BANK OF ENGLAND

Speech

Let it grow: how monetary policy can support sustainable economic growth

Speech given by

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To the CBI East of England Annual Lunch, Suffolk

22 March 2011

I would like to thank Tomasz Wieladek and Adrian Chiu 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.

Good afternoon, ladies and gentlemen. I am delighted to have the opportunity to address this year's CBI East of England annual lunch. In my time as a member of the Monetary Policy Committee, I have particularly appreciated the opportunity to talk to businesses and business groups around the UK. As an economist with strong roots in the business world, I place great weight on the input that the MPC receives from the business community, which we get from a wide variety of sources – including business surveys and the reports from the Bank's Agents. But there is no substitute for visiting individual companies and meeting business groups to gauge economic sentiment at the grass roots level around the country. It is a great strength of the MPC that regional visits are a key part of the activities of all members of the Committee. And in the four and a half years I have spent as a member of the Committee, I estimate that I have visited around 140 individual businesses and talked to around 100 business groups – across England, Scotland, Wales and Northern Ireland.[1]

There are two reasons why I am particularly pleased to speak at today's lunch. First of all, the East of England is my home region as I live in Essex and have done so for over a quarter of a century now. Second, I am always delighted to speak on a CBI platform as the seven and a half years that I spent as a CBI economist in the late 1980s and the early 1990s was a very important and formative period in my career. I have a great respect for the work of the CBI which remains the pre-eminent business organisation in the UK.

That period I spent working in the CBI's Economics Department about twenty years ago was also a period of major economic turbulence in the UK. I joined the CBI in September 1986, just as the "Lawson Boom" was getting underway. And I was the CBI's Director of Economic Affairs from 1989 until the end of 1993 as boom turned to bust and the UK economy went through the last major recession before the global financial crisis of 2008/9. We also went through a great deal of upheaval on the policy front – with a major surge in inflation in the 1980s, joining the ERM in 1990 and then leaving it two years later, and also having to deal with a very large public sector deficit in the wake of the early 1990s recession. Perhaps when I was appointed to the MPC in 2006, twenty years after I joined the CBI, alarm bells should have been ringing in the business community. Both my periods of involvement with national economic policy-making have coincided with periods of major economic turbulence in the UK economy! Maybe you can take some comfort from the fact that my term on the MPC finishes at the end of May – which should usher in a calmer period for the UK economy and policy-making if past experience is any guide!

From a personal point-of-view, however, this has been a fascinating period to be involved with UK economic policy-making. In my view, the actions taken by the MPC from the autumn of 2008 and through 2009 played a key role in stabilising the UK economy in the face of the negative and destructive forces created by the global financial crisis. But now that we have passed the worst phase of that crisis, a reassessment of policy is needed. I have been arguing for some time that we should be gradually removing some of the monetary

[1] MPC members typically undertake 2-day regional visits which include around 4 in-depth discussions with individual companies and 3 meetings with groups of business executives. Since I joined the Committee in October 2006, I have undertaken 35 regional visits of this sort.

stimulus provided in the depths of the recession by raising interest rates to reflect the improvement in the economy at home and abroad and to counter the rather worrying tendency of inflation to run significantly above the 2% target set by the government.

In recent months, however, there have been concerns about the sustainability of the UK economic recovery which might seem to weaken this case for higher interest rates. The GDP data for the final quarter of last year were disappointing, even allowing for the impact of the snow, and there are worries about the impact of fiscal tightening as it begins to have an impact through public spending restraint and higher VAT. There are also concerns about volatility on the international scene, with political instability in the Middle East and North Africa and the effects of the earthquake and tsunami on Japan, the world's third largest economy.

In today's speech I want to discuss the growth of the UK economy over the current recovery and how it should be reflected in the MPC's decisions on monetary policy. I will aim to cover three topics: first, the progress of the economic recovery to date; second, the prospects for UK economic growth looking ahead over the next couple of years; and third, and most crucially, the role of monetary policy in supporting sustainable economic growth in the UK economy over the economic cycle.

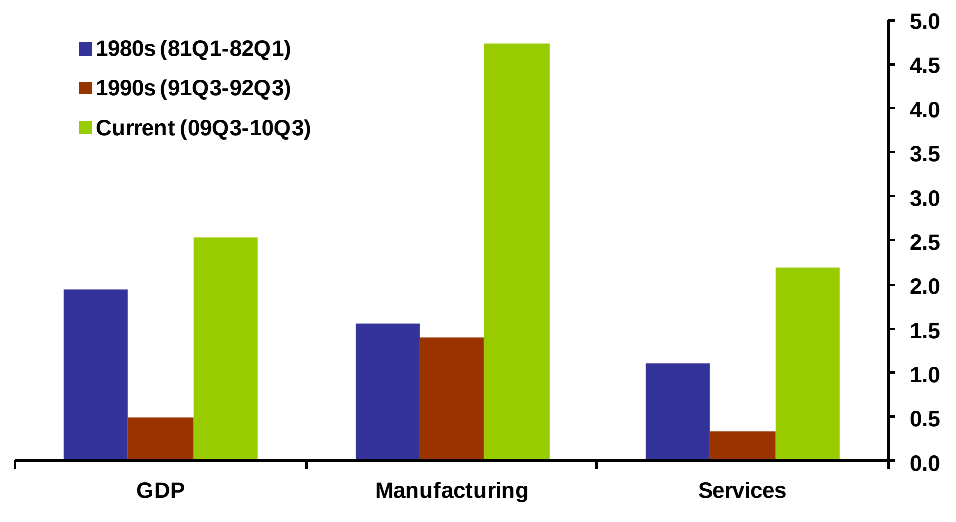
The current recovery – progress to date

Economic recoveries are normally uneven – particularly in their early stages – and we should not be surprised to see significant fluctuations in the GDP growth rate from quarter to quarter. We have seen this in previous recoveries, with the quarterly rises in GDP fluctuating from zero to 1.5% in the first three years of the 1980s recovery and from -0.2% to 1.4% in the equivalent period when the UK economy was recovering in the early 1990s.[2] In this context, the performance of the UK economy over the recovery so far does not look unusual. Before the snow arrived at the end of the year, we had four quarters of economic growth in which the rise in GDP fluctuated from 0.3% to 1.0%. In fact, until the snow-affected fourth quarter, the growth of the UK economy over the first year of this recovery was stronger than in the equivalent period of the early 1980s and early 1990s recoveries. As Chart 1 shows, UK GDP grew by 2.5% in the year following the trough of output in the third quarter of 2009, compared with 2.0% growth following the trough in the early 1980s and a rise of just 0.5% in GDP in 1991/92.[3] Manufacturing industry has performed particularly strongly, benefiting from the global recovery and a competitive pound, and the recent annual growth of manufacturing output has been the strongest recorded since 1994.

[2] Initial estimates of GDP growth made in the 1980s and 1990s were even more volatile, with quarterly GDP changes fluctuating from -1.8% to +2.3% in the first three years of the 1980s recovery and from -0.8% to +1.2% in the early phase of the 1990s recovery.
[3] Growth was stronger in the first year of sustained recovery in the second half of 1992 and the first half of 1993, but this was later in the cycle (ie longer after the cyclical peak) than the other periods shown in Chart 1.

Chart 1 – Early recoveries compared

Annual percentage growth in the four quarters after cycle trough



Source: ONS

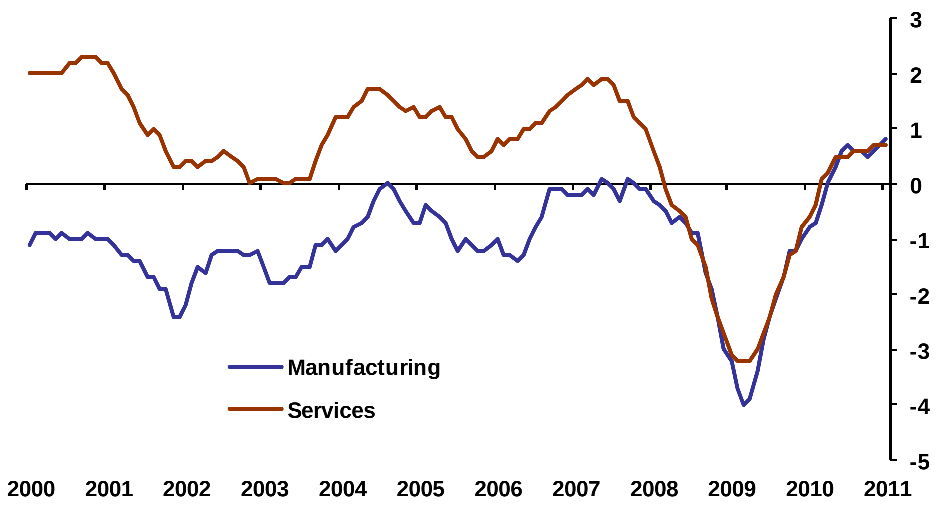
However, confidence in the progress of the recovery has been affected by the most recent GDP release which showed a fall in output in the final quarter of last year. We know that growth in December was heavily affected by the snowy weather but there are also concerns that the economy may have slowed for other reasons. We would have to wait until April for the next quarter's GDP data, but even when this arrives it will be a very provisional estimate. So it makes sense to look at other data sources to gauge the pace of recovery – notably the employment figures and business survey information, which also have the benefit of being less subject to data revision.

The employment data broadly support the view that the underlying momentum of growth has remained healthy despite the impact of December's weather on activity levels. Unlike the early 1980s and the early 1990s, when unemployment continued to rise in the early phases of the recovery and the jobless rate rose to over 10%, we have seen a much earlier turnaround in employment in this recovery. Employment picked up in the first half of last year and has risen by nearly 300,000 since last winter.[4] More recently, jobs growth has eased off with falling public sector employment offsetting increases in the private sector. But the official Labour Force Survey unemployment rate has remained at around 8% or just below since the recovery started in the second half of 2009. Indeed, the most recent figure we have for unemployment – the claimant count number for February - indicates the lowest jobless total on that measure for almost two years.

[4] The total number in employment (aged 16+) increased by 296,000 between the three months Nov 2009 – January 2010 and Nov 2010 to Jan 2011, according to the latest labour Force Survey.

Chart 2 – Employment intentions*

Bank of England Agents' scores



*: Employment intention scores reflect firms' expected changes in workforce size over the next 6 months.

Source: Bank of England

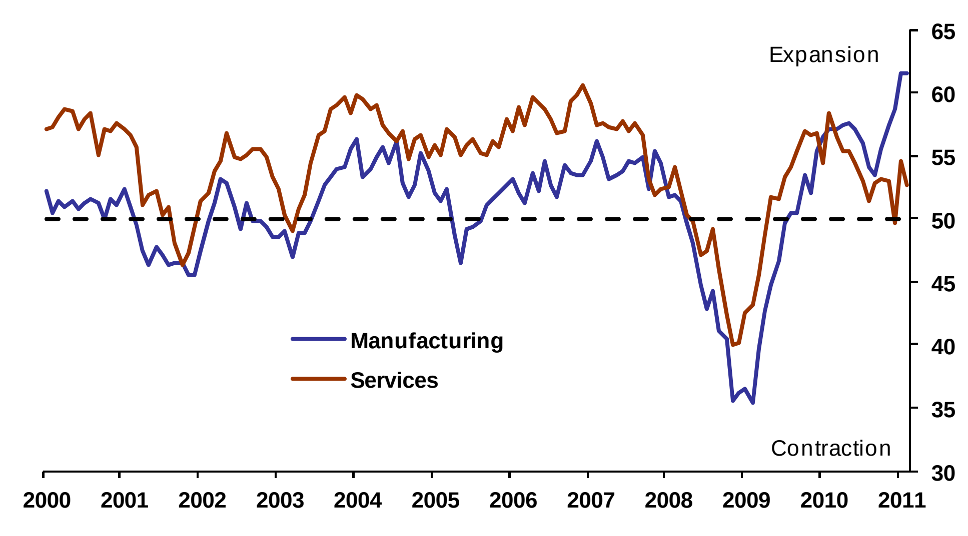
Vacancy levels are also holding up well and employment surveys – such as the Bank of England's Agents' survey also show a reasonably positive picture for employment intentions, as Chart 2 shows.

Business surveys from the early months of this year are also consistent with a continuing economic recovery. In the manufacturing sector, all the major business surveys published in the early months of this year – from the CBI, the British Chambers of Commerce, and purchasing managers – are showing record or near-record responses for output and orders, consistent with the strong growth reported by the official output figures. Indeed, the latest CBI Monthly Trends Enquiry of manufacturers, released today, shows one of the strongest responses for expected output growth that we have seen in the past two decades.

But – sadly – manufacturing industry is now a small proportion of the UK economy. The overall level of economic activity in the UK is dominated by the services sector and here the picture is more mixed. However, a good survey barometer of the services sector is probably provided by the purchasing managers' index which is published every month. The latest survey shows that after a dip in December, services activity returned to growth in the early months of this year (see Chart 3).

Chart 3 – CIPS survey activity balances

Index of activity (above 50 indicates expansion)



Source: The Chartered Institute of Purchasing and Supply

The rate of growth in the services sector indicated by recent business surveys is not as strong as we saw in the period before the recession. But that should not be a surprise. The services sector is more heavily dependent on domestic consumer demand than manufacturing, and therefore the impact of higher VAT and other imported price rises may be more noticeable in the short-term. It is also worth noting that services growth was particularly strong from the mid-1990s to the mid-2000s, growing much faster than manufacturing and other sectors of the UK economy.[5] With the economy rebalancing and the manufacturing sector now performing more strongly, we should not expect services growth to return to the strong rate seen before the global financial crisis.

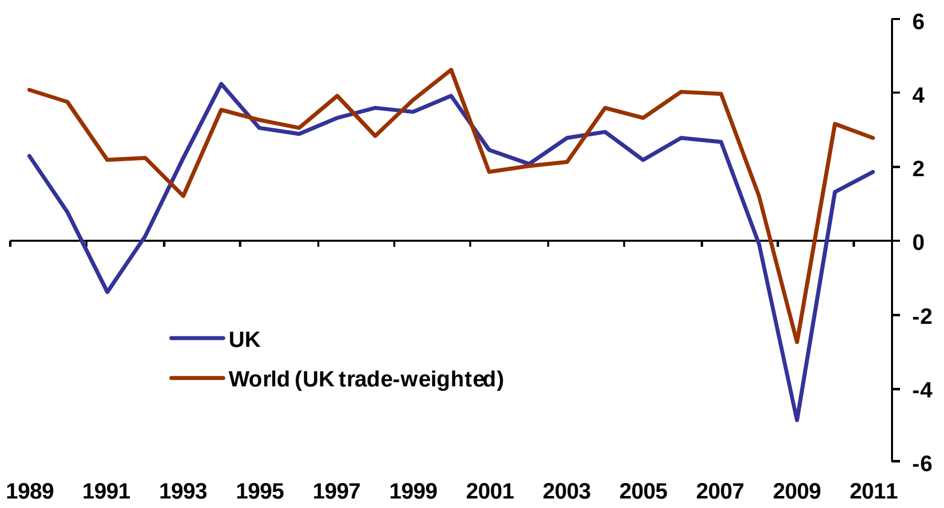
UK economic growth prospects

Looking ahead to this year and next, current forecasts for economic growth are relatively subdued at present. The latest CBI forecast, for example, predicts growth of 1.8% this year and 2.3% next year and these figures are very close to the current Consensus Forecasts of growth for this year and next – 1.9% in 2011 and 2.1% in 2012. Most forecasters expect the manufacturing sector to continue to perform strongly, supported by strong growth across the world economy.

[5] The output of the UK services sector rose at an annual rate of 3.8% between 1995 and 2007, compared with 2.9% average growth across the economy as a whole over this period.

Chart 4 – UK and world economic growth

Annual percentage change in real GDP



Note: 2011 growth rate for the UK are consensus forecasts; those for the world are IMF forecasts.

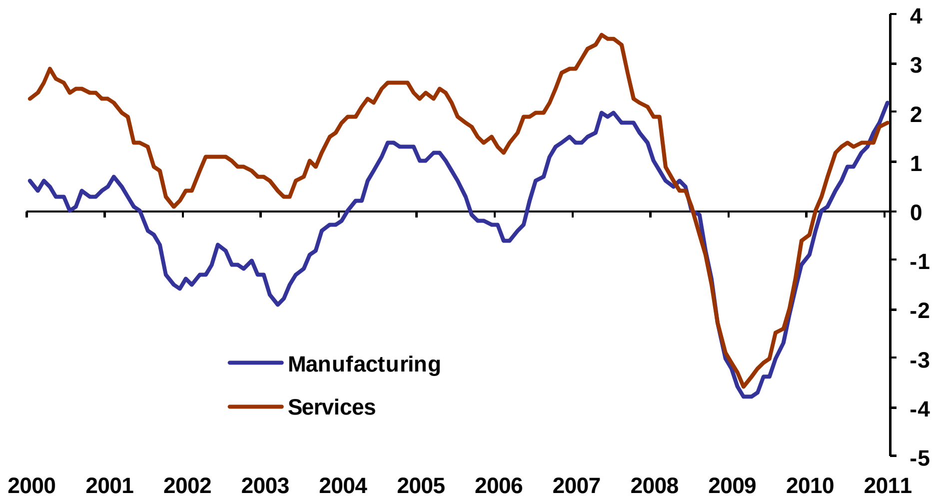
Source: ONS, IMF World Economic Outlook, Consensus Economics

While the impact of the recent Japanese earthquake and tsunami is very tragic and we are likely to see continued political turbulence in Middle East and North Africa, I would expect these developments to have only short-term effects on global growth. The economies of Asia and other emerging markets are likely to continue to provide strong momentum to global growth, and the gradual recovery which is emerging in the United States and continental Europe should continue to gather momentum. As Chart 4 shows, the growth of the UK economy follows quite closely the trade-weighted average of our major trading partners - and the IMF and other economic forecasters are projecting the continuation of relatively strong growth across the world economy this year and next.

Business investment should also be a positive force for growth over the next couple of years. The latest CBI Industrial Trends Survey showed the strongest investment intentions in manufacturing industry since 1997 and the Bank of England Agents' reports also indicate healthy investment intentions (see Chart 5), in both the manufacturing and services sectors. Many companies are dusting off investment plans that they put on hold in 2008 as the economy moved into recession, and the latest GDP figures show a 10% rise in business investment has already taken place over the past year.

Chart 5 – Investment intentions*

Bank of England Agents' scores



*: Investment intention scores reflect firms' expected expenditure over the next 12 months.

Source: Bank of England

So if the world economy is growing healthily and investment is rebounding, why is UK economic growth expected to be so disappointing? The answer lies in the outlook for public and private consumption. It is not surprising that public sector spending will act as a dampener on the growth of the UK economy as the government rebalances its finances. We experienced a similar phenomenon in the mid-1990s as the economy recovered from the early nineties recession. But in that episode, private consumption was more resilient, increasing at an annual rate of 3% a year in the five years 1993-97. Most forecasters are currently much more downbeat on private consumption, and a similar view underpins the Bank of England's Inflation Report forecast.

An important contributor to the weakness of private consumption – particularly this year – is the squeeze on household incomes from high inflation. Indeed, in money terms, household consumer spending rose by over 5% last year – the strongest nominal consumption growth since 2000. But the squeeze from rising prices limited the real growth to less than 1%. With consumer price inflation remaining high, this pattern is likely to continue through this year. Most forecasters are assuming that there will be limited upward pressure on wages from high inflation in the short-term, partly because of the downward influence of relatively high unemployment and partly because the rise in inflation is expected to be temporary. The latest consensus forecast is for average earnings growth to pick up to 3% by 2012 from the current underlying rate of increase of 2.3%. However, Income Data Services are already reporting that pay settlements have moved up to 2.8% in the private sector, pushed up by a number of pay deals linked to the Retail Prices Index. In my judgement, there are upside risks to both inflation and consumption growth from a stronger rebound in wage growth as the recovery proceeds. This is one of the reasons – though not the only one – why I believe that the current Inflation Report forecast that inflation will fall back to the 2% target is relatively optimistic.

The behaviour of wages and consumption will therefore be an important influence on the outlook for both growth and inflation over the next couple of years, and this is clearly an area that the Monetary Policy Committee is monitoring closely. With imported price pressures and VAT adding to inflation in the short-term, we should not be surprised to see a squeeze on real incomes and relatively subdued consumer spending in the first half of this year. But if wage increases start to pick up more than current forecasts suggest in response to persistently high headline inflation, we are likely to see some combination of stronger consumption growth and higher medium term inflation. This scenario, which I see as quite likely, would reinforce the case for raising UK interest rates to head off inflationary pressures.

Economic growth and UK monetary policy

The UK's monetary policy framework is focussed on the objective of price stability, which is currently defined in terms of a 2% target for CPI inflation. There are good reasons why we have made the achievement of price stability the centrepiece of monetary policy here in the UK, and why many other countries follow the same approach. While monetary policy can affect the growth rate of the economy in the short term, over the medium to long term, economic growth is driven by supply side factors – enterprise, innovation, investment and skills. Attempts to boost growth solely by loose monetary policy policies – which we experienced in the 1970s and the late 1980s – ended up creating greater economic instability and almost certainly hampered longer-term growth prospects. The best contribution that monetary policy can make to supporting the underlying forces of growth is therefore by fostering a climate of stability – primarily in terms of the level of prices but also by seeking to promote a relatively stable demand climate and by avoiding potentially destabilising lurches in policy.

As I have already noted, the need to stabilise the UK economy in the face of a massive global financial shock in late 2008 and early 2009 fully justified the large cuts in Bank Rate and the injections of Quantitative Easing that the MPC made at that time. But now the economy is growing again and inflation is running persistently above the 2% target, such a large degree of monetary stimulus is no longer appropriate and is in danger of creating more instability in growth and inflation, rather than stabilising the economy as monetary policy should.

One justification which is frequently used for maintaining current monetary policy settings is the "output gap" model of the inflation process. According to this view of the world, stabilising growth and keeping inflation on target are two sides of the same coin. Weak growth builds up a margin of spare capacity which then pushes down on inflation, whereas strong growth is more likely to be associated with above capacity working and a build-up of inflationary pressures. The UK economy appeared to conform to this model for the first decade of the MPC, but recently it has broken down and is no longer acting as a reliable guide to policy-setting.

In a speech last month, I set out the reasons why this might be the case.[6] First, the relationship between spare capacity and inflationary pressures may be much more complex than the simple model suggests – particularly in the services sector which now dominates the UK economy. Second, the very accommodative policies we pursued in the depths of the recession allowed companies to pass through cost increases and may have encouraged companies to believe they have more pricing power than in the past. We have seen further evidence of this today in the very strong price expectations which are continuing to be registered by manufacturers in the CBI survey. And, third, the UK is a very open international economy. Global price pressures and the value of the pound appear to be having a greater impact on our inflation rate than the domestic margin of spare capacity.

There are other criticisms which can be made of the "output gap" view of the world. Measures of the "output gap" are frequently revised, partly because of GDP data revisions and partly because of changes in our view of where the trend or capacity level of output truly lies. For both these reasons, the "output gap" is notoriously difficult to measure in real time.[7] Indeed, there have been quite significant revisions to the GDP profile of the early 1990s recession from the initial estimates. And we have already seen some revision to the GDP data through this recession and recovery – for example the rise in 2009 fourth quarter GDP growth has been revised up from a provisional estimate of 0.1% to 0.5% in the space of just twelve months.

For all these reasons, I believe we need to be particularly wary of basing monetary policy at present on fine judgements about the current and future growth of the economy. The MPC's remit is clearly couched in terms of keeping consumer price inflation on target and we have a responsibility to take action when we see the sort of significant upside deviations we have experienced, not just recently, but over a number of years now.

Most of the evidence suggests that recovery is underway and it is likely to continue, even though the pace of growth is somewhat uncertain. There are upside risks to the growth outlook as well as downside concerns. The world economy is growing strongly and this is a major factor underlying current inflationary pressures from global energy and commodity prices. And a stronger response of wage growth to current high headline inflation could support stronger growth of consumption than most forecasters currently expect.

We have entered a period of UK monetary policy-making when the judgements made by the MPC are much less straightforward than they appeared to be before the financial crisis. The global climate is now more inflationary and it seems unlikely that the margin of spare capacity in the UK economy will prevent current inflationary pressures from becoming embedded, without monetary policy being tightened. We have heard

[6] See Sentance (2011).
[7] This is a point repeatedly made by Orphanides. See his recent comments in Orphanides (2011), for example.

the news today that CPI inflation has risen again – to 4.4% – and it could easily rise above 5% later this year. Once businesses and individuals come to expect higher inflation – and there are increasing signs that they are beginning to do so – these expectations will be much harder to dislodge.

In this environment, with inflation running very considerably above its target level and set to rise further, failure to take timely monetary policy action risks a more abrupt and destabilising rise in interest rates in the future. That is surely something which the businesses represented here today would not want to see. And that could be a much bigger threat to future economic growth than the gradual increases in interest rates which I have been arguing for since the middle of last year.

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