Monetary Policy Roundtable

On 17 December, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their eleventh Monetary Policy Roundtable. These events provide a forum for economists to discuss key issues relevant to monetary policy in the United Kingdom.(1) As with previous Roundtable discussions, participants included a range of economists from private sector financial institutions, academia, public sector bodies and industry associations. There were two topics of discussion:

- state-contingent forward guidance: rationale and reactions; and
- how quickly can the UK economy grow following the Great Recession?

This note summarises the main issues raised by participants.(2) The Roundtables are conducted under 'Chatham House Rule' and so opinions expressed at the meeting are not attributed to individuals. This summary does not represent the views of the Bank of England, the Monetary Policy Committee (MPC) or the CEPR.

State-contingent forward guidance: rationale and reactions

In August 2013, the MPC issued explicit forward policy guidance, committing not to raise Bank Rate at least until the unemployment rate, as measured by the Labour Force Survey, falls to 7%, provided that such an approach remains consistent with its primary objective of price stability and does not endanger financial stability. The first session of the Roundtable discussed the rationale for introducing forward guidance, and participants' views on the design and usefulness of such guidance.

On the rationale for introducing forward guidance, there was general agreement that a key objective was to reduce uncertainty about the future conduct of monetary policy, by explaining in more detail how policymakers would envisage reacting to certain economic developments. One speaker noted that understanding policymakers' reaction functions was particularly difficult at the present juncture as the policy rate had been unchanged for many years while there was little previous experience of how policymakers might vary other instruments such as asset purchases. The nature of the interaction between monetary policy and macro and microprudential policies added an additional source of uncertainty.

Other motivations for adopting forward guidance were also discussed. One speaker felt that forward guidance could be particularly effective at the current juncture by preventing market participants overreacting to early signs of a recovery in economic growth, so allowing market interest rates to normalise at an appropriate pace. Another speaker thought that forward guidance might be particularly valuable where market expectations of interest rates have diverged from those of policymakers. While noting the Bank's view that forward guidance was not intended to provide additional economic stimulus by committing to hold interest rates lower for longer than would be justified by the inflation target, that speaker felt that if forward guidance did lower market expectations about short-term interest rates, then that would provide a boost to economic activity.

There was much discussion of how best to design a framework for forward policy guidance. Participants generally favoured state-contingent forward guidance, given uncertainty about the macroeconomic outlook. One participant likened state contingency to providing an 'automatic stabiliser', building in a response to changing economic circumstances. But some participants questioned whether the unemployment rate was the right variable against which one should link state-contingent forward guidance. One speaker felt that this design placed too much emphasis on a single and imperfect measure of economic slack. Another participant noted that the focus on the unemployment rate stood in contrast to Milton Friedman's belief that central banks should focus on nominal variables. But there was little support among participants for alternative reference variables, such as nominal GDP growth.

The discussion touched upon the 'knockouts' that apply to the MPC's forward guidance. One speaker questioned whether the focus the MPC placed on anchored inflation expectations might be unhelpful, given that lower expected inflation might be associated with higher real interest rates and lower growth.

(1) This report was prepared by Lai Wah Co, Will Dison, Michael Goldby and Katharine Neiss of the Monetary Analysis area of the Bank. Roundtables are held twice a year. The next Roundtable is scheduled for Summer 2014.
(2) For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.

But another participant countered that this was an important part of the guidance, noting the likely difficulty and cost of regaining control of inflation expectations if they became less well anchored to the inflation target. One participant noted the importance of the financial stability knockout at the current juncture, given potential risks arising from the housing market.

One of the main areas of discussion centred on whether the MPC should provide additional guidance about what might happen to policy once the 7% unemployment threshold is reached. Two speakers argued that UK monetary policy makers should set out their preferred paths for Bank Rate and asset purchases, conditional on the state of the economy. They argued this would further reduce uncertainty, which they thought remained significant, and provide more clarity about policymakers' reaction function. They favoured the approach taken by the US Federal Open Market Committee and the Swedish Riksbank, who publish projections for the policy rate.

But other participants argued against publishing projections for the policy rate. Some participants were sceptical that a published path for the policy rate and the stock of asset purchases would be useful given the substantial uncertainty surrounding the evolution of the economy and therefore the appropriate future setting for policy, and were concerned that such projections might be interpreted as a commitment to follow a particular policy. One participant thought that there were important procedural difficulties associated with publishing projections where monetary policy is set by a committee with rotating membership. Another participant noted that if central banks published 'too much' information, this could reduce the incentives for private agents to invest in producing their own forecasts, and lead to herding behaviour in financial markets.(1) But other participants were sceptical that this would happen in practice.

On the impact of the MPC's forward guidance, one speaker noted that it was very difficult to test for this, given the objectives of the policy and the lack of knowledge of how the economy would otherwise have evolved. That speaker cited the fall in the implied volatility of UK short-term interest rates since the policy announcement as being consistent with some reduction in uncertainty. Some participants thought forward guidance had influenced the interest rate expectations of the private sector to some degree.

In summary, most participants felt that the forward guidance issued by the MPC was helpful. But there were differing views about the optimal design of such guidance, and some participants thought that forward guidance would be improved by the publication of policymakers' conditional forecasts for Bank Rate and the stock of asset purchases.

How quickly can the UK economy grow following the Great Recession?

The UK recovery since the end of the Great Recession in 2008/09 had been weak compared with previous and current recoveries in many other advanced economies and compared with the average experience following past regional banking crises. At the time of the Roundtable discussion, the level of real GDP remained 2.5% below its pre-crisis peak. The second session of the Roundtable considered the outlook for UK growth, in light of considerable uncertainties regarding: the strength of headwinds generated by the global financial crisis; the degree of spare capacity in the economy and how productivity will evolve as the economy recovers; and unprecedented monetary stimulus over the recent past. How fast could the UK economy grow without posing risks to price stability?

Participants discussed the strength of the latest UK Purchasing Managers' Index (PMI) output and employment indices in relation to the official Office for National Statistics (ONS) data. The UK PMI output data had recently reached their highest levels since the late 1990s, outperforming those for the United States, euro area and Japan, with growth broad-based across sectors. Other survey measures of recruitment, pay growth and investment intentions had also improved. For one speaker, these presented a particularly encouraging picture, with above-trend growth in the UK economy considered possible over the next year. Another participant questioned the signal from the PMI surveys however, suggesting that the historical relationship with measured GDP growth may have changed since the financial crisis.

One window onto the strength of recent and prospective growth is employment, which increased strongly through 2012. There was some discussion over how strong employment had been, with a weaker steer from the PMI surveys causing some to question the official data, although others noted that the ONS employment figures have historically been subject to relatively small revisions. It was therefore uncertain just how weak productivity had been and why, complicating the question of how fast the recovery in GDP growth might be.

Two of the speakers thought that the United Kingdom's trend annual growth rate was now in the range of 1.0%–1.5%, much lower than historical average rates. One speaker thought that the United Kingdom's sustainable growth rate will remain subdued because output sectors that had benefited from cheap external finance pre-crisis would continue to struggle in

(1) Morris, S and Shin, H S (2002), 'Social value of public information', *The American Economic Review*, Vol. 92, No. 5, pages 1,521–34.

the face of more restrictive and keenly priced credit. Those sectors were construction, distribution, financial services and real estate, where output growth has been much weaker than prior to the recession. The other speaker noted that they did not believe the estimated strength of productivity growth prior to the recession, which may have exaggerated the reduction in productivity growth that we have seen.

On aggregate supply, one of the speakers cited OECD estimates which imply that falls in total factor productivity had been the main drag to UK potential GDP growth.(1) Such a negative supply shock was consistent with a worsening growth and inflation trade-off that was evident from persistent growth underperformance and inflation overshoots relative to Consensus forecasts. The key reasons cited for modest productivity growth were, first of all, fewer less productive companies going out of business, given relatively low interest rates, meaning that employees were not moving to more productive businesses; and second, insufficient business investment.

This characterisation of the United Kingdom was contrasted with the United States, where labour productivity had grown much more strongly. There was much discussion among participants about the nature of the supply shocks thought to have hit the UK and US economies, with a range of alternative views put forward. One participant suggested that tight credit conditions may have weighed on potential supply growth in the United Kingdom, which may therefore pick up as conditions ease. Labour supply growth in the United Kingdom, meanwhile, had held up. By contrast the United States had experienced a sharp fall in labour participation, such that overall supply growth in the United States looked less favourable than measures based on productivity.

Regarding inflation, one speaker expected wage inflation to creep upwards over the next year, given the trend in recent survey data. Another speaker was worried that the United Kingdom would hit 'speed limit' constraints as the output gap closed by mid-2014, so that interest rates might rise sooner than expected.

One speaker argued that structural policies were needed to tackle the productivity problem in the United Kingdom, with demand stimulus alone not being sufficient. Another speaker even thought that quantitative easing (QE) may have had a negative supply-side impact, since it distorted the allocation of capital. Unlike interest rate movements, it was argued that companies find the impact of QE difficult to understand and calibrate. The term structure of inflation expectations had shifted up, and companies perceived an uncertain real rate of return, so they favoured equity buybacks and accelerated dividend payments as opposed to capital spending. But participants differed in their views on this, since QE had driven equity prices and therefore 'Tobin's Q' higher, implying a greater incentive for capital investment; and QE had also prompted greater corporate debt issuance, likely in part to fund capital spending.

In summary, participants thought the current UK recovery was likely to be sustained, but predictions for growth over the coming year varied, and some thought the United Kingdom's sustainable growth rate was now in the range of 1.0%–1.5%. Participants differed in views on whether UK productivity growth had been as weak as reported in the official data, and there were more mixed opinions about the nature of the supply shocks in the UK and US economies.

(1) Inferred from calculations based on the OECD *Economic Outlook* projections for potential GDP, potential employment and productive capital stock.