



BANK OF ENGLAND

Speech

The economic outlook

Speech given by

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Good morning and thank you for that kind introduction!

In the very early part of this year, with the recovery from the 2008-9 recession seemingly becoming more solidly based and inflation running at double our 2% inflation target, the Bank's Monetary Policy Committee, of which I am a member, was edging towards starting to withdraw some of the considerable monetary stimulus we had injected during the downturn. Indeed, as recently as our May meeting, a third of the Committee were voting to raise Bank Rate from its emergency level of 0.5 per cent. Although I did not join them in voting to raise Bank Rate, I did view the arguments for and against a tightening as being finely balanced. Now, just a few months later, the Committee has unanimously voted to re-start its programme of asset purchases financed by the issuance of additional central bank reserves, also known as quantitative easing. In my address this morning, I thought I would say a few words about why the Committee's view of the outlook has shifted so dramatically and what we can expect additional purchases to achieve.

As I said, earlier this year the recovery seemed broadly on track. But, as time has passed, so it has seemed less secure. That is not so obvious in the figures for quarterly GDP growth (see left-hand panel of Chart 1), which have been buffeted by a variety of special factors, such as: the bad weather late last year; the impact of the Tōhoku disaster on global supply chains; and the extra bank holiday for the royal wedding. These last two, in particular, provided a temporary boost to the third-quarter growth rate of 0.5 per cent released on Tuesday. But business surveys and other indicators suggest that the underlying rate of expansion has probably eased (see right-hand panel of Chart 1). Those same surveys point to only very moderate growth at best in the final quarter of this year.

This slowing in growth is not confined to the United Kingdom. Growth has eased in the euro area and the business surveys are consistent with contraction in the second half of this year (see Chart 2). Though output growth has picked up in the United States according to the latest official data, the business surveys suggest this may prove ephemeral (also see Chart 2). And there are signs that China and some other emerging economies have slowed too, though in their case the slowing was partly policy-induced in order to alleviate inflationary pressures.

I would highlight two primary drivers of this slowing. The first is the heightened tension in financial and bank funding markets associated with the twin euro-area banking and sovereign debt crises. Stretched fiscal positions have raised questions about the ability of several euro-area governments to support their banking systems. And the weak position of those same banking systems has also heightened doubts about the sovereigns' fiscal sustainability (Chart 3). Though UK banks' exposure to peripheral country debt is relatively modest, interlinkages with euro-area banks that are more heavily exposed have meant that UK banks have also experienced heightened funding difficulties in recent weeks. Unless those conditions improve, our banking contacts indicate that the availability of credit to the real economy may soon begin to suffer. Moreover, the

heightened tensions in financial markets are likely to have raised uncertainty more generally and further depressed household and business confidence. Our regional Agents are already starting to tell us that some businesses are putting investment projects on hold as a result.

In the early hours of last Thursday morning, European leaders agreed to take further steps: to address the fiscal sustainability of Greece and other periphery countries; to expand the firepower of the European Financial Stability Facility; and to buttress the resilience of European banks through recapitalisation. While the major UK banks will not be required to raise capital, they would nevertheless be well advised to take advantage of any opportunity that does arise to further strengthen their capital and liquidity buffers, thereby putting themselves in a better position to withstand any further deterioration in conditions, without needing to constrain lending. Last Thursday's agreement represents an important element of a satisfactory resolution to the euro area crisis, but there are still many details to be worked out. Moreover, the announcement by the Greek government that it plans to hold a referendum on its package has injected additional uncertainty. And, even if the 27 October agreement is eventually implemented, the peripheral economies of the euro area will still be faced with substantial adjustment challenges, including the need to rebalance their economies and improve their competitiveness. So the strains in the euro area seem likely to continue for some while yet.

The second factor behind the unexpected slowing in growth is the substantial rise in energy and other commodity prices during the latter part of 2010 and first part of this year, associated with strong growth in the emerging economies as well as interruptions to the supply of oil as a result of geopolitical developments in the Middle East and North Africa. UK inflation over the past year has consequently been around 1½ percentage points higher than the central view in our November 2010 *Inflation Report*, with the twelve-month rate reaching 5.2% in September. That has added to the squeeze on real household incomes already taking place as a result of earlier increases in energy and other import prices, together with the increase in the standard rate of VAT to 20 per cent. In the eight quarters since the trough of the recession in the middle of 2009, real household income has fallen 2½ per cent, as only modest wage growth has been more than offset by elevated inflation. And with higher utility prices pushing consumer prices up another 1¼ per cent since June, it is probable that real household disposable income will turn out to have fallen during the second half of this year too. Against that background, it is not surprising that real consumer spending growth has been weak.

Although elevated inflation has been the medium through which some of this squeeze in living standards has been brought about, the squeeze reflects three deeper real economic forces that monetary policy can do little to negate. The first force is the aforesaid rise in the price of commodities, relative to the prices of global goods and services, associated with the confluence of strong demand growth in the emerging economies and commodity producers' inability or unwillingness to increase supply to match the extra demand.

The second force is the fall in the purchasing power of sterling. Before the financial crisis, the UK was operating with an unsustainably low level of national savings and an associated current account deficit. In addition, the crisis has probably led to a long-lasting hit to the demand for financial services exports. Generating an expansion in net exports in order to counterbalance the necessary increase in savings and to offset any reduction in the demand for financial services exports then requires a real depreciation of the currency. This was achieved by a fall of a quarter in the trade-weighted value of the nominal sterling exchange rate between the start of the crisis and the end of 2008¹. Although the impact of this depreciation on net exports initially seemed rather disappointing, recent revised data from the ONS now suggest that the impact on net exports has been roughly in line with that seen after previous large movements in the exchange rate (Chart 4).

The third force is the loss in output and income associated with the financial crisis. Output presently lies almost 15 per cent below where it would have been if it had continued to grow in line with its pre-crisis trend. Even if that shortfall does not prove to be permanent, the experience after previous recessions following banking crises suggests that it is likely to be highly persistent (see Chart 5, which shows the UK experience since the start of the recession, together with the range of analogous historical experiences). Initially, households and businesses were protected from the full impact of this downward shift in prospective incomes by the previous Government's decision to let the budget deficit temporarily take the strain. But the necessary subsequent fiscal consolidation has led inevitably to a higher tax burden and lower public spending growth.

As already noted, inflation reached 5.2 per cent in September. But much of that reflects the combined impact of higher VAT and prices for energy and other imports. A range of estimates of the impact of these factors is provided by the blue swathe in Chart 6. The remainder is attributable to domestically-generated inflation, estimates of which are provided by the green swathe in the same Chart. This appears to have been running well below the 2 per cent target, reflecting in large part the unusually low rate of pay growth, which is in turn symptomatic of the slack in the economy.

As we go into next year, so last January's increase in VAT will drop out of the calculation, knocking around one percentage point off inflation. And commodity prices have started to fall back as the pace of global expansion has eased (Chart 7). So the contribution of energy and other commodity prices to inflation should fall back sharply as we go through the year. Of course, we cannot assume that the evolution of domestically-generated inflation is independent of these factors. Indeed, some countervailing pickup in the contribution of domestically-generated inflation is quite possible if businesses look to provide their employees with some recompense for the past squeeze in living standards. Moreover, one cannot rule out further adverse external price shocks. But a sharp fall in inflation is the most likely outcome and that in turn should mean that the squeeze on real household incomes will ease, providing some support for consumer spending.

¹ It is worth emphasising that the bulk of this fall occurred before the MPC cut Bank Rate sharply in the wake of the collapse of Lehman Brothers and subsequently embarked on quantitative easing. It cannot therefore be attributed to lax monetary policy. Sterling has been broadly stable since the beginning of 2009.

Even so, real income growth will still only be moderate and high levels of indebtedness may weigh on the spending of some households. Moreover, the uncertainties associated with the euro area are likely to persist, retarding growth there. Not only will that weigh on our exports, but funding conditions may also remain difficult, while British businesses are likely to remain cautious about investing and hiring.

At its October meeting, the Monetary Policy Committee agreed that the outlook for UK output growth was markedly weaker than it had believed earlier in the year. Without action, and despite the present excessive level of inflation, the extra margin of slack meant that inflation would consequently be more likely to undershoot, rather than overshoot, the 2% target in the medium term. So it was against that background that we decided to re-start our asset purchases, buying another £75 billion of gilts.

As you will no doubt know, quantitative easing aims to depress a range of longer-term yields and raise asset prices, so boosting demand. Our analysis suggests that our first £200 billion of asset purchases reduced the yields on gilts and corporate bonds by around a percentage point². Studies for the United States, using a similar methodology, find comparable effects from the Federal Reserve's large-scale asset purchases, which is comforting. The asset purchases also have the effect of boosting banks' holdings of the most liquid asset, central bank reserves, which may be of particular value at the current juncture. While one cannot be confident about the impact of our earlier purchases on the real economy, our analysis points to a peak effect on output of 1½-2 per cent and of ¾-1½ percentage points on inflation. At this juncture at least, we have no reason to believe that, suitably pro-rated, the current phase of purchases will be greatly different in their effect on either asset markets or on the real economy.

Several commentators have suggested that the effectiveness of quantitative easing could be enhanced by spending the newly created money on something other than government debt. Conceptually, one can always think of this as raising extra government debt to finance whatever is bought, combined with conventional quantitative easing that offsets the extra debt issued. In addition to highlighting the potential interest of the Treasury in the first leg of the intervention, splitting it up in this way can also help to clarify analytical issues.

For instance, one idea that has been floated involves sending households a voucher, which could then be spent in the shops and redeemed for cash by the retailer. This may sound like a good idea, as it seems to get the money quickly into action in stimulating demand. Now, such a policy in effect combines an increase in borrowing to finance a temporary increase in income tax allowances with some conventional quantitative easing in which gilts are exchanged for claims on the Bank of England³. But economic theory, as well as considerable empirical

² For a summary of the evidence, including references to related studies, see Michael Joyce, Matthew Tong and Robert Woods (2011), "The United Kingdom's Quantitative Easing Policy: Design, Operation and Impact" *Bank of England Quarterly Bulletin*, 51(3), 200-212.

³ In fact using the PAYE system would probably be the easiest way to implement such a scheme. Moreover, if the Government were actually to send out vouchers redeemable into cash it might well fall foul of the prohibition on monetary finance contained in the Lisbon Treaty.

evidence, suggests that such a temporary increase in disposable income would be likely to be very largely saved⁴. Only households that wish to borrow, but presently cannot, would be likely to increase their spending materially. And making the voucher time-limited would do little to help, as households could always use the voucher instead of the cash they would have spent. In sum, this hardly seems the most effective way to add additional stimulus.

Let me conclude by offering you a comment on what all this might mean for the housing market and the demand for mortgages. As my colleague, David Miles, argued in a speech to the Home Builders Federation earlier this year⁵, we are presently in a transition from a pre-crisis world with compressed risk premia and in some cases imprudently generous loan-to-value and loan-to-income ratios, to a more sustainable equilibrium with lower ratios. That implies a period during which first-time buyers and those hoping to move up the housing ladder save the necessary extra equity, low transactions and a fall in the share of owner-occupiers. That is pretty much what we have seen and the transition has been made harder by the squeeze in real incomes. The prospective moderation in the squeeze on real household incomes should help those saving for a deposit to get onto, or move up, the housing ladder. So, as well as supporting consumer spending, it should also help support mortgage demand. That would, no doubt, be a most welcome development to you, as well as to the households themselves.

On that note, let me finish by hoping that the rest of your conference today proves most stimulating and valuable. Thank you!

⁴ Note that this only requires consumers to wish to smooth their spending over time, not that they internalise the implications for future taxes of more government borrowing (so-called 'Ricardian equivalence').

⁵ David Miles (2011), "Mortgages and Housing in the Near and Long Term", <http://www.bankofengland.co.uk/publications/speeches/2011/speech488.pdf>



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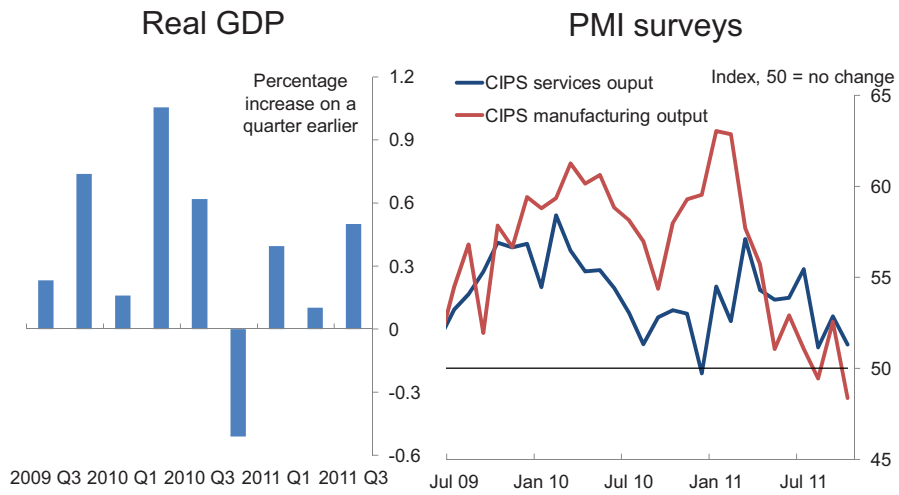
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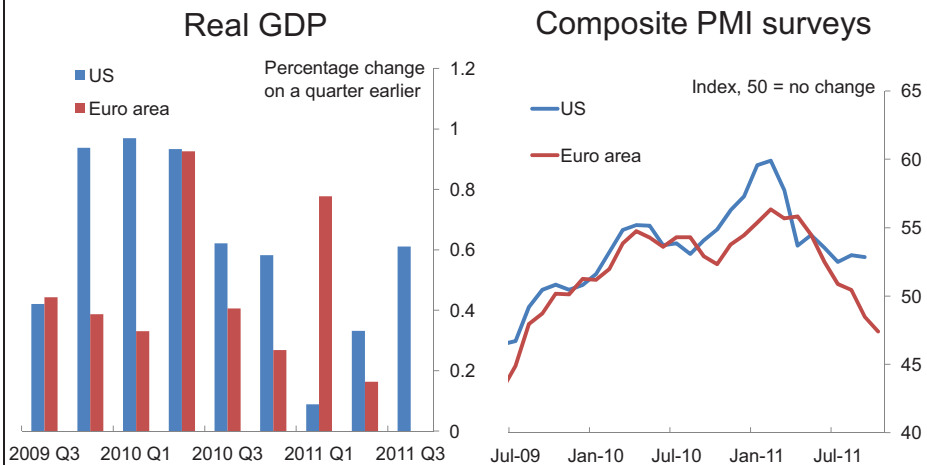
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Chart 1: UK activity



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Chart 2: International activity



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Chart 3: Euro-area sovereign and banking risks

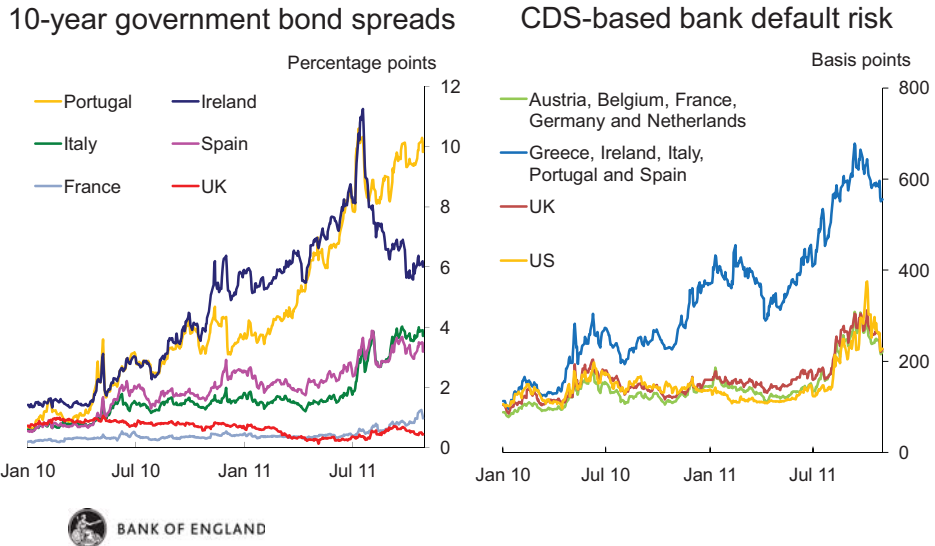


Chart 4: Change in net exports after big sterling moves

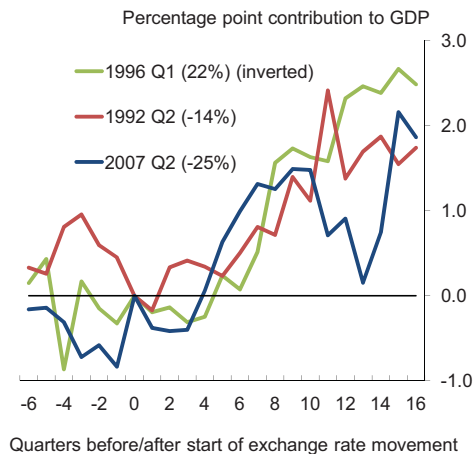


Chart 5: Output losses after banking crises

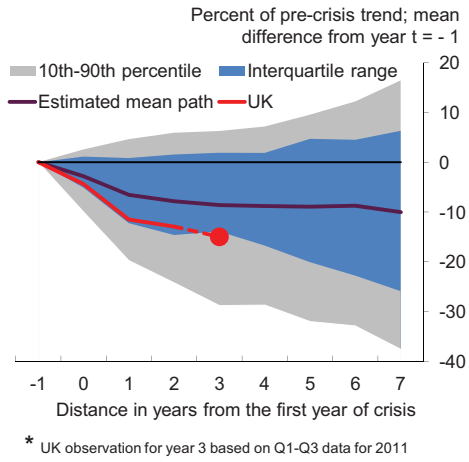


Chart 6: UK inflation

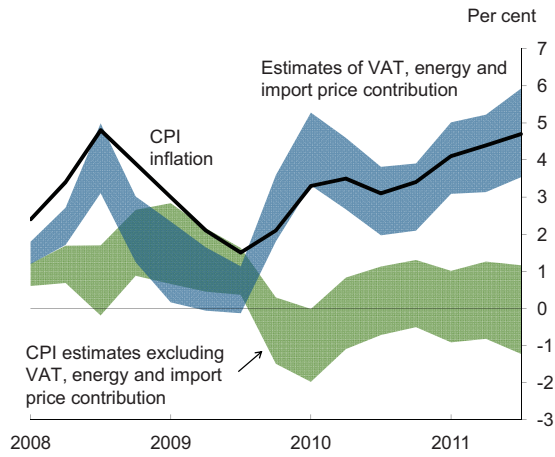
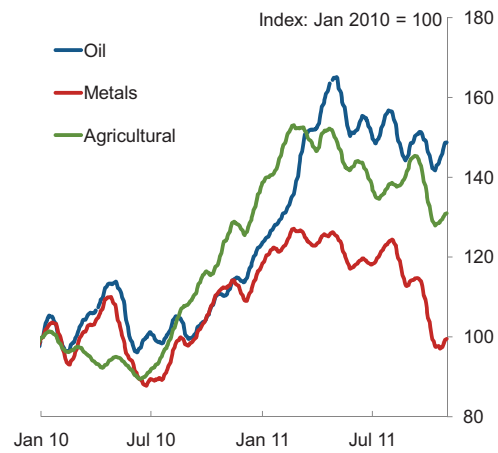


Chart 7: Commodity prices



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