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BANK OF ENGLAND

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The outlook for the UK economy - speech by Paul Fisher

Speaking in Cardiff today, Paul Fisher, the Bank's Executive Director for Markets and a member of the Monetary Policy Committee, gives a personal view on why the recovery from recession has been slow and is likely to continue to be prolonged. He also reviews the recent institutional changes at the Bank of England which, he says, "will help shape the policy environment for a generation".

Paul Fisher notes that the advent of the Prudential Regulation Authority as a subsidiary of the Bank will "help us to exploit the synergies between microprudential supervision on the one hand and the markets, economics and financial stability expertise of the wider Bank on the other." The Financial Policy Committee (FPC) is now established with statutory powers. He notes that much of the work of the interim FPC was geared towards trying to ensure banks have enough capital: "If we are to have a set of banks fit to provide credit and offer payments services to the UK economy, they must be better capitalised and less leveraged than they have been in the past."

Moving on to the economic outlook, Paul Fisher notes that "the economic data have been disappointing for some time ... Trend growth should be more like 0.6% a quarter and we have only had five quarters of growth at that rate or higher in the 21 quarters since the start of 2008. There had been no such weak period in the UK since quarterly GDP data were first published in 1955." He goes on to offer a possible explanation. "It is as if the different groups within our society have all decided that their future financial positions, on average, will be worse than they thought before the crisis". He highlights that households are saving more than they were pre-crisis, and that one likely reaction to lower expected incomes is for people to try and work harder and to avoid unemployment if at all possible. That "explains in part why unemployment has stayed much lower than we would have expected, given the weakness of output growth. Much of the labour force has priced itself into work." At the same time, he says, the Government are trying to reduce public expenditure, the financial sector is addressing balance sheet issues, and UK businesses continue to save rather than invest as much as they could. "Collectively the economy as a whole also needs to rebalance. The significant external trade deficit built up pre-crisis needs to close up further to be sustainable in the medium term."

Paul Fisher asks why this has happened and how it affects the outlook. He emphasises that it is the sources of the revision to income expectations that matter in the longer term. In the near term, he argues that, whatever the cause, it is likely that growth will continue to be below its previous trend until more of the real adjustments to balance sheets across the economy have been made. "In my view we are maybe two thirds to three quarters of the way through in each case, varying both across and within sectors." Nonetheless, he believes we "may be beginning to see some signs of a pick-up", though a return to boom conditions is "unlikely in the UK anytime soon".

Paul Fisher notes that inflation has been above target now for most of the past five years. "But it would be hard for anyone to argue that inflation has been high because of excess demand growth in the UK. And because monetary policy works in large part by boosting or restraining nominal demand that would not seem to be the root cause of such high inflation either." Rather, he says, we have been subject to a range of cost-shocks. And while it may sound perverse, he says his concern for much of the past five years has been the risk of eventual deflation. "QE ... has been crucial in avoiding that outcome". Moreover, "if QE has contributed to inflation still being somewhat over-target at around 2 ½% now, that seems to me a much better outcome than the alternative of a deeper recession and a greater risk of deflation ... I have not heard anyone suggest a more convincing or attractive policy stance for monetary policy than that which we have pursued."

Paul Fisher then turns to what should be done with monetary policy as the shocks work their way out of the system. He notes that while the low level of nominal rates may reflect monetary policy, real interest rates are low in large part because there has been so little real growth in the economy. "One can't expect to earn low-risk but high real rates of return in financial markets if the underlying real economy is not growing sufficiently to generate those returns – the two are inextricably linked. That is why savers have been having such a hard time. To improve the position for those with net savings we really need to see stronger real growth so that nominal interest rates can start to normalise. So pursuing a strategy of monetary accommodation will be in the interests of savers in the medium-term, even if it feels like the opposite in the short-run."

Paul Fisher says his own policy vote has been driven by the need to continue supporting the required real adjustments, but "cautiously, so as not to risk inflation expectations becoming de-anchored". He notes that the Bank has been particularly active in seeking to support the real adjustments in the banking sector, with the extension to the Funding for Lending Scheme, and the FPC's complementary capital recommendation. "Monetary accommodation should generally be helpful to balance sheet rebuilding, but there are limits." By way of example, he says he is not convinced that a further reduction in interest rates would stimulate demand at this stage. "Working from such a low level of interest rates, we do not know for sure whether those effects remain the same, given pressure on the incomes of savers and high debt levels of borrowers: further cuts in rates may not feed through to higher consumption in the normal way and some of the effects could even be perverse."

In conclusion, Paul Fisher emphasises that the public should expect the Bank to continue to play its part in supporting the recovery towards genuine real growth, whilst being careful not to let inflationary pressures build, consistent with its remit. "But monetary policy can only take us so far and the necessary real adjustments will need real changes and, most importantly, real time to work through."