BANK OF ENGLAND

News release

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1 December 2010

2010: A progress report - speech by Spencer Dale

In a speech made at the Kent Business School, Spencer Dale - member of the Monetary Policy Committee and Chief Economist - reflects on events of the past year and what they herald for the future. His 'progress report for 2010' focuses on two key issues: how much comfort should we take from the recovery so far and what factors are likely to determine its future vigour; and to what extent are the Bank's new responsibilities for macroprudential policy likely to address the "missing instrument" problem exposed by the financial crisis.

Spencer Dale notes that the pace of the recovery to date compares favourably with previous episodes and some encouragement can be taken from the composition of growth. The pickup in private sector spending has helped offset a weaker net trade performance but "...it is too soon to say we are out of the woods." He highlights that "Economic recovery has to be judged in terms of the level of output, not the rate at which it is growing...One year of growth does not make a recovery."

Spencer Dale goes on to identify the "...gale force winds blowing in both directions". He highlights two headwinds hampering growth. The most obvious is that public sector spending, as a share of GDP, is projected to fall by around 8 percentage points over the next 5 years. His central view is that "The direct impact of this reduced spending...is unlikely to derail the recovery." But business and household confidence and behaviour could respond in either direction - which "...is something that the MPC will continue to monitor carefully". A second headwind is that UK banks are still not in a position to lend normally, which is particularly affecting smaller companies. But banks have strengthened their capital and funding positions and Spencer Dale is "...hopeful - but by no means certain - that strains within the banking system will exert increasingly less drag on the economy going forward."

The most significant tailwind is the highly accommodative stance of policy which continues to provide significant support to economic activity. Also, the level of sterling following its substantial depreciation should encourage a rebalancing of the economy towards external demand. Spencer Dale notes "...the increased competitiveness of our goods exports has succeeded in arresting the persistent decline in our share of world export markets seen over the past 15 years or so." In contrast, exports of services have fallen, possibly reflecting reduced global demand for financial and business services in the current environment.

Judging the net impact of these opposing forces is very difficult and "The pattern of growth from quarter to quarter is quite likely to be choppy". But Spencer Dale's central view is similar to the MPC's November Inflation Report, "...that over the next few years the economy is likely to continue to grow at rates around or a little above its historical average...".

Spencer Dale then discusses the "missing instrument problem" and the planned development of a Financial Policy Committee at the Bank to carry out macroprudential policy, expanding "...the range of instruments available to policymakers, so they are better equipped to ensure the resilience of the financial system." In so doing, macroprudential policy should "...contribute greatly to our future economic stability", but he points out that it is unlikely to solve the missing instrument problem entirely, partly because it "...is not the instrument that will solve the problem of global imbalances". That requires international coordination. Also, some financial bubbles, such as equity-financed bubbles, are not associated with credit cycles and increased banking exposures. And, finally, actions necessary to preserve the resilience of the banking system may not be sufficient to prevent credit cycles altogether". "Just as monetary policy does not attempt to eradicate the business cycle, so macroprudential policy is unlikely to be able to eradicate fully credit cycles."

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Spencer Dale sums up, "The creation of the Financial Policy Committee with the responsibility for conducting macroprudential policy represents a major advance in responding to the missing instrument problem". But it "...is not - nor is it intended to be - the solution to all problems associated with financial markets and the international monetary system."

He concludes by returning to monetary policy. He says, "This uncomfortable juxtaposition of high inflation and loose policy has led some people to put two and two together and make five. The MPC has gone soft on inflation, they claim... But it is simply not true." He points out the size of the effects of the temporary price level shocks that we have seen and points out that, "...had these shocks to the price level not occurred, inflation would have been substantially lower and almost certainly below target." He explains why, in the face of persistently high inflation, the MPC has not tightened policy. He concludes by stressing that "...the MPC remains as hard-nosed as ever in its determination to hit the inflation target."

Key Resources

2010: A progress report – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech465.pdf