Speech by

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Introduction

It is an honour to be invited here this evening to help you and the Business School celebrate its 21st anniversary. Birthdays are a natural time to pause and reflect – especially those that mark a coming of age.

Reflecting on your first 21 years, much has changed since the Business School was founded. Some of you may remember that 1989 was the year in which Nigel Lawson resigned as Chancellor and the Berlin Wall fell. You may remember less well that it was also the year that Kylie and Jason enjoyed four Number 1 hits and Coronation Street attracted its largest ever audience to watch Alan Bradley meet his grisly end under a Blackpool tram. How time flies.

The economy has also had its fair share of ups and downs since then. After the 1990s recession, we enjoyed 63 quarters of consecutive growth, withstanding en route the effects of Black Wednesday and the dotcom bubble. Inflation targeting was introduced, the Monetary Policy Committee created and we benefitted from a sustained period of low and stable inflation. But as you know, this period of Great Stability came to an abrupt end with the largest financial crisis for at least a generation. Output fell like a stone and inflation was buffeted by a series of price level shocks.

I want to continue this theme of reflection in my comments tonight. However, with 2010 drawing to a close, I will restrict my observations to events over the past year – and what they may herald for the future – rather than your entire 21 years. A progress report for 2010.

This has certainly been a busy year. The UK economy continued along the road to recovery. A new coalition Government was formed and set in train what is planned to be the largest fiscal consolidation of the post-war period. The Government also announced a major reform of the structure of financial regulation, assigning considerable new responsibilities to the Bank of England. These events have taken place against a backdrop of strong global recovery, but one in which some countries, most notably within the euro area, continue to face acute fiscal and banking pressures, and large imbalances between surplus and deficit countries persist across the globe.

You will be relieved to hear that I do not intend to consider all of these developments tonight. Instead, my progress report will focus on two key issues. First, how much comfort should we take from the recovery seen so far and what factors are likely to determine its future vigour? And second, to what extent are the Bank's planned new responsibilities for macroprudential policy likely to address the 'missing instrument' problem exposed so painfully by the financial crisis? I will conclude with some reflections on monetary policy.

The recovery so far

There has been a strong start to this recovery. After four consecutive quarters of growth, the pace of the recovery to date compares favourably with previous episodes: output is estimated to have grown by 2.8% over the past year, quicker than at the same stage of either the 1980s or 1990s recoveries.

Some encouragement can also be taken from the composition of growth. Spending by households and businesses has begun to pickup; this despite strains on private sector balance sheets, muted disposable income growth and an impaired banking system. Over the past year, this increase in private sector spending has helped offset a weaker net trade performance, which has been particularly disappointing given the early and substantial depreciation of sterling.

However, it is too soon to say we are out of the woods. Economic recovery has to be judged in terms of the *level* of output, not the rate at which it is growing. It is the level of households' incomes that determines their well-being. And it is the level of economic activity which governs companies' profitability and their viability. The fall in output during this recession was larger than that in either the 1980s or 1990s recession. One year of growth does not make a recovery. We need to see a sustained period of robust growth for the economy to function normally again.

So what are the prospects for demand and output, and how likely are we to achieve this sustained period of growth?

The strength of the recovery over the next few years will depend on the balance of the substantial headwinds and tailwinds buffeting our economy. Economic forecasting at the best of times feels like a triumph of hope over experience. That is especially so in the current environment in which the economy is subject to gale force winds blowing in both directions. But it is at least possible to identify some of the key factors that will determine the future pace of growth.

Headwinds and Tailwinds

Consider first the main headwinds hampering growth.

Most obvious is the fiscal consolidation now underway in the UK. Public sector spending, as a share of nominal GDP, is projected to fall by around 8 percentage points over the next 5 years.

My central view is that the direct impact of this reduced spending, via the impact of lower government procurement and smaller transfer payments, is unlikely to derail the recovery. The spending cuts will certainly dampen growth. And some households and companies directly affected by the cuts could suffer significant hardships. But the substantial stimulus from monetary policy and the lower level of sterling should ensure that the recovery continues.

The impact of the fiscal consolidation may be partially mitigated if it causes businesses and households to become less uncertain about their prospects and so behave less cautiously. But the reverse is also possible. In that regard, it is perhaps notable that, following a brief revival, measures of consumer confidence have fallen back since the spring of this year.

The importance of Keynes' animal spirits has been demonstrated all too clearly by recent events. Although the recession was triggered by a financial crisis, the speed and severity of the downturn was greatly amplified by the accompanying collapse in confidence, as companies and families pulled back on spending and increased savings. More recently, the pickup in private sector spending has occurred alongside a fall in the household saving ratio and a stabilisation in company saving.

A recent survey carried out for the Bank provides some evidence on households' attitudes towards the fiscal tightening.[1] 90% of survey respondents said that they thought the fiscal consolidation would have some impact on them. Perhaps surprisingly, a majority of these households said they had not yet taken any actions in response to the consolidation. But it's clearly still early days in this process and there is a chance they will react more as the impact of the austerity measures increases. This is something that the MPC will continue to monitor carefully.

[1] This is an annual survey conducted for the Bank by NMG Financial Services Consulting. This year's survey was conducted between 24 and 30 September 2010 and covered almost 2000 households. Some results from this year's survey featured in the November 2010 *Inflation Report* (pages 22-23). Full details of the survey will be made available in an article published in the 2010 Q4 *Quarterly Bulletin* on 13 December.

A second headwind tempering the pace of progress is that UK banks are still not in a position in which they can lend normally. As many of you know only too well from your own experiences, the banking crisis led to a marked tightening in credit conditions, making it difficult for businesses and households to borrow.

UK banks have made significant strides over the past year in strengthening both their capital and funding positions. However, the extent to which that has led to increased access to credit appears to have varied across different sectors of our society.

For large businesses, conditions do appear to have improved. For such companies, with strong cash flow and good credit ratings, the corporate bond markets have in recent months been open with yields close to historical lows. Furthermore, the Bank of England's Credit Conditions Survey indicates that the availability of bank credit has increased and spreads have fallen.[2] This thawing in credit conditions for large firms is important since they account for the majority of investment in our economy.

But for smaller companies, who are typically more dependent on bank finance, progress has been more glacial. Smaller businesses regularly tell our Agents that they continue to have difficulty in accessing affordable finance. And this is not really disputed by the major lenders, who report in the Bank's survey of credit conditions that the availability of credit for small firms has increased only slightly.

The tightening in credit conditions contributed materially to the severity of the recession. But the extent to which continuing constraints on the supply of bank credit are likely to impede the recovery is less clear.

On the one hand, banks still face significant challenges, especially in terms of the ease and cost at which they can refinance maturing funding. This is undoubtedly affecting the ability of some small firms to borrow at affordable rates.

On the other hand, many companies started this recovery with increased levels of savings and so are in a position to finance increased investment if and when they wish to. And we have seen 'creditless'

[2] Those developments are also consistent with results from the Deloitte CFO surveys – the 2010 Q3 survey indicated that a majority described credit as easily available for the first time since the survey began in mid-2007.

recoveries in the past. For example, the corporate sector in aggregate repaid bank lending in each of the first three years of the 1990s recovery.

I'm hopeful – but by no means certain – that strains within the banking system will exert increasingly less drag on the economy going forward.

But what of the tailwinds that are pushing against these factors and ensuring that the burgeoning recovery continues?

The most significant factor is the highly accommodative stance of monetary policy. As you know, Bank Rate remains at 0.5% and the stock of asset purchases – quantitative easing – has been maintained at £200 billion. Although monetary policy has not been eased substantially further over the past year, the stance of policy remains highly stimulatory and continues to provide significant support to economic activity.

The level of sterling following its substantial depreciation through 2007 and 2008 should also aid the recovery by encouraging a rebalancing of our economy towards external demand.

However, at first blush, the support provided by the lower level of sterling over the past year looks distinctly underwhelming. Yes, the most recent data suggest that net trade made a positive contribution to growth in the third quarter of this year and this is encouraging. But these early estimates are noisy and prone to revision. Stepping back, net trade has detracted from growth over the past year. And within that, the growth of exports has underperformed expectations, especially when judged against the acceleration in global demand.

However, the story is somewhat different if we look at the performance of goods and services exports separately.

The lower level of sterling does appear to have supported goods exports, which have increased by well over 10% over the past year. Perhaps more tellingly, the increased competitiveness of our goods exports has succeeded in arresting the persistent decline in our share of world export markets seen over the past 15 years or so.

In contrast, exports of services – at least as measured – have fallen. These declines are concentrated in exports of financial and business services, areas in which the UK has particular expertise. It would not be surprising in the current environment if this weakness partly reflects reduced global demand for these types of services. If that is the case, our prospects for net trade will depend in part on the extent to which demand for financial and business services revives as the recovery in world demand continues and the functioning of the financial system gradually returns to normal.

Where does all this leave us?

Judging the net impact of these opposing forces on the growth outlook is very difficult. The pattern of growth from quarter to quarter is quite likely to be choppy. But smoothing through this, my central view is that over the next few years the economy is likely to grow at rates around or a little above its historical average, supported by monetary policy and the lower level of sterling. This is similar to the outlook in the November *Inflation Report*. But to repeat the point I made earlier: the depth of the recession means that output and employment are likely to remain below what would feel like normal levels for many companies and families for some considerable time. I will return to the monetary policy implications of this growth outlook in a while.

The missing instrument problem

But before doing so, I want to report on the progress that has been made in strengthening the macroeconomic policy framework in the UK in response to some of the fault lines exposed by the financial crisis.

Much analysis and soul searching has been conducted in the aftermath of the crisis, and the lessons and implications for different aspects of economic, financial and other areas of public policy are wide ranging.

In terms of the lessons to be learnt for monetary policy, many commentators and policymakers – myself included – told a variant of what could be termed the missing instrument problem.[3] This analysis argues that the case for an inflation targeting framework remains sound: the focus on a clear numerical target for monetary policy has served our economy well, and low and stable inflation remains a cornerstone of our long-term prosperity. However, it acknowledges that control of short-term interest rates – the main tool of monetary policy – is a relatively blunt instrument best deployed

[3] Dale (2009)

maintaining a broad balance between nominal demand and supply. In particular, movements in short-term interest rates are not well suited to managing risks from credit cycles and other imbalances within the financial sector. As such, a key lesson from the financial crisis is the need to expand the range of instruments available to policymakers, so they are better equipped to ensure the resilience of the financial system.

This missing instrument problem provides the backdrop to the Government's announcement earlier this year that it intends to create a new policy committee in the Bank – the Financial Policy Committee – which will have responsibility for conducting macroprudential policy. In 2010, quantitative easing was entered into the Oxford Dictionary of English, along with chillax and defriend (don't ask!). I predict that 2011 may be the year of macroprudential policy.

The legislation determining the precise tools and objectives of macroprudential policy is still to be enacted. But as the Governor recently emphasised, the over-riding objective is to ensure the resilience and stability of the banking system.[4] If successful, macroprudential policy will represent a significant advance. As we have seen repeatedly through history and across countries, banking crises come hand-in-hand with deep and costly recessions. Promoting the resilience and smooth functioning of the financial and banking system in bad times as well as good would contribute greatly to our future economic stability.

But it would be wrong to conclude from this that macroprudential policy is likely to solve the missing instrument problem entirely. That is for at least three reasons.

First, macroprudential policy is not the instrument that will solve the problem of global imbalances. Charlie Bean – the Bank's Deputy Governor – likened the various factors contributing to the financial crisis to a murder in an Agatha Christie novel in which everyone had a hand in it.[5] But a central character in almost any telling of the financial crisis story are the huge capital flows associated with the imbalances between surplus and deficit countries. These capital flows affected the price of financial assets and distorted the incentives of borrowers and creditors. These global imbalances remain and are forecast to get bigger.[6] Macroprudential policy should mean that the tensions associated with these imbalances manifest themselves in different ways, in particular in ways that are

[4] King (2010). See also Tucker (2009) and Haldane (2009).
[5] Bean (2010)
[6] IMF (2010)

less damaging to the stability of the banking system. But it does not address the underlying problem. Solving global imbalances requires international coordination and we are still missing the instruments that will truly deliver that.

Second, it is unlikely, at least as currently conceived, that macroprudential policy will be designed to prevent equity-financed bubbles. These types of bubbles have a long and colourful history: from the 18th century South Sea bubble, the 19th century railway mania to the more recent 20th century dotcom bubble. Importantly, equity-financed bubbles are not associated with credit cycles and increased banking exposures and so are unlikely to threaten financial stability, which is the focus of macroprudential policy. [7] Moreover, because the effects of these types of bubbles are not amplified by financial instability, they typically have a smaller impact on output.[8] But that does not mean that equity-financed booms and busts cannot have sizeable macroeconomic consequences via other channels, such as misallocating resources, wealth effects and their impact on confidence. In the 5 years following the dotcom bust, GDP growth in the US averaged almost two percentage points lower than in the preceding 5 years; this despite a very aggressive easing in monetary policy.

Third, as Claudio Borio of the Bank for International Settlements and others have stressed, actions necessary to preserve the resilience of the banking system may not be sufficient to prevent credit cycles altogether.[9] A much-studied example of this comes from Spain. Since 2000, Spain has had a system of dynamic provisioning whereby banks had to put aside more capital as they increased lending. This increased the resilience of the Spanish banks, but it did not prevent a large run-up and subsequent crash in house prices in the Spanish property market. If – and it is a big if – macroprudential policy could be used to prevent such credit cycles it could potentially have even greater benefits for our economy. But we need to be careful not to expect too much from this new set of policy instruments, especially at the outset as the newly formed Financial Policy Committee learns about the use and effectiveness of its policy tools. Just as monetary policy does not attempt to eradicate the business cycle, so macroprudential policy is unlikely to be able to eradicate fully credit cycles.

The creation of the Financial Policy Committee with the responsibility for conducting macroprudential policy represents a major advance in responding to the missing instrument problem. Ensuring the

[7] See Tucker (2009)
[8] See Mishkin (2008)
[9] Borio (2010)

stability of our banking system will contribute greatly to our future prosperity. But macroprudential policy is not – nor is it intended to be - the solution to all problems associated with financial markets and the international monetary system. Unless or until effective instruments can be found to manage these other issues, vulnerabilities will remain, to which monetary policy will need to stay vigilant.

Monetary Policy

So what does all this imply for monetary policy?

The job of the Monetary Policy Committee is to hit the 2% inflation target. Judged against that objective, we might not appear to have done a very good job recently. CPI Inflation stood at 3.2% in October. Over the past 4 years, inflation has been above target for 39 of the 48 months and has averaged almost 3%. And inflation is likely to remain above target throughout 2011, elevated by the increase in VAT to 20% at the beginning of next year.

But despite inflation being above target, monetary policy remains highly stimulatory. Interest rates are close to zero and we've injected a huge sum of money into the economy via quantitative easing. This uncomfortable juxtaposition of high inflation and loose policy has led some people to put two and two together and make five. The MPC has gone soft on inflation, they claim. It has taken its eye off the ball.

I understand why some people think this. But it is simply not true.

The deep recession that we have all just endured has led to a degree of spare capacity opening up in our economy. That's evident in the increase in unemployment we have suffered. It's also evident in the relatively low levels of productivity within firms. There is a very real question as to exactly how much spare capacity there is and what impact that's likely to have on costs and prices. Even so, it seems clear to me that there is some degree of spare capacity and that this is likely to damp inflationary pressures. This is most apparent in the labour market, where annual private sector earnings growth has averaged below 1½% since the start of the recession, around a third of its rate in the preceding five years.

But this downward drag on headline inflation has been offset by a sequence of large shocks – to energy and other commodity prices, to VAT, and to the value of sterling – which have increased the level of prices. Any of you that have read the Bank's *Inflation Report* or heard other MPC members speak will know that we have made this point repeatedly over the past few years. My concern is that although many people understand the basic argument, it is easy to forget the sheer size of the effects.

Let me give you some idea of the magnitudes involved. CPI inflation averaged 3.1% in Q3. Some rough back-of-the-envelope calculations suggest that of that 3.1%, increases in energy prices may have contributed between 0-0.5% points, the increase in VAT earlier this year 0.5-1% points and the increase in import prices associated with sterling's depreciation around 1-2% points.

Now these estimates come with two very significant health warnings. First, they are highly uncertain and other plausible assumptions would give different ranges. Second, it is not possible simply to sum these different impacts together to calculate how much lower inflation would have been in the absence of these factors. If these events had not happened, many other aspects of the economy would have been different. But the scale of these effects does suggest that, had these shocks to the price level not occurred, inflation would have been substantially lower and almost certainly below target.

But who cares you may say. Inflation is inflation. Your job is to hit the inflation target based on the factors affecting inflation. Not based on what would have happened to inflation had it not been affected by a series of unfortunate events.

That is a perfectly fair argument. The Committee's mandate, as given to us by the Government, is an inflation target of 2% at all times. The onus is on us to explain why, in the face of persistently above target inflation, we are not tightening policy.

My current approach to policy is based on the judgement that as long as these price level shocks aren't repeated, and aren't reflected in medium-term inflation expectations or wage setting, they are unlikely to have implications for inflation in the medium term. They lead to an increase in the level of prices, not to a persistent increase in inflation. If a significant degree of spare capacity persists in the medium term, inflation is likely to fall below target. The current focus of monetary policy is on providing the stimulus necessary to support the recovery so the degree of spare capacity in our economy is gradually reduced. That is critical if we are to hit the inflation target in the medium term.

To have tried to have used monetary policy to offset the impact of these price level shocks on headline inflation would have required us to have tightened monetary policy in the depths of the recession.

That would have led to an even bigger fall in output, an even bigger rise in unemployment, and an even bigger risk of materially undershooting the inflation target in the medium term.

But there are clearly significant risks to this strategy of looking through the temporary impact of price level shocks on inflation. Most importantly, if the strategy causes companies and households to question the MPC's competence or its commitment to maintaining low inflation, and this starts to be reflected in wage and price setting. If that were to happen, we would be forced to tighten policy, potentially aggressively so with all the output costs that would entail, in order to avoid a return to the bad old days of the 1970s and 80s with truly high and volatile inflation. My single most important message to you this evening is that the MPC remains as hard-nosed as ever in its determination to hit the inflation target. That is the remit given to us by Government, and for which we are accountable to Parliament and the public.

To sum up my progress report for 2010: it has been a busy year; substantial progress has been made, both in terms of starting along the road to economic recovery and responding to some of the fault lines exposed by the financial crisis; but there is still a long way to go. There will be as much to do in your 22nd year as there was in your 21st. Happy birthday.

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