Report to the Treasury Committee

Mark Carney, Governor of the Bank of England

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Economy and voting record

Context

At the time of my previous report, the global economy was growing at its fastest pace in several years. More than three-quarters of the world was growing at above-trend rates (see **Chart 1**), and the global expansion was increasingly driven by investment and trade. Global financial conditions were highly accommodative.

This strong global environment was supporting UK activity. UK growth had picked up slightly, from its slow pace earlier in 2017, with net trade benefiting from strong external demand and the past depreciation of sterling. British exporters were in a sweet spot, with sterling down around 16% overall (and around 20% against the euro) relative to its November 2015 peak in anticipation of a Brexit that had not yet happened.

Domestic demand growth was relatively modest, despite accommodative financial conditions, and solid household and corporate balance sheets. The drag from Brexit-related uncertainty was restraining business investment. Consumption growth was subdued as households were adjusting to the squeeze in real incomes following sterling's past depreciation.

CPI inflation was around 3.0%. The overshoot of the MPC's 2% target was entirely due to the effects of higher import prices as a result of sterling's depreciation. I expected inflation to fall back gradually to target over the next few years, as external factors gradually diminished and domestic inflationary pressures firmed with the economy moving from excess supply into excess demand.

Against this backdrop, I judged (along with the rest of the MPC) that it would likely be appropriate to reduce the degree of accommodation at a limited pace and to a gradual extent in order to return inflation sustainably to target.

In the following months, it became clear that the economy had slowed sharply in the first quarter with GDP growth of 0.1%, its weakest pace in six years. Inflation also came in notably lower than expected.

By the time of its May meeting, the MPC faced the key question whether that softness in activity would prove temporary or persistent; in other words, was the weakness in the first quarter due to disruptive weather or a new weaker *economic* climate?

At the time, I judged that the weakening in activity largely reflected the weather, and that the underlying pace of growth was more resilient than the headline data suggested. I joined the majority of the MPC in judging that it was appropriate to maintain the accommodative stance of monetary policy in May recognising the value in seeing how the data unfolded over the coming months. The costs to waiting for additional information appeared modest, given the need for only limited tightening over the forecast period to return inflation sustainably to the target. I explained this approach in a speech to the Society of Professional Economists on 24 May 2018. I believe that ensuing events were consistent with that judgement.

By August, incoming data was consistent with the view that the dip in activity in the first quarter was temporary. A number of indicators of household spending and sentiment had bounced back strongly, employment growth had remained solid, and surveys of business activity had been stable. The labour market had also continued to tighten. Unemployment was at a 42 year low, the employment rate and number of vacancies were at record highs, and job-to-job flows were around pre-crisis levels. Indicators of pay growth had continued to strengthen (see **Chart 2**), broadly as expected. Private sector wage growth has increased to a little under 3%, up from 2½% in 2017 and 1½% over 2010-14.

With evidence of domestically generated inflation building and the prospect of excess demand emerging, in August I judged that a modest tightening of monetary policy would be appropriate to return inflation to the 2% target sustainably, and voted along with the rest of the MPC to raise Bank Rate by ¼ percentage points from ½% to ¾%. This increase in Bank Rate was another step on the path of the gradual removal of policy stimulus which had begun in November 2017.

Since August, a series of transitions both at home and abroad have affected the outlook for the UK economy and the stance of monetary policy.

At home, business investment weakened further in second half of 2018 and evidence suggested this primarily reflected Brexit-related uncertainty. On the most recent data, business investment fell 3.7% over the past year and its level is now lower than prior to the referendum (see **Chart 3**). The Bank's Decision Maker Panel of over 7000 firms suggested that Brexit's importance as a source of uncertainty has risen, and the Bank's Agent surveys of investment intentions cites Brexit as the largest headwind to capital spending.

Global momentum weakened over the autumn in all major regions and downside risks intensified. By late 2018, the proportion of the global economy growing above trend had fallen to one-third (see **Chart 1**). As a result, financial markets now expect more accommodative monetary policies in all major economic areas.

The deceleration of the global economy reflects the shift from accommodative to tighter financial conditions over 2018, rising trade tensions, and growing policy uncertainty. The impact of growing protectionism on the global economy is an issue I had spoken about earlier in the year at the Northern Powerhouse Business Summit in July, and again in February of this year at Frobisher Hall.

UK growth slowed sharply in late 2018 and appears to have remained weak in early 2019. This slowdown reflects softer activity abroad and greater effects from Brexit uncertainties at home.

The current outlook is clouded by uncertainty around the UK's economic relationship with the EU. This uncertainty is creating a series of tensions for business, households and in financial markets that will cause short-term volatility in the economic data, which I expect to provide less of a signal about the medium-term outlook.

Judging the appropriate stance of monetary policy requires focusing on the more persistent factors affecting inflation. The fundamentals of the UK economy are sound. The financial sector is resilient. Corporate balance sheets are strong. And the labour market is tight.

In the February 2019 *Inflation Report*, I voted to keep Bank Rate unchanged and noted that if conditions evolve in line with our projections, which are conditioned on the assumption of a smooth transition to the average of a range of possible outcomes, limited and gradual rate rises are likely to be needed to return inflation sustainably to target.

Providing Guidance on the MPC's Reaction Function

The MPC's conduct of policy over the course of the past year has provided important perspective on how it can be expected to react to evolving economic conditions.

The objective of forward guidance is to give insights into the MPC's reaction function – in other words, how the Committee will adjust policy when the outlook for growth and inflation changes.

In a perfect world, guidance would be redundant. People would know how the MPC intends to set rates over the future and how those intentions would adjust to economic developments in all eventualities. But the world is complex and people do not have endless time to devote to understanding monetary policy. In practice, therefore, guidance can be useful in providing people with information about how the MPC sets policy and, over time, in improving understanding of how monetary policy will adjust to news.

Guidance helps people to think along with the Committee so that their expectations about the path of policy adapt with ours as economic circumstances change. This can make monetary policy more effective by reducing unwarranted volatility in interest rate expectations, and as a consequence, the extent to which the MPC has to move Bank Rate to meet the inflation target.

Guidance is not a promise of the future path of policy. And its use will not mean that all observers will agree on the likely path of policy for the simple reason that not everyone will agree on the likely path for the economy. However, with guidance, someone who has a different outlook can better anticipate how the MPC will adjust once the scales fall from the Committee's eyes.

Over the past year, the MPC has provided three forms of guidance.

First, the MPC has consistently stressed that any future increases in Bank Rate were likely to be at a gradual pace and to a limited extent. As a result, interest rate expectations of households and businesses have remained in line with this guidance (see **Chart 4**). This guidance has anchored expectations in financial markets that interest rates will rise at a gradual pace and to a limited extent (see **Chart 5**), and dampened the volatility of interest rates, consistent with the expected and actual path of policy rates. This guidance has reduced the impact of economic uncertainty on short-term interest rates (**Chart 6**).

Second, the MPC provided important, updated guidance on its asset purchases in June of last year. Previously, the Committee had noted that it would not begin reducing the stock of assets until Bank Rate had reached around 2%. That reflected the MPC's preference to use Bank Rate as the primary instrument for monetary policy and its desire to have sufficient scope to cut Bank Rate materially, if necessary to respond to adverse shocks.

Although the principles guiding the MPC's choice of threshold still hold, the creation of the Term Funding Scheme had reduced the effective lower bound on Bank Rate from ½% to 0%. The MPC now views that the level from which Bank Rate can be cut materially is now around 1½%. Reflecting this, the MPC now intends not to reduce the stock of purchased assets at least until Bank Rate reaches around 1½%.

Third, the MPC set out its monetary policy strategy to Brexit in a box in the November 2018 *Inflation Report*. That strategy recognises that Brexit is a regime shift that has markedly increased the range of possible outcomes for the UK economy and therefore the potential paths of monetary policy. The predictability of monetary policy can break down when there are large structural changes in the economy's supply capacity, equilibrium interest rates or trading relationships. In such circumstances, forward guidance can help anchor expectations and improve the effectiveness of monetary policy.

The Committee has stressed that the appropriate response of monetary policy to any particular Brexit scenario will depend on the balance of the effects on demand, supply and the exchange rate.

The MPC discussed and commented on a range of Brexit scenarios produced by Bank Staff, including one consistent with the *Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom* and one consistent with a transition to default World Trade Organisation (WTO) rules. These scenarios were submitted in a report to the Treasury Committee on the 28 November, following a request by the Treasury Committee.

In the case of a smooth transition to a relatively close economic relationship with the EU, the extent to which domestic inflationary pressures increase would depend on the balance between an expected rebound in demand as uncertainty fades, any further impacts on supply over the MPC's policy horizon as investment rebounds and some capacity is retrieved, and the likely appreciation of sterling.

In contrast, a disruptive withdrawal from the EU would probably result in a further decline in the exchange rate and a large, immediate reduction in supply. Tariffs might also be extended. Each of these developments would tend to increase inflation. Set against that, it is likely that demand too would weaken, reflecting lost trade access, heightened uncertainty and tighter financial conditions. The overall extent of inflationary pressures would depend on the balance of these forces, as well as the evolution of inflation expectations.

Although the nature of EU withdrawal is still uncertain at present, and its impact on the balance of demand, supply and the exchange rate cannot be determined in advance, under all circumstances, the MPC will respond to any material change in the outlook to bring inflation sustainably back to the 2% target while supporting jobs and activity. The MPC have made clear that the response of monetary policy to Brexit is not automatic and could be in either direction.

As my colleague Gertjan Vlieghe has noted, that does not necessarily mean that, in the event of a no deal no transition scenario, either direction of policy is equally likely. Given the exceptional circumstance associated with Brexit, I would expect the Committee to provide whatever monetary support it can consistent with the price stability remit given to the Committee by Parliament. But there are clearly limits to its ability to do so. Moreover there are possible no deal, no transition Brexit scenarios, particularly those in which there is a material hit to the supply capacity of the economy and inflation expectations threaten to become less well anchored, where the MPC's tolerance for a sustained overshoot of the inflation target could be breached and some tightening of monetary policy would therefore be required to bring inflation back sustainably to target consistent with the MPC's statutory duties.

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 with members of the public, businesses, and market participants.

Traditional outreach activities

I have continued to explain monetary policy and my voting record through existing approaches, including speeches, press conference and committee appearances, meetings with a wide range of businesses, and regional outreach visits.

Over the past year, I have participated in 102 speaking engagements about the Bank's work, including six on-the-record speeches covering aspects of monetary policy and given four *Inflation Report* press conferences (and two press conferences on the *Financial Stability Report*). I have given evidence to the Treasury Committee on monetary policy four times, and once on the Bank's report on the UK's withdrawal from the EU at the Committee's request.

I have made five 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 February 2018, 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) and the World Economic Forum. I have also participated in roundtable events in Argentina, 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 over the course of the year to gather perspectives on the global economy.

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 Productivity Leadership Group, as well as having a wide range of *ad hoc* meetings with industry groups to discuss how developments are shaping the economic outlook.

I have also 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 2018, the Bank received and responded to around 340 letters to the Bank about monetary policy from members of the public. I have given 24 national and regional television, radio and print interviews since February 2018.

New outreach initiatives

Explaining monetary policy to a broader audience is central to the Bank's new strategy. We have revamped our publications to make them more accessible, and now produce more creative content targeted at different audiences that can be more readily shared on social media. Building on the introduction of *Inflation Report* visual summaries in November 2017, we launched *Bank Overground* in January 2019. This new digital platform – which compliments *Bank Underground* - publishes bite-size posts that summarise a piece of staff analysis, which supported a policy or operational decision in order to provide more visibility on the evidence that informs our decisions.

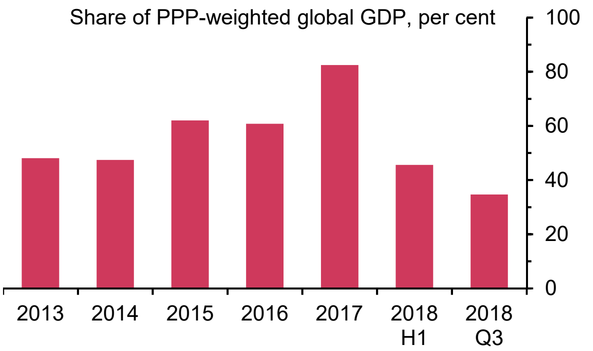
We have also broadened our public outreach and educational initiatives. We have been building new partnerships with other educational organisations to extend our impact and reach, and developed more teaching materials for schools, such as econoME. econoME is a free education resource aimed at young people, designed to be accessible for students and teachers alike, which launched in April 2018. The material is designed to help young people understand the economy better and provide them with the analytical skills to make informed decisions. To date, over 1,300 individual schools have registered for the resources, representing almost 30% of total secondary schools in the UK in 2017/18.

The 2018 Future Forum '*Let's Decide the Future of Money*' was the first held digitally, running on a virtual platform, to involve as many people as possible across the whole of the UK. As part of this Forum, I hosted the culmination event - a roundtable discussion - with my fellow Deputy Governors, 6 industry contacts and 20 of the most engaged platform users.

The Bank also piloted its first set of Citizens' Panels in 2018. The aim of these panels is to establish, in a structured, systematic and comprehensive way, a two-way dialogue and collaboration between the Bank and a panel of citizens on the economy, financial system and policy. The inaugural panels were held in Northern Ireland and North East England in 2018 Q4, and feedback from both events was extremely positive. We are aiming to run 24 panels, 2 in each region, over 2019/20, and expect them to become a permanent feature of our outreach efforts.

Annex

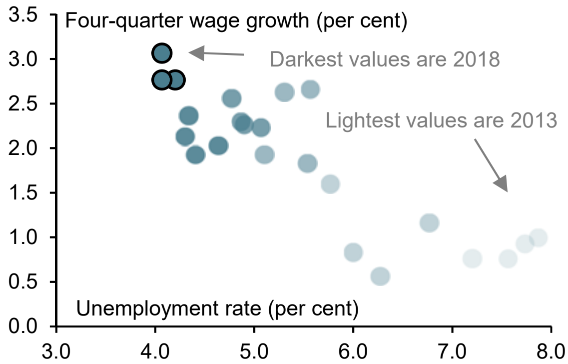
Chart 1: The global outlook has weakened with fewer countries growing above potential



Sources: Datastream from Refinitiv, IMF WEO, OECD and Bank calculations.

Note: Averages of annualised quarterly growth in real purchasing power parity (PPP)-weighted GDP.

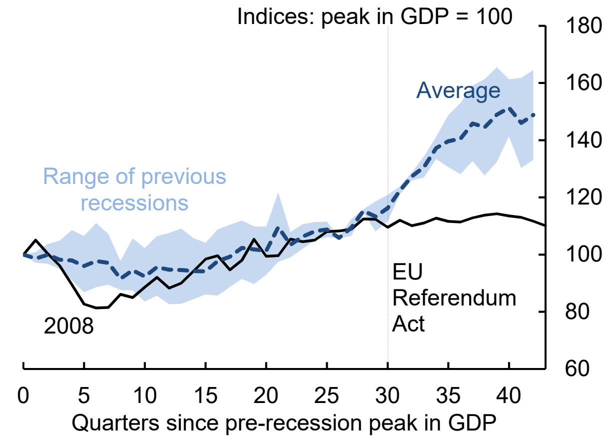
Chart 2: UK wage pressures are building as slack is absorbed



Sources: ONS and Bank calculations.

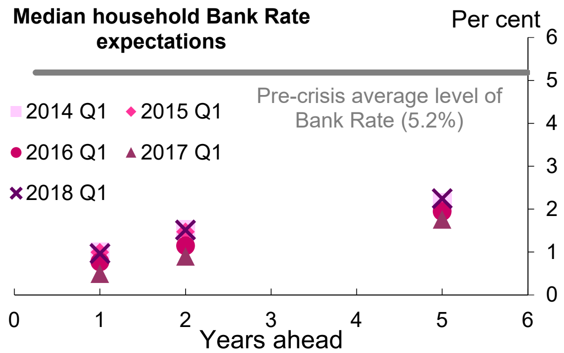
Note: The wage measure is Average Weekly Earnings (AWE) regular pay.

Chart 3: The recovery in UK business investment has stalled since the EU referendum



Sources: ONS and Bank calculations.

Chart 4: Households and businesses have consistently expected increases in interest rates to be gradual and limited



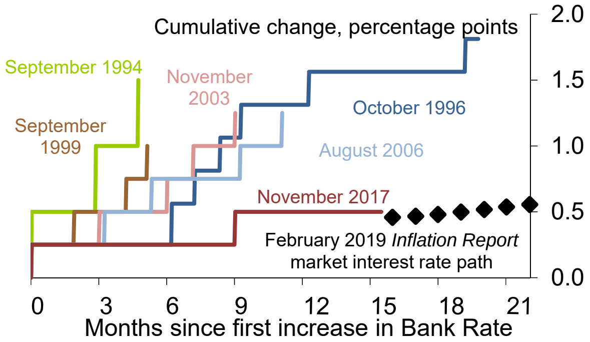
Sources: Bloomberg Finance L.P., ICE, and Bank calculations.

Notes: Household expectations are from the Bank/TNS Inflation Attitudes survey and show how Bank Rate is expected to increase relative to the rate prevailing at the time. Pre-crisis average Bank Rate is calculated from 1997 to 2007 inclusive.

Chart 5:Guidance has anchored expectations in financial markets that interest rates will rise at a gradual pace and to a limited extent

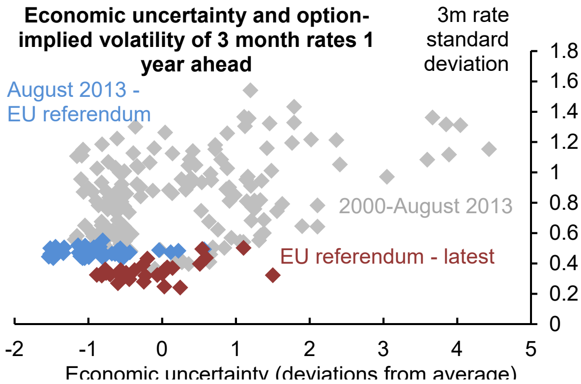
Historic UK Bank Rate tightening cycles

Chart 6: Guidance has reduced the correlation between economic uncertainty and interest rate volatility



Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

Notes: Tightening cycles since the start of inflation targeting in 1992. Tightening cycles are shown up to when interest rates reached their highest level before they were next reduced. The curve is estimated using instantaneous forward overnight index swap rates.



Sources: Bloomberg Finance L.P., ICE, and Bank calculations.

Note: The indicator of economic uncertainty is based on the principal component from seven measures: FTSE and sterling option-implied volatility, dispersion of company earnings forecasts and among forecasters' growth projections, proportion of companies reporting that uncertainty is limiting investment, households' unemployment expectations, and number of press articles citing 'economic uncertainty'.