Monetary Policy Roundtable

Introduction

On 15 December, the Bank of England and the Centre for Economic Policy Research hosted the third Monetary Policy Roundtable. These events are intended to provide a forum for economists to discuss key issues affecting the design and operation of monetary policy in the United Kingdom.(1) As always, participants included a range of economists from private sector financial institutions, academia and public sector bodies. At this third Roundtable there were two discussion topics:

- monetary policy and the current conjuncture; and
- the recession and the UK labour market.

This note summarises the main points made by participants. Since the Roundtable was conducted under the 'Chatham House Rule', 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

Views about short-term economic prospects were generally downbeat. Although the cuts in Bank Rate since October 2008 had led to considerable reductions in households' debt interest payments, consumer spending had remained subdued as households increased saving and began to repair their balance sheets. Household spending was likely to remain weak in the near term, but there were different views about the likely persistence of this weakness. Some believed that the recession would lead to a protracted period during which consumers would be averse to borrowing and would seek to reduce their leverage. Participants pointed to previous episodes of significant balance sheet restructuring — in the United Kingdom, Japan, Sweden and Thailand — which had lasted around six to eight years, although the unprecedented nature of the current recession limited the insights from these historical comparisons.

Others, however, thought that a persistent change in consumer attitudes to debt was less likely. Little of the rise in household savings had been used to repay debt or accumulate financial assets. Instead, most of the savings had been channelled into a further accumulation of housing assets. That was corroborated by the recent rally in house prices, which had recovered much more quickly than in the 1990s recession. Consequently, a recovery in the supply of mortgage credit would likely lead to a reduction in the savings rate, and hence slow the deleveraging process. That, however, would also take time — the banking system remained significantly impaired, and although banks had begun to repair their balance sheets, significant further adjustment was required. Banks' strategies for raising capital and liquidity ratios and reducing leverage multiples were likely to inhibit a rapid recovery in bank lending. As a result, tight credit conditions were likely to remain a feature of the economic landscape for some time. Participants noted that many macroeconomic models did not account for the role of balance sheets and frictions in credit markets. As a result, such models have only been able to provide limited insight into the economic impact of recent developments in credit conditions.

Investment was also likely to remain subdued. In part, that reflected the wide margin of spare capacity in the economy. But it also reflected the expected tightness of credit conditions. Although lenders had reported improvements in corporate credit availability during the second half of 2009, surveys of borrowers suggested that many companies, particularly small and medium-sized businesses with limited or no access to capital markets, had continued to find credit conditions highly restrictive. In addition, businesses' desire to reduce leverage further (following record levels of bank debt repayment), was likely to restrict investment.

Inventory levels had been cut back aggressively over the past year. A reduction in the pace of de-stocking would boost GDP growth in the coming quarters. But participants were sceptical of any substantial increase in stock levels going forward. The stock-output ratio was close to its average of the past fifteen years; and some surveys suggested that the current level of inventories was already deemed sufficient to meet expected demand. Moreover, tight credit conditions and the desire to preserve buffers of working capital may encourage businesses to hold lower levels of stocks than in the past. Those businesses which needed to increase stocks to provide for a recovery in demand may find it difficult to raise the necessary finance.

(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 Roundtables are scheduled for July and December 2010.

Participants noted that the fiscal plans outlined in the *Pre-Budget Report 2009* (*PBR*) contained little news about the timing, composition and extent of any further consolidation in the public finances. Many thought that the *PBR* projection of a sharp rise in public sector debt relative to nominal GDP would leave little headroom for any further fiscal expansion. Other countries, which had also experienced deteriorations in their public finances, faced similar challenges.

In the past, net trade had played an important role in the early phases of economic recovery. Participants discussed whether the same would be true this time. It was thought that the significant exchange rate depreciation since the summer of 2007 should boost exports and reduce imports in the coming quarters. But some participants were cautious about a strong recovery in net trade. Tight credit conditions continued to restrict activity in the export sector. Some exporters whose prices are fixed in local currency terms (ie in terms of the currency of the foreign destination) had used the exchange rate depreciation to boost their margins. And some surveys suggested that perceived export competitiveness had not risen by as much as the exchange rate depreciation may have implied.

Monetary policy had been loosened significantly over the past year. Bank Rate had been reduced to 0.5%, and maintained at that level for most of the year. And in March 2009, the MPC had embarked upon a programme of asset purchases financed by the issuance of central bank reserves. At its November meeting, the Committee had voted to extend that programme by £25 billion, to a total of £200 billion.

Some participants questioned the efficacy of the Bank's asset purchases. The introduction of quantitative easing in Japan had not generated a rise in bank lending. And some believed that the Bank's asset purchase programme would have only a limited impact on an economy with few willing lenders and weak private sector demand for credit. As a result, those participants advocated alternative policies, aimed at providing credit more directly to the corporate sector.

Others argued that the MPC's asset purchases were having a demonstrable impact on the economy. Corporate bond yields had fallen and stock markets had rallied markedly since March. These developments had both reduced the cost of corporate debt and equity issuance, which had risen to record levels. These improvements in debt markets had enabled businesses to repay bank loans, which in turn would help banks rebuild their balance sheets. But some participants were concerned that policy had served to reinflate asset prices and spending, and hence hinder the necessary adjustment in private sector balance sheets.

CPI inflation was likely to rise over the coming months, reflecting the reversal of the December 2008 cut in VAT and (for some) the continued impact of the past depreciation of sterling. Thereafter CPI inflation was likely to fall back sharply, and remain subdued in the medium term. Some participants attributed this underlying weakness in inflation to the significant margin of spare capacity that had emerged during the recession, which would bear down on prices going forward. Others, who had questioned the impact of the output gap on prices, attributed the expected weakness of inflation to a prolonged period of balance sheet adjustment and the associated weakness in money and credit growth.

The recession and the UK labour market

The second discussion topic at the Roundtable centred on the response of the UK labour market to the recent recession. The labour share of income (which accounts for changes in both earnings and the number of people employed) had risen in line with the experiences of the 1980s and 1990s recessions. But compared to these past recessions, the current episode had a number of important differences: output had fallen by significantly more; employment had fallen by significantly less; and wage growth had moderated markedly. Roundtable participants discussed a number of possible explanations. Some attributed the limited response of employment to an increase in wage flexibility — wage growth had moderated markedly over the past year, enabling businesses to hoard more labour than in previous recessions. But others thought that the labour share of income would need to fall back substantially. And the relationship between vacancies and unemployment, another proxy for changes in labour market flexibility, had remained little changed since the previous recession.

Others thought that the disparity between the falls in output and employment, and the precipitous decline in labour productivity they implied, suggested that either the decline in output had been overestimated, or the fall in employment underrecorded. But there was a lot of evidence against this view. Output had fallen sharply all over the world: the fall in other countries' output was corroborating evidence that output had fallen sharply in the United Kingdom too. As for employment, the data may not properly capture migrants who have lost their jobs and returned home. But these were likely to be concentrated in certain sectors such as construction, and falls in employment had been broad-based across all sectors.

The limited response of employment in the United Kingdom stood in stark contrast to the marked rise in unemployment in the United States. Participants noted that comparing the behaviour of these two labour markets may help to shed light on the unusual behaviour of the UK labour market. Some attributed the pronounced rise in US unemployment to the fact that wage growth outstripped that of labour productivity prior to the recession. Earnings should grow in line with productivity in the medium term, so some combination of weaker earnings growth or higher productivity growth was required. The significant reductions in US employment may have been part of this adjustment.

It was noted that some of the rise in US unemployment may also reflect a growing degree of 'mismatch' in the labour market, with employers finding it increasingly difficult to recruit appropriately skilled staff to fill their vacancies. The number of vacancies in the United States had remained little changed of late despite increases in unemployment, which was consistent with an increase in mismatch.

Participants thought the outlook for the UK labour market to be highly uncertain. The muted rise in unemployment may in part reflect lags in the labour market. Some businesses may have chosen to hoard labour in the expectation of an economic recovery, which, if proved unfounded, could lead to a further rise in unemployment. And although pay prospects remained muted, wage growth had exceeded productivity growth in Q2, suggesting that some further moderation in earnings growth may be required to prevent additional cuts in employment. The upcoming round of wage negotiations and the degree of restraint employees exerted in their wage demands would have a material influence on the outlook for employment. Finally, the planned fiscal consolidation may entail some reduction in public sector employment, which had continued to increase in recent quarters. This would put upward pressure on unemployment.

On balance, participants expected unemployment to peak lower than in previous recessions. But many expected hiring to remain subdued and that unemployment would stay high for longer than in previous similar episodes, with businesses choosing to work their employees more intensively, rather than recruiting new staff.