Monetary Policy Roundtable

Introduction

On 8 June, the Bank of England and the Centre for Economic Policy Research jointly hosted a Monetary Policy Roundtable. This was the second in a regular series intended to provide a forum for economists to discuss key issues affecting the design and operation of monetary policy in the United Kingdom.(1) Participants included a range of economists from private sector financial institutions, academia and public sector bodies. There were four discussion topics:

- monetary policy and the current conjuncture;
- quantitative easing;
- sterling and capital flows; and
- lessons from monetary history for the current policy challenges.

This note summarises the main points made by participants at the Roundtable. The event was conducted under the 'Chatham House Rule' and, as such, none of the opinions expressed at the meeting are attributed to individuals. The views expressed in this summary do not represent the views of the Bank of England, the Monetary Policy Committee (MPC) or the Centre for Economic Policy Research.

Monetary policy and the current conjuncture

Short-term prospects for the UK economy were generally perceived to have picked up in recent months. Surveys indicated that output had stabilised towards the end of the second quarter. Conditions in financial markets had improved, with lower spreads and increased activity in markets for risky assets. There was also growing evidence that housing market activity had been rising, albeit from low levels.

The severity of the recession had been partly attributable to a pronounced stock cycle. Companies had cut their holdings of stocks, in part due to pessimism about future sales, and in part due to a need to conserve cash. The pace of de-stocking was likely to decline through 2009, which could potentially support a sharp pickup in GDP growth. But stockbuilding was notoriously difficult to forecast, so the precise profile was uncertain.

Looking further forward, there was a range of views on the prospects for growth. Some speakers argued that household consumption spending had been excessive for a number of years and the saving rate would need to rise significantly to correct that. Others pointed out that household consumption had not grown at extreme rates in recent years. And in aggregate the private sector had been running a financial surplus. So there may not be large imbalances to unwind. There was a general consensus that the prospect of a sharp fiscal tightening would potentially dampen growth. But it was also noted that tighter fiscal policy could be consistent with a continued weak sterling exchange rate, which would stimulate some growth through net exports.

There was little consensus on the likely path for inflation. Some participants argued that there was a large margin of spare capacity in the UK economy, which was likely to persist for several years. Given past experience in recessions, that presented a significant risk that inflation would fall below the MPC's target and could potentially result in a period of mild deflation. Others thought that the chance of deflation was low. They emphasised the aggressive fiscal and monetary policy responses and credibility of the inflation target, the weak sterling exchange rate, recent increases in commodity prices, and the relatively low levels of spare capacity implied by service sector business surveys. It was noted that inflation expectations implicit in the price of index-linked bonds were consistent with inflation remaining close to target, although others took little comfort from that.

The MPC's action to introduce a programme of large-scale asset purchases was viewed to have reduced the threat of deflation. Some speakers, however, felt that any MPC statements on how this programme might be wound up could reduce the stimulus to growth and inflation. Others perceived a risk that the programme strayed too close to fiscal policy issues and so might lead to concerns that the MPC was not independent of the government.

Returning to growth prospects, overall it was judged that the rapid policy responses across the globe had almost certainly averted the risk of a global depression as severe as in the 1930s. Some participants thought that there could be a period of protracted weakness for the UK economy, given the combination of high debt levels and the potential for deflation. Others were sceptical, reiterating that the chance of deflation in the United Kingdom was small.

(1) Roundtables are held twice a year: a full-day event in the first half of the year and a half-day event in the second half of the year. The next Roundtable is scheduled for December 2009.

Quantitative easing

This session covered three subjects: how the MPC's programme of asset purchases (sometimes known as quantitative easing) could stimulate the economy; issues in implementing quantitative easing; and challenges for monetary policy strategy.

Four theoretical explanations of how quantitative easing could stimulate the economy were highlighted. First, it could raise expectations of future inflation. There is some statistical evidence that this channel was the most effective part of the Japanese approach to combating deflation. It was argued that the credibility of the Bank's inflation target meant that there was perhaps less to be gained from this mechanism. Second, central banks purchasing assets that are imperfect substitutes for money can change the composition of balance sheets, thereby pushing up asset prices and reducing borrowing costs. Views differed on the theoretical and empirical evidence on the effectiveness of this channel. Third, increasing banks' liquidity may encourage them to lend more. Fourth, direct operations in corporate credit markets could reduce the cost of borrowing in those markets. But some argued that thinking in terms of these channels overcomplicated the issue, as increasing the growth rate of household and corporate deposits was a necessary and sufficient condition for economic recovery; measures such as M4 had been correlated with nominal GDP growth over many decades.

There were three issues about the implementation of quantitative easing. First, how should the MPC decide on the amount of assets to purchase? The Committee's approach of estimating the shortfall in nominal income, and then using a range of models to map that into asset purchases, was discussed. Second, which assets should the MPC purchase? Participants who felt that the composition of the Bank's balance sheet was the most important channel advocated purchasing assets that were poor substitutes for cash such as corporate bonds. Other speakers thought that purchasing gilts from the non-bank private sector would be sufficient to increase broad money growth, without incurring credit risk. Third, how could the success of the policy be measured? Opinion was divided here, with different weights attached to well-functioning markets, financial market prices, intermediate indicators such as money growth, and inflation projections relative to target.

On monetary policy strategy issues, there was a discussion of the Bank's exit strategy from quantitative easing. Views differed on whether it mattered if asset purchases were reversed before any increase in Bank Rate. There was a general consensus that the macroeconomic impact and correct timing of tighter policy was crucial, but hard to judge. It was also argued that the MPC could raise inflation expectations by committing to maintain low interest rates for a period of time. But there were a number of drawbacks with such commitments.

Sterling and capital flows

This session discussed the significant depreciation of the sterling exchange rate during the financial crisis. Speakers focused on the role of short-term factors, changes to the equilibrium exchange rate and the credibility of the inflation target.

One view was that periods of sterling's depreciation could be linked to expectations of future UK interest rates falling by more than their foreign equivalents, but this link could be obscured by periodic re-ratings of sterling. Some speakers thought that this factor was unable to account for the scale of sterling's depreciation and noted that the information content of interest rate differentials was affected by the foreign exchange 'carry trade'. Links between sterling and equity markets were also discussed.

Several reasons were advanced for why the financial crisis could have caused sterling's equilibrium value to fall, including: by causing UK consumers and firms to become less optimistic about the United Kingdom's future relative economic performance, which would reduce UK demand for non-traded goods relative to traded goods; by reducing the previously strong contribution of financial services to the current account; and by adversely affecting the United Kingdom's net foreign asset position, given losses on 'sub-prime' assets. One approach to examining such issues, given the time lags in the official data, was to examine proxies for capital account flows such as international merger and acquisition transactions. But there were complications in interpreting these data.

Another approach was to use models to examine the impact of alternative assumptions about macroeconomic variables such as the sustainable current account position. Conclusions differed here. One view was that a substantial sterling depreciation could be accounted for using reasonable assumptions, although the fall would be smaller once supply-side adjustments were taken into account. Another view was that, once wealth effects from asset stocks were considered, a large proportion of sterling's depreciation remained unexplained. It was also argued that the crisis might have no effect on sterling's equilibrium exchange rate if it represented a permanent decline in wealth. A final view was that the crisis should cause sterling to appreciate since, relative to other countries, it had a larger effect on UK national income but a smaller effect on UK output.

There was also a discussion of whether sterling's depreciation reflected a decline in the credibility of the inflation target, perhaps linked to the deterioration of the UK fiscal position. One view was that this was not an important story, given the structure of UK public sector debt. Other speakers referenced the rise in financial market measures of UK sovereign debt default, although it was noted that they had declined from their peaks.

It was stressed that conclusions about exchange rates needed to be consistent at an international level. The role of emerging market economies, as well as the industrialised countries, was discussed.

Lessons from monetary history for the current policy challenges

Discussion in this session centred on the lessons that could be learnt from the Great Depression and the more recent experience in Japan.

The Great Depression of 1929–33 was the most catastrophic event in American economic history and has been the most-intensively researched topic in economic history. But there was still disagreement over its causes and the reasons for the eventual recovery. One view was that the Great Depression reflected the failure of the US Federal Reserve to take appropriate actions, thereby not preventing a sharp contraction in the money supply. And it was argued that, rather than a fiscal stimulus, the main reason for the eventual recovery in the US economy was the monetary expansion which occurred alongside the United States leaving the gold standard. The dollar's depreciation raised inflation expectations and reduced real interest rates. Improved confidence in the banking system, reflecting insolvent banks being closed, also contributed. Lessons from this experience were that the banking system needed to be provided with adequate liquidity and that such liquidity should be removed when the crisis ends.

The discussion of the Japanese experience since 1990 focused on the role of balance sheet problems. These were a result of high corporate debt accumulation, followed by asset price falls. And they forced Japanese businesses to pay down debt even when interest rates were around zero. It was suggested that these debt repayments remained in the banking system due to weak household borrowing, putting downward pressure on the economy. In such a recession, the economy does not enter self-sustaining growth until private sector balance sheets are repaired. One lesson was that government borrowing can be helpful in such situations: between 1998 and 2007 the Japanese Government borrowed more and spent the excess savings of the private sector to sustain economic activity. And there were argued to be similarities with the US Great Depression experience: US money supply growth after 1933 was also made possible by increased government borrowing.

Another view was that one of the lessons from history is that the big crises cannot be avoided by monetary policy intervention. Rather, severe balance sheet recessions following the collapse of asset price bubbles are best avoided by regulation.

Several arguments were advanced for why central banks should worry about asset price bubbles: misallocation of capital during the bubble period; overheating in the economy due to wealth effects, which could raise inflationary pressures; and a sudden collapse of asset prices may amplify a recession. This might suggest that monetary policy should try to lean against asset price bubbles, as some participants argued. But there were also reasons why a central bank should not intervene, including the difficulty involved in knowing the extent of the asset price overvaluation and the negative impact on the economy more generally from raising interest rates to tackle the asset price bubble.