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News release

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The UK Economy after the Crisis: Monetary policy when it is not so NICE - Speech by Charles Bean

In a speech in London today to alumni of Cambridge University, Charles Bean - Deputy Governor for Monetary Policy and member of the Monetary Policy Committee - talks about what the future might hold for the British economy and draws lessons from the recent crisis for the future conduct of monetary policy.

After discussing recent economic history and the end of the NICE (Non-Inflationary Consistently Expansionary) decade, Charles Bean turns his attention to the strength of the recovery over the medium term and looks at the underlying forces driving the demand for UK goods and services. He finds both ".reasons to be fearful and reasons to be cheerful".

The reasons to be fearful include:

- Further balance sheet repair is needed by the banking sector which is likely to continue to restrain the credit supply. Charles Bean notes that "The spreads on lending to businesses and households,., will be higher in the future than they were in the period preceding the crisis".
- The housing boom has resulted in some households, especially younger ones, carrying forward high levels of debt. However, ".the burden of servicing these debts is manageable because of the low level of mortgage interest rates." and ".unemployment has so far risen by much less than many observers, including the MPC, feared".
- The fiscal deficit is unsustainable in the medium term and creates a difficult balancing act. Cutting spending and/or raising taxes is likely to result in lower domestic demand, though a failure to do so may lead long-term interest rates to rise, also hitting demand.
- Uncertainty about recovery in the rest of the world and particularly in the UK's main export markets such as the euro area.

The reasons to be cheerful include:

- A substantial policy stimulus is still working through the economy. Bank Rate remains at a historic low of 0.5% and the Bank has bought some £200billion of assets, the purpose of which is to raise nominal demand. Charles Bean suggests that the asset purchase programme has helped to lower gilt yields by around one percentage point and contributed to lower corporate bond yields (which have fallen by 4 percentage points); higher equity prices (which have risen by around 50%) and strong capital market issuance. He explains that the programme ".works around an impaired banking system by stimulating activity in the capital markets" and recognises that other measures by the Government have been put in place to help banks to lend normally.
- The real depreciation in sterling ".boosting the competitive position of UK producers in both domestic and overseas markets." is part of the mechanism to bring about a rebalancing of the economy "away from domestic spending towards net exports and so reduce the UK's current account deficit.". While it is normal for the initial impact to be seen mainly in expanded profit margins Charles Bean expects ".to see the contribution from net exports gradually building as the global recovery proceeds".

The path of the recovery will be determined by the balance between these forces "But the quarterly path is sure to be uneven.".

Charles Bean moves on to look at inflation and uncertainties about the extent of downward pressure from spare capacity in the economy. He states that the MPC ".stand ready to react to those risks if and when they crystallise, either resuming asset purchases if further stimulation is required, or tightening policy through Bank Rate increases and ultimately asset sales".

He then defends the broader monetary policy framework - both the scope of the inflation target and the inflation rate set. He argues "There is a real danger in overburdening monetary policy if it is expected to achieve price stability and financial stability simultaneously. With two objectives, one needs two independent means of achieving them." He argues that ".prudential regulation and supervision should surely be the first line of defence." against financial market excesses.

Charles Bean concludes ".no regulatory regime is perfect.there may be times in the future when monetary policy needs to work alongside regulatory policy in order to restrain excessive credit and asset price growth, even though the achievement of the inflation target may not immediately appear threatened. But, in my view, that is best facilitated by retaining the clarity of the present remit.".

Key Resources

The UK Economy after the Crisis: Monetary policy when it is not so NICE - Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech429.pdf
Accompanying slides
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech429charts.pdf