Report to Treasury Select Committee

Charles Bean
Deputy Governor for monetary policy
February 2010

Voting record

My previous report, in November 2008, was written in the immediate aftermath of the worst international banking crisis for at least a hundred years, and as the international and UK economies entered their sharpest downturn in the post-war period. It was already clear then that the downturn would be sharp, warranting a substantial reduction in Bank Rate, but its precise magnitude was uncertain. I fully supported the sharp reductions in Bank Rate to 2% in December 2008 and then in steps down to 0.5% by March 2009, as the economic news came in to the downside.

By the early part of 2009, it was also clear that further monetary stimulation would be required to boost demand and keep CPI inflation on track to meet the 2% target. With Bank Rate at its effective floor, that would have to come through asset purchases financed by the issuance of central bank money ('quantitative easing'). The MPC had little historical evidence to help it assess the likely quantitative impact of such purchases, but in the light of what we did know, an initial stock of purchases of £75 billion appeared appropriate. Given that the outturns for UK activity continued to surprise to the downside, I then found it relatively straightforward to support the subsequent extensions in May and August, to total purchases of £125 and £175 billion respectively.

My decision was more finely balanced in November. There was uncertainty about the magnitude and timing of the impact on nominal spending of the purchases we had already made, and a risk that large-scale purchases could raise inflation expectations and long-term interest rates if people failed to grasp that the purpose of the programme was to prevent money and nominal spending growth, and hence inflation, falling too low. In the event, the unexpectedly weak release for output growth in Q3 persuaded me that a further increase to a total of £200 billion was warranted.

The Committee lowered its central (modal) projections for GDP growth and inflation in its latest *Inflation Report*. But at the same time it also moderated the downside risks to GDP growth and correspondingly increased the upside risks to inflation. As a result, the average (mean) projections for both growth and inflation taken across the whole of the fan charts are broadly similar to those in November. In the light of the continuing uncertainties already mentioned, I therefore did not feel that a further extension of the programme was presently warranted.

The outlook

The UK economy appears to have been "bumping along the bottom" during the second half of 2009. I expect to see the economy gradually pick up steam through this year, reflecting: the substantial stimulus from policy, much of which is still working through; the lower level of sterling, which should gradually boost exports and discourage imports; a gradual decline in uncertainty, which should make businesses and households more willing to undertake expenditures that were put on hold over the past year. But against that, there is a considerable headwind in the shape of the continuing de-leveraging within the financial sector. As a result, the availability of bank credit is likely to remain restricted for some while; an open question is the extent to which a revival in bank lending is necessary for a healthy recovery. The need to strengthen public and private sector finances will also weigh on demand. On balance, I share the view in the Committee's latest *Inflation Report* projections that the recovery is most likely to be rather slow and protracted, leaving output below its previous peak for some time.

CPI inflation was 3.5% in January. The pickup in inflation from 1.1% in September reflects both higher petrol prices and the restoration of the standard VAT rate to 17.5%. Assuming stable oil prices, and in the absence of further increase in indirect taxes, inflation should fall back this year, reflecting the waning influence of the depreciation of sterling and the growing influence of the substantial margin of spare capacity. There is, however, substantial uncertainty about both the impact of the recession on supply capacity and the impact of the margin of spare capacity on inflation. Past international experience suggests that recessions in the aftermath of banking crises can have a lasting effect on an economy's supply potential. There is, though, considerable heterogeneity of experience and isolating the mechanisms whereby supply is depressed, and their likely importance at the current juncture, is not straightforward. It is likely that supply is, in part, endogenous to the course of demand, so that a rapid recovery might result in only limited impairment of supply in the longer run, while a very protracted recovery might have more lasting effects. At the present juncture, I believe that the stance of monetary policy is appropriate to keep inflation on track to meet the target in the medium term, but that will need to be continuously re-evaluated in the light of economic developments.

Explaining monetary policy

Since my previous report in November 2008, I have given five on-the-record speeches on monetary policy issues, together with numerous off-the-record presentations to a variety of audiences. Between 13-21 July, I visited 13 towns and cities (Leeds, Newcastle, Edinburgh, Manchester, Maidstone, Brighton, Nottingham, Derby, Leicester, Reading, Bristol, Cardiff and Birmingham) explaining quantitative easing to a variety of business audiences and doing interviews with local media; BBC News also accompanied me on the first leg of this ‘roadshow’. I subsequently participated in separate London events explaining quantitative easing to City economists and to journalists. I also made four other regional visits (to Southampton, Sheffield, Inverness and Newcastle) involving various meetings and events with local business people. Finally, as Deputy Governor for Monetary Policy, I also represent Bank views in a number of international settings, including the G7, G20 (which the UK chaired in 2009) and the OECD.