# Charles Bean: The UK economic outlook

Speech by Mr Charles Bean, Deputy Governor for Monetary Policy of the Bank of England, at the Society of Business Economists Annual Conference 2013, London, 22 October 2013.

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Good morning! It is now more than five years since Lehman Brothers collapsed, ushering in the worst phase of the financial crisis, followed by a sharp and synchronised contraction in global economic activity. While growth was reasonable for the first year after output troughed in the middle of 2009, the pace of expansion since then has proved disappointingly weak. Just how disappointing is illustrated by Chart 1, which shows our August 2010 *Inflation Report* projection for GDP growth, together with the ONS's present estimates of what actually happened. It is not a pretty sight. Whereas our central expectation was for a cumulative rise in output of 9% over the following three years, the actual rise is presently estimated to have been a miserable 2%. And we weren't alone. The performance of other forecasting outfits was pretty similar.

At a global level, a similar story can be told. The IMF has consistently revised down its projections for global growth. Back in October 2010, it was forecasting a cumulative expansion in output of 14% over the following three years, whereas the actual figure was just 10%. Indeed, the Fund has revised down its world growth forecast for 2013 in every subsequent *World Economic Outlook*: it now expects just 2.9%, against the 4.6% it projected three years ago.

But there are at last signs that a recovery may be gaining traction. In the United Kingdom, output rose by a little more than 1% in the first half of the year. And business surveys point to something closer to 2% for the second half of this year, somewhat faster than the economy's historical average rate of expansion. That is good news. But can we expect it to be sustained? Or is there a danger that it will prove short-lived? That is the first issue I want to address this morning.

A good place to start is by looking backwards, for if we understand the past, then there is surely a better chance of getting future prospects right. Why, then, was the growth performance shown in Chart 1 so disappointing? Back in the summer of 2010, our expectation was that demand growth would be supported by a steady improvement in credit conditions and a gradual decline in uncertainty. That would foster both an increase in consumer spending as the saving rate fell back from post-crisis highs and a recovery in business investment. Moreover, we expected net trade to provide a significant stimulus, as global activity continued to recover and the 25% depreciation in sterling since the beginning of the crisis worked its magic.

That was not quite how it worked out, of course. Chart 2 shows the cumulative contributions of the main expenditure components to growth since the middle of 2010. Most of the growth, such as it was, was down to private and public consumption, though the former was nevertheless quite a bit weaker than we expected. Net trade was distinctly disappointing relative to our expectations. And fixed investment continued to drag on growth. Lurking behind this picture was: first, a much less pronounced improvement in credit conditions than expected, with the spreads over Bank Rate of borrowing and lending rates actually increasing for much of the period and only falling sharply after last summer; second, much weaker global growth, as the problems of excessive indebtedness in the euro-area periphery and the associated uncertainties concerning the resilience of European banks pulled the region into a second recession; and, third, the kick to net exports from the depreciation of sterling was apparently offset by a fall in foreign demand for business and financial services triggered by the financial crisis.

As far as inflation goes, at the time of our August 2010 *Inflation Report*, CPI inflation was a little over 3%, reflecting higher oil prices, the restoration of VAT to 17.5% and pass-through from the depreciation of sterling (Chart 3). Our central expectation was for inflation to remain elevated in the short term, as VAT was raised further to 20%, but then to fall back to well below the 2% target when that rise dropped out of the twelve-month comparison. And with growth turning out much weaker than expected, one might also have expected to see inflation turning out even weaker than that in the medium term.

As Chart 3 shows, however, the outturn was in fact markedly higher than in our central projection, with inflation peaking at 5.2% in September 2011. In large part, that was down to higher than anticipated energy and import prices, as the strong recovery in the energy-intensive emerging economies, together with supply concerns, put upward pressure on oil and other commodity prices. Higher energy and import prices also further depressed UK domestic demand growth through their adverse impact on household real incomes.

The primary reason for believing that the nascent resurgence in growth that we have seen this year will be sustained lies in the moderation of these past headwinds. First, UK banks have made considerable progress in bolstering their capital positions, in part prompted by the Prudential Regulation Authority's balance sheet exercise earlier this year. Price-to-book ratios have risen back to around unity. And bank funding costs have fallen sharply over the past year (Chart 4), aided by the Funding for Lending Scheme. UK banks are now well placed to provide the credit necessary to support a recovery.

Second, the euro area is no longer in existential crisis, in part as a result of the willingness of the European Central Bank (ECB) to take redenomination risk off the table through its Outright Monetary Transactions programme. The countries of the euro-area periphery have also made progress in restoring competitiveness and rebalancing the composition of demand, though there is still quite a way to go. Member states are working towards the creation of a functional banking union, which has the potential to break the link between sovereigns and banks. And in preparation for becoming the euro-area banking supervisor, the ECB is planning a rigorous review of the quality of banks' assets, to be followed by a set of stress tests and, if necessary, recapitalisation. Provided these carry credibility with the market, this could do much to restore confidence in the euro-area banking system.

But while some headwinds are abating, others remain. The need to restore the public finances to sustainability means that fiscal consolidation will continue for some years yet. And, for some households, the past accumulation of debt may weigh on spending. Finally, even though the cloud of uncertainty may be lifting, businesses are likely to remain cautious about increasing their investment spending until it is clear that the recovery in demand will be sustained. So the pace of the recovery is likely to remain fairly modest by historical standards. That will mean that it is likely to be some time before the economic slack that built up during the recession has been brought back into use. I will say a little more about that later.

It is against this background that the MPC in August decided to provide some explicit guidance about the considerations that will inform our policy decisions over the coming months. In particular, we wanted to signal that we would not immediately begin to withdraw the considerable monetary stimulus injected after the financial crisis simply because growth had picked up. Rather we wanted to make clear our intention to maintain the stance of policy until it was clear that the recovery was well entrenched and the margin of economic slack had been substantially reduced, provided doing so did not entail material risks to price stability or financial stability.

As you will all know, we implemented that by committing not to raise Bank Rate until after the unemployment rate has fallen to 7%. This is a little higher than our current estimate of around 6.5% for the medium-run equilibrium rate of unemployment – that is, the sustainable unemployment rate once nominal rigidities and other transient factors have worked their way through. In the long run, one would expect the sustainable rate to be even lower, as workers who have become disconnected from the labour force are encouraged back into it.

Specifying our guidance in terms of the unemployment rate, rather than, say, some estimate of the output gap, makes particular sense because of the uncertainty surrounding the achievable level of productivity in the economy. Since the start of the crisis, output per hour worked has fallen by around 5%, leaving it more than 15% below where it would have been if it had simply continued growing at its pre-crisis trend rate. As discussed in past *Inflation Reports*, as well as numerous speeches by MPC members, there are a variety of explanations for this weak productivity performance. These include: specific factors, such as the decline in North Sea oil production and an exaggeration of productivity growth in the financial sector before the crisis; the hoarding of overhead and skilled labour through the downturn; unusually low rates of investment on the back of heightened uncertainty about the outlook; the adoption of more labour-intensive production techniques, encouraged by the high degree of wage moderation; thick-market externalities, which make it easier to find and transact business when demand is strong; and a misallocation of credit as banks repair their balance sheets, with heightened forbearance shown on existing loans to low productivity firms, coupled with caution as regards lending to risky businesses that offer the prospect of higher productivity.

Some of these mechanisms depressing productivity can be expected to unwind naturally as demand recovers. But others might take longer and require the restoration of the banking system to full health. And some of the lost productivity growth may prove to be permanent, for instance because of the foregone opportunities for learning by doing. Now while we have several explanations for this "productivity puzzle", I think it is fair to say that none of them yet seems to provide a completely convincing explanation. And although different MPC members place different weights on the possible explanations, we all agree that there is considerable uncertainty as to how productivity will evolve as the recovery proceeds.

Unemployment is certainly not a perfect guide to slack in the labour market. For instance, the recent increase in the number of workers wanting to work more hours suggests it understates the absolute level of slack[1.] But it is not unreasonable to expect this margin of "potential hours worked" to move in line with unemployment. And, unlike in the 1980s, we have not seen a substantial movement in the labour force participation rate, which suggests that the number of discouraged workers has not risen markedly. So overall, *changes* in the unemployment rate are, we think, likely to provide a reasonable guide to the evolution of labour market slack.

Now consider what will happen if the weak productivity performance of recent years is simply a consequence of the weak state of demand and so reverses as the recovery proceeds. In that case, businesses will be able to supply the extra demand without greatly expanding their workforces and unemployment will be slow to fall. In these circumstances, it is indeed appropriate to keep monetary policy loose as potential output is well above actual output. Conversely, suppose that the financial crisis and subsequent recession has wrought lasting damage to productivity. In that case, unemployment is likely to fall faster as demand grows, meaning that unemployment will reach the 7% threshold sooner. Then it will be appropriate to tighten policy sooner in this case, as potential output will be lower. The only case where the linkage of policy to unemployment is potentially problematic is where there is scope for productivity to increase as demand recovers, but for some reason firms take on extra labour *before* the increase in productivity takes place. But this seems rather unlikely to me.

In any case, it is important to realise that the 7% threshold does not constitute a trigger for the MPC to raise Bank Rate. Rather it represents a prompt for the Committee to undertake a

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1 See Bell, D N F and Blanchflower, D G (2013) 'Underemployment in the UK revisited', *National Institute Economic Review, No. 224.*

broad assessment of the prospects for demand, supply and inflation. If it appears that there is still a substantial degree of slack in the economy which can be absorbed without threatening the achievement of the 2% inflation target in the medium term, then there will be scope to maintain the existing stance of monetary policy longer, perhaps re-setting the unemployment threshold to a new lower level at the same time. In any case, as a breach of the threshold becomes imminent, it seems likely that the Committee will wish to provide further guidance on the future determinants of policy in order to reduce any uncertainty surrounding our reaction function.

Can we say anything yet about the effectiveness of the introduction of forward guidance? As already noted, the primary objective is to give confidence to business and households that policy will not be tightened until there is a material reduction in economic slack (assuming that neither price nor financial stability are threatened) and to prevent an excessive snap-back in market interest rates taking place simply because a recovery is under way.

As far as the broad message to businesses and households goes, contacts of the Bank's Agents suggest that businesses have got the message that the MPC will only begin to tighten policy once the recovery is entrenched and slack has been materially reduced. And in the period after the MPC's announcement, the Markit Household Finance Index suggested that households expected Bank Rate to rise later than before, although the date has since come back in again, perhaps reflecting the continued flow of positive data.

At first sight, the evidence from market interest rates is more equivocal. Chart 5 shows the instantaneous forward yield curve in May, August and today. Yields have risen substantially since May. On the face of it, that appears to suggest that the guidance has not been very effective at influencing the expectations of market participants. Interpreting movements in market rates is, however, complicated by the fact that other factors influencing yields have not been constant.

First, the recent run of UK data has been unusually strong relative to market expectations. That should generate upward pressure on market interest rates as, other things equal, a reduction in the degree of monetary stimulus would indeed become appropriate sooner if growth turns out stronger than expected. Bank staff have constructed a time series for the news in the incoming data by calculating, for 14 different data series, the deviation of the outcome from the market's expectations (as recorded by the median expectation of economists polled by Bloomberg), normalised by its standard deviation. An aggregate time-series measure can then be obtained by taking an (unweighted) average across the most recent observations for each series. Chart 6 shows such a measure back to 2006, together with analogous series for the United States and the euro area. The series for the United Kingdom recently reached its highest level over this period, emphasising just how much upside news there has been here recently. Moreover, although both the United States and euro area have also generally seen upside news of late, it has been nowhere near as strong as in this country. Market interest rates should therefore have been expected to rise, and by more here than in the other two jurisdictions.

Second, yields rose globally in the summer on the back of expectations that the US Federal Reserve was about to taper its asset purchase program; more recently they fell back when the Federal Open Market Committee (FOMC) unexpectedly decided not to begin phasing out its asset purchases at its September meeting. Given the relatively high degree of substitutability between UK gilts and US treasuries, and assuming that long-term inflation expectations are anchored in both countries, it is reasonable to expect a high degree of correlation of UK long rates with US long rates. But one might expect the correlation to be less pronounced at the short end of the curve, where differences in cyclical positions – and therefore differences in monetary stances – should come to the fore. Strong co-movement should only be seen if either the shock is common in nature, or the international transmission of a shock from one country to the other is strong.

Now, as it happens, measures of co-movement have generally been high since the start of the financial crisis. In the earlier phase of the crisis, when contagion through financial markets was particularly strong, it was reasonable to believe that what happened in the United States was critical to the outlook here. That seems less plausible now, given the substantial progress in repairing the banking systems in the two countries. This thinking lay behind the Committee's decision to issue a statement after its July meeting that the recent upward movement at the near end of the yield curve was "unwarranted". More generally, the explicit guidance provided in August should also serve to emphasise that UK monetary policy decisions are taken with reference to the domestic outlook and will only be influenced by developments elsewhere in so far as they affect that outlook.

There is mixed evidence thus far on whether guidance has helped to de-couple movements in UK short-term rates from those overseas. The prime exhibit against this having happened is the high degree of correlation between UK and US interest rates at the time of the FOMC's unexpected decision at its meeting on 17/18 September not to begin to taper its asset purchases. As far as market participants were concerned, this was surely primarily news about the FOMC's policy reaction function, not about the US economic outlook. So it ought also to have had little impact on UK interest rates. As Chart 7 shows, however, the movement in UK one-year interest rates two years ahead was almost as large as for the corresponding US series. That, together with the high co-movement prior to the September FOMC meeting when US interest rates rose, suggests that market participants may have not yet grasped the extent to which decisions over the level of Bank Rate will be driven by the domestic outlook.

There is, however, other evidence which suggests that some de-coupling may have taken place. Chart 8 shows the correlation between UK forward interest rates and the UK and US data surprise series that I described earlier, split by time period. That the responsiveness of forward interest rates to data news was particularly low during the 2009–April 2013 period is not surprising as Bank Rate was constrained on the downside by the zero lower bound, so that the distribution of policy rates was truncated. That is still relevant today, but economic news has been more consistently to the upside recently, attenuating the impact of the constraint. Importantly, there is some evidence that the response of UK rates to US data surprises has declined since the introduction of the MPC's forward guidance, although the small sample in the most recent period means that the coefficients are not that precisely estimated.

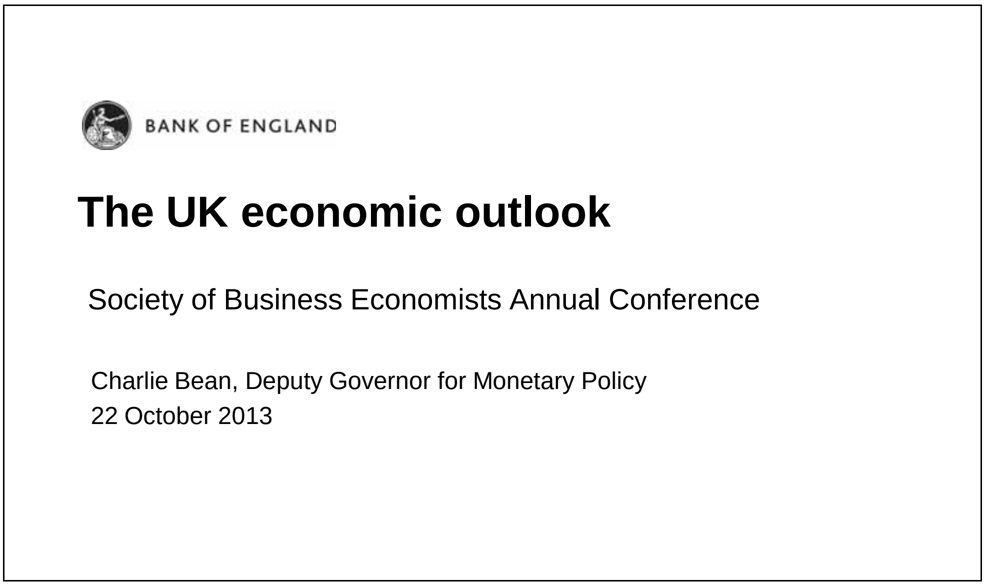
A final piece of evidence, which is at least consistent with the central aim of the MPC's guidance, is presented in my final chart. As I noted earlier, a prime concern was to convey the message that a return to growth did not imply an early withdrawal of stimulus. Rather, if slack was substantial, then it should be possible to maintain the highly stimulatory monetary stance for some while before price stability – as embodied in the inflation target – is threatened. Historically, and particularly in the pre-crisis period, there was a reasonably strong correlation between indicators of growth and the slope of the yield curve at the short end. This is illustrated in Chart 9, which plots the composite Purchasing Managers Index and the spread between the two-year swap rate and the overnight rate.

Now it is not too surprising that there should have been such a relationship during the period before the crisis, as growth was generally steady, with inflation close to target and output close to potential. A period of strong (weak) growth could then be expected to lead to excess demand (supply) and a tendency for inflation to move above (below) the target. Consequently it was quite rational for market participants to expect the MPC to increase (reduce) Bank Rate. But things are different now, as there is potentially a substantial margin of economic slack that needs to be absorbed. In that case, the steepening in the short end of the yield curve ought to be far less pronounced. Fortunately, that is exactly what we see in the most recent data. The curve has steepened alongside the sharp increase in the PMI, but by far less than similar episodes of rising growth in the past would suggest. This too may be an indication that the guidance has had some effect in preventing unwarranted movements at the short end of the yield curve[2]. I am sure, however, that there is scope for much more analysis of the impact of our guidance on the behaviour of market interest rates and, indeed, on the broader economy.

That guidance is, of course, qualified by three overrides or "knockouts". Two of these relate to the risks to price stability. One of these stipulates that our own projection for inflation 18–24 months ahead should be at least as likely to fall below 2.5% as to be above it. The other asks whether there is any evidence that measures of the inflation expectations of households, businesses and market participants have become insufficiently well-anchored to the target. At this stage, we do not see anything to worry about on this score.

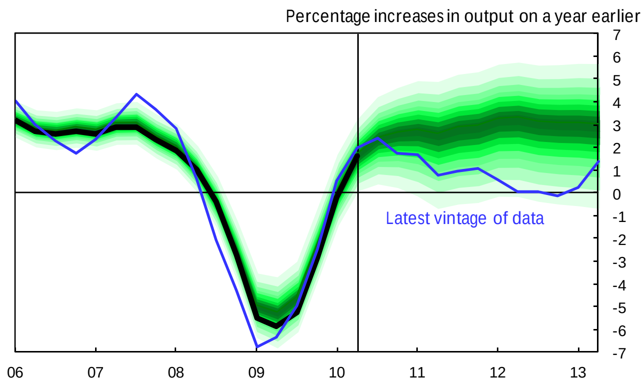
The third override condition, delegated to the Bank's Financial Policy Committee, relates to whether the monetary policy stance is resulting in the build-up of dangerous financial stability risks. If the FPC cannot contain these risks using the range of recommendations and powers at its disposal, then it will alert the MPC, who will then decide whether an increase in Bank Rate is called for. Increasingly noisy commentary that a new housing bubble is brewing – and concerns that the second stage of the Help to Buy scheme will add fuel to the fire – may mean that this condition becomes material. I do not have time left today to do justice to this issue. But it is important to remember that mortgage approvals for house purchase are still running at a little over half their pre-crisis average and, outside London, house price inflation is still quite modest. So we appear to be still some way off seeing an unsustainable house-price boom on the back of excessive credit growth. That said, neither the MPC nor the FPC can afford to be complacent.

The past five years or so have presented the policy makers here and elsewhere with many difficult challenges. We have discovered that we knew even less about the workings of the economy than we thought we did. And we have moved into policy territory that we could scarcely have imagined during the halcyon days of the Great Moderation. Happily, there are signs that a recovery is at last starting to gain traction here in the United Kingdom. But there is still a long way to go before we can say the economy is mended. Until that is the case, monetary policy will need to remain supportive and the guidance we issued in August was intended to make that clear. Thank you!




[2] This point was originally made in a Credit Suisse note entitled "Market to Mark", 4 September 2013.

## Chart 1: GDP projection in August 2010

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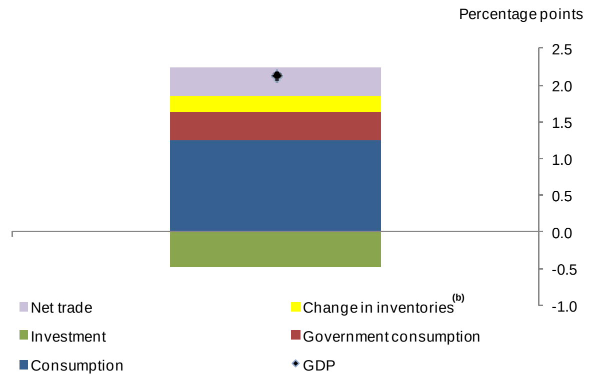
## Chart 2: Cumulative change in GDP since 2010Q2[(a)]




(a) Chained-volume measures. Components may not sum to total due to chain-linking, the statistical discrepancy and the alignment adjustment.
(b) Excludes the alignment adjustment.

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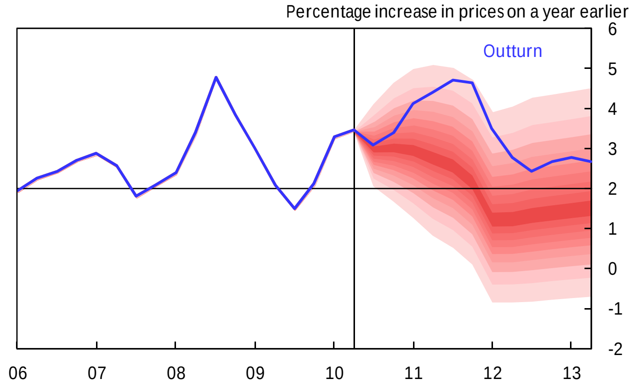
## Chart 3: CPI inflation projection in August 2010

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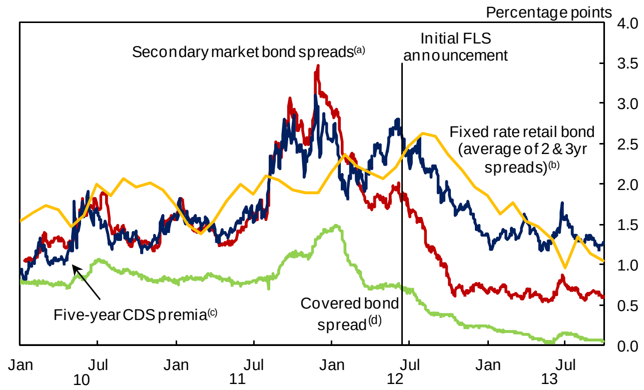
## Chart 4: Indicators of bank funding spreads




Sources: Bloomberg, Markit Group Limited, Bank of England and Bank calculations.

(a) Constant-maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro senior unsecured bonds.
(b) Sterling. Spread over the relevant swap rate for fixed-rate retail bonds.
(c) Unweighted average of the five-year senior CDS premia for the major UK lenders.
(d) Constant-maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro-denominated covered bonds, where available.

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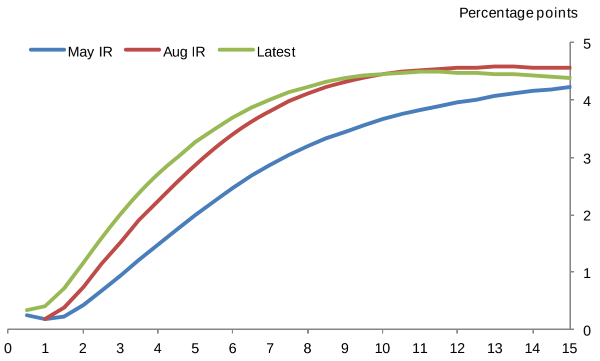
## Chart 5: Instantaneous forward yield curves[a]




Sources: Bank of England and Bloomberg.

(a) The May and August Inflation Report curves are based on the final day of the respective 15-day averages. The latest curve is from the 17 October.

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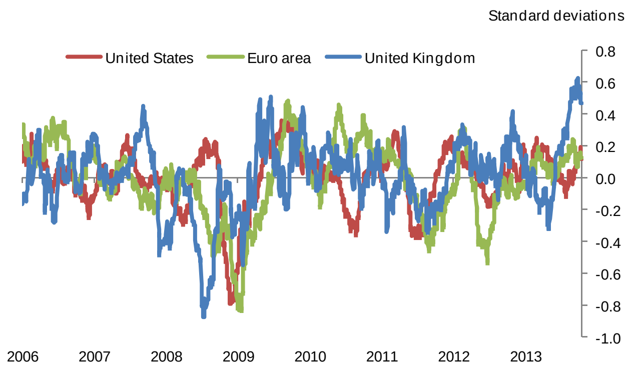
## Chart 6: Economic 'surprise' indicators[a]




Sources: Bloomberg and Bank of England calculations.

(a) Moving average of unweighted data surprises over a 60-day rolling window. Data surprises for each variable are scaled by the historical standard deviation of surprises for that variable. Variables are selected according to the number of Bloomberg alert subscriptions, but data on consumer prices, producer prices and wages are excluded.

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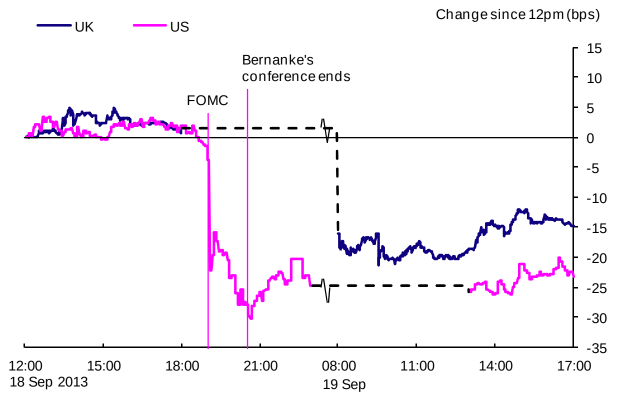
## Chart 7: Interest rate reaction to FOMC meeting 18/9/2013[(a)]




Source: Bloomberg.

(a) 1-year OIS rates, 2-years forward.

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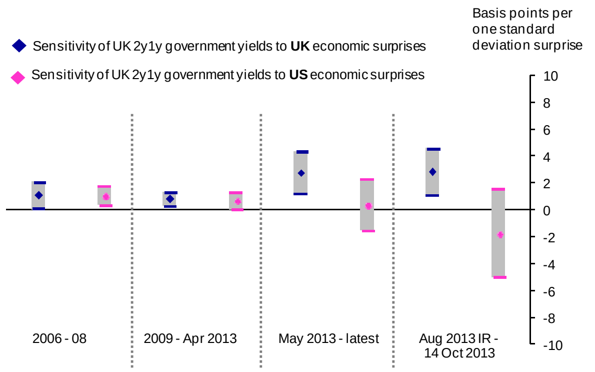
## Chart 8: Sensitivity of UK interest rates to economic news[(a)]




Sources: Bloomberg and Bank of England calculations.

(a) Based on bi-variate regressions of daily yield changes on the daily average surprise in the variables within the Economic Surprise Indicators. The diamond shows the regression coefficient and the bars indicate plus or minus two standard deviations.

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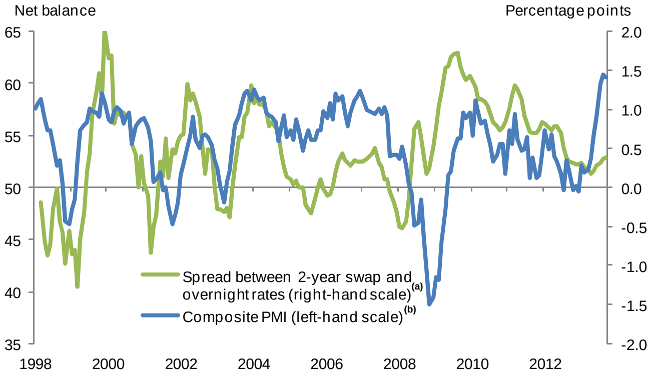
## Chart 9: Composite PMI and spread between 2-year swap and overnight rates




Sources: Bloomberg, Markit Economics, ONS and Bank calculations.

(a) Three-month moving average of the end-month spread between the 2-year swap rate and the SONIA rate.
(b) Based on the Markit/CIPS manufacturing and services PMIs.

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