BANK OF ENGLAND

Speech

Tough Times, Unconventional Measures

Speech given by

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The UK economy is in a deep recession. Output in the United Kingdom fell at its fastest rate in nearly thirty years in the final quarter of last year, and a similar fall in output in the first quarter of this year appears likely. We are in the throes of a synchronised global downturn, which has spread far and wide.

But the darkest hour is just before the dawn. Although immediate prospects appear bleak, the substantial economic stimulus that is underway means that there are grounds for thinking that economic conditions may start to improve later this year. An important part of that stimulus stems from the extraordinary measures taken by the Monetary Policy Committee over the past six months, including our decision to start using unconventional policy measures.

Today, I will describe my view of the economic outlook and outline the factors that I believe will spur a gradual turnaround in our economy. And I will explain why, earlier this month, the Committee voted to use unconventional policy measures: how they will work and how we will monitor their effectiveness.

I am delighted to have the opportunity to discuss these issues at the Association of British Insurers. The insurance industry is a key part of the UK economy and of the financial sector in particular. Indeed, it accounts for a third of all the jobs in the UK financial sector. Your industry, like virtually every other sector of the UK economy, is being affected by the recession. And given your members' significant holdings of gilts and corporate bonds, it will have a key role to play in the transmission of the unconventional policy measures recently begun by the Committee.

1. THE ECONOMIC OUTLOOK

The causes of the current recession can be traced back to at least the summer of 2007. The fallout from the sub-prime mortgage crisis and the resulting pressure on banks' balance sheets led to a sharp tightening in the price and availability of credit. And the first stages of what became a renewed and prolonged surge in oil and other commodity prices began to erode households' spending power and eat into companies' profit margins.

As a result, the UK economy gradually slowed through the end of 2007 and into the first half of 2008. But the economic outlook took a dramatic turn for the worse in the autumn of last year. That deterioration followed the failure of Lehman Brothers, which triggered the most severe banking crisis for almost a century. Confidence in the very essence of banking – as well as in individual financial institutions – was shaken to its core and measures of financial market risk and uncertainty ballooned. The resulting contraction in the supply of credit has had a significant impact on the ability of households and companies to borrow and spend.

But the nature of the downturn over the past six months cannot be explained solely in terms of the direct effects of the collapse of Lehman Brothers on the supply of credit. The impact of changes in credit conditions on investment and consumption decisions tends to be gradual, as existing loans mature and new contracts are negotiated. This contrasts with the dramatic pace at which economic activity and sentiment turned during the final quarter of last year. Output, orders and investment all fell precipitously in a matter of months. Moreover, the downturn in economic activity was seemingly indiscriminate. Output in virtually every corner of the world fell sharply, irrespective of a country's exposure to sub-prime loans, the state of its banking system, or its level of indebtedness. The effects of the shock were also felt far beyond its epicentre in the financial sector. Manufacturing output has been particularly hard hit, with UK manufacturing output estimated to have fallen by 4.9% in the fourth quarter of last year; the largest quarterly fall for over thirty years. Many other countries have suffered even larger falls: Japanese manufacturing output is estimated to have contracted by over 12% in Q4 and German manufacturing output by over 7%. World trade is estimated to have fallen by over 6% in January alone.

The pace, breadth and spread of the global downturn suggest that tighter credit conditions were not the only force at work. It seems clear that a pronounced and widespread collapse in confidence also played a major role. With the failure of Lehman Brothers it became all too apparent that the problems in the financial sector were more acute than had previously been thought. This was compounded by the realisation that even the largest financial institutions were not 'too big to fail'. More fundamentally, the demise of Lehman Brothers may have led to a questioning of policymakers' ability to deal effectively with such unprecedented financial turmoil. The view that the impact of the financial crisis would be largely restricted to the exclusive confines of the Square Mile and Wall Street was dispelled once and for all. Households and businesses cut back on their spending as it became increasingly apparent that the effects of the financial crisis on the real economy were likely to be deeper and more widespread than previously envisaged.

The impact of the tightening in the supply of bank credit and of the widespread collapse of confidence was compounded by developments in the supply of trade credit. In previous recessions, many large businesses in the UK were able to support smaller companies by reducing payment times to companies further up the supply chain and by extending credit to those further down. But pressures on corporate cash flows and the reduced availability of bank credit may have limited the scope for larger companies to behave in this way in this downturn. The Monetary Policy Committee, via its network of regional Agents, is monitoring closely developments in the demand for and availability of trade credit.

The reduction in the availability of trade credit has been accompanied by a tightening in the supply of credit insurance. This is at a time when the demand for such insurance is at its highest. Similarly, heightened uncertainty about the global environment has increased the demand for letters of credit from UK exporters.

These developments are understandable and predictable: the economic environment has deteriorated markedly and as insurers you need to protect yourselves against future losses. There is a limit to how much insurance premiums can be raised before they exceed the profit margin associated with a particular transaction. Higher prices can have the same effect as the complete withdrawal of supply.

I know that members of the ABI are working hard with Government and with business to agree how best to meet these challenges. It is vital for the long-term success of both your industry and our economy as a whole that a workable solution is found.

Where next for the UK economy?

The Monetary Policy Committee set out its latest economic outlook in the February *Inflation Report*. That *Report* went to great pains to stress the considerable uncertainty surrounding the prospects for the economy. Nobody can predict with any certainty how the UK economy, or indeed the world economy, is likely to fare over the next year or so. So beware of anyone that suggests otherwise.

With that warning in mind, let me outline my central economic outlook, which is broadly similar to that described in the February *Report*. Near-term prospects are bleak. Output is likely to contract further in the first half of this year, as a weakening labour market and concerns about job prospects weigh on consumption, companies run down their stocks and scale back investment spending, and the synchronised slowing in world demand restrains export growth. But as we go through 2009, I believe it is most likely that the pace at which output is contracting will ease and that we will see some signs of recovery by around the turn of this year.

This view is based on the substantial stimulus that is already starting to flow through the pipelines of our economy. There has been a marked easing in global monetary and fiscal policies; authorities around the world have also enacted substantial initiatives to revitalise the global banking system; the sharp falls in commodity prices will boost households' purchasing power; and the marked depreciation in sterling should support demand, both at home and abroad, for domestically produced output. The scale of this stimulus is significantly greater than that seen at comparable stages of the recessions in the 1970s, 80s or 90s.

But to repeat, there is huge uncertainty about the precise form and timing of the recovery and so this central path should be treated with a healthy degree of scepticism. In particular, I think the risks around this central path are weighted to the downside, reflecting the possibility that the actions taken by the authorities around the world to improve the availability of credit and to restore business and consumer confidence are slow to take effect. So there may still be more to do.

Learning from past recessions

When considering the likely scale and duration of this recession, it is natural to examine the experience from past recessions. And simple comparisons with recent recessions are not encouraging. For example, taking account of developments in Q1, output appears likely to have fallen by more in the first few quarters of this recession than in any of the preceding ones. But when making these comparisons, it is important to recognise that the parallels are far from perfect. The causes of this downturn are very different from those of most recent recessions and, as I have just described, the policy response on this occasion has been much quicker and more decisive. There is also a third factor that needs to be borne in mind when drawing lessons from history.

This is the first recession in the UK for nearly 20 years. The structure of our economy has changed significantly since the early 1990s, and even more so since the early 1980s and 1970s. The UK economy has undergone extensive reforms and deregulation, and businesses have been transformed by the implementation of new technology and the effects of globalisation. It is hard to quantify precisely the various ways in which the structure of the economy has changed. The appropriate data are not always available and it may be a long time until the effects are discernible in aggregate economic statistics. Importantly, the significance of some of these structural reforms may not be fully apparent until the economy is subjected to a substantial shock.

For example, one consequence of globalisation is that supply chains around the world are far more integrated. This is likely to have played an important role in the speed and synchronisation of the world downturn, as the effects of falling demand in a few countries were translated into lower orders and production in many in a matter of weeks. That increased integration is also likely to affect the speed and nature of the recovery.

Similarly, the technology used to control and manage inventories has changed substantially over the past twenty or thirty years. This may have enabled companies to run down their stocks earlier in this recession than in previous downturns. And indeed there is evidence that firms have already cut back aggressively on their stock levels. A corollary of this sharp correction is that the stock cycle may be shorter lived than in previous recessions.

The behaviour of the labour market may also have changed. I have been struck by the number of business people who tell me about the array of measures they have already taken since their orders starting falling sharply last autumn. Wages have been frozen or even cut, hours have been reduced, working practices have been adjusted. To the extent that wages and hours are now more flexible, the adjustment in employment may be less. But if it is easier for companies to vary their labour force than in the past, much of this adjustment may come through more quickly than in previous downturns.

It is hard to know at this stage how significant these structural changes will be in determining the depth of the recession and the speed of the recovery. But the possibility that there has been a material structural change in our economy highlights a further danger of viewing the current recession through the prism of previous ones. The latest economic data on world trade, output and unemployment are unmistakeably grim, but we must continually challenge ourselves about how to interpret these and the economic data to come. They could be telling us something about the causes and size of the downturn, the impact of the policy measures taken so far, or how changes in economic structure are affecting the response of output and employment.

Let me now say a little about the role the Monetary Policy Committee is playing in addressing the challenges posed by the global economic downturn.

2. UNCONVENTIONAL POLICY MEASURES

The MPC responded to the marked deterioration in the economic outlook with an aggressive easing in monetary policy. We reduced Bank Rate from 5% to an historic low of just 0.5% in a matter of months. Moreover, at our policy meeting earlier this month, the Committee agreed to finance £75 billion of asset purchases by the issuance of central bank reserves, in order to boost the supply of money and improve the functioning of corporate credit markets.

The purchase (and sale) of assets by central banks is nothing new; central banks have always implemented monetary policy by changing the size and composition of their balance sheets. Nor, importantly, has the objective of monetary policy changed, which is to hit the Government's 2% target for CPI inflation. What is different, however, is the range of assets being purchased by the Bank and the scale of those purchases. Given those changes, I want to explain the rationale for large scale asset purchases in the current economic climate. In doing so, I will address two key questions. First, how will asset purchases help us meet the inflation target? And second, how will we monitor the progress of the policy and assess its effectiveness?

How will asset purchases help us to meet the inflation target?

The objective of the asset purchase programme is to boost nominal spending in order to hit the inflation target. The tightening in the availability of credit and the collapse in confidence has led to a sharp slowing in the growth of nominal demand. The four-quarter growth rate of nominal GDP sank to a record low in the final quarter of last year. The weakness in nominal spending has been accompanied by a sharp slowdown in the growth of bank lending to firms and households and in the growth of money holdings of the non-financial sector. At our policy meeting earlier this month, the Committee judged that without the additional stimulus provided by the asset purchase programme, the growth of nominal spending would be insufficient to meet the inflation objective.

The MPC instructed the Bank to use the additional reserves to purchase two types of assets: gilts and high-quality corporate debt. This twin-track approach allows for asset purchases to stimulate nominal spending in a variety of different ways. Such a pragmatic strategy seems entirely sensible given that this in the first time these unconventional tools have been used in the UK.

I find it helpful to summarise the different mechanisms through which asset purchases may boost nominal spending into three broad channels.

First, the purchases of gilts will act to increase their prices and reduce their yields. This change in the relative attractiveness of holding gilts is likely to cause investors to reallocate their portfolios into other assets, such as corporate bonds, which in turn will tend to reduce the yields on those assets. In so doing, the borrowing costs faced by firms and households should fall. As of today, the Bank has purchased £13bn of gilts from investors.

Second, purchasing assets with central bank reserves will significantly increase the amount of liquidity in the system. This expansion in the supply of money may in itself encourage greater levels of lending and borrowing. Bank deposits are likely to increase, providing banks with a ready source of funding to finance additional lending. Similarly, as the additional liquidity permeates through the economy, companies may feel less constrained by the need to hoard liquidity and more able to undertake investment projects.

Third, purchases of high-quality corporate debt should help to improve the functioning of corporate credit markets. Strains on financial institutions' balance sheets, combined with heightened levels of uncertainty and risk aversion, have impaired the liquidity of key corporate credit markets. Firms' access to some of these markets has been restricted and the cost of credit inflated. By purchasing assets in a targeted way, the Bank can aid liquidity in these markets and so improve the availability of corporate credit. The Bank has been purchasing commercial paper for over a month now. It made its first purchases of corporate bonds this week. And we are reviewing the case for intervention in other corporate credit markets.

Importantly, the objective of the Bank's operations within corporate credit markets is not to purchase a specific quantity of assets; rather it is to improve the functioning of those markets. The scale of purchases required to improve market liquidity may in fact be relatively small: the very knowledge that the Bank stands ready to purchase assets may be as beneficial as the actual asset purchases themselves. Moreover, the required scale of purchases is likely to diminish over time as liquidity improves and private investors return to the market. It is important not to judge the potential significance of this channel by the scale of asset purchases.

How can we monitor the effectiveness of the purchases?

It is much too soon to come to a firm judgement about whether this programme of asset purchases is having its desired effect. In particular, the impact on the growth of broad money and credit will not begin to be discernible for several months yet. There are, however, some encouraging signs. Since the MPC's announcement, yields on gilts have fallen by 40-60bp at the horizons at which the Bank is making purchases. This has been accompanied by falls in yields on non-financial corporate bonds of up to around 30bp. And since the Bank started to operate in the commercial paper market, spreads have tightened and issuance has increased. These developments have been mirrored in the positive feedback the Bank has received from issuers of commercial paper.

Over the coming weeks and months, the MPC will be monitoring a wide range of indicators as we form an initial assessment of the likely effectiveness of the asset purchase programme in stimulating nominal spending. A critical issue will be the extent to which movements in asset prices and market spreads are translated into lower borrowing rates faced by businesses and households. Equally important will be the extent to which the additional liquidity and lower borrowing rates act to spur the growth of broad money and credit.

I am confident that increasing the supply of money will eventually lead to an increase in nominal demand. But there is considerable uncertainty about the relative importance of the different channels through which it may work. As such, I welcome the eclectic, twin-track approach adopted by the Committee. There is also considerable uncertainty about the overall size and timing of the impact of the monetary expansion on nominal spending and on the prospects for inflation. That is why in the minutes of its March meeting, the MPC indicated that, just as with its decisions on Bank Rate, we would review the appropriate scale of the asset purchase programme each and every month.

3. CONCLUSION

The extraordinary developments in the global economy since the autumn have been matched by the magnitude of the policy response. Monetary policy continues to play its part, with Bank Rate set at a historically low level and the launch of a large-scale asset purchase programme. Throughout these dramatic developments, the objective guiding the Committee's decisions has remained the same: the need to keep inflation on track to meet the Government's 2% inflation target. It was that objective that underpinned the decisions to reduce Bank Rate to unprecedented levels. And it was that objective that drove the MPC to adopt unconventional policy measures.

The inflation target will also dictate the rate at which the stance of monetary policy is returned to normal as economic prospects recover. The outlook for inflation relative to the inflation target provides the natural guide to exiting from this period of exceptional monetary stimulus. Importantly, this exit strategy is clear, transparent and open to public scrutiny. Openness and transparency have been the cornerstones of UK monetary policy since the Monetary Policy Committee was established in 1997. That has never been more important than now.

The inflation target is symmetric. That requires the MPC to set policy in a symmetric way. The Committee adjusted monetary policy boldly and decisively on the way down in order to meet the inflation target. And, let me assure you that, when the time comes, we will be prepared to respond with equal vigour on the way back up.