Paul Tucker: A few remarks on current monetary policy in a rebalancing economy

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at The Joint 1900/City Club Lunch, London, 22 November 2011.

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The outlook for economic activity has deteriorated over the past few months. The MPC has responded with a further round of quantitative easing to underpin demand, and so reduce the chance of inflation undershooting our target in the medium term.

Monetary credibility: accommodating the price level shocks

Our ability to provide and sustain that stimulus depends absolutely on the credibility of our commitment to the 2% inflation target. If our credibility were to slip and medium-term inflation expectations were to rise, we would have to run with a tighter monetary stance than otherwise in order to put the genie back into the bottle. The Committee's most important judgment over the past year or so has, accordingly, been that the elevated rate of inflation, now about 5%, is temporary. We have had conviction in that judgment because of the observable upward impulses to the price level from sterling's depreciation, the VAT increase, and the rise in commodity prices. There is occasionally a rather odd debate about whether the MPC could have avoided the consequent increase in inflation. Big picture, the answer is that we could have done, but we chose not to. We have, in effect, accommodated something like half of the cumulative impulse to the price level. We could have chosen instead to offset the price level shocks by running a much tighter monetary policy. Had we done so, spending in the economy, activity and employment would all have been squeezed. Conditions have anyway been difficult for many households due to the squeeze on real incomes, but I think it would have been worse if we had tightened policy. Our ability to sustain exceptional monetary stimulus has, I should reiterate, depended on the credibility of our commitment to low inflation ***over the medium term*** being preserved. I worried that chatter in the markets in late 2010/early 2011 marked incipient signs of fragility in that credibility.

That was one of the reasons why, at the beginning of this year, I had expected to vote for an increase in Bank Rate at our February meeting. The weak output data for Q4 2010 published shortly before that meeting changed my mind, and the Committee's course, as they revealed that the economy was softer than I had thought.

Escape velocity

In the months that followed, I made clear that, with inflation well above our 2% target, I would be looking for an opportunity to begin the process of withdrawing the exceptional monetary stimulus once the economy had achieved "escape velocity". By that, I meant that the economy would need to be growing, and be set to continue to grow, at a rate that would gradually absorb the slack in the economy. "Escape velocity" has not yet been achieved.

The principal sources of the deterioration lie overseas – from the squeeze on real incomes due to the rise in commodity prices and, more recently, weakening global demand due largely to the euro area crisis. Even if, as we all hope, a credible solution to the euro area's problems can be put in place in the coming weeks, the traumas of the past few months will take a while to overcome. Confidence has been sucked out of financial markets. Pressured European banks are deleveraging by disposing of assets, or letting loans run off, elsewhere in the world. Trade finance is again becoming impaired. Capital raising by companies has declined.

And confidence has been drained out of the UK real economy too. Earlier in the year, we faced a tug of war between a resilient corporate sector looking to expand when demand picked up, and a fragile household sector worried about a rising cost of living, jobs and house prices, with some households therefore saving more in order to strengthen their balance sheets. In recent months, as confidence amongst businesses has flagged, they have been tugging on the same end of the rope, with the MPC at the other end, in effect tugging back.

Part of that easing in monetary conditions has come through lower interest rates. In case that sounds odd given that Bank Rate has been at 0.5% for over two years, I should underline that, even in normal circumstances, monetary policy works through the expected ***path*** of our policy rate. The markets now expect us to keep Bank Rate low for longer. Two-year risk free money market rates are over 100bp lower than in the late spring. That has helped to offset the rise in credit spreads, and so means lower borrowing costs in the real world. I place weight on that, as my MPC colleagues know. Above that, we have decided to add £75bn to our programme of Quantitative Easing (QE). The degree of monetary stimulus will slowly increase as the agreed QE is executed. That money does not, as is sometimes suggested, get stuck with the banks. The whole point of the Bank's operating framework for QE has been to avoid that. All central bank money is ultimately held by banks: that is what a banking system is. But by buying bonds from insurance companies, pension funds and others, we put the money into their hands. It is money that, by construction, provides a meagre return – negative in real terms – and so money that they will want to get rid of by purchasing other higher-yielding assets. Policy still works through asset prices, increasing wealth and reducing the cost of capital relative to where they would be otherwise.

Rebalancing: impediments

We recognise that the stimulus we have provided risks slowing further progress with the necessary medium term rebalancing of the economy. Rebalancing will not, in any case, be easy. The composition of demand in the UK was imbalanced for so long that the productive capacity of economy is unbalanced. Crudely, the balance of aggregate demand needs, over the medium term, to shift away from household and public consumption towards net trade and investment. Up to a point, some of that has already happened. But domestic monetary expansion will work partly through deferring some of the restructuring of household balance sheets, underpinning consumption. And, looking ahead, the greater question is whether rebalancing can be sustained as and when the economy returns to "full employment", ie when the economy's spare capacity is utilised again.

Rebalancing is already impeded by tight credit conditions. Although our banking sector has done much to strengthen capital and liquidity over the past few years, it would still have ground to cover in rebuilding balance sheets even if the external environment were more propitious. With instability from the euro area crisis threatening the UK, our banks cannot avoid being exposed to outsized risks. That is reflected in elevated funding costs, which they pass on to their customers to a greater or less extent. The gradual improvements in credit conditions seen until the summer, and documented in the Bank's quarterly Credit Conditions Survey, have been arrested for now.

In my book, this is not only bad for the needed cyclical recovery in aggregate demand. I suspect that it will impede the rebalancing of the economy's productive capacity. Firms wishing to enter or expand export markets, or compete against importers, often need credit. Finance is the oil that lubricates the allocation – and so, in current circumstances, ***re***allocation – of capital in our economy.

This is manifestly affecting SMEs. My hunch is that housing market conditions are a factor too. As long as anyone can remember, a crucial element of SME finance has been the capacity of entrepreneurs to pledge their home at the outset of a loan or, contingently, if and when their business hits choppy waters. Uncertainties about the path of house prices do not make that a comfortable backdrop for lenders in current conditions.

Rebalancing will affect labour market conditions too. Perhaps the greatest surprise to the MPC over the past few years has been subdued productivity growth. One could think of this as firms maintaining employment at higher levels than would have been predicted given the fall in the level of output. Labour hoarding. That squares with business managers explaining that they worry about "structural" skill shortages and so are loathe to lose employees who they will need when their markets recover. But it does not really square with surveys of business conditions reporting that firms say they are carrying relatively little spare capacity. We have scratched our heads about this. One possible explanation is that, in an economy based heavily on the production of services, firms have been putting their teams to work on marketing and sales to drum up business against a backdrop of weak overall demand. Those teams may well be working hard. In that case, it may not feel to managers, when filling in surveys, as if they have lots of spare capacity, But, as I have described it, those staff would be working on inputs rather than outputs – making productivity across the economy as a whole look weak.

Nor does labour hoarding square obviously with relatively healthy growth in ***private sector*** employment over 2010 and the first half of 2011, before the recent slowing. In our internal debates, I have posited that this could be a symptom of the economy's necessary rebalancing. Firms facing expanding markets and demand may be hiring. Whereas, against a backdrop of a very low policy rate and some forbearance by banks, individual firms in contracting sectors could be holding out, either not recognising that their market is contracting or believing and hoping that it will be their competitors rather than themselves that end up cutting capacity or closing. It can be argued against that that rising employment, and weakness in productivity, is spread fairly evenly across the private sector. But I suspect that we have to dive down into the data to get a more disaggregated picture than we, as macroeconomic policymakers, usually need. I am glad to say that my colleagues Ben Broadbent and Martin Weale are now working with Bank staff on just that. While we cannot yet tell whether a clear message will emerge, it is the kind of work that is needed when the real economy is undergoing a degree of structural change.

Policy

The uneven and unavoidably difficult path for rebalancing in the real economy makes it harder than usual to read the signals of cyclical conditions. But, by the same token, our monetary accommodation can help to ease the costs to firms and households of adjusting. By smoothing the path of aggregate demand, the impact on capital resources and on human livelihoods can be limited somewhat.

In the Committee's latest forecasts, the central projection is for inflation to be ***under*** the 2% target in two-to-three year's time. But it also has inflation rising back towards target through that period as monetary stimulus gradually helps the economy to achieve escape velocity, reducing slack in firms and the labour market. Given the ferocity of the shocks that have already hit the economy, and the pervasive uncertainty that persists about global economic and financial conditions, these are circumstances where taking longer than usual to reachieve the 2% target is warranted. It will help to mitigate the risks of the economy's supply capacity being impaired.

But that is to look ahead to the most likely path of inflation in a year or two. In the meantime, inflation is uncomfortably high, and an absolute precondition for maintaining our support to demand is the credibility of monetary policy. Over the next few quarters, the Committee's most important judgment call will be put to the test. We will all discover whether inflation declines rapidly from 5% towards 3% as the effects of the price level shocks wane.

Finally, let me stress that the gloom should not be overdone. The record is that flexible economies with sound macroeconomic regimes recover from almost any crisis. The UK ***will*** recover. Meanwhile the MPC will continue to underpin demand, consistent with getting back to the 2% inflation target and so with sound money.