the Chancellor on behalf of the MPC explaining the reasons for low inflation in late 2016 and one this month to explain elevated inflation following the referendum vote. I also wrote to the Chancellor requesting a further extension of the indemnity for the Asset Purchase Facility in light of the MPC's August 2016 monetary policy decision. All of these letters are in the public domain.

I have made eight visits around the United Kingdom to hear from business leaders from a range of sectors on their perspectives on the economic outlook. These included on-site company visits, roundtable events with local business people, and third-sector stakeholders including the voluntary sector, unions and schools.

Since September 2016, I have attended a number of international meetings to explain the monetary policy position in the UK. This includes speaking at the G7, G20, IMF, FSB (as Chair), ESRB (as First Vice-Chair), BIS (as Chair of the Global Economy Meeting and the Economic Consultative Committee since 1 December 2017) and the World Economic Forum. I have also participated in roundtable events in China, India, 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.

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, Confederation of British Industry and the Banking Standards Board, as well as having a wide range of *ad hoc* meetings with industry groups to discuss how developments are shaping the economic outlook.

To explain monetary policy to a broader audience, the Bank has made how we communicate central to our new strategy: Vision 2020. That's because our policies work better if our objectives are clear and the British people have confidence that we will do the right thing whatever happens.

We have revamped our publications to make them more accessible. We produce more creative content targeted at different audiences that can be more readily shared on social media. We started with the November *Inflation Report* in 2017, using icons and graphics to convey our messages on webpages designed for mobiles and tablets, rather than relying only on pages of words on paper. We boiled down a 50 page report to a single webpage that provides a visual summary of our monetary policy decision and the main judgements that shaped the decision.

The second strand of this strategy is to develop our education and outreach. We need to equip the next generation with the tools and skills they need to understand the economy, as well as our role in it. As part of this we have developed more teaching materials for schools, as well as building new partnerships with other educational organisations to extend our impact and reach.

Since September 2016, I have engaged in a number of events to develop public understanding and expand our outreach. This includes five school visits and hosting two ‘Future Forums’ (which followed on from the ‘Open Forum’ event in 2015) across the country.

In 2016 I travelled with my fellow Deputy Governors to Birmingham to host a Future Forum to discuss with members of the public how the Bank of England can maintain stability in times of change and serve society. We met almost 400 people during the day, 80% of whom agreed they had a good experience at the Future Forum.

The 2017 Future Forum in Liverpool was run in partnership with Economy and Rethinking Economics, two organisations that are at the forefront of the campaign to make economics open, relevant and accessible. The event brought together 300 people across two sites and over 10,000 online to discuss what the Bank has been doing to make the economy and our work more accessible to all, and showcased our new education programme, our revamped major publications and our new website.

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. In total the Bank has received and responded to almost 1000 letters to the Bank about monetary policy from members of the public.

Finally, I have given 40 national and regional television, radio and print interviews since September 2016.