

## Paul Tucker: Monetary strategy and prospects

Speech by Mr Paul Tucker, Deputy Governor Financial Stability at the Bank of England, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of the Prudential Regulation Authority Board, at the Association for Financial Markets in Europe flagship conference on “Financing growth”, London, 24 September 2013.

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Around the western world monetary policy is at a critical juncture. As differences in the relative pace of recovery in different economies become apparent, each central bank is having to articulate how it sees the particular conditions it faces. Contrast that with early 2009, when we were all simply priming the monetary pumps to prevent our economies slipping into depression and deflation. Indeed, contrast it with 2011 and 2012 when, again, central banks acted more or less in unison to contain, as best we could, the spillovers from the crisis in the euro area periphery. Today, although normality is hardly restored, we are back to circumstances where differences in local economic conditions matter to domestic monetary prospects and to exchange rates.

### The big policy trade off

In the UK, the core challenge lies in balancing two medium-term risks – to the economy’s productive capacity and to price stability.<sup>1</sup> Concretely, the longer the weakness in activity, the greater the erosion of the economy’s capital resources and the damage to the skills and capabilities of our labour force. The Monetary Policy Committee has needed to provide monetary stimulus not only to contain the short-term economic weakness but, even more important, to reduce its longer-run costs – social and economic. But we cannot do that at the expense of price stability – or, more technically, of allowing *medium-term* inflation expectations to drift away from the target of 2%. Were the anchor to slip, our ability to support recovery would be undermined. It is sometimes suggested that independent central bankers are more averse to inflation than to periods of low growth and increased unemployment. I hope the past few years have demonstrated that, in fact, it is the credibility of the Bank of England’s commitment to price stability that enabled us to provide such exceptional monetary support to help the recovery. It is unimaginable that, prior to Bank independence in 1997, any government would have been able to hold the policy rate at effectively zero and make a further monetary injection of £375bn without inflationary expectations – and government financing costs – spiralling out of control.

But credibility is not to be taken for granted. Even we cannot provide stimulus without limit, without a wary eye to inflation expectations.

Nor has it been at all easy to judge just how much stimulus has been needed to secure recovery given the extraordinary uncertainties about what is going on in the real economy. On the one hand, the rise in unemployment, while inflicting a terrible cost on those directly affected, has been a lot smaller than anyone would have expected given the weakness in output. On the other hand, this means that productivity has fallen over recent years, leaving it some 15% below current estimates of its pre-crisis trend path – in sharp contrast to the US. Let’s be clear: we do not understand why productivity has been so weak. And that means that we are highly uncertain about the amount of slack in the economy currently and prospectively; uncertain about the extent of the consequent downward pressure on domestically-generated inflation; and, thus, uncertain about the path of output and employment consistent with non-inflationary growth. That sums up the background to my

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<sup>1</sup> This is reflected in pages 13–15 of Monetary Policy Committee’s document on forward guidance, available online at <http://www.bankofengland.co.uk/monetarypolicy/Pages/forwardguidance.aspx>.

approach to policy settings over the past couple of years. Provide stimulus; pause to see whether inflation expectations remain anchored; if, but only if, they are and more stimulus is needed, provide it etc. A “probing” approach.

### **The MPC’s framework of forward guidance**

And, as I see it, that is broadly consistent with the Committee’s new framework of Forward Guidance. The government having revised its Remit to the MPC, the Committee has, in effect, formally clarified that it is adopting a probing approach to policy in order to strike the right balance between risks to stability and the risks of sclerosis.

To be clear, I do not see the Forward Guidance – and personally would not favour – committing the Committee to knowingly keeping policy loose beyond the point that would be prudent. I say that because, in parts of academia and the commentariat, the expression “low for long” is used in a rather special way to mean just that: that policy should be loose *beyond* the period that, *ex post*, would warrant special stimulus, in order *actively* to deliver a *persistent* rise in inflation and inflation expectations above target, thereby pushing down prevailing real rates of interest and so accelerating recovery.<sup>2</sup> While not without insight on the mechanics of monetary stimulus, that stream of economic modelling makes the absolutely critical assumption that even as the monetary authority deliberately generates a persistent rise in inflation, its anti-inflation credibility remains 100% intact; later, the central bank simply announces that things are back to normal. That is utterly unrealistic.

To re-iterate: the MPC’s forward guidance provides an articulated framework for a probing approach to policy, without a change in our preferences on inflation.<sup>3</sup>

Saying more about the Committee’s approach to policy in this way might be particularly valuable during a period when signs of recovery have become more apparent. These are conditions in which it would be very easy for the financial markets, businesses and households to jump to the mistaken conclusion that monetary stimulus will soon begin to be withdrawn. Given the slack in the economy, the Committee is not in a rush.

Assuming anchored inflation expectations, an orthodox central bank would not contemplate beginning to withdraw stimulus until the economy had reached “escape velocity”, which I have defined to mean “the economy growing, and being set to continue to grow, at a pace that gradually absorbs the slack in the labour market and within firms”.<sup>4</sup> And at that point the central bank would assess the erosion of slack in the economy and thus the extent to which downward pressures on inflation were dissipating.

Since my own policy deliberations have been framed in terms of “escape velocity”, I saw real merit in any MPC Forward Guidance being cast in terms of a threshold for real growth. Manifestly, this could not be a measure of slack in the economy; it would be clear what it was and was not. Once passed, it would prompt a rich assessment of slack and inflationary pressures, drawing on the widest possible range of indicators. The Committee decided on a threshold specified in terms of unemployment.

The MPC’s threshold is what it says: a threshold for assessing inflationary pressures, although the Committee must maintain that broader assessment month-by-month, quarter-

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<sup>2</sup> See Woodford (2012), “Methods of Policy Accommodation at the Interest-Rate Lower Bound,” presented at the Jackson Hole symposium.

<sup>3</sup> This is consistent with Bean (2013), “Global aspects of unconventional monetary policy”, the Monetary Policy Committee’s Forward Guidance document (op cit); and with the Governor’s remarks during the August Inflation Report Press conference: “guidance is not a change in the reaction function, but it gives a better sense of the MPC’s reaction function to financial market participants”.

<sup>4</sup> See remarks at the Treasury Select Committee hearing to discuss the Inflation Report on 28 June 2011, and 2012 and 2013 Annual Reports on Monetary Policy to the Treasury Select Committee.

by-quarter. The threshold is not a target. Indeed, a monetary authority cannot have a target for unemployment; it can have a target only for price stability, as Paul Volcker recently stressed.<sup>5</sup> That is why the Committee's Forward Guidance incorporates, crucially, a "knockout" for inflation expectations, where individual members will have to judge whether they are "*sufficiently well anchored*".

Beyond that, I am glad that in its "financial stability knockout", the Committee has in effect recognised that monetary policy influences risk-taking behaviour in the financial system.<sup>6</sup> This does not mean that the MPC will suddenly lurch towards a supplementary goal of trying to control excesses in markets. The UK's new architecture gives the Financial Policy Committee some tools to do that where there is a threat to the stability of the financial system. But in the limit monetary policy can be a backstop – as booms and busts increase the likelihood that inflation will be volatile in the future.

Overall, the Committee's Forward Guidance can forestall *avoidable* uncertainty about its "reaction function", about how policy will be set. But it does not affect the greater uncertainty about the evolution of the recovery.

### **Uncertainties about the economic outlook**

Of course, financial markets inevitably transform the Committee's state-contingent guidance into predictions of *when* the Committee will begin to withdraw monetary stimulus; the markets trade instruments with different maturities, ie with time-contingent features not with state-contingent contractual triggers. But the MPC provided state-contingent guidance for a reason. We cannot wave away the uncertainties surrounding the performance of the real economy. If we only understood *why* productivity growth has been so weak, we could be more confident about whether or not it will recover in tandem with a recovery in spending. If that does happen, the fall in unemployment could be slow, and monetary stimulus might not need to be withdrawn for some time. If, on the other hand, productivity growth remains weak, job creation as the economy recovers could be strong, as it has been on average over the past couple of years. That is why there is a wide band of uncertainty around the MPC's August forecast for unemployment. My own probability distribution for unemployment is broadly "flat" in the sense that I do not regard one of those scenarios as materially more likely than the other. As data comes in, the Bank's projections for unemployment are far more likely to change, in one direction or the other, than the Committee's forward guidance. Probabilistically, that could explain part of the rise in the money market curve given the signs of recovery. All this underlines the need for the Committee to keep under review, month by month, a wide range of indicators of slack in the labour market and in firms. For example, if participation in the workforce develops in unexpected ways, the degree of slack implied by any rate of unemployment might change.<sup>7</sup>

That recovery is, I trust, finally underway should not be a complete surprise. The MPC has provided a massive amount of monetary stimulus over recent years. Its effects were arrested for an extended period by the threat of severe turmoil in the euro area, coming on top of an erosion of spending power from rising commodity prices. Monetary policy (and credit policy for that matter) works partly by incentivising households and firms to bring forward future spending. They were not likely to do so when the risks and uncertainties on our Continental doorstep were so great and so unusual. As those immediate risks and uncertainties receded,

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<sup>5</sup> See Volker (2013), "Central banking at a crossroad".

<sup>6</sup> On the "risk channel" of monetary policy, see Stein and Hanson (2012), "Monetary policy and long-term real rates"; Tucker (2012), "National balance sheets and monetary policy: lessons from the past"; and Borio and Zhu (2012), "Capital regulation, risk-taking and monetary policy: a missing link in the transmission mechanism?".

<sup>7</sup> This is broadly comparable to shifts in the velocity of money affecting the interpretation of the rate of growth of the money stock when monetary aggregates were used as targets by UK governments in the 1980s.

it was as if UK monetary policy was being switched back on.<sup>8</sup> With monetary stimulus maintained, now within the framework provided by the Committee's Forward Guidance, recovery will continue to be underpinned – although of course the road will be bumpy.

That is a key element of what, in our internal discussions, I have called the Keynesian part of the Bank's policy response to the crisis. The Funding for Lending Scheme; the liberalisation of our liquidity insurance to the banking system – through the Extended Collateral Term Repo scheme and the liberalised Discount Window Facility; and the Financial Policy Committee's related Recommendation to the Prudential Regulation Authority to relax liquidity requirements on banks – all these fell under the same broad heading. "Keynesian" because we are supporting demand in order to help smooth the adjustment the economy is going through.

But a central bank's monetary and liquidity interventions cannot remove the need for adjustment. The UK economy entered the crisis with too much debt in banking, in the household sector, in government and, for the nation as a whole, externally. And the UK entered the crisis with the composition of demand imbalanced – too much public and private consumption, too little net trade. Indeed, aggregate demand had been unbalanced for so long that the economy's productive capacity was (and probably still is) unbalanced, investment in capital having followed the pattern of demand. For prosperity to be put on a secure footing for the longer term, adjustment is still needed.

With one vital exception, engineering structural change in the economy is not the responsibility of the central bank.

The exception of course is the safety and soundness of the banking system, which is a precondition for broader monetary stability. An undercapitalised banking system would not be able smoothly to supply sufficient credit to aid recovery as demand picks up, enabling investment in innovations and efficiency. Nor has it been able to do so as much as needed to help capital shift to firms and sectors that are beneficiaries of the new pattern of global and domestic demand. In my view, that may explain some of the weaknesses in productivity growth.<sup>9</sup> The Financial Policy Committee required recapitalisation of the UK's big banks and building societies not simply because that is needed to underpin stability, which it is, but also because a resilient banking system is a precondition for sustained and better balanced recovery. New entrant banks can do a bit, but the big incumbent banks need to be healthy too.

Their repair *is* now underway. That has required, and will continue to require, realism about asset values, expected losses and risks – not pretending, taking the medicine. In that sense, it is a policy in the spirit of Hayek.<sup>10</sup> So the overall policy package has combined Keynes and Hayek.

## Conclusion

In the wake of such a massive crisis, recovery has needed active monetary, liquidity and banking policy. Beyond the realm of central banking, it needs supply-side reform – to create optimism about higher incomes and better investment opportunities in the future.

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<sup>8</sup> See the Minutes from the Monetary Policy Committee's meeting on 7–8 November 2012: "At the present time, it was possible that elevated uncertainty and a desire to reduce leverage meant that real activity was less responsive to lower borrowing costs than normal. But this situation could easily reverse, and with it the traction that lower yields could have in stimulating demand and output."

<sup>9</sup> See Broadbent (2012), "Productivity and the allocation of capital", pages 30–33 of the Monetary Policy Committee's November 2012 *Inflation Report*; and Tucker (2013), Annual Report to the Treasury Select Committee.

<sup>10</sup> There is echo of this in Bean (2013), "Global aspects of unconventional monetary policy".

If recovery does gain traction, the MPC will need to avoid misperceptions about the likely course of policy. The MPC is using Forward Guidance to help avoid those possible misconceptions. The Committee cannot make the uncertainty about the supply side of the economy and, thus, about the degree of slack go away. But by adopting a probing approach and maintaining an eclectic approach to its assessment of the outlook, the MPC has the wherewithal to provide broadly the right degree of stimulus without risking, or diluting its commitment to, price stability.