Monetary Policy Roundtable

On 14 July, the Bank of England and the Centre for Economic Policy Research hosted the fourth 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 fourth Roundtable there were four discussion topics:

- what have we learnt about inflation dynamics?
- quantifying the effects of quantitative easing;
- global prospects and the impact on the UK economy; and
- monetary and fiscal policy.

This note summarises the main points made by participants.(2) 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.

What have we learnt about inflation dynamics?

UK inflation had been elevated during the past few years, even after excluding the impact of rising energy prices. And it had been higher than many forecasters, including the MPC, had expected. That had contrasted with other economies' experiences, for instance the euro area and the United States, where inflation had been lower and where measures that exclude the direct effects of food and energy had been trending downwards. Speakers discussed what factors might account for these divergent patterns and what they might imply for the inflation outlook.

UK inflation outturns could be rationalised by the influence of factors that might prove to be temporary or by changes in the process determining inflation. Temporary factors operating in the United Kingdom included the significant exchange rate depreciation and changes to VAT. If those effects were the main explanations, then inflation could be expected to fall back as their influence waned and the role of spare capacity in pushing down inflation became more apparent.

Most agreed that the exchange rate depreciation had been a key factor accounting for the relative resilience of UK inflation. It was suggested by one speaker that lags between changes in the exchange rate and consumer prices could potentially be quite long: history indicated that it took some time for prices to adjust to the levels charged by overseas competitors following major shifts in the exchange rate. Others argued that the lags from the exchange rate to CPI inflation were variable and would depend on the circumstances that applied at the time. Ultimately, the impact on inflation would depend on the reason for the change in the exchange rate.

It was also noted that the level of spare capacity might be lower than many currently judged. In particular, the financial crisis might have impaired potential supply by more than had been expected. Furthermore, the effect of a given level of spare capacity on inflation might have changed. Alternatively, inflation expectations may have risen.

The existence of slack in parts of the economy was clear, notably in the labour market. It was more difficult to assess spare capacity within businesses. Assessing how capacity might be affected by firms' decisions to 'mothball' some parts of their operations presented a particular challenge.

International evidence pointed to spare capacity having its expected effect in bearing down on inflation. So, for some, this was evidence that spare capacity was having a similar impact in the United Kingdom, and that this would become apparent once the effects of the temporary factors pushing up inflation had worn off. An increase in inflation expectations was a risk, nonetheless. Certain survey evidence had pointed to some crystallisation of that risk, but that might have reflected temporary moves in actual inflation.

Although inflation had been persistently above target recently, the statistical properties of inflation pointed to a significant reduction in the persistence of inflation over time. This was an important feature of inflation dynamics and had changed across different monetary regimes. In particular, lower inflation persistence seemed to coincide with inflation targeting. If that was due to a better anchoring of inflation

(1) Roundtables are held twice a year: the next Roundtable is scheduled for December 2010.
(2) This summary was originally published on the Bank of England's website on 23 August 2010. For both this and previous summaries, see www.bankofengland.co.uk/publications/other/monetary/roundtable/index.htm.

expectations it highlighted the importance of keeping inflation expectations fixed around the inflation target.

Quantifying the effects of quantitative easing

More than a year had passed since the Bank had begun its programme of quantitative easing (QE). Attempts to quantify the precise impact of QE had been hampered by the lack of an observed counterfactual: what the economic and financial environment would have been like had QE not taken place. Participants identified two main transmission mechanisms through which QE could have affected the economy: by influencing gilt yields and other asset prices; and by increasing the money supply.

Participants noted the inconsistency between the perception that shocks to the supply of and demand for gilts could have had local effects on the yield curve and the predictions from most standard economic models. But if, for example, markets consisted of investors with preferences for specific maturities in addition to risk-averse arbitrageurs, then demand and supply shocks could affect gilt yields by changing the price of risk. In general, discussants agreed that QE had had a clear impact on gilt yields, as they had fallen markedly around QE announcements. The immediate reaction of individual gilts to QE announcements in 2009 also seemed to suggest segmentation: gilt-OIS spreads had decreased significantly more for gilts included in the QE purchase range than outside it, although the effects had lessened over time.

There was, however, a range of views among discussants about the exact impact of QE on gilt yields. In a recent *Bank of England Working Paper* that had examined the reaction of market prices over a relatively short interval around each QE announcement, the authors had concluded that QE might have depressed gilt yields by around 100 basis points.(1) There was a range of uncertainty around these calculations, as estimated effects of QE from event studies were inevitably sensitive to the chosen interval for evaluating the policy. Some participants thought that this estimate might have been too large, and that the impact of QE had been confined to temporary flow effects. Gilt yields and gilt-OIS spreads had edged up since Autumn 2009 which lent some support to that argument. Others believed that the true impact of QE had been larger than the Bank's estimate, as UK gilt yields had been lower than those in other countries with similarly high projected government debt issuance. Some remarked that QE could have caused interest rates first to fall and then to rise, if it had served to increase growth prospects or had led to higher inflation expectations.

The reduction in government bond yields should have had an impact on the interest rates faced by the private sector. But it was noted that falls in long-term interest rates would have been likely to affect firms more than households, as businesses had tended to issue longer-term debt while households had been more exposed to short rates. There was some consensus that QE had affected corporate bond yields, as they had fallen around the time of QE announcements as well, and that it had aided the recovery in equity prices. QE was also thought to have played a role in the recent pickup that had been seen in equity and corporate bond issuance.

Some participants thought that QE had boosted the supply of money as broad money growth had not decreased by as much as might have been expected given how much nominal spending had fallen. There was some evidence that those who had sold gilts to the Bank of England may have been buying banks' equities and long-term debt with the proceeds. This would have reduced deposits, but would have been beneficial for the economy as it would have increased banks' capital and so lessened the pressure on banks to shed assets. Other participants expressed some concerns about the fact that broad money growth had still fallen after QE.

Participants discussed the potential future impacts of withdrawing the current level of monetary stimulus. Participants welcomed clarification on the approach to exit given during the Governor's Mansion House speech. It was likely that the MPC would use Bank Rate as the active instrument, raising it first, before conducting asset sales in an orderly programme over a period of time. A reasonable benchmark for the impact of asset sales was that they would be the mirror of QE asset purchases, but several arguments were advanced by participants as to why this might not be the case. First, the extent of banking sector impairment, which might have diminished the effect of QE, might be lower in future. Second, markets might interpret the announcement of any programme of sales as a signal about future Bank Rate tightening. And third, the sales might coincide with a period of strong gilt issuance by the Debt Management Office. Overall, there was broad agreement that QE would continue to be a valid monetary policy instrument if it had to be used again, even if the circumstances were different.

Global prospects and the impact on the UK economy

In the aftermath of the financial crisis, global growth had appeared to be returning. Global output had regained its pre-crisis peak in 2010 Q1. But this had been largely due to strong growth in China and other emerging markets. Advanced economies had recovered a little, but growth had remained relatively subdued.

(1) Joyce, M, Lasaosa, A, Stevens, I and Tong, M (2010), 'The financial market impact of quantitative easing', *Bank of England Working Paper no. 393*.

Some participants were relatively upbeat about the outlook for global growth. Final demand was playing its part in the recovery so far, which had not been completely accounted for by the rebuilding of inventories after sharp de-stocking during the downturn. The position of the corporate sector had looked comparatively healthy across many advanced economies, given the extent to which output had fallen. And although the fiscal retrenchment envisaged in 2011 was large, it was not unprecedented.

But leading indicators of output growth had fallen back recently, indicating that the global economy might have been losing momentum. And it was agreed that the risks to the outlook were largely to the downside. A major downside risk had arisen over the past few months as fears about the sustainability of some European sovereigns' debt positions had increased. There was also a risk that fiscal consolidation or new banking sector regulations could be implemented too quickly or be overly severe. And, as yet, there had not been a resolution to the problem of 'global imbalances'.

In the euro area, sovereign bond spreads over German bunds had picked up for a number of countries, as market participants' concerns over the sustainability of debt positions had risen. One participant pointed out that this had to be seen in the context of the remarkable compression of spreads that had occurred in the previous ten years. But any debt restructuring could give rise to a new source of solvency risk for banks. The uncertainty surrounding which banks were exposed to these problems had raised interbank rates. And one participant noted that economists did not yet fully understand issues of contagion — the degree of interconnectedness had meant that even problems in small entities could spill over and affect the entire financial system. It was essential that these problems were resolved rapidly to prevent a further slowing in growth.

Large fiscal consolidations had been announced around the world, particularly in Europe. It was considered likely that these would slow GDP growth, but there could be some helpful offset if borrowing costs fell. One participant noted that the costs of greater regulation on the banking sector would probably be small in the long run, and indeed there would be benefits as the probability of crises occurring and the economic costs of any crisis would be lowered. But the risk of another banking sector crisis could increase in the short run if rules were introduced rapidly.

Participants discussed the outlook for global imbalances. There were a range of outcomes, but three main paths were suggested by one participant. First, the world could rebalance as countries that had run current account surpluses consumed more. Second, rebalancing could occur alongside stagnation in global growth as countries which had traditionally run current account deficits grew less rapidly, with no offset from demand in surplus countries. Third, domestic demand in the United States could, with support from monetary and fiscal policy, continue to support global growth, at least in the short run, with little global rebalancing. The participant considered the third outcome most likely.

Other participants suggested that continued Asian growth would help the world rebalance. It was thought by some that greater domestic demand in Asia would allow countries to 'decouple' somewhat from advanced economies. Nevertheless, the demand provided would probably be insufficient to increase output in the rest of the world substantially.

The outlook for UK exports was dependent on the extent of the global recovery. Exports had not yet picked up and it was not clear why the United Kingdom had not seen a bigger impact from the strength of global demand in 2010 Q1 and the depreciation of sterling. Some participants thought that the financial crisis might have led to problems with exporters gaining access to credit, so businesses had increased margins to generate cash flow. But most suggested that the impact from sterling's depreciation would eventually become apparent, it was just taking time to orientate the UK economy towards the tradables sector.

Monetary and fiscal policy

Participants debated the extent to which UK monetary and fiscal policy were co-ordinated. One view was that central bank independence in 1997 had not created a co-ordination problem. The Government set the monetary policy maker's goals, so there was no tension between the two institutions' aims. And the MPC took the Government's fiscal projections as given in its forecast. So the Chancellor could determine the policy mix, as long as the MPC's reaction function was known. The presence of an HM Treasury observer at MPC meetings allowed the Government to be informed of the reaction function. A contrary view was that there was little public evidence on how this co-ordination took place and it was possible that there was a co-ordination issue. For example, both the Government and the MPC were reluctant to discuss publicly hypothetical policy responses, which would be one route via which reaction functions could be better understood.

Participants discussed how the formation of the Office for Budget Responsibility (OBR) was likely to affect the co-ordination of monetary and fiscal policy. The creation of the OBR had the advantage of increasing confidence that the economic forecasts on which fiscal policy was based were not affected by political expediency. But the new arrangements had posed new challenges. The OBR had itself acknowledged that presenting forecasts based on the market profile for interest rates was a challenge. For one thing, such interest rate projections might embody expectations of future fiscal policy,

or the likely monetary policy response to them, that the OBR did not share.

Participants debated the potential effects of fiscal policy on the economy. The decision over the appropriate degree of fiscal consolidation faced a difficult trade-off. On the one hand, there was considerable evidence that high debt and deficits pushed up long-term interest rates, and so a significant consolidation could be beneficial for growth on account of lower long-term interest rates. On the other, the contraction itself would probably reduce demand. By how much was hard to say: the range of academic estimates of the 'fiscal multiplier' was quite wide. Two factors suggested that the planned contraction in UK fiscal policy could have a larger effect than those measured historically. First, monetary policy might not be able to loosen as much to compensate. Second, many countries were contracting at the same time. In a small open economy, a contraction might normally be expected to lead to a real exchange rate depreciation and an increase in external demand. But this stimulus would be limited if many of the United Kingdom's trading partners were reducing demand at the same time.

Participants discussed the academic literature on the optimal design of fiscal policy. This literature identified several factors that policymakers needed to weigh up. On the one hand, there was the motive to ensure that taxes were not volatile from one period to the next, because such volatility was costly for the private sector. This motive led to the optimal fiscal policy being one that did not attempt to correct for past shocks that had driven debt up. On the other hand, there were likely to be limits to either the willingness or the ability of governments to levy taxes to service ever higher stocks of debt, and so there was a motive to correct shocks to debt to prevent it from becoming unboundedly large. A third force pulling on the optimal fiscal policy was the concern that not acting to reduce government debt might crowd out private investment. Furthermore, there was the question of intergenerational equity. One perspective on this was that risk should be shared out across generations: a single generation should not be expected to bear all the costs of having the bad luck to experience a war or a financial crisis directly. Finally, the design of the optimal fiscal policy was bound up with the debate about optimal monetary policy. A very high stock of (nominal) debt might increase the perceived temptation for the government to force the central bank to reduce its real burden with a burst of inflation, a perception which could lead to rising inflation expectations.