Spencer Dale: Inflation and growth – what role for monetary policy?

Speech by Mr Spencer Dale, Executive Director, Monetary Policy, and Chief Economist of the Bank of England, to the Asian Business Association and the Chinese Business Association of the London Chamber of Commerce and Industry, Bank of England, London, 15 March 2013.

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Monetary policy is under the spotlight. The previously sedate world inhabited by middle aged, grey suited – too often, male – central bankers has been turned upside down by the financial crisis. A global debate is raging about the role monetary policymakers can – and should – be playing in trying to stimulate growth in their economies. Here in the UK, the breadth and urgency of that debate is unlike anything we have seen since the birth of inflation targeting 21 years ago.

Nobody should be surprised by this. Our recovery from the financial crisis is proving to be long and arduous. At the same time, inflation remains stubbornly above target. The Monetary Policy Committee (MPC) faces tough choices as it tries to both support the recovery and bring inflation down. And away from home, central banking is undergoing considerable change: both the Federal Open Market Committee (FOMC) in the United States and the Bank of Japan have recently made policy changes that emphasise their commitment to provide further monetary stimulus until their economies recover.

Against that backdrop, people are understandably asking what role monetary policy in the UK should play in determining growth and inflation? This is an important debate and one that is likely to be central to economic policymaking over the next few years. What I would like to do today is to offer some of my own thoughts on this issue.

I want to focus on two aspects in particular.

The first concerns the objectives of monetary policy. The inflation target, given to the MPC by the UK government, states that our primary objective is to ensure that CPI inflation is equal to 2%. But it also makes clear that, in so doing, we should be mindful of the implications that our policy actions have for growth and employment. How should we go about reconciling those different objectives?

The second issue relates to the current operation of monetary policy. What should we make of the view, repeated in many quarters, that the trade off between growth and inflation may be unusually favourable in present circumstances. That we could buy quite a bit of extra growth at little or no cost in terms of higher inflation? Do such free lunches really exist?

The two objectives of monetary policy

Let's start with the objectives of monetary policy and the mission of the MPC to hit the 2% inflation target but to do so in a way that supports growth and employment.

Those twin objectives were highlighted starkly only last month by the Committee's reaction to its updated forecast for inflation contained in the February *Inflation Report*. Inflation was projected to rise further in the near-term – to above 3% in the second half of this year – and to remain above the 2% target for the next two years or so. But rather than tighten policy, we issued a statement explaining that, in present circumstances, we thought it appropriate to bring inflation back to target more slowly than usual.

Our reaction was partly driven by the judgement that this protracted period of above-target inflation would, for the most part, reflect higher university tuition fees and domestic energy bills. Importantly, these price rises are largely the consequence of regulatory decisions, rather than market forces. In contrast, costs and price pressures resulting from the balance of demand and supply in the domestic economy looked to be well contained. Although the inflationary impact of these higher administered and regulated prices is likely to persist for several years – as is the impact of the recent weakening of sterling which is also pushing up on inflation – they are likely to wane over time. As such, inflation was expected to fall back to around the 2% target by the end of 2015.

But the Committee was also explicit that its willingness to tolerate this period of above-target inflation was driven by the weakness in our economy and by the concern that attempting to bring inflation back to target more quickly would risk derailing the recovery.

Indeed, this desire to support growth as well as to control inflation has been characteristic of the MPC's behaviour since the onset of the financial crisis. CPI inflation has been above its 2% target for much of the past 5 years, but during that period we have cut Bank Rate from over 5% to 0.5%, we have conducted an asset purchase programme – QE – on a scale equivalent to almost 25% of nominal GDP, and we have launched the Funding for Lending Scheme to boost credit growth to the real economy.

I accept that for much of this period the Committee expected inflation to fall back to target more quickly that it actually did. Even so, it remains the case that monetary policy was loosened very aggressively at a time when inflation was persistently above target in the near certain knowledge that not doing so would lead to a deeper and potentially much more painful recession.

The suggestion made in some quarters that the MPC has slavishly followed the inflation target in recent years – that it has been fixated with inflation at the expense of growth and employment – is simply at odds with the facts. Based on the MPC's central projection for inflation published last month, over the decade to the end of 2015, CPI inflation will average close to 3%. It will have been above its 2% target for 90% of that time, and above 3% for 40% of the time.

Yes: some of this might be the result of poor forecasting. But much more important was the recognition that a lower profile for inflation was possible only by tightening monetary policy at the cost of an even deeper recession and an even larger rise in unemployment.

Monetary policy has been on the frontline in supporting our economy through the financial crisis and it continues to be so.

Indeed, it is striking that while some criticise the MPC for focussing too narrowly on inflation, others argue that we've worried too much about the real economy and taken our eye off the inflationary ball. "Is the MPC's job to hit the inflation target or not", they ask? Has the inflation target become a sham?

The remit given to the Monetary Policy Committee makes clear that our job is to hit the 2% inflation target. But it also acknowledges that inflation will on occasions deviate from its target as a result of shocks and disturbances, and that "...attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output".[1] Although the language is arcane, the meaning is clear: monetary policy should try to prevent damaging booms and busts in output and employment.

This secondary objective matters and has been central to the recent conduct of monetary policy. To repeat: we could have delivered lower inflation over recent years, but only at the

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[1] The relevant clause of the remit states "The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output." See http://www.hmtreasury.gov.uk/d/open_letter_from_chx_to_boe_22032011.pdf

expense of providing less support to growth and employment in the midst of the most significant economic downturn of our generation.

That monetary policy should be concerned with growth as well as inflation is nothing new. Indeed, way back in 1997 – the year that the MPC was first established – Mervyn King, then just the lowly Chief Economist of the Bank of England, referred to the value of the "constrained discretion" built into the inflation targeting regime.[2] The "discretion" relates to the speed with which inflation is returned to target. In response to certain kinds of developments – in the jargon, so-called "supply shocks" that move output and inflation in opposite directions – inflation can be returned to target relatively slowly in order to minimise harmful fluctuations in output. But this is subject to the "constraint" that inflation ultimately has to be returned to the target and has to be done so in such a way that maintains the target's credibility.

Inflation targeting is not a sham: the discipline of the inflation target is paramount. But it can be operated in a manner that also supports output and employment as long as – and only as long as – our credibility is maintained. Without credibility there can be no discretion.

This concern with the consequences for growth and employment within an inflation targeting regime is sometimes referred to as "output smoothing". Monetary policy does not have the ability to affect the level of output in the long-run, but it can help to smooth out cyclical variations. More recently, it has underpinned references to "flexible inflation targeting": the MPC has the flexibility to vary the speed with which inflation is returned to target depending on the circumstances. Most colourfully was the observation, again made by Mervyn King, that an inflation target does not compel policymakers to behave like "inflation nutters": there is scope to care about stabilising output and employment as well as controlling inflation.[3]

That monetary policymakers should be concerned with the implications of their actions for the real economy – for the growth of output and for the strength of employment – must surely seem right to all of us. The late Eddie George – who, together with Mervyn King, perhaps did more than anyone to cement the importance at the Bank of England of low and stable inflation – stressed repeatedly that low inflation "is not an end in itself .... [it is] a necessary means to the end of sustainable growth of output and higher living standards".[4] It's important that we don't lose sight of this overriding aim.

Eddie was equally clear that, in the long run, the best contribution that monetary policy could make to achieving a prosperous and vibrant economy was to deliver enduring price stability. He had seen at first hand the pernicious costs of the high and variable inflation of the 70s and 80s: companies and households unable to budget and plan efficiently; resources misallocated; long-term contracts avoided for fear that large swings in inflation would end up biting one party or the other. The value of hard-earned savings eroded. Out of that pain and misery emerged a consensus – a hard won consensus – that low and stable inflation was a prerequisite for economic prosperity.

More recently, though, there have been some worrying signs that cracks may be appearing in that consensus. A sense that inflation is somehow yesterday's war. That central banks should focus more on growth. That a period of higher inflation may even aid the recovery. This is dangerous talk.

It sometimes feels like we've been here before. One of the mistakes made by policymakers in the late 1960s was to allow inflation to get out of control after nearly two decades of price

[2] King (1997), "Inflation targeting 5 years on", speech given at the London School of Economics.

[3] King (1997), "Changes in UK monetary policy: Rules and discretion in practice", Journal of Monetary Economics.

[4] George (1999), Annual Cornwall Lecture.

stability. As Sir Alec Cairncross, who worked in a host of senior economic roles in the heart of the civil service during this period, put it "...governments in the last years of the 1960s …allowed inflation expectations to develop that proved increasingly difficult to extinguish" (Cairncross 1992). There is little doubt that policymakers of that time had a strong aversion to inflation, but they were complacent about the risks posed by further stimulus. It would be irresponsible to repeat the same mistakes again.

How do we ensure that the lessons of yesteryear are not forgotten? That a period of relative price stability does not breed complacency? That the collective national memory is maintained?

A key part of the answer can be found in the role of regimes and institutions.[5] Individual policymakers and officials come and go. Intellectual ideas pop in and out of fashion. The inflation target and the MPC are the result of a long and painful search for a credible money anchor. They provide the memory to ensure that we don't return to the inefficiency and inequity of the 70s and 80s. They provide the memory that underpins the consensus that low and stable inflation is a perquisite for economic prosperity. And they provide the memory that guards against some of the dangerous talk of late.

Let me sum up this section on the twin objectives of monetary policy.

The MPC has objectives for growth as well as for inflation. The current inflation targeting regime provides considerable flexibility for the MPC to support output and employment. And in recent years, the MPC has used that flexibility to the full. Indeed, some have argued excessively so. The MPC has been at the forefront in supporting growth and employment and continues to be so. But that flexibility is constrained by the discipline that monetary policy must be set in a manner consistent with inflation coming back to its target. Without that credibility, monetary policy wouldn't have the flexibility to support the real economy. And ultimately delivering low and stable inflation is the best contribution monetary policy can make to achieving a robust and sustainable recovery.

The trade off between growth and inflation

Let me turn now to the second issue I wanted to discuss today which concerns the operation of monetary policy and, in particular, the likely trade-off between growth and inflation in the current environment.

As I said, in February the MPC made clear that we thought it appropriate to bring inflation back to target more slowly than usual in order to support the nascent recovery. But is there a case for monetary policy going even further? What if, as some commentators have claimed, it were possible for the MPC to inject additional monetary stimulus, thereby providing even greater support to growth, with relatively little consequence for inflation. Stronger growth with little or no higher inflation: surely that would be a good use of the MPC's flexibility?

There are two strands of argument put forward as to why the current trade-off between growth and inflation may be unusually favourable.

The first is that cost and price pressures in the current environment may be relatively insensitive to the degree of slack in our economy. If that were the case, the economy could grow relatively rapidly, absorbing spare resources and capacity, without putting much upward pressure on wages and prices. In economists' speak, the so-called Phillips curve – which sketches out the relationship between spare capacity and cost and price pressures – may be relatively flat at the moment.

[5] King (2012) and Tucker (2012) make similar arguments in the context of financial stability and the role that the newly formed Financial Policy Committee can play in this respect.

The second possibility is that the effective capacity of the economy to supply goods and services depends on the state of demand: the stronger the demand, the greater somehow the capacity of companies and employees to meet it. The likely responsiveness of supply to an increase in demand, it's argued, means that it would be possible for the economy to grow relatively rapidly without significantly reducing the degree of slack in the economy and so without adding markedly to cost and price pressures.

Let's consider briefly each of these possibilities in turn.

The suggestion that the Phillips curve may be relatively flat appears, at least at first blush, to be consistent with our experience over recent years. Following the worst recession in living memory, our economy has barely grown over the past two years. Output is well below its pre-crisis level, unemployment close to 8%. But inflation remains stubbornly above target.

The trade-off between output and inflation has indeed been remarkably flat. But that doesn't mean that the flatness of this trade-off can be relied upon to continue in the future: it depends on why inflation has been so sticky.

Much of the slack in our economy is concentrated in the labour market, where unemployment remains painfully elevated. And, as would be expected, that higher unemployment has been associated with a marked moderation in wage growth. Indeed, as shown in ***Chart 1***, the relationship between wages and unemployment over the past three years looks pretty similar to what we experienced in the mid-90s when the unemployment rate was similar to what it is today. There is no strong evidence to suggest that the wage Phillips curve in the UK is flatter now than it was twenty years ago.[6]

If not in the labour market, is it possible that spare capacity within companies may be having less impact than usual on pricing decisions? Maybe, especially if cash-struck companies are less willing or able to cut their prices in order to utilise spare capacity and gain market share. But to the best we can tell from surveys measures and the intelligence gathered by our network of Agents, the current margin of spare capacity within companies is not particularly pronounced. So even if companies' pricing strategies have become less sensitive to space capacity, this is unlikely to explain much of the recent stickiness in inflation.

All told, I'm not particularly persuaded that the relationship between economic slack and cost and price pressures has become unusually weak. Wage growth has moderated broadly as expected given the rise in unemployment. And there does not appear to be a significant margin of spare capacity within companies.

What is unusual is that the moderation in wage growth has not been reflected in a corresponding fall in domestic cost pressures. From an accounting perspective, that reflects the unprecedented weakness in productivity in recent years. The level of private sector productivity is around 15% below the level implied by a continuation of its pre-crisis trend. This weakness in productivity has meant that, despite muted pay growth, unit labour costs – the single biggest determinant of companies' costs – have grown at or above their historical rate for much of the four years since the financial crisis.

And indeed, it's this weakness of productivity that underpins the second argument put forward for why the relationship between growth and inflation may currently be unusually favourable.

The suggestion here is that the recent stagnation in productivity – and of the supply side of our economy more generally – is in large part a direct consequence of demand weakness. If only demand were to pickup, this – on its own – would prompt an increase in the effective supply capacity of companies. The economy could recover without significantly reducing the degree of spare capacity and with little or no additional inflation.

6 My MPC colleague Ben Broadbent made a similar point in a speech last year (Broadbent 2012).

The possibility that persistent demand weakness may erode supply capacity is not new. Indeed, it was central to the economic doldrums that characterised our economy in the first part of the 1990s. But what is different is that many of the channels which were important in detracting from our supply capacity then don't seem to be operating particularly strongly today. In particular, the scourge of long-term unemployment and of discouraged job seekers leaving the labour market that typified the malaise of the early 90s has been in far less evidence in this downturn. The rate at which the long-term unemployed are able to move back into employment has remained around its historical average (***Chart 2***). And labour market participation has held up pretty well (***Chart 3***). Likewise, the surge in corporate insolvencies and associated increase in capital scrapping seen in the early 90s has not been repeated (***Chart 4***).

If demand deficiency is weighing on the supply side of our economy, it's doing so via different channels than in the past. But that is not to deny that it may be happening.

There are a number of other mechanisms through which persistent demand weakness may be eating away at the effective supply capacity of our economy. Indeed, many of you may have experienced these firsthand. The need to retain core skills and maintain minimum staffing levels means that as demand falls some companies – especially smaller companies – have not been able to reduce their workforces by a corresponding amount. Others choose to hold on to experienced workers, even if currently underutilised, for fear of losing valuable experience and knowhow. Companies comment to us that the time and resources needed to win new business and secure contracts has increased sharply in the face of weak demand.[7]

I'm sure that these mechanisms and many more like them are at work today. But are they sufficiently strong for us to be confident that the likely relationship between growth and inflation would be unusually favourable were demand to increase strongly? Why should these mechanisms be so much more pronounced now than in previous recessions? Wouldn't most of them have seemed equally important in the past? I find it hard to believe that these types of effects are the entire – or even the main – explanation for the weakness in productivity.

What is unusual about this downturn is that it has been associated with a severe and prolonged financial crisis. Several of our banks are still not in a position to lend normally. Many firms have had to economise on working capital as the cost has increased and the availability reduced. The ability of many SMEs to raise finance to fund new investments or business expansion has been constrained. The efficiency with which banks have been able (or willing) to reallocate funds from outdated businesses and sectors towards new and dynamic companies has been stunted. It seems implausible to assume that the impairment of our banking system – the very life blood of our market economy – has not affected the productivity and general efficiency with which companies operate.[8] If that is the case, we may be less confident that the supply capacity of our economy will pickup markedly purely in response to an increase in demand, unless and until some of these credit frictions are repaired.

Where does all this leave us?

The argument that it's possible to grow the economy without much increase in inflation is, of course, seductive and enticing. It's like being offered a free lunch. And yes, there are some grounds for thinking that the trade-off between growth and inflation may well be unusually favourable. But how strong those mechanisms actually are is far from clear. And it seems

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7 For a more detailed discussion of some of these points, see McCafferty (2013).

8 There are a number of empirical studies that suggest financial crisis can have material effects on productivity and output. See, for example, Furceri, D and Mouragane, A (2009), Oulton, N and Sebastía-Barriel, M (2013), IMF World Economic Outlook (2009).

particularly optimistic to assume that the financial crisis and the near crippling of our banking system has played little role in the recent limp supply-side performance of our economy.

Taken to its limit, the argument that monetary policy can be used to expand demand with little or no implications for inflation challenges the consensus that the best contribution that monetary policy can make to the long-term health and prosperity of the economy is to deliver price stability. That consensus is based on painful experience that monetary policy can't affect the level of output in the long run. That we can't generate permanently higher output and permanently higher employment simply by printing more money.[9] We should be nervous about how quickly we overturn that consensus.

Conclusion and summary

Let me conclude.

The financial crisis has thrust the rather reserved world of central banking and monetary policy into the spotlight. That is both understandable and healthy. Monetary policy failed to prevent the financial crisis. And in many countries, including the UK, it has failed to stimulate the growth that we all long to see. It's only right that inflation targeting – the dominant paradigm governing the operation of monetary policy in much of the industrialised world – should be questioned and challenged.

And to my mind it has a good story to tell. The inflation target ensures that the primary objective of monetary policy is to deliver price stability. But it affords the flexibility that it can be operated in such a way as to support output and employment. The MPC has used that flexibility to the full in recent years: it has been at the forefront of providing support to our economy in the aftermath of the financial crisis and it will continue to be so.

But we must remember our mistakes of the past. Without credibility there can be no flexibility. And ultimately, the best contribution that monetary policy can make to sustainable growth and long-run prosperity is to deliver enduring price stability. That is important to remember in the face of suggestions that inflation is somehow yesterday's battle and that the focus of monetary policy should be turned even more firmly towards growth. It should also be remembered when making difficult judgements about the likely trade-off between growth and inflation and about how far to push the MPC's flexibility.

9 This consensus is a reflection of the belief that the long-run Phillips curve is vertical. Taken literally, the suggestion that it is possible for monetary policy to stimulate increased output with little or no increase in inflation points to a near horizontal long-run Phillips curve, at least over some range of output expansion.

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Annex: Charts

Chart 1: Simple wage Phillips Curve

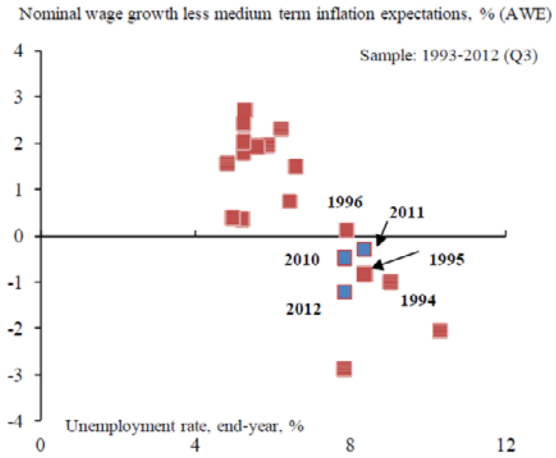


Chart 2: Exit rates from unemployment, by duration

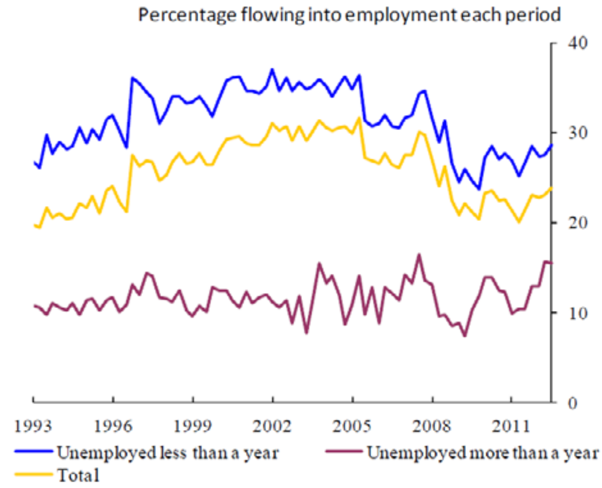
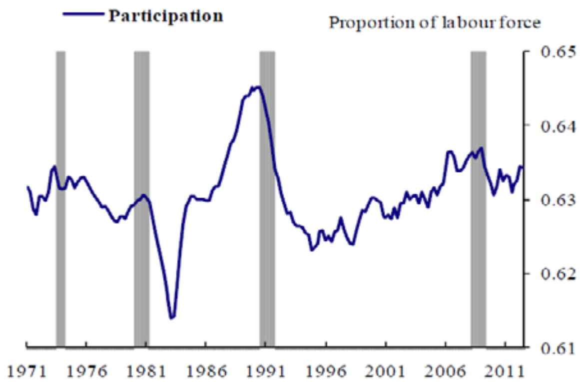


Chart 3: Labour force participation rate



Shaded areas indicate recessions

Chart 4: Corporate insolvencies

Source: Insolvency Service, BIS and Bank calculations. Rate is the number of insolvencies (defined as liquidations plus other insolvency procedures) over the latest four quarters, divided by the number of active companies.