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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Rebalancing and the real exchange rate – speech by Ben Broadbent

In a speech at Thomson Reuters in London, Ben Broadbent – External Member of the Bank of England Monetary Policy Committee (MPC) – examines the cause and consequences of sterling's depreciation in 2007-8. He argues three main points.

First, he explains that "the depreciation was not caused by monetary policy" – it was not accompanied by the movements in market-based measures of forward inflation that one would have expected if monetary policy was at its root. He states: "...if monetary policy were loosened significantly, independently of anything else, you would see sell-offs not just in the currency but in (non-indexed) bonds as well. That's not what happened in 2008." Rather, he argues, the depreciation "...reflects the need to rebalance UK supply – away from non traded goods and services, and towards the production of tradables – in order to match an equivalent shift in the composition of demand". He suggests that this shift in the composition of demand has come about primarily because of the vulnerability of tax revenues to the financial crisis. Tax revenues in 2009-10 were £109bn lower than expected in early 2007, "...bigger than the decline in government receipts in the Eurozone (relative to GDP) and worth almost a third of current spending on public services. Even without markets' concerns about the exposure of taxpayers to banks' bad assets, and even relative to the UK's trading partners, this was surely enough materially to contract ... government consumption over the future and with it the demand for non-traded UK output."

So, the depreciation is the economy's way of ensuring that supply in the UK adapts to the new pattern of demand by making it more profitable to allocate capital to the production of internationally tradable output and less profitable to produce output that can only be consumed at home. This leads to Ben Broadbent's second key point: the process of rebalancing – and the size of the exchange rate depreciation necessary to induce it – depends on how easy it is to reallocate productive resources between sectors of the economy. That process is likely to be hampered "...in the presence of a sclerotic banking system that is finding it hard to reallocate capital", he says, noting the relatively low rates of company start-ups and bankruptcies. That makes the necessary depreciation of the exchange rate all the larger. It also means that "...rebalancing and overall productivity growth will remain sluggish for as long as the banking system itself is in poor health". "There is a connection between slow productivity growth and slow rebalancing", he says, adding that: "...at least for given trends on the demand side, sterling's real exchange rate will have to remain weak for some time to come".

Ben Broadbent's third main point is that, although the shift in relative prices and the exchange rate need not have had an impact on aggregate inflation, "...rigidly sticking to the inflation target through this period would have involved significant economic costs, costs that the MPC's remit explicitly tells it to avoid. Given the scale of the adjustment going on underneath, stabilising the aggregate CPI would have required outright declines in prices of many non-tradables and, because their production is labour-intensive, declines in nominal wages as well. This in turn would probably have meant much higher unemployment. What the MPC has effectively done, therefore, is to employ the flexibility in its remit to accommodate part of this shock as a higher aggregate price level. And although these first-round effects have been significant and uncomfortable, contributing to a prolonged period of above-target inflation, it's hard to detect any real sign of second-round effects on either wage growth or medium-term expectations of inflation. With the relative price adjustment now largely complete, that is very reassuring."

Ben Broadbent concludes by drawing some longer-term lessons from the UK's experience. "One is that the credibility of the UK's inflation-targeting regime looks reasonably robust", although "...that's clearly not something that can, or should, be taken for granted". "Second, however, even credible monetary policy has its limits. The long rise in commodity prices, the financial crisis and the sluggish rebalancing of supply have all acted to reduce real household incomes. It matters to some degree whether this occurs via higher inflation or lower nominal wages, because the latter route would probably have involved higher unemployment, if only for a time. Credibility means monetary policy can, within limits, choose the former course. But the hit to real incomes would have occurred either way." And third: "...controlling inflation is harder when the real economy is more volatile". "The early years of globalisation brought steady rises in the terms of trade, steady declines in long-term real interest rates and, thanks in part to the accompanying growth in banks' balance sheets, buoyant government revenue. All that made it easier to keep inflation low, and most of it has since been reversed." He concludes: "one can hope, at least, that the next few years will be not be as difficult as the last few have been".

Key Resources

Rebalancing and the real exchange rate – full speech