



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

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The economic outlook - speech by Charlie Bean

In a speech to the Northern Ireland Chamber of Commerce in Belfast, Charlie Bean - Deputy Governor for Monetary Policy and member of the Monetary Policy Committee (MPC) - describes the economic outlook and the changes that the UK economy is undergoing.

A crucial question for the MPC, Charlie Bean says, is whether the slowing of growth around the turn of the year "...just represents a temporary "soft patch" of the sort often seen during the early stages of economic recoveries, or whether it is instead the harbinger of a prolonged period of slow growth". He then goes on to discuss the likely prospects for the recovery over the next year or so. Having stagnated over 2010, Charlie Bean views it likely that "...consumer spending will remain subdued through this year at least". He adds that: "Public spending will also provide little impetus to overall activity, given the necessary fiscal consolidation that is now under way".

This means that the prospects for growth are heavily dependent on business spending and external trade, which Charlie Bean addresses in turn. Regarding investment spending, he provides three reasons for some optimism. First, businesses are at some point likely to re-instate replacement investment projects that were postponed during the recession. Second, the rebalancing of economic activity towards the tradable sectors of the economy is likely to necessitate some expansion in capacity. And, third, many large companies are presently cash-rich, so, for them, the availability of finance should not be a constraint.

On external trade, Charlie Bean says: "Given the past substantial depreciation of sterling and the associated improvement in the competitive position of UK suppliers, the performance of net exports has so far been somewhat disappointing. That is less to do with exports... Rather the let down has been on the import side, where there has been less substitution of domestically supplied goods and services for imports than past experience would have led one to expect." That might be because demand is less responsive to changes in prices than previously, or because it will take time for domestic suppliers of products that compete with imports to enter the market. In any case, Charlie Bean concludes, "...the MPC still expects net exports to contribute substantially to the overall growth in demand over the next few years as the necessary rebalancing gradually takes place".

Even though the MPC expects an economic recovery to around average growth rates, Charlie Bean says, that would still leave the level of activity well below what one might have expected before the recession - a feature typical of recoveries following banking crises for three main reasons. "First, banks and highly-indebted households and businesses need to get their balance sheets back in order, typically resulting in a period of low credit growth and high savings. Second, the injection of public funds into stricken banking systems, coupled with a loss of tax revenues in the downturn, results in a deteriorating fiscal position, which subsequently needs correction. Third, such crises often also result in some long-lasting impairment of the economy's supply capacity." Related to the last factor, Charlie Bean goes on to describe the puzzling weakness of UK productivity growth during the recovery, which could suggest that the degree of spare capacity within businesses is limited.

"Even if the margin of spare capacity in businesses is no longer all that great, the elevated level of unemployment should have put downward pressure on inflation. And, indeed, wage growth has been, and remains, subdued", Charlie Bean argues. He goes on to explain that "...the current elevated inflation rate of 4.5% can be largely accounted for by the effects of energy and import prices and VAT: energy prices and VAT are probably each contributing around one percentage point to current inflation, and non-energy import prices around double that". He explains that the extent to which inflation will fall back after the impacts of those factors dissipate will depend on: the possibility of further significant movements in commodity prices; the extent to which households will resist the erosion of their real living standards, resulting in faster pay growth; and to what degree businesses seek to restore the profit margins that have been squeezed by low productivity growth.

Charlie Bean concludes with two general points about the economic situation. "The first is that the next few years are likely to continue to be rather difficult, especially for households and consumer-facing businesses", as the economy adjusts to the consequences of the banking crisis, the rise in commodity prices, and the depreciation of sterling. "The second, and related, point is that while monetary policy cannot ultimately insulate us from the associated hit to our living standards, it can affect the adjustment path. In particular, the MPC's chosen approach has been to accept a temporary period of above-target inflation, rather than seeking to hold inflation as close to the 2% target as possible at all times. Achieving the latter would have required a markedly higher level of Bank Rate and with it most probably a somewhat higher level for sterling. That would have moderated some of the external inflationary impulses facing us, but would also have depressed activity and pay even more and retarded the requisite re-balancing of the economy. The Committee's approach has, I believe, been consistent with its mandate from the Chancellor of the Exchequer..."

Key Resources

The economic outlook – Full speech