



BANK OF ENGLAND

# Speech

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## **Prospects for the British Economy after the Financial Storm**

Speech given by

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At the Royal Holloway, University of London

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I would like to thank Michael Hume and Abi Hughes for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

I am delighted to have this opportunity to speak here at Royal Holloway this evening. My association with Royal Holloway goes back over a decade to 1998, when I joined British Airways as their Chief Economist and worked at their Waterside headquarters just a few miles away. It was then that the Economics Department here, which had been established only a few years before in 1995, invited me to be join them as a Visiting Professor. Since the late 1990s, the Department of Economics here at Royal Holloway has gone from strength to strength, establishing itself among the Top 10 Economics Departments in the UK in terms of research rankings. And I was very honoured last year when my association with Royal Holloway was acknowledged with the award of an Honorary Doctor of Science degree.

The economic volatility we have seen over the last eighteen months would have been familiar to Thomas Holloway, the nineteenth century founder of this college. As I have argued before, a recession driven by a major financial crisis has closer parallels with the economic fluctuations seen in the nineteenth and early twentieth centuries than with our more recent postwar inflationary boom-bust economic cycles.<sup>1</sup>

Fortunately, over the last six months, the financial storm which swept around the world just over a year ago has abated to a large degree. A wide range of indicators point to improving conditions in financial markets – including rising equity markets, falling interbank market interest rates, improving funding conditions for banks and increasing corporate bond issuance. But just like a hurricane in the physical world, the financial storm has left a great deal of damage in its wake. It has caused banks to become much more cautious about lending, limiting the access of smaller firms and some households to finance and making the terms and conditions attached to new borrowing much less favourable. And it has created a global recession which has affected every major economy around the world, and from which it will take many years to recover fully.

Today, I want to discuss the prospects for Britain's economic recovery in the wake of the financial storm – and some of the factors which are likely to shape its course. It is encouraging that we have seen a number of positive indicators for short-term

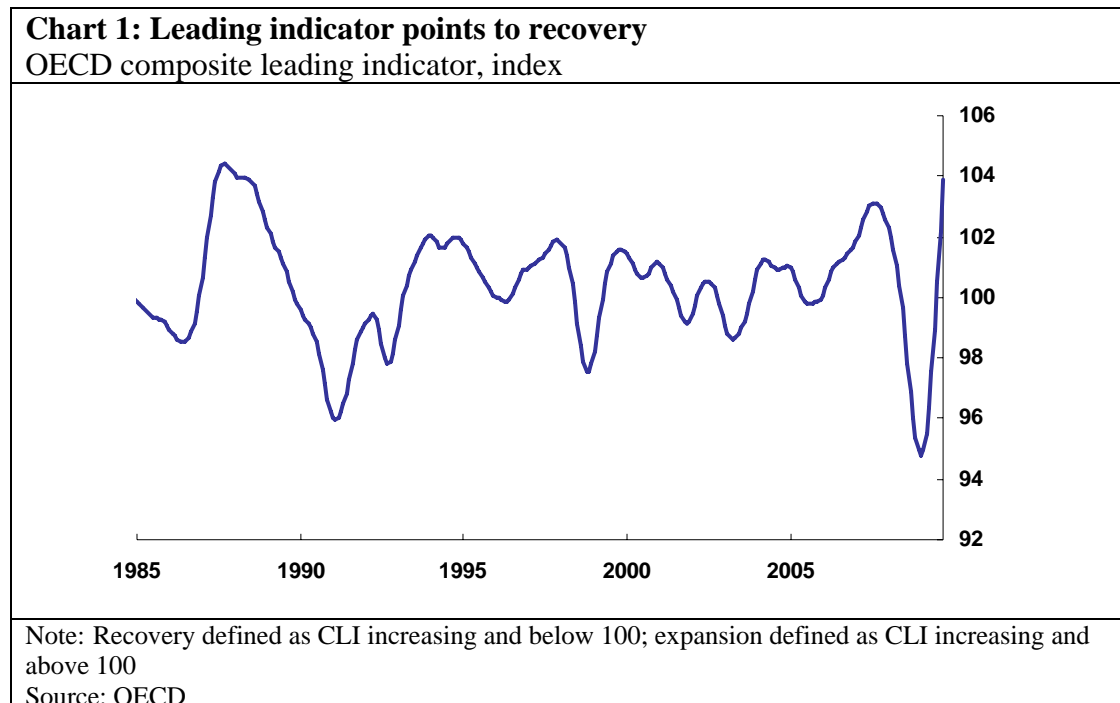
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<sup>1</sup> See Sentance (2008) and Sentance (2009b).

growth prospects over the last few months and I will start by reviewing these. But there are still major uncertainties – at home and abroad – which will affect the way in which the recovery might develop over the next few years. I will discuss these issues before concluding with some observations about the policy choices that we will need to make as the recovery develops.

### Signs of recovery

A few weeks ago, the Office for National Statistics surprised the financial markets and many economic commentators by announcing that their initial estimate of UK Gross Domestic Product (GDP) in the third quarter fell by 0.4%, in contrast to the rise most forecasters were expecting. This news came as a shock because most of the other economic indicators we have seen in recent months have been pointing in a positive direction. This surprise fall in GDP was seen as a setback to recovery hopes – despite the fact that these initial estimates are frequently revised and can be particularly unreliable close to turning points in the cycle.



A very different view of the world is, however, shown by the latest set of economic leading indicators published by the Organisation for Economic Co-operation and Development (OECD). These indicators draw on a wide range of survey and other

data which tend to be correlated with future industrial growth in major economies. As Chart 1 shows, the OECD's UK leading indicator has bounced back very sharply and has been pointing to a resumption of growth since the first half of this year. Indeed, this indicator of recovery has picked up more strongly than after the previous recession in the early-1990s.

It might be argued that this leading indicator is forward-looking, which contrasts with the GDP figures which look back to the past quarter. However, the more positive picture portrayed by the OECD's leading indicator does appear to be supported by a wider body of evidence which suggests the UK economy has moved onto a recovery track and growth has resumed in the second half of this year.

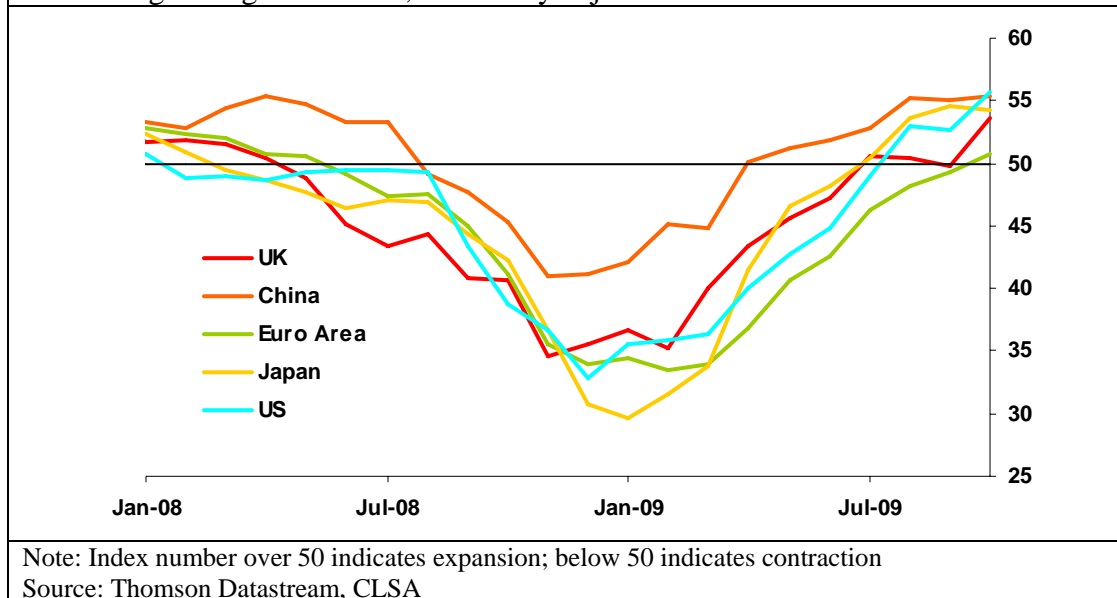
There are four main elements supporting this view that the UK economy is now moving out of recession and into the recovery phase of the cycle. The first element is the signs of a return to growth which are evident across the global economy. As a major trading nation, economic conditions here in the UK are strongly influenced by the performance of other parts of the world economy. Just as big negative international shocks pushed us into deep recession a year or so ago, so a broader global recovery is likely to help lift us out of the recent downturn.

According to the latest economic growth estimates, the UK's largest export markets – the euro area and the United States – returned to economic growth in the third quarter. An even stronger impetus to growth in the global economy is coming from Asia, where China and most other major economies have bounced back strongly in the second and third quarters of this year. As Chart 2 shows, this global turnaround is reflected in surveys of manufacturing activity around the world, which are showing a return to growth in all the major economies and regions of the world after a downturn which reached a trough earlier this year.<sup>2</sup>

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<sup>2</sup> Chart 2 is based on surveys of Purchasing Managers conducted around the world, which provide a timely barometer of economic activity. An index number over 50 indicates growth in activity whereas a figure of below 50 points to contraction.

**Chart 2: Global manufacturing activity**  
Purchasing managers' indices, seasonally adjusted



A second element of the more positive growth picture is the improvement shown by a wide range of business surveys here in the UK. I am a close follower of the CBI's surveys, partly because I am well acquainted with them from my earlier career at the CBI and also because they have the longest track record – which can help us calibrate the recovery from the recent downturn against previous experience. In this respect, the CBI's Industrial Trends Survey is particularly useful as it has been running since 1958 and has tracked every major postwar recession.

**Chart 3: Business confidence in UK recessions**  
Percentage balance of firms

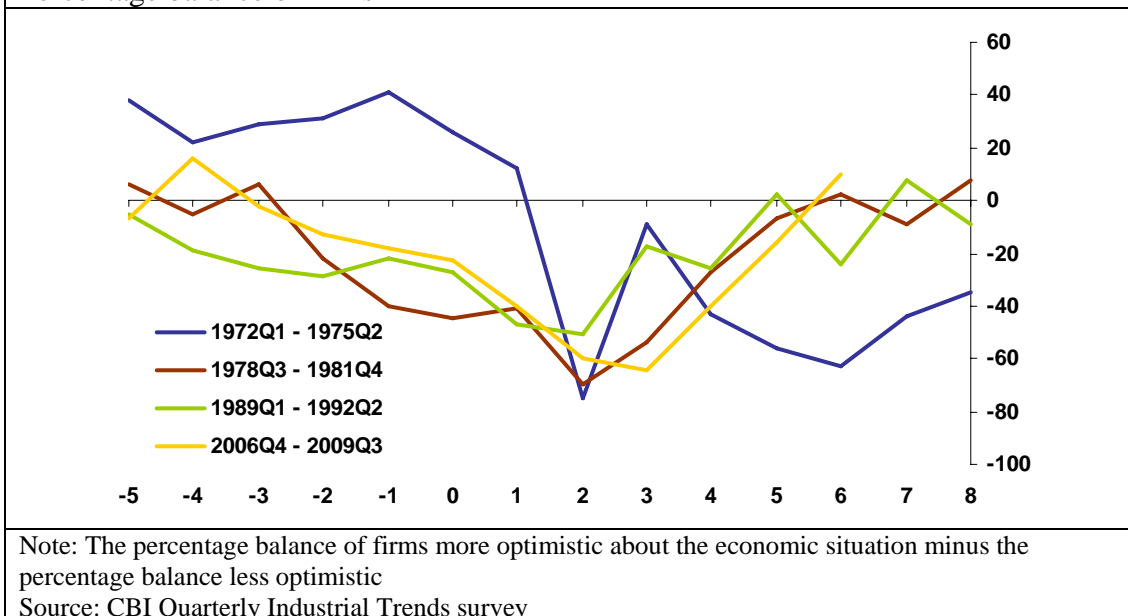
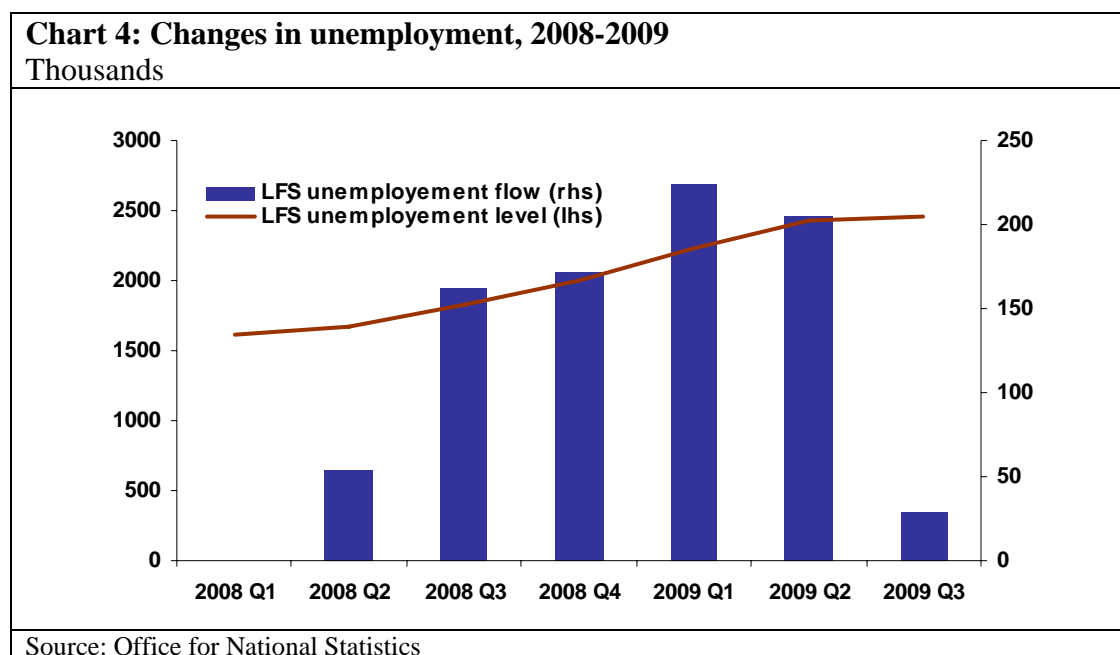


Chart 3 shows that the responses from the latest CBI Industrial Trends Survey in October are actually more positive than at the equivalent stage of the cycle in the previous three recessions – with a positive balance of respondents reporting an increase in confidence compared with negative balances in earlier recessions. Other responses from the survey show a similar picture – notably investment intentions and stock levels.<sup>3</sup>

A third area where we are seeing a number of more positive signs is in indicators of consumer spending and confidence. The CBI's Distributive Trades Survey signalled a return to growth in the retail sector in September and registered a further improvement last month. This was confirmed by the British Retail Consortium's sales monitor for October which showed the strongest October retail sales growth for seven years. The improvement in measures of consumer confidence, and the increased willingness of households to make major purchases – including cars and houses – are also consistent with the same picture.



The final area where we can see positive evidence of UK growth emerging is in the labour market data. The sharp increases in unemployment recorded in late 2008 and earlier this year have eased dramatically in recent months, as Chart 4 shows. The rise

<sup>3</sup> In a speech earlier this year, Sentance (2009a), I argued that the business confidence, investment and stock balances were particularly important indicators in recessions and recovery periods.

in unemployment in the most recent quarter – from July to September this year – was just 30,000, compared with a rise of 200,000 in the previous quarter. Instead of increasing inexorably towards three million, unemployment appears to be levelling off at around two and a half million. The latest official figures also suggest that employment rose in the third quarter, which is consistent with a wide range of survey indicators which are also pointing to an improvement in employment prospects. This employment picture is particularly hard to reconcile with the GDP figures, as in previous recessions unemployment has continued to rise significantly for a while even when recovery is underway.<sup>4</sup>

However, though we have seen a wide range of signs of recovery in the UK economy in recent months, we are still in the very early stages of a resumption of growth. Not all businesses will be seeing an improvement in trading conditions and some may still be experiencing declines in demand and activity. So it is not surprising that business organisations report that the recovery in confidence and the pick up in demand and activity is very fragile. That has also been my experience in talking to business executives, in groups and individually, around the country over the last couple of months. And it is not unusual at these very early stages of recovery.

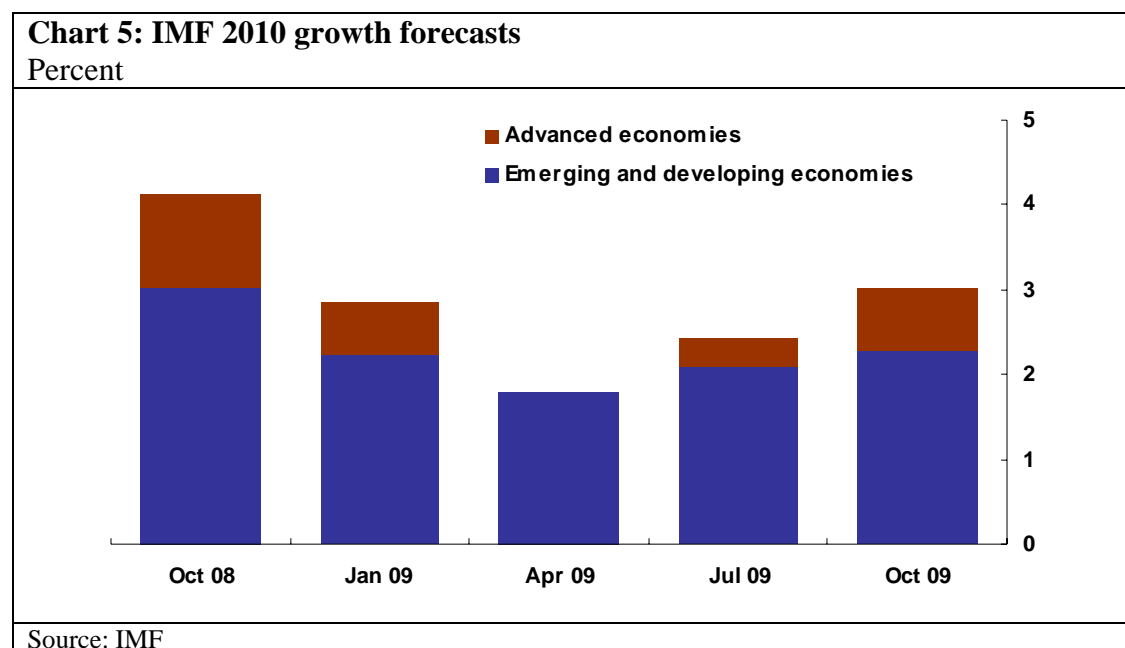
In previous recoveries we have seen this nervousness fading and confidence building as growth proceeds and memories of recession become more distant. But overlaid on this natural nervousness about the early phase of recovery are more fundamental concerns about the impact of the financial crisis and recession on the economy, both at home and abroad. I would like to move on to discuss these under two broad headings – uncertainties surrounding the pace of global recovery, and the potential impact of the rebalancing of demand which needs to take place within the UK over the years ahead.

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<sup>4</sup> In the 1980s, unemployment continued to rise until 1986, about five years into the recovery. In the early 1990s, the peak in unemployment was in mid-1993, about eighteen months after the economy had begun to recover.

## Global economic prospects

As I mentioned earlier, the UK has strong trade and investment links with the rest of the world. So a key issue for our economic prospects is the pace of global economic recovery. Over the last six months, as evidence of a global economic recovery has accumulated, projections of growth in the world economy next year have been revised upwards quite significantly, as Chart 5 shows in relation to the forecasts produced by the International Monetary Fund (IMF).



The IMF is also quite positive about medium-term growth prospects. Its projections for average growth in the five calendar years 2010-14 is 4.2% per annum. This is less strong growth than the period immediately preceding the current recession, when world economic growth averaged close to 5% per annum in the mid-2000s.<sup>5</sup> But that was a period of exceptionally strong global economic activity. If we compare the IMF's latest projection with the mid-1990s recovery, it is nearly one percentage point stronger in terms of the projected annual growth rate.<sup>6</sup>

<sup>5</sup> See the IMF World Economic Outlook, October 2009. Average world economic growth in the four years 2004 to 2007 averaged 4.9%, driven particularly strongly by growth in emerging markets and developing economies.

<sup>6</sup> World economic growth averaged 3.3% across the calendar years 1993 to 1997.



A key feature highlighted by Chart 5 is the dependence of world growth next year on emerging market and developing economies, particularly in Asia. In the short term, this is not an unreasonable projection. The most significant emerging market economies – such as China and India – were less directly affected by the financial crisis and they have not experienced the same problems in their banking systems as the economies of North America and Europe. Rather, they were indirect casualties of the confidence shock which is now unwinding. Asian governments have also built up strong public finances over the last decade – which has put them in a good position to use fiscal policies to support demand, with China leading the way.

There are good grounds for expecting this stronger performance from emerging market and developing economies to be sustained as the upswing continues. Many Asian and other emerging market economies have very strong supply-side fundamentals which are supportive of healthy medium-term growth prospects – large supplies of labour, flexible economies and considerable potential to catch up with productivity levels in richer countries. There have also been signs in the current recovery that the strong pick-up in China and other Asian economies has been driven by their own internal demand, in contrast to the export-driven growth experienced in the mid-2000s. With Asia home to around half of the world's population, consumer and investment spending from this region clearly has the potential to become a strong engine of global demand.

Clearly, we cannot expect Asia and other emerging markets to shoulder the whole burden of global recovery. As we move through next year and into 2011 and beyond, we should expect to see world economic growth become more balanced – with the advanced economies in the United States and Europe making a stronger contribution, as they escape the drag created by the financial crisis and banking systems begin to recover. However, that raises the prospect of another risk associated with the global recovery. The last time the major economies of the world were growing in such a synchronised way – in the mid-2000s – we saw strong upward pressure on world energy and commodity prices, leading to the surge in inflation we saw last year. As I argued in a speech a couple of months ago<sup>7</sup>, a re-emergence of these upward price

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<sup>7</sup> Sentance (2009c)

pressures is also a risk associated with global recovery – particularly if the policy stimulus injected across the global economy produces a strong and synchronised rebound in growth. The fact that the oil price has stabilised at a historically high level of \$75/barrel in a weak global economy must give rise to concern about further upside risks to oil prices.

There are clearly downside risks to the global economic outlook too, including the potential impact of policy stimulus being withdrawn too quickly and longer-lasting impacts from the financial crisis. However, the current competitive level of the pound, particularly against the euro, does provide us with some potential additional support to external demand in this scenario – as it did in the mid-1990s. We see this reflected in the responses from the October CBI Industrial Trends Survey, which recorded the strongest confidence in export prospects for the year ahead registered by the survey since 1995.

### Domestic rebalancing

Alongside the uncertainties surrounding the global economic outlook, there is also the potential impact of a period of rebalancing which needs to take place in the UK economy over the recovery. However, to set this issue in context, it helps to take a historical perspective on the way in which financial balances have moved in our economy over previous economic cycles.

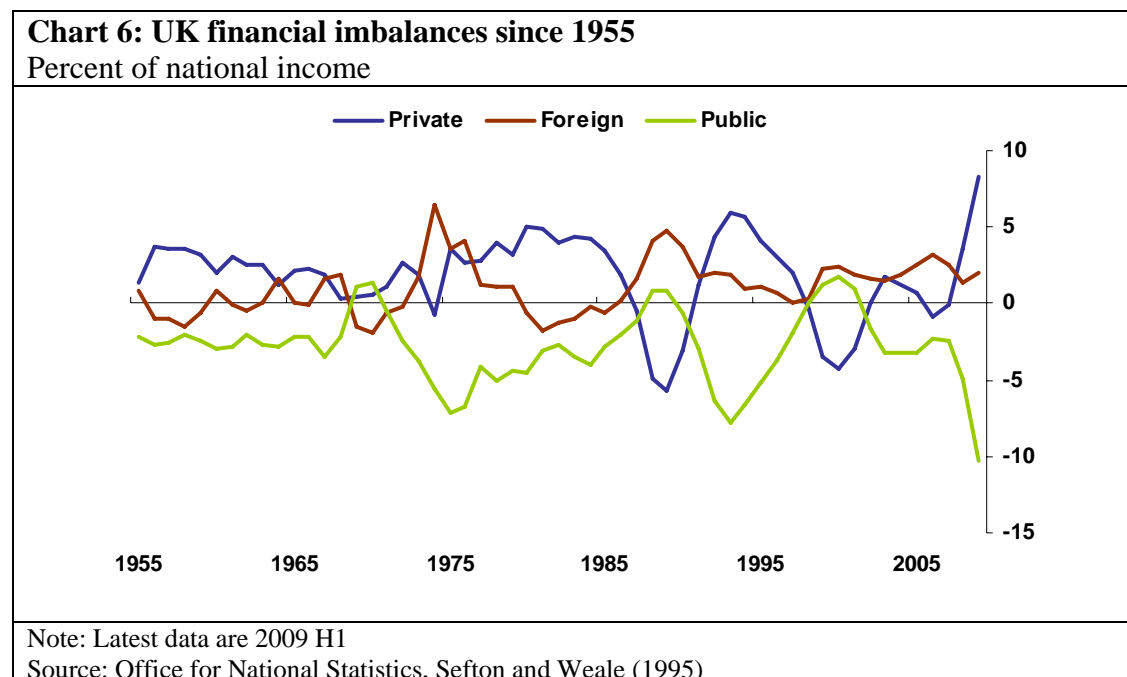
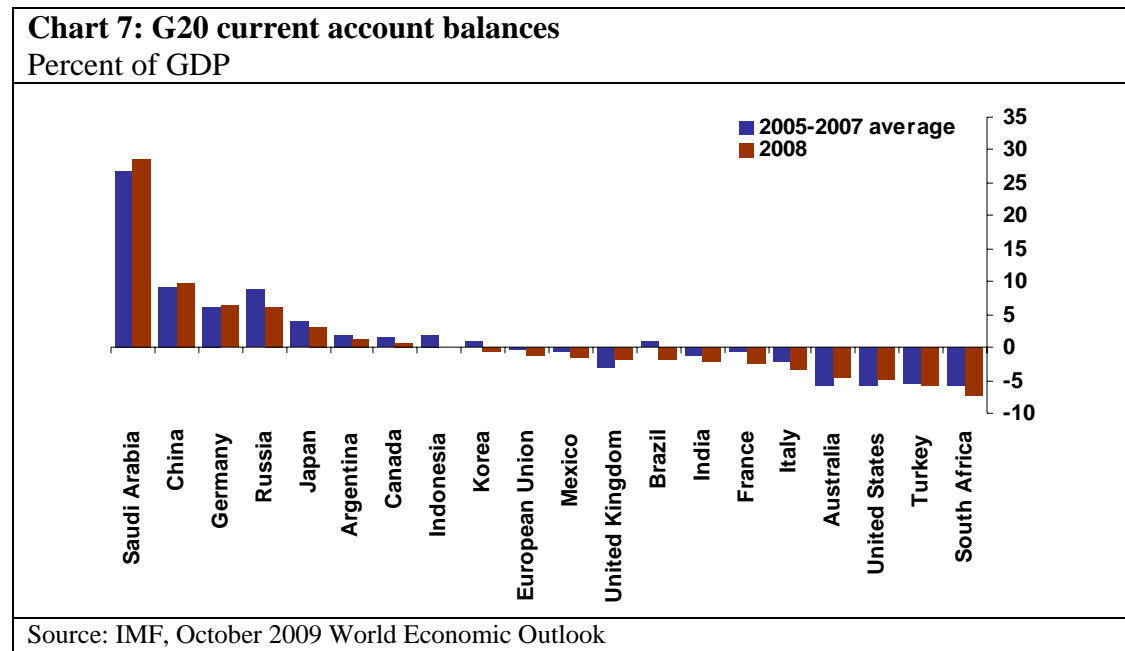


Chart 6 shows the main financial balances in the UK economy in the period since 1955. These financial balances reflect differences between income and expenditure in the public sector and the private sector, alongside their combined impact on the financial imbalance with the rest of the world. A deficit on the current account of the balance of payments means that the rest of the world has a surplus with the UK and is shown as a positive foreign balance in this chart. These financial balances also give rise to flows of finance, which are needed to plug the gap between income and spending. So when the public sector is in deficit, as it is now, there needs to be a flow of finance to meet the government's borrowing requirement. And if the country as a whole is in deficit, there needs to be a flow of finance from the rest of the world to support the higher level of spending relative to income.

Chart 6 shows that though there has been some movement in the foreign balance that has not been the major source of fluctuations in these financial balances in the UK economy. Swings in the external balance have been dwarfed by major shifts in the financial balances between the public and private sectors. These have often taken place in periods of either strong growth or recessions, as we are seeing now. The public sector plays an important stabilising role by maintaining its spending in recessions when tax revenues fall sharply, which can result in high levels of public borrowing. At the same time, cutbacks in private spending during the recession mean that this public sector deficit is normally matched by a private sector surplus.

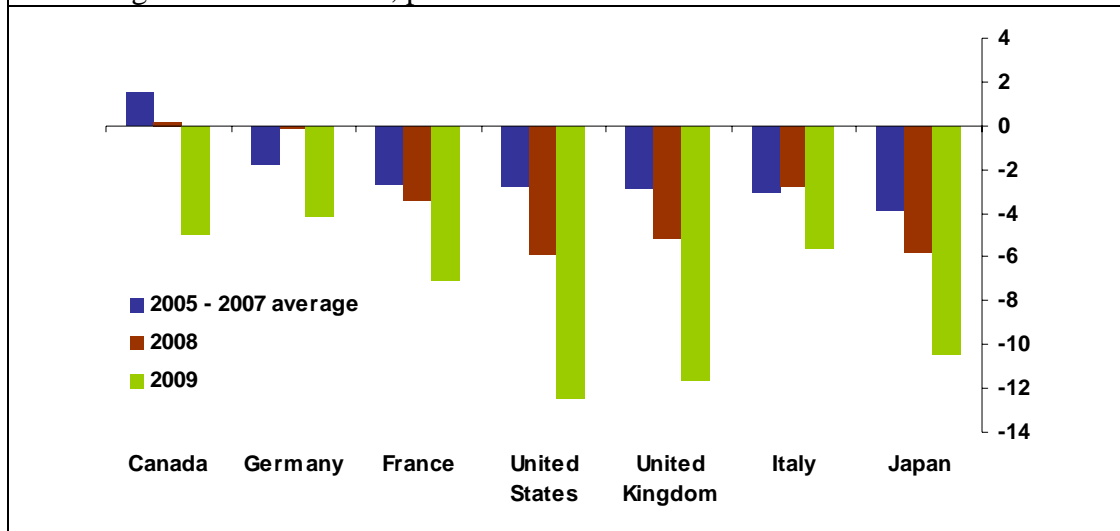
As Chart 6 shows, this is very much the pattern we have seen recently, and it is very similar to the large public sector deficit which emerged in the early 1990s recession. By contrast, though the UK does have a deficit with the rest of world on the current account of the balance of payments, this is relatively modest, averaging just over 2% of GDP in the last twelve months, down from a peak of just over 3% in 2006.



A comparison with other major economies points to the same broad conclusion – that the main rebalancing challenge for the UK economy as it emerges from recession is between the public and private sectors rather than the external balance. Chart 7 shows the current account positions of the G20 economies – measuring their external surpluses and deficits with the rest of the world in relation to GDP. In the period 2005-7 before the financial crisis, there were some large deficit countries – including the US – and the counterpart of these deficits were large surpluses in some emerging market and developing economies – notably China and oil producing economies. Some of these balances began to adjust as the financial crisis took hold in 2008. But whether we look at 2005-7 or 2008, the UK does not stand out as a country with a major external imbalance. And the significant fall in sterling that we have seen over the last two years will work – over a period of time – to erode the external deficit that we do have.

**Chart 8: Public sector balances in major economies**

General government balance, percent of GDP

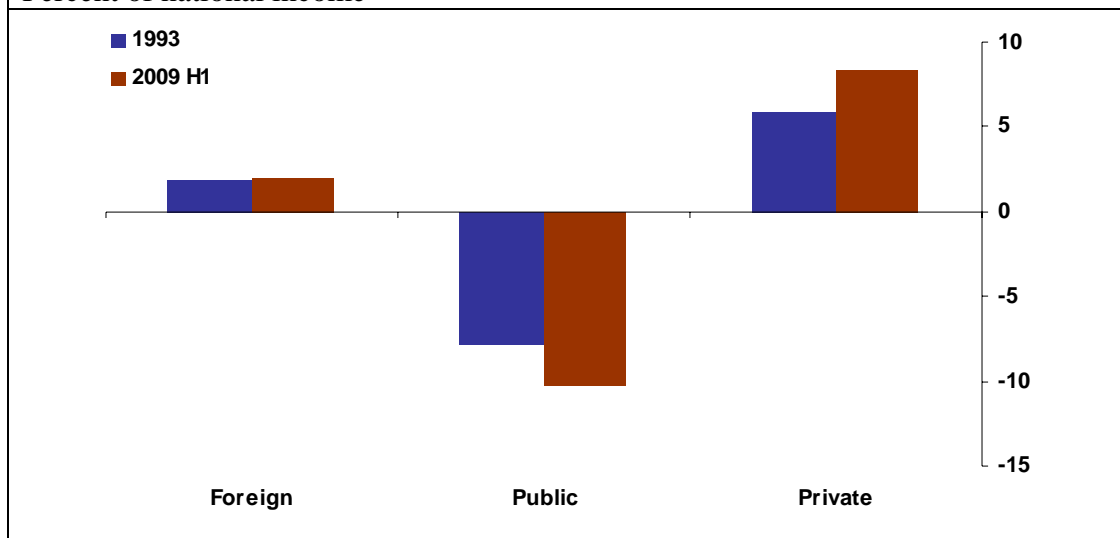


Source: IMF, October 2009 World Economic Outlook

However, the UK does stand out as one of the major economies with the largest public sector deficits of the major economies – as Chart 8 shows. In terms of its fiscal deficit, the UK is one of three G7 economies which are expected to have deficits of around 10% of GDP or more this year. We may regard ourselves in not so bad company, as the other two economies with large fiscal deficits are the United States and Japan – the two largest economies in the world. But that does not take away the fact that cutting the government deficit will be a major challenge for the British economy as we move through the coming recovery phase of the economic cycle.

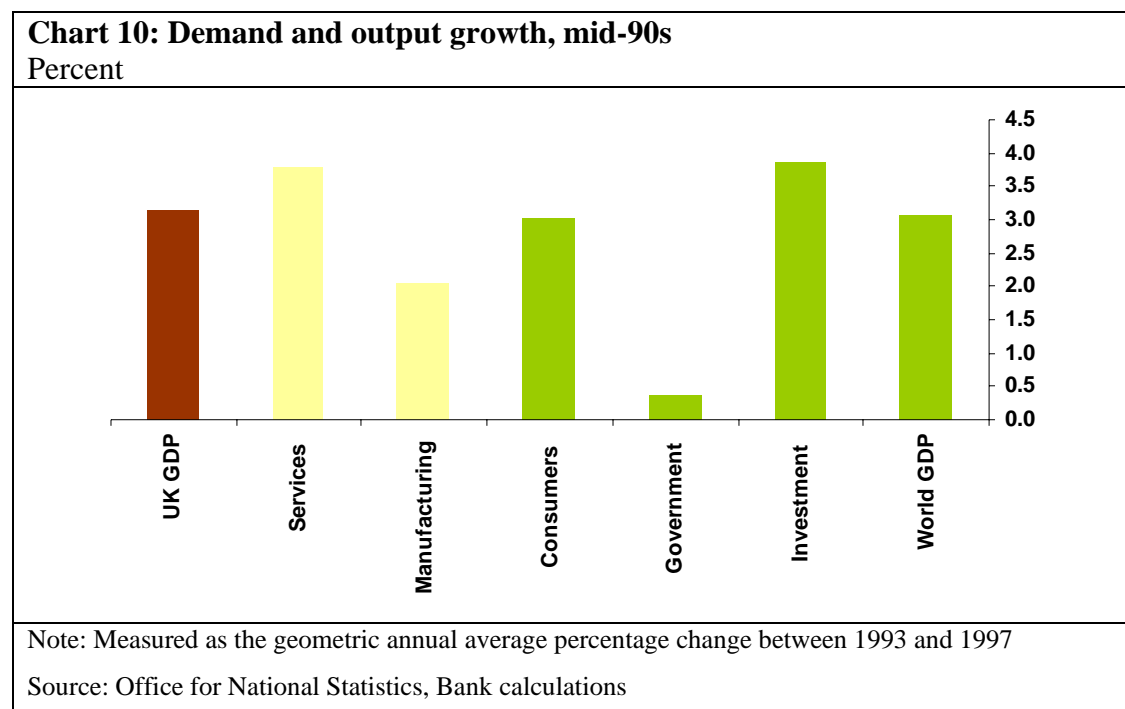
**Chart 9: Key UK imbalances, 2009 H1 and 1993**

Percent of national income



Source: Office for National Statistics

But as I noted earlier, this problem of an imbalance between the public and private sectors was also a legacy of the previous recession in the early 1990s. Indeed, Chart 9 shows that as we move into recovery, our starting point – in terms of the key financial balances in the economy – looks remarkably similar to the position in 1993, the peak year for government borrowing after the early 1990s recession. This deficit was successfully closed by a series of budgets which raised taxes and restrained public expenditure, so that by the late 1990s, the budget deficit had been largely eliminated.<sup>8</sup>



As Chart 10 shows, this process of rebalancing in the mid-1990s was accompanied by reasonably healthy GDP growth of over 3% a year, with unemployment gradually falling. Both manufacturing output and services benefited from the recovery. Manufacturing industry and tradeable service sectors were helped by the competitiveness of the pound, as is the case now – though interestingly services output still grew more rapidly than manufacturing. The main differences on the demand side of the economy were between the growth of public and private spending. Both household consumption and investment grew reasonably healthily, whereas government spending barely rose at all in real terms. So both the competitive pound

<sup>8</sup> The public sector deficit peaked at 7.8% of national income in 1993 before falling to 2% of national income in 1997 and registering a small surplus in 1998.

and a recovery in domestic private spending supported economic growth while the public sector deficit was reduced.

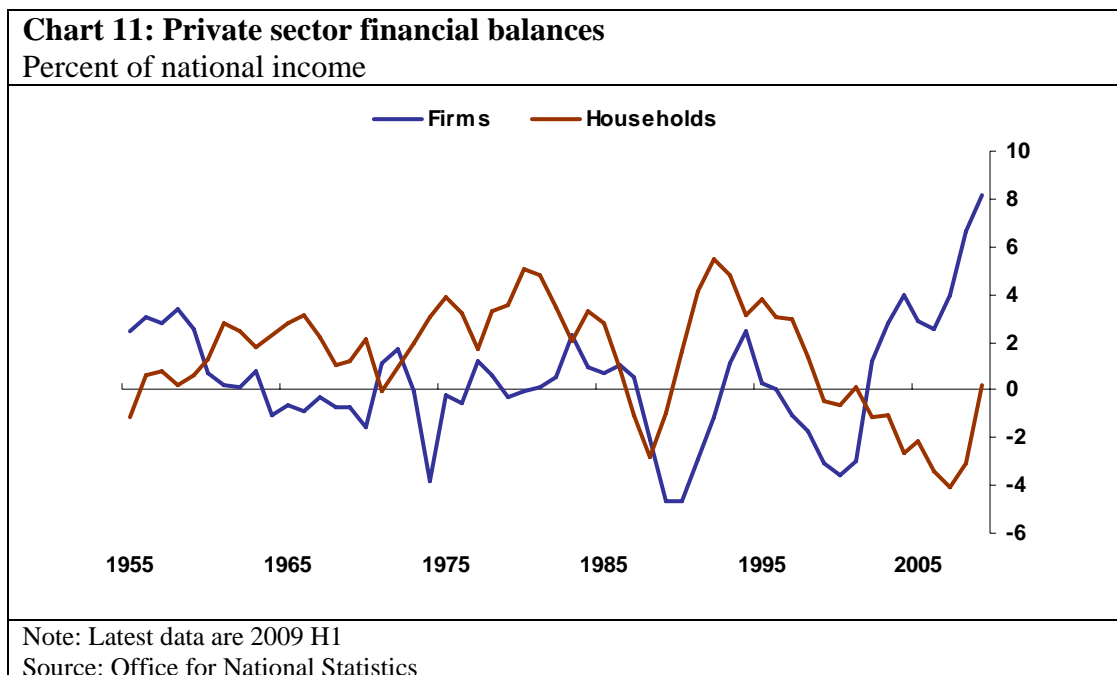
As we move into this recovery, we once again have the benefit of a competitive pound to support exporters and underpin a manufacturing recovery. But in terms of private sector spending, there are potential headwinds which were not present in the mid-1990s.

The first is the legacy of the financial crisis. As I noted at the beginning of the speech, that has left the major UK banks in a position where they are being more cautious about lending and also tightening the terms and conditions under which loans are provided. There is also a danger that this caution will be exaggerated by the pressures they are under to repair their balance sheets, and that private sector spending will be constrained in the upswing as a result.<sup>9</sup>

It is quite clear, from all the evidence that the MPC has received as the financial crisis has unfolded, that the terms and conditions under which banks supply lending – particularly to smaller firms – have been tightened considerably. But at the same time, Bank Rate has fallen sharply and the margin between Bank rate and the LIBOR rates on which many banks are now basing their lending terms has narrowed significantly over the last six months. Indeed, LIBOR spreads are now back to close to their pre-crisis levels. But whatever the size of the effect, it is quite likely that there will be some inhibition to the growth of private spending from the adjustment in the banking sector, as the economy moves into its recovery, and a key issue for the MPC is to calibrate the size of this effect and ensure we continue to take it into account in our assessment of the monetary stance.

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<sup>9</sup> It may also be the case that the financial crisis has left the public finances in a structurally weaker position than in the early 1990s. Buoyant financial sector activity had been an important source of government tax revenues in the 2000s and making up for this shortfall in tax receipts over coming years may be a further headwind relative to the early 1990s.



The second difference between the current position and the early 1990s is the pattern of imbalances in the private sector. As Chart 11 shows, the household sector actually moved significantly into deficit in the mid-2000s in a not dissimilar way to the late 1980s. The UK was one of a number of countries in which household spending was supported by the global credit boom, which emerged in the 2000s, including the United States.<sup>10</sup> With the bursting of the credit bubble, household finances are now adjusting.

Chart 11 shows that the household sector has already adjusted its position back to broad balance in the first half of this year and this adjustment may have further to run. In the wake of previous recessions, the household sector has built its financial balance back to between 3-5% of national income, before starting to increase spending relative to income once again. This raises the question of whether we should expect households to continue to restrict spending relative to income over the recovery as they rebuild their balance sheets, holding back the growth of consumer spending.

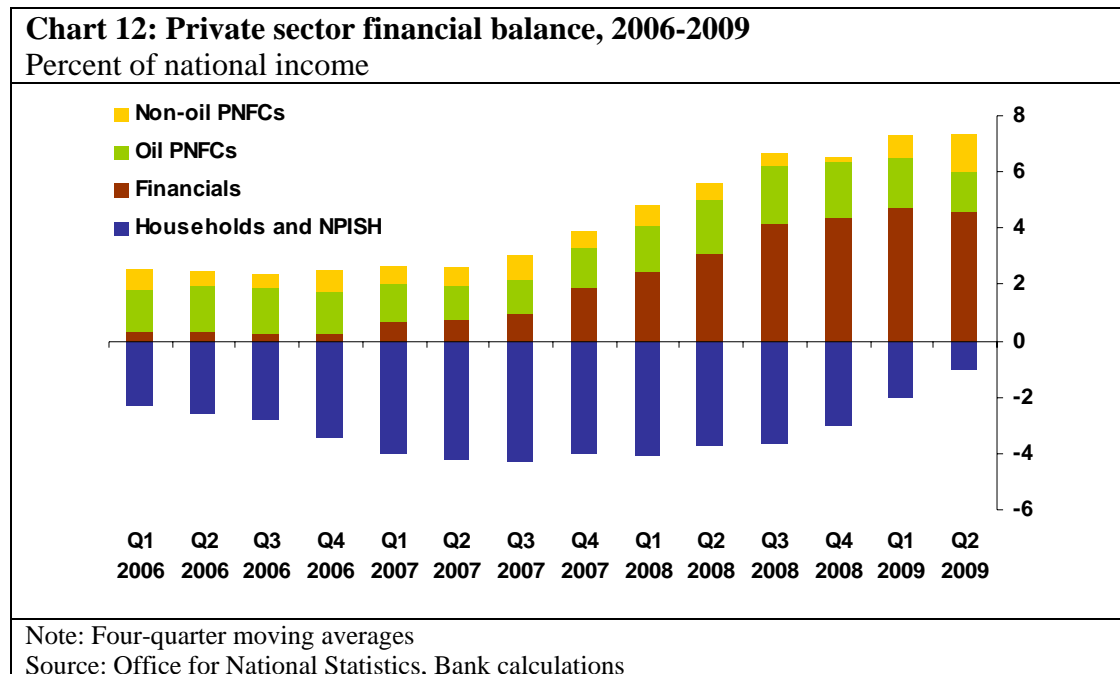
There are arguments for and against expecting such a further adjustment in household spending. In favour is the prospect of fiscal consolidation. If tax increases and/or spending cuts are on the way, those uncertainties must surely add to uncertainty and

<sup>10</sup> See Hume and Sentance (2009) for a fuller analysis of the global credit boom of 1990s and 2000s.



act as a dampener on private sector spending. On the other hand, we have record low interest rates, reducing the servicing costs of existing debts for many households. And the latest evidence from the labour market suggests that unemployment is no longer rising so sharply – reducing concerns about job uncertainty. It is also unclear how households will react to recent asset price movements – with house prices and equity prices both down on their cyclical peaks, but now recovering from the low points about six months ago.

The second feature of the private sector's financial position shown by Chart 11 is the large surpluses currently being run by the corporate sector in the UK economy at present. This is partly because UK firms were running surpluses before the recession – because profitability was healthy and these profits had not been used to support a large increase in business investment. In this respect, the corporate sector financial position through the recession has been much healthier than in the early 1990s, and this may help account for the greater resilience which firms have shown in seeking to maintain employment levels in the face of a sharp downturn in demand.



As we have moved through the financial crisis, the main factor pushing up the surplus of the UK corporate sector has been the behaviour of financial institutions, as Chart 12 shows. The efforts made by banks to widen margins and conserve cash underpin

these surpluses, which are being generated to offset past losses. These surpluses are also being reinforced by foreign-owned banks retaining funds in the UK to strengthen balance sheets rather than remitting profits back to their parent companies.

The way in which these corporate sector financial balances shift as we move into recovery will be a key issue affecting the strength of private sector demand. A benign scenario is one where the corporate sector financial surplus begins to decline, as the banking sector recovers and temporary measures taken by companies in the recession to conserve cash – including de-stocking and investment cutbacks – begin to unwind. An unwinding of this corporate sector financial balance could offset further retrenchment by households and support private sector spending through the recovery.

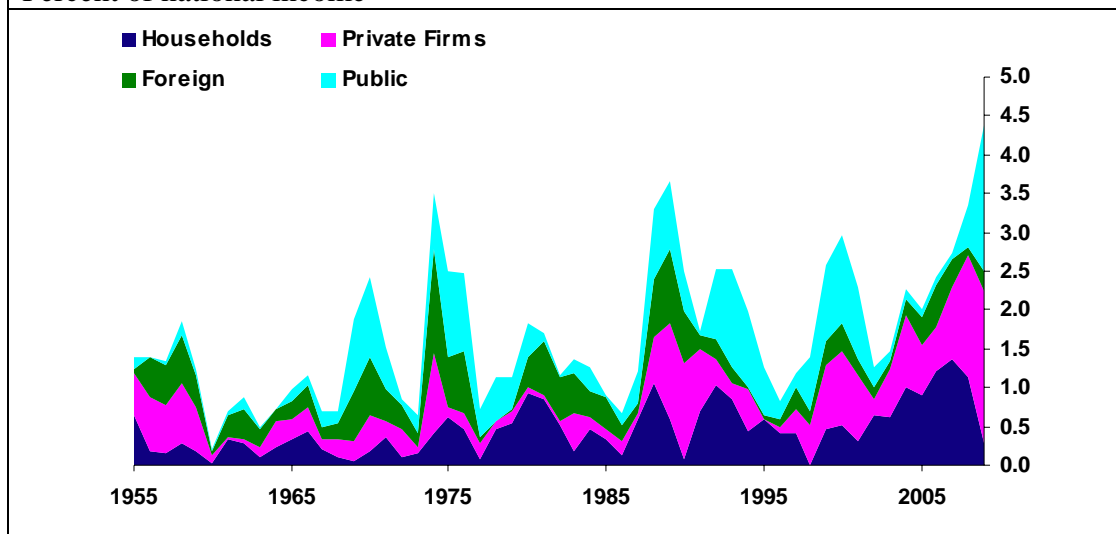
A less benign scenario would be one where the corporate surplus is sustained at a high level over the recovery and the household sector retrenches further. Which of these scenarios unfolds over the recovery will have an important bearing on the conduct of monetary policy, through its impact on the ability of the private sector to offset a lower contribution to demand from the public sector.

### **UK economic outlook and policy implications**

What are the implications of this overview for UK economic prospects? I have argued that the short-term economic news has been generally very positive at home and abroad and points to the beginnings of economic recovery. We should see that confirmed by the GDP figures in due course, and for that reason I would not take a negative signal from the decline recorded in the third quarter – which may change anyway as the result of data revisions. There is enough positive evidence elsewhere to suggest that recovery is getting underway, though it is fragile and in its early stages.

**Chart 13: UK index of financial imbalances, 1955-2009**

Percent of national income



Note: Latest data are 2009 H1

Source: Office for National Statistics, Sefton and Weale (1995), Bank calculations

At the same time, the UK faces a process of rebalancing, which is particularly significant relative to past episodes. Chart 13 aims to put the current imbalances in context, by measuring the financial position of key sectors of the economy in absolute terms relative to historic averages.<sup>11</sup> The chart looks like a mountain range with a small number of Himalayan peaks and troughs. The biggest of the peaks have occurred close to major recessions – in the mid-1970s, late 1980s and early 1990s and at the present time. This is because imbalances either build up in the period of growth before the recession, or because the recession itself generates substantial imbalances.

However, even in relation to past recessions, the current imbalances are large, with the degree of imbalance in the UK economy reaching an all time peak in the first half of 2009. The financial crisis has played a part in aggravating this situation, by driving cutbacks in private sector spending and encouraging banks and other financial sector firms to run larger financial surpluses. Against this background, the large public sector deficits we now see are largely the result of measures to stabilise the economy during recession – and are not wholly unwelcome. But they will need to be corrected over the medium-term as the economy recovers.

<sup>11</sup> Chart 13 shows the average absolute deviation of each component financial balance relative to its historic average. Four balances are included in the Chart – households, government, private firms (including the financial sector) and overseas. The height of the combined total therefore summarises all the imbalances discussed so far in this speech.

In terms of that process of adjustment, the good news is that we undertook a similar rebalancing in the 1990s with respectable growth and falling unemployment. The less encouraging news is that banking problems and other financial adjustments in the private sector may hold back spending to a greater extent this time round. That would make it harder for the public sector to correct its deficit, as over the recovery we will be relying on growth driven by private sector expenditure to offset the weakness of public spending and underpin the growth in tax receipts.

In setting monetary policy, the MPC's key objective is to maintain price stability, measured in relation to a target of 2% consumer price inflation. That has been a major challenge against the background of the global volatility we have seen over the last two years. Last year, we faced the challenge of rising energy and food prices – which pushed CPI inflation to over five percent just over a year ago. It has since dropped back to 1.1 percent and, as the Bank's latest Inflation Report showed, the risk is that inflation will be below target in the short-term, which is not altogether surprising given the downward pressure of the recession.

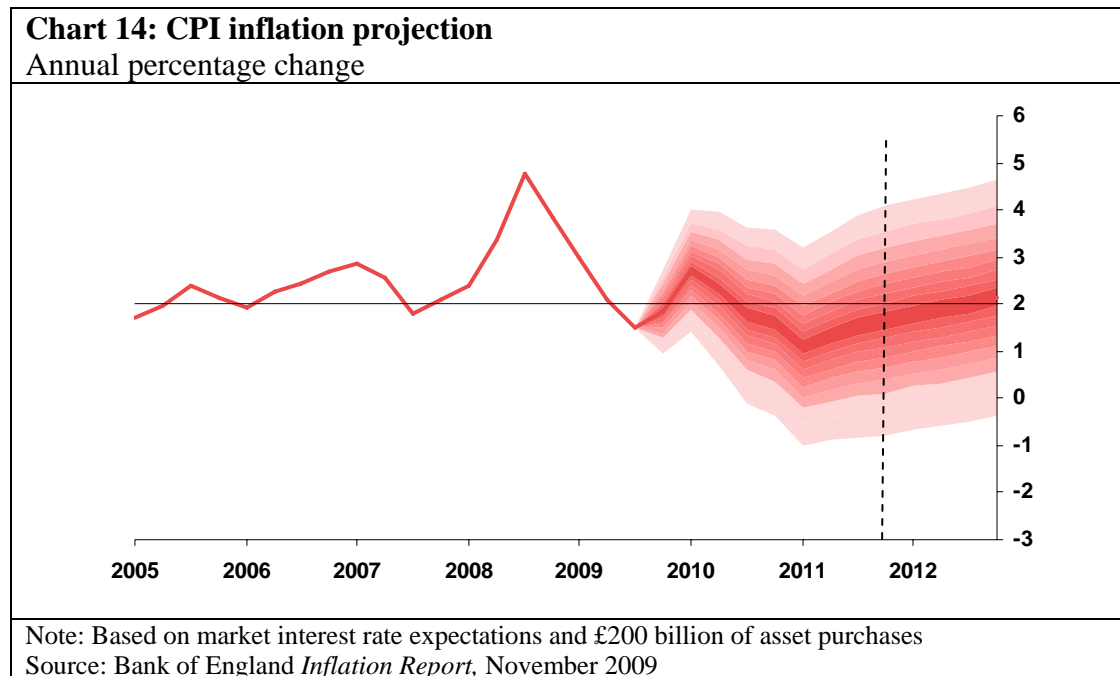


Chart 14 shows the MPC's latest Inflation Projection in its now well-known fan-chart form which summarises a probability distribution of possible outcomes. This projection assumes that the money we have injected into the economy through the

policy known as Quantitative Easing is maintained at the higher level we agreed at our November meeting – £200bn. Alongside that, the projection also assumes some gradual rise in Bank Rate, in line with our best estimate of market expectations. There is a high degree of uncertainty affecting the projection, partly reflecting the difficulty in forecasting the pace of recovery with much precision and also because the relationship between growth and inflation may be affected by the unusual circumstances of this financial crisis and the policy responses to it.

Though my main concern as a member of the MPC has to be the implications of this situation for monetary policy, we cannot ignore the impact that fiscal policy has on the outlook for the economy. The analysis I have presented today suggests that a very significant fiscal tightening is necessary to rebalance the UK economy, but it must be seen as a long-term project. It is likely to take five years or maybe more to get the current fiscal deficit down to more comfortable proportions. As we saw in the 1990s, a sustained fiscal tightening need not jeopardise the prospects for economic growth if there is sufficient support for demand from the global economy, a competitive exchange rate and a recovery in private sector spending.

The current stance of monetary policy is, I believe, very supportive of private sector spending. Since the beginning of October last year, the MPC has cut Bank Rate by four and a half percentage points and directly injected £175bn of new money into the economy, which will rise to a total of £200bn by early next year. Not only is this the most dramatic and decisive monetary policy relaxation I believe we have seen in response to any postwar UK recession. But it has been accompanied by direct interventions to stabilise the financial sector and other government measures to support spending in the UK economy. At the same time, we have seen similar packages of measures implemented in every major economy across the globe, which has underpinned the stabilisation and beginnings of recovery in the global economy.

I do not believe that we have yet seen the full impact of this policy relaxation. Over the last twelve months, there has been a strong headwind from the financial market and confidence shocks which rocked the world economy last autumn as the full force of the financial crisis became clear. So we can only properly assess the impact of policy stimulus as that headwind abates. In addition, there are lags in the impact of

monetary policy on demand and spending, and even longer lags in terms of its effects on inflation. Normally, I would expect it to take about six to nine months before a change in interest rates begins to significantly affect demand and output in the UK economy. And these policy lags are potentially longer and less predictable for the asset purchases we are undertaking under the current programme of Quantitative Easing.

On the basis of these lags, the full impact of the big interest cuts we saw last autumn and winter will only just be coming through in the data. And we have yet to see the potentially significant impact that Quantitative Easing could have on spending by households and firms, though the financial market effects we have seen so far do suggest that it is feeding through into asset prices and helping to ease funding conditions for businesses.

Over the months ahead, I believe the MPC will need to assess whether the signs of recovery are sufficiently well-established, and therefore that the economy does not need further stimulus from additional money injections. The Committee did not feel that we had reached that point in November, though the rate of injection of new money has now slowed significantly. When we have completed the latest injection of £25 billion, we will have further evidence about the performance of the economy late this year and in early 2010. Alongside the February Inflation Report forecast, we will then be able to reassess the appropriate stance for policy, while also being prepared to respond to any dramatic changes in economic conditions in the meantime.

As the recovery develops there will also come a point where we need to tighten monetary policy. As I pointed out earlier, the inflation fan chart in Chart 14 assumes some policy tightening does take place. And it is worth noting that the latest Inflation Report shows that if we do not tighten policy to some degree, and keep interest rates at their current low levels, inflation is in danger of moving above the target beyond the two-year horizon. As we look further out, therefore, the Inflation Report projections are highlighting the risk of keeping policy too loose for too long.

But there are clearly major uncertainties. And someone who has served on the MPC for the last three years, as I have, would need to be especially cautious about the

ability of the global economy in particular to deliver new and unusual surprises. A major strength of the MPC process is our ability to respond and adjust to changing economic circumstances – as we have done through the recession. As policy-makers, we are hopefully now moving from the role of fire-fighters in the recession to a more familiar role – steering the economy through an upswing underpinned by low inflation. That is excellent news. But the recovery will bring its own set of challenges – uncertainties about the pace of global growth, and the combined impact of fiscal tightening and balance sheet adjustments by the private sector. In line with the Committee’s mandate, the objective of price stability – as defined by our current inflation target – should continue to be our guide as we meet these challenges.

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