Report to Treasury Select Committee
Charles Bean, Deputy Governor Monetary Policy, Bank of England
26 February 2013

Voting record

In my previous report, in February 2012, I said that I expected underlying growth (i.e. abstracting from special factors such as the Queen's Diamond Jubilee) to be subdued in the first half of the year, followed by a gradual strengthening, reflecting an ease in the squeeze on household incomes as inflation fell back towards the target, complemented further out by some recovery in investment. But the headwinds from de-leveraging, tight credit conditions and the fiscal consolidation pointed to a margin of spare capacity persisting for some while to come. My personal judgement was that inflation was likely to be a little higher than the Committee's best collective judgement at that time. The biggest risk was of disorderly developments in the euro area.

Over the course of the past year, the picture generally – yet again – has been one of growth disappointing and inflation turning out higher than expected. Much of the weakness in growth has, however, been down to contraction in three sectors: manufacturing (hit by a slowing in global trade); construction (hit by the fall-off in public construction); and oil and gas extraction (a continuation of a longer-term trend). In contrast, the output of the services sector grew at a moderate pace, and is now back to pre-crisis levels. The labour market has confounded this picture of a very weak recovery in output, however, with employment growing robustly, at rates one would only expect to see when output is growing at historically above-average rates. Inflation has been subject to further adverse shocks, including much larger than expected contributions from university tuition fees and from other 'administered and regulated' prices. So far, a disorderly resolution of the indebtedness and competitiveness problems of the euro-area periphery has been avoided. Indeed, the ECB's announcement of its willingness to buy short-term periphery sovereign debt in order to remove 'euro-exit' premia, together with the moves towards a euro-area banking union, has provided a fillip to prospects there.

At the time of my previous report, the Committee had just announced further asset purchases – which I supported – taking the total stock to £325 billion by May. At the May meeting, growth seemed to be coming in a little weaker than expected, while the outlook for inflation in the near-term was markedly higher than before. Given that, I considered it appropriate to vote to pause to take stock, recognising that asset purchases could be re-started if conditions dictated.

By the time of the July meeting, the news on growth had been distinctly disappointing, while the upside inflation risks appeared to have diminished somewhat. Moreover, the stresses in the euro area, and in financial markets, had intensified significantly (ultimately prompting ECB President Draghi's "Do whatever it takes" pledge shortly thereafter). The preceding month had seen the Bank announce the Funding for Lending Scheme (FLS) designed to counteract the rise in bank funding costs and provide incentives to banks to increase lending to the real economy, as well as activating the Extended Collateral Term Repo Facility in order to stress that backstop liquidity was available to the banks if required. While those actions should have helped to support UK demand, I judged that it made sense to vote to complement them by undertaking an additional £50 billion of asset purchases.

By the November meeting, the stresses in the euro area had moderated significantly, while early indications of the impact of the FLS on bank funding conditions had been encouraging. UK growth was also estimated to have been strong in Q3, though partly reflecting the Olympics. Moreover, the inflation outlook for the next year or two looked substantially worse because of the unexpectedly large prospective contribution from administered and regulated prices. Accordingly I voted for no further asset purchases, and have maintained that stance since.

The outlook

There has been a marked improvement in financial market sentiment in the past few months, though that has yet to be translated into a pickup in the activity indicators. At present, my expectation is that growth will gradually strengthen this year and next on the back of that, a further easing in credit conditions, and an improvement in the global environment. But downside risks remain, especially in the euro area. Inflation now looks likely to remain elevated above the target for longer than we thought. Given the source of that – the unusually large increase in administered and regulated prices – I think there are good reasons to look through it, so long as inflation expectations remain anchored.

Prospects hinge heavily on the explanation for the conundrum of weak output growth juxtaposed with strong employment growth. I take the view that part of the associated weak productivity can be expected to unwind if demand picks up, though it is difficult to know precisely how much. But some may be associated with a combination of low interest rates and forbearance by banks, which has allowed some businesses to survive whereas they might have failed in previous downturns when interest rates were higher. Unlike some commentators, I do not believe this is necessarily a bad thing: if a business has problems meeting its loan commitments now, but has a viable long-term business model, then it may be more efficient to keep it going than to liquidate it.

Explaining monetary policy

Since my previous report in February 2012, I have given three on-the-record speeches on monetary policy issues (one of these also covered the work of the Financial Policy Committee), together with numerous off-the-record presentations to a variety of audiences. I made six regional visits (to Norwich, Thames Valley, Leeds, Cardiff/Caerphilly, Birmingham/Hereford, Manchester) involving various meetings and events with local business people. I also attended a variety of events with journalists, City economists and market participants. Finally, as Deputy Governor for Monetary Policy, I also represent the Bank's views in a number of international settings, including the G7, G20, and the OECD.