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News release

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Inflation, Growth and Stability: Balancing the Bank of England's Economic Priorities - Speech by Paul Tucker

In a speech in London today, Paul Tucker - member of the Monetary Policy Committee and Deputy Governor for Financial Stability - discusses some of the current challenges facing monetary policy and issues relevant to the overall framework for preserving macroeconomic stability.

Paul Tucker considers four aspects of the current conjuncture that will be central to monetary policy judgements over the coming months. First, he discusses the effects of household and bank balance sheet repair on aggregate demand, which pose a downside risk to the outlook for activity. Second, he considers how supply capacity has been affected by the recession. He states: "There are a number of reasons for thinking that the 'effective supply' capacity of the economy has been depleted temporarily due to the shock to credit supply and confidence. How much, and how temporary, are major uncertainties... If demand recovers robustly, firms are likely to bring some capacity back on line. If, on the other hand, demand proves anaemic, then suspended-capacity is more likely to be permanently scrapped". A path of stronger demand is preferable provided it is consistent with the inflation target. He says: “In aggressively stimulating demand in order to absorb slack, we aim to keep inflation in line with the target over the medium term and also to reduce the extent to which the economy’s productive capacity is wasted."

Third, Paul Tucker notes the volatility of inflation and its impact on medium-term inflation expectations, which the MPC has to be sensitive about. And, fourth, he discusses how the monetary effects of the MPC’s asset purchases may come through gradually, and how they may have assisted the process of de-leveraging by banks.

Turning to lessons for maintaining macroeconomic stability, Paul Tucker discusses how the evolution of the financial system can alter the transmission mechanism of monetary policy and the sorts of data that need to be analysed when assessing it. He stresses the need to embed renewed interest in financial markets, money and credit and the need to try to make sense of risk and liquidity premia.

Paul Tucker repeats his views about the limitations of using monetary policy to ‘mop up’ after credit cycle excesses. But he says, “...the financial authorities need to be sensitive to when a marked appreciation in asset prices is becoming fuelled by rapid credit growth and looks likely to get carried away beyond anything warranted by fundamentals". This highlights the debate about macroprudential instruments as a means of addressing threats to stability from credit bubbles*. Paul Tucker says: "The basic question is whether the authorities could lean against credit-fuelled booms by tightening capital or liquidity requirements for lenders....". Noting that warnings by the authorities have not on their own been sufficient, he adds: "If the authorities were able to deploy credible macroprudential tools, their stability warnings would probably be taken more seriously in future, because they would be able to follow up words with actions."

All threats to stability cannot be headed off in this way, such as slow-growing domestic and global imbalances. Governments remain the final protection against economic collapse. If societies in this and other countries believe they should provide insurance against financial crises and other disorders, Paul Tucker suggests there needs to be debate over the medium term about the appropriate level of national debt. The higher the level of debt, the more resilient the financial system would need to be.

In conclusion, Paul Tucker states that: "...it is the credibility of our commitment to price stability that has enabled the Bank to cut interest rates and to inject money so aggressively in order to support nominal demand in the wake of the credit crisis... That underlines the risks of tinkering with central bankers' inflation targets...." But another element of stability - in the financial system - needs to be addressed. He says, "...macroprudential instruments ...could be used to lean against future credit booms and for making our financial system more resilient. If we could manage that, it might be the most significant extension in the overall international macro policy framework in a generation."

* See 'The Role of Macroprudential Policy - a discussion paper'
http://www.bankofengland.co.uk/archive/Pages/digitalcontent/historicpubs/news/2009/111.aspx
Bank of England, November 2009.

Key Resources

Inflation, Growth and Stability: Balancing the Bank of England's Economic Priorities - Full speech
http://www.bankofengland.co.uk/archive/Pages/digitalcontent/historicpubs/speeches/2010/speech424.pdf