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News release

20 March 2012

Rebalancing the supply side of the UK economy: what; how; and issues for monetary policy – speech by Spencer Dale

In a speech to mark the centenary of the Department of Economics at the University of Aberystwyth, Spencer Dale – Bank of England Chief Economist and member of the Monetary Policy Committee (MPC) – discusses the imperative of rebalancing the supply side of the UK economy, and explains why this process poses significant challenges for UK monetary policy.

Changes are required in the pattern of UK spending, but such changes cannot be enough on their own, Dale insists. The types of goods and services that the UK produces must also shift, in order to match the re-orientation of demand. And it is this supply-side leg of rebalancing that he fears may prove "more difficult and potentially more disruptive" for the economy.

The required structural changes are "broad and deep" and, Dale argues, there "is much more to supply side rebalancing than simply a bigger manufacturing sector". "The traditional distinction between manufacturing and services is simply not meaningful in many successful companies today" Dale observes, contending that we need to "produce more of the goods and services others want to buy and which we have a comparative advantage in producing." Moreover, firms and households will have to respond to other dimensions of rebalancing: to the relative decline in public sector spending; and to costs of obtaining credit that Dale considers unlikely to fall all the way back to pre-crisis levels.

This "slow and challenging journey" towards rebalancing which the UK currently faces presents monetary policymakers, such as Dale, with two significant issues.

The first follows from the observation that changes to the structure of an economy can be associated with short-term pain. Dale assesses that "We may need to take one step back to take two steps forward." During the period of adjustment, the potential for the long-term unemployed to become detached from the labour market – as skills get rusty or discouragement kicks in – creates great uncertainty over the drag from unemployment on wage growth, as well as causing "enormous personal and social costs".

The second policy issue is the impact of the stance of monetary policy on the pace of rebalancing and "the delicate balancing act between providing short-term support to the economy without stifling the incentives for change." Dale is convinced that the substantial loosening in monetary policy undertaken in recent years was "essential in order to prevent the UK economy from falling into a deeper and more protracted recession". But at the same time he acknowledges that "this loosening also served to blunt some of the incentives driving the rebalancing of our economy." It encourages people to spend more and save less, and slows the reallocation of capital and labour to more productive uses. "In this context", Dale notes "loose monetary policy can in part be thought of as a form of forbearance: putting off difficult changes and adjustments to a later day". Monetary policy must trade off short-term support against stifling long-term change. "Like good parenting", as Dale puts it, "monetary policy should provide support but it can't protect us from the harsh realities of life."

Dale briefly reflects on the current outlook for inflation and monetary policy. He expects inflation to continue to fall back towards target, but thinks the "chances of inflation being above or below 2% by the end of this year and into 2013 are somewhat more balanced" than the best collective judgment of the MPC, published in last month's *Inflation Report*. Dale believes that "inflation is just as likely to be above as below the inflation target in the medium term".

Dale also explains that the MPC has recently begun to use a new forecasting platform to produce its inflation projections. At the heart of this platform sits a relatively small central organising model, with a broad range of insights also incorporated from a suite of alternative economic models: "Small and suite." For Dale, a much larger central model, for example one incorporating roles for banks and financial frictions, would still be "an incomplete description of a complex reality", but also "less useful as a tool for thinking through economic issues and forming economic judgments". Dale stresses that "the introduction of the new forecasting platform does not, of itself, imply any changes to the MPC's forecasts or to how we set policy."

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