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The UK economy: the road ahead? - Speech by Ian McCafferty

In a speech given to a "Women in Business" event at the Coventry and Warwickshire Chamber of Commerce, Ian McCafferty sets out his assessment of recent UK economic performance, the outlook for the economy and the role for monetary policy.

Ian McCafferty explains that growth has been "lethargic" because of several legacies from the financial crisis – undercapitalised banks needing to reduce their leverage, consumers focused on saving more, and the inevitable fiscal austerity required given the deterioration in the public finances. In the past two years, growth has been further depressed by several factors: a dramatic squeeze on household incomes due to elevated inflation largely arising from higher import prices; a global trade slowdown; and heightened uncertainty from the ongoing crisis in the euro area. Nonetheless, he notes that "if we adjust overall GDP growth for the sharp falls in construction and North Sea oil output, the rest of the economy - over 90% of GDP – grew by 1.2% last year - ...somewhat removed from the reports of semi-permanent, triple dip, recession".

Ian McCafferty judges that "the introduction of QE has helped to provide...monetary stimulus...by lowering long term interest rates and supporting asset prices...and the UK economy would have fared significantly worse if the Bank had not responded to the deteriorating economic environment with unconventional policy easing". He also believes that "the FLS has helped to reduce the cost of funding for UK banks...the main impact has been seen in the mortgage market, where availability has risen and loans rates have come down." He thinks "we have yet to see a pickup in the levels of lending to the real economy" but does "not agree with some commentators that this is evidence that the FLS is not working...it is too early to judge the full effects of the FLS on bank lending volumes."

Ian McCafferty is "hopeful for the UK economy through 2013 and into 2014." "Credit conditions are improving, in part due to the impact of the FLS, with some signs that lending to households will pick up in the coming quarters. An improvement in the housing market, combined with resilient employment should help to support modest growth in consumption". He has also been "struck by the improvement in business sentiment due to the perceived reduction in the tail risk of a disruptive and sudden unravelling in the euro area", though he notes that "confidence is still fragile, so any pickup in investment is likely to be gradual". Finally he suggests the international outlook is improving...benefitting UK exports", and that "UK businesses are now starting to succeed in re-orientating their exports into the faster growing emerging markets".

Ian McCafferty suggests that "the outlook for inflation is more concerning...[since] it is expected to remain elevated for much of the next two years". He "believes it is appropriate to tolerate above target inflation...based on a careful analysis of the particular reasons behind the upwards pressure". One reason is the unusually sharp rises in administered and regulated prices, which are "relatively insensitive to monetary policy". But the other reason is the recent depreciation of sterling which has pushed up import price inflation. He argues that "to the extent that a fall in the currency reflects real factors, such as a need to rebalance the economy towards exports or an unwinding of haven flows, it would not be sensible to prevent the real adjustment by tightening monetary policy. If, however, the weakness in sterling were deemed to reflect concerns regarding the Bank's anti-inflation credibility...then I strongly believe that the case for accommodation is much weaker. So far, there is little evidence that inflation expectations have become de-anchored, while domestic inflationary pressures, in particular wage growth, remain very subdued."

He concludes that it remains appropriate to look through the current shocks to inflation, but “making use of such flexibility is in no way a departure from the inflation targeting framework in place since 1997”.