Not such an island after all – speech by Megan Greene at the Institute of Directors

Transcript of Megan Greene's Q&A with Anna Leach, Chief Economist at the IoD.

12 February 2025

Anna Leach: You've highlighted, amid the UK's exposure to international developments, the increased sensitivity of market rates in the UK to data surprises, particularly those from other economies. What do you think is the reason?

Megan Greene: When I showed you that chart showing the sensitivity of rates to different data releases around the world, I split it up between before this rate hiking cycle and after this rate hiking cycle, in part to show that it's really just a sensitivity since we started hiking rates.

And so I think one reason that our curve has moved in response to things happening that don't necessarily on the face of it, have much to do with the UK economy is just because inflation was so high and the monetary policy response was so significant. So I think there's more sensitivity because of that.

I also think it's partly to do with the specifics of the UK economy. There is a correlation between current account deficits and bond yields. It's a negative correlation. So if you have a big current account deficit, your bond yields tend to be higher. And that's because to offset a current account deficit you need to have a capital account surplus. And this to some degree means that, you know, to quote our previous governor, the UK ends up being reliant on the kindness of strangers to buy its bonds.

Now the UK is not at all alone in this. The US is 100% in this category as well. It's just the US is a safe haven, so it benefits from that exorbitant privilege. But I think it also means that there's a bit more sensitivity for UK rates when there are developments happening outside the UK as well, because of that.

Anna Leach: Do you think this sort of shift in the sensitivity is permanent?

Megan Greene: We're likely to see it return to sort of previous relationships. I think it's too early to say to be honest. But we also look at how much our curve is just driven by developments outside. So not necessarily data releases, but also, financial market moves in other countries as well. And what we found is that before the pandemic, about a third of the moves in our curve were driven externally. Now it's roughly half. So that is a post-Covid shift.

It's too early to say whether that's permanent as well, but it seems possible that we might just be more sensitive to the developments externally.

Anna Leach: Looking at other risks that might impact the UK, we've talked a lot about what's directly or indirectly coming out of the US, particularly on the tariff side. But you did mention some other risks out there, of course, to which the UK is exposed. So what about what's going on in Europe and China?

Megan Greene: As I showed, the EU is the UK's biggest trade partner. And so the UK is exposed to what's happening in the EU. And growth in the EU has been pretty weak and we expect it to be weak going forward. It's driven particularly by Germany, which faces kind of persistent structural challenges. As someone who covered the Euro crisis very closely, it's interesting that Germany now faces structural reforms, whereas it was demanding that previously from a lot of other countries.

But in any case, it also faces an election. So there's policy uncertainty which will drive growth as well. So to my mind, the weakness in the eurozone will certainly have an impact on the UK through trade and also through financial markets.

There are also risks coming from China. The property sector, in particular the Chinese authorities have been trying to put a floor under it. So there is a risk that there are more defaults to come out of the property sector. To my mind, the Chinese authorities have tools that they can use. So I'm a little bit less worried about that.

Also, as I showed, the UK has exposure to China, but less so, particularly through trade, direct trade and indirect trade linkages than it does to the EU.

Anna Leach: On tariffs, it was quite striking to see the updated inflation forecast last week with that quite chunky upgrade to the peak of inflation this year, because it's more than about a percentage point higher than in the November forecast. Half of it is I think down to gas prices. But you've also mentioned how tariffs could play through to the economy and to inflation. And it rather looks like a trade war might be helpful for inflation, if that's one way of looking at it. What's your perspective on that?

Megan Greene: So I'm a little more hesitant to suggest as much. There are a couple uncertainties I've highlighted with the models. In the scenario where we had tariffs and retaliation, it seemed on net according to how it's aggregated in this ECB model to push down on output and also on inflation. So I would say we have near-term inflation in the UK that we don't expect to persist.

And so if we're trying to achieve our target over the medium term, we've judged that it probably won't result in second round effects. And we can talk more about that if you want. But, we're looking towards the medium term in terms of how to set policy, and who knows when any of this trade stuff will propagate or whether it even will. So that's one point.

Another is I mentioned the exchange rate channel is really dominant in this model, and it assumes immediate full pass through of exchange rate movements to import costs. And in the in the real world, in our experience it tends not to be immediate and full.

And so that means there's some uncertainty about the magnitude and speed of those changes in exchange rates. And so there's some uncertainty about that channel, which is the driving one. And then also the point I mentioned about what's not included in the model, you know, supply chain reconfiguration, which we've seen in recent history.

So it seems quite possible, that on net would be inflationary. So pushing in the other direction and that's not included in the model. But I'm also just highlighting how much uncertainty underpins all of this. Because who knows what any of this will look like.

Anna Leach: You mentioned the second-round effects, which is interesting because you'd also, referenced earlier the fact that inflation expectations are rising again, over the second half of last year. And the fact that, inflation has been elevated for a long time. Can you talk a little bit about what's driving that confidence that you won't get second round effects this time?

Megan Greene: If you look, in our monetary policy report, we break down what the contributions to this near term hump in inflation that we're forecasting are and a lot of it is energy, which we can't really do much about in any case. A lot of it is sort of indexed and regulated prices. There's a bit of it from the NICS as well. So a lot of this is sort of one off, measures, that shouldn't be repeated going forward.

I also think the last time we had second round effects was a fundamentally different environment than this one. We know inflation peaked at 11.1%. We're suggesting in the near-term hump that it will go up to 3.7%. Those are vastly different magnitudes. The academic literature would suggest that people don't pay attention to inflation unless it breaches 4%. So this will be under that.

But also really importantly, the labour market isn't nearly as tight this time around as it was last time around. And you need a tight labour market for workers to go and say, you've got to pay us more in order to compensate for our standard of living adjustment. So we're facing different environment this time around.

I also think it's possible that the threshold for second round effects setting in could be a bit lower. It's possible people are a bit more sensitive towards inflation, given the cumulative price increases that we've seen over the past. And so it's certainly something that we'll be watching.

Anna Leach: When you look at what seems to have driven down growth over the last year, in the last half year in particular, a lot of it seems to be confidence, which you would think would be a little bit more of a demand shock. So can you give us a bit more detail on why you have sort of concluded that this is both demand and supply moving relatively closely together, which means that ultimately there's not that much more scope for interest rates to move quicker than otherwise would have done?

Megan Greene: Well, I think realistically it's always going to be a bit of demand and supply. And so the trick really is to work out, which one it is more relative to the other. And so I do think that there is certainly a component to the weakness that we've seen in activity. But, you know, as I mentioned, I think the wage growth data and also the forward looking surveys suggest that wage growth is a bit more persistent than what we had expected and also than what our suite of wage growth models would suggest.

There's kind of an unexplained component in there, and I think that might suggest that there could be supply factors at play. And then also inflation's coming down. We've hit our target temporarily, but we expect to hit it in a sustainable way over our forecast period. But some components of inflation have been stickier than we expected. And some of them particularly energy and food price inflation, they really are salient for household inflation expectations.

And that is key for second round effects kicking in. So I think that's also a suggestion that maybe supply is a bit of a factor here as well. It's interesting you mentioned confidence and you have this survey of business confidence. I think there's a whole generation of economists who, who just think about these things in terms of demand, because that's mostly what we had observed for a number of years. Business confidence is an interesting thing because weaker business confidence could also reflect weaker supply. It's not just a question of demand. So it will be a challenge going forward to really parse this out. That's for me at the forefront of my thinking.

Anna Leach: And just thinking about the latest interest rate decision, looking at where interest rates could ultimately head. The MPC talked about a "gradual and careful" approach. What does it mean for you?

Megan Greene: So gradual is a term we've used already. Careful is kind of a new word that we've inserted this time around. And for me, it really goes back to this question about whether it's weak demand relative to supply or weak supply relative to demand. I think careful suggests that there's sort of a two way risk now. So there are risks in both directions, both in terms of whether it's demand or supply, but also in terms of domestic versus external risks that we're facing as well.

So I think I would just suggest that there are two way risks in a way that we weren't quite facing previously.