

Charles Bean: The economic outlook for 2011 and beyond

Speech by Mr Charles Bean, Deputy Governor for Monetary Policy at the Bank of England, at the Market News International Annual Seminar, London, 13 December 2010.

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Good morning! Christmas is the traditional time for looking back over the events of the past year and contemplating what the new year might bring. Today I shall follow that tradition by taking stock of economic developments over the past year and looking at the challenges ahead.

Many of the recent activity indicators have been somewhat comforting. Global growth has recovered strongly on the back of a strong rebound in the emerging economies, with the IMF projecting expansion of close to 5% this year and more than 4% next year. Here in the United Kingdom, we have also seen a nascent recovery; output in the third quarter was, according to the latest ONS estimates, some 2.8% higher than a year earlier. That is marginally stronger than our projection for the most-likely path of four-quarter growth made a year earlier in our August 2009 *Inflation Report*.

Around half of the growth over the past year was, however, down to the contribution of stockbuilding, as businesses reduced the rate of inventory decumulation and, in some cases, started to rebuild stocks. That can only provide a temporary boost to aggregate demand growth. And the contribution of public spending to growth is also set to fall as the Government's planned fiscal consolidation gets underway. So economic prospects depend crucially on private final domestic demand and net exports picking up the baton; fortunately there have been signs that handover might be starting to take place in the latest quarterly data.

Private final domestic demand fell sharply in the recession. Consumer spending decreased by more than 4% over the five quarters from 2008Q2, as the prospect of reduced real incomes led households to cut their borrowing and build up precautionary savings balances. During this period, the household savings rate rose by almost six percentage points. Since then, we have seen a modest recovery in consumer spending, and measures such as the CBI Distributive Trades Survey suggest that recovery is likely to have continued into the final quarter of this year.

The prospects for household spending through next year and beyond depend crucially on households' expectations of their future incomes, as well as their balance sheet positions. Consumer confidence measures have generally weakened through this year, possibly reflecting concerns about the prospective fiscal consolidation. An open question is how far the impact of that consolidation has already been taken on board by households in their spending decisions, and how much adjustment is yet to come. The annual survey of households' financial positions carried out for the Bank by NMG Consulting¹ included some special questions on this topic and found that, while the majority of households expected to be affected in some way, less than half had so far responded by spending less, working longer hours or looking for a new job. That suggests there may be further adjustment to come.

Investment fell even more sharply than private consumption during the recession – down almost 20% – as the higher cost and reduced availability of finance, coupled with sharply heightened uncertainty about economic prospects, led businesses to cancel or postpone

¹ See "The financial position of British households: evidence from the 2010 NMG Consulting survey" by Mette Nielsen, Silvia Pezzini, Kate Reinold and Richard Williams, Bank of England *Quarterly Bulletin*, Winter 2010.

investment projects. While the outlook remains highly uncertain, the improvement in both financial markets and in the real economy since mid-2009 is likely to have contributed to the modest recovery seen in businesses' capital spending over the past year. And though continued tight credit conditions may restrain the investment spending of small and medium-sized enterprises, the bulk of capital expenditure is carried out by large businesses. They appear to be less credit-constrained and also have better access to the capital markets. Moreover, despite the downturn, the corporate financial position appears to be relatively healthy. So the availability of finance is unlikely to be a major brake. Rather investment spending is likely to be restrained by the juxtaposition of muted product demand and an overhang of spare capacity.

For almost as long as I have been a member of the Bank's Monetary Policy Committee, we have pointed to the need for a re-balancing of the composition of demand at some juncture, away from domestic demand and towards net exports. Accompanying that re-balancing would be a re-orientation of the structure of activity away from businesses that predominantly meet domestic needs towards those producing internationally tradable goods and services. The substantial depreciation of sterling – down around a quarter since August 2007 – should facilitate that re-balancing by making it more profitable to produce for export or to compete against imports. For example, relative unit labour costs in the United Kingdom are now more than 25% lower than before the crisis.

The contribution of net exports to the recovery had – at least until the very latest GDP release – been somewhat disappointing. Net exports reduced growth by a total of 0.7 percentage points over the past four quarters, as import growth outstripped that of exports. As world output, weighted according to countries' importance to UK trade, grew somewhat faster over that period than UK activity, the weakness in the UK's net export performance cannot be attributed to a more rapid recovery here. Some of the weakness can perhaps be ascribed to strong import growth associated with the working out of the stock cycle, as inventories are relatively import intensive. But closer investigation suggests that the weakness has been especially concentrated in exports of financial services, no doubt in part reflecting the impact of the banking crisis. Foreigners' demand for UK financial services may plausibly continue to be somewhat lower than before the crisis, so this weakness may persist.

In contrast, there are signs that the depreciation in sterling is having the expected effect on the market share of goods exporters. That is also reflected in the robust growth in manufacturing output and in business surveys which report buoyant export orders. So far, there is less sign that the lower level of sterling is leading to the substitution of imports by domestically produced goods and services. But it is likely that the producers of internationally tradable goods and services take time to respond to the improved opportunities associated with a lower real exchange rate, especially if investment in foreign distribution networks or the repatriation of off-shored activities is required. So, other things equal, it seems reasonable to expect the impact of the lower level of sterling on net exports to continue to build through next year.

The prospects for net exports obviously depend not only on the response to the past depreciation of sterling, but also on demand in the UK's main export markets. While global growth has been strong over the past year, much of that has been in emerging economies that presently account for a relatively small proportion of UK exports.

Growth has been patchier in the developed economies. In the United States, following a series of soft indicators through the late summer and early autumn, the US Federal Reserve announced additional purchases of US treasuries. And the Obama administration is seeking to inject a further fiscal stimulus, incorporating not only the widely expected extension of the Bush administration tax cuts, but also a temporary cut in payroll taxes. The extension of the Federal Reserve's large-scale asset purchase programme has proved controversial, with some US critics asserting that it is inflationary and policymakers in some of the emerging

economies claiming that it is both an attempt to engineer a beggar-my-neighbour devaluation and that it will boost capital inflows and foster asset-price bubbles.

These criticisms seem to me mostly off the mark. Central banks undertake asset purchases financed by the issuance of central bank money in order to boost nominal spending. They do that by depressing a range of longer-term real yields and raising asset prices. The earlier phases of quantitative easing both here and in the United States indeed appear to have lowered longer-term nominal and real yields below where they would otherwise have been.² This time around, the transmission channel has been rather different, as after falling on the anticipation of further asset purchases, longer-term US yields rose. But the policy should only prove inflationary in the medium to long run if it results in excessive nominal spending growth, which hardly appears likely at the current juncture. Only if the Federal Reserve fails to tighten policy promptly as the recovery takes hold is excessive inflation likely to be a problem.

The criticisms from outside seem to me almost as misplaced. While quantitative easing is likely to be associated with exchange rate depreciation, it also boosts domestic spending. Demand in other countries therefore rises as a result of the increased demand in the United States, as well as falling as a result of the appreciation of their currencies. These are just the normal mechanisms that operate when official interest rates are cut in one country. It is then an empirical matter which is the dominant channel. Quantitative easing is consequently very different in character from sterilised exchange rate intervention, which merely redistributes global demand.

There is, though, more substance to the concern that stimulatory monetary policies in the developed economies have encouraged a search for yield and capital inflows into the emerging economies. So there is some justification for the imposition of temporary restraints on those inflows. But where such asset price pressures are building, they seem more likely to be related to overly loose monetary and financial policies in those countries and their unwillingness to allow exchange rates to bear more of the strain.

It is the euro area, however, that is of particular importance to the United Kingdom. In aggregate, the euro area looks to be undergoing a steady recovery, not dissimilar to ours. Output in the third quarter was 1.9% higher than a year earlier, roughly in line with the euro area's historical average growth rate. But that masks markedly divergent performance and prospects within the euro area. Germany is growing rapidly, led in part by an expansion in exports to the booming Asian economies. The countries of the periphery are, however, struggling in the face of significant fiscal and structural challenges. While the countries of the euro-area periphery are each confronted by specific challenges, they all need to restore their competitiveness without the option of devaluation. Instead, in the absence of effective structural reform, they face the prospect of sustained low growth in order to drive down wages and prices. That itself makes the task of stabilising public debt harder.

Support to Greece and Ireland from the IMF and rest of the European Union has given those countries a breathing space in which to undertake the necessary adjustments. Financial support for other countries may or may not prove necessary – only time will tell. But the important thing for us is whether an intensification of the difficulties in the euro-area periphery could also derail the recovery here.

² Analysis of the earlier phases of quantitative easing both here and in the United States suggest that purchases of the order of 12–14% of GDP have lowered longer-term government and corporate bond yields by around 70–100 basis points relative to where they would otherwise have been. See Michael Joyce, Ana Lasaosa, Ibrahim Stevens and Matthew Tong, “The Financial Market Impact of Quantitative Easing,” Bank of England Working Paper No.393, 2010, and Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack, “Large-scale Asset Purchases by the Federal Reserve: Did They Work?” Federal Reserve Bank of New York, Staff Report No.441, 2010.

Sharp fiscal consolidation and very slow growth in the periphery countries would, of course, have some adverse impact on the demand for our exports. But the more significant links are potentially through the financial system. Fortunately, UK banks have done much to improve their resilience over the past couple of years and, even under a very adverse scenario, they should be able to absorb the likely losses on their direct exposures to Greece, Ireland, Portugal and Spain without too much difficulty. There is, though, the possibility of further indirect effects arising through the interconnectedness and cross-border operations of European banks which could amplify the impact. So some adverse effect on the funding costs of UK banks and the supply of credit remains a possibility.

Harder to gauge is the potential effect on household and, especially, business confidence. In the aftermath of the collapse of Lehman Brothers, this was arguably the most significant transmission channel to the real economy. An intensification of the sovereign debt problems in the euro area could therefore administer a blow to the recovery here. But given the very high degree of uncertainty, there is little that the MPC can do to deal with this risk ahead of crystallisation.

While UK output growth has come in much in line with our expectations, the same cannot be said of our primary objective, inflation. Back in August of last year, our central projection was for CPI inflation to be around 1.5% now. But inflation has been markedly stronger than that – 3.2% on the latest reading. Why has inflation been so much higher, especially given that our expectations for growth have largely been fulfilled? There are three factors that account for this.³

First, energy and non-oil commodity prices are substantially higher than in the summer of 2009. By convention, we base our forecasts for these variables on futures prices, which were relatively flat at that time. The buoyancy of commodity prices since then reflects the rebound in global activity, and especially the strength in the emerging economies. In addition, temporary supply factors have boosted the prices of some agricultural commodities. At present there appears to be a margin of spare capacity in the oil market, so that may permit global growth to remain strong without putting further upward pressure on energy prices immediately. But a low elasticity of supply of other commodities means that their prices, relative to those of finished goods and services, may continue to drift upwards. That would constitute an additional headwind for the United Kingdom.

A second factor behind the unexpectedly high inflation appears to have been greater than expected pass-through into final prices from the depreciation of sterling after August 2007. Evidence from the United Kingdom and other countries during the Great Moderation suggested that pass-through had fallen, perhaps because inflation expectations were better anchored. We expected something similar on this occasion too. In the event, the strength of UK goods inflation, relative to that in the other G7 economies, suggests that the pass-through of the depreciation was in fact rather greater, and similar to that before the Great Moderation.

The third potential ingredient behind higher inflation is a more moderate drag from the margin of spare capacity in the economy. Pay growth has been subdued during the recession, and that has helped to ensure that unemployment has risen far less than many commentators feared. Rather the puzzle is on the pricing side, as prices have been higher relative to costs than expected.

That could indicate that the margin of spare capacity is not as large as the collapse in activity might suggest. On current estimates, output is presently about 10% below a continuation of its pre-crisis trend. But historical experience indicates that the output losses – relative to the pre-crisis trend – after banking crises tend to be highly persistent. That suggests that such

³ See pages 48–49 of our August 2010 *Inflation Report* for more on this.

crises are associated with an impairment of supply capacity too. Business surveys are consistent with this, implying that the margin of spare capacity in firms is now relatively limited – in fact not much larger than after the bursting of the dotcom bubble. But against that, it is difficult to find any direct evidence of supply impairment. For instance, liquidations have been running at less than 1% (compared to 3% in the 1990s recession). One resolution of the puzzle may be that producers have mothballed capacity, which could, at a cost, be brought into use if demand conditions warranted.

The MPC's view is that the current elevated level of inflation is likely to persist in the near term – indeed our central expectation for inflation is somewhat higher than that of outside commentators. Ultimately, however, this period of elevated inflation should prove temporary. The standard rate of VAT is set to rise again at the beginning of next year, but once that drops out of the annual comparison a year later, so the inflation rate is likely to fall back sharply. The impact on prices of sterling's past depreciation should be starting to wane. And the relatively moderate expansion that we expect over the next year or two should ensure that there is some, albeit uncertain, brake on inflation from spare capacity. We have seen muted underlying inflation pressures in both the euro area and the United States, reflecting the spare capacity in those economies, and there is no reason to believe that the United Kingdom will behave differently once the temporary influences subside.

But there are risks to this scenario. They are twofold. First, that strong global growth continues to generate upward pressure on the prices of commodities and tradable goods more generally. And, second, that the period of elevated inflation causes medium-term inflation expectations to drift up, leading to higher rates of increase of both wages and prices. Measures of near-term household inflations have moved up in line with the MPC's own assessment of near-term inflation, but the rise in longer-term measures has been considerably more muted. And measures derived from inflation swaps suggest that the expectations of financial market participants five years ahead have remained stable. But given the unexpected strength of inflation in recent months, this risk has probably increased of late. So we shall be watching these indicators, and their impact on wages and prices, like proverbial hawks.

What are the implications of all this for monetary policy? The recovery has so far turned out to be broadly in line with that expected a year ago, but the outlook for growth remains highly uncertain. Though inflation has been running well above target and is likely to continue to do so for a while yet, beyond the end of next year it should fall back to near the Committee's 2% target. In the light of that outlook, I believe we have made appropriate use of the "constrained discretion" granted to us in the Chancellor's remit, looking through the temporarily elevated inflation to the medium term in order to avoid unnecessary volatility in output. Tightening policy sharply in order to deal with the currently elevated level of inflation would simply have put a brake on the recovery unnecessarily and would have made inflation more likely than not to fall below the target in the medium term.

If all goes to plan, however, and private final demand continues to pick up the baton as the fiscal consolidation proceeds, then the margin of spare capacity will shrink and it will at some juncture become appropriate to begin withdrawing the current extraordinary degree of monetary stimulus. And, when that point comes, the MPC will aim to do so in a timely, but measured, fashion.

As 2010 draws to a close, the good news, then, is that the recovery, here and more widely, has remained on track, following the sharpest downturn in activity since the Great Depression. Such an outcome was by no means guaranteed twelve months ago; for that we must be grateful. But there remain significant challenges for the year ahead. In many developed countries, the after-effects of the financial crisis still linger, in the form of banks that are still overly reliant on official support, fragile household and business confidence, and bloated public sector deficits and debt. Moreover, the rapid recovery in emerging markets

has reawakened global inflationary pressures. And here in the United Kingdom, inflation has been running above the MPC's 2% target for an uncomfortably long time.

It may be some while yet before normality is restored. Thank you.