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News release

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Debt, Demographics and the Distribution of Income: New challenges for monetary policy - a speech by Dr Gertjan Vlieghe

In a speech to the London School of Economics Dr Gertjan Vlieghe - an external member of the Monetary Policy Committee - examines the effects of debt, demographics and the distribution of income on growth and interest rates. In his first public speech since joining the MPC, Jan argues that these 3 Ds "are interacting powerfully to create an environment where a given level of growth might be consistent with substantially lower interest rates than in the past". Jan explores these forces in turn and concludes by looking at the implications for UK policy. The 3 Ds in combination with the current outlook mean he continues to be "patient" about the need for a rate rise.

"Debt matters." The crisis has shown that households with high debt levels reduce spending more sharply in response to a downturn than less leveraged households. This in turn makes recessions that follow a substantial build up in debt "more severe and longer-lasting". Monetary policy is likely to have to respond to a significant debt overhang by cutting and maintaining low interest rates. This has been seen in the UK where, following almost 7 years of Bank Rate at 0.5%, private (non-financial) sector debt to GDP ratio has fallen from 190% in prior to the recession to 160% today. However, many other advanced economies have not reduced their debt burden and many emerging economies are still increasing their indebtedness. "This has the potential to create persistent spending disappointments, if monetary policy is unable to stimulate other spending sufficiently."

Simultaneously we have seen two important demographic changes. We are living longer and having fewer children. The interaction between these two forces is complex and further research is required to understand the likely consequences. However, initial studies and the experience of Japan suggest that overall demographic shifts will lower the equilibrium rate of interest and "there is at least the possibility that the effect is quite large". Moreover, "demographic effects are even more slow-moving than debt effects, so the impact on real interest rates might be even longer-lasting."

The monetary policy implications of the third D, the distribution of income, are the least well understood but the work so far "suggests it matters greatly" for our understanding of the monetary transmission mechanism and that rises in inequality could "affect both total savings and reinforce the rise in debt and associated deleveraging effects".

In sum, “it is not hard to imagine – though very hard to model – a story where all three Ds interact. A high debt economy faces headwinds and needs lower interest rates. A high debt economy with adverse demographic trends needs even lower interest rates. And a high debt economy with adverse demographic trends and higher inequality … well you get the picture.”

Current economic models do not reflect these changes, but policy makers must not assume “that the future will look like the past” and they must “be prepared for the possibility that real interest rates will remain well below their historical average for a very long time”.

Both these considerations make Jan “relatively more patient before raising rates” and in combination with the recent slowing in UK growth, continued weak inflation and an absence of upward wage pressure mean current conditions do not “warrant an increase in Bank Rate”. Jan adds that the need for patience is reinforced by the current asymmetry in monetary policy in that policy makers’ ability to stimulate spending is smaller than their ability to restrain it. This “potentially makes the effects of bad news more persistent even when monetary policy does all it can”.

Jan concludes: “In order to be confident enough of the medium-term inflation outlook to raise Bank Rate, I would like to see evidence that growth is not slowing further, and that a broad range of indicators related to inflation are generally on an upward trajectory from their current low levels.”

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