Monetary Policy Roundtable

On 14 December 2010, the Bank of England and the Centre for Economic Policy Research hosted the fifth 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 fifth Roundtable there were two discussion topics:

- how different will this recovery be?; and
- how fast can the economy grow without hitting capacity constraints?

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 or the Centre for Economic Policy Research.

How different will this recovery be?

History suggests that recoveries from recessions involving banking crises are often more drawn out than standard recoveries, although there is great heterogeneity between cases (see, for example, Reinhart and Rogoff (2009)).(3) This session discussed the nature of the current UK recovery, highlighting differences with previous UK and international episodes, and sought to draw lessons for policymakers.

One participant outlined reasons to be optimistic about the current recovery. Signs were so far promising. The UK and global recoveries had been stronger than expected to date. For example, forecasts for UK and global growth in 2010 had been revised up significantly over the past 18 months. And output growth in the OECD countries during this recovery had recovered to its pre-crisis trend in less than half the time taken during the 'Big Five' financial crises (Spain (1977), Norway (1987), Japan (1990), Sweden (1990) and Finland (1990)).

The speaker noted that a key factor behind the relative strength of the current recovery was the swiftness of the monetary policy response. Global real interest rates had turned negative quickly this time around, in contrast to the Great Depression and the 'Big Five' crises, which had seen real interest rates rise during the early months of the crises and remain elevated for some time. Furthermore, the introduction of quantitative easing in the United Kingdom, United States and euro area had taken place much earlier than in Japan during the 1990s recession.

The speaker pointed out that fluctuations in private investment had driven much of the global cycle to date. Its recovery could continue to provide a fillip to the growth of activity, particularly in the United Kingdom where its level remained low relative to pre-crisis trends. A downside risk stemmed from banks' ongoing efforts to reduce the size of their balance sheets, which could make it harder for businesses to obtain credit. However, the corporate sector financial surplus remained high in the United Kingdom, which would allow businesses to tap into their own funds to invest. And the high rate of return on capital should encourage firms to continue to invest.

Other participants were less optimistic about the prospects for the recovery. One speaker identified three impediments to the recovery, which he characterised as key differences from the United Kingdom's recovery in the 1980s.

First, income growth had been weak, reflecting the composition of the recovery in employment. Employment had recovered particularly quickly during this recovery, perhaps reflecting earlier, unobserved strength of the economy (for example, if the labour market had entered the recession tighter than previously assumed). But that recovery had been predicated on a rise in part-time jobs and self-employment, which had depressed hourly pay growth. Subdued income growth did not augur well for the recovery of consumer spending and the wider economy.

Second, the resilience of inflation had constrained real take-home pay, weighing on consumption and restricting household debt repayments. Some of the causes behind the rise in inflation may have been structural rather than cyclical,

(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 2011.
(2) This summary was originally published on the Bank of England's website on 20 January 2011. For both this and previous summaries, see www.bankofengland.co.uk/publications/other/monetary/roundtable/index.htm.
(3) Reinhart, C M and Rogoff, K S (2009), *This time is different: eight centuries of financial folly*, Princeton Press, Princeton, NJ.

for example reflecting increasing energy demand from the rapidly growing emerging market economies (EMEs).

Compounding this, the United Kingdom was poorly placed to benefit from strong EME growth via greater trade, as the share of EMEs in UK exports remained low. One participant argued, however, that strong EME energy demand might just result in a step change in the level of commodity prices. If so, the impact on the rate of inflation would dissipate after a couple of years. Another participant noted that, in any case, the high volatility of commodity prices in recent years had been an additional challenge for policymakers.

Finally, there were significant downside risks from the fiscal consolidation. The UK consolidation plans called for an unusually strong private sector response to maintain momentum in the recovery. But evidence from past recoveries offered no clear steer about the reaction of private consumption to government spending cuts. And countries which in the past had experienced fiscal consolidations had benefited from strong export markets, falls in bond yields and transfer payments from the European Union — circumstances that might not prevail this time around.

One participant noted that assessing how this recovery might progress depended crucially on the permanence of the output losses incurred during the recession. If output had been permanently reduced, then the recovery might well be in its final stages.

Most participants agreed that a big downside risk to the recovery stemmed from problems in the euro area, particularly in the peripheral countries. Any deterioration of the growth outlook would be particularly bad news for the United Kingdom, given the high share of the euro area in UK exports.

Finally, one speaker explored the lessons that could be learned from the experiences of the United Kingdom and United States during the Great Depression. Four lessons were drawn.

First, fiscal consolidation can expose the economy to the risk of a double-dip recession if monetary policy is not supportive. For example, US policymakers' decision in 1936/37 to double banks' reserve requirements while balancing the budget had tipped the United States into recession in 1938, following a strong, monetary policy induced recovery in 1933–37.

Second, real interest rates really matter to recoveries. The recoveries in the United States and United Kingdom in 1933 had been underpinned by a sharp fall in real interest rates, into negative territory. In the United States, this had reflected a sizable pickup in inflation expectations, coupled with near-zero nominal interest rates following the exit from the gold standard.

Third, banking crises can lead to permanently lower levels of output. The impact primarily comes through reduced investment and a slower accumulation of the capital stock, as seen in the United States during the 1930s.

Finally, the mix of fiscal consolidation can affect productivity. Consolidation through the reduction of 'non-productive' government expenditure and higher indirect taxes is less detrimental to growth than raising direct taxes (as was the case in the United Kingdom in 1933–37) and cutting back on 'productive' expenditure.

How fast can the economy grow without hitting capacity constraints?

As the economy recovers from the recent deep recession, participants agreed that an important influence on the recovery, and on inflationary pressure, would be the speed at which the economy could grow without hitting capacity constraints. That would be determined by both the current degree of spare capacity in the economy and by the future growth rate of potential output.

Participants discussed how different indicators offered contrasting views of the margin of spare capacity currently within companies. Survey evidence suggested that the degree of spare capacity had narrowed and that only a limited amount remained. But the depressed level of productivity relative to its pre-recession trend pointed to a larger degree of spare capacity.

Surveys of labour market slack had begun to narrow over the past year, but by less than the surveys of spare capacity within companies. When the two sets of surveys were combined, one participant suggested that a composite measure of slack implied that the level of output might be about 2% below its potential, only around half what it was at the height of the recession.

Some participants thought that while surveys of capacity utilisation were useful to assess whether or not there was spare capacity within companies, they were less useful for assessing the extent of that spare capacity. And there was some uncertainty about exactly how companies defined the concept of 'normal' levels of capacity when responding to these surveys, and whether they took into account capacity that was temporarily unavailable. But others argued that the surveys were a good guide and that these data were broadly consistent with recent developments in inflation.

The difficulties of using the gap between productivity and its pre-crisis trend as a measure of spare capacity were also discussed. The trend may be sensitive to the period over which it is calculated. In particular, it could be overstated if it included the late 1990s, a period of unusually strong productivity growth. And the trend may have been affected by the recession. Participants also noted difficulties in measuring productivity, particularly in the service sector. It was unclear in which direction measurement issues might affect output, and it was possible that hours worked were currently overstated, implying stronger hourly productivity than presently measured. However, it was unlikely that these factors were large enough to account for all of the additional spare capacity currently implied by the weak productivity data.

If surveys were accurate, and there was limited spare capacity in the economy, then the depressed level of output relative to its pre-recession trend implied that potential output had fallen by around 7% or 8%. Most participants agreed that it was hard to explain the channels through which a fall of this magnitude may have occurred. But some argued that the lack of a clear explanation for such a large fall in supply did not necessarily mean that it had not happened.

Some participants thought that one reason why the surveys indicated limited spare capacity was that supply was endogenous, and that as demand picked up supply would return. It was noted that there were examples, such as the United States in the 1930s and Sweden in the 1990s, where output had fallen sharply but had eventually returned to its previous trend, suggesting that a loss of actual output does not necessarily imply a loss of potential output.

Some participants thought that the main impact of the financial crisis was likely to be on the level of output rather than its growth rate in the future. Relatively high use of information and communications technologies was one reason why UK productivity growth had been strong relative to other countries prior to the financial crisis. And these technologies were likely to continue to have an important and positive effect on future UK growth. But other participants thought that increases in uncertainty and the cost of capital could reduce future growth. There was some discussion of how cuts in the public sector could affect potential growth. On the one hand, they might release more skilled labour into the private sector. But on the other, reduced spending on infrastructure and research and development could reduce growth in the private sector.

Labour supply is also an important component of potential output growth. It was noted that migration had made a substantial contribution to labour supply growth over the recent past, but recent changes in government policy suggested that migration from outside the European Union might slow. And increases in retirement ages could act in the opposite direction by raising labour force participation rates.