Paul Fisher: The outlook for the UK economy

Speech by Mr Paul Fisher, Executive Director for Markets of the Bank of England, to the Cardiff Breakfast Club, Cardiff, 24 May 2013.

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Introduction

It's nice to be back in Cardiff again. As always, I will be taking the time while here to visit a number of local businesses in an effort to find out what is happening "on the ground" in the Welsh economy. Our network of agents across the UK provide the MPC with valuable intelligence on a continuous basis, but there's nothing quite like hearing it at first hand for oneself.

Recent changes at the Bank of England

I'd like to start this morning by outlining some of the recent institutional changes at the Bank of England, which will help shape the policy environment for a generation.

First of all, supervision is back! The new Prudential Regulation Authority, a subsidiary and therefore part of the Bank of England, has moved into its new offices at 20 Moorgate, just a two minute walk from the back of Threadneedle Street (or faster on a cold morning!) The move back to the Bank will help us to exploit the synergies between microprudential supervision on the one hand and the markets, economics and financial stability expertise of the wider Bank on the other. But most importantly this is an opportunity to change the way in which banks (and building societies, credit unions, insurers and major investment companies) are supervised. There will always be financial firms that fail through making bad judgements and taking risks which crystallise; or because unforeseeable events crop up. We have to allow that to happen in an orderly manner and without the use of public money. But good supervision should make sure that financial firms are focussed on the big issues, are appropriately capitalised, sufficiently liquid and not excessively leveraged. The PRA will focus on those institutions and issues which pose the greatest risk to the stability of the financial system. And their approach to supervision will be to make forward-looking judgements about the risks posed by firms, based on evidence and analysis (and not constrained by a narrow interpretation of either domestic or EU rules).

Second, the Financial Policy Committee is now established with statutory powers. Its primary objective is to identify, monitor and take action to remove or reduce systemic risks with a view to protecting and enhancing the stability of the UK financial system whilst having a secondary objective – like the MPC – to support the economic policy of Her Majesty's Government, including its objectives for growth and employment. Much of the work of the interim Committee on which I served for the past two years was geared towards trying to ensure that banks have enough capital. Frankly, the banks did not like this very much, since raising capital in the current environment would appear to reduce the return on equity in the short term. But banks and building societies need to be seen as safe and sound to fund themselves and to secure other business. When banks are under-capitalised, raising capital can improve the market's perception of their creditworthiness and so make it easier for them to borrow more cheaply. If we are to have a set of banks fit to provide credit and offer payments services to the UK economy, they must be better capitalised and less leveraged than they have been in the past. I want to make one point about this debate which bears repeating: if a bank becomes better capitalised that need not be at the expense of lending to the real economy – capital is actually a source of funding which supports lending. And an improved capital position, for most of the large lenders, need not come about by reducing real economy lending but by a number of actions such as restricting distributions (salaries, bonuses or dividends), by raising new capital or by running down other parts of their balance sheets. The FPC has always been explicit that banks should not meet the need for more capital by reducing lending to the real economy.

The new FPC is one of a small number of macroprudential committees in existence. Few other advanced economies have delegated such macroprudential powers to a technical committee. Will it work to make the UK financial system more robust? I hope so. We have already seen positive benefits just from the supervisors working more closely with the Bank over the past couple of years. And last summer, when the Bank and HMT launched the Funding for Lending Scheme (the FLS) it received policy support not just from the MPC, but from the FPC, the FSA and the DMO. I think it may have been a world first for such a wide group of policy acronyms to be working together to implement a single initiative!

I should also mention the creation of the Financial Conduct Authority, a new institution formed out of the old Financial Services Authority (and not part of the Bank), which will be responsible for ensuring that relevant markets function well. In doing so, it will aim to advance the protection of consumers, the integrity of the UK financial system and promote effective competition. It will be responsible for the conduct regulation of all financial services firms, and the microprudential regulation of those financial services firms not supervised by the PRA, for example, asset managers, hedge funds, many broker-dealers and independent financial advisers.

Developments in the real economy

Whereas those institutional arrangements are new and exciting, the economic data have been disappointing for some time, notwithstanding some improvement in the most recent indicators. Since the trough in output in mid-2009, GDP has averaged just 0.3% per quarter. This “recovery” has been much weaker than previous cyclical upswings – and according to the recently published May *Inflation Report* projections, output is more likely than not to remain below its pre-crisis level for another year or so. There has recently been a lot of discussion about whether the UK has suffered a double-dip recession or not. But to focus on whether growth is a bit negative or a bit positive is to use the wrong reference point. Trend growth should be more like 0.6% a quarter and we have only had five quarters of growth at that rate or higher in the 21 quarters since the start of 2008. There had been no such weak period in the UK since quarterly GDP data were first published in 1955. Even compared with previous examples of financial crisis – whether at home or abroad – the UK economy has been puzzlingly weak for a long time.

I want to take the opportunity today to offer a possible explanation that at least fits some of the data. Much of what follows has been used as a narrative in recent *Inflation Reports*.

It is as if the different groups within our society – households, businesses, banks and the Government – have all decided that their future financial positions, on average, will be worse than they thought before the crisis. As economists, we would say “a reduction in estimated permanent income”. I will come back to reasons why, but, given that premise, we can explain much of what is happening.

The household sector, of course, has people in many different circumstances, so one can’t tell a single story. But, subject to the vagaries of data revisions, it appears that people on average are saving much more than they were pre-crisis. Some may be trying to reduce debt levels; some saving to fill holes in expected pensions; some for university tuition fees and some in response to heightened uncertainty about future employment. Meanwhile, many of those who want to leverage up – such as first-time house buyers – are having to save for a larger deposit than they would have done pre-crisis. Consumption growth has been very muted: in 2012 it grew at less than half its average rate in the pre-crisis decade. And the level of consumption remains about 4% below its pre-crisis peak.

One possible household reaction to lower expected incomes is for people to try and work harder, and certainly to avoid unemployment if at all possible. This means being willing to stay in (or find) work even though the benefits from that – real wages – are being squeezed. Labour market participation – the number of people in work or actively seeking employment – has held up well since the 2008/09 recession; this contrasts with previous recessions when workers were discouraged from the labour market and the participation rate fell sharply. The acquiescence of the UK labour force in accepting lower real wages is quite remarkable for those of us who grew up during the wage-price spirals of the 1970s and 80s. It explains in part why unemployment has stayed much lower than we would have expected, given the weakness of output growth. Much of the labour force has priced itself into work.

The public sector has also been addressing its finances. There was clearly a greater structural deficit in the fiscal position than anyone thought pre-crisis and the Government are trying to reduce public expenditure and raise income to get back onto a sustainable footing. I should note that no consolidation at all would have been unsustainable and was never an option. Nevertheless, as the May *Inflation Report* noted, it is likely that the consolidation has weighed on output over the past three years and will continue to do so.

The financial sector also has its balance sheet problems. The major banks in particular have been re-structuring, reducing wholesale market borrowing, improving their liquidity positions and building up capital. I believe every large UK lender has at least one non-core portfolio they are running down, and commercial property lending is typically a common factor.

Finally, the corporate sector. In aggregate, UK businesses continue to save rather than invest, running up a significant and on-going corporate surplus. But like the household sector, there are different sub-groups. Some, especially large companies, are cash rich and profitable but not investing as much as they perhaps could. Some companies have long-standing pension fund deficits that need to be fed, if not eliminated. Others, particularly some SMEs, ought to be leveraging up as they grow but may be struggling to get sufficient credit (at least in aggregate). And many firms borrow to fund activity in the commercial property sector which remains relatively weak.

Collectively the economy as a whole also needs to rebalance. The significant external trade deficit built up pre-crisis needs to close up further to be sustainable in the medium term.

If this description of the changing economy is correct, why has it happened and how does that affect the outlook? Until 2008 it did not appear that the UK economy was growing faster than the very long established trend. Maybe that trend had shifted without anyone noticing? Perhaps the growth of the financial sector crowded out other industries and the financial crisis has left a hole that needs to be filled by other sectors? Perhaps globalisation has shifted activity from developed to emerging economies? The rise in global energy prices clearly makes us all worse off and is likely to be an important factor. Or maybe it is just that the crisis in Europe has turned out to be such a big drag on the UK – not just through trade but through financial markets and through general household and business confidence? The source – or sources – of the revision to income expectations will matter in the medium to long term. If the downward revision to income expectations proves to have been justified then the level of output is unlikely to return to its previous path. We don't know yet – it will depend in part on how persistent these shocks turn out to be – but this is clearly important to the longer-term outlook for both growth and inflation.

In the near term, whatever the source of the changes in perceptions of permanent income, it is likely that growth will continue to be below the previous trend until more of the real adjustments to balance sheets across the economy have been made. That includes households, the public sector, banks and other businesses. In my view we are maybe two thirds to three quarters of the way through in each case, varying both across and within sectors. There is nothing scientific or "official" in that assessment! It's just a personal best guess on the back of how the economy is behaving plus some direct knowledge of the progress of the banks with their deleveraging plans. To be clear, we do not need to be 100% finished before growth strengthens at all, and we may be beginning to see some signs of a pick-up. And I think this prognosis is consistent with our *Inflation Report* central projection of a gentle, albeit sustained, recovery over the next three years. That is a somewhat sobering, but not calamitous, outlook for real growth. Most of the economic problems we face will be eased as growth recovers but, in my view, a return to boom conditions is unlikely in the UK anytime soon.

If that is the outlook for growth, then what about inflation? That has been above target now for most of the past five years. But it would be hard for anyone to argue that inflation has been high because of excess demand growth in the UK. And because monetary policy works in large part by boosting or restraining nominal demand that would not seem to be the root cause of such high inflation either. Rather we have been subject to a range of cost or supply-side shocks including high energy prices internationally, compounded by the large depreciation of sterling during the financial crisis, and tax changes and other "administered" or regulated price rises reflecting difficult policy choices (such as producing cleaner energy). As a relatively small open economy, overly dependent on financial services, the UK has been more exposed than most countries to externally-driven cost pressures.

It may sound perverse, but my concern for much of the past five years has been the risk of eventual deflation: that once the temporary effects of the various price level shocks work off, weak demand growth would leave us with a Japanese-style economic malaise which would have been very difficult to escape from. The asset purchase programme – or QE as it is generally called – has been crucial in avoiding that outcome. During the recession we have been trying very hard to stimulate the economy – but always with an eye on inflation returning to the 2% target in the medium run, as we are required to do. If QE has contributed to inflation still being somewhat over-target at around 2 ½% now, that seems to me a much better outcome than the alternative of a deeper recession and a greater risk of deflation. We have had our critics over the past few years and an open debate on monetary policy is to be welcomed. But I have not heard anyone suggest a more convincing or attractive policy stance for monetary policy than that which we have pursued.

The question now is what we should do with monetary policy as these shocks work their way out of the system. It feels as if monetary policy has done well to underpin the economy and to stop recessionary forces from gaining the upper hand. But it hasn't been sufficient to generate a return to trend growth yet, let alone any catch up. The reason may be in the real balance sheet adjustments that I have described. Low interest rates and increases in the money base make the economy very liquid. Those with excessive debt levels can take their time to adjust in an orderly fashion. Tighter monetary conditions would have risked forcing the adjustments to take place in a more disorderly way, with negative spillovers driving a much weaker path for output, higher unemployment and the possibility of more persistent damage to economic potential. But loose monetary conditions can't force the adjustment to be made at any particular pace – the problem is asymmetric. If we push too much money into the system, the risk would be that it does nothing for real output, which is being driven by real adjustments, instead it could just end up in higher inflation. We cannot guarantee that a specific monetary boost will split into real and inflationary outcomes in the way that we might all wish.

We may like to think that low interest rates are the result of MPC decisions. That may be true of nominal rates. But real interest rates are low in large part because there has been so little real growth in the economy. One can't expect to earn low-risk but high real rates of return in financial markets if the underlying real economy is not growing sufficiently to generate those returns – the two are inextricably linked. That is why savers have been having such a hard time. To improve the position for those with net savings we really need to see stronger real growth so that nominal interest rates can start to normalise. So pursuing a strategy of monetary accommodation will be in the interests of savers in the medium-term, even if it feels like the opposite in the short-run. We should all want to see sufficient growth such that interest rates can start to rise.

Taking all that together, my policy vote has been driven by the need to continue supporting the required real adjustments – which still have much to work through – but cautiously, so as not to risk inflation expectations becoming de-anchored. My personal view is that faster growth in the near-term might actually help keep inflation down for a while as productivity growth picks up. Eventually, however, reductions in the degree of spare capacity in the economy should bring domestic inflationary pressures back to normal, so it will be important that other factors influencing inflation do not remain elevated. The MPC is committed to getting inflation back to around the 2% target – which it will in due course, in the absence of further shocks and if we are careful with policy.

Monetary accommodation should generally be helpful to balance sheet rebuilding, but there are limits. For example, I am not convinced that a further reduction in interest rates would stimulate demand at this stage. Cuts in interest rates work in part by encouraging spending (or investment) at the expense of saving. Working from such a low level of interest rates, we do not know for sure whether those effects remain the same, given pressure on the incomes of savers and high debt levels of borrowers: further cuts in rates may not feed through to higher consumption in the normal way and some of the effects could even be perverse. We may well find that getting rates back to normal is part of re-establishing economic activity at potential in due course.

If monetary policy is limited in terms of its ability to generate growth, what else could we do to support the real adjustment of the economy? In the banking sector we have been particularly active. The Funding for Lending Scheme has been extended until the end of 2014, and amended to provide additional incentives to lend to SMEs and to non-bank providers of credit to the real economy. The FPC's capital recommendation should be seen as complementary – seeking to spur the increased capitalisation of the banks' balance sheets so they are seen as safe and sound and hence have market access to reasonably priced funding in the future, while using our facilities to make sure they have access to sufficient reasonably priced funding in the meantime. The banks are responding, quite rightly, by not adjusting their strategic balance sheet aims of running off weak portfolios, often commercial property related, but they are maintaining or increasing lending to their core customers. Some are consciously rebalancing their books between retail and corporate lending. Much has been done even in the weakest institutions. But there is more to do to complete the task of ensuring that the banking system is fit for purpose.

My main message today is that you should expect the Bank of England to continue to play its part in supporting the recovery towards genuine real growth, whilst being careful not to let domestic inflationary pressures build, consistent with our remit. But monetary policy can only take us so far and the necessary real adjustments will need real changes and, most importantly, real time to work through.