Spencer Dale: The UK's economic recovery – why now; will it last; and what next for monetary policy?

Speech by Mr Spencer Dale, Executive Director, Monetary Policy, and Chief Economist of the Bank of England, at the Confederation of British Industry (CBI) East of England Midwinter Lunch, Newmarket, 13 December 2013.

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I would like to thank John Lewis, Matt Trott and Gavin Wallis for their considerable help in preparing this speech. The views expressed are my own and do not necessarily reflect those of other members of the Monetary Policy Committee.

I thought I would start today with a short reminiscence about the late Eddie George, who was Governor of the Bank of England between 1993 and 2003.

Soon after becoming Governor, Eddie gave an interview in which he was asked how he would judge the success of his Governorship. Now this was before the advent of the Monetary Policy Committee, so he couldn't frame his response simply in terms of hitting the inflation target. Instead, Eddie replied that "My personal ambition is that the rate of growth of output should be above the rate of inflation for three years in a row".[1]

At the time, this seemed a fairly tall order: prior to Eddie taking over, this hadn't been achieved even once since the Second World War.

But as it turned out, growth was stronger than inflation in every single year of Eddie's 10-year reign. And that continued for the next few years after he'd retired. Indeed, during the halcyon days of the so-called Great Moderation that preceded the financial crisis, it started to seem that Eddie's ambition was no longer quite so demanding.

But – as you all know – then came the crisis! That, combined with a commodity price boom and a sharp depreciation in sterling, meant that the days of GDP growth outstripping inflation quickly became a thing of the past. We've failed to live up to Eddie's ambition for each of the past six years.

The good news is that recent developments – on both growth and inflation – mean that we appear to be heading back towards an environment of which Eddie would have approved. Over the past six months, output has grown at an annualised rate of almost 3%, almost a quarter of a million new jobs have been created and indicators point to a continuation of strong growth. At the same time, inflation has fallen sharply and, at 2.2% in October, CPI inflation is as low as it's been for four years.

In terms of growth, the obvious question this raises is, why now? Why, after throwing everything bar the kitchen sink at the economy over the past few years, has the economy started to grow only now? Even more importantly, will the recovery last? Having seen a few false dawns over recent years, has the recovery really taken hold this time? And what does all this mean for monetary policy. In particular, what does the MPC's so-called forward guidance, which we announced in the summer, mean for you – the businessmen and women driving this recovery?

And that's the plan for today: to consider three key questions about the economic recovery that we're now finally enjoying – why now, will it last, and what next for policy?

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1 Securities and Investment Review, September 1993.

Why now?

First, why now? Why after several years of frustration and disappointment has the economy begun to grow? It's hard to be certain: this time last year we were not predicting such a sharp turnaround in growth and there's a danger of appearing to be wise after the event. But, at least with the benefit of hindsight, two developments in particular seem important in driving the turnaround: an easing in credit conditions; and a reduction in economic uncertainty.

Let me say a few words about each, starting with credit conditions.

Improved credit availability

Although it's still patchy and there's further to go, we've observed a marked improvement in the ability of many companies and households to access credit over the past 18 months or so. Some of that stems from a lessening of tensions within the euro area, which has helped to ease pressures on banks both sides of the channel. It's also been aided by domestic polices, including the Funding for Lending scheme, a series of regulatory actions to improve the strength and resilience of our banking system and, more recently, the Government's Help-to-Buy policies.

I fully recognise that the ability of many SMEs – perhaps many of you here today – to access credit at reasonable rates still remains impaired. But even here my sense is that some progress has been made. That's the message from surveys of small businesses, from reports by the Bank's Agents, and indeed that I get from my own conversations with many businesses around the country. We're not there yet – and the Funding for Lending scheme remains in place to encourage banks to lend more to companies, particularly SMEs – but we have taken a step in the right direction.

For households, the improvement has been more marked. Interest rates of new mortgages, especially those for fixed-rate mortgages and those with higher loan-to-value ratios, have fallen by well over a percentage point since the summer of 2012. Unsecured personal loan rates have fallen by even more. The greater ease with which many families can access credit has fed through to the housing market, which until recently had been in a state of deep freeze. Housing transactions fell very sharply in the wake of the financial crisis and subsequently flat lined. Nominal house prices moved sideways for several years. But over the past six months or so, there's been some thawing. Housing transactions and mortgage approvals have started to show signs of life. House prices have picked up.

A healthy housing market is good for our economy and will help to support the recovery. Most importantly, it will underpin further increases in house building, which has played an important role in driving the economic growth we've enjoyed this year and which, as a nation, we need to see. It will foster greater labour mobility by allowing people to move more easily to where new jobs are being created. It will help to support consumer confidence.

But let's not be naive. Anyone with more than a passing interest in British economic history is aware that the UK housing market has a sort of microwave type quality to it, with a tendency to turn from lukewarm to scalding hot in a matter of a few economic seconds. The Bank is fully aware of this risk. The good news, however, is that it's far better equipped to respond to these types of risks than in the past. In particular, the new Financial Policy Committee (FPC) – the sister Committee to the MPC – has explicit responsibility for maintaining the resilience of the financial system. And, together with the other regulatory bodies, the FPC has the policy instruments which can address potential excesses in the housing market – and in other markets – which pose a threat to the stability of the financial system.

So although there are risks and there is further to go, particularly for SMEs, credit conditions for many companies and households have eased over the past 18 months and this has helped to stimulate activity, particular so within the housing market.

Consider next the reduction in economic uncertainty which has probably played a greater role in turning the economy around this year.

Reduced economic uncertainty

It seems clear that economic uncertainty has diminished over the past year or so. Think back, for example, to the middle of last year, when the euro area appeared once again to be teetering on the edge. Or even as recently to the beginning of this year, when all the talk at home was of the possibility of a triple dip.

To some, appealing to "reduced uncertainty" as a driver of the economic recovery may sound rather vague and nebulous. A convenient ex post rationalisation perhaps for something we don't really understand.

But it seems clear to me that uncertainty and fear greatly amplified the initial impact of the financial crisis.[2] How else, for example, can we explain the speed with which a failure of a US investment bank in September 2008 led to output and orders up and down our country, and indeed around the world, "falling off a cliff" within a matter of months?[3]

More generally, speaking to companies over recent years, I've been left in no doubt that heightened uncertainty has served as a significant brake on their activity and plans for expansion. And for good reason.

Most obviously, when faced with greater uncertainty about the economic outlook, many companies may hold off undertaking new investments or starting new ventures and wait for the uncertainty to be partially resolved before deciding whether or not to go ahead. The value of waiting – or keeping your options open – is especially marked when considering lumpy investment projects which are hard or costly to reverse once made.[4]

Uncertainty may delay actions and investment within companies, even if managers are not waiting for it to be resolved. Take, for example, a company deciding whether to invest in, say, a new IT system. It may be that at current levels of orders and activity, it's too close to call whether this investment will pay off, and so the decision is put on hold until orders increase sufficiently to tip the balance decisively. But suppose the economic outlook is particularly uncertain, so the company is very unsure whether, even if orders were to rise, that strength would continue. In that case, the company is likely to require an even bigger increase in orders before taking the plunge. As a result, heightened levels of uncertainty will tend to push down on aggregate investment.[5]

More generally, many companies faced with a more uncertain economic outlook may adopt a defensive strategy, hunkering down to ensure that they survive the economic storm. Sure, this may mean deferring potentially profitable business opportunities for a while, but better that than risk your long-term future. In this context, it's worth remembering that it's the most

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[2] For more a detailed discussion of the role increased uncertainty may have played in contributing to the depth of the recession, see the recent article by Abigail Haddow, Chris Hare, John Holley and Tamarah Shakir (2013) in the Bank of England's Quarterly Bulletin.

[3] This phrase was used by Mervyn King in evidence to the Treasury Select Committee in November 2009: "At the beginning of the year we had experienced two quarters when the world economy, in the words people around the world have used, fell off a cliff".

[4] For example, Dixit and Pindyck (1994) show that for a company to undertake an investment project its net present value must not merely be positive, but must be greater than the implied option value of waiting until the next period.

[5] Bloom (2009) shows that higher uncertainty tends to lead to lower investment because it widens the "zone of inaction" associated with companies waiting for the economic environment to move decisively in once direction or the other. The partial irreversibility of investment means that there are more companies at the margin deciding whether to invest than those at the corresponding disinvestment margin. Widening this region of inaction causes more new investments than disinvestments to be cancelled, and hence lowers total investment.

successful companies with the brightest futures that are likely to be most affected in this way, since they have the most to lose.[6]

As I said, the good news is that the cloud of uncertainty has started to lift. And just as heightened uncertainty greatly amplified the downturn, this reduction in uncertainty can provide a powerful spur to the recovery.

This leads to our second question for today: will the recovery last?

Will it last?

The reduction in uncertainty and the easing of credit conditions appear to have started to unlock pent-up demand and so fuel a recovery.

That recovery to date has been largely driven on the household side: high-street sales have increased modestly as consumers have spent a greater share of their pay, and investment in residential housing has increased significantly. The dominant role of the household sector in the early stages of the recovery is not particularly surprising: businesses are likely to need a sustained pickup in demand before they have either the need or the confidence to increase capacity. But the durability of the recovery will depend on the baton of growth being handed over to the corporate sector, whose spending and investment will help to foster stronger growth in productivity and real incomes.

And here the reduction in uncertainty may continue to play an important role. It's perhaps easy to see how reduced uncertainty may help to prompt a one-off increase in business spending, as companies move away from defensive, wait-and-see strategies and blow the cobwebs off plans for deferred investment projects. But the impact of diminished uncertainty may stretch beyond simply a short-run boost.

In part that reflects the possibility that the combination of reduced uncertainty and increased spending by households and companies may become self-reinforcing: reduced uncertainty helps to spur additional spending and investment, which in turn further reduces uncertainty about future demand and so on.[7]

Movements in uncertainty can amplify the recovery just as they amplified the downturn.

This virtuous circle may be enhanced by the benefits reduced uncertainty can have for the supply-side of our economy. Increased investment will add to our productive capacity. A strengthening labour market may give employees confidence to move jobs, so better aligning available skills with vacancies. Companies may lift

the shutters and start to take the types of risks and entrepreneurial activities necessary for our long-run prosperity.[8] Such improvements in the supply performance of our economy would greatly enhance the durability of the recovery.

Diminished uncertainty may also bolster the impact from the past easing in monetary policy. The MPC has loosened monetary policy aggressively since the financial crisis, both by cutting Bank Rate to historically low levels and by the use of more unconventional tools, such

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6 The costs associated with bankruptcy means that, in times of high uncertainty, a firm may opt to adopt a strategy which is most robust to their view about the world being proved wrong, sometimes referred to as "robust satisficing" (See Ben Haim (2010) for an overview).

7 My colleague David Miles (2013) made a similar point in a recent speech.

8 Bloom et al (2001), Bond and Lombardi (2004) and Gilchrist et al (2010) all discuss the constraining impact uncertainty can have on business investment. Reduced uncertainty may also make companies more willing to enter new markets. Disney, Haskel and Heden (2003) provide evidence that such activities are an important source of productivity growth. Lazear and Spletzer (2011) show that reduced uncertainty can prompt greater "churn" in the labour market leading to more efficient matching of skills to jobs.

as Quantitative Easing and the Funding for Lending scheme. But if, over recent years, many companies have been largely focussed on survival, waiting for some of the uncertainty to be resolved before actively considering opportunities to invest and expand, it's possible that the easing of borrowing costs brought about by these policies has not yet fully translated into spending decisions. As uncertainty lessens, past monetary policy actions may gain greater traction, thus further supporting the recovery.

So there are good reasons for thinking that the reduced uncertainty may help to facilitate this handover to business spending we need to see, and that some of those effects may be long lasting.

But we also need to be alive to the possibility that the events of the past few years may colour and contaminate business behaviour for many years to come. It may be a long time before companies look ahead with the same confidence that they did during the period of remarkable stability prior to the crisis. Before their trust is restored that the authorities are able to stop really bad things from happening. Before they rebuild their relationships with their banks.

On this final point, many companies were let down by their banks during the financial crisis, and I fear that many will be reluctant to return to a business model which relies on their banks providing liquidity and support in times of need. The reluctance today of some companies to borrow from their banks may be less a lack of demand and more a breakdown of trust. Although an understandable response to the events of the past few years, an increased prevalence of self-insurance is not good for the efficient functioning of our economy.

The scarring effects of the financial crisis and the uncertainty it brought with it, together with the fiscal consolidation and the weakness of the euro area, are likely to continue to weigh on the recovery over the next few years. Yes: our economy appears to have turned a corner. And yes: there are good reasons for optimism that the recovery will persist. But we can't take it for granted: there's still a long way to go. And that sense of how far there is to go underpins the policy guidance provided by the Committee earlier this year and takes us to our third and final question: what next for monetary policy?

What next for monetary policy?

The primary objective of monetary policy remains to hit the Government's 2% target for CPI inflation. Despite missing the target for much of the past five years, I've no doubt that the credible nominal anchor it provided served our economy well during the crisis. Indeed, without that credibility it wouldn't have been possible to loosen monetary policy as aggressively as we did in order to support output and jobs.

As we have seen, the good news is that inflation has fallen sharply over the past few months and the 2% target is now in sight for the first time in over 4 years. But this isn't a time for complacency. To repeat, inflation has been above the 2% target for most of the past five years. There are good reasons why policy wasn't tightened in order to bring inflation back to target more quickly. But ultimately, the MPC will be judged by the success of our actions, not the elegance of our arguments. We need to demonstrate our commitment to bring inflation back to target and to keep it there.

But we have also needed to trade off the speed with which we bring inflation back to target against the support that monetary policy can provide to the recovery. The MPC's forward guidance gives greater clarity about our view of the appropriate trade-off.

More important for us today, our guidance is rooted in the recognition that it's a long way back to the economy being fully recovered. The damage and losses associated with the financial crisis and the years of frustration and disappointment that followed won't be reversed simply by one or two quarters of strong growth. Our guidance makes clear that we intend to maintain the current exceptionally stimulative stance of monetary policy until we've seen a sustained period of strong growth and the margin of slack in the economy has narrowed significantly, as long as this does not pose risks to either price or financial stability.

As you may know, our guidance was framed in terms of so-called thresholds and knockouts. The MPC intends not to raise Bank Rate or reduce the stock of asset purchases at least until the unemployment rate reaches a threshold of 7%, subject to three knockouts designed to guard against risks to price and financial stability.

But abstracting from the details of these thresholds and knockouts, our message to you – the businessmen and women driving this recovery – is clear. You can plan for the future in the knowledge that the MPC intends to keep interest rates low until we have seen a prolonged period of strong growth, unemployment is significantly lower, real incomes are higher.

Based on some of the reporting, you might be forgiven for thinking that forward guidance is far more complicated than this. To take just one example, let me read to you the opening sentence of an article last month reporting on the MPC's November Inflation Report. Under the headline "Forward guidance fails", the article began: "The Bank of England now expects the economy to grow strongly next year, highlighting the fact that its policy of forward guidance has effectively failed."

Strong growth, falling unemployment: if that's failure, I wish I'd failed long before now!

The aim of the Committee's guidance isn't to provide a commitment that interest rates won't rise until some particular date in the future. Monetary policy has to respond to the changing state of the economy. We can no more commit to keeping our prices and quantities unchanged irrespective of economic circumstances than you can. Rather, our guidance should reassure you that, absent risks to either price stability or financial stability, we will tighten policy only when we are well along the road to recovery. Yes: interest rates will rise at some point. But only against a far stronger economic backdrop, when your output is higher, your order books are fuller, and you and your customers are better able to withstand a rise in borrowing costs.

Moreover, although still some way in the distance, we shouldn't look at the prospect of an eventual rise in interest rates with a sense of dread and fear. Assuming that interest rates rise due to the vigour and durability of the recovery, rather than concerns about either inflation or financial stability, we should see interest rates beginning to rise as a sign of the strength of our economy. As a sign that that we are well on the way to making a full recovery. As a sign that the emergency life-support measures put in place since the crisis are no longer required.

The MPC is fully aware that extraordinary low interest rates are likely to be needed for some time yet. But when they cease to be, this will be a sign that we have finally turned the corner for home.

Conclusion

Let me summarise

At long last, we appear to be moving back to an economic environment of which Eddie would have approved. One in which the economy is growing robustly and inflation is close to target. A recovery appears to have finally taken hold, spurred by reduced uncertainty and easier credit conditions. There are good reasons for optimism that the recovery will be durable. But the journey back to full recovery is long and many challenges still remain. Monetary policy is there for the long haul. That is the essence of our forward guidance.

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