

Paul Fisher: The economic outlook – some remarks on monetary policy

Speech by Mr Paul Fisher, Executive Director for Markets of the Bank of England, to the Agency for Scotland, London, 23 May 2011.

* * *

I would like to thank Ronnie Driver for his help in preparing this speech.

For most of us, the current outlook for the UK economy is not a very attractive prospect. After experiencing a precipitous fall in demand during 2008/09, the latest estimates suggest that UK output in 2011 Q1 remained around 4% below its peak pre-crisis level. The Monetary Policy Committee's (MPC) central projection published in its *May Inflation Report*, is for output to grow at around its historical trend rate (**Chart 1**), such that it would be mid-2012 before that previous peak level is regained (**Chart 2**). At the same time annual CPI inflation, far from being subdued by the recession, has picked up to 4½%. In the short-term it is likely to go higher still before, we expect, falling back towards the 2% target (**Chart 3**). All this poses a significant challenge for policy makers, not least because of the genuine hardships slow growth and high inflation cause for businesses and households up and down the country.

Chart 1

GDP projection based on market interest rate expectations and £200 billion asset purchases

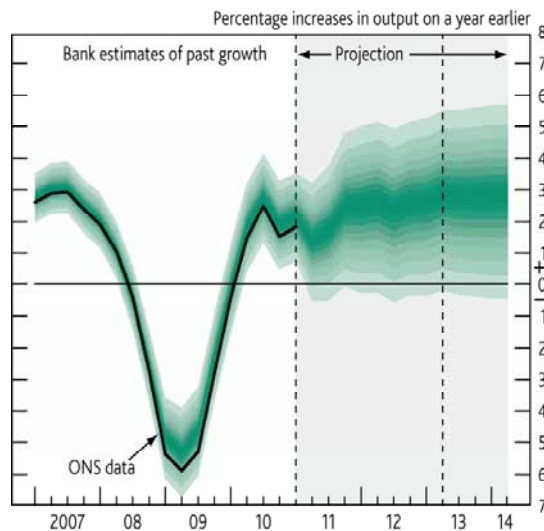


Chart 2

Projection of the level of GDP based on market interest rate expectations and £200 billion asset purchases

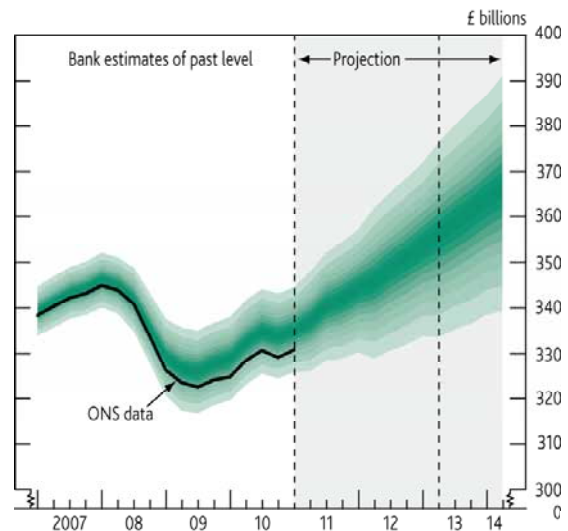
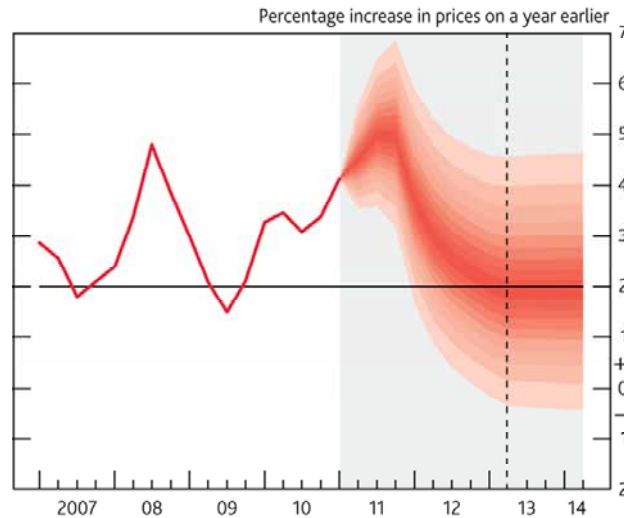


Chart 3

CPI inflation projection based on market interest rate expectations and £200 billion asset purchases



The recent data has not been particularly encouraging. Official figures for 2010 Q4 and 2011 Q1 suggest that there was no underlying growth (allowing for the unusual impact of snow in December). And the unemployment rate remains at just under 8%. The data may not be totally reliable – they never are – but the message we get from our business contacts in all parts of the United Kingdom is not inconsistent with this broad picture painted by the official statistics. Meanwhile, CPI inflation is likely to go yet higher if (as the MPC expects) rises in the price of energy get reflected in utility bills in due course.

The largely unanticipated path of CPI inflation over the past couple of years can be explained by three factors: changes in the standard rate of VAT, unforeseen changes in wholesale oil and gas prices and higher-than-expected import prices following the 25% depreciation of sterling since mid-2007. Given our target of 2%, the recent path of CPI inflation is uncomfortable to say the least. Nevertheless, the nature of the price shocks were such that, in my view, there was little that monetary policy should or even could have done to offset them. Rather, given that changes in Bank Rate (or asset purchases) take a long time to have their full effect on the economy, monetary policy needs to be forward looking, focusing on the medium-term outlook for inflation yet to come. Trying to respond to every short-term movement in prices would probably be futile and would certainly involve a lot of unnecessary volatility. The Remit we have from the Government allows for these circumstances:

“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”.¹

To meet our remit we should ideally try to look through one-off price level shocks, in either direction, only responding if there are risks to the rate of inflation expected to prevail in the medium term. That theory is all well and good: but the one thing we know about the future is just how little we know for sure.

¹ The Remit for 2011 is available at <http://www.bankofengland.co.uk/monetarypolicy/pdf/chancellorletter110323.pdf>

Since I joined the Committee in March 2009 – the very week we announced the “quantitative easing” programme, buying gilts in large scale – I have voted with the majority at every meeting. As a result, my individual views on policy have mostly been wrapped up with those of others in the *MPC Minutes* and the *Inflation Report*. So today, I want to offer some more personal thoughts on how I see the economic outlook developing; how I interpret the balance of risks to output and inflation in the medium term; and why I have been voting for no change in Bank Rate or the scale of asset purchases at recent meetings.

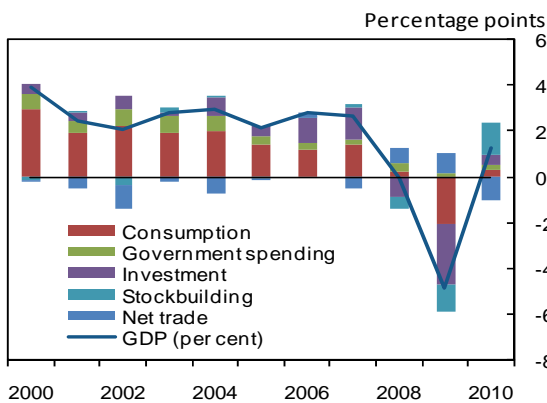
The outlook for growth

The financial crisis brought with it the deepest recession the UK has experienced since at least the Great Depression of the 1930s. The MPC responded by cutting Bank Rate as low as it could reasonably go and injecting £200bn of extra money into the economy (14% of annual nominal GDP). Since the trough in output in the autumn of 2009, the UK economy has been on a gradual, if bumpy, path of recovery. That was to be expected. Historically, and internationally, we know that economic recovery after a major financial crisis is usually slow and seldom smooth – the MPC (and I personally) have been aware of this and flagging it for some time.

Even though we have been predicting a rough ride, the output data at the end of last year and the beginning of this still came as an unwelcome surprise. Analysis of past data suggests that the most likely explanation is that we are currently going through a temporary soft patch. We can't be sure since no two historical episodes are ever exactly the same. Until underlying growth resumes, we can't be certain that it will, of its own accord. At the very least, that makes me pause to consider when policy should start to be normalised or even whether further loosening might be justified.

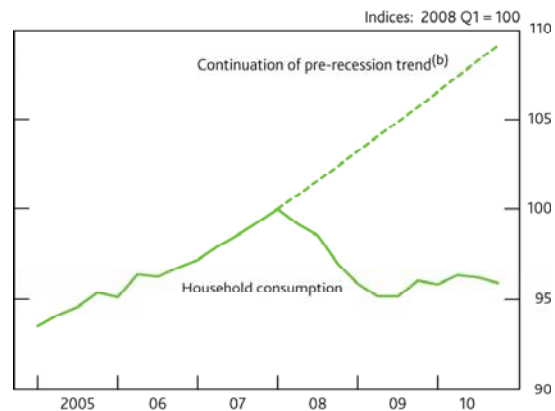
The recovery in 2010 was driven by a particularly strong contribution from business investment and stock-building (**Chart 4**). The latter was always likely to offer a transitory boost to overall growth as companies returned stock holdings towards their desired levels, after de-stocking during the recession. And investment was always likely to make some positive contribution – at least once delayed projects and routine maintenance were re-started. But that boost is unlikely to persist without a pick-up in final demand to justify it. And consumer spending, the most important component of UK demand, has been stagnant for a year (**Chart 5**). The current behaviour of consumption is markedly different to that during the 1980s and 1990s when consumption had broadly regained its pre-recession level by this point in the cycle, rather than being around 4% below it (**Chart 6**).

Chart 4
Contributions to 4-quarter
GDP growth(a)



(a) Investment includes valuables. Stocks excluding the alignment adjustment.

Chart 5
Household consumption(a)



(a) Chained-volume measure. Includes non-profit institutions serving households.

(b) Pre-recession trend calculated by projecting forward household consumption from 2008-Q2 using the average quarterly growth rate between 1998 Q2 and 2008 Q1.

Chart 6
Consumer spending during
recessions and recoveries(a)

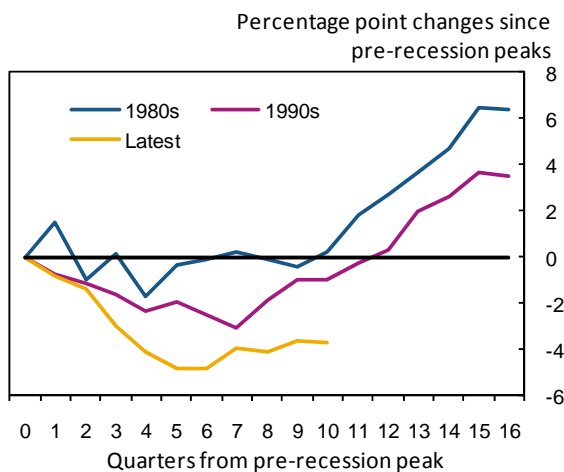
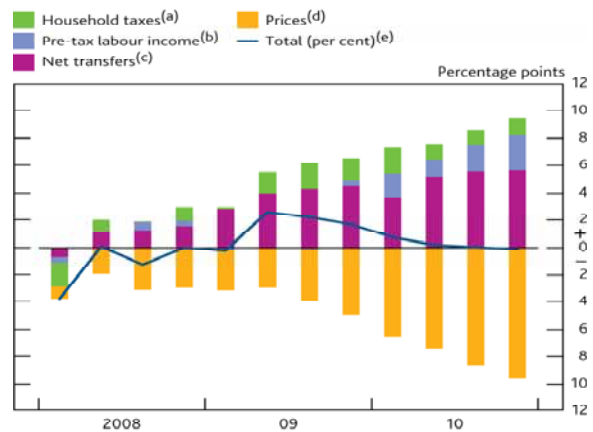


Chart 7
Contributions to growth in real post-tax
labour income since 2007 Q4



(a) Household taxes include income tax and Council Tax.

(b) Wages and salaries plus mixed income.

(c) General government benefits minus employees' National Insurance contributions.

(d) Calculated as a residual.

(e) Nominal post-tax labour income divided by the consumer expenditure deflator (including non-profit institutions serving households).

Relative to its pre-crisis trend, a weak recovery in consumer spending was always expected. Prior to the financial crisis, the UK economy had become badly unbalanced, relying on overly robust domestic demand to offset weak net export demand. The depreciation of sterling starting in mid-2007 was in part a reaction to that and it was always likely to generate slower domestic demand growth and a stronger contribution from net trade. So, a switch away from domestic consumption – both private and public – and towards net exports was a necessary, if painful, development.

What is making it so painful is that one of the channels through which rebalancing is occurring is a significant squeeze on households' real post-tax incomes. According to the latest data, the level of households' real take-home pay in 2010 Q4 was the same as in 2007 Q4 (**Chart 7**). Put bluntly, real incomes have stagnated over the past three years. The main driver of the squeeze was the elevated rate of consumer price inflation reflecting, in part, the required increases in indirect taxation (VAT) needed to help rebalance the government budget, and increases in import prices relative to domestic wages and prices. But it also reflects the falls in labour productivity and the degree of slack in the labour market, which have weighed down on nominal earnings growth. During the depths of the downturn in 2009, nominal wage inflation fell sharply (and in many cases pay cuts were introduced), as companies sought to reduce costs and, together with their employees, reacted flexibly to the risk of severe cut backs in employment. Even so, the unemployment rate rose by 3 percentage points, peaking at 8% in February 2010.

Normally, following a recession, one might expect household income to start recovering, once unemployment stops rising and productivity growth recovers. But not this time. Although the data released last week suggested that unemployment has continued to fall back a little from its peak, it has not moved much. And nominal regular pay growth (which strips out bonuses, but includes merit related increases in pay) has remained subdued over the past year, averaging around 2%. Assuming that the potential growth rate of the economy has not been damaged by the financial crisis (and there is no compelling evidence to suggest that it has), then this level of wage growth would be too low to be consistent with the inflation target in the medium term.

Looking ahead, it is most likely that there will remain a reasonable margin of slack in the labour market, which should help contain any pressure on nominal wages and hence price inflation. But this is unlikely to persist indefinitely. Historical analysis of the UK labour market shows that the longer individuals are unemployed, the lower their chances of getting a job become. Hence, persistently high actual unemployment tends to be followed by an increase in the level of structural unemployment. Theory and empirical evidence predict that the structurally unemployed exert less downwards pressure on wage inflation. Major shifts in the pattern of employment – as we are likely to see from the shifts in growth from services to manufacturing, and from the public to private sector – tend to reinforce that effect. If structural unemployment rises sufficiently, then the downwards pressure on inflation from spare capacity will eventually start to dissipate.

For now, contacts of the Bank's Agents confirm that the margin of slack in the labour market should continue to restrain wage growth in the coming months. In my view, that should continue for the next few years, even if structural unemployment begins to rise: the latter is a relatively slow process. Given the inflation outturns so far in 2011 and the prospects for near-term inflation outlined in the *May Inflation Report*, the squeeze on household real incomes is likely to be intensifying in the short term. Overall, it could be quite some time before we start to see rising real take-home pay.

The marked decline in household confidence since the start of the crisis might also have played a role in the weakness of consumer spending during 2010. For a given level of income, households may decide to spend less (and hence save more) if they are uncertain about the outlook for the economy and, especially, about the security of their job. Although survey measures suggest that households' unemployment expectations have fallen slightly,

the fiscal consolidation now underway might encourage greater precautionary savings among some households – indeed, the MPC has been, to some extent, incorporating such an effect in its projections for over a year.

The worry now is that consumer confidence has fallen back a second time: a forward looking measure derived from the GfK survey is close to its trough of mid-2008 (**Chart 8**). And the balance that assesses households' views about “whether it is a good time to make a major purchase” has also fallen back substantially since the start of the year – although that is likely, to some extent, to reflect the impact of the rise in VAT.

Chart 8

Measures of consumer confidence



Source: Research carried out by GfK NOP on behalf of the European Commission.

(a) Average of the questions on households' current financial situation, and the general economic situation, over the next 12 months.

Other factors, such as the ongoing restrictions on the availability of credit and households' concerns about their levels of debt, may also contribute to the likely weakness of household spending going forward, by encouraging households to save more and spend less, for a given level of income.

Overall, given the continuing squeeze in household real incomes and the renewed fall in consumer confidence, I wouldn't be surprised if there was only slow growth in consumer spending over the next year or so. The risks around that are probably skewed to the downside. Even if we do get the anticipated boost to net exports, overall growth in output is unlikely to be much above its historical average rate. That is a lot slower than would be needed to regain the level of output implied by a continuation of the pre-recession trend.

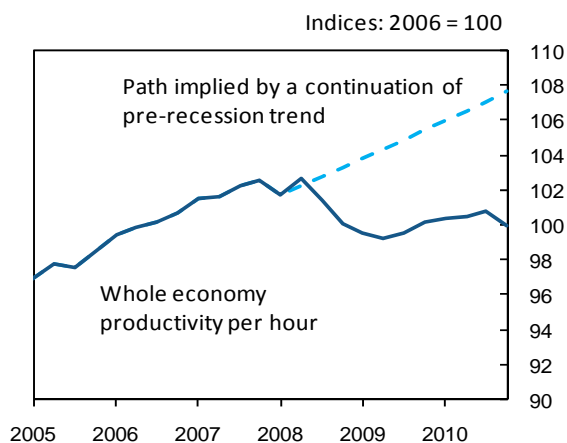
The outlook for inflation

For many quarters, the judgment about the outlook for inflation two to three years ahead has been shaped by two opposing factors – the balance of demand and supply in the economy, and the extent to which the resulting degree of spare capacity bears down on prices; and the extent to which price shocks cause higher inflation expectations to become embedded, prompting higher nominal wage and price increases.

On the economy's potential supply, the evidence is highly conflicting (there are few aspects of the economy where the data are clear!) On the one hand, labour productivity remains around 8% below the level it would have reached had it followed its pre-crisis trend (**Chart 9**), implying a significant margin of spare capacity in the economy. But on the other hand, the main business surveys suggest that there is little spare capacity within businesses (**Chart 10**). Moreover, the expansion in output since the trough has been met by an increase in employment, rather than by productivity growth. Coming to a judgment about the degree of spare capacity in the economy is therefore difficult – but at the same time crucial. Given the scale of the numbers involved, small differences in the judgment about the relative roles of cyclical and structural explanations for the recent path of productivity can have enormous implications for one's views of the risks to inflation.

Chart 9

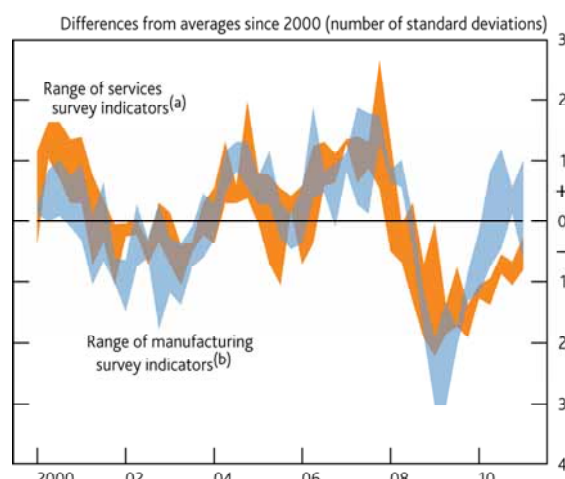
Whole economy labour productivity per hour(a)



(a) The pre-recession trend is calculated by projecting forward labour productivity from 2008Q2 using the average quarterly growth rate between 1996Q1 and 2008Q1.

Chart 10

Survey measures of capacity utilisation by sector



Sources: Bank of England, BCC, CBI, CBI/PwC and ONS.

(a) Includes measures of services capacity utilisation from the Bank's Agents, BCC and CBI. The CBI measure weights together financial services, business/consumer services and distributive trades surveys using shares in nominal value added. The BCC data are non seasonally adjusted.

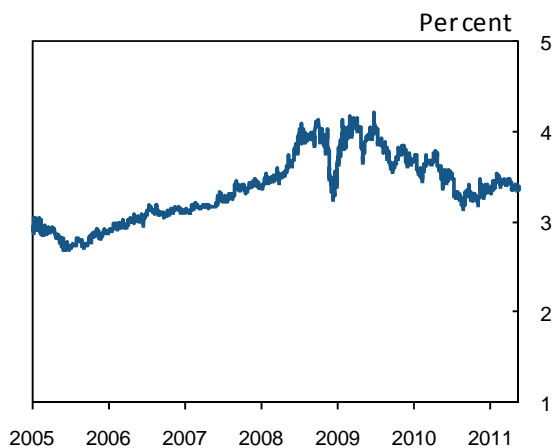
(b) Includes measures of manufacturing capacity utilisation from the Bank's Agents and CBI, and a measure of non-services capacity utilisation from BCC. The BCC data are non seasonally adjusted.

Personally, I believe that there is a significant margin of slack in the economy – you need only look to the labour market for evidence of that. But it is also likely that there is less slack in the economy than implied by the deviation of productivity from its pre-crisis trend. Looking ahead, the degree to which the margin of slack is eroded will depend on the outlook for demand. If demand recovers strongly, that would close up the degree of slack in the economy. But if demand stays weak, then potential supply will gradually respond downwards, also closing the margin of slack (although that process would probably be slower than if it was faster demand growth doing the work).

The risks from inflation expectations are also difficult to assess, principally because we do not have good data on the true expectations of businesses and wage bargainers, only what they record in surveys. Personally, I look for signs of de-anchoring inflation expectations in two places. The first is in nominal wage growth, which as I have discussed earlier, remains subdued. The second is in financial prices, where we can extract information on inflation expectations by looking at the differences between the yields on conventional and index-linked gilts or by looking at inflation swap markets. These data – like any other – need to be interpreted and analysed with caution. Financial markets are prone to bouts of volatility. The instruments are linked to RPI and not CPI inflation. The short maturity end of both the gilt and the swap markets are relatively illiquid, and the long-end of the markets can be moved around by structural demand (e.g. from pension funds looking to maturity-match their long-term liabilities). What this means is that it is difficult to separate moves driven by changes in market liquidity, investor mandates or preferred habitat from moves driven by changes in underlying inflation expectations. For me, the inflation swaps market, which has grown and deepened in recent years, gives a more reliable read on underlying market participants' views of inflation expectations than the gilt market data. Those swaps suggest that there has been little change in medium-term inflation expectations for some time (**Chart 11**).

Chart 11

Medium term inflation expectations derived from inflation swaps(a)



Sources: Bloomberg and Bank calculations.

(a) Based on the 5-year, 5-year forward.

Policy

In these remarks, I have tried to explain how I personally read the main forces acting on the outlook for GDP growth and CPI inflation over the next few years. The final step is to explain my policy vote based on those views.

At the moment, I see the risks to CPI inflation in the medium term as broadly balanced, around the 2% target. In particular, I expect that the upside risk from any deterioration in the level of potential supply is broadly offset by the downside risks to consumer spending. While there are certainly upside risks to the outlook from higher inflation expectations, those are not of immediate concern. I see little evidence that inflation expectations might generate the start of a wage-price spiral for example.

There are, however, immediate downside risks to the growth outlook. Although my central expectation is that the recent weakness will just be a soft patch, I do worry about a more

prolonged weakness in demand, and in particular, consumer spending. That could knock the recovery off course for a sustained period, shifting the balance of risks around medium-term inflation to the downside. With that risk in mind, putting up Bank Rate could be exactly the wrong thing to do at this precise moment. If it further damaged consumer confidence then it could be the marginal factor that makes a soft patch turn into something worse.

Of course, at some point, Bank Rate will have to rise: interest rates will need to normalise if, once the spare capacity in the economy has been eliminated, monetary policy is to be consistent with the 2% target. And because of the lengthy lags involved, Bank Rate will need to start the long journey back to more normal settings well before the degree of spare capacity is eliminated.

But for now, I believe there remains time to allow the economy to recover before the eventual tightening begins. I am not trying to give any hints today as to exactly when that will be. I honestly don't know. I can only continue to assess the data and the outlook as it changes, month by month. As always, I stand ready to change my views should the economic outlook change sufficiently to warrant it.