



BANK OF ENGLAND

Speech

Monetary policy in a weak economy

Speech given by

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Introduction

Even before the recent problems associated with the euro area, most countries were experiencing a disappointing recovery from the aftermath of the recession which began in 2008. In the United Kingdom things have been particularly slow. In this speech I would first like say rather more about our own recent experience and some of the factors which make the last few years so different from our earlier experiences of business cycles. I will focus particularly on the unusual behaviour of both productivity and consumption. Secondly I would like to discuss what the Bank has been doing to support the economy. I will then broaden this to discuss some of the other proposals which have been suggested and reach conclusions about the evolution of aggregate demand compatible with a well-balanced and sustainable recovery.

The UK Recovery in a Historic and International Context.

Perhaps I could begin by putting some flesh round the observation that we are experiencing the slowest economic recovery since the First World War. There have been six recessions since 1920 and, working with colleagues from the National Institute and Cambridge University, it has proven possible to construct monthly profiles of these. Those for the recessions between the two wars are interpolated using the monthly activity indicators collected by *The Economist* during the period (Mitchell, Solomou and Weale, 2009). The post-war recessions are interpolated from quarterly data using manufacturing output and retail sales as monthly indicator variables (Mitchell, Smith, Weale, Wright and Salazar, 2005).

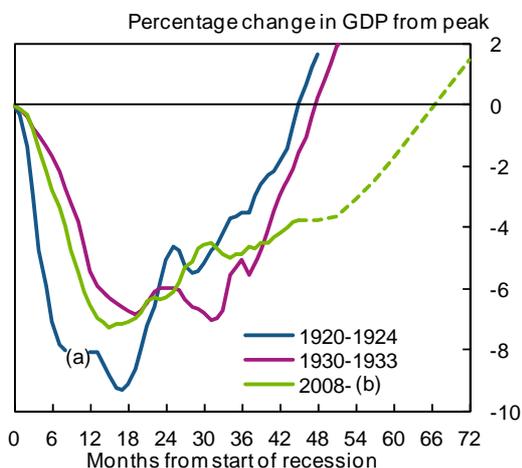
In Charts 1 and 2 I show the time profiles of these, measuring GDP in each month (as a three-month moving average) relative to GDP at the start of the contraction. In interpreting these charts we need to remember that all of the data are uncertain and that the most recent data are at particular risk of significant revision. We can see from the charts that there have been two relatively mild recession/recovery periods, those of the mid-1970s, associated with the oil crisis, and the early 1990s and four recessions which were similar in their depth, those that began in 1920, 1930, 1979 and 2008. Nevertheless the first pre-War recession was slightly deeper than the more recent recessions. Its trough was over 9% below the pre-recession peak.¹ The 1932 trough, like the trough in the current recession, was about 7% below peak with the recession in 1979 being milder. But we can also see that, for the three completed cycles, the time needed for output to recover to its pre-recession level was no more than four years and one month.

We might now ask how long it is likely to be before output regains its level of early 2008. The central estimate of economic growth associated with the MPC's latest forecast, published in the *Inflation Report*, shows this happening in the third quarter of 2013. Of course this is no more than the centre of a range of dates implied by our fan-chart, but it suggests a cycle lasting more than twelve months longer than its

¹ Excluding the effects of the coal strike in 1921 which reduced output by a further 10 per cent.

predecessors. In other words, in terms of duration if not depth, our forecast suggests that this will be the worst of the cycles for which we can produce more than annual indicators.

Chart 1: Pre-war UK recessions and recoveries

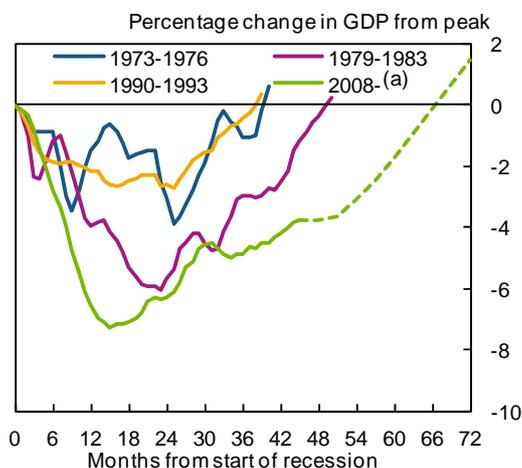


Sources: Mitchell, Solomou and Weale (2009) and Bank of England.

(a) Omits erratic fall due to coal strike from April to June 1921 when output fell to 19.5% below peak.

(b) Dashed line shows MPC's Nov 2011 central projection of quarterly GDP growth spliced onto NIESR monthly GDP estimates.

Chart 2: Post-war UK recessions and recoveries



Sources: NIESR and Bank of England.

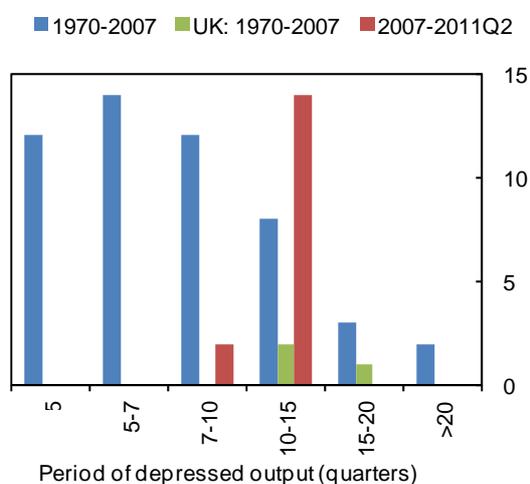
(a) Dashed line shows MPC's Nov 2011 central projection of quarterly GDP growth spliced onto NIESR monthly GDP estimates.

At this point a digression is helpful. Why do we refer to the 1930s cycle as the Great Depression if it was shallower than the 1920s cycle and slightly less protracted than the cycle around 1980? The answer is because other countries experienced much sharper contractions than we did. Over the period output fell by between a quarter and a third in Austria, Germany, Canada and the United States as compared to our figure of around 7%. The United States did not regain its output peak of 1929 until 1936 – in other words there output was depressed below its peak for about seven years as compared to our four years and one month. So, seen from the perspective of movements in GDP, the Great Depression merits a special label because of its impact on these and other countries and not because of its impact on the United Kingdom.

A study by the IMF suggests that the mean time taken for output to fall during a recession and then regain its previous peak, an interval which I subsequently refer to as a period of depressed output, is 6.8 quarters, rising to 11.3 quarters if the recession is associated with a financial crisis (IMF, 2009). So all of the completed periods of depressed output in the UK have been much longer than the average for developed countries. Indeed they have all been longer than the average for periods of depressed output associated with financial crises. Even if one looks at periods of depressed output associated with financial crises that are

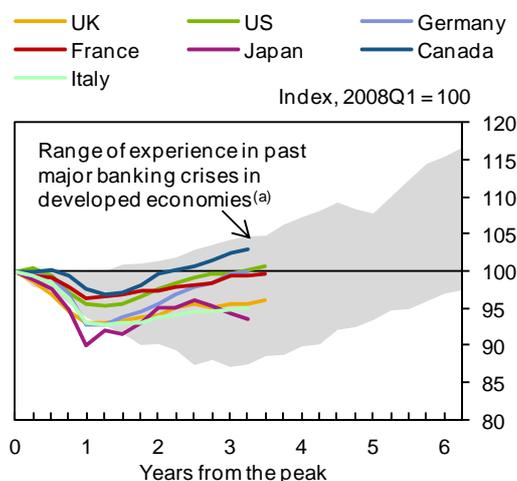
highly synchronized, the mean duration is 14.1 quarters, while for those associated with major banking crises (which might be considered more comparable to our recent experience than the wider range of crises covered by the IMF work) the mean duration is 13 quarters. Fourteen quarters have already elapsed since the start of the current period of depressed output. So four of the six phases since 1920 will have lasted longer than the worst mean case identified by the IMF, associated with highly synchronised financial crises. The unusual length of such periods in the UK can be seen in the chart below. This looks at the distribution of the duration of periods of depressed output. The periods associated with the post-war UK recessions are all in the tail of the distribution, as are the recent periods associated with the financial crisis.

Chart 3: Distribution of lengths of depressed output in developed economies 1970 to now



Source: IMF and bank calculations.

Chart 4: Recession and recovery in the G7 economies^(a)



Source: OECD and Bank calculations.

(a) Start dates for recessions associated with major banking crises are: Norway 1988Q1; Sweden 1990Q1; Japan 1993Q1; Finland 1990Q1; Spain 1978Q2.

What can be learned if we look at the experience of the other major advanced economies? Might our weak recovery be associated with the magnitude of the recent banking crisis? In Chart 4 we can see the paths that the G7 countries have followed since the start of the crisis. Canada is the obvious winner, but then there are two groups. The United States, Germany and France, at least so far, have shown recovery paths close to the top of what might be expected following major banking crises. In contrast the United Kingdom, Italy and Japan have performed near the bottom of the range of outcomes indicated by past experience. The crisis in the United Kingdom was probably not more severe than in the United States while Italy and Japan, for all their other problems, did not have banking crises (Barrell, 2010). And the period I am considering finishes before the problems of the euro area started to affect Italy. So, on this basis too, UK experience is not easy to explain.

Does it become any easier to understand if, instead of looking at averages of earlier recessions, we try to account statistically for the lengths of those earlier recessions on the basis of the circumstances which gave rise to them? There has, of course been a wide range of studies looking at influences on the depth and duration of recessions and the speed of economic recoveries. These studies typically either examine the probability of a recession taking place or, conditional on that happening, explore some other characteristic such as its depth, its duration, or the variable of particular interest to me today, the time taken for output to recover to its pre-recession peak.² Ideally one should examine jointly the probability that a recession occurred and the time taken for output to regain its previous peak. To the extent that other discrete events are involved, such as the presence or absence of financial crises, one should also look at the determinants of such events rather than treating them as exogenous.

Matthew Corder and I have carried out an attempt to look at this joint determination of recessions and crises together with the determination of the length of the recession and recovery given that it has occurred. We have been unable to address satisfactorily the last issue, that of modelling jointly the risk of a crisis together with an examination of the risk of a recession and the duration of the recession/recovery phase conditional on a recession happening.

Across a selection of 14 developed economies between 1981 and 2006, we found that recessions (defined as at least two quarters of falling output)³ were more likely following a fall in real house prices or real equity prices. A deterioration in the current account also increased the likelihood of recession. These results were broadly in line with our earlier work presented in Corder and Weale (2011).⁴

After controlling for the factors that account for the onset of a recession, there are only a small number of factors that appear to help predict the length of time that output remains depressed: the current account and the occurrence of banking crises. A larger current account deficit prior to the crisis was associated with a longer period before output recovered its previous peak. The occurrence of a banking crisis during a period of depressed output also delayed a recovery. But beyond this we were not successful in identifying factors which play a role in affecting the time needed for output to recover to its pre-crisis level; I hope further work by us or others will be more successful.

Nevertheless, even after accounting for the factors we can identify, the UK's recovery is unusually slow. Our model suggests that at the outset of the recession output in the UK would have been expected to be depressed below its previous peak for only two years; as I noted, the central path of the MPC's latest forecast implies that it will probably take five and a half years for output to recover to its previous peak.

² One might argue that it would be more sensible to look at the time taken to regain the previous trend. But if the recession is associated with a permanent reduction in trend output, that would never happen.

³ We had an additional criterion that omitted any recession where output recovered to its previous peak after only a quarter.

⁴ There were some slight changes because of the move to quarterly data, which changed the dating of some recessions relative to the earlier definition based on falls in calendar year GDP.

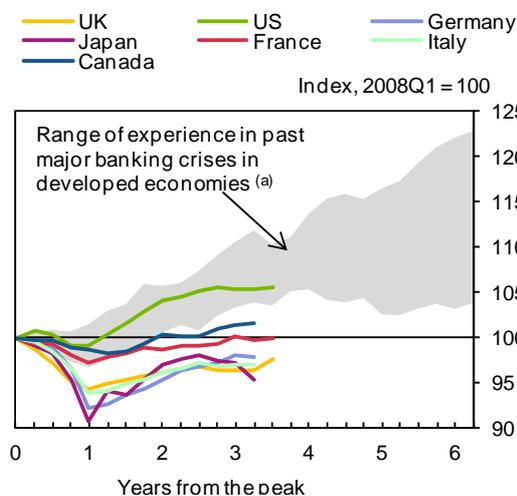
Productivity and Consumption

There are in fact two striking features of our current circumstances, also observed to a greater or lesser extent in other advanced economies. First of all, productivity, after falling during the period of recession, has recovered, but has not regained its previous path. Secondly, household consumption has been unusually weak. Consumption fell by more than 5% between 2008 and 2009, its largest peace-time fall since that of over 8% in 1921; unlike in the early 1920s, it has shown no real recovery. I would like to examine the movements of these two variables before discussing what the connections between them might be.

Productivity

As Chart 5 shows, the weakness in UK productivity is much more marked than in North America and slightly more marked than in some of the other major European countries. Only in the United States, however, is productivity performance comparable with what might have been expected on the basis of the aftermath of previous major banking crises. If we look at UK market sector productivity and compare it with where it would have been had the pre-crisis trend continued, we can see (Chart 6) that it is now nearly ten per cent lower.

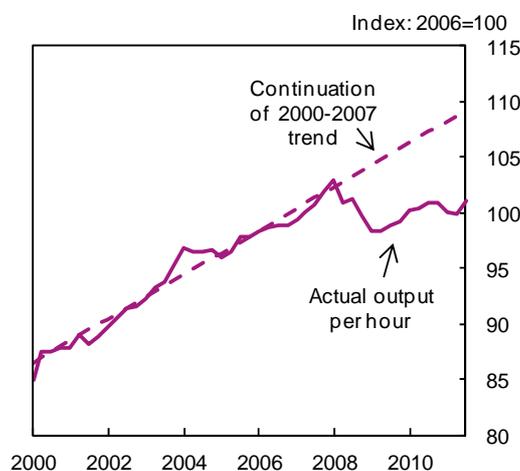
Chart 5: Productivity in G7 economies^(a)



Source: OECD and Bank calculations.

(a) Start dates for recessions associated with major banking crises are: Norway 1988Q1; Sweden 1990Q1; Japan 1993Q1; Finland 1990Q1; Spain 1978Q2.

Chart 6: UK market sector productivity



Source: ONS.

If productivity growth is effectively exogenous, as is assumed by those who see it as an important cause of economic fluctuations (see Kehoe and Prescott, 2007), that might be the end of the matter. But my colleagues and I would prefer to have some explanation.

Some authors (e.g. Martin, 2011) have argued that productivity growth is weak because demand is weak. Were demand to grow faster then supply would expand to meet that demand. Could the economy function like a modern version of Elijah's widow's cruse? This view of the economy was a recurring theme of the 1960s and early 1970s at a time of full employment. Might its application be more successful today given that the economy is suffering from an unprecedented period of weakness? If it were clear that businesses were hoarding labour as a result of weak demand, then an increase in demand would result in them increasing their output without the need to recruit any more labour and measured productivity would rise. Arguably the better productivity, but worse unemployment experience of the United States could be attributed to less labour hoarding there because costs of hiring and firing are lower than at home. But we know that, in the early part of this year some service industries were taking on new labour even though their productivity levels were well below trend; this is not consistent with labour hoarding.

A separate argument, to which we should give some weight, is that some businesses are having to work much harder than they were in order to bring in business. Firms selling goods and services may have to work much harder to find buyers. If there were more overall demand then less work would go into finding buyers and productivity would increase. There may be some truth behind this, but manufacturing productivity remains a long way below its previous trend even though, until recently, output growth has been buoyant.

Disney, Haskel and Hedin (2003) draw attention to the importance of restructuring as a source of productivity growth. Much of the improvement to productivity comes from closing down inefficient establishments and replacing them with more productive establishments. For single-establishment firms this is obviously associated with turnover of businesses. One might think that the pressure for restructuring will be particularly strong at a time of weak demand. But it is possible that the combination of a healthy corporate financial position and forbearance by banks mean that this effect is much weaker than usual.

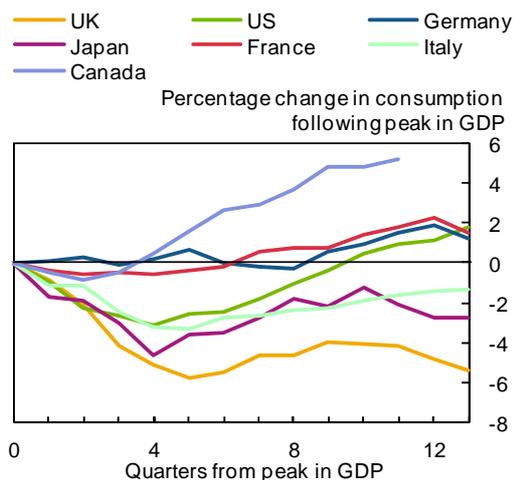
Consumption

I mentioned earlier that consumption had been unusually weak and had also failed to recover. Chart 7 shows that, while the experience of the UK is further from that of the other G7 countries than it was with GDP growth, there is a pattern of consumption broadly similar to that identified in Chart 4 for GDP. Canada is again leading the pack followed by France, Germany and the United States while Italy, Japan and the United Kingdom show weak consumption.

Consumer spending is often discussed, rather unhelpfully in my view, with reference to "consumer confidence". Spending has to be paid for somehow and I therefore prefer to look at consumption in the context of what is happening to income (although Bank work suggests that consumer confidence surveys can provide a good indicator of income in real time). We can see in Chart 8 that post-tax household income

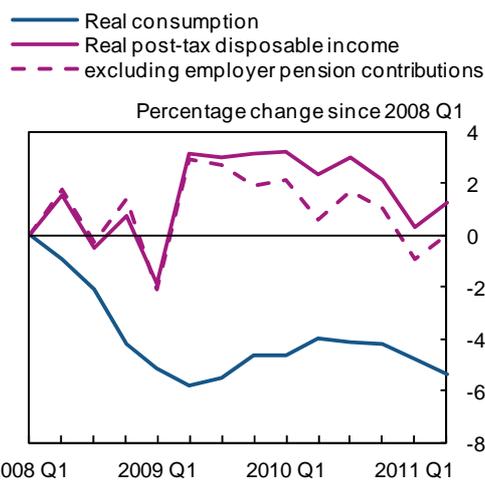
is slightly higher than it was at the start of the recession. Even if one looks at household income excluding employer pension contributions, perhaps a better measure of the money passing through people's wallets, we can see that it is no lower than before the crisis. Consumption, on the other hand has stagnated since early 2009 and is, as I noted, more than 5% below its value at the start of 2008. Why should consumption have fallen and stayed low?

Chart 7: Consumption in G7 economies



Source: IMF.

Chart 8: Movements in consumption and income in the UK



Source: ONS and Bank calculations.

The reference framework used by most economists to look at consumption is the life-cycle model. The basic principle underlying this is that people choose their spending not with reference to their income in any one year but with reference to their current wealth and their expectations of future incomes so that expected marginal benefit of consumption, discounted for the fact that future spending may be worth less than current spending, is equated over their expected remaining life-time. A key point which follows from this is that people are unlikely to choose paths which require jumps in consumption. If the benefit of spending in any one year declines with the amount spent, then welfare can be increased if, instead of high spending today and low spending tomorrow, people reduce their spending somewhat today so as to be able to afford more tomorrow.

If we accept this view of spending, then the implication is that the sharp reduction in consumption is telling us something about people's expected future incomes. While there is any number of ways in which those expectations could have changed, I would like to focus on two possibilities. One is that the financial crisis has led to a downward jump in the path of expected future output, but that, from this lower level, its expected trend growth rate has not changed. A second possibility might be that, for some reason the expected trend growth rate of productivity is lower than it was before the crisis. If this were the case, then the rational thing might be for people to capitalise that shortfall and adjust their spending in the light of this. Perhaps the key point is that both these explanations place productivity to the fore. Another way of making the point is that

people were prepared to save almost none of the income in the late stages of the boom because they hoped for continuing and sustained rises in income.

Of course this story cannot account fully for differences between countries in consumption movements. Productivity in Germany has been almost as weak as at home, but its consumption and GDP have recovered better, at least ahead of the euro area debt crisis. So I should mention some other factors which may be holding consumption down. First of all, people may want to plan in the way described above, but, particularly at a time when incomes are weak, they may not have access to the resources they need to maintain their spending. Obviously the chance of this happening is particularly high if credit has tightened unexpectedly; it may be affecting some consumers even though, as we have noted, income in aggregate has held up better than consumption.

Secondly, I should say something about the role of risk. The forward-looking consumption model, properly implemented, takes account of risk. So an unexpected increase in the risk of unemployment now or in the future leads to an increased desire to save. Equally, an expectation that credit will be tighter in the future means that rational people will choose to save more now so that they build up their own buffer against future shocks.

But an additional explanation of weak consumption in the UK, both in absolute terms and relative to other countries is that in the middle years of the last decade, far from consumers making rational calculations, consumption was simply too high, sustained only by a continuing willingness and ability of consumers to borrow. One indicator of the unsustainable nature of consumption could be gained by looking at household consumption *per capita* at purchasing power parities. From 2003 to 2007 the UK was ranked eighth or ninth in terms of GDP *per capita* but second in terms of consumption.⁵

A reasonable conclusion is that worsened productivity growth is one factor contributing to the weakness in consumption, but that other influences may also be important. More importantly, even if weak consumption is an important factor behind the poor performance of the economy, that does not mean that rapid growth in consumption is the only way of sustaining the recovery. This remains true even if faster growth in demand might improve productivity performance. However, I would like to discuss means of supporting the overall level of demand before turning to the issue of rebalancing.

Monetary Policy Response

The focus of the Monetary Policy Committee's attention is to ensure, as best it can, that demand in the economy is adequate to sustain inflation at its target rate. It makes policy decisions with reference to the overall state of demand and not to any particular pattern of demand. We recently voted unanimously to set

⁵ Omitting from both calculations the economies of Iceland, Ireland and Luxembourg for which GDP is not a good guide to their available resources.

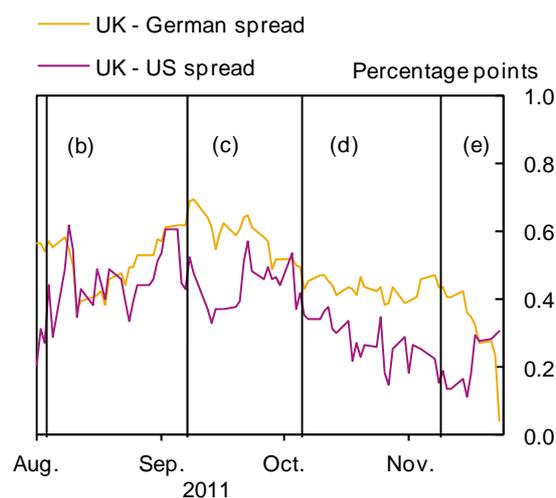
in train a new programme of asset purchases. The Bank is buying in government debt at a rate of close to £25bn per month, extending asset purchases by £75bn to a total of £275bn by the end of January. Even after allowing for the effects of this stimulus, our recent forecast shows inflation expected to fall somewhat under target at a two to three year horizon.

The policy is intended to reduce long-term interest rates. Yields on gilts have indeed fallen to levels not seen since the years immediately after the Second World War. Indeed, with the price of 4% Consols above par and the price of 3 ½% War Stock (popularly War Loan) only just below par, it is hard not to wonder whether these venerable stocks will themselves be casualties of our current circumstances. Both of them are now callable⁶ and once their prices pass par it is in the tax-payer's interest for them to be converted or redeemed. But interest rates have fallen internationally and one should not attribute the whole of the recent decline here to the effects of our asset purchases. An international comparison offers a better guide.

Yields on ten-year gilts have fallen relative to those in the United States and Germany (Chart 9) by between 14 and 38 basis points (bp) since the MPC minutes released on 17th August first suggested that further purchases were likely. This is broadly consistent with the approximately 35 bp move that might have been expected based on evidence following the MPC's earlier round of asset purchases, particularly as precise comparisons are probably muddled by policy measures taken by the Federal Reserve at much the same time. And, if the interest rate component of the discount factor which relates expected future company earnings to share prices has fallen by the same amount, then the policy is expected to raise share prices by up to 7½%.

Studies of consumer behaviour that focus on explaining the data rather than working with the narrow constraints of the life-cycle model suggest that the resulting capital gains will support consumption with typical estimates of propensity to consume out of household wealth in the range 2-5%. Lower interest rates and higher share prices also have the effect of reducing the cost of capital. Taking the existing mix of corporate finance as given, the interest rate movements identified have the effect of reducing the cost of capital by up to 40bp. The policy may also have some impact on the exchange rate. Indeed one would expect it to, because if

Chart 9: UK gilt yields relative to yields on German and US government debt^(a)



Sources: Bloomberg and Bank calculations.
 (a) Spread between ten-year spot zero-coupon yields.
 (b) August MPC meeting.
 (c) September MPC meeting.
 (d) October MPC meeting.
 (e) November MPC meeting.

⁶ 3 ½% War Stock is callable in 1952 or after and 4% Consols in 1957 or after. Reinhart and Rogoff (2011, Table C2) describe the debt conversions of callable stock in the 19th century as "mostly voluntary" restructurings. Of course they were not voluntary, any more than would be a conversion of these two securities.

domestic demand is increased, then overall, the economy needs to be more competitive to satisfy the external inter-temporal budget constraint.

In addition, it would be odd if only long-term financial assets were affected by a decline in long-term interest rates. Reduced long-term rates should be expected to affect the prices of houses, or at least that of the land on which they stand⁷ and the effect on house prices is likely to be larger than that on share prices because the yield on housing is lower than the earnings yield on shares. Micro-economic evidence on whether people spend out of housing wealth or not is conflicting (see Campbell and Cocco, 2007 and Attanasio, Blow, Hamilton and Leicester, 2009). But the macro-economic evidence is reasonably definitive (Barrell and Davies, 2007); an increase in house prices should also support household consumption. Combining these effects, and allowing for the fact that, while higher demand leads to higher incomes and higher second round spending, there are also substantial leakages from the circular flow of income, these calculations overall point to an effect of our current programme of asset purchases on GDP of up to ½%, a figure equal to the central estimate implied by the analyses described in the *Quarterly Bulletin* in August (Joyce *et al.*, 2011). However there are also good reasons for expecting some of the effects, working on investment, to lead to a permanent increase in supply.

The possibility that the impact of the policy may be weaker than the bulletin article suggests, does not, in itself, create an argument for increasing the size of the programme, because it may also be the case that, as in the past, the Bank has understated the degree of persistence in the inflation rate. At least that possibility could hardly be ruled out and it might be prudent to wait to see that the sharp fall in the inflation rate which we have been forecasting actually happens before making any further decisions. But nevertheless, unless the economic situation improves, there is likely to be a strong case for extending the asset purchase programme after the current one comes to an end.

Other Forms of Demand Management

Are there other things which might be done to support demand and would these be more effective? It is widely said that if the Bank “gave” the money to some group other than bankers it would have more effect on demand. Of course with asset purchases the Bank is not giving money to anyone, it is buying government debt (mainly from non-banks). Even if it is nearly fifty years since a politician referred to state benefits as donations, it is governments and not central banks which are in a position to give public money away. As Bean (2011) noted, schemes such as shopping vouchers are fiscal rather than monetary in form. Indeed the same must be said of the helicopter drop of bank-notes described by Friedman (1969).

⁷ The fact that mortgage finance is generally related to short rather than long-term interest rates does not weaken this argument. One would expect a change in the long-term interest rate to affect the price of land even if it were all owned outright.

One other suggestion which has gained some currency is that there should be a target for the price level rather than for the inflation rate.⁸ Obviously a price target implies that, if inflation is below target, then future inflation will be allowed to rise to compensate for this. To the extent that expectations of future inflation are associated with expectations of low real interest rates that may serve to provide an extra stimulus to demand. I do not want to discuss this in great detail, but I would like to point out that, if we had a target for the price level rather than for inflation in place at the moment, the Monetary Policy Committee would probably be increasing interest rates rather than embarking on extra asset purchases. I have not heard anyone seriously propose that we should seek to claw back the excess of inflation over its target of the last couple of years or so; this is what would have been required if a regime of price-level targeting had been in place for the last few years.

Banking Liquidity and Disintermediation

Quite separately from these different ways of supporting demand I should also mention the issue of maintaining the liquidity of the banking system. One important indicator of the health of the banking system suggests that the strains we saw a few years ago are not present at the moment, the gap between Bank Rate and LIBOR is much smaller than it was after the run on Northern Rock; nevertheless it has risen recently, perhaps because of rising tensions in the interbank market. While the maintenance of liquidity is not the responsibility of the Monetary Policy Committee, it would be difficult to cover the subject matter of this talk without some discussion of ways in which banking liquidity can be maintained if the need arises.

The monetary system is much more robust than it was in 2008. First of all, the average ratio of capital to risk-weighted assets of the major UK banks has risen from 6.5% in early 2008 to 10.4% now. Secondly, the commercial banks are much more liquid; indeed holdings of sterling liquid assets are now at a thirty-year high – an outcome which is, in part, a consequence of our asset purchases. Thirdly, of course, the Bank of England has also learned from the experience. It has conducted a thorough review of its operations in sterling money markets and made changes to the way it provides liquidity insurance to the banking sector to ensure they are more effective in future. These changes were set out in its ‘Red Book’ (Bank of England, 2010). Indexed Long-Term Repo operations enable banks to borrow from the Bank for periods of three or six months in return for two different sets of collateral. The Discount Window Facility allows banks to borrow gilts (or, in exceptional circumstances, cash) from the Bank in return for a wider range of less liquid collateral. The new framework allows the Bank to increase the provision of liquidity to the banking system, should it be needed, without delay. It has also taken steps to promote supply-chain finance. So far the take-up of the scheme in which it has been involved has been limited; the scheme nevertheless remains open.

It has been suggested that the Bank should lend directly to the private sector, disintermediating the commercial banks. Of course it did this for more than three hundred years by discounting bills of exchange.

⁸ As was adopted in 1932. The price target was to be achieved by foreign exchange intervention to maintain an appropriate exchange rate (Howson, 1975). I am grateful to Nick Crafts for drawing this to my attention.

But, by the early part of this century they had no role except as instruments for obtaining credit from the Bank and in 2005 the Bank stopped discounting them, with the observation that “central bank operations are best carried out using instruments that have a life and market of their own” (Bank of England, 2005).

There are in fact two issues with private sector lending and in particular lending to small businesses. First, there is a long-term issue of whether small businesses have adequate access to credit. This is not a new concern; the Macmillan Committee (1931) drew attention to it, and we have seen a stream of solutions focused on the issue of equity provision since then.⁹ The second issue is the provision of working capital in the event that banking conditions worsen. While this could affect large businesses as well as small businesses, we currently see that the largest businesses in the UK are regarded by the market as more credit-worthy than some banks. Thus the focus of concern must again be small businesses and this is an issue which could become more pressing in the near term. The Chancellor of the Exchequer has said that he will announce a scheme or schemes, secured by the Government’s balance sheet, to provide credit for small businesses and I will wait with interest to see the form they take.

Rebalancing and Aggregate Demand

The actions of the Committee draw attention to what the Governor (King, 2009, 2011) described as the paradox of policy. I have argued (Weale, 2011) that past levels of consumption were too high in the absolute sense that, given current spending and saving, people were likely to be disappointed by future spending possibilities. Far from helping to correct this imbalance, policies, such as asset purchases, which support current consumption, probably worsen it. From the narrow perspective of the MPC’s mandate the case for them is that we believe they are required to prevent inflation falling below its target in the medium term. Seen from the perspective of demand management, we are trying to maintain a balance between overall demand and supply such that inflation is brought close to its target. From a broader economic perspective, further progress with rebalancing will be easier when normal economic growth has resumed.

The MPC obviously has no instrument to promote rebalancing. But I am pleased to see that, with respect to housing, the government is developing measures to encourage investment spending by the private sector. These come over and above any help for small businesses and, at least in principle, they may have more scope to add to overall investment and thus to aggregate demand.

Looking to the longer term, however, it is hard to avoid the conclusion that the economy needs to be more competitive internationally. Over the past few months I and others have worried about the inflationary impact of the aftermath of the exchange rate movement of 2008. Work in the Bank suggests that we have now seen most of the effects of the rebalancing following on from that depreciation. But the economy is still running an external deficit, albeit smaller than before the crisis. A sustainable expansionary path will undoubtedly see

⁹ For example at present the Enterprise Investment Scheme and venture capital trusts offer tax benefits to investors in small businesses.

much of the shortfall in demand that concerns us filled by higher exports/ lower imports as well as higher domestic investment. This requires some combination of a lower real exchange rate and more demand from the countries which are currently running external surpluses. Such a policy combination is also outside the gift of the Monetary Policy Committee.

Conclusions

It is hard to avoid the conclusion that the British economy is seeing the after-effects of living beyond our means. How far this problem has been compounded by a long-term productivity shock will not become clear for many years but I share the general view of the Committee that something close to normal productivity growth, the driver of our long-term growth in prosperity, will resume in the near future. We should then also be able to sustain improvements in living standards similar to what we have experienced in the past. Nevertheless, it is unlikely that there will be a rapid return to the sort of path we might have followed in the absence of the crisis. For this reason none of us are advocating an attempt to make up more than a part of the short-fall in demand relative to the pre-crisis trend.

Nevertheless, the Committee's recent forecast suggests that, as a result of weakness over the next three quarters, inflation is more likely than not to undershoot its target at a two to three year horizon. It is fair to say that this, in turn, suggests a strong case for further support once our current programme of asset purchases is complete. At the same time I can understand the case for waiting until the marked reduction in inflation which we are predicting is clearly underway. And I should also add that, should the situation improve to the extent that I think some tightening is needed to deliver the inflation target, then I shall not hesitate to vote for that tightening. But the key point I would like to communicate today is that current circumstances make clear more than ever that monetary policy is only one part of overall economic policy and a much smaller part of the general economic environment. Monetary policy cannot, on its own, set the economy on a sound and sustainable long-term growth path.

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