Report to the Treasury Committee

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Economy and voting record

UK GDP growth was volatile over 2019, largely reflecting the short-term effects of negotiations with the EU. GDP growth was boosted in Q1 by companies building up stocks in order to mitigate the effects of a possible disruptive EU exit on 29 March. For the same reason, some auto firms brought forward their usual summer shutdowns to April. The resulting decline in production weighed on output in Q2, as did the unwind of the effect from stockbuilding. Growth in Q3 was boosted by a rebound in car production, and a small amount of stockbuilding ahead of the October Brexit deadline.

Looking through this volatility, the underlying pace of growth slowed to below its potential rate. Quarterly growth over 2019 as a whole averaged only ¼%, little more than half the average in the previous three years.

Subdued UK growth also partly reflected a weaker external backdrop, which has been weighing on both net trade and investment.

Over the past two years, the global economy moved from a broad-based expansion to a widespread slowdown, with manufacturing slipping into recession, global trade contracting, and overall growth falling to its weakest pace since 2009. Trade protectionism and related uncertainties have clearly weighed on activity. Past tightening in global financial conditions and domestic weakness in some large emerging market economies also contributed to the slowdown.

More importantly, entrenched Brexit-related uncertainties have added to the global drag on UK activity, weighing particularly hard on business investment. Business investment has risen just 1¼% since the referendum, significantly underperforming the rest of the G7, where it has increased by 12% on average over the same period.

Consumer spending has been more resilient, underpinned by strong employment and a pickup in real wage growth. However, there has been evidence of a degree of precautionary behaviour, as consumption has grown less strongly than labour income over the past year. And uncertainty has weighed on the housing market.

Overall, UK growth last year was the weakest since 2010, leaving the economy operating with a margin of excess supply at the end of the year.

In parallel to the loss of momentum in activity, CPI inflation fell below the MPC's 2% target, reaching 1.4% in 2019 Q4. While this weakness largely reflects energy prices, core inflation also slowed, and domestically generated inflation pressures, outside the labour market, have remained contained.

As the minutes of the MPC's meetings throughout 2019 document, the MPC had anticipated that weaker global growth and elevated Brexit-uncertainties would drag on UK growth. The Committee also projected that those headwinds to growth would dissipate over its three-year forecast period. Global growth had been expected to be supported by a partial easing of trade tensions and more supportive financial conditions, the latter in part reflecting the impact of the significant loosening of monetary policy by many central banks over the past year. Elevated Brexit-related uncertainties were expected to subside gradually in this and coming years, consistent with the MPC's Brexit conditioning assumption.[1]

Against this backdrop, the question facing the MPC has been whether the headwinds to UK activity and inflation would fade sufficiently to ensure that growth would recover to above potential rates and inflation would return sustainably to target, or whether monetary policy would need to reinforce the recovery.

Throughout the past year, my view – shared by majority of the Committee – has been that the recovery in confidence and activity would be sufficiently strong without additional support from monetary policy. I therefore voted consistently to maintain Bank Rate at 0.75% and the stock of purchased assets at £435 billion at each meeting.

At the MPC's most recent meeting, however, my decision to hold policy was more finely balanced.

The UK economy lost further momentum towards the end of last year, with the latest GDP data confirming that output stagnated in Q4. Indicators of domestic inflationary pressures have softened, and in my estimation, slack has widened over the past year. Following our annual stocktake of the supply side of the economy, conducted during the January 2020 forecast round, the MPC judged that the weakness in domestic price inflation indicated that the margin of slack has been slightly greater over the past few years than it had estimated previously and the prevailing degree of spare capacity was larger than it had expected at the time of its November *Monetary Policy Report*.

[1] The MPC conditions its forecasts on prevailing Government policy. Consistent with that approach, in the May and August 2019 *Inflation Report*s, the MPC's projections were conditioned on the assumption of a smooth withdrawal of the UK from the EU to the average of a range of possible outcomes. The Committee's November 2019 *Monetary Policy Report* (MPR) projections were conditioned on the assumption of an orderly transition to a deep free trade agreement between the UK and the EU. Its January 2020 *MPR* projections were conditioned on the assumption that there is an immediate but orderly move to a deep free trade agreement with the EU on 1 January 2021.

Against this disinflationary backdrop, early indications were that both of the conditions underpinning the projected UK recovery – the pickup in global growth and reduction in domestic uncertainty – were on track.

The most recent signs at the time of the Committee's January meeting were that global growth had stabilised, reflecting the partial easing of trade tensions and the impact of the significant loosening of monetary policy by many central banks over the past year. The global manufacturing PMI had returned to expansionary territory, helping push the composite PMI to a six month high in December. And the hard data seem to be following suit, with global industrial production swinging from contraction to expansion in November, and recent growth outturns in the US, and non-China emerging market economies coming in slightly stronger than expected.

Domestically, indicators of uncertainty had fallen, broadly as the MPC had expected in its November projections. For example, the proportion of firms citing Brexit as one of their top three sources of uncertainty in the Bank's DMP Survey fell below 45% in January from 55% in November, and sterling implied volatilities had fallen substantially since the election.

While hard data, released in January but related to activity prior to the election, was generally soft; more timely survey data that relate to output growth following the election had increased sharply, with the movements particularly marked in the most recent releases. The latest surveys available at the time of the MPC's January meeting suggested that growth will pick up in the first quarter to around 0.2%, in line with the MPC's projections three months ago.

Businesses had reported a sharp rise in investment intentions in the recent manufacturing CBI and Deloitte CFO surveys. And there were signs that lower uncertainty is boosting housing market activity, the area of consumer spending where the drag from Brexit had been most evident.

The latest data also show that the labour market remained resilient, with employment growing strongly towards the end of last year and unemployment at its lowest level in over 40 years. Vacancies rose modestly in December, reversing the pattern of near-continuous falls since the start of 2019 and tempering earlier signs of a slowing in labour demand. Households remained confident about their own financial situation, and their confidence about the general economic outlook had improved to its highest level in a year and a half.

Reflecting these positive developments, I continued to judge that it was appropriate to maintain policy.

To be clear, these are still early days, and it is less of a case of so far so good, than so far, good enough. It will be important for the hard data on activity to follow through on the recent pickup in the surveys, and for domestic price inflation to strengthen.

Though the global economy looks to be recovering, caution is warranted. Evidence of a pickup in growth is not yet widespread. And any one of the known risks, such as a renewal of trade tensions, could reverse recent progress. The threat from a new strain of coronavirus is a reminder of the need to be vigilant. At a minimum, COVID-19 will disrupt activity in the world's largest economy and impact trade. Though the tragic human cost of the virus is all too apparent, it is too early to tell whether its economic impact will track that of other viral epidemics like SARS, impacts that have tended to be relatively short-lived.

In the UK, although early signs are encouraging, the recoveries in growth and inflation are also not yet assured. Uncertainty is still elevated by historical standards. Stronger investment intentions need to be translated into action. Domestic price inflation has remained muted even as growth in unit labour costs has risen. Core inflation has slowed over the past year, and core services inflation has generally been some way below the rate estimated to be consistent with inflation at target.

It should also be noted that, by comparison, the MPC's January projections do not make any provision for the upcoming Budget. A material expansion of fiscal policy could have a notable impact on the prospects for growth and inflation, and therefore monetary policy. The MPC will make these assessments in due course.

Should either the more positive signals from recent indicators of global and domestic activity not be sustained or should indicators of domestic prices remain relatively weak, monetary policy may need to reinforce the expected recovery in UK GDP growth. Further ahead, if the economy recovers broadly in line with the MPC's latest projections, some modest tightening of policy may be needed to maintain inflation sustainably at the 2% target.

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I would like to conclude this section with a few reflections on monetary policy more broadly.

During my term as Governor, the UK economy has experienced shocks and structural developments ranging from a major positive shock to labour supply to persistently weak productivity growth, a very large and sustained fall in equilibrium interest rates, and potentially deep changes to its trading relationships.

Throughout this period, inflation targeting has proved to be a framework for all seasons, delivering price stability and supporting jobs and activity. Despite the economy being buffeted by diverse and sizable shocks since the UK recovery began in early 2013, inflation has averaged 1.7%; GDP growth has generally been robust, averaging around 2%, and above the subdued rate of potential supply growth. The wide margin of spare capacity present after the crisis has largely been absorbed, the unemployment rate is at multi-decade lows, and employment at an all-time high, having risen by 3 million net jobs. Real wages have finally returned to relatively strong rates of growth. Inflation expectations have remained anchored to the target, even when CPI inflation has temporarily moved away from it.

The MPC has employed a range of policy initiatives to achieve the inflation target and, subject to that, support growth and activity. It provided forward guidance, first to secure the nascent recovery in 2013 at a time of substantial uncertainty about the supply potential in the economy by linking policy to unemployment, a widely understood indicator of slack; again in early 2014, when recognising that the fall in equilibrium interest rates meant that 'limited and gradual' rate rises were expected to be appropriate to eliminate slack and keep inflation close to the target; and more recently, following the referendum, when the MPC noted that the response of monetary policy to Brexit would depend on the balance of its effects on demand, supply and the exchange rate. Monetary policy has also coordinated with macroprudential policy when required. For example, following the Brexit vote, the MPC implemented a large, comprehensive stimulus package, whose coherence was further enhanced by the actions of the FPC, including cutting the counter-cyclical capital buffer to zero and emphasising that banks' liquidity reserves were usable.

In my view, this time of consequence provides some important lessons about the effectiveness of the current inflation targeting framework.

- First, <u>the flexibility inherent in inflation targeting is highly valuable</u>, particularly when combined with mechanisms to improve transparency and accountability. This was particularly evident following the Brexit referendum, when the MPC's aggressive monetary easing, despite a sharply depreciating currency and rising inflation, was made much more effective by the new requirements under its remit to explain clearly the trade-off it was pursuing. However, the value of flexibility applies more generally, given the UK is subject to unusually large and protracted exchange rate pass-through that can affect inflation at the policy-relevant horizon.

  This goes to a more general point: a variety of aspects of the UK's monetary policy framework – including our open letters, our new MPR and greater clarity over forecast assumptions and sensitivities – are designed to help market participants, businesses and households understand the MPC's reaction function and thereby anticipate how monetary policy will evolve with the economy. This makes policy both easier to predict and more effective. In the past seven years, interest rate volatility has been exceptionally low and the interest rate expectations of households and businesses have been aligned with the MPC's limited and gradual guidance.[2]

- Second, monetary policy is also more effective when it is combined with vigilant macro- and micro-prudential policies. In many situations monetary policy actions are complementary to financial stability. After all, stimulating more risk taking is one of the goals of low policy.

  More fundamentally, risks to financial stability should primarily be addressed by (macro and micro) prudential policy, with monetary policy as the last – not the first – line of defence. This approach is now codified in the UK institutional set-up, with independent monetary and financial policy committees that are required by remit to have regard of the actions of each other. By addressing macro financial risks at source and building *systemic* resilience, the PRC and FPC allow monetary policy to concentrate on its job of delivering price stability.

- And third, "unconventional policies", including asset purchases and forward guidance, are powerful policy tools in a low r* environment with more frequent encounters with the effective lower bound.

  A growing body of research shows that asset purchases led to substantial, long-lasting, reductions in long-term yields, providing support to activity when policy rates are constrained. Bank staff estimate that the MPC's £60 billion of asset purchases in August 2016 were equivalent to a Bank Rate cut of around 50 basis points. As the MPC noted at the time, there was considerable scope to increase purchases and to use the Term Funding Scheme to reinforce the pass through of further cuts to Bank rate had additional stimulus been required. At present, the wide range and the effectiveness of the MPC's unconventional policy tools mean that the MPC has considerable monetary policy ammunition, if required.[3]

[2] See my speech 'Guidance, Contingencies and Brexit', given at the Society of Professional Economists, 24 May 2018.
[3] See my speech 'A framework for all seasons?', given at a Bank of England Research Workshop on *The Future of Inflation Targeting*, 9 January 2020.

Looking ahead, deep structural changes in advanced economies are creating disinflationary pressures at a time when conventional monetary policy space is already limited. Inflation targeting frameworks will be tested in new ways. In particular, this environment raises questions over whether the current inflation targeting framework will provide monetary policymakers sufficient scope to respond to adverse shocks to demand, whether it needs to be adjusted or even replaced.

As I noted in my written and oral testimony when I first appeared in front of this Committee, and as I reiterated in a speech at the start of this year, the bar to changing the current framework is high. We should not lose sight of the fundamental success in achieving price stability that has resulted from delegation of inflation targeting to an independent central bank.

However, as I also noted when I first appeared, it is valuable to review the monetary policy framework periodically. Open, periodic reviews reinforce the legitimacy and acceptance of this vital component of the UK's macroeconomic landscape. And they can yield valuable insights on how we can best operate the framework in ways that maximise the welfare of UK citizens.

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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 80 speaking engagements about the Bank's work, including five on-the-record speeches covering aspects of monetary policy, and given four *Monetary Policy Report*[4] press conferences (and two press conferences on the *Financial Stability Report*). I have given evidence to the Treasury Committee on monetary policy three times.

[4] The MPC's *Inflation Report* was renamed the *Monetary Policy Report* in November 2019, and its structure and content were revised in order to give greater prominence to the most pressing issues shaping each monetary policy decision.

I have made six 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, and schools.

Since February 2019, 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, 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 Japan, 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, 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 2019, the Bank received and responded to over 300 letters to the Bank about monetary policy from members of the public. I have given 21 national and regional television, radio and print interviews since February 2019.

Recent innovations in the Bank's outreach initiatives

Explaining monetary policy to a broader audience is central to the Bank's 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. Since its launch, there have been 7 posts related to monetary policy, and a further 12 on other topics related to the Bank's work.

We have also broadened our public outreach and educational initiatives.

For example, 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 (around secondary school age), 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, almost 1,900 individual schools have registered for the resources, representing two fifths of all secondary schools in the UK in 2018/19. We are continuing to adapt and expand the materials available through econoME, in response to feedback from the teachers and students using them.[5]

We are also currently working in partnership with educational organisations to develop teaching materials on the economy and managing money that are suitable for primary school teachers and children. We aim to launch this education resource, named “Money and Me”, in time for the 2020 summer term.

The Bank continued to pilot its first set of Citizens’ Panels in 2019. The aim of these panels is to establish, in a structured, systematic and comprehensive way, dialogue and collaboration between the Bank and a panel of citizens on the economy, financial system and policy. To date, we have run 18 panels since they were launched in 2018, with a further five scheduled for this month. There has been at least one panel in each of the twelve Agency areas, with many of those twelve hosting two (in a different location on the second occasion to increase the regional coverage). Around 400 members of the public have participated in these panels, the majority of whom are also engaged in the online community that we set up in September 2019 to complement the panel events.

Feedback on the Citizens’ Panels has been very positive overall. Nearly all of those who attended told us that taking part in the panels increased their levels of understanding and trust in the Bank, and, for the vast majority, their knowledge of the economy more broadly as well. Almost all attendees thought that the representatives from the Bank used language that was easy to understand, and reported that they would like to find out more about the Bank’s work following the panel. Later this year, we plan to publish a report outlining the themes that have emerged from these panels. With the pilot stage nearing an end, we will review how best to continue with these panels as part of our broader outreach efforts.

The Bank’s outreach initiatives are much more than an opportunity to explain our actions. They provide valuable opportunities to engage with the people we serve across the United Kingdom. In my time as Governor, they have provided some of the most rewarding experiences and have confirmed what a privilege and honour it has been to serve in this role.

[5] For example, following feedback from teachers that they would like econoME to include more coverage of financial literacy, we are currently developing a fourth econoME lesson focused on ‘saving, borrowing & protecting your money’. The new lesson is scheduled for release to schools in the week commencing 9 March.