Paul Fisher: Inflation, interest rates and forward guidance

Speech by Mr Paul Fisher, Executive Director for Markets of the Bank of England, at State Street Global Advisors London Pensions and Investments Breakfast Briefing, London, 23 January 2014.

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The speaker is also chair of the ifs *University College. Any views aired in this speech are given in his capacity as a member of the Monetary Policy Committee of the Bank of England. The speaker is grateful to Geoff Coppins for helping to prepare this talk and many colleagues for comments, but any blame for the content is for the speaker alone.*

This morning I would like to discuss some of the important issues currently influencing the setting of monetary and financial policy by the Bank of England. Those policies may have a direct bearing on pension funds; most obviously you might think via the yields on financial assets but perhaps more importantly via the stability of the real economy.

Developments in inflation

First of all I want to note the importance the Monetary Policy Committee (MPC) attaches to CPI inflation being close to its target of 2%. Indeed it is currently at exactly its target of two point zero per cent for the first time since April 2006! (Although it did drop below 2% for a time in 2007 and 2009). Although we can't expect inflation to be exactly 2.0% very often (just four times since it was announced as the target variable in December 2003), inflation has been above target for most of the past six years. Both the extent of the overshoot and its persistence were greater than the MPC initially expected. The pain of that experience of high inflation over the past few years should remind us all why the UK attaches so much importance to keeping inflationary pressure under control and why we have an inflation target.

Inflation is costly in all sorts of ways.[1] It can destroy real incomes, for example by acting as a hidden tax[2], and destroy wealth through a misallocation of resources. Those on fixed nominal incomes or who depend on savings income may be badly affected whereas it can inflate away the debts of others. And it generates a variety of other economic costs and distortions as changes in the general level of prices start to dominate the information contained in relative or "real" prices. Many of these costs are pernicious by being implicit; for example in businesses having to change price lists, or consumers having to spend more time looking for real value.

The MPC could have set a tighter monetary policy to try and limit the rise in inflation. Why didn't we? First, because we were pretty sure that the factors driving inflation higher were going to cause changes in the price level rather than being consistent with, say, excess demand generating persistently higher inflation. We expected inflation to fall back, once those changes had passed through. And, second, to prevent even a temporary rise in inflation consequent to those price level shifts, the MPC would have had to try to depress the economy even further, by consciously pushing down on output, employment and nominal wage growth – so real wage growth would have been weaker, not stronger – at a time when the economy was already very weak. So, despite the costs of the inflation which were

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[1] For a comprehensive review of the costs associated with anticipated and unanticipated inflation, see Briault, C (1995) "The costs of inflation", Bank of England Quarterly Bulletin: February 1995 (http://www.bankofengland.co.uk/archive/Documents/historicpubs/qb/1995/qb950102.pdf)

[2] Because no interest is paid on bank notes and coins. Also because of nominal rigidities in the tax system like fixed personal allowances.

experienced, the costs of the policy needed to counteract it would have been even greater in this specific circumstance of one-off shocks and left the UK economy in a much worse position now.

I want to stress that these calculations would not lead to the same conclusion were inflation being driven by pressure arising from excess demand or if inflation had led to expectations of above-target inflation in the medium-term. In those circumstances, where inflation would be more persistent and hence much more costly, the benefits of bringing inflation back to target would outweigh the short-run costs of doing so. The recognition of these different short-run trade-offs, depending on the forces driving inflation, lie right behind the specification of the Remit we have been given by the Government.

The fact that inflation has now returned to target confirms to me that we were broadly correct in our underlying assessment that the factors pushing up on inflation would be temporary, although the near-term path for inflation hasn't always been what we expected. It is very difficult to anticipate the precise trajectory of prices and we have certainly learned more about the dynamics of inflation during this difficult period: the effects of the 25% depreciation in the sterling effective exchange rate between mid-2007 and early 2009 were larger and longer-lasting than we anticipated for example[3]. But tightening policy in response would have been a major mistake: a tighter policy then and we could now be facing the threat of deflation and depression, rather than inflation around target and the prospect of real recovery.

The MPC's policy has been to keep short-term interest rates low, by setting Bank Rate at 0.5%, and to stimulate the economy through asset purchases and latterly through forward guidance. Although asset purchases work through several channels, I want to spend a little time on their contribution to depressing longer-term interest rates. Low interest rates – at all maturities – have been necessary to help stimulate spending and so help set the conditions for a recovery in the economy. But for many investors, such a policy generates low financial returns which are difficult to cope with. Pension funds, for example, need relatively long-term, low credit risk investments – such as gilts – and those have been generating lower than normal returns for some years. In fact, the search for yield has tended to depress all financial returns. But I want to reflect on the relationship between rates of return and the real economy. As a general proposition, one cannot expect to earn high risk-adjusted real returns from financial investments if the underlying real economy is not growing. For example, it is business profitability which drives equity dividends and prices. The real "risk-free" interest rate is also associated with real growth. Slow economic growth and low financial yields have been a feature of most of the developed world in recent years because of the global nature of the recessionary forces at work. Once a recovery in the UK economy has been firmly established then one would naturally expect real financial returns to be higher, and the real policy rate (i.e. Bank Rate minus expected inflation) can start to normalise.

We can express this thought in a different way. Would it have helped financial investors to have had higher nominal interest rates over the past few years? If that had meant a deeper recession, deflation and an even longer-lasting malaise in the economy, then very few UK-based medium-term investors would have been better off as demand and activity would have dropped off further, credit risk crystallised and a range of credit investments went bad. Those with longer term investment horizons – such as everyone in this room should have – will appreciate that the best outcome for UK monetary policy is for it to be set at the right level to lay the foundations for a stable economy.

In that regard, we should bear in mind that the economy will always be subject to unforeseen shocks which tend to push it away from stability for a period of time. The job of the MPC is to

[3] With such a large change in the nominal exchange rate, one only needs to be slightly out in estimating the marginal impact to generate large errors in the total impact.

react to those shocks by bringing inflation back to target and, subject to that primary objective, in a manner which helps sustain output and employment.

As well as inflation back around target, we have also seen a resurgence in growth over the past year. It was difficult to explain the suddenness of the change in sentiment which accompanied the recovery during 2013 but growth in itself should not be regarded as surprising. It is the near stagnation from 2010–12 which was harder to understand. We have been stimulating the economy with historically extreme levels of monetary policy for a long time and a variety of headwinds (including the problems in the euro area, a tightening of credit conditions, the drag on activity from fiscal consolidation, and a squeeze in household real incomes resulting from the fall in productivity and higher energy and commodity prices) have all contributed to limit the effect of that stimulus. What seems to have happened in 2013 is that at least some of those headwinds were perceived to have diminished, allowing the policy stimulus to come through and the resulting growth has generated the renewed consumer and business confidence which reinforces demand.

We are very conscious that the headwinds have not gone away: much of Europe and some other parts of the world continue to struggle for sustained growth; fiscal consolidation in the UK (and elsewhere) is likely to continue for a while to come; and the financial sector still needs some rebuilding. Indeed, the official production and construction data released earlier this month were rather disappointing, reminding us that strong growth from here on is by no means guaranteed. But to varying degrees perhaps the very worst of the storms may be behind us. Just a tailing off in some of their negative impacts may have been sufficient to allow the economy to start growing again.

Interest rates and forward guidance

So why aren't we moving to tighten policy straight away, why did we issue forward guidance around monetary policy? The answer is in the ***levels*** of output and employment, not their growth rates. After nearly 6 years since the start of the crisis, the level of output in the economy is still 2% below its peak in 2008. A conservative extrapolation of the pre-crisis trend would suggest that UK output is some 15–20% below where it would have been expected to be by this time in the absence of the crisis. It seems unlikely that we will recover much of that gap and in any case the calculation is getting less precise and less relevant. Eventually, economic historians may work out what happened to potential output and we should establish a new reference point. As things stand today, it is difficult to know precisely where the new sustainable growth path of the economy lies (especially as data for the past few years are still likely to undergo significant revision by the ONS). But with unemployment still elevated, and diminishing signs of inflationary pressure in both goods and labour markets, we can be reasonably confident that the economy needs to grow strongly for some time to come, to regain a stable and sustainable medium-term trajectory.

The challenge for the MPC is to assess when inflationary pressures will be building and thus when we need to start withdrawing stimulus, so that once we have eliminated slack in the economy, monetary policy is consistent with stable, sustainable growth and hence stable inflation around the target (subject of course to the other forces acting on the economy at the time). That's an extremely optimistic expectation of what policy can achieve, so let me put it slightly differently. The realistic challenge for the MPC is to avoid a big mistake either by choking off the recovery too soon, leaving the economy in a quagmire, or by allowing inflationary pressures to build excessively, requiring a sharp tightening in interest rates (and the potential for another recession) to bring inflation back under control.

Forward guidance is a policy framework designed, amongst other things, to help avoid big mistakes. We can encourage and probe growth in the economy by committing not to tighten policy until the economy has used up more of its spare capacity. On one view the policy is simple – we must give the economy plenty of time to establish the recovery before we start to raise interest rates or unwind asset purchases. At another level, some critical judgements are

going to be needed because the timing is inevitably uncertain. Given those uncertainties, forward guidance delivers a framework within which the MPC can explore the scope for economic expansion without putting price and financial stability at risk. That guidance should help to give confidence to businesses and households and help to support demand growth. By reducing uncertainty about our reaction function, guidance should also have helped to counteract the pressure in financial markets to price in the chance of a rapid increase in Bank Rate.

We chose unemployment as the threshold indicator not because it was ideal – far from it – but because other indicators were all less attractive. Of course, no sooner had we announced a policy linked to the unemployment rate than it began to fall unusually precipitously. But what is there not to like about sharply falling unemployment? After all, getting the economy back to a medium-term path quickly, allowing policy to normalise, would be a good thing? Right?

Well, falling unemployment is undoubtedly a good thing for the individuals who are back in work and on many other social counts. It could only be a purveyor of the dismal science who found rapidly falling unemployment disappointing! Yet, in order to see rising living standards on average, it is crucial to see rising output per head (i.e. rising productivity) – which ultimately drives real national income per head and hence how well off we are as a country. So we need to see rising employment accompanied by even faster growth in output.

The implied productivity performance of the UK economy has, in fact, remained poor – according to the official statistics, output simply doesn't appear to be growing fast enough to support the employment growth recorded as well as generate the rapidly rising real incomes one would like to see. Something has to give. I hope that it will be that output grows faster – either through upwards revisions to recent growth rates or faster growth in future. If, on the other hand, the UK economy uses up all its spare capacity, without having had a substantial rise in real national income, then we should all be disappointed.

The weakness in productivity growth has been well documented, but a convincing explanation remains elusive. There are many plausible explanations of factors which could have contributed to the weakness, but each explains only a small part of the whole puzzle. I don't have time to get into that debate today, but we do offer a variety of candidate explanations in recent *Inflation Reports*.

One better feature of the current situation is that price pressures seem to be subsiding, not growing. Despite good rates of employment growth, there is no sign of nominal wages over-reacting to general tightness in the labour market. Other price pressures also appear to be easing somewhat. Month by month there have been a series of small downside surprises in the inflation rate as oil prices have been relatively stable; the effects of administered and officially regulated prices now seem to be a bit less than previously expected; inflation expectations remain well anchored and the exchange rate has been rising which may help keep a lid on imported costs for a while (but importantly, at the cost of less balanced growth which is a separate problem). Taking the inflationary news together, it would appear that we have a favourable situation in which to explore how much more capacity the economy has, before inflationary pressures begin to build.

Another positive factor supporting our probing strategy is the emergence of macro-prudential policy. Monetary policy has a difficult challenge ahead, as I have outlined. It will help enormously if financial policies can help deal with, or at least mitigate the risks from, some of the imbalances that are arising in the economy while the MPC aims to restore medium-term stability in the economy as a whole. The housing market is an example of where monetary and macro-prudential policies can helpfully interact and the November 2013 *Financial Stability Report* sets out some of the policy measures that are underway or could be called on if necessary.

Funding for Lending Scheme

One decision that has been implemented is in relation to the Funding for Lending Scheme (the FLS). The FLS contributed to a substantial fall in bank funding costs after it was launched in July 2012. This fed through to a significant improvement in household credit conditions. Rates on new household lending have fallen markedly since mid-2012, with falls of more than 100 basis points in some representative mortgage rates. Both gross secured lending and repayments have picked up strongly. And the number of approvals for house purchase has risen significantly, indicating higher mortgage lending in future. The Scheme has probably been one of the driving influences behind the resurgence of business and consumer confidence – although there are many other factors behind the sort of swing we have seen.

Partly because of its own success, there is no longer a need for the FLS to provide broad support to household lending. It is not the case that net lending for mortgages by UK banks is, as yet, excessive. Indeed, the annual rate of growth in the stock of secured lending to individuals was under 1% in November 2013. But sharply rising house prices are a potential source of instability and we should not risk adding policy oil to that particular fire. Credit conditions for smaller businesses have also improved, but to a lesser extent, and lending to businesses overall remains muted. The FLS extension will therefore provide continued substantial support for lending to businesses, with incentives in the scheme skewed heavily towards lending to small and medium-sized enterprises (SMEs). As the MPC noted in the minutes of its December 2013 meeting, the changes to the FLS provided support to the MPC's policy guidance by reducing the risk of triggering the financial stability knockout.

Conclusion

Yesterday, the Labour Force Survey headline unemployment rate for the three months to November was published at 7.1%, after another large fall. But even if the 7% unemployment rate threshold were to be reached in the near future, I see no immediate need for a tightening of policy. The MPC has been clear all along, that upon reaching the 7% threshold we will have to consider what the medium-term pressures on the economy are and make an appropriate judgement about the direction and pace of policy, and any further guidance that we may choose to issue in future. It is probably best to think about that in the context of our medium-term inflation projections published in the *Inflation Report*.

Overall, the macroeconomic outlook is much more comfortable than it was – but we still have much to do and much to concern us. There is no room for complacency. Can the UK keep growing at the sort of rate consistent with recovery if our key European export markets remain so sluggish? How much more adjustment is needed in the financial sector and in the fiscal position? Have households sufficiently rebuilt their balance sheets to be able to withstand a normalisation of policy? Many of these considerations argue against being hasty in tightening monetary policy. But the inflation target remains our primary objective and we will have to be careful not to allow pressures to build up from excess demand. It would be a relief, probably for both you as investors and for us as policy makers, to get back to more normal policy conditions, but my own judgement is that we are still some way off the point where it is appropriate to start raising Bank Rate and that when it is time, it would be appropriate to do so only gradually.