Paul Fisher: Current issues in monetary policy

Speech by Mr Paul Fisher, Executive Director for Markets of the Bank of England, at the University of Bristol – London Alumni Event, Bristol, 26 February 2013.

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Thank you very much for inviting me to speak to you this evening. The University of Bristol is a very fine institution in a very fine city and I have extremely fond memories of my time there from 1977 to 1980 as a student in Economics with Statistics. In music at that time we had the latter stages of punk rock, and Bristol was also very good for folk music; in football I remember watching Bristol City playing Tottenham at Ashton Gate in what was then the true First Division; and in the economy there was continuing economic and social unrest (the Winter of Discontent) with inflation and unemployment stubbornly high. I recall a flatmate conducting a survey of students' inflation expectations in 1978 when RPI inflation had just fallen below 8% for the first time since 1972. Unemployment was thought to be high at the time, as a result of the first oil crisis but was to take a further upwards lurch in the early 80s and I remember how lucky I was to get a research job at Warwick University when I left Bristol – having spent the summer of 1980 painting rusty trolleys in a factory, which was itself knocked down to create housing later in the 80s.

Whilst these may appear to be self-indulgent memories, the comparison of the economy then and now does provide a thoughtful backdrop for what I want to discuss with you this evening. Compared with the economy in the 70s, maybe things aren't as bad now as we sometimes like to believe! The first topic I want to cover will be what central banks can do to help achieve the holy grail of low inflation, stable growth and full employment. In particular I will take a monetary approach to explaining the issues. Second, I want to talk about the monetary policy decisions facing us right now and explain my own recent voting position. Third, I want to give an update on our latest initiative, the "Funding for Lending Scheme".

Money and the balance sheet of the central bank

In the Acknowledgements to his 1988 classic "A Brief History of Time", Stephen Hawking notes that he was told that each equation he included in the book would halve its sales. He only included one.[1] You may be relieved to hear that there are no equations in this talk tonight. But I mention this because I am going to refer regularly to something which has been empirically proven to send some journalists to sleep faster than counting sheep. The Bank of England's balance sheet. I hope you are all still awake? Good, because the Bank's balance sheet is actually where all the action is. It is what allows the Bank to deliver its core functions including the issuance of banknotes, implementing monetary policy, and acting as lender of last resort to the banking system. Only the central bank can undertake these tasks because the central bank is the monopoly supplier of domestic currency: sterling in the UK. In this context (leaving aside the small stock of coins in circulation[2]) sterling means banknotes and commercial bank reserves held at the Bank of England, which in combination comprise "base" or "narrow money"[3]. Notes and reserve balances form the vast majority of the liability side of the Bank's balance sheet (see Chart 1) and these two types of money provide the ultimate means of settling payments between individuals, commercial firms, the Government and banks. I will talk about broader concepts of money, including commercial bank deposits,

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1 E=mc2

2 Coins are actually the responsibility of the Royal Mint, not the Bank of England. The amount in circulation is around £4bn.

3 The old M0 definition in the UK. Narrow money can also be defined to include demand deposits at commercial banks – eg M1 in the US.

a little later. The Bank of England can control the amount of sterling liabilities it issues and thus decide the amount of narrow money in the economy and/or its price. That is unique to the central bank and is the fundamental operational tool we have to implement monetary policy.

Bank of England consolidated balance sheet[(a)]

Chart 1: Liabilities

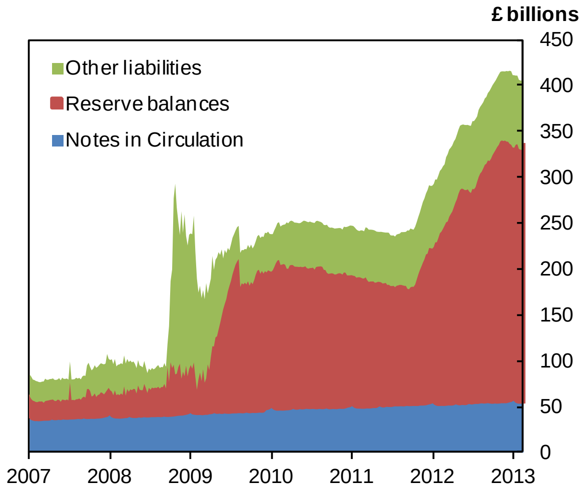
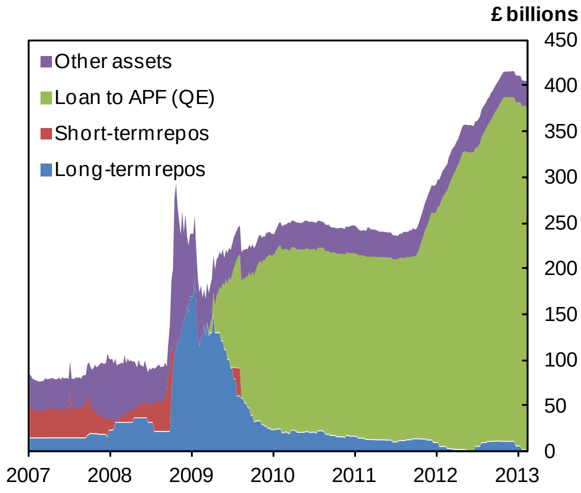


Chart 2: Assets



[(a)] Weekly data to 13 February 2013

In addition to controlling the size of our balance sheet and/or the price of money, which may affect the total supply of credit in the economy directly, we can alter the composition of the assets held on the Bank's balance sheet, or conduct off-balance sheet operations, and so affect the composition of private sector asset holdings. Executed judiciously, we can thus influence the price and/or quantity of particular types of credit in the economy.

Finally, by talking about what we might do in the future, the Bank can influence the price and quantity of money and credit for some time to come. The power of communications as an operational tool should not be underestimated and the MPC has always used a range of communication channels to help accomplish its objectives.

I should also note that, from April 1st this year, the new Financial Policy Committee (the FPC) of the Bank will also have statutory responsibility and powers to make the financial system more resilient through macroprudential policies[4] and the Prudential Regulation Authority (the PRA) within the Bank of England will take over from the Financial Services Authority the job of micro-prudential supervision of firms. These functions do not depend on the central bank balance sheet and so, in principle, do not ***need*** to be undertaken by the central bank. But they are being put in the central bank for very good reasons, which include, for example, exploiting the synergies with central bank operations and skills, and eliminating the underlaps that arise from separate institutional arrangements. Because they do not necessarily involve the Bank in conducting financial operations, I will say no more about macro- or micro-prudential polices today. (Else I will still be going at midnight!)

In summary, the primary operational policy levers available to the Bank of England to influence the macroeconomic outlook are: setting the price or quantity of money; influencing

[4] For more on my views about the FPC see: http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech550.pdf

the price and quantity of credit; and the communication of our actions, analysis and views[5]. Let me unpack these policy operations a little further.

Our monetary policy objective is set in the annual Inflation Target Remit given to us in a letter from the Chancellor.[6] The Remit requires the Monetary Policy Committee to target a 2% inflation rate in the Consumer Price Index, but it is also made clear that we should avoid "*undesirable volatility in output"* which might arise from "*external events or temporary difficulties"* beyond the control of the monetary framework.

In order to steer inflation towards the 2% target, in effect we can control either the price or the supply of narrow money. Prior to 2009, we would set Bank Rate and then adjust the supply of commercial bank reserves to guide overnight interest rates towards it. To do this the Bank would conduct Open Market Operations (OMOs) in which we lend to, or borrow from, the commercial banks so as to increase or decrease the level of reserve balances in aggregate, in line with the banks' stated targets. We would adjust those operations precisely to ensure that short-term market rates are driven towards the rate we pay on those reserve balances – which is Bank Rate. Since we also charge Bank Rate in our routine OMOs, Bank Rate is essentially the anchoring price of short term money. I am not going to go into details tonight about the precise economic mechanisms which make overnight market rates converge on Bank Rate, but there is plenty of technical material available on that if you wish to know precisely how that works.[7]

In my first week as Markets Director of the Bank of England, in March 2009, we set Bank Rate at 0.5% where it has remained ever since; a record low for the policy rate in the Bank's history of over 300 years. Since that left little scope to adjust the price of money downwards directly, we switched at that point to directly affecting the supply of narrow money. The Asset Purchase Programme – more popularly called "Quantitative Easing" or just "QE" – has since reached of total of £375bn, the vast majority of which has been by purchasing gilts, financed by increasing the supply of reserve balances (net of other flows across the Bank's balance sheet – see Charts 1 and 2).

The economics of QE is actually more simple than is often portrayed: by buying a large amount of assets from the market, in exchange for cash, we can greatly increase the amount of sterling in the economy. We inject the most liquid asset of all – short-term sterling reserve balances – and take out of circulation a long-maturity, less liquid asset, gilts. That switch in maturity and liquidity leads to a range of effects, as the economy has to rebalance its holdings of financial assets. As people try to move out of cash deposits and into typically higher yielding assets, QE will reduce liquidity and term premia, push up a range of asset prices and bring down interest rates at a wide range of maturities. All of that will benefit borrowers, increase wealth and help to stimulate nominal demand. Injecting money is actually not so different from cutting its price (Bank Rate).

There are some very important caveats however and I will focus on three. First, monetary stimulus works by giving an incentive to businesses and households to spend now rather than in the future. That creates only a temporary boost to growth. To carry on influencing growth, the stimulus needs to get ever larger. But we know that ultimately, the sustainable growth rate in the economy depends not on monetary conditions but on real factors. I shall return to this point later. Second, and relatedly, a monetary injection can create extra nominal demand for goods and services, but the precise split between real growth and price inflation is unfortunately out of our control. Taking these two points together, the creation of extra

5 I will leave aside the issuance of banknotes, the quantity of which passively reflects demand by the public.

6 http://www.bankofengland.co.uk/monetarypolicy/Documents/pdf/chancellorletter120321.pdf

7 See for example "Recent Developments in the Sterling Monetary Framework" available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech487.pdf

money can surely be relied on to prevent deflation, but even if it provides a temporary boost to real activity it can't guarantee sustaining a particular real growth rate. Third, the split into prices and real output and the overall outturn for the economy, depend on what else is happening at the same time: monetary policy is just one of the various forces at work shaping the pressures on output and inflation. We don't conduct monetary policy in a scientific laboratory where everything else can be held constant.

QE is often described as being a great experiment. In fact, the theory of monetary policy in the economic textbooks that I was brought up with at Bristol, and later, all considered the supply of money to be the central bank's primary policy instrument. The use of interest rates to set monetary policy appeared to be viewed by many academic authors as something of a slightly unfortunate and uninteresting practicality[8].

I want to be clear about one very important point: for monetary policy to stimulate the economy, the Bank of England has to cut interest rates and/or increase the supply of money. That gives firms and households an incentive to spend rather than to save. And it works in part by shifting net interest income from those who do save to those who borrow (and hence are more likely to spend out of marginal income). Not surprisingly, loosening monetary policy is often unpopular with savers, just as tightening policy is unpopular with borrowers. We have every sympathy for those who are net savers and especially if they rely on investment income, but we have to set policy for the good of the economy as a whole, in line with our Remit. Ultimately, economic recovery is in everyone's interests.

Monetary policy famously has "long and variable lags". One of the main reasons why is because the demand for money depends on many other factors in the economy outside of the central bank's control. There are other forms of money apart from sterling as I have defined it so far. Economic activity is also supported by the extent of deposits created by the commercial banks. Various measures of this are available, usually labelled "broad money" and the definition most commonly used in the UK is known as M4[9.] Ideally, that wider definition of money is what we would like to boost to ensure an increase in nominal demand for goods and services.

In the UK it has been clear over the past four years that while we have been busy increasing the supply of narrow money, the growth of broad money has remained weak. Broad money demand will fall if individuals or firms use the increased cash injected into the system to pay down bank debts, or simply seek to borrow less. Similarly the supply side of broad money can contract if banks consciously shrink their balance sheets. That would happen, for example, if the banks are short of capital or funding, or simply can't earn sufficient return on their assets. All of these demand and supply factors have been at work in recent years. As a result, the balance of forces between the demand and supply of broad money against the injection of narrow money has meant that growth in the stock of broad money in the economy has remained weak.

That does not mean that QE has been unsuccessful, as many commentators seem to conclude. Without QE, the amount of broad money in the economy would clearly have shrunk much further than it did – it actually held up reasonably well while the economy was contracting. Had broad money shrunk a lot further, the resulting deflation would have meant that the outcomes for output and employment in the UK would have been far, far worse than they have been. I will say more on the causes of deflationary forces a bit later, but this analysis partly explains why the Bank of England has also been engaged on special operations to support the liquidity, funding and capital positions of the banks through,

[8] See for example, FR Glahe, (1977) "*Macroeconomics Theory and Policy*", 2nd edition, publ: Harcourt Brace Jovanovich.

[9] The definition of M4 can be found here: http://www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/m4.aspx

respectively, the Special Liquidity Scheme, the Funding for Lending Scheme and the capital recommendations by the FPC.

What of our ability to influence credit markets directly? I want to argue that it largely reflects ***how*** we go about changing the supply of money. On the one hand, to increase the quantity of money in scale, quickly and safely, it is quite clear that gilts are the best instrument to buy: there is a large market and there is no resultant private sector credit risk taken by the public sector. Many financial instruments tend to be priced by reference to the interest rates on sovereign debt and so changing gilt yields will have effects across sterling markets.

In addition to buying gilts to inject money, we can consider two other ways to affect credit markets. First we can buy financial instruments outright. If particular markets have become dysfunctional so that general monetary expansion doesn't help, relatively small amounts of direct purchases may unblock the relevant markets. Second we can lend liquid assets – including cash – against assets that are, or have become illiquid. That is what we did with the Special Liquidity Scheme and more recently the Funding for Lending Scheme.

In 2009 the Bank launched two schemes making outright purchases of assets other than gilts.[10] We started to buy sterling commercial paper (up to 3 months maturity) and investment grade corporate bonds. At that time, in the worst conditions of the recession, the markets for these financial instruments had not been functioning normally. An increased demand for liquidity and heightened concerns about counterparty risk, caused many markets to dry up and asset prices to fall. By intervening as "Market Maker of Last Resort" the Bank was able, over about a 12–18 month period, to support the markets for both commercial paper and corporate bonds and drive prices back to more appropriate levels. The commercial paper scheme came to a natural end as prices rose and our holdings – which peaked at about £2.4bn in 2009 – matured. The corporate bond scheme is still in operation. Each week we offer to buy from a list of bonds, or sell from our stock. After reaching a peak in 2010 of some £1.5bn in holdings, the revitalized market has steadily bought the bonds back from us so that our stock is now only around £20mn.

Curiously, we still get people advocating the purchase of corporate bonds in large scale as well as gilts. But it is not clear to me what this would be intended to achieve. Apart from the simple fact that the Bank is already in the market every week offering to buy corporate bonds, and we have been doing that for nearly four years, this aspect of the capital markets is functioning well in terms of providing credit to businesses. Any firm that has an issuance programme – typically the larger firms with credit ratings – can issue whenever and whatever bonds they choose at historically low interest rates. The backstop to corporate bonds provided by the Bank's operations is still there – but it is not being used much because it is not needed.

The power to intervene in credit markets is one to use cautiously. Any intervention by the public sector carries the risk of creating distortions. Usually, we intervene because there is a demonstrable failure of private markets – so that the central bank is undoing distortions caused by other factors. Buying private sector paper also carries the risk of credit losses – ultimately of public money. And it is a very short step to cross the boundary from seeking to improve credit supply generally to determining the credit allocation between individual borrowers – which the central bank is neither equipped nor empowered to do. That is best left to private markets.

When a central bank – or any public authority – takes actions, it has to remember that the precedent of that action can be as powerful as the action itself. Market participants – and indeed the general public – will learn about the authorities' behaviour and shape their own

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[10] For more information, see "The Corporate Sector and the Bank of England's Asset Purchases" available at: http://www.bankofengland.co.uk/publications/Pages/speeches/2010/423.aspx

accordingly. Moral hazard is one aspect of this – that can lead to market participants taking more risky actions because of the perceived backstop provided by the central bank.

More generally, communications strategies can be a positive part of the toolkit, in particular by giving out information about the central bank's monetary policy "reaction function". For the most part it is helpful for markets to be able to predict what the central bank will do. That way one can often hope to generate the desired responses with less severe policy actions than otherwise. Credibility matters. For example, if people believe that inflation will be 2% in the medium term, and act accordingly, it is much more likely that inflation will stay close to 2% in practice without big swings in monetary policy. Keeping inflation under control is much more costly for the economy if expectations become de-anchored from the official target.

But how explicit do we need to be about our forward plans? This is a very live policy debate. The recovery in financial markets that we have seen in the past 6 months or so, is in part driven by the statement that the ECB will do "whatever it takes" to keep the euro area together and the perceived commitment that the Fed will do whatever it takes to restore growth in the US. The belief in these policy approaches has been immensely powerful. But it must be backed not only by perceived intent but also by capability and delivery if needed – and economies always generate some surprises. If the actions don't follow the words when necessary, then similar policy statements in future will be less effective.

In the UK, market expectations are already consistent with monetary policy remaining very supportive for some time to come, indicating no change in Bank Rate until well into 2015. Yet there is still a debate about whether the MPC should give more "forward guidance". In practice we have being doing this through the *Inflation Report*. The most recent edition makes it clear that we do not see much pressure arising from domestically generated inflation. Rather, we continue to see inflation being driven by factors such as tax changes, higher commodity and energy prices, and other external influences. These and similar adverse relative price changes have made us all financially worse off and contributed to keeping inflation higher than target over the past few years. In response, the Bank could have chosen to tighten monetary policy to keep measured inflation rates down. But that would have meant deliberately trying to weaken output growth and seeking to raise unemployment so that domestic inflationary pressures were lower. The relative price changes would still have happened, albeit at a lower overall inflation rate (wage growth would also have been lower). That would not have been consistent with the Remit that the MPC has been given and I doubt it would have been a more attractive outcome to most people.

The current policy debate

Despite the medium-term limitations of monetary policy, my own view is that QE has nevertheless been a powerful force in supporting the economy at crucial points over the past 4 ½ years. Given the shocks that have hit the UK since 2008, and the dependence of the UK on financial services, output could have fallen much, much further than the 6% fall from peak to trough that is actually recorded, and the unemployment rate could easily have peaked well into double figures instead of the 8 ½% that actually transpired. But I have also made clear that I do not think monetary policy can itself guarantee sustained real growth in the medium-term. It can provide a temporary stimulus and the right monetary conditions for a recovery, but sustained real growth will depend on real factors such as real external demand for UK-produced goods and services. We need real productivity growth to make UK production competitive and we need real supply-side reforms to boost expected future real incomes. Monetary policy can help, and it can underpin the economy by preventing a slide into deflation. So support from monetary policy is necessary but won't be sufficient to restore sustained real growth until these real determinants are also pushing the economy forwards.

One way to think about what has happened during the past 4 years is that there has been a need for balance sheet rebuilding across the economy. The shocks of 2008 revealed that many parts of the economy had become over-extended: some UK commercial banks are still rebuilding their balance sheets; the Government will take several more years to rebalance expenditure and income; households are still increasing savings rather than spending in aggregate; and some corporates are reluctant – or unable – to take on new debts. And given a very large trade deficit built up prior to the crisis, the overall UK economy had to rebalance, away from domestic demand towards net exports. These are real adjustments that need to be made within the economy. Growth should return, but it is likely that growth can only be sustained at a satisfying pace once the drag on demand and supply from rebalancing lessens. Monetary policy can play a supporting role because the extra liquidity in the economy allows the necessary rebalancing to happen without a disorderly adjustment (eg in asset prices). But patience will be required.

One detailed factor that has complicated monetary policy recently is the effects on measured retail price inflation of regulated and administered prices such as above-inflation rises in utility bills, university tuition fees, rail fares etc. Individually these may be perfectly sensible public policy choices and I do not want to be interpreted as criticising their motivation. But the effect on CPI inflation is important. These prices – which are about 16% of the CPI basket – will contribute around one percentage point to the CPI inflation rate in the next couple of years, largely regardless of what happens to domestic demand. Pushing inflation down to 2% would require very low price rises in the other 84%. The risk of overall deflation is much less likely as a result.

At our February meeting we faced, as so often in the recent past, a difficult choice. Should we offer more monetary stimulus, or should we not? My own choice, on a balanced assessment of the risks, was that we could and should do more now to support a nascent recovery with a further monetary injection. I do not believe the assertions of those who claim that that QE is noticeably less powerful than previously – although I have noted that there are limits to what monetary policy can be expected to achieve on real growth and it is impossible to measure the impact of monetary policy with any degree of precision. As with changing interest rates, the precise effects will always depend on the state of the economy. I judge that there are some upside risks to inflation, should confidence about achieving the 2% inflation target in the medium run be lost. But there are also downside risks if growth remains very subdued. As long as medium-term inflation expectations do remain consistent with our objective – in particular as long as wage growth remains so weak – I believe that we can and should continue to support the economy through the supply of money. But there is a case for taking a slightly longer-term approach than previously.

Because of the underpinning from regulated and administered prices, and the fact that the economy is currently flat rather than contracting, I think the risk of deflation is considerably reduced. Rather than a very large, rapid programme of asset purchases to avoid an imminent slump – as was needed in 2009 and again in 2011/12 – a slower, more gradually supportive policy might be more appropriate and less risky to nurse the economy through the next phase of recovery. It is sustained momentum that the economy needs now rather than emergency action.

Because of that, in February I voted for an additional £25bn over 3 months thinking that this could be the first instalment of a more prolonged run of purchases at a somewhat slower pace than previously, and with a relatively modest addition to the total by the end. If we were to do that, then it would be straightforward to accelerate or to stop purchases as the economic outlook developed and the risks became clearer. In fact this is not so different from what we have done before. Although we have always decided on asset purchases for a 3 or 4 month period at a time, we have often rolled into further purchases. The total amount is only decided – and then only temporarily – at the point we stop! So we could contemplate a rather longer horizon for asset purchases, even if we continue to cautiously decide on a few months at a time.

The majority of the MPC took a view in February not to make any more purchases. I accept that there was a good case to be made for that position, even if on balance I took a different view. But I think we need to keep under review whether there is merit in undertaking more asset purchases under a slightly different dynamic approach. Indeed the February meeting Minutes made it clear that the Committee will keep all its options open.

Funding for lending

Finally, I want to turn to our most recent approach to credit easing. The Funding for Lending Scheme (the FLS) was launched in 2012 jointly with HM Treasury after we saw that interest rates being charged to borrowers had been rising at a time when our asset purchase programme should have been bearing down on market rates. The principal reason for rising lending rates was that bank funding costs were being kept high by the continuing crisis in the euro area.

The FLS offers banks cheap funding for up to 4 years – with the price linked to how much lending a bank makes to UK firms and households. It is carefully designed to provide incentives to all banks to lend more than they would have done in its absence. The actual mechanism is a liquidity upgrade as we lend 9-month Treasury bills against illiquid loan collateral.[11] The Treasury bills can easily and cheaply be converted into cash, thus reducing the banks' reliance on more expensive market funding.

How successful has it been? The impact comes in three phases. First of all the FLS tackles the problem at source by cutting the funding costs of banks. That phase has been remarkably successful. Market-based measures of UK bank funding costs have fallen across all sources: secured and unsecured term debt; inter-bank borrowing; deposit rates and so on. It has no doubt helped that coincidental developments in Europe have brought down bank funding costs there. But in the UK they fell quickly once the FLS was first announced, and generally by more for UK banks than for their European peer group.

The next stage is for banks to pass on lower funding costs to their customers. This is happening, albeit a bit more slowly. Of course it is only the banks' marginal funding costs which are reduced. Their pre-existing stock of funding will reflect historical borrowing costs. So the largest falls in loan costs are directed at new lending, rather than the stock. The impact is also more obvious on mortgage than on corporate lending. Three quarters of total lending is to households rather than to firms, and it is easier for banks to launch new offers in that sector. In the corporate sector, we have seen banks take different approaches to SME lending: one bank offers a cash back scheme; another has scrapped arrangement fees; a third is offering guaranteed discounted borrowing costs. The true impact for corporate customers is not easily measured in "standard" interest rate data, but the potential economic benefit is there. Overall, we think there is more action to come in lower lending rates.

The final stage is the impact of lower lending rates on the quantity of credit. That will take some time to work through from applications to approvals to actual lending and is the most uncertain leg. The FLS has clearly shifted the supply of credit: loans are generally available at lower cost than previously. That in itself is a monetary boost as new borrowers will be better off than they were before because they are paying lower interest rates. But whether there is more borrowing in total will depend on the demand for credit and the creditworthiness of borrowers. If firms or households, for whatever reason, are reluctant to borrow, a change in the marginal interest rate may not make much difference. For example I have personally heard from small firms who say they do not want to "get in hock to their banks again" and so they are turning to alternative funding sources or simply not investing at all.

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[11] Technically this is a collateral swap, and in line with good accounting practice it is not recorded on balance sheet. But there is full quarterly disclosure, bank-by-bank.

And from the lender's point of view, they still have to judge the chances of getting their money back. Again this is more complicated for lending to businesses than for households – especially small businesses which are much more diverse. At the margin there will be some individual business credits which look a better bet at a lower interest rate, but some other businesses won't get credit at any price. In aggregate, corporate lending is also probably being held back by the fact that the commercial property market is still weak. Nearly 50% of bank and building society lending to corporates is to the property sector and a good part of the rest will be secured on property. Given losses suffered by most banks on their commercial property portfolios, they are reluctant to increase lending for that purpose. Finally, some banks have had to cut back particular forms of lending as a result of State Aid rulings, so they will struggle not to reduce their total lending, even if they use the FLS to the full to support their core activities.

We do need to keep the pressure on the banks individually and collectively to make sure that they continue to pass through lower funding costs and are lending where they can. The Bank has made the funds available to support lending to UK households and businesses, it is up to the banks to deliver. That is one reason why we are publishing bank-by-bank outcomes under the Scheme.

We wait to see what the impact is of the FLS on the stock of lending. The next data release on 4 March will be for end-December data. Even though lending rates have fallen, that is still quite early for much extra money to have flowed from the application stage into actual loans, compared with previous plans which showed that lending was most likely to fall in aggregate without the FLS. I would not expect to see a return to rising aggregate quantities until we start getting data for 2013 at the earliest. Indeed the aggregate data which have been published already – for all banks, not just those in the FLS – showed a small fall for the last quarter of 2012. Nevertheless, it does seem that we have the beginnings of a revival in mortgage activity which is visible in the approvals data and that trend is widely supported by business contacts throughout the country.

The underlying message from the FLS is much the same as for monetary policy. Monetary and credit policies can help provide the foundations for growth and ease the path for necessary real adjustments. But ultimately, the growth of the economy will depend on real factors such as expectations of real income growth and the productivity of UK firms and workers. Households will borrow for housing or consumption if they have expectations of secure real incomes. Firms will similarly borrow if they have expectations of demand for their goods and services. Cheaper loan rates will help that process, but the fundamental drivers will still be those of the real economy.

Conclusion

The headwinds holding back the UK economy over recent years have been predominately real ones: an ongoing crisis in our main export markets of Europe; the necessity of fiscal consolidation at home; the need for rebalancing of the UK economy towards net exports; and balance sheet repair across all sectors. The weak relative performance of the financial services sector following the crisis has also been a direct drag on output as well as hampering the supply of credit. The central expectation in the February *Inflation Report* was for growth to resume in 2013, albeit at a relatively modest pace. Patience will be needed. Meanwhile, the Monetary Policy Committee remains committed to supporting the economy whilst aiming to keep inflation low and stable in the medium term, in line with our Remit. Monetary policy can help, even if it can't solve all the challenges of restoring sustainable real growth.