



BANK OF ENGLAND

Speech

The Road to Recovery and the Inflation Target

Speech given by

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At the 8th Annual Economic and Business Conference hosted by the Coventry &
Warwickshire Chamber of Commerce

12 June 2009

Introduction

The UK economy is experiencing its worst recession for at least a generation and quite possibly the worst for over 70 years. The recession was preceded - and has been accompanied - by what is probably the biggest global financial crisis in history. Today's meeting is under the title of 'The Road to Recovery'. For my contribution, I would first like to make some observations about the current domestic and international economic situation and explain some of the thinking behind our recent monetary policy decisions. Second, I would like to offer some wider thoughts about the role of the Inflation Target in guiding monetary policy during the recession.

The current conjuncture

In the first quarter of 2009, UK GDP fell by around 2% on a quarter earlier. That took the cumulative fall in output during this recession to over 4 % so far. The backward looking data on output is consistently weak, not just in the UK but internationally. Based on data available for the first quarter, most of the developed world economy is in recession. And the global contraction has hit many countries harder than the UK. For example, both Japanese and German GDP in the first quarter is estimated to have fallen by around 4%.

Looking back, the global economy perhaps took a surprisingly long time to show a strong reaction to the financial crisis that began in the middle of 2007, but growth was slowing in many countries by the summer of 2008. The collapse of Lehman Brothers in September then precipitated the worst phase of the financial crisis and was followed by a pronounced loss of business and consumer confidence globally, with severe consequences for the world economy.

The collapse of Lehman Brothers last autumn came as a shock to nearly everyone. Perhaps the actions of the US authorities in resolving Bear Stearns in March 2008 had lulled everyone into a false sense of security that all large, complex firms would get rescued. The reaction to the Lehman event was both rapid and synchronised across countries and affected not just the financial sector but all parts of the global economy. There was an immediate dislocation in financial markets which led to a sudden increase in the cost of credit in all its forms and a reduction in its availability. Perhaps the effects on the real economy showed most starkly in the automotive sector – as you are well aware in the West Midlands. Given the sudden and massive increase in uncertainty about the economic outlook, it was not that surprising that firms and individuals stopped buying new cars – many of which are bought using credit. It

was an easy way for households and firms to restrain their borrowing. The decline in demand left manufacturers and dealers alike with significant excess stocks. As a result, within a couple of months a number of UK-based car manufacturers had announced a shut down in production and laid off a large number of staff. Both imports and exports of cars and components shrunk markedly. To a greater or lesser extent, similar patterns were repeated across other sectors of industry, affecting both manufacturing and services. With construction already badly hit by the downturn in both the housing and commercial property markets, there were not many sources of growth left in the private sector. And unemployment, normally a lagging indicator, started to rise quickly as firms adjusted to the lower output levels.

Note that this discussion of the UK economy would apply equally well to many other countries – the car industry was similarly affected across the world, from Brazil to Japan.

More recently, there has been better news: despite the weak data on GDP growth, more timely information from monthly data and from business surveys have been consistently signalling that output is at least no longer contracting so quickly. For example, the CIPS output surveys for manufacturing and services have been rising for the past 4-6 months. The overall picture of output slowing less rapidly is also consistent with the reports of the Bank's regional Agents. And we can see similar survey results in a number of other countries.

These signs of a slowing in the rate of contraction are important – they help us project where the economy might go next and offer at least the possibility that we may have started on that 'road to recovery'. That prospect in itself should help to start restoring business confidence. But, although it would be very nice to say the worst is over, we should not be complacent – there are likely to be bumps in the road ahead, with many twists and turns.

As demand globally has fallen and commodity price inflation has reversed, price inflation has also fallen off. In the UK, inflation was a little bit 'sticky' during the early months of 2009 - probably because of the extensive depreciation of sterling during 2008 - and CPI inflation, at 2.3%, remains slightly above the MPC's target of 2.0 %. But the inflation rate is likely to continue to fall during 2009, as the effects of energy price inflation diminish and there is likely to be continuing downward pressure on prices into the medium term as a result of the amount of spare capacity in the economy. The main feature of the MPC's inflation projections reported in the *May Inflation Report* was the risk of inflation falling significantly below the target in the medium term.

The outlook

In the *Inflation Report* we listed a number of factors that should support a recovery in output growth over the next year or so. First, as the cycle of de-stocking slows, that should start to add to GDP growth. A similar dynamic around stocks should support GDP growth in other countries. The second factor is the very significant policy stimulus that has already been injected both at home and abroad from both monetary and fiscal policy. Third, but specific to the UK, the substantial depreciation of the exchange rate during 2008 should support UK exports and inhibit the demand for imports.

So, reasons to be cheerful? Maybe. But the *Inflation Report* also highlighted a number of factors which could moderate the pace of that recovery. First the availability of credit to companies and households may improve only gradually. The financial sector generally, and the banking sector specifically, plays an absolutely crucial role in allocating resources – directing money from savers into investment in industry and commerce (and of course for housing, car purchases etc). If the banking sector cannot lend enough, then economic growth could be restrained significantly. The second factor is the possibility that households decide to save more and spend less. In the long-run a higher UK savings rate and some household balance sheet adjustment would be a good thing, but in the short-run a sharp move higher in the savings rate might slow the recovery. Third, the domestic and global economies remain vulnerable to further shocks, especially given the low levels of consumer and business confidence.

Taken together, the uncertainty around these factors makes it very difficult to predict the course of the economy with any degree of precision. The general picture is that output will probably be lower in the second quarter of 2009 than the first, and the economy as a whole should move back to positive annual growth over the next year or so. One can argue about what is the best forecast rate for growth in 2009 or 2010 but the question uppermost in my mind is about further ahead: whether the rate at which output can grow in the medium term without generating inflation (the ‘potential’ growth rate) will have been affected by the recession.

Of the three downside risks to output mentioned in the *Inflation Report*, it is the state of the banking sector which could do most damage to the potential growth rate. The provision of credit is important to sustain investment growth and to provide the working capital which allows for the normal efficient operation of business. If potential growth were to be adversely affected by an impaired financial sector (as happened in Japan) even for a few years, then

unemployment will stay higher for longer and living standards generally will be lower than they would have been. And if that was the outcome, we could find inflationary pressures returning faster than they would have done when nominal demand was eventually restored. In my view, damage to the supply side of the economy is a key risk we must try to avoid and the deeper and more protracted the recession, the more likely that the potential growth rate will be adversely affected. The full range of policies needed to address that risk go wider than my subject matter today, but monetary policy certainly has its part to play in restoring nominal demand as soon as possible.

The Monetary Policy Committee's responses

Through much of 2008 the MPC were setting Bank Rate in the face of two big risks. The Committee noted that there was an upside risk to inflation should inflation expectations get established at a much higher level than the target, and a downside risk to output should “the dislocation in credit markets lead to a deep and prolonged period of subdued demand”¹. During the course of 2008 it seemed that each of those risks grew larger. But once the upside risks to inflation had diminished, and the downside risk to output was further accentuated from the collapse of Lehman Brothers, the Committee cut Bank Rate aggressively: from 5% at the start of October to a record low of just 0.5% by March this year. The depth of the recession, and resulting downwards pressure on inflation, justified further action. The Committee – which I joined as a member on March 1st – voted to begin an expansion of the money supply by purchasing £75bn of financial assets. The purchases are financed by the issuance of central bank reserves. We have since expanded that programme to £125bn of purchases. That’s a significant monetary stimulus. To help you scale the amount, £125bn is roughly equivalent to 9% of nominal annual GDP.

Implementing such an aggressive monetary policy followed directly from the pursuit of the Inflation Target. In the MPC’s best judgement there was a significant chance of substantially undershooting the 2% inflation target over the next few years and, to avoid that risk, action needed to be taken quickly. And I stress that, given how long it takes for monetary policy to impact on inflation, it is the outlook for future inflation, not the current inflation rate which matters. However, it was no coincidence that this unparalleled easing of monetary policy started during a deep recession. The various forces at work in the global economy had combined to deliver a severe shock to demand which both depressed output and reduced

¹ August 2008 *Inflation Report*, page 8.

inflationary pressures. So there was no conflict between taking action to meet the inflation target and supporting economic activity.

The Asset Purchase Facility

The ‘unconventional’ purchase of assets from the private sector is worth further explanation. Even setting conventional monetary policy by changing Bank Rate is seldom straightforward. The MPC sets a single interest rate which in turn influences other market rates of interest. Those changes in interest rates affect the incentives for people and firms to spend, save or invest, and there are cashflow effects on the income of both savers and borrowers. There can also be other effects of policy changes. One of the most potent effects can come via inflation expectations, making the MPC’s communication strategy a policy tool in its own right. Interest rates will also affect the economy through influencing a range of other asset prices, including the exchange rate. But changes in Bank Rate can take a long time to have their full impact on output or inflation –up to 2 years in the case of inflation – and, since the transmission mechanism depends on the behavioural responses of real people, the precise scale and timing of the impact is always unknown.

At very low levels of interest rates, the impact of changes in Bank Rate becomes even less certain. Behavioural reactions, including in expectations, become less predictable. There is even a risk that further cuts in Bank Rate, when it is already very low, could have a negative effect on confidence. And eventually there is a practical lower bound to interest rates. If Bank Rate has reached such a low level that further cuts are infeasible or counter-productive, and yet the economic outlook demands further monetary stimulus, how should policy be implemented?

The answer goes by the rather ugly name of ‘quantitative easing’. Instead of easing monetary conditions by cutting Bank Rate – thus affecting the price of money – we ease conditions by increasing the quantity of money in the economy directly. To do that the central bank must buy assets from the private sector and put cash out into the system instead. To fund the operation, central bank reserves are increased. This does not mean ‘printing’ money in the sense of notes and coins. Rather the Bank of England pays its counterparts for the assets bought by crediting their accounts (or those of their agents) held at the Bank.

The effect of increasing the supply of money in this way works through several channels:

- i) Portfolio effects: altering the balance between cash and less liquid assets in the financial system should increase the demand for the remaining assets, increasing

their price and encouraging the issuance of new securities such as corporate bonds and equities. Higher asset prices also mean lower interest rates in the markets for those assets, reducing borrowing costs.

- ii) Bank lending: expanding the commercial banks' reserves holdings at the Bank of England increases the liquidity of those banks, which could support bank lending.
- iii) Expectations: expanding the money supply gives people confidence that policy will be kept supportive, supporting economic activity and diminishing the expectations of, and hence the risk of, deflation.
- iv) Improved market function: by targeting the purchase of specific private sector assets, liquidity in key markets can be improved, encouraging the supply of private sector finance to the corporate sector. So far the Bank has targeted commercial paper and corporate bonds. Earlier this week we announced plans for an expansion to include commercial paper secured on loans for working capital and a possible facility for supply chain finance.

The transmission mechanism sounds complicated, but really it is not much more complex than that for a change in Bank Rate. In both cases, the impact ultimately depends on how people and firms respond to the policy change - both in terms of their changed incentives and their expectations.

In principle, the assets bought could be anything, but there are some practical constraints. Buying corporate assets exposes the public sector to the risk of credit losses, which is not a desirable consequence of monetary policy operations. And there has to be enough of the assets to buy in sufficiently large scale. The market for UK government debt - gilts - is the most obvious place to buy a large quantity of sterling-denominated assets quickly and without incurring credit risk. So far the Asset Purchase Facility (APF) has bought £83 ½ bn of gilts and around £3bn of other assets. Corporate assets have been bought in small size, to try to stimulate liquidity in the relevant markets and hence improve the flow of private sector credit to UK businesses rather than to acquire a large publicly-held portfolio. And under the terms of the agreed with the Chancellor, corporate assets purchased by the APF must be broadly investment grade, sterling denominated and traded in markets which will remain viable.

Has inflation targeting been successful?

The fact that the UK economy is in recession inevitably prompts the question of whether the macroeconomic policy regime being operated has in some sense 'failed' and therefore needs reform.

Let us look at the evidence. First of all, we should recall that most developed countries in the world have seen a recession, irrespective of their monetary policy regime, irrespective of whether they had a boom in house prices and irrespective of the size and nature of their banking systems. It is not clear to me that any monetary policy regime, or any setting of Bank Rate, could have prevented a UK recession of some degree in these circumstances. Indeed, what we have seen is consistent with the UK (and indeed the US) suffering rather less of a slowdown so far than many of our trading partners.

Second, we should remember that the current monetary policy regime is inflation targeting. There are at least two strong and related motivations for targeting inflation. First, high and volatile inflation (or indeed deflation) is itself a ‘bad thing’. There are many costs and inefficiencies associated with inflation. Let me remind you of just a few. Inflation constitutes a hidden tax on cash and in particular undermines the living standards of those on low, fixed incomes – often the most vulnerable people in our society. Inflation obscures the signals in relative prices and can lead to an inefficient allocation of resources. And increased costs are associated with coping with inflation, rather than everyone focussing on improved real living standards. Anyone who remembers the days when annual pay rounds were dominated by the ‘cost-of-living’ component will recall some of the worst implications. So maintaining low and stable inflation is a worthwhile end in itself.

Third, although monetary policy is only likely to affect real output temporarily, low and stable inflation has been the best environment for generating stable growth in output and employment in the medium-term. Our remit allows the Committee some discretion to support the Government’s objectives for output and employment – principally in respect of the speed with which policy should react to shocks that have driven inflation away from the target. Given the significant downside risks to inflation in the medium term, the MPC are taking action to get the expected path for inflation in the medium term back to target quickly, and the required monetary stimulus should also help support output and employment sooner rather than later.

Given the fact of recession, how successful do we think inflation targeting has been in meeting these objectives? I would offer two observations which are relevant. If we look back over the past 15 years or so (the inflation targeting framework began in the autumn of 1992 of course, before being embedded in the new framework in 1997) the UK experienced the most stable domestic macroeconomic conditions, in terms of low and stable inflation and steady output growth, that it has ever experienced. Some commentators have attributed this period

of stability to 'benign' global conditions. But there were a number of shocks to the global economy during this period and the UK's track record of internal stability compares relatively favourably with any other country.

We should also compare the path of monetary policy during this recession with previous episodes. In the early nineties, policy had to cope not just with an imminent recession but with moderately high and volatile inflation, with interest rates being set to maintain sterling's value within the Exchange Rate Mechanism. In consequence interest rates could not be cut substantially until after the lowest point of the recession in mid-1992 had already passed. And interest rates were held substantially above both the actual and prospective inflation rate at all times.

In the late seventies/early eighties the scenario was similar but worse. Inflation was very high and volatile, and interest rates were actually rising as the economy went into recession. Interest rates were kept in line with actual inflation, (probably lower than they would have been had it not been for a very sharp appreciation of the exchange rate related to the second oil price shock). I will not depress you further by commenting on the early-to-mid seventies!

Returning to the subject of the current recession, the reductions in Bank Rate started within a few months of what we now know was the start of the recession. And Bank Rate has been cut to a level lower than actual and prospective inflation in an effort to keep inflation at the 2% target (so the 'real' interest rate has been made negative). This degree of supportive monetary action has only been possible because previously strong inflationary pressures were kept in check. In Europe and North America consumer price inflation had picked up to around 5% by mid-2008, largely in response to the rise in commodity prices – notably the price of oil which peaked at over \$140pb in July last year. The rising price of oil, along with high global price inflation in many other commodities, could have led to higher and more volatile inflation had monetary policy been set too loose. Had that been the case, interest rates might have had to stay higher, for longer, during the recession.

During 2008, the sterling effective exchange rate fell by around 25%. In previous recessionary episodes, with inflation high to start with, and without inflation expectations anchored by a nominal target, this depreciation would have been considered a major inflationary shock requiring an offsetting monetary tightening. Instead, in the context of a credible inflation target, the 2008 depreciation has been a largely supportive real exchange rate adjustment which will help correct the UK's external imbalance.

Compared with previous experience, monetary policy in the UK has been reasonably effective in keeping inflation low and stable and inflation expectations well-anchored. So policy was able to respond relatively early in the recession. But monetary policy alone can not prevent all recessions. So what other policy levers might help?

Currently, I see the major downside risk to output growth facing the UK economy as stemming from the difficulties of the financial sector. It is a generally accepted proposition that one needs at least as many policy instruments as one has policy objectives. So if we want to ensure financial stability as well as monetary stability, then we need additional tools. A genuine debate has started over what those tools should be, with particular reference to a 'macroprudential' policy instrument. That could comprise counter-cyclical capital requirements or leverage limits for banks for example. This speech is too short to do justice to that topic but the Bank would like to see a substantial debate about what the objectives of such an instrument should be, and hence how it should be designed.

A second debate - which has not yet begun - will be needed around international policy co-ordination. A major part of the problem underlying the current recession was the build up of international imbalances – large current account surpluses and deficits - which neither deficit nor surplus countries took sufficient action to address. These imbalances were bound to be corrected at some point and it looks like they could now be resolved, at least in part, in a rather disorderly fashion as a result of the global recession, rather than in an orderly way as a result of policy action. These cross-border co-ordination issues will not be easy to resolve.

I have just one more point before I finish. Over the years, a number of MPC members have voiced public concern that the unprecedented stability of UK inflation and output would lead to over-optimistic expectations of what monetary policy could achieve. It's quite clear to me from what has happened in the global economy that no alternative domestic monetary policy framework could have prevented some degree of recession in the UK, given the shock to the global financial system. A macroprudential policy instrument (or two) may help in future to guard against financial market excess and that would be a significant achievement. But it would not be enough to guarantee that there cannot be future recessions. There will be real shocks that monetary and financial policy will not be able to offset. The best we can do is to try to make the economy as resilient as possible, to mitigate the impact of such shocks.

Taking the various messages from this speech together you might conclude that I am a pessimist about the 'road to recovery'. I do not think of it that way. Rather I want to be realistic about the complexity of the challenges ahead so that we are better prepared

collectively to deal with them. And I hope that I have given you some reasons to believe that, although the inflation targeting framework may not have been sufficient on its own to prevent the UK economy going in to recession, there are reasons to think that it is proving a flexible and effective framework for guiding the economy through to recovery.