Report to the Treasury Committee

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19 February 2020

Economy and voting record

1. At the time of my last annual report in August 2018, I had just voted along with my colleagues on the MPC to raise Bank Rate to 0.75%. CPI inflation was above our two percent target, while steady increases in wage growth signalled that domestic cost pressures were building. The labour market had been tightening, suggesting that GDP had been growing at rates a little above the MPC's estimate of potential output.

2. I also explained at the time that my central expectation was that further gradual rises in Bank Rate would be required in the three-year forecast period to bring inflation back down to target. That view was predicated on continued strong global growth in 2019. It also anticipated a reduction in Brexit-related uncertainty once withdrawal negotiations were concluded. I expected both factors to help support steady GDP growth over 2019. To prevent this feeding into increases in domestic-cost growth and a prolonged period of above-target inflation, a gradual raise in Bank Rate would be needed.

3. Although that was my central expectation, I stressed two key uncertainties that might limit the need for further tightening, and could require Bank Rate to remain constant for a longer period of time. The first of those, which I discussed in detail in a speech in March 2019, was that higher wage growth had so far not resulted in commensurate increases in measures of core inflation. The second was that the economic outlook would depend on progress towards an agreement on EU withdrawal and the nature of any deal that was agreed.

4. Since my last report, I have voted in each meeting to maintain Bank Rate at 0.75%, offering slightly more monetary policy support to the economy than I (or financial markets) anticipated 18 months ago. Despite slightly looser than expected policy, GDP growth and inflation have been weaker than forecast over 2019. The MPC's August 2018 forecast was for four-quarter GDP growth of 1.8% in the year to 2019 Q4, with inflation of 2.2% over the same period. The actual outturn for GDP growth was 1.1%, while inflation came in at 1.4%.

5. By contrast, the labour market has performed largely as I had expected. Over the second half of 2018 and into 2019, the labour market continued to tighten – the unemployment rate edged below 4% - and wage growth picked up to around 3½%. The chain of events was exactly as predicted by traditional Phillips curve theories, which suggest a negative relation between unemployment and wage inflation. There had been much discussion in the UK and around the world about the supposed breakdown of the link between the variables. In my academic research and in policy speeches I had argued that a

careful reading of the evidence was still consistent with Phillips-curve thinking – the pick-up in wage growth corroborates those arguments.[1]

6. With wage growth picking up as expected, the weaker outturns for inflation and GDP were partly driven by the two uncertainties I had raised, where events did not transpire as in the MPC's central forecast.

7. First, despite acceleration in wages, price-based measures of domestic inflationary pressures, such as core inflation and core services inflation, remained stable. I argued in my March 2019 speech that when we are uncertain about the supply side of the economy it can be preferable to place more weight on the inflation data in determining the amount of spare capacity in the economy. Over the course of 2019, measures of core inflation continued to remain subdued. This was one important factor influencing my votes against any immediate rise in Bank Rate over 2019. With no clear signs of building inflationary pressure in the CPI data, I judged the risk of inflation rising rapidly above target to be small.

8. The second uncertainty was over the nature and timing of the UK's withdrawal from the EU. Brexit did not happen in March 2019 as envisaged in the MPC's central forecasts until then. While the extension of the deadline ruled out the possibility of an immediate, disorderly no deal Brexit, it did not remove uncertainty over the negotiations among UK companies, households and financial markets. During 2019, the series of rolling possible withdrawal dates led to a period of entrenched uncertainty, which dampened business investment and GDP growth.

9. The effect of Brexit uncertainty on investment was visible in many of our business surveys, as well as intelligence from the Bank's regional agents. These highlighted that many firms preferred to postpone decisions on new investment until more clarity over the Brexit process emerged, to avoid the costs associated with reversing those plans.

10. Analogously, I thought that there were advantages to the MPC in waiting before adjusting interest rates, given the short period until more clarity emerged. This was particularly true because I judged that it was more likely that monetary policy would have to be loosened than tightened in the event of a disorderly, no deal Brexit. I articulated my thinking on this in my speech in July 2019.

11. Underlying GDP growth continued to weaken into the second half of 2019. As I discussed in my speeches during the year, that also reflected a far less supportive external environment than I had expected. The global economy moved from a period of synchronised rapid expansion, to increasing divergence in growth outturns across countries, to a synchronised global slowdown. Global

[1] See McLeay, M. and Tenreyro, S. (2019), "Optimal Inflation and the Identification of the Phillips Curve", *NBER Macroeconomics Annual 2019*, volume 34 and Tenreyro, S. (2018), "Models in macroeconomics", speech at the University of Surrey, Guildford.

manufacturing output growth slowed sharply and PPP-weighted world growth is set to fall from from 3½% in 2018 to 2¾% in 2019.

12. The evidence suggested that a major factor driving the slowdown has been the escalation in trade tensions between the United States and China. Although looser monetary policy around the world had cushioned some of the impact of higher trade barriers and the associated uncertainty around them, it had not been able to fully offset it.[2] Spillovers to other countries have been negative, with the slowdown particularly acute in the euro area, driven by Germany.

13. Together, the weakening of UK GDP growth alongside persistently subdued domestic price inflation data led me to believe that spare capacity had not been narrowing as much as we had estimated over the past, and had likely begun widening slightly again. While this was at odds with the behaviour of the labour market, it was consistent with many survey indicators of spare capacity. With more capacity and a weaker near-term inflation outlook, even under a deal that envisioned a smooth transition to a new trading arrangement with the EU, I judged that policy would be able to wait longer before a rise in Bank Rate was required.

14. Global growth continued to slow into late 2019, dragging further on UK export demand and manufacturing output. Brexit uncertainty also weighed further on business investment. With underlying UK GDP growth weakening, and output surveys signalling at best stagnation, I judged it was becoming more likely that monetary policy might have to loosen to reinforce the recovery. However with an imminent general election, which could lead to some resolution of uncertainty and change in business confidence, I felt it was prudent to wait to see how the economy evolved.

15. Collectively, the MPC communicated in November and December that if global growth failed to stabilise or if Brexit uncertainties remained entrenched, monetary policy may need to reinforce the expected recovery in UK GDP growth and inflation. In subsequent remarks in January this year, I set out my own view that there were risks that uncertainty would not decline quickly enough to reverse the recent weakening in demand. If that was the case, then my inclination was towards voting for a cut in Bank Rate in the near-term.

16. In the run-up to our January meeting, while the official GDP data continued to weaken, these related to the period before the general election. The key question for me was whether there had been enough of a step-change in business confidence and fall in uncertainty to bring demand quickly back in line with potential. To varying degrees, the surveys and agency intelligence have all signalled a sharp turnaround in activity. Taken together with signs of stabilisation in global growth, I judged that so far, there was sufficient evidence that UK growth may recover strongly without further monetary policy support.

[2] For more on these points, see Tenreyro, S. (2019), "Monetary policy and open questions in international macroeconomics", speech given as the John Flemming Memorial Lecture, London.

The outlook

17. The recent output surveys suggest a pickup in GDP growth over the near-term. The surveys have not been perfect predictors of UK demand over the recent past, however. They also tend to be over-sensitive to swings in sentiment. As the MPC communicated in the January Monetary Policy Report, uncertainty will need to fall further and the official data will need to follow the upturn in the surveys in order to meet our forecast for 1.4% growth over the next four quarters. While this is my central expectation, depending on the evolution of core inflation and other indicators, I think a stronger rebound may be needed – towards the top end of the range suggested by the surveys – to remove the case for near-term stimulus.

18. The outlook will also depend on the stance of fiscal policy chosen by the new government in the next Budget. The MPC's January forecasts were conditioned on fiscal policy measures announced in the previous parliament. More expansionary fiscal policy than this would tend to boost aggregate demand and require less monetary policy support in order to meet the inflation target. The scale of any implications for the MPC will depend on the degree to which fiscal policy affects supply as well as demand; and on the usual lags between policy announcements and implementation.

19. The UK growth outlook also depends on international developments. With the spread of the new coronavirus in China and around the world, the priority is rightly the human health consequences. But it will of course have economic effects, which are likely to affect activity in the UK, given the importance of China to the global economy. It is still early to gauge with any certainty the magnitude of these effects.

20. The outlook for inflation in the MPC's January forecast was that it would stay below target throughout 2020, partly as a result of temporary falls in energy and utility price inflation. Inflation returns to target by the start of 2022 and slightly above-target later in the forecast. However, as I have stressed over the past 18 months, measures of core inflation have been subdued and are now below the rates consistent with meeting the inflation target. In my view, this persistent weakness in price pressures relative to labour costs is a downside risk to the MPC's inflation forecast.

21. I have raised several possible causes for weak price inflation in my speeches including falling markups or increased competition, mismeasured productivity growth and lower price inflation in other productive inputs. The weakness of commercial rent inflation, a non-negligible input into production, is likely to be part of the story. The MPC's forecast assumes that some of the current inflation weakness is due to cyclical factors. If the source is longer-lasting or represents greater spare capacity, then stronger GDP growth than the forecast will be needed to bring inflation back to target.

Explaining monetary policy

22. Since my last report, I have continued to seek a range of opportunities to explain all aspects of the economy and monetary policy to different audiences around the UK. I made agency visits to meet people and businesses around the country (to Scotland, North West, South East and East Anglia, South West and Greater London). I find that conversations on these visits are an incredibly valuable source for understanding the economy and the microeconomic decisions that drive some of the macroeconomic data.

23. My regional visits also provide a great opportunity to explain our forecasts and policy decisions to a diverse audience, for example, by giving media interviews and talks to students at local schools. In each region I also made several company visits and participated in roundtable discussions.

24. I have also explained my views on monetary policy and other issues in economics in three on-the-record speeches, and in remarks during a public discussion of the labour market in January 2020. In March 2019 I discussed subdued core inflation and how we should set policy when we are uncertain about potential supply in the economy. In July I examined why different demographic groups in the UK perceive inflation differently. I set out why inflation perceptions and expectations matter for monetary policy, and for financial literacy in society more widely. In October I gave the John Flemming memorial lecture on a range of global issues affecting the UK economy, including the impact of US-China trade tensions.

25. I have continued my academic research focused on relevant topics for UK monetary policy. I presented and discussed these ideas and other topics in international policy meetings and research conferences, including, in 2019, the Jackson Hole Symposium; the Brookings Institution; the NBER Macroeconomics Annual conference and various events at the European Central Bank.