Monetary Policy Roundtable

On 3 July 2014, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their twelfth 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:

- what impact might a reduction in the stock of assets held by the Asset Purchase Facility (APF) have on the UK economy? and
- how worried should the Monetary Policy Committee (MPC) be about the United Kingdom's current account deficit?

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 MPC or the CEPR.

What impact might a reduction in the stock of assets held by the APF have on the UK economy?

In the immediate aftermath of the financial crisis, the level of interest rates necessary to keep inflation close to the target and to maintain supply in line with demand fell sharply and became negative. Having already reduced Bank Rate to record low levels, the MPC began a programme of asset purchases ('quantitative easing', or 'QE') in order to support demand through the injection into the economy of central bank money. Between 2009 and 2012 the MPC purchased £375 billion of assets, primarily gilts, and since March 2013 has reinvested the cash flows associated with the maturing gilts held in the APF in order to maintain the stock at £375 billion.[3]

In due course, the stance of UK monetary policy will normalise. Over time this will involve both increases in Bank Rate and a reduction in the stock of assets held in the APF (the MPC provided some guidance as to the respective roles of these instruments in its May 2014 *Inflation Report*).[4] In this context, the first session of the Roundtable discussed participants' views regarding the impact that a future reduction in the stock of assets held by the APF might have on the UK economy.

Analysis by Bank staff estimates that the peak cumulative impact of the MPC's asset purchases on the level of real GDP may have been around 2.5%.[5] Participants noted that in addition to such estimates being uncertain, the impact of changes in the size of the APF are likely to depend crucially on conditions prevailing at the time, for example the degree of economic and financial stress both at home and abroad.

In order to gauge the impact of a reduction in the size of the APF, estimates based on past purchases might therefore provide a starting point. But simply assuming an equal and opposite impact was generally agreed to be far too simplistic. Many participants framed possible reasons why this may be the case in terms of the different channels through which asset purchases are thought to have affected the economy, including portfolio rebalancing, policy signalling, impacts on liquidity premia and changes in bank lending.

The portfolio balance channel refers to the mechanism whereby changes in the relative stocks of different assets available to be held by the private sector affect their relative prices. One speaker noted that this channel seemed to have been an important linkage between APF asset purchases and the UK real economy. But the strength of this channel will depend crucially on other factors affecting the balance of supply and demand in the gilt market. Another speaker emphasised the importance of institutional investors, whose appetite for gilts will depend, in ways that can be hard to predict, on a number of factors, including regulatory and legislative changes. Returns on gilts relative to other governments' debt, and so monetary policy in other countries, was also thought to be important for the impact of changes in

(1) This report was prepared by Maiting Zhuang of the International Directorate area of the Bank, together with Matt Roberts-Sklar and Matt Trott of the Monetary Analysis area.
(2) For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.
(3) The APF also had facilities for the purchase of private sector assets through the Commercial Paper Facility, the Corporate Bond Secondary Market Scheme and the Secured Commercial Paper Facilities. See www.bankofengland.co.uk/markets/Pages/apf/default.aspx.
(4) See page 41 of www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14may.pdf.
(5) See, for example, Joyce, M, Tong, M and Woods, R (2011), 'The United Kingdom's quantitative easing policy: design, operation and impact', *Bank of England Quarterly Bulletin*, Vol. 51, No. 3, pages 200–12, available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110301.pdf and Weale, M and Wieladek, T (2014), 'What are the macroeconomic effects of asset purchases?', *External MPC Unit Discussion Paper No. 42*, available at www.bankofengland.co.uk/research/Documents/externalmpcpapers/extmpcpaper0042.pdf.

the size of the APF. Several participants emphasised the impact of gilt issuance by the Debt Management Office (DMO), which was projected to remain high for several years, on the net demand for gilts. The Bank's intention to liaise with the DMO when deciding any programme of sales was reiterated in the May *Inflation Report*.

Another mechanism through which asset purchases were thought to have affected the real economy was by sending a signal about the future stance and potency of monetary policy. The first round of asset purchases in particular was thought to have had a larger impact in part because it demonstrated that policy stimulus could be provided even if Bank Rate was not cut further, and perhaps also because it signalled that Bank Rate would remain low for an extended period. Participants generally agreed that the signalling effect from any announcement of a reduction in the stock of assets would depend on MPC communications and, in particular, the nature of any prevailing policy guidance regarding Bank Rate. Several participants noted that over the periods that asset purchases had taken place, their ultimate total scale was unknown. By contrast, much more is now known about the extent to which the APF may reduce in size. The signalling impact of any given reduction in the APF might therefore be greater if it were taken to preface a programme of subsequent further reductions. On the other hand, the ultimate extent of the reduction being more clearly bounded than was the case for purchases may lessen signalling effects. One participant felt that the signalling channel could have a particularly large impact on the economy via the exchange rate, although there was a range of views on both the sign and magnitude of such an effect.

Some participants felt that the much improved functioning of financial markets since the period when assets were purchased meant that the impact of changing the size of the APF on liquidity premia could be smaller. Others, though, noted that an excessively rapid reduction in assets held could still lead to material effects through this channel. By contrast, it was noted that the effect on bank lending of reducing the stock of assets could be greater than it had been for purchases, given improvements in the capacity of the banking sector to lend since purchases took place. Increased demand by banks to hold gilts to help satisfy regulatory requirements was cited by one speaker as a potential factor affecting the strength of the bank lending channel.

A recurring theme throughout the session was that the effect, through all of the channels discussed above, of the APF reducing in size would depend crucially on MPC communications regarding this process. The box in the May 2014 *Inflation Report* on asset purchases and Bank Rate as the economy recovers was therefore welcomed. There was some discussion of the extent to which the impact of reductions in the size of the APF would start to take effect upon relevant announcements or only as these changes actually take place. Participants generally agreed that announcement effects could be important through the signalling and portfolio balance channels, as suggested by market moves in 2013 around the time of the US Federal Open Market Committee's communication on tapering its asset purchases. But the act of reducing the stock could matter more for the liquidity premia channel.

Some participants thought that MPC communications relating to a reduction in the size of the APF could be complicated by the fact that, under plausible assumptions, HM Treasury may in the future need to transfer sizable sums to the APF. In November 2012, HM Treasury announced arrangements to transfer gilt coupon payments received by the APF, net of interest costs and other expenses, to the Exchequer. As has been flagged previously,[1] the Treasury's indemnification of the APF means that a proportion of these flows may well need to flow in the other direction as assets in the APF mature or are sold. While not a macroeconomic risk, participants felt that this would need to be explained clearly if it were not to confuse broader communications on policy normalisation.

In summary, there was general agreement that the impact of reductions in the stock of assets was uncertain and would probably differ from the past impact of comparable purchases. While the MPC's communication to date on the principles of normalising policy was welcomed, participants emphasised the need for further careful communication ahead of reducing the stock of assets.

How worried should the MPC be about the United Kingdom's current account deficit?

The United Kingdom's current account deficit reached a record level of 5.9% of nominal GDP in 2013 Q3, and remains large by historical standards. Unlike previous episodes in which a sizable current account deficit has opened up, the deterioration since 2011 has not reflected an increasing trade deficit but rather a marked reduction in net investment income from abroad. Yet despite repeated deficits, the value of foreign assets held by UK residents relative to the claims of foreigners on domestic assets — the United Kingdom's net international investment position (NIIP) — has changed very little. In the second session of the Roundtable participants discussed some of the potential causes of the current account deficit and whether it should be seen as a cause for concern about the UK economy in general and for the Monetary Policy Committee in particular.

Attendees noted that a current account deficit may be worrisome if it were considered symptomatic of persistent

(1) See, for example, the speech by Spencer Dale, available at www.bankofengland.co.uk/publications/Documents/speeches/2012/speech622.pdf.

imbalances in an economy. In some extreme cases, the current account balance could be forced to close sharply through a reduction in capital inflows and a pronounced depreciation of the currency. Marked movements in the exchange rate could have important impacts on the outlook for inflation.

Some attendees looked to historical precedent to help assess the implications of the deficit. One speaker felt that while deficits of a similar size may have been associated with sterling crises in past decades, this seemed unlikely to be repeated given the subsequent deepening of financial markets and the establishment of a credible inflation-targeting regime in the United Kingdom. Another noted that while there is some evidence that current account deficits in emerging market economies tend to precede a period over which the associated currencies depreciate, such a relationship appears absent for advanced economies.

There was a broad consensus that in order to assess the risks posed by a current account deficit, it is insufficient to focus exclusively on its size. It is also important to consider its composition, its counterparts in the financial balances of sectors of the domestic economy and the stock of net foreign assets (the NIIP).

In terms of the composition of the deficit, some saw the absence of a deterioration in the trade balance as a source of comfort. One participant contended that, after abstracting from idiosyncratic factors, the United Kingdom's trade balance had evolved broadly as one would have expected following the sharp depreciation of sterling in 2007–08. Another speaker noted that the recent deterioration in net investment income could reflect the United Kingdom's cyclical position relative to its main trading partners, for example through a reduction in returns on investment projects in the euro area relative to those in the United Kingdom. In this case, a recovery in the euro-area economy would help to improve the United Kingdom's current account balance.

The counterparts to the current account — a country's external financial balance — are the net financial balances of sectors within the domestic economy. For one speaker, a current account deficit may be less worrying if its counterpart is a financial deficit in the corporate sector, as this is likely to be associated with investment and so a future stream of income. Conversely, a deficit in the household sector might signal greater cause for concern. This speaker claimed that the United Kingdom's present current account deficit corresponds to a deficit in the public sector. They inferred that while no pronounced shift in private sector behaviour was obviously required to close the deficit, its persistence would be a function of fiscal policy.

The United Kingdom's estimated net external asset position has remained broadly in balance even as the current account has deteriorated, in part reflecting capital gains on the United Kingdom's foreign assets.(1) The apparent resilience of the United Kingdom's NIIP, and so a healthy external 'stock' position, reduced the likelihood many participants foresaw of the current account deficit posing serious difficulties in the near term. However, measuring and interpreting a country's external debt position is difficult: the NIIP can be affected by revaluation effects, exchange rate moves and companies changing the country in which they are domiciled.

It was nonetheless thought important to monitor developments in the current account carefully. One risk was that the net income position would not improve along with the euro-area economy. More generally, persistent external imbalances could indicate chronic distortions in the domestic economy, such as resource misallocation between the tradable and non-tradable sectors, which monetary policy makers would need to take a view on when deciding on their policy stance.

Overall, there was a broad consensus among participants that the United Kingdom's current account deficit is unlikely to be the primary cause of a large depreciation of sterling in the near future, although it might limit the extent to which the appreciation of sterling over the past year or so will continue. In addition to the points noted above, one speaker argued that although the United Kingdom is highly leveraged in the sense of having a large external balance sheet relative to GDP, this primarily reflects London's position as a global financial centre: they did not think the United Kingdom in aggregate was using this leverage to fund excessively risky investments and nor did they feel it was associated with a worrying maturity mismatch between assets and liabilities.

(1) Bank estimates suggest the NIIP might in fact be positive (May 2014 *Inflation Report*, page 22, available at www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14may.pdf).