Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at the CBI Northern Ireland Mid-Winter Dinner, Belfast, 22 January 2013.

* * *

I am delighted to be in Belfast to deliver my final regional speech as Governor. After the Bank obtained independence in 1997, we decided to establish a physical presence in Northern Ireland for the first time. And I was able to announce the opening of the Agency when I visited Belfast in May 1999. Since then the links between the business community and the Agency have gone from strength to strength. None of this would have been possible without the commitment of a remarkable group of Bank of England Agents: first, Nigel Falls, then Phil Eckersley and now Frances Hill, all supported by Gillian Anderson, today the Deputy Agent.

During that same visit, I met with a group of politicians from right across the political spectrum. They were surprisingly eager to talk with, not at, each other – because they wanted to exchange views about the economic future of Northern Ireland, and to get away, at least for a while, from the divisive nature of daily politics. You would have been hard put to identify the affiliation of those politicians from their views on how to promote economic prosperity in Northern Ireland. And this is the key to the future. In my regular visits, I have criss-crossed the Province and come to realise how important is the business community as the agent of change and reconciliation. It is a challenge to which you continue to rise with spirit and determination. And it is why I enjoy coming here to meet with you, to learn about your progress, and to appreciate the extraordinary beauty of the Province.

I am conscious that there are significant differences between the economies of Northern Ireland and the rest of the United Kingdom. Tonight, however, I want to focus mainly on the economic outlook for the United Kingdom as a whole.

What are the Bank of England's diagnosis, prescription and prognosis for the UK economy?

At one level, the ***diagnosis*** is self-evident. Growth has been much weaker than most commentators expected. In fact, according to the official figures, there has been barely any growth at all over the past 2½ years. Unemployment, at a rate of almost 8%, is markedly higher than the level of around 5½% before the crisis. And inflation, despite its fall over the past fifteen months from over 5% to around 2½%, remains above our 2% target. Living standards have been squeezed for longer than at any time in living memory.

Much of this reflects the inevitable correction of exuberance on the part of borrowers and lenders, the conditions for which were created by the failure to tackle the global imbalances that left most major countries with unsustainable exchange rates, unsustainable paths of consumption, saving and borrowing, and unsustainably low long-term real interest rates. Our economy too needs to rebalance as it recovers, and that affects the pace of recovery. Although the downturn in UK GDP from the peak in 2008 to the trough in 2009, at around 6%, was broadly similar to that in most other industrialised countries, our recovery has been noticeably slower, with a cumulative rise in output from the middle of 2009 of only about 3½% compared with 6% or more in many other countries. But has the process of recovery and rebalancing been derailed or merely delayed? With the right prescription we can ensure that it has been only delayed.

Three factors in particular have adversely affected the pace of recovery in the UK. The first is an especially deep and protracted squeeze on the level of many people's real take-home pay. Over the past four years, money wages have on average been rising at less than 2% a year. And higher energy and food prices, as well as tax changes and a lower exchange rate, passing through to the level of consumer prices, have all contributed to the squeeze. On average, real take-home pay is no higher than back in 2004. That has been responsible for

an unusually weak recovery in consumer spending which, after falling initially by some 7%, is still more than 4% below its peak. The result is a large number of vacant retail premises – visible here in Belfast, as elsewhere.

The second factor is the extent to which the balance sheets of the major UK banks had grown before the crisis hit, and had been financed primarily by borrowing. So the subsequent reduction in bank lending – the deleveraging – was greater here than in many other countries. That deleveraging has as its counterpart a reduction in the amount of (broad) money in the economy and a reduced willingness on the part of banks to expand lending to finance the recovery.

And the third is the crisis in our main trading partner – the euro area – where the near term outlook is weak, and the longer term prospects for tackling the evident fault lines in the monetary union uncertain. The former means that our current account deficit has remained stubbornly high, and the latter is holding back corporate investment

With a disappointingly slow recovery, and unemployment one million higher than before the crisis, the main aim of economic policy has been to generate both a recovery and a rebalancing of the economy, and bring unemployment down without putting at risk hard-won medium-term price stability.

The Bank of England has played its part by administering a powerful combination of medicines. First, interest rates have been at all-time lows, with Bank Rate at near zero now for nearly four years. This has lowered the rate at which families, businesses, the government and banks can borrow. Second, the Bank's programme of asset purchases has prevented what might have been a serious contraction of the money supply. An enormous amount of new money has been injected into the economy, now amounting to about 25% of annual GDP. This was crucial in avoiding a depression. And, in addition to these monetary policy measures, we introduced last summer, in conjunction with the Treasury, the Funding for Lending Scheme to provide cheap funding to banks for a period of four years to enable them to finance lending to UK households and businesses. The Scheme has already reduced banks' funding costs: for example, major UK banks' senior unsecured bond spreads have fallen by around 125 basis points. And the availability and price of credit for many borrowers has improved.

But there remains spare capacity – certainly in the labour market. So should we do more to revive the patient?

The short answer is yes – but the harder question is, what?

In many countries, including the UK, fiscal policy is constrained by the size of government indebtedness, and monetary policy has come to be seen as the only game in town. Monetary stimulus is already very powerful. Markets expect policy rates to remain at exceptionally low levels for a considerable period of time. Of course, we could provide even more monetary stimulus through further asset purchases. And we will continue to assess the benefits and costs of further reductions in overnight interest rates. Be in no doubt that we are ready to provide more stimulus if it is needed.

Relying on generalised monetary stimulus alone, however, is not a panacea. Monetary policy works, at least in part, by providing incentives to households and businesses to bring forward spending from the future to the present. But that reduces spending plans tomorrow. And when tomorrow arrives, an even larger stimulus is required to bring forward yet more spending from the future. As time passes, larger and larger doses of stimulus are required. We are not in a typical post-war business cycle recession.

And, as with many medicines, there are side-effects from the prolonged use of monetary stimulus. With long bond yields at unsustainably low levels, there is a risk to financial stability. Real interest rates (that is, returns adjusted for expected inflation) on government bonds are negative out to a horizon of 25 years. That is not consistent with a sustainable economic recovery and a return to more normal levels of interest rates.

A long period of exceptionally low interest rates may also encourage excessive risk-taking, leading to vulnerabilities in important financial institutions.

So if we cannot rely on monetary stimulus alone, what additional policies should we consider? The right ***prescription*** now is a programme that complements monetary stimulus with measures to promote the necessary long-run rebalancing of the economy, enabling us to return eventually to more normal levels of interest rates. Only then can we return to a sustainable growth path. We must not be inactive, but we must be selective in order to be effective.

What are those other policies? They come under three headings: restoring confidence in our banks, reforms to raise the future potential supply of our economy, and changes in the world economy and exchange rates.

Much has already been done to fix the banking system in this country. And there has been a real improvement in the position of UK banks. Capital ratios have risen, leverage has fallen, liquidity has improved, and bank funding costs have fallen sharply, especially since the announcement of the Funding for Lending Scheme last summer and an improvement in market sentiment towards the euro area.

Banks are now overflowing with liquidity, largely as a result of the enormous increase in central bank reserves held by commercial banks. Yet there remains anxiety in markets about the resilience of UK banks. That is affecting the terms on which banks can obtain funding and so their ability to lend to the rest of the economy. Some argue that UK banks' capital ratios compare favourably with many of their continental counterparts. They do, and we should welcome that. But there is only one simple test of whether UK banks now have sufficient capital. It is whether they can convince investors that it is safe to provide them with funding at reasonable spreads over Bank Rate without central bank support. As the Financial Policy Committee (FPC) noted in its recent Review, UK banks are still some way from being able to convince the market in this respect.

Regulators, who from 1 April will be in the Bank of England's new Prudential Regulation Authority, are now working hard to ensure that banks are making adequate provisions for future losses, the likely costs of regulatory penalties and compensation to customers, and stating the riskiness of their assets in a more prudent way. A lesson from past crises, and also from this one, is that it is important to act now rather than hope that problems will go away of their own accord. As the FPC said last December, it is likely that banks will be required either to raise more capital or to restructure their businesses or exposures, and the FPC will review the position in March. There is no single remedy appropriate to all banks. With proper implementation, there is no reason why the two banks with significant state shareholdings could not largely be back in the private sector within a relatively short period. After all, in the United States banks that received state support are already back in private hands.

Restoring our banking system to full – and transparent – health is only one of the structural changes that will be necessary to rebalance the economy. Structural reforms are the familiar mantra of all international meetings. As a means of compensating for a large loss of competitiveness they are too slow acting to be effective. But in current circumstances they are, for the UK, a necessary complement to the other measures I have described. Since the crisis began real wages have fallen by almost 10% – a large but necessary adjustment to make the production of tradable goods and services more attractive than non-tradables, and to stabilise the public finances. Supply reforms can make that adjustment more palatable, and, by raising expected future incomes, they increase the rate of return on new investment and encourage spending, both investment and consumption, today.

It cannot be for a central bank to design a programme of such supply initiatives, but in economic terms there has never been a better time for supply-side reform.

The need to rebalance the economy means that all of the policy responses I have discussed will be required to restore the economy to full health.

The final part of the prescription is outside the UK's control. Engineering a recovery while our main trading partner is in a downturn is a difficult undertaking. We would all benefit from a resolution of the problems in the euro area. The actions by the ECB have brought a period of calm to financial markets, and so bought more time. But, as the President of the European Central Bank, Mario Draghi, has said on many occasions, only politicians can produce lasting solutions to the problems facing the euro area, whether by restoring competitiveness to the periphery or creating a framework for a transfer union.

The euro area illustrates a major problem for the world economy as a whole – the need to rebalance domestic demand away from countries with trade deficits to those with trade surpluses. Without that, an increasing number of countries are coming to the view that only a lower real exchange rate will provide the stimulus to demand that their economies require. Several have taken action to achieve that end. That is a recipe for competitive depreciations, what some have called "currency wars". Yet the existing configuration of exchange rates is unlikely to deliver stability. For almost two decades the world has struggled with, but failed to resolve, this problem. So it is hard to be optimistic about how easy it will be to manage the resulting tensions.

The fall in our own exchange rate, of some 25% between late 2007 and the beginning of 2009, has reduced the gap between our exports and imports in real terms from around 3½% of GDP to around 1½%. But the persistence of the current account deficit is evidence that an adjustment of sterling of that order was certainly necessary for a full rebalancing of our economy.

With that diagnosis and prescription, what then is the ***prognosis***: what does 2013 hold in store for the UK economy? On Friday we shall see the first official estimate for growth in the fourth quarter of last year. As we saw throughout last year, quarter to quarter changes in growth rates tell us little about the underlying strength of the economy, affected as they are by one-off factors such as the Diamond Jubilee and the Olympics. The continuation of the "zig-zag" pattern of growth rates last year means that, whether negative or positive, growth in Q4 will almost certainly turn out to have been considerably weaker than in Q3.

Inflation too has disappointed recently. It is set to remain above target for much of this year – in part because administered and regulated prices, such as those for electricity and gas, rail fares and university tuition fees, will put unusually strong upward pressure on inflation. Those prices are less susceptible to the influence of monetary policy, and will soon be contributing around one percentage point to measured inflation. So prices set in the market sector of the economy will need to rise by only about 1% a year if inflation is to meet the 2% target. That is a tall order. But the Monetary Policy Committee can respond flexibly by looking through the effects of administered prices as long as market-generated inflation pressures remain subdued.

There are good reasons to suppose that a gentle recovery is underway. Broad money growth, adjusted for transactions between financial intermediaries, is now rising at around 4½% a year, a rate that should, if maintained, show up in a recovery during 2013. Credit conditions have improved, and should improve further as the impact of the Funding for Lending Scheme kicks in. Mortgage rates have fallen, especially for high loan to value mortgages. Big companies have large holdings of cash and ready access to capital markets. Equity prices are nearly 10% higher than last January. If the policy prescriptions I mentioned earlier were adopted, then confidence that we were moving in the right direction should translate into higher business and housing investment, and underpin the recovery.

Recent actions by central banks and governments in a number of industrialised countries have raised questions about the frameworks within which monetary policy is being conducted. In the UK, the inflation target was introduced almost 21 years ago, and it has now come of age. It would be sensible to review the arrangements for setting monetary policy.

Last October I reviewed the first two decades of experience with the inflation target. In that speech, I argued that there were times when a concern for financial stability might justify deviating from the inflation target, but that policies aimed directly at preventing too rapid an expansion of financial balance sheets, of the kind now available to the Bank's Financial Policy Committee, might be a less costly way, in terms of lost output and employment, of achieving overall stability. And I also argued that price stability in the long run remained essential for economic success.

That is why price stability is the central plank of the remit given to the MPC by the Chancellor. The other part of the remit makes clear that we are not expected to pursue 2% inflation in the short run whatever the cost – it recognises that attempting to hit the inflation target at all times may cause "undesirable volatility in output". The remit overall has become known as "flexible inflation targeting". It is a way of trading off output and inflation variability in the short run, while ensuring that inflation remains on track to return to the 2% target.

Until the crisis, there appeared to be no real tension between hitting the inflation target and ensuring steady growth. More recently, we have had to make difficult choices. The MPC has looked through the impact of temporary external shocks and administered prices (including changes to VAT) on the level of CPI inflation and focussed on the level of domestically generated inflation in the market sector. Money wage increases have been low and stable. But CPI inflation has been above the 2% target for a long period. Should the MPC have taken action to bring inflation down? To do that would have meant driving down wages by creating a deeper recession, even higher unemployment and lasting damage to the job prospects of many young people. I know of no-one who has argued that the problem with the UK economy is that it has not had a sufficiently deep recession. Inflation rose to over 5% but has now come down to 2.7%, and the Committee believes that it is likely to come back to the target over the next two years. In effect the MPC has allowed a longer inflation overshoot than usual in order to avoid pushing up unemployment.

Our current remit does not specify how the MPC should strike a balance between growth and inflation in the short run. The horizon over which inflation should come back to target is effectively delegated to the MPC.

But should the MPC itself choose how quickly to bring inflation back to target, or should the government use its annual remit to set that horizon? Is there a gain from trying to quantify how the MPC should manage the trade-off between growth and inflation in the short run? The recent guidance by the Federal Reserve about the conditions under which it would continue to hold interest rates at close to zero is a way of quantifying the "flexibility" in flexible inflation targeting. It describes how the Federal Reserve will interpret its freedom to balance its twin objectives for employment and inflation. How much discretion to give to the MPC and how much should remain with the Chancellor is an interesting question that was raised, but not fully resolved, in 1997 with the system of open letters which gives the Chancellor the opportunity to comment on the horizon over which the MPC plans to bring inflation back to target. So there are certainly aspects of the inflation targeting regime to consider.

In assessing the current framework, however, there are two factors that should not be ignored. First, the primary responsibility of any central bank is to ensure stability of the price level in the long run. To drop the objective of low inflation would be to forget a lesson from our post-war history. In the 1960s, Britain stood out from much of the rest of the industrialised world in trying to target an unrealistic growth rate for the economy as a whole, while pretending that its pursuit was consistent with stable inflation. The painful experience of the 1970s showed that this illusion on the part of policy-makers came at a terrible price for working men and women in this country. The battle to bring inflation expectations down was long and hard, and involved persistently high levels of unemployment. Wishful thinking can be indulged if the costs fall on the dreamers; when the costs fall on others, it is unacceptable. So a long-run target of 2% inflation should be an essential part of our macroeconomic framework. And it is interesting to note that within the past year both the Federal Reserve

and the Bank of Japan have adopted a target for annual inflation of 2%. The anchoring of inflation expectations has been the most successful aspect of the inflation targeting regime and it has allowed the Bank to avoid an unnecessarily damaging tightening of policy in response to short-run movements in inflation. It would be irresponsible to lose that.

Second, the inflation target is not an impediment to achieving recovery today. It has not prevented the MPC from taking measures to combat the downward momentum in the economy following the shock of 2008. It is precisely because inflation expectations have so far remained firmly anchored that the MPC has been able to respond flexibly to weak demand. So the challenge we face is not the inadequacy of the framework, but the fact that there is no easy route to recovery after a major banking crisis. Recovery is inevitably slow and protracted. The healing process will take time, and patience is not a quality associated with our political debate.

Patience and a sense of realism are sometimes mistaken for fatalism. Our economy is recovering, more slowly than we might wish, but we are moving in the right direction. The Bank has not been, and will not be, inactive. Low interest rates will not be withdrawn prematurely, but we should not rely solely on general stimulus to aggregate demand. If we embark on the type of programme I have outlined tonight, I believe we can roll back the black cloud of uncertainty darkening the outlook for demand, allow the rays of supply optimism to peer through, and sustain a recovery based on a successful rebalancing of the UK economy.

The need to fix the banking system and introduce improvements to the future supply performance of the economy are, I know, felt even more keenly here in Northern Ireland than in Great Britain. And patience is a quality that has been demanded of you all in the Province over many years. The business community is the key to the prosperity of Northern Ireland. I wish all of you success in the challenges ahead. And I look forward to returning in a private capacity to enjoy the beauty of your Province.