Intro – Ollie G.

Good morning. Today, we consider what lies ahead for the UK economy in the next 18 months and the implications on us as monetary policy decision makers. I'm Oliver and I will be considering the state of aggregated demand in the UK economy. I am joined by Africa who will review output's influence on price levels, Owain who will analyse cost push factors and finally Frank who will examine financial markets and their stability. Frank will also conclude with our recommendation for monetary policy in the UK.

Let's begin with a quick gauge of context. Core inflation has remained at around 1.3% for almost a year while the level of CPI inflation has remained at 0.6% (September). Second quarter growth was stronger than expected at 0.6% however the IMF 'slashed' its UK growth forecast down to 1.3% for 2017, following the UK's vote to exit Europe. This paints a vapid picture of gently abating growth in the UK economy with uncertainty weighing heavily on investment and consumption.

Demand-pull factors – Ollie G

Household spending, the most significant component of aggregate demand, comprising around 61% of the total, has performed well with consumer spending rising by 0.9% in the second quarter of 2016 - signalling a possible strengthening of demand pull inflationary pressure on the UK economy. (**Consumer survey data).** However, disposable incomes may soon take a hit from rising oil prices.

Although not included in CPI inflation, house prices do implicitly affect the rate inflation through the wealth effect. A rise of just 0.4% into July 2016 illustrates a weak picture for demand. The housing shortage is still likely to worsen as a result of a lack of viable supply side policies with the government attempting to use demand side policies, in order to solve the predominantly supply side problem.

Average weekly earnings were up 2.3% in the three months to July 2016. Combined with an 11-year unemployment low of 4.9% it is likely that we will see consumer spending increase and growing demand pull inflationary pressure as a result. Alongside a post-Brexit lift in consumer confidence, which saw GfK's consumer confidence index increased from -12 to -7 into August 2016, aggregate demand may strengthen as a result of this boost in consumption.

The performance of both foreign direct and UK business investment are affected by a variety of factors. Firstly, the accelerator effect can drive business investment as household spending on exports increases and therefore strengthens demand. In addition to this a depreciation of the sterling to $1.32 has increased foreign demand for British exports therefore incentivising domestic expenditure by firms on new capital. Following the Brexit vote, it is likely that in the short term we will see a decrease in foreign direct investment with projects being put on hold whilst business confidence remains weak. Although, domestic investment shows little sign of contraction with the Purchasing Manger's Index for manufacturing at its highest level since October of last year. Furthermore, Chinese investment, including the building of Hinkley Point nuclear power station, will help prop up aggregate demand.

Contractionary fiscal policy, in the form of lower government spending is likely to reduce aggregate demand in the economy. Although we expect these reductions to be offset by our aforementioned optimism for consumption and investment.

International demand for UK exports has increased due to the depreciation of the sterling, as I mentioned earlier. With the Eurozone expected to grow by 1.7% in 2017 (per the OECD) and 55% of British exports destined for the Eurozone this may cause demand to continue to grow before the UK's exit from the European Union. US demand for exports will remain relatively strong due to the interest rate hike last year which makes UK exports cheaper due to the appreciation of the dollar.

To conclude, as demonstrated by our swingometer, I believe that although consumption and the increased demand for UK exports may cause an increase in demand pull inflationary pressure, the recent rate drop to 0.25% as well as the uncertainty around the Brexit vote prompts me to recommend that the base rate be maintained whilst also maintaining the current level of asset purchase facility.

I will now hand over to Africa who will look at output's effect on inflation.

Output – Africa J.

As monetary policymakers, the output gap can be used to determine inflationary pressures within the economy.

Using the output gap as primary indicator to determine inflationary pressures and consequently determine policy carries with it some problems. The output gap is notoriously difficult to estimate; forecasters require a high level of judgement to make predictions and estimations are commonly revised.

As a result, estimations vary widely from institution to institution; we took forecasts of the output gap in 2017 from six institutions. (-0.184).

A negative output gap indicates slack within the economy and disinflationary pressures. However, with a mean estimation of the output gap in 2016 of -0.3%, there is a notable rise in actual output as a percentile of productive capacity.

This indicates that after an 18-month time lag, these disinflationary pressures will unlikely be present, certainly not to the extent that warrants a further cut in the base rate.

Real unemployment currently stands at 4.9%; this is looks to cause no significant deflationary pressures with NAIRU estimated as 5%.

The labour force looks to grow in the next 18 months due to increase inwards migration before the trigger of Article 50 and, looking further ahead, the increase in the state pension age in December 2018. This increase in capacity would cause deflation assuming demand remains the same. However, migration is likely to provide demand-pull inflation that would counter any cost-push deflation and therefore the impact to price level is likely to be minimal.

However, underemployment is growing concern within Britain. Although unemployment figures are falling, this disguises a gross deterioration in the quality of paid work. This contributes to stagnated productivity within Britain. (data from survey)

The 'productivity puzzle' has a significant impact upon output in the UK. The most distinctive cause of this seemingly impenetrable statistic is the structure of employment within Britain. During recovery of the 2008 financial crash, unemployment fell but the proportion of workers in low-productivity sectors rose against those in high-productivity sectors.

The rise in zero-hour contracts (over 20% over the past year as of September) furthers the decline in quality of employment within the UK. Low productivity causes an inwards shift in the supply curve cost-push inflationary pressures. Issues look to be worsening as business confidence stumbles over uncertainty since the Brexit vote. The value of contracts in the infrastructure industry fell by 20% in July compared to June. This does not paint a hopeful picture for the future of British productivity.

It is arguable that this is a long-term problem that should be dealt with using supply-side policies. Phillip Hammond has abandoned the target to eliminate the budget deficit, opening an opportunity for vital government spending on infrastructure. Whilst inflationary pressures caused by low productivity lends itself to suggesting a rise in the base rate, the priority of the Monetary Policy Commitment should be to support the economy and encourage investment.

Furthermore, the Sports Direct incident in August 2016 over labour practices publicly highlighted many of the flaws within the British labour market. This high-profile debate, paired the new living wage of April 2016, should begin a trend of increasing labour productivity taking effect within our 18-month period.

To conclude, output looks to be contributing inflationary pressures. However, at a time of uncertainty within the economy, I do not recommend cutting the base rate further. I recommend no changes to the base rate and asset purchase program to support the economy whilst not overshooting our 2.0% target 18 months down the line.

Costs and Prices - Owain T-W.

The uncertainty that lingers around Brexit forced the pound to plummet and keeps it down as it sits at $1.31 against the dollar. This has increased import costs and imported inflation has risen, as the UK's **domestic goods that require imports have seen higher costs. The Producer Price Index (PPI) has shown that the price of goods bought and sold by UK manufacturers has increased for July and August following 2 years of falls, as factory gate inflation, which includes the prices and costs of manufacturing UK goods, rose by 0.8% in August.**

Oil prices remain low as stockpiles in the US were announced higher than forecasted, alongside skepticism that OPEC and Non-OPEC members can cooperate to restrict output. The release of the IEAs most recent monthly report has also helped to add deflationary pressure to oil prices as demand growth for the year was revised down due to trembling Asian demand as well as lower consumption in Europe. Considering the future, the IEA also revised down next year's **forecasts.**

The latest index from the British Retail Consortium indicates that food prices fell by 1.1% in August after 0.8% falls in the previous 2 months, despite warnings of rocketing food prices with a weaker pound. It seems that competition between supermarkets as they battle for the lowest prices has been driving the deflation negating (so far) the effects of Brexit. Large stockpiles of wheat have also weighed heavily on prices with a projected rise in world stocks. However new reports suggest that rising global temperatures are will shrink wheat supply in the long term, this is added to the short-term warnings that the weakened pound will drive up grocery prices in the coming months.

Over the summer energy markets have had their steepest climbs in 5 years, the small, independent suppliers are being hit the hardest as they must put up their prices now to cover higher costs, whereas the Big Six energy suppliers can hold off on a rate hike. The ICIS Power Index (IPI) which gives an insight into price trends on the UK wholesale electricity

market has seen a steep rise in June and July as prices have increased by just under £10 per MWh in 3 months. The ICIS' **latest report also stated the referendum result had propelled prices to nine-month highs due to a lift in demand for British energy from traders dealing in euros. This ascent of prices witnessed in the summer has continued to grow reaching almost £48 per MWh (24th October) significantly higher than before summer began.**

Despite fears from Brexit, the number of people claiming jobseekers allowance unexpectedly fell in July and the unemployment rate in the three months up to July remained low and unchanged at 4.9%. There is however concern that higher import costs will erode real wages and despite the status of the unemployment rate, it is expected to rise over the long term, as businesses wait for more clarity on the UK's **relation with the EU, before making decisions.**

Although in the short term it may seem cost push factors aren't doing too much to push up CPI to the target 2.0%, I believe that we should wait for further clarity in the UK economy and wait to see if the effects of a weakened pound are yet to be felt as many have speculated. Removing volatility by looking at core inflation we see a rate of 1.5%, if oil prices swing the way of the big producers then CPI would push much closer to the target, so by looking at core inflation and short-term uncertainty I can conclude the base rate should be left unchanged.

Financial Stability - Frank M.

Whilst technically the domain of the FPC, we deemed financial stability's impact on greater economic stability as well as inflation too important to omit.

The extent to which irrational exuberance is fuelling asset bubbles is indicative of how effective financial markets are at reflecting the true value of such assets. Current house prices will not have felt the 'Brexit effect', as negotiations take several months to complete, so stable prices post-June has only gone to show homebuyers haven't tried to renegotiate down on existing deals. Countrywide forecasts have been mirrored by economists at PwC who expect prices to "cool not crash". This will go some way in bringing the suspected bubble back down to earth, although with prices set to rise again in 2018, the bubble might yet inflate again. However, the latest numbers are only grounded by speculation, so forecasters are waiting for more data until they pass judgement on how the referendum result has affected the market.

The current level of debt in the economy means the UK is poorly placed to withstand a fall in income or, importantly, the inevitable base rate rise when it eventually happens. This being said, higher debt is a price worth paying for wider credit availability through maintaining or lowering the base rate. Increases in debt levels has been shown to increase consumption volatility, making predicting future demand-pull inflationary forces harder. This is due to their increased sensitivity, as they are more aware of economic events due to the effects it may bring on their debt burden.

While actual Brexit impacts are yet to be fully felt in illiquid markets such as housing, due to the intrinsic speculative nature of equity and bond markets, these have seen immediate reactions.

The lauded FTSE 100 rebound post Brexit doesn't reflect its actual impact. The disparity between even the FTSE All-share and domestic companies demonstrates this, as most FTSE 100 companies are so global that the only threat Brexit posed was through association with Britain. The accuracy of the FTSE 100 as a barometer of UK equity stability is therefore questionable at best. Furthermore, many believe the FTSE rebound was due to the double-edged sword of an exchange rate drop.

Despite picking up recently, the expansion of the asset purchase program has artificially pushed down bond yields even further. With bonds typically used to provide stability for portfolios, riskier and riskier assets are required to try and maintain returns. This will prove to make equity markets even more volatile, which will eventually restrain consumption once credit starts tightening.

As Carney eloquently put, 'large lumpy irreversible investments' such as houses or business capital like machinery dropped off, impacting cost-push pressures, as well as obviously output through lesser business confidence. The FPC's decision to reduce the countercyclical buffer rate from 0.5% to 0% in July reflects the lack of faith in credit stability, prioritising credit availability over procyclicality. This rate cut allows banks to draw a new £5.7bn from the old buffers, freeing up £150bn in increased lending, combined with the Term Funding Scheme should help alleviate such a risk. Again, the introduction of such a scheme suggests MPC's real faith in credit stability.

The impact of financial instability on the transmission mechanism is defined as shocks outside the Bank's control. Primarily impacting exchange rates, asset prices and money and credit, the diagram shows how this will subsequent stages. Low bond yields and volatility in asset markets will make it more difficult for monetary policy to pass through to supply and demand in general goods markets. Obsession with Brexit and its potentially negative effects on financial stability will place monetary policy on the periphery, meaning it will flow through less effectively as people take less notice. Obstruction to the mechanism will increase the already massive difficulty in estimating when monetary policy will lead to price developments. Notably, mechanism-altering instability **now** will also adversely affect monetary policy set in the past.

To conclude, the state of the financial system is in a moderately secure state. Coping very well with the mid-2016 stress tests, the Bank of England was given the necessary confidence to reduce the capital requirements for commercial banks. Unless credit availability actually picks up though, such confidence will be in vain. Inflationary pressure previously caused by the housing bubble is likely to gently abate, and the risk of deflationary pressure looms large with increased risk among UK portfolios. High private debt levels however are providing more inflationary pressure, and will continue to do so until it actually starts falling, which isn't forecast anytime soon.