



BANK OF ENGLAND

Speech

The UK economy: the road ahead?

Speech given by

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At Women in Business, Coventry and Warwickshire Chamber of Commerce

23 April 2013

I would like to thank Marilyne Tolle and Evan Wohlmann for their help in preparing this speech. The views expressed are my own and do not necessarily reflect those of the other members of the Monetary Policy Committee.

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Introduction

Thank you for inviting me to speak here today.

Few would disagree that we are living through possibly the most turbulent and difficult economic period for over 80 years. Looking back from where we stand today, output in the United Kingdom has been broadly flat for almost two years following a very deep recession, and the outlook for 2013 is more subdued than we would have thought some six months ago. This has inevitably led to criticism that monetary policy has had little traction and that we are condemned to a “lost decade” of economic stagnation and declining living standards. Today, I would like to set out the reasons why I do not share such a pessimistic view of the economic outlook and the role of monetary policy.

Let me first explain why I think economic performance in the United Kingdom has been so weak and what has been the impact of policy to date. I will then turn to the outlook for the economy and the role for monetary policy, particularly in light of the recent discussion around the MPC’s inflation targeting remit and the update to the Monetary Policy Framework announced by the Chancellor. Overall, and perhaps most importantly, I would like to leave you with a few reasons why I have some hope for the UK economy in 2013 and beyond.

Why has UK economic growth been so disappointing?

This has been a lethargic recovery, on the heels of a deep and prolonged recession. Real output is still some 20% below its pre-crisis trend, assuming that the average rate of growth prior to the crisis had remained unchanged (**Charts 1 and 2**). Let me set out the reasons why I think growth has been so disappointing, which I suspect are more diverse and complex than sometimes portrayed.

History suggests that financial crises are usually associated with a number of legacies which generate substantial headwinds to the subsequent recovery.¹ There is evidence to believe that three have been an important determinant of recent UK performance.

First, the shock to the UK banking system revealed that some banks at least were undercapitalised and needed to reduce the substantial amount of leverage that had been built up prior to the crisis. This has led to significant constraints on lending to households and businesses. But the banks are not alone in seeking to get their house in order. Consumers have also focused on saving more and limiting their indebtedness, illustrated by the fall in the household debt-to-income ratio of 27 percentage points from its peak in early 2009 (**Chart 3**), and this has constrained the pace of consumer spending. Third, the impact on public

¹ In “What’s the Damage? Medium-term Output Dynamics After Banking Crises”, IMF Working Paper No. 09/245 (2009), Abiad et al. document how recoveries following a severe banking crisis can be anaemic.

finances of the shrinkage of the economy, the fiscal support through the recession and the direct cost of bank rescue means that some form of fiscal austerity became inevitable. These three factors together act as significant headwinds to growth, and dictate that any recovery was always going to be slow and difficult, compared with more normal economic cycles.

But over the past couple of years, growth has turned out even weaker than the Bank (and others) forecast in 2010.² This may have been due to some underestimation of the scale and duration of these legacy headwinds from the financial crisis. But more importantly it also reflects a number of other shocks to the system.

- In addition to dealing with their debt levels, consumers have had to contend with a period of elevated inflation, reflecting the rise in import prices following the 25% depreciation of sterling from 2007 to 2009; the surge in energy prices driven by increased political uncertainty following the Arab spring; a rise in food prices caused by unfavourable weather conditions; and the rise in value added tax. And more recently, increases in administered and regulated prices have also added to inflation. As a result, consumers have been faced with a dramatic squeeze in their real incomes, which have fallen by around 5% over four years.
- The United Kingdom has also been at the mercy of a global slowdown. Throughout 2011 and into 2012, the slowing of many emerging market economies, notably China, as well as the supply chain disruption emanating from the tsunami in Japan made it more difficult for the UK to source imports and sell its exports. World trade grew just 2% in 2012, down from 5.2% in 2011. And, closer to home, over the past year the recession in the euro area, our main trading partner, has had an even more direct impact on the United Kingdom, depriving our economy of much-needed external demand.
- Compounding these factors has been the uncertainty arising from the ongoing crisis in the euro-area. Surveys of large UK businesses show that concerns over the euro-area crisis continue to have a large negative impact on business investment. And this uncertainty has also made it more expensive for banks, including those in the UK, to obtain funding, adding to the constraints on credit growth.

So where does that leave us? UK growth over the past two years can be characterised as weak, at best. Headline GDP growth in 2012 was only 0.3%. But I feel that the picture has been made worse in popular consciousness by a number of features which have made it all the more difficult to assess the underlying health of the economy. First, quarterly growth has been very erratic: the additional Diamond Jubilee bank

² This is also true for the Office for Budget Responsibility (OBR). In November 2010, the OBR forecast annual growth to be 2.1% and 2.6% in 2011 and 2012 respectively, higher than the realised growth rates of 0.8% and 0.3% in these two years.

holiday no doubt contributed to the 0.5% contraction in Q2, while the Olympics delivered a temporary boost in Q3 which then reversed in the last quarter of 2012. Second, the weakness in total GDP was heavily affected by the weakness in two particular sectors. If we adjust overall GDP growth for the sharp falls in construction and North Sea oil output, the rest of the economy – over 90% of GDP – grew by 1.2% last year. I do not wish to sound complacent; growth of even 1.2% across much of the economy is still at best a slow and difficult recovery. But it is also somewhat removed from the reports of semi-permanent, triple dip, recession.

What has been the impact of policy?

Let me start by briefly outlining the current, extraordinary, policy landscape. Following the provision of emergency liquidity to commercial banks as the financial crisis took hold, the MPC rapidly reduced Bank Rate to 0.5% (**Chart 4**) – its lowest level ever. The introduction of the Bank's Asset Purchase Facility, popularly known as Quantitative Easing (QE), has helped to provide further monetary stimulus over the last four years (**Chart 5**) by lowering long-term interest rates and supporting asset prices and spending by firms and households.

There has been much debate about the effectiveness of QE, but it would be wrong to conclude that the sluggish performance of the economy is, by itself, evidence that it hasn't worked. One would need to start by answering the question: what would have happened in the absence of policy action? In my view, the UK economy would have fared significantly worse if the Bank had not responded to the deteriorating economic environment with unconventional policy easing.

One area where QE has had limited impact is on bank lending. It is a common misconception that the policy was designed to support banks, and bank lending, directly. In fact, most of our asset purchases have been from non-bank investors, such as pension funds and insurance companies. By increasing the amount of reserves in the economy, QE may have helped to improve the liquidity position of banks, thereby indirectly encouraging more lending. But the headwinds facing the banking sector have meant that this impact on bank lending has been limited. And over the past couple of years, stress from the euro area has meant that UK banks have had to pay more to borrow in wholesale markets. It is in light of this that the Funding for Lending Scheme (FLS) was introduced in 2012 to help reduce the funding costs of UK banks and encourage them to lend more to the real economy.

Since its introduction last summer, the FLS has helped to reduce the cost of funding for UK banks, which in turn is starting to have an impact on bank lending rates. So far, the main impact has been seen in the mortgage market, where availability has risen and loan rates have come down, across a number of LTV mortgages (**Chart 6**). As yet, the impact on lending criteria for the SME sector has been less marked, though it was always expected that changes in lending to this sector would take longer than in the mortgage

market. However, the cost of loans to companies has also fallen slightly since the middle of 2012, and some lenders are using cashback deals or fee reductions to pass on the benefits of lower funding costs. The impact of the FLS is likely to be more marked in coming months; the Bank's latest *Credit Conditions Survey* shows that the recent improvement in the availability of credit, particularly in the household mortgage sector, is expected to continue (**Chart 7**).

While these are encouraging signs, we have yet to see a pickup in the levels of lending to the real economy (**Chart 8**). Aggregate net lending to households and businesses by those banks participating in the FLS fell by around £2.5bn in the last quarter of 2012. But I do not agree with some commentators that this is evidence that the FLS is not working. The small reduction in net lending at the end of last year likely reflected normal seasonal factors and a bank-by-bank analysis showed that the weakness was largely confined to those banks undergoing significant balance sheet restructuring, much of which reflected plans agreed with the authorities to reduce non-core business. And, given that it will take time for lower bank funding costs (and the extra incentives to lend provided by the FLS) to be reflected in increased lending, I think it is too early to judge the full effects of the FLS on bank lending volumes.

What is the outlook for the UK economy?

A number of factors make me hopeful for the UK economy through 2013 and into 2014.

First, credit conditions are improving, in part due to the impact of the FLS, with some signs that lending to households will pick up in the coming quarters. An improvement in the housing market, combined with resilient employment should help to support modest growth in consumption, albeit that low nominal wage growth and persistent above-target inflation will continue to squeeze real purchasing power.

Second, business investment, which was concentrated in utility and energy sectors over the last year, may start to show some recovery in other sectors over the next 18 months. I have been struck, on recent regional visits, by the improvement in business sentiment relative to last summer and autumn, much of which has been due to the perceived reduction in the tail risk of a disruptive and sudden unravelling of the euro area. Larger firms are also benefiting from an active corporate bond market which places them in a strong position to invest. However, confidence is still fragile, so any pickup in investment is likely to be gradual, particularly as many companies are also struggling with the impact of rising pension liabilities, which may divert cash away from investment spending.

Third, the international outlook is improving – there are some encouraging signs that the slowdown in China is ending and the recovery in the US is gaining momentum – benefitting UK exports. And there is growing evidence – from conversations with Bank agents as well as the detail of the trade statistics – that UK

businesses are now starting to succeed in re-orienting their exports into the faster-growing emerging markets, reducing our dependence on the slow-growth markets closer to home.

Overall, I am hopeful for a modest pickup in growth as some of the negative factors that have made the last couple of years so difficult start to fade, and as levels of confidence, so badly battered by the impact of the euro crisis, start to heal.

The outlook for inflation is more concerning. Inflation has been persistently above the 2% target for the past five years (**Chart 9**). Late last year, inflation picked up rather sharply, reflecting increases in university tuition fees and domestic energy bills. Very recently, inflation has edged up higher. It now stands just shy of 3%, uncomfortably close to the letter-writing threshold, and is expected to remain elevated for much of the next two years.

A flexible inflation targeting framework

The combination of at best a slow recovery in activity with persistent above-target inflation poses a real challenge to the MPC, of a degree that is more acute now than at any time since the MPC's inception 15 years ago. Faced with this trade-off, how should the MPC set monetary policy?

At the February MPC meeting, the Committee judged that inflation was likely to remain above the 2% target for the next two years, returning to the target only by the end of the third year of our forecast. This prompted an outcry from some commentators who took this as evidence that the MPC had "gone soft on inflation". Let me stress that we have not "gone soft". We remain committed to delivering price stability in the medium term.

Let me further explain why I believe it is appropriate in the current environment to tolerate above-target inflation over the next two years and why this is entirely consistent with the MPC's remit.

Most importantly, the decision to accommodate current above-target inflation is based on a careful analysis of the particular reasons behind the upward pressure on prices.

Much of the upward pressure comes from two sources. First, administered and regulated prices, such as university tuition fees and network charges for energy utilities. The contribution from these prices to CPI is particularly high at present (**Chart 10**), adding around 1 percentage point to inflation in each of the next couple of years. They are determined by regulatory decisions, rather than the balance of domestic supply and demand, so are relatively insensitive to monetary policy. But while their impact is expected to be felt for the next couple of years, it is effectively a shift in relative prices, and should not have a permanent effect on the rate of CPI inflation.

The second shock to inflation has been the recent depreciation of sterling, and the effect on the prices of imports. How policy should respond to this is a more complex question. To the extent that a fall in the currency reflects real factors, such as a need to rebalance the economy towards exports or an unwinding of haven flows, it would not be sensible to prevent the real adjustment by tightening monetary policy. If, however, the weakness in sterling were deemed to reflect concerns regarding the Bank's anti-inflation credibility, leading to an increase in inflation expectations, then I strongly believe that the case for accommodation is much weaker. So far, there is little evidence that inflation expectations have become de-anchored, while domestic inflationary pressures, in particular wage growth, remain very subdued.

The current shocks to inflation are therefore such that, in my view, it remains appropriate to look through them. Indeed, in these circumstances, we would only be able to bring inflation back to the target more quickly by depressing domestic activity and hence possibly derailing the recovery.

Our current policy stance, I would argue, is fully consistent with the MPC's remit. The Committee's remit has always embodied a flexible inflation target, with an explicit, though secondary, requirement to support the Government's objective of high and stable growth and employment. During the first 15 years of the MPC's existence, prior to the financial crisis, that auxiliary goal did not conflict with the objective of delivering low and stable inflation. But the crisis has crystallised the need to make full use of the flexibility afforded by the Bank's remit – to deliver price stability in a way that avoids undesirable volatility in output. Making use of such flexibility, as recently confirmed by the Chancellor's decision to update the MPC's mandate, is in no way a departure from the inflation targeting framework in place since 1997.

Conclusion

We are still living in very uncertain times. The economic recovery over the next year or so will continue to be slow and difficult, but I hope I have provided some reasons why the headwinds of the past may now be starting to ease, and why I remain cautiously optimistic about the road ahead. On balance, I think the outlook is now looking more encouraging than for some time. Of course, there remain substantial risks that may still knock us off course, not least from the challenges facing the euro area, and if required, the MPC stands ready to respond.

Chart 1: UK real GDP

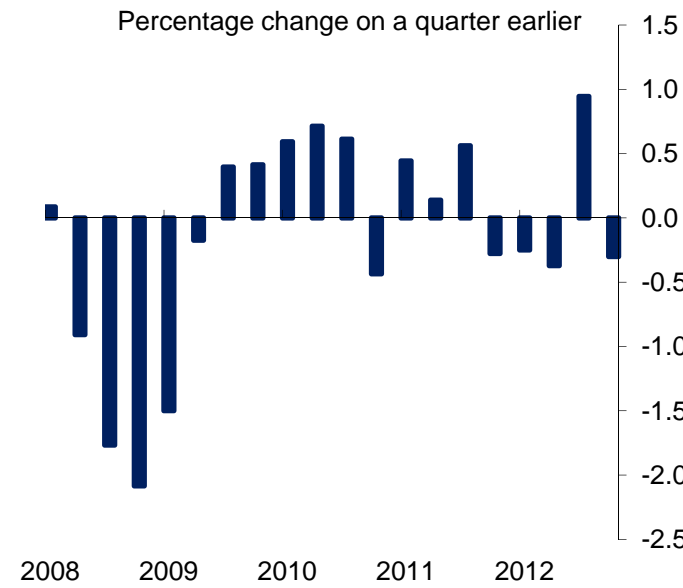
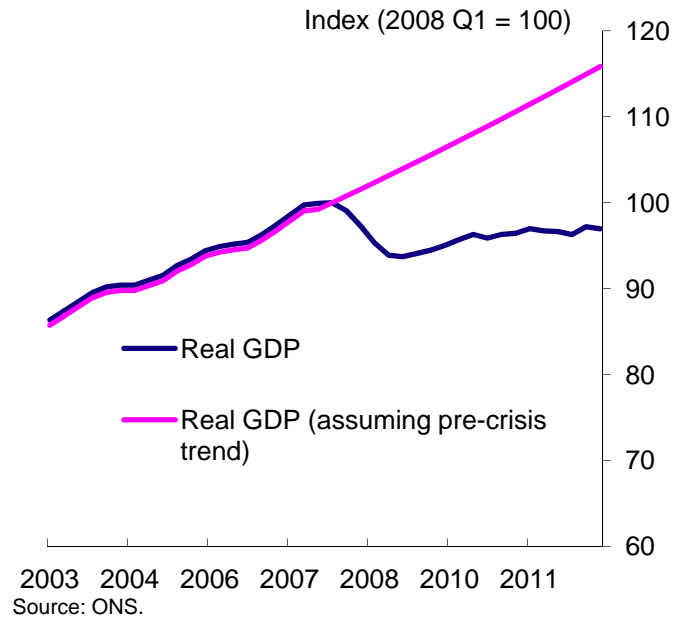


Chart 2: UK GDP relative to pre-crisis trend^(a)



(a) Pre-crisis trend estimated as average growth from 1998-2007.

Chart 3: Household net debt to income

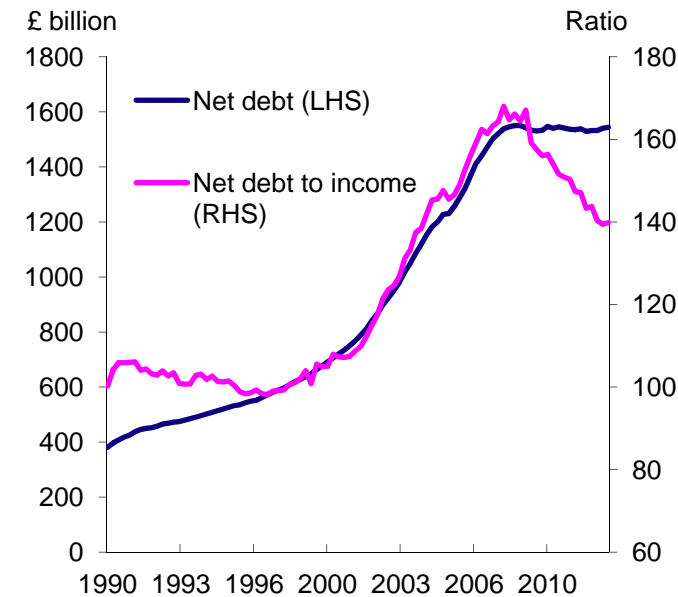


Chart 4: UK Bank Rate

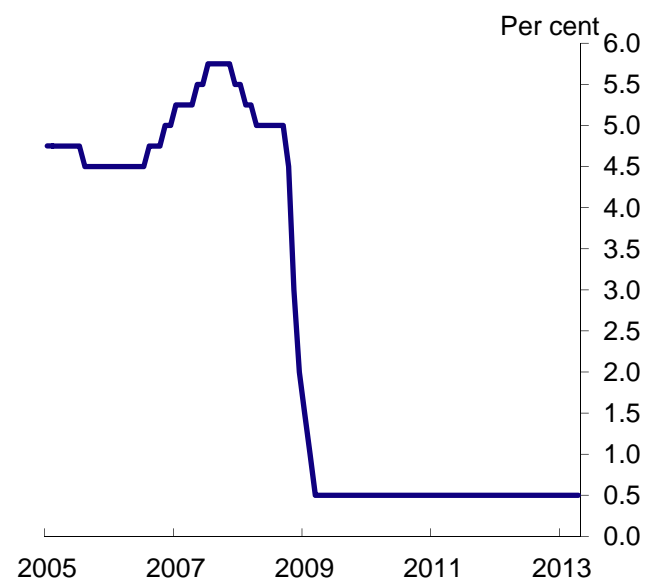
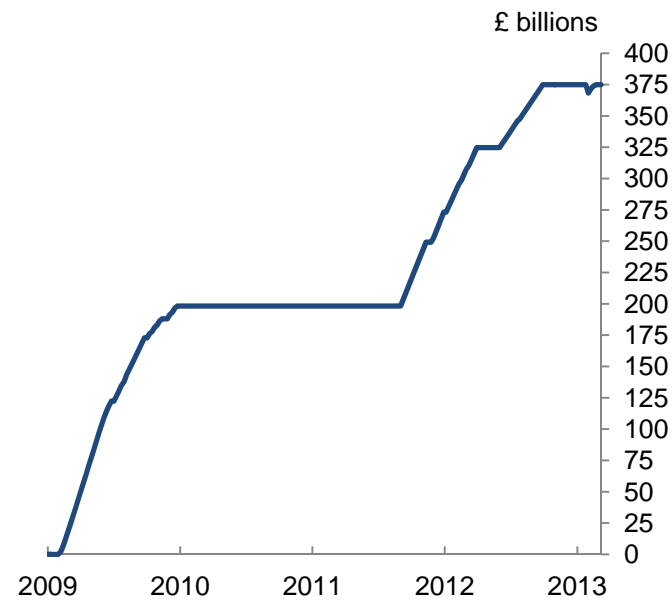
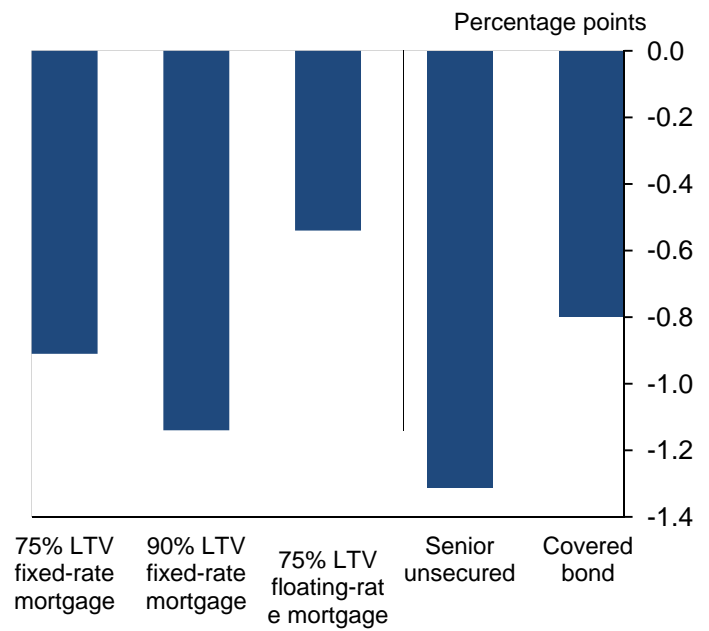


Chart 5: Cumulative gilt purchases



Source: Bank of England.

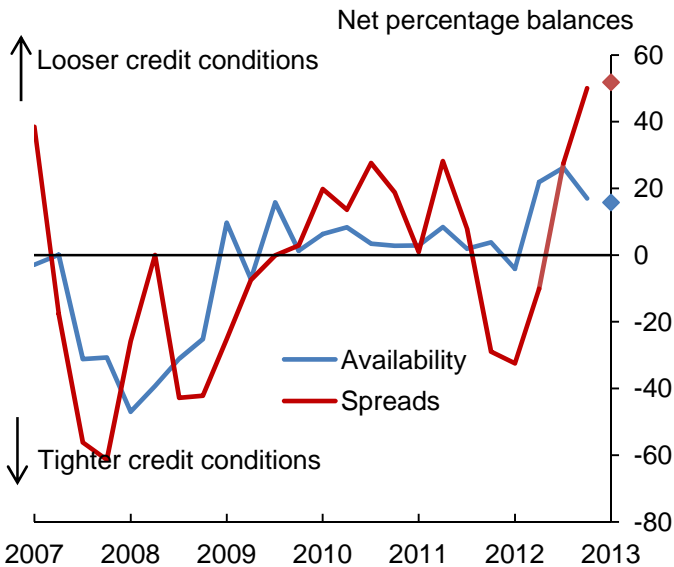
Chart 6: Changes in average quoted new mortgage rates and indicative UK bank funding costs since June 2012^(a)



Sources: Bank of England, Bloomberg and Bank calculations

(a) Change between end June 2012 and end March 2013. All quoted rates are for 2 year mortgages. Senior unsecured funding cost is measured as the sum of the five-year swap rate and a constant maturity unweighted average of UK banks' five-year senior unsecured bond spreads. Where a five-year bond is unavailable, a proxy has been constructed based on the nearest maturity of bond available for a given institution and the historical relationship of that bond with the corresponding five-year bond. Same for covered bonds.

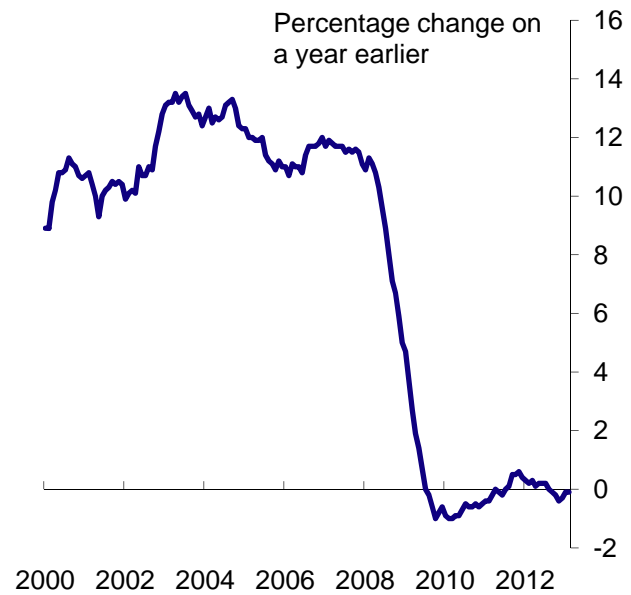
Chart 7: Credit Conditions Survey – changes in availability of and spreads on secured loans to households^(a)



Source: Bank of England.

(a) Weighted responses of lenders. Changes over the past three months. A positive balance indicates that more (less) credit was available or that spreads over reference rates had fallen (risen) over the past three months. The diamonds show lenders' expectations for the next three months, reported in the 2012 Q4 survey.

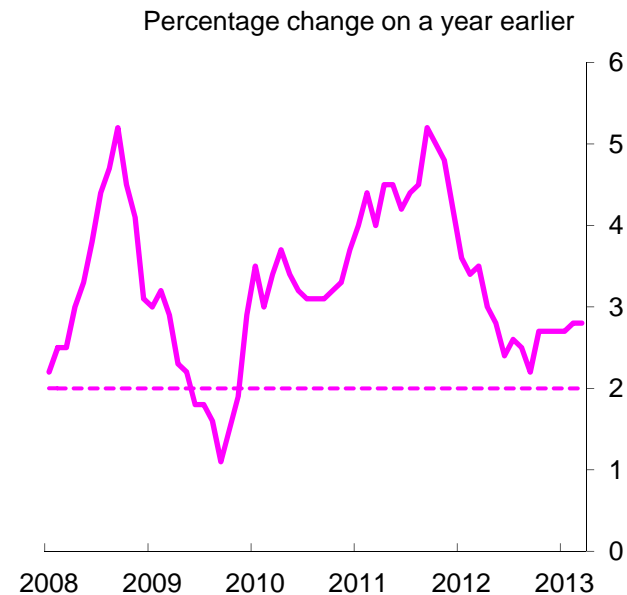
Chart 8: Lending to UK households and PNFCs^(a)



Source: Bank of England.

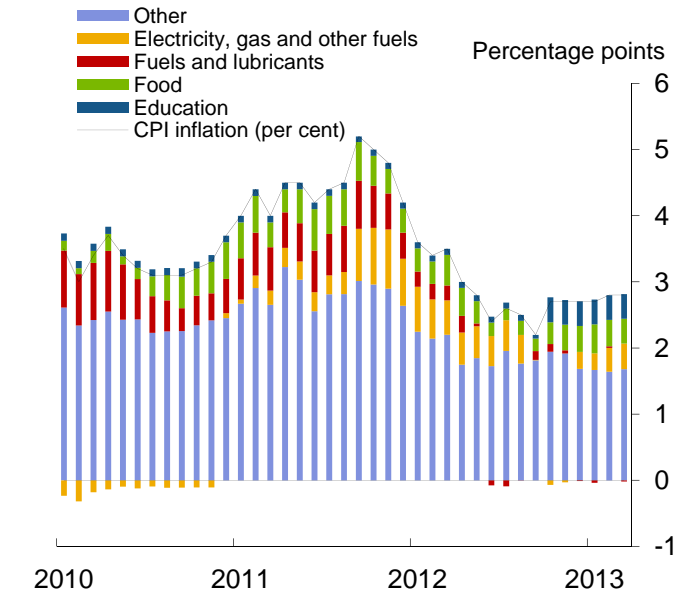
(a) Sterling loans by UK-resident monetary financial institutions (MFIs) and related specialist mortgage lenders excluding the effects of securitisations and loan transfers. Non-seasonally adjusted.

Chart 9: UK CPI



Source: ONS.

Chart 10: Contributions to CPI inflation^(a)



Source: ONS and Bank calculations.

(a) Contributions to annual CPI inflation. Data are non-seasonally adjusted. The "Other" contribution is calculated as a residual.

References

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