



BANK OF ENGLAND

Speech

The spirit of the season

Speech given by

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It is always a pleasure to be in New York during the festive season. At this time of year in this city everything seems possible. However for some time now, appearances have deceived. The hopes and dreams of the holiday season have gone unfulfilled as the bright lights of December have given way to the grim realities of January.

Around this time every year policymakers, investors and economists take stock. For four of the past five years, perhaps caught up in the seasonal spirit of goodwill, they have rendered the same verdict: the outgoing year was disappointing but the incoming one will be better (Chart 1). This year is no different. The IMF, the Bank of England and private forecasters all predict faster growth in the advanced and global economies in 2014. Will such hopes again be dashed once the New Year dawns?

More profoundly, as the string of disappointments lengthens, some are raising deeper questions. It is being suggested that a malign spirit, a spectre of Christmases past, haunts our future. In particular, no less an authority than Larry Summers has raised the prospect that “secular stagnation” could be the root cause of past excess and current weakness.

Today, I want to explore those deeper questions and what they mean for policy. But before raising the pessimists’ challenge, let me first keep with recent practice by setting out this year’s reasons for optimism.

Grounds for optimism

The news from the UK is positive. Inflation has fallen, from more than 5% in 2011 to 2.2% now, jobs are being created at a rate of 60,000 per month, and growth is – for the moment – the strongest in the advanced world.¹ This recovery is relatively recent, having started in earnest during the second quarter of the year. Its timing and pace caught most unawares. Certainly, the cumulative run of economic surprises has dwarfed those of the other major advanced economies (Chart 2).

With the wisdom of hindsight, there were three main drivers of the recovery: a marked reduction in extreme uncertainty (Chart 3); significant progress on repairing the core of the financial system, with risk-weighted capital ratios doubling in recent years; and a marked improvement in household balance sheets, where debt to income ratios have fallen by about 30 percentage points.

Together, improved access to finance and raised expectations of future prospects led to a reduction in precautionary savings by households, a modest recovery in consumer spending, a revival in housing investment from very low levels and an increase in business confidence to a 15-year high.

¹ 60,000 jobs per month in the UK is roughly the equivalent of monthly increases in US non-farm payrolls of 300,000.

The American and British experiences underscore that recovery is not possible without a meaningful and transparent re-capitalisation of the banking system, and that households need to de-lever before they have the confidence to consume again.

The question now is whether such progress is sufficient for durable, strong and balanced recoveries over the medium term.

Growing pessimism

The pessimists would argue that it isn't. Their case starts from the observation that advanced economy growth rates remain below pre-crisis trends, despite the scale of the fall and years of emergency monetary stimulus. More fundamentally, pessimists point to the pre-crisis period when (retrospectively) loose financial conditions did not generate a boom in output and associated inflation.

They ask: could stagnation be the new normal?

Today I want to consider two possible explanations for why advanced economies may have entered a low growth phase. First, on the demand side, they could be in a persistent liquidity trap, making it difficult for resources to be fully utilized, and second, there may have been a persistent deterioration in the supply side such that full utilisation of resources is consistent with slower growth.

1. *Persistent liquidity trap*

A liquidity trap occurs when the short-term nominal interest rate hits the zero lower bound. Typically in a liquidity trap, the equilibrium real interest rate is negative, creating a persistent inability to match aggregate demand and supply.

Before proceeding, I should make clear what I mean by the equilibrium (or natural) real interest rate. Let me use Roger Ferguson's definition: it is the level of the real policy rate that, if allowed to prevail for several years, would place economic activity at its potential and keep inflation low and stable.

For small open economies, like the UK, that equilibrium real rate is determined at the global level by the balance of the supply of savings and demand for investment. In the run-up to the crisis, that balance had shifted decisively as what Chairman Bernanke christened a 'savings glut' from emerging economies developed. The flipside of that was low demand for advanced economy exports and low domestic demand in emerging economies. Only very low global real interest rates could spur sufficient domestic demand in advanced economies to maintain activity at its potential level.

The problem of course was that the expansion of demand in advanced economies largely took the form of unsustainable consumption rather than business investment.

The ensuing financial crisis pushed the equilibrium real interest rate down further and, with nominal interest rates stuck at zero and inflation low, monetary policy was unable to push actual real rates to a level low enough to maintain full employment.

The danger in such a situation is that it can become unstable as weak demand and uncertainty cause companies to hold back investment and households to postpone spending. With the balance of savings and investment deteriorating, the equilibrium real interest rate falls even further. At the same time, wages and prices are forced down, pushing actual real interest rates higher. A deflationary spiral results.

That is not the only danger. Attempts to reach a very low or negative equilibrium real interest rate – both through conventional reductions in short-term interest rates and through unconventional asset purchases – can risk generating unbalanced, unsustainable demand.

In particular, as my predecessor Mervyn King has emphasised, by encouraging spending to be brought forward from the future and debt to be accumulated in the present, a greater shortage of demand tomorrow will develop unless the income of those who have taken on the debt picks up.² If it does not, monetary policy will have to ‘double down’ in order to sustain demand. Such compounding stimulus could promote financial vulnerabilities through an indiscriminate search for yield, a compression of risk premia to unsustainable levels or via extrapolative expectations of future asset prices. Perceptions of a ‘central bank put’ – where the market interprets all bad news as good news because it will be met with more central bank stimulus – can reinforce these risks. When the inevitable correction finally occurs, the shortfall in demand and scale of the liquidity trap is insurmountable.

To what extent does this sketch resemble the current situation in the UK?

As its policy stance reflects, the Monetary Policy Committee (MPC) judges that the equilibrium real interest rate has been, and continues to be, negative. Despite very low interest rates, resources are not fully employed. 850,000 more people are out of work than in the years before the crisis and GDP is around 20% below an extrapolation of its pre-crisis trend.

As bad as these figures are, the scale of the mismatch between aggregate supply and demand has not been large enough to generate a deflationary spiral. Despite persistently weak nominal wage growth, rising import prices and weak productivity growth have meant that the UK’s problem has been the need to bring inflation back to the target from above. In this regard, there has been welcome progress. Headline inflation has

² A point emphasised by Mervyn King, for example here: <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech613.pdf>.

fallen back much sooner than we expected at the start of the year, and core inflation measures are running close to but slightly below the 2% target.

What then of the risks of unbalanced growth? This is more delicate. Despite admirable progress by British households in recent years, aggregate debt levels remain high at 140% of incomes. In addition, housing activity is picking up and price growth appears to be gaining momentum. Moreover, the UK current account deficit is near record levels.

These developments merit vigilance but not panic. The housing recovery could reflect higher future income expectations, prompted by the nascent recovery, and better credit conditions. Although the current account position underscores the need for the recovery to shift over time towards investment and export growth, it would be unreasonable to expect that to have happened already. Recoveries are seldom led by investment and strong demand from the UK's major trading partners, including the euro zone, appears some way off. Ultimately, a sustained recovery in the UK will require a more robust and balanced global recovery.

In summary, the UK has been in a situation where the equilibrium real rate of interest has been negative, but with monetary policy gaining traction, there is early evidence that the liquidity trap will be escaped over time. That is not to suggest the warnings are without merit, that interest rates can return to normal soon, that the risks to financial stability arising from the emergency stance of monetary policy are not real, or that escape would bring the freedom to grow at historic rates.

It is in this last respect that the second story for a 'secular stagnation', persistently weak supply, is most relevant.

2. *Supply pessimism*

In many advanced economies, despite persistently disappointing output growth, unemployment rates have remained surprisingly low. Based on a simple Okun relationship, the current UK unemployment rate would be expected to be closer to 14% and the US rate to be around 10%. In fact, they are 7.6% and 7.0% respectively (Chart 4).

These discrepancies have reinforced the worries of some that weak potential supply growth will constrain the pace of recovery. Possible explanations for such weakness range from demographics to a slowing in the rate of technological progress.

It seems unlikely that communicating in 140 characters – useful discipline though that is – represents the apex of human progress. Nor should central banks always and everywhere take supply as exogenous. Central banks can affect people's decisions about how much to work and firms' decisions about how much to invest. When the outlook is particularly uncertain, as it is in the wake of a major financial crisis, this influence

could affect potential supply. Monetary policymakers must consider the extent to which their decisions affect, not just depend on, the path of output.³

In the US this question has been the subject of much debate. A recent Federal Reserve Board paper argues that potential supply growth is likely to respond to demand as the economy recovers, for example through capital deepening, as well as the behaviour of the labour market.⁴

The rise in unemployment here in the US has been tempered by a fall in the rate of labour force participation and a slowdown in productivity growth (Charts 4 and 5). It is quite possible that, with a recovery in demand, those discouraged from looking for work will return to the labour force. Given the risks of hysteresis, that is more likely to happen the more quickly demand recovers. This dynamic suggests scope for a strong recovery in which falls in unemployment are much more limited than usual.

Potential growth in the UK could also be pro-cyclical but for different reasons. In Britain, the employment rate has fallen only a third as much as in the US (Chart 6). The flipside of that strength has been exceptionally weak productivity growth (Chart 7). Will UK productivity growth pick up alongside demand? The fundamentals are promising. Given the flexibility of its labour market, the continued openness of the economy and the credibility of macro policy, it is hard to think of any reason why there should have been a persistent deterioration in the rate of potential growth in Britain.

This hypothesis holds particularly now that the UK financial system is beginning to function more effectively. Until recently, the weakness of the banking system limited the reallocation of capital and labour from less to more productive activities. Indeed, whereas half of all productivity growth at the economy-wide level in the years prior to 2008 occurred through this channel, reallocation appears to have made no contribution to productivity growth in recent years.⁵

There are other reasons to think that growth itself should bring a supply side improvement. As the economy recovers, investment should pick up and part-time workers should shift into more productive full-time work. With the sharp fall in real wages during the recession (Chart 8), employees effectively priced themselves into low-productivity work at a time of weak demand. To the extent that this allows skills to be retained and reduces costs of replacing particularly skilled employees as the recovery takes hold, the recovery could generate greater supply capacity and real wage growth as it proceeds.

³ In economists' jargon, the extent to which potential supply is endogenous. This opens the possibility of there being 'multiple equilibria', something my colleague David Miles has reminded us was a central message of Keynes but that has been lost to much of the latest generation of New Keynesian modelling. See "Monetary Policy and Forward Guidance in the UK," a speech by David Miles, available at: <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech681.pdf>.

⁴ David Reifschneider, William L. Wascher, and David W. Wilcox (2013). "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy," Finance and Economics Discussion Series 2013-77. Board of Governors of the Federal Reserve System (U.S.). <http://www.federalreserve.gov/pubs/feds/2013/201377/201377abs.html>.

⁵ See Alina Barnett, Maria Barriol, Adrian Chiu and Jeremy Franklin. "The Productivity Puzzle: Firm-Level Perspectives," Bank of England Working Paper, forthcoming.

It would be unreasonable to expect these positive outcomes to materialise immediately. Weak growth may have meant that companies have missed out on productivity advances that would otherwise have been made through learning by doing. Skills have atrophied through underemployment rather than unemployment. The recovery will therefore need to be sustained for a period before productivity – and real wage – gains can resume in earnest. That picture is borne out in the latest UK data, which show that the early phase of recovery has been accompanied by some productivity gains but also by further strong employment gains.

In summary, while the UK's experience does not rule out the possibility that supply growth has slowed, the thesis is only beginning to be tested. And the nature of the slowdown, particularly in the labour market, suggests that supply will likely increase with demand for some time.

Policy Implications

The risks to supply and the risks associated with the liquidity trap imply that central banks need to deploy a wide range of policies in a coordinated fashion.

The most obvious implication is that monetary policy should respond aggressively. To prevent the liquidity trap from becoming a coffin, central banks have set monetary policy at emergency levels by reducing short-term interest rates to their lowest feasible levels, undertaking large-scale asset purchases, and pursuing targeted interventions to ease funding and credit conditions. The possibility that potential supply will itself depend on the speed of recovery reinforces this policy bias.

Forward guidance is integral to the response. It reduces uncertainty by providing reassurance that monetary policy will not be tightened prematurely before the recovery is sufficiently entrenched to sustain higher rates. This helps give households and businesses the confidence to spend and invest. And, by setting a threshold for the unemployment rate, guidance helps us to test the endogeneity of supply. If supply responds to recovering demand, unemployment will fall more slowly than otherwise and the point at which we will re-evaluate the stance of monetary policy will come later.

What of unbalanced growth? The Bank of England is alive to the risks of extended stimulus, and given its responsibility for macro-prudential policy, it can act in a timely fashion to mitigate them. The Bank demonstrated this flexibility recently with a package of measures targeted at the housing market, and it has outlined a broad range of additional tools if further action were required.

The synergies of combining the monetary and macro-prudential authorities in one institution could be considerable. By sharing analysis and clearly assigning a hierarchy of responsibilities between them, the Bank's MPC and its financial policy equivalent, the FPC, are ensuring that measures are timely, proportionate and targeted. For example, the Bank's Funding for Lending scheme, originally put in place for

monetary policy purposes, was refocused from household to small business lending for financial stability purposes. Similarly, both committees have made it clear that monetary policy is the last line of defence against financial stability risks, thereby establishing clear lines of responsibility and accountability.

This coordination is particularly important if either of the 'secular stagnation' stories is relevant. By addressing risks to financial stability, the Bank's FPC helps ensure that monetary policy can remain as stimulative as necessary for as long as necessary to achieve its objectives. In doing so, it reduces the risk of a deepening liquidity trap caused by compounding debt-fuelled consumption. And it helps to lay bare more clearly the underlying growth potential of the economy.

The third aspect of the policy response is better financial regulation and supervision. In both the US and UK, the repair of the financial sector was a prerequisite for recovery. Indeed, one of the reasons behind a persistently negative equilibrium real interest rate has been the restricted supply of credit from a damaged banking system. Going forward, financial reforms will help guard against excessive pro-cyclicalities that could emerge in a "low for long" environment.

But financial reform is about much more than fixing the failings in advanced economies; it is one of the keys to rebalancing the global economy. The global savings glut will not disappear in the absence of further financial liberalisation in China. That will only proceed if there is a transparent, resilient global financial system worth joining, and will only be completed by further internationalisation of the renminbi. Those realities are key reasons why the Bank of England is so engaged in the work of the Financial Stability Board and has moved to support London as a hub for renminbi clearing.

Conclusion

For the first time in a long time it seems reasonable to expect the hopes and dreams of the holiday season to be fulfilled.

The Ghost of Christmas Present is a cheerful spirit. As uncertainty diminishes, credit conditions improve and balance sheet repair progresses, monetary policy is gaining traction. The strength of the UK recovery and the fall in its unemployment rate suggest that the equilibrium real interest rate is now rising gradually back towards zero.

The Ghost of Christmas Past should not be forgotten. A recovery may be gaining pace but our economies are a long way from normal. Leverage is still high and weak demand for advanced economy exports could persist for some time.

The Ghost of Christmas Yet to Come suggests that it is unlikely that equilibrium interest rates will return to historically normal levels any time soon. This prospect puts a premium on macro-prudential policies and

financial reforms to manage the associated risks without abandoning the need to keep interest rates in line with the equilibrium level.

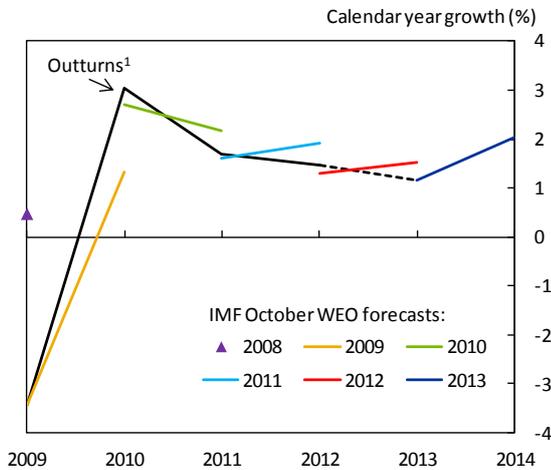
So while it is unsurprising that the ideas behind secular stagnation are being revived, it would be a mistake to rush to a more extreme macroeconomic response. There is a long history of pessimism in economics, from Thomas Malthus through Alvin Hansen to Robert Gordon. Such worries have proven misplaced in the past and scepticism is warranted now. Don't forget that the US economy is more than 13 times larger than when Hansen first formulated his ideas.

Similar performance must again be possible. Central banks are playing a catalytic role to help deliver it but their contribution will ultimately be limited. The most important drivers of long term prosperity will be measures taken by others to increase the growth of supply, particularly those that reinforce an open, global economy. Such good deeds will truly merit the goodwill of all men and women.

Thank you.

Annex

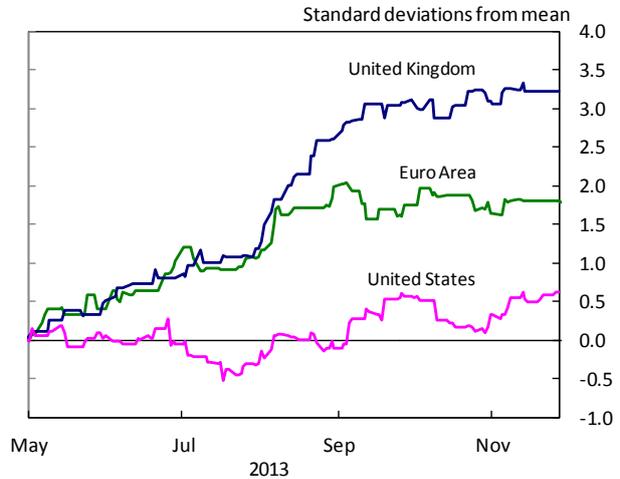
Chart 1: Persistent disappointment in advanced economies' GDP growth



¹ Outturns are taken from October 2013 WEO, 2013 point is a forecast.

Source: IMF

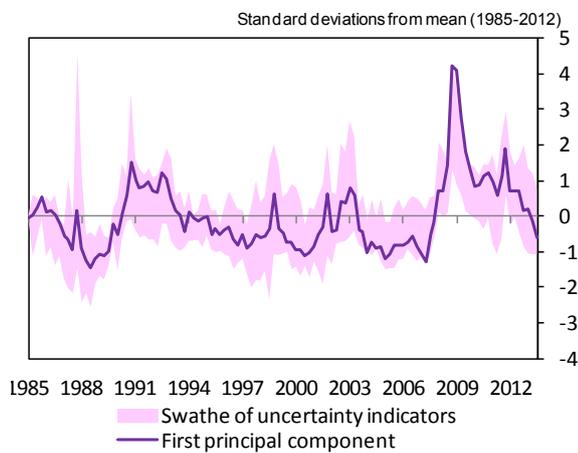
Chart 2: Cumulative surprise in UK activity indicators since May 2013 has dwarfed that of US and euro area ¹



¹ Shows the cumulative sum of normalised differences between selected indicators of economic activity and their expected value as surveyed by Bloomberg, divided by the square root of the number of releases.

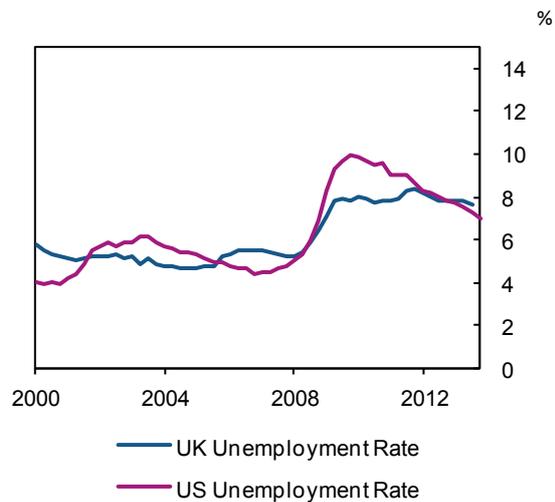
Sources: Bloomberg and Bank calculations

Chart 3: Measures of uncertainty in the UK have fallen sharply ¹



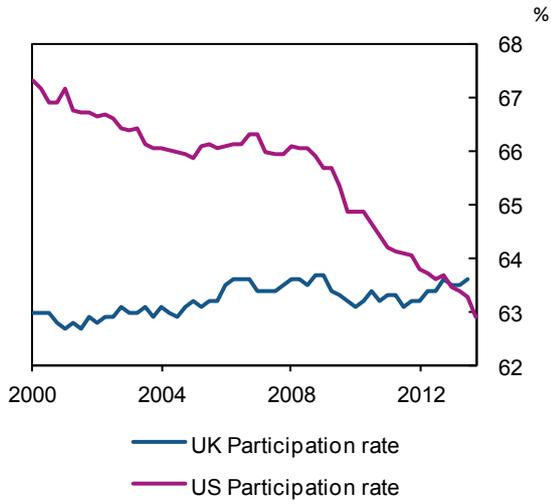
¹ For further details, including of the indicators used and sources, see Haddow, A, Hare, C, Hooley, J and Shakir, T (2013), 'Macroeconomic uncertainty: what is it, how can we measure it and why does it matter?', *Bank of England Quarterly Bulletin*, Vol. 2, No. 2, pages 100-109.

Chart 4: US unemployment rate has fallen by more than UK



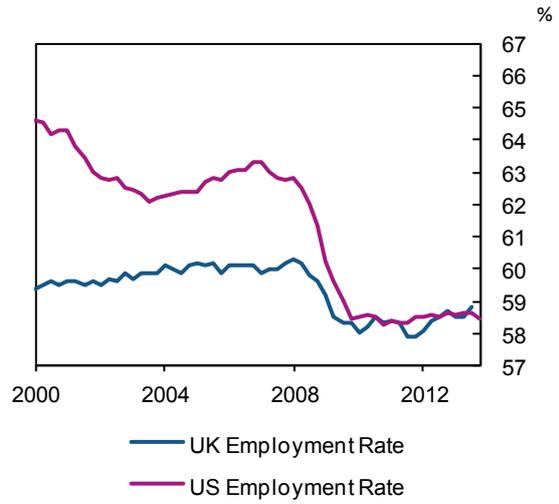
Source: ONS, BLS

Chart 5: US participation rate falling, UK rate rising



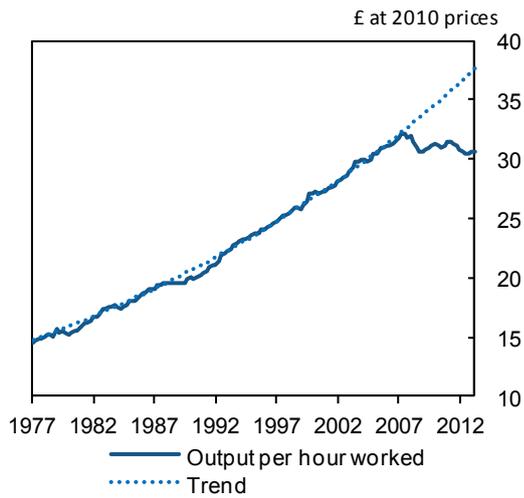
Source: ONS, BLS

Chart 6: US employment rate has fallen by more than UK rate



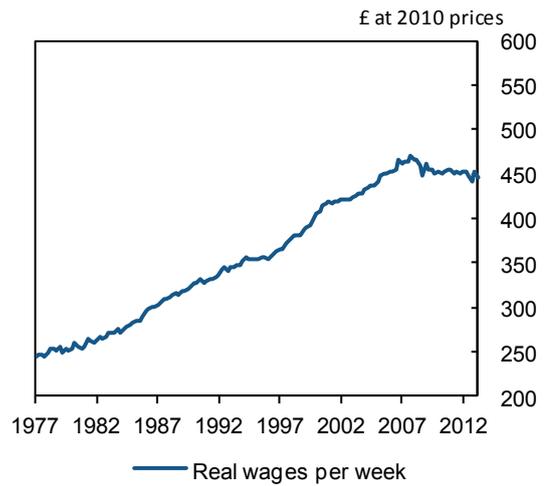
Source: ONS, BLS

Chart 7: UK productivity exceptionally weak



Source: ONS, Bank of England calculations

Chart 8: UK real wages have fallen



Source: ONS, Bank of England calculations