



BANK OF ENGLAND

Speech

Rebalancing the supply side of the UK economy: what; how; and issues for monetary policy

Speech given by

Spencer Dale, Executive Director, Monetary Policy, and Chief Economist, Bank of England

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Thank you so much for the invitation to speak to you this evening and to join your centenary celebrations for the Department of Economics.

I last came to Aber as an undergraduate in the late 1980s as part of the University College Cardiff tennis team. My memory of that weekend is of a very long journey up from Cardiff, a rather quick (and humiliating) thrashing at tennis, and an even longer journey home the next day as I nursed the combined effects of a bruised ego and a sore head!

It's good to be back!

Much has changed in the 100 years since the economics department was established. At that time, the University had a little over four hundred full-time undergraduate students. That number has now risen to over seven and half thousand. Another George was Chancellor in a coalition government, but that was David Lloyd in a Liberal-led coalition. And England beat Wales 8-0 in only the third ever running of the Five Nations on their way to winning the Championship that year.

How times have changed!

Much has also changed in the economy over this period.

At the time the Department of Economics was first established, manufacturing accounted for around a third of the UK's total output, and mining and manufacturing combined provided around a half of total employment in Wales. That hardly changed until the 1960s, since when those shares have been in persistent decline. That decline broadly coincided with our economy becoming ever more open, with the integration of global markets and growing importance of external trade. It also contrasted with trends in the financial intermediation sector, whose share of GDP has doubled since 1970.

I would like to focus most of my comments this evening on some of the key structural challenges facing our economy today as it rebalances towards a more sustainable medium-term path. And in so doing ask what lessons we might draw from the past 100 years of history, and what issues this rebalancing might pose for monetary policy.

I would also like to update you on some recent changes we have made at the Bank of England to the way in which the Monetary Policy Committee produces its inflation forecasts. At the risk of sounding like a fruit seller, I'll outline the virtues of 'small and suite'.

And I'll conclude by briefly describing some of the key issues affecting the outlook for inflation and monetary policy.

Rebalancing

Let's start by considering some of the structural challenges facing our economy.

It's hard to listen to the news or read a newspaper today without being told by politicians, economic commentators, or even MPC members of the need for our economy to rebalance towards a more sustainable pattern of demand and output.

At its heart, this imperative stems from the recognition that, for many years, as a nation we have been living beyond our means. The sum of what as a country we have previously set aside in (net) savings, together with estimates of the income we can realistically expect to earn in the future, is unlikely to be sufficient to cover our future consumption plans.¹ We can't go on as we have been.

The stakes are high, especially for our children and our children's children, who will bear the burden if our economy does not rebalance.

But what does this actually mean? And what challenges might it pose?

The need for rebalancing is most often framed in terms of the changes in the pattern of spending we need to see. Domestic consumption, by both households and in particular the public sector, needs to take up a smaller share of the UK's output. More of our output has to be sold abroad. More of the proceeds from our labours need to be saved in order to provide for the future.

These changes in spending patterns are indeed necessary.

But they will only be sustainable if they're accompanied by a corresponding change on the supply side of our economy: in the types of goods and services we produce.

But we hear far less about the supply side. And I fear this dimension of rebalancing is more difficult and potentially more disruptive. Capital and labour have to move between companies, industries and sectors of the economy in order that the appropriate combination of goods and services are produced to match the reorientation of demand. The nature and speed of that adjustment may pose substantial challenges for our economy and for economic policy. This is where I want to focus my comments tonight.

What type of changes are we likely to need to see on the supply side of the economy? How might this come about? And what monetary policy issues might it pose?

¹ For a more detailed discussion of the adequacy of national savings see the speech last year by my colleague Martin Weale (2011).

Consider these three questions in turn.

What?

A natural response to the first question – what types of changes do we need to see to the structure of industry in our economy – might be that we need to see a larger manufacturing sector, exporting more to the rest of the world.

And to some extent that must be right.

As we all know, the importance of manufacturing in the UK has fallen sharply over the past fifty years or so and now accounts for a little less than 10% of the UK's total economic activity. And in order to increase the proportion of output that we sell to the rest of the world, we're likely to have to see some increase in our manufacturing base. Although manufacturing accounts for less than 10% of the output produced in this country, it accounts for over half of our exports.

But there is much more to supply side rebalancing than simply a bigger manufacturing sector. Let me highlight three points in particular.

First, there's nothing unique about manufacturing in the context of exports. Yes: 60% of our exports in the last quarter of 2011 were manufactured goods. But 40% were exports of services.² Moreover, in this day and age, where many of our successful manufacturing companies are integrated into global networks of production – with the high valued-added design and business operations based in the UK, and the lower skilled production work outsourced to other countries – the distinction between manufacturing and services has become increasingly blurred.

Take Apple, one of America's most successful companies. What is Apple? A manufacturing company? A high tech design company? A consumer and business services company? All of the above? Only a small proportion of Apple's hardware is actually manufactured on US soil. But a vast majority of its valued added is produced there.

The traditional distinction between manufacturing and services is simply not meaningful in many successful companies today.

The key principle that should guide changes in our industrial structure is to produce more of the goods and services which others want to buy and which we have a comparative advantage in producing. That's what truly matters, not whether it's labelled manufacturing or services.

² The proportion of the value of our exports which were themselves originally imported is greater for goods exports than for services. This suggests that the share of services in UK value added exports is likely to be even greater than 40%.

Second, as the share of output that is consumed by the public sector falls over the next few years, in line with the government's fiscal plans, the structure of the private sector will need to adapt with it. Companies currently supplying and supporting the public sector will need to shift their focus elsewhere. People who previously would have worked in the public sector will need to have the right skills to find productive employment within private companies.

Third, we may need to become less dependent on the financial intermediation sector and the provision of credit than we were prior to the crisis. This is not so much a comment about the size of the financial intermediation sector itself. In terms of the two aspects of the guiding principle I just mentioned – global demand and comparative advantage – much of our banking and financial system passes with flying colours.

Rather, if it turns out – as I suspect it will – that the cost of credit enjoyed by many companies prior to the financial crisis was unsustainably low, then our industrial structure will need to adjust to a higher cost.³ Certain industries which in the past have been particularly heavy users of bank credit – such as some parts of the construction sector – may need to change the way they operate. And individual companies may need to find ways to use working capital more efficiently.

The rebalancing likely to be required on the supply side of our economy is both broad and deep. The answer is not simply a bigger manufacturing sector. Which leads me to my next question: how might this rebalancing come about?

How?

The key will be changes in relative prices and relative returns. As profitability in one sector of the economy increases, capital will tend to flow to that sector. Likewise, the most highly skilled and talented labour will be attracted to those parts of the economy offering the highest wages.

In that respect, it's encouraging that the exchange rate – an important determinant of the rate at which we buy and sell goods and services with other countries – has already moved materially in the right direction. The real exchange rate has fallen substantially since 2007, as result of sterling's depreciation. This has provided significant support to the tradables sector in the UK: companies who produce goods and services which are traded with the rest of the world. Exports have been boosted. Just as importantly, the flow of imports into the UK has been dampened, as domestic companies are more able to compete against foreign competitors in home markets. And this is evident in an improvement in our trade balance. Net trade

³ The cost of credit to many companies and households has increased materially in the wake of the financial crisis. The cost and availability of credit should hopefully improve over the next few years as banks further strengthen their balance sheets and their access to funding improves. Even so, the cost is unlikely to return to pre-recession levels.

contributed almost 2 ½ pp to GDP growth in the four years between 2007 and 2011, in sharp contrast to the negative contribution on average over the past fifty years.⁴

But while the response thus far has been welcome, it may take considerable time for this shift in the exchange rate to have its full effect. Companies need to form a view as to whether the lower exchange rate is likely to persist. It takes time to find new overseas markets and to develop new products. But over time, this boost to the relative competitiveness of our tradables sector – if sustained – should help to encourage a shift of resources.

And indeed, looking back over the past 100 years, there are many examples that testify to the potency of the real exchange rate in affecting the supply side of the economy.

Perhaps most striking is the depreciation of sterling following the UK's exit from the Gold Standard in 1931. This was instrumental in stabilising industrial production in the UK, whilst activity in countries which remained on Gold continued to tumble.⁵ Improved competitiveness allowed domestically produced manufactured goods to substitute for more expensive imports, which fell by over 50% in 1932 (Thomas 1994).⁶ The share of manufacturing in total output increased in subsequent years, prior to the onset of rearmament in 1938.

There are other instances in our history which also demonstrate the capacity of the exchange rate to drive structural change, even though in some of those cases the exchange rate moved in an unhelpful direction. For example, the sharp appreciation of sterling in the late 70s and early 80s played a material role in quickening the decline of the manufacturing sector.

The exchange rate is a powerful tool in driving changes on the supply side of the economy. And the depreciation of sterling in 2007 and 2008 is an important component of the rebalancing that our country needs to undertake.

But what issues might that rebalancing pose for monetary policy – which is my third question.

Issues for monetary policy

I would highlight two issues in particular: the potential short-run costs associated with rebalancing and the implications these may have for the inflation outlook; and the need to manage the delicate balancing act between supporting the economy in the short run without dampening the incentives for structural change.

⁴ For more details, see Kamath, K and Paul, V (2011), 'Understanding recent developments in UK external trade', Bank of England Quarterly Bulletin, Vol. 51, No. 4, pages 294–304.

⁵ Bernanke and James (1991) found that a decision to remain part of the Gold Standard until the mid-1930s cost the average country making this choice about 17% of industrial output.

⁶ The depreciation of sterling was not the only factor behind this sharp fall in imports. Domestic demand was weak. Protectionist tariffs also played a role: the Abnormal Imports Act was introduced in November 1931; the General Tariff three months later.

Consider these in turn. Starting first with the possible short-run costs.

Although the structure of our economy needs to adjust, and the lower exchange rate should continue to act as a powerful impetus for that process, such adjustments can be slow and painful.

Some plants and machines can be easily switched from one use to another. But many can't. Capital in some declining sectors of the economy may be scrapped or become obsolete. It takes time to build up capacity in sectors which need to grow in importance. For a period, whilst this process of adjustment is underway, growth of the productive potential of our economy may well be held back.

We may need to take one step back to take two steps forward.

The same challenges also apply to our workforce, especially when combined with the current environment of weak demand. Some people may not initially have the skills required by the new growth industries. For those without work, existing skills may become increasingly rusty the longer they remain unused. More generally, they may become discouraged from looking for work after months of unsuccessful job applications and repeated rejections. Such effects can lead to what economists somewhat insensitively refer to as hysteresis, whereby the long-term unemployed become increasingly detached from the labour market, with less chance of finding work.

Such hysteretic effects can have enormous personal and social costs. More parochially, the strength of such effects is a key uncertainty facing the MPC. If the long-term unemployed do become less attached to the labour market they are likely to have less of a moderating impact on wage growth and hence inflation. Our economy will be able to grow less quickly, unemployment fall by less, before we start to see inflation pressures rising. The size of this effect will depend both on the level of long-run unemployment, and the extent to which unemployment duration erodes labour market attachment.

Our historical landscape has been blotted too often by this type of effect. In the 'dismal decade' of the thirties, the proportion of unemployed people recorded as having been out of work for more than a year jumped from 5% in the 1920s to 25% in the 1930s.⁷ A survey by the Ministry of Labour in 1929 found that the probability of an unemployed worker successfully moving back into work fell sharply during the first month of unemployment. More recently, some estimates of the rate of unemployment in the 1980s consistent with stable inflation rose to as high as 8% (Layard, Nickell and Jackman (1991)).

Although it's of little comfort to those currently seeking work, the labour market appears to be functioning better now than at times in the past. Unemployment has risen significantly and is causing severe hardship

⁷ Unemployment figures at that time were restricted to those with unemployment insurance. Underestimation on this account is likely to have been especially acute in the 1920s (Crafts (1987)), but this would not change the observation that long-term unemployment increased markedly in the 1930s.

to many. But given the extent of the falls in output during the recession, and the muted recovery seen since, many feared that it could have been far worse.⁸ The rate of long-term unemployment has not increased disproportionately, and indeed has increased by less than in the early 90s despite the recession being far deeper. Importantly, the rates at which the long-term unemployed are able to find jobs and move back into work have so far held up around pre-crisis levels.⁹

Nonetheless, the MPC must remain vigilant to any pickup in structural unemployment. Weak demand combined with structural change is a dangerous cocktail, both for the efficient functioning of the labour market and for our society more generally.

The second policy issue concerns the delicate balancing act between providing short-term support to the economy without stifling the incentives for change.

The time and effort required for companies and households to adjust to the demands of a changing economic structure highlight the perils of an economy rebalancing too quickly. Companies unable to keep pace with the speed of adjustment may fail and go out of business. Existing skills may become obsolete more quickly than new skills can be learnt. The costs – both economic and human – can be large and long lasting.

Economic policy can play an important role in mitigating those costs, providing help and incentives for firms to invest in new technologies, making it easier for the workforce to learn new skills.

And indeed, in days gone by, the Bank of England has sometimes played an active role in this process. In the late 1920s, for example, my predecessors at the Bank established the Lancashire Cotton Corporation to help restructure the spinning industry. This intervention was motivated by a desire to preserve the stability of a number of banks who had lent heavily to the industry, which had come under increasing threat from foreign competition.¹⁰

The responsibility for industrial policy now – quite rightly – rests with politicians, and is well beyond the remit of the Bank of England and monetary policy. Even so, the stance of monetary policy can have an important bearing on the pace of rebalancing.

The substantial loosening in monetary policy undertaken in recent years was essential in order to prevent the UK economy from falling into a deeper and more protracted recession, and to prevent inflation materially undershooting the 2% target.

⁸ For a discussion of how the functioning of the UK labour market during the recent recession compares to that in previous recessions, see Faccini and Hackworth (2010).

⁹ See Chart 3.7, p 26 of the February 2012 *Inflation Report*.

¹⁰ For more details see Sayers (1976).

But this loosening also served to blunt some of the incentives driving the rebalancing of our economy. Most obviously, rather than prompting households to save more, the low level of interest rates encourages people to spend more and save less. Likewise, the lower level of borrowing costs and support for demand may have allowed inefficient firms to remain in business for longer and slowed the reallocation of capital and labour to more productive uses.

In this context, loose monetary policy can in part be thought of as a form of forbearance: putting off difficult changes and adjustments to a later day. And just as with other types of forbearance, it faces a delicate balancing act between providing short-term support without stifling long-term change.

I've no doubt that had monetary policy not responded quickly and aggressively to the financial crisis, our economy would be in a far worse state today: many more fundamentally sound companies would have gone bust; levels of long-term unemployment would be much higher. But there is a limit to what monetary policy can achieve when real adjustments are required. The forces driving the adjustment need to be allowed to operate. Monetary policy cannot prevent those adjustments, nor should it try to.

Like good parenting, monetary policy should provide support but it can't protect us from the harsh realities of life.

So where do these thoughts in response to my three questions leave us?

The chorus of voices calling for our economy to rebalance is likely to continue for a good few years yet. Rebalancing has important implications for the pattern of our spending. But it has equally important implications for the supply side of our economy and for the structure of our industrial base. The lower exchange rate should help to drive that process. Even so, it's likely to be a slow and challenging journey, especially while it is played out against the current backdrop of weak demand. Monetary policy will need to remain alert both to the implications of that rebalancing for the growth of the supply potential of our economy and to the need to manage the delicate balance between providing short-term support and facilitating long-term change.

Forecasting Platform

Before turning to the outlook for monetary policy, I wanted to provide a brief update on some changes we have made to the way in which the MPC produces its inflation forecasts. In particular, the MPC has recently begun to use a new forecasting platform to produce its inflation projections.

I say forecasting platform rather than model because a central principle underlying the new approach was not to construct an even 'bigger and better' economic model. Indeed, bigger was unlikely to be better for our

purposes. Instead, the Committee has moved to using a smaller central workhorse model supported by a suite of other models. Small and suite.

At first blush, this approach might seem odd. The financial crisis exposed many failings with models typically used by economists. Most didn't assign a meaningful role to banks and the ways in which they can affect the real economy. Financial frictions in these models were relatively few and far between. Surely we should respond to these issues. And we will.

But I worry about a strategy which tries to add these insights (and many others from the crisis) into one single, ever larger, forecasting model. The model would still be an incomplete description of a complex reality. But its size and complexity would render it far less useful as a tool for thinking through economic issues and forming economic judgements.

The central organising model at the heart of the MPC's new forecasting platform is instead relatively small.¹¹ It provides a basic framework of many of the core relationships and mechanisms that the Committee think are important in explaining the economy. And it imposes a discipline on the Committee by ensuring that its various judgements remain internally consistent. But it does not try to capture all the channels and linkages driving economic fluctuations and determining the outlook for inflation.

Instead, the MPC uses the forecasting platform to incorporate the insights from a range of alternative models. Some of those models provide greater detail about certain parts of the economy, such as the labour market and indeed financial intermediation. Some capture mechanisms which are deliberately excluded from the central model, such as credit frictions. Others are based on simple reduced form relationships that have provided good predictions in the past. Importantly, some of these models embody different views of the mechanisms which are contained within the central model and so provide a cross check and challenge to our thinking.

I should stress, however, that the introduction of the new forecasting platform does not, of itself, imply any changes to the MPC's forecasts or to how we set policy. The Committee's forecast is exactly that: the Committee's. It's based on the best collective judgements of the nine MPC members. By making it easier to consider the insights from a range of alternative models, the new forecasting platform should aid the Committee's thinking and understanding of the economy. But its forecasts will remain judgemental.

¹¹ The new central organising model is called COMPASS (Central Organising Model for Projections and Stochastic Simulations). It is a DSGE model that explains the behaviour of 16 – a relatively small number – of macroeconomic variables in terms a set of underlying economic shocks. In general, the structure of COMPASS is similar to models used in other central banks, although a few aspects have been tailored specifically to the UK economy. Further details of COMPASS will be published in due course.

Outlook for inflation and monetary policy

Let me conclude by saying something about the outlook for inflation and monetary policy.

The MPC is marking its own anniversary this month: it's three years since the MPC reduced Bank Rate to 0.5% – its lowest ever level – and embarked on a programme of large scale asset purchases (QE).

I've no doubt that had the MPC not loosened monetary policy substantially in the aftermath of the financial crisis the depth and duration of the recession would have been far worse.

But it's also true that CPI inflation has been above its 2% target for the vast majority of the past three years. Surely if monetary policy had been less expansionary, inflation would have been lower?

Yes – but at what cost?

Over the past three years, inflation has been driven up by increases in commodity and other import prices and by the increase in VAT. The only way the MPC could have offset those price level shocks would be to have set a materially tighter monetary policy. This would have led to a deeper recession, higher unemployment, and a far greater risk that inflation would substantially undershoot the inflation target once the effect of those price level shocks had dissipated.

I fully recognise that the period of high inflation and low interest rates has caused pain and hardship to many groups within our society. But it's hard to argue that policy should have been set materially tighter in the face of the most severe downturn in the post-war period.

The good news is that inflation is now on its way down.

CPI inflation peaked at 5.2% in September last year, and data released today showed that inflation fell to 3.4% in February.

But we're not out of the woods yet.

The sharp fall in inflation over the past six months or so reflects the effect of the price level increases we saw around this time last year – from the VAT rise and from increases in petrol prices – dropping out of the twelve-month inflation rate.

There are still a few more base effects to drop out of the annual calculation over the next couple of months. But what is far more uncertain, and far more important for the path of monetary policy, is how far and how fast inflation will fall thereafter.

There are good reasons for thinking that inflation will continue to fall. There is some degree of slack within our economy, primarily within the labour market. And although I expect growth to resume this year, the pace of the recovery is likely to remain weak in the near term. Those factors should continue to push down on domestic costs and prices and so cause inflation to fall further.

In the Inflation Report published last month, the best collective judgement of the MPC was that inflation was likely to fall to below the 2% target by the turn of this year, with the balance of risks throughout 2013 weighted quite heavily towards inflation being below target.

My own view is that the chances of inflation being above or below 2% by the end of this year and into 2013 are somewhat more balanced.

In part that reflects concerns that external price pressures might continue to push up on domestic costs and prices. One obvious worry in that regard is the possibility that tensions within the Middle East could escalate and put further upward pressure on oil prices.

It also stems from concerns that domestic cost and price pressures may fall by less than anticipated. Productivity growth may continue to disappoint. Businesses may attempt to rebuild their margins by raising prices.

Even so, absent another oil price spike, inflation is likely to continue to fall. And conditioned on the assumption that the size of the asset purchase programme is maintained at £325 billion and Bank Rate follows a path implied by market rates, I think inflation is just as likely to be above as below the inflation target in the medium term.

What will actually happen to policy over the next few years will depend on developments both at home and abroad. The rebalancing of our economy is likely to continue against a backdrop of weak demand. The support being provided by monetary policy is likely to have to remain in place for some time yet. But we will also have to remain mindful that there is a limit to what monetary policy can achieve when real adjustments are required. There is a delicate balancing act to manage. The best contribution that monetary policy can make to the long-run health and sustainability of our economy is to ensure that inflation remains on track to hit the 2% inflation target. That's our responsibility. And that is what we will do.

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