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Brexit and Monetary Policy – a speech by Martin Weale

In his final speech as a member of the Monetary Policy Committee, Martin Weale outlined his analysis of the economic and financial market impact of the referendum vote and its implications for monetary policy.

Martin noted that the most prominent effect of the referendum result had been on the exchange rate, which has fallen sharply.

Martin stated that one reason this had happened was as a consequence of expected lower future productivity. He explained that, if expectations of a lower path for GDP are assumed to arise from a lower path for productivity, then it follows that real wages should also be weaker. To the extent that this is delivered through more inflation, then the exchange rate will have to be lower to offset the international effects of this. In other words, as Martin put it: “The relative fall in GDP resulting from Brexit might then be thought to set an upper limit to the decline in the exchange rate which would result from Brexit.”

However, Martin also noted there were good reasons for thinking that the impact on the exchange rate will be larger than implied by the lower path for GDP. He said: “To the extent that the productivity effects work through reduced competition, then those are likely to be in the sectors of the economy most exposed to foreign competition – i.e. in the sectors of the economy producing internationally traded goods. If, say, half of our economic activity produces internationally tradable output and the productivity effect were actually limited to the tradeable sector, then the overall loss in productivity there would be twice as large in the economy as a whole. And, since the exchange rate needs to ensure that our internationally tradeable goods are competitive, the adjustment to the real exchange rate would need to be twice as large as if the loss were spread evenly across the economy.”

Turning to the current policy decision, Martin noted that there remained a very high degree of uncertainty around the implications of leaving the EU. Uncertainty itself would suggest waiting for firmer evidence of what those implications might be. However, , Martin does believe the short-term impact on demand will be more severe than that on supply, dampening inflation. “So is there a case for a stitch in time?”

Martin argued, however, that the effects of weaker demand needed to be traded off against the implications of the lower exchange rate for inflation; the Committee might need to address that even if it gave substantial weight to output movements. He said that, at his last policy meeting he would balance his views on any overshoot of inflation beyond its target in two to three years time against possible weakness in GDP. He added: "For there to be a case for easing policy I will need to expect weakness in output to be large enough more than to compensate for any overshoot in inflation on the assumption that policy is unchanged in the near term. "

He concludes by dismissing two arguments for rate cuts. First, he rejects the notion that markets would be disappointed were there to be no easing in August, noting that market participants should remember that the MPC sets policy each month – not in advance. Secondly, he gives little weight to the argument that early action is needed to reassure people, noting there was no sign consumers or businesses were "panic-struck"

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