BANK OF ENGLAND

Speech

A little bit of stodginess?

Speech given by
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"*In my view both as a citizen and as a policymaker, a little stodginess at the central bank is entirely appropriate*"[1]

Alan Blinder's 1999 advice to central bankers, quoted above, was not, I am pleased to say in these fitness conscious times, an injunction on the appropriate nutrition for monetary policy makers.

Rather, it was advice on how to respond to uncertainty or, to be precise, the need for caution when faced with a particular type of uncertainty – uncertainty about the impact of monetary policy on the key variables in the economy it seeks to influence.

But I would like today to look at the case for 'stodginess' when faced with uncertainty more generally about possible changes in how the economy works and the 'model' of the economy that policymakers necessarily have in their minds.

Uncertainty, as I have noted before is the natural environment of monetary policy. There is a large academic literature on the optimal way for policy to deal with different types of uncertainty. But I would like to look at these issues first in the context of my time on the MPC and then in relation UK monetary policy going forward.

The MPC since I joined it at the end of 2013 certainly appears to have been pretty consistently stodgy in the sense of slow moving. We have moved policy twice over that period. And one of those moves was a response to an exceptional and unprecedented exogenous event – the Brexit referendum. Only one move, the rate increase last November can be thought of as usual, 'bread and butter' monetary policy. There has been one or more votes for changing policy in only 22 of the 49 meetings.

When I compare this to 2002 to 2007 -- my period on the Committee as the Treasury representative -- the contrast is striking. Over that period, the Committee moved policy 12 times and with one or more votes for changing policy in 41 of the 56 meetings.

This lack of action from the Committee since I joined it as a member in 2013 was certainly not the reflection of lack of developments in the UK economy. From mid 2013 to early 2015, unemployment dropped like a stone – by 2pp in the space of 18 months, the fastest rate for 25 years. At the same time, growth was picking up from close to 1% to about 3%.

[1] Blinder (1999)

Nor was it the result of lack of advice. As Mark Carney has recently pointed out, the pre-crisis MPC had always tightened policy in response to accelerating growth and firming business confidence. With pre-crisis rules of thumb and the BoE's pre-crisis reaction function in mind, there were many and loud calls for pre-emptive tightening to prevent the build up of inflation pressure.[2]

The Committee's reluctance to tighten was of course motivated by the sizeable output gap and the need to allow a stimulative policy stance more time to squeeze out slack in the labour market – or as one Committee member put it at the time "don't just do something, stand there…(and think)".[3]

But underlying this, there were more fundamental doubts about what had happened to the supply side of the economy during the crisis, particularly around the labour market and around the collapse of productivity growth.

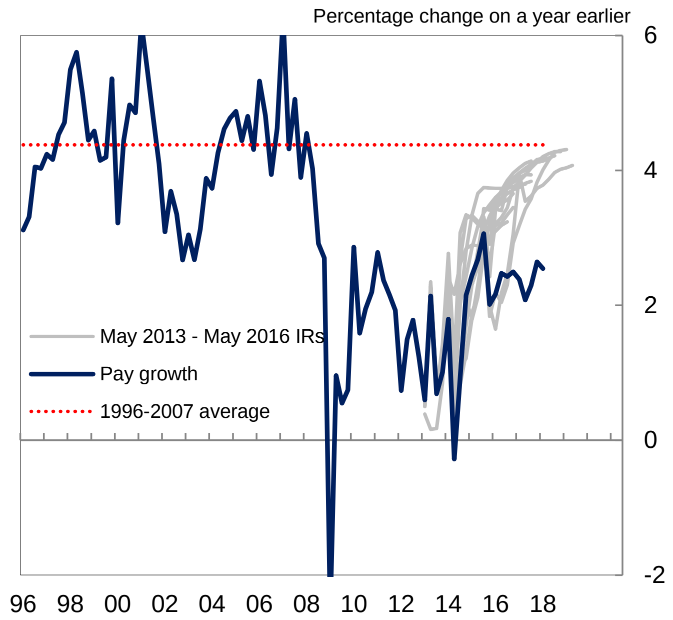
It was these concerns that underlay the Committee's decision, shortly before I joined, to give forward guidance that it would not consider changing policy until unemployment fell to a certain level.
As the expansion progressed from mid 2013 towards the Brexit referendum in 2016, evidence grew that the supply side was not returning to pre-crisis norms. Unemployment reached 5% - the pre-crisis estimate of the natural rate - in early 2016 without any hint of upward pressure on pay. Pay growth serially undershot the MPC's forecasts (**Chart 1**).

At the same time, as the expansion progressed, it became disappointingly clear first that the UK would not recover any of the productivity growth lost in the crisis and ensuing recession and then that it would not recover anything like the pre-crisis rate of productivity growth (**Chart 2**).

I have noted before the much greater degree of attention to the supply side given by the post-crisis MPC relative to its pre-crisis predecessors.[4] This is clearly accounted for by the much greater inability to forecast the evolution of supply and its impact on inflation (**Charts 3 & 4**).

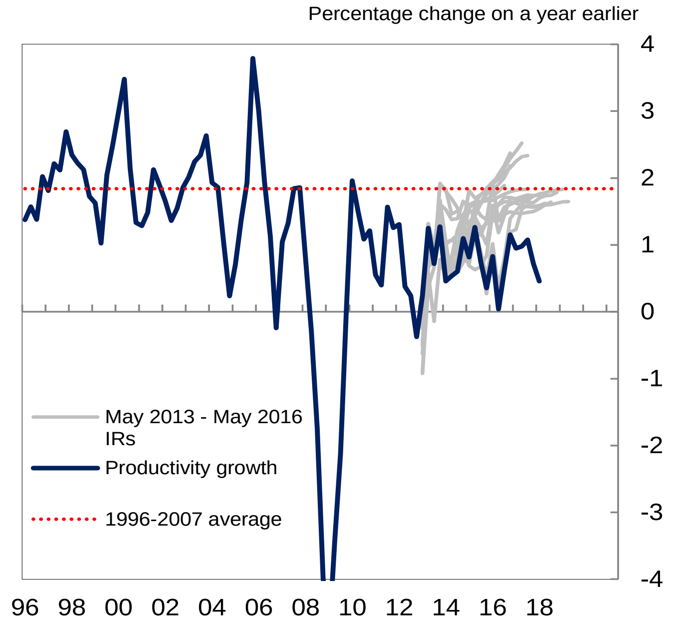
[2] Mark Carney's recent speech illustrates that bank rate might have risen by 2-3 percentage points between August 2013 and the end of 2014 if the post crisis MPC's had followed the reaction function of its pre-crisis predecessors. And the important role that forward guidance played in preventing financial markets and real economy agents acting in expectation of such tightening.
[3] Miles (2015)
[4] The rate of mentions of 'supply' and 'productivity' in the minutes of MPC meetings in the past decade has been about twice that in the decade prior to the crisis. (Cunliffe 2017)

Chart 1: Inflation Report pay growth forecasts



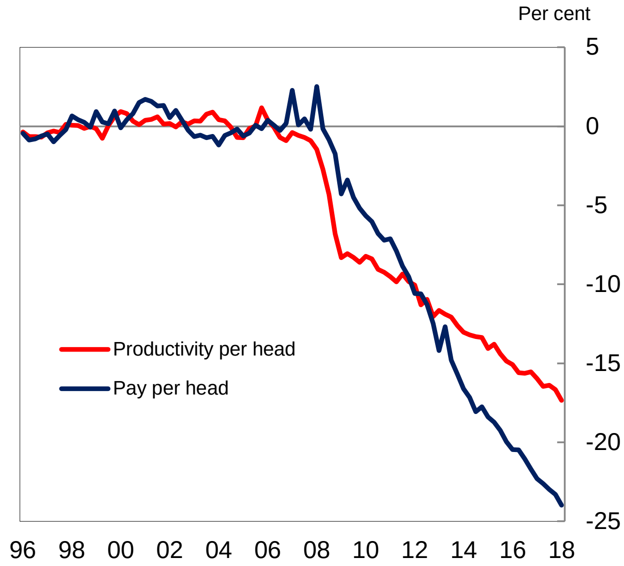
Source: ONS and Bank calculations

Chart 2: Inflation Report productivity per head forecasts



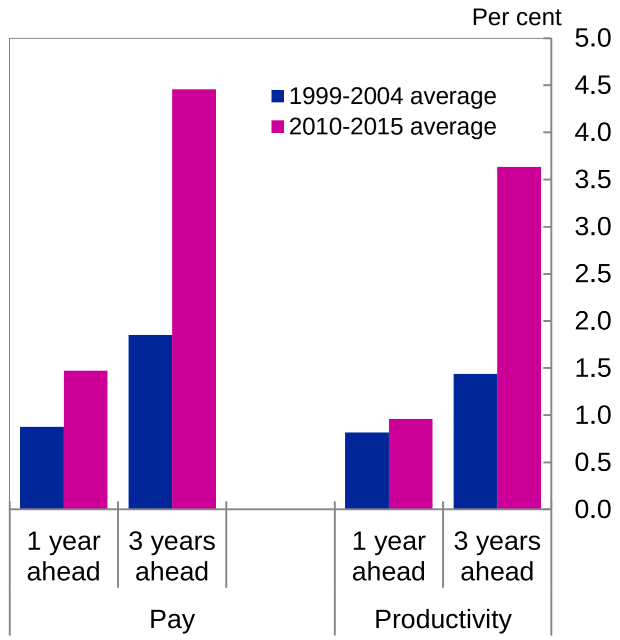
Source: ONS and Bank calculations

Chart 3: Deviations from pre-crisis trends (%)



Notes: shows nominal pay per head, and real productivity per head.

Chart 4: Average absolute error of cumulative growth in forecasts



Headline CPI was blown about during this period by external pressures – the collapse of the oil price, and the creeping but sizeable appreciation of Sterling between the end of 2014 and the end of 2015. But the MPC's stodginess in the face of deep uncertainty about the supply side was justified by the very subdued evolution of domestically generated inflation even as unemployment rate sank well below its pre-crisis natural rate and activity recovered towards pre crisis growth rates of around 3% in 2014 (**Charts 5 & 6**).

Chart 5: GDP and unemployment

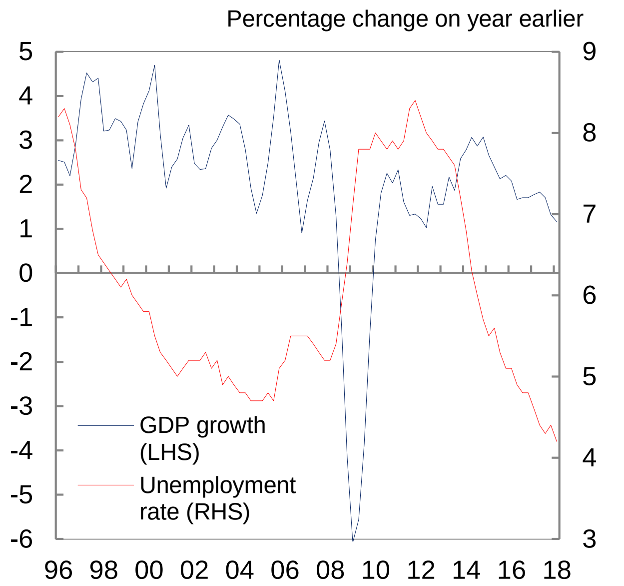
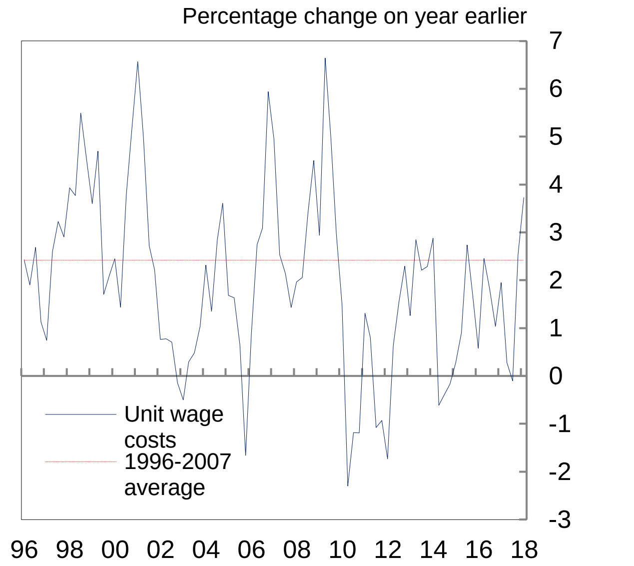


Chart 6: Unit wage cost



In fact, the combination of the shortfalls against expectation of productivity and pay growth – which were in part related – had the effect of keeping unit wage costs and hence domestically generated inflation roughly at the level the Committee had expected to see at higher rates of pay growth and productivity growth.

The key point here, I think, is not that pay and productivity growth serially undershot the MPC's forecasts but rather the need to be 'a bit stodgy' when faced with evidence that consistently suggested the possibility of fundamental changes in the way the economy works – or, in more technical language, uncertainty about the macro-economic 'model'.[5]

[5] The prevailing macro-modelling paradigm had become largely one of cyclical models – given that described the pre-crisis economy well. For example, almost all DSGE models were set up to describe fluctuations around a steady state. With a major feature of the crisis being a disruption to the steady state/supply side, these models weren't suited to describing the resulting fluctuations.

Following the deepest recession since the war, a recovery slower than the recovery following the great depression and a badly damaged financial system, there was good reason to be concerned about deep structural changes to the UK economy. And, as the recovery finally gathered momentum and turned to expansion,[6] the incoming data on pay and productivity certainly suggested something had indeed changed. Similar evidence appeared in the data on other economies. [7]

Against that background the case for 'stodginess' was in my view very strong. Two years ago, I posed the question of whether what we were seeing was some form of 'super-cycle' following a breakdown of the financial system in which it could take up to a decade for us to return to something resembling the old economic model, or whether what we were seeing was more secular stagnation and even longer lasting change.

I concluded in favour of optimism or at least that we should not yet give up hope of a return something more like the old model – though with weaker potential growth, given the likely persistence of some longer term economic forces.[8]

Since then the picture in the UK has been clouded by the impact of the Brexit vote. The global picture however does I think provide evidence of the slow healing story.
Having grown at rates below pre-crisis norms for the post-crisis period, the world saw an increase in growth rates from around the middle of 2016. That return to stronger growth was broad-based both in that it was true for the whole of the G7 – excluding the UK – and emerging markets in aggregate and that it was driven by a pick-up in investment not just consumption. At the same time, in the US, partly in response to very low levels of unemployment, pay and inflation have risen from subdued 1-2% to rates closer to 2-3% over 2015 to 2018.

So is there still a case for any 'stodginess' in the approach to monetary policy in the UK?

Headline CPI inflation is running at 2.4% above its 2% target. The overshoot, however, is entirely due to imported inflationary pressure. This has come primarily from the post referendum depreciation in sterling plus some more recent pressure from the increase in oil prices. The inflationary pressure from sterling's depreciation is already passed its peak. In May the MPC forecast that CPI would be at 2.2% by the year end.

The MPC's remit is to keep inflation at target 'at all times'. The objective therefore is not solely to bring down inflation that is currently above target due to external pressures that are waning, but to ensure that inflation is neither above nor below target when those pressures have passed through of the economy.

[6] UK GDP surpassed its 2018 Q1 peak in 2013 Q2.
[7] In the US, productivity growth initially appeared to be bouncing back after the crisis but from 2011 fell and failed to pick back up to pre-crisis growth rates.
[8] Cunliffe (2016)

The key question, therefore, is how much inflation is domestic economic pressures likely to generate over the next couple of years. Let me turn to that now.

We do not yet have all the evidence. But the significant drop in activity in the UK in the first quarter of this year looks to have been largely an aberration, driven by poor weather.

Retail sales – which declined in the first quarter of the year – have bounced back. GDP in the three months to May – the ONS's first of its new monthly GDP releases – grew at 0.2%, with services growing at 0.4%, indicating a recovery over April.

The soft data currently available also suggest that the economy recovered its end 2017 growth path in the second quarter of the year with the composite PMI for output back to its highest level since December albeit with somewhat different composition.

If this is confirmed, as I think probable, the overall picture is of an economy expanding around or a little above its potential rate of growth. The combination of lower rates of productivity and labour force growth mean that potential is growing at around 1.5% about a percentage point below its pre-crisis rate.[9]

Trying to make very precise forecasts of the output gap is a fool's errand but the balance of evidence is there appears to be little slack left in the labour market and little spare capacity in firms.

Unemployment is at 4.2% – pretty much the MPC's revised estimate of the natural rate. Underemployment is low.[10] Non-price measures – for example, surveys of recruitment difficulties and measures of churn in the labour market – have been signalling increasing labour market tightness for a number of years.[11]

Whole economy regular pay growth reached 2.5% in December and has stayed above that level through the first few months of 2018 though there has been a slight slowing in the latest – April – data (from 2.9% in March to 2.8% in April). The higher frequency measure of pay growth, 3 month on 3 month growth, has been above 2.5% for 11 months between last May and March this year – the longest run of such consistent wage growth since the crisis (**Chart 7**).

[9] See February 2018 Inflation Report, Section 3, Supply and the limits to growth for a fuller description of the MPC's assessment of the UK's potential growth rate.

[10] For example, there has been a marked fall in the share of part-time workers who would like to be in full time employment and 'net additional desired hours' are now below zero (i.e. people reporting they want to work more hours are outweighed by the quantity of hours that people report they'd like to work less).

[11] BCC and CBI surveys are at around their long-run averages, the same range they have been since 2015. Measures of churn – quit rates and job–to-job flows – have risen from their post-crisis lows to levels at around or a little below their pre-crisis levels, at around the levels they have been for the past couple of years.

Chart 7: whole economy regular pay growth

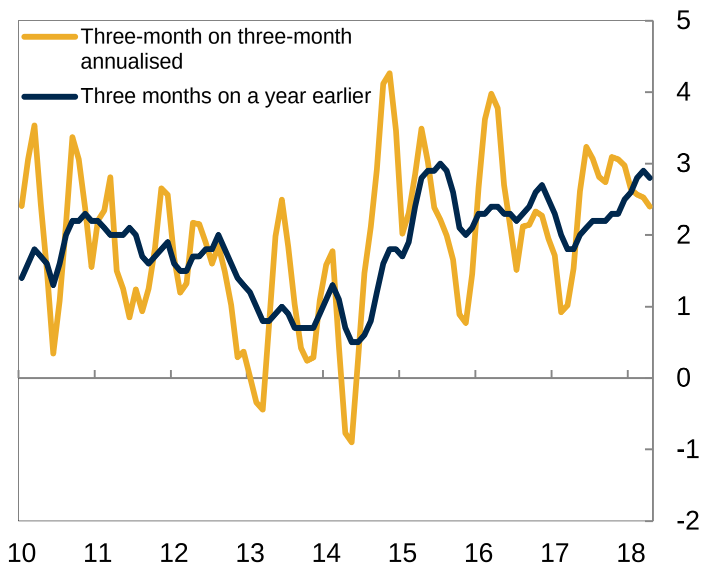
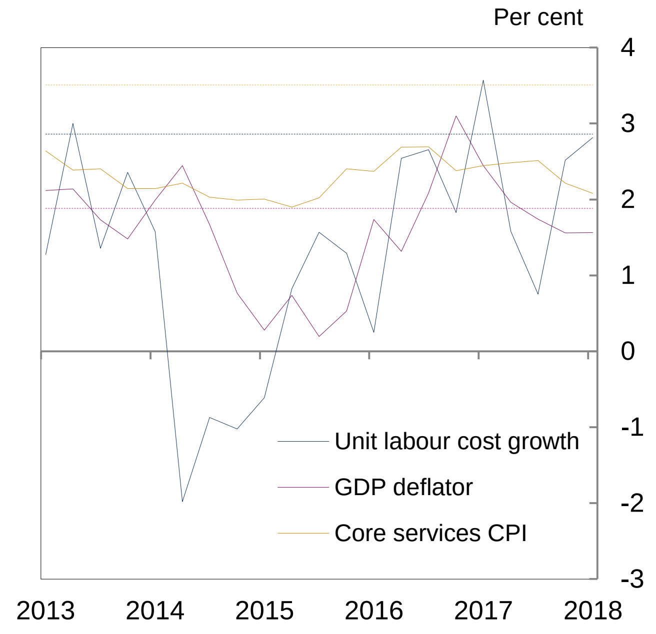


Chart 8: measures of domestically generated inflation



Notes: dotted lines show 1997-2007 average for each measure.
There is no clean measure of domestically generated inflation, the chart shows a subset of the range of measures that the MPC considers as a guide to domestically generated inflation.

We have of course seen false dawns before. Last November, with those very much in mind, I voted against a rate rise. For me, structural uncertainties about the economy warranted a stodgy approach. In the face of these types of uncertainty I was prepared to trade off moving more slowly in order to let evidence accumulate, with a little more resistance in our reaction function, rather than moving more in line with the forecast.

I will await our August forecast of course for the latest assessment of the evolution of domestic inflation pressures and of the first quarter of the year.

But the balance of evidence so far seems to me to suggest that MPC's May forecast of the growth path remains broadly intact. And, crucially, that the domestic economy is likely to generate the relatively gentle inflation pressure necessary to meet the target over the next two years, as the current external inflationary pressures from sterling's depreciation wane.

The May forecast was of course conditioned on a market yield curve that implied a limited and gradual tightening of 75 basis points over the forecast period.

So has the need for a stodgier approach now gone?

It seems to me that while diminished, there remains considerable uncertainty about the supply side. Domestic inflation pressures, while strengthening a little are not yet established at levels consistent with inflation at target (**Chart 8**). Pay growth has established itself in the 2.5-3% range. But the latest readings do not signal strongly that pay growth will make the next step to establish itself firmly in 3% territory in line with the May forecast.[12] We may still be underestimating supply in the labour market.[13]

In short we are still learning about the relationships between key economic variables in the post crisis economy and are still a long way off the old rules of thumb**.** This for me still implies an approach with a little more resistance in our reaction to developments.

Such an approach is not, however, a stopped approach.

Nor is it about taking only one step at a time with no view at each stage about what the necessary path of policy is likely to be further out. I do think it is important for the MPC to have such a view and to communicate it, broadly, to households and businesses and to financial markets. This need not require publishing precise paths for policy as both Mark Carney and Ian McCafferty have recently pointed out.[14]

Rather, it implies a bias to needing a little more confirmation at each stage that the supply side is evolving as we have forecast – a somewhat higher burden of proof that I hope will diminish as we learn more and as we become more confident about the 'model' of the economy that we hold in our minds.

Such an approach is not without its risks. The parable of the brick attached to a piece of elastic is never far from central bankers' minds. Something pulls on the elastic with increasing force but nothing happens – until the brick flies towards you to high speed.[15]

Domestic inflation pressure may increase more quickly than we imagine. Productivity growth may disappoint even the MPC's relatively low forecast – increasing inflationary pressure for any given level of activity, though I have to say here that as my colleague Silvana Tenreyro has argued, there are reasons to believe productivity growth might recover more sharply than we expect.[16]

[12] Having been at 3% or above through the last quarter of 2018, the 3m-o-3m rate was 2.5-2.6% for the first three months of 2018 and weakened a little more, to 2.4%, in April.
[13] As Bell and Blanchflower (2018) have highlighted, though low, indicators of underemployment remain above pre-crisis levels.
[14] Carney (2018) and McCafferty (2018)
[15] Or as elegantly put by Rudi Dornbusch – crises take longer to arrive than one would expect, but then happen faster than one would have thought.
[16] Tenreyro (2018)

My assessment is that these are the lesser risks; while more familiar economic relationships seem to be re-establishing themselves we are unlikely fully to go back to the future – some of the changes in the structure of the economy we have seen will be persistent.[17]

I have managed to get pretty close to the end of my discussion of policy and uncertainty without mentioning Brexit – which is surely an achievement nowadays. Brexit, both the eventual end state and the path to it, create very material uncertainties for the UK economy. I do not, however, see these uncertainties as justification for stodgier approach.

Brexit is already affecting the UK economy. The depreciation of sterling following the referendum generated inflation that has in turn squeezed real incomes and led to the drop in consumption and activity in the UK at the end of 2016. It has also generated export growth that has help support the economy. More recently, there are signs that Brexit uncertainty is holding back investment.

These impacts are incorporated into the MPC's assessment of policy and forecast of the economy. But it is much harder, and in my view it would be mistaken, to set policy in anticipation of any particular Brexit outcome. There is a very wide range of possible outcomes and paths to those outcomes. And it is not at all clear how the evolution of demand, supply and the exchange rate would respond in different circumstances – which could mean very different implications for monetary policy.

Over time, Brexit is likely to affect the supply side of the economy which has evolved and specialised over the last 45 years in the context of our EU membership. If the Brexit outcome generates the types of uncertainty about the economic model that I have been discussing, that will need to be factored into the policy approach.

But for the present, my view is that the best course for the MPC on Brexit is to react to the economy as we now see it conditioning our forecasts on neutral assumptions about Brexit outcomes.[18] At the same time, we should stand ready to respond, quickly and vigorously to any sharp impacts on supply, demand and the exchange rate that might emerge – as the Committee did immediately following the referendum.[19]

A rather different set of concerns about monetary policy strategy, and particularly about a more stodgy strategy, centre on the fact that UK interest rates are currently very low and the stock of assets purchased in the course of quantitative easing remain on the Bank of England's balance sheet.

[17] Haldane (2017)

[18] The MPC's projections are conditioned on the average of a range of possible outcomes for the United Kingdom's trading relationship with the European Union. They also assume that households and companies base their decisions on the expectation of a smooth adjustment to those new trading arrangements.

[19] Following the United Kingdom's vote to leave the European Union, the exchange rate fell and the outlook for growth weakened. At the time of the August 2016 MPC meeting, that weakening was particularly evident in surveys of business activity, confidence and optimism. In response, the MPC voted for a package of measures designed to provide additional support to growth and to achieve a sustainable return of inflation to the target. As the Governor set out in his opening remarks at the August 2016 *Inflation Report* press conference: "by acting early and comprehensively, the MPC can reduce uncertainty, bolster confidence, blunt the slowdown, and support the necessary adjustments in the UK economy".

I want briefly to look at three of these arguments: I will call them as 'room for manoeuvre', 'financial stability' and the 'time value of money'.

A number of commentators have suggested that if policy rates stay much closer to the zero lower bound than in the past, monetary policymakers will have insufficient conventional ammunition to stimulate demand in future downturns. All else equal, this would argue for erring on the side of speed and perhaps higher rates to create future room for manoeuvre.

One cannot help acknowledging this concern. If, as seems likely, we are and will continue to be in a lower natural interest rate environment, policy rates will not approach levels seen before the financial crisis. The average level of Bank rate was around 5% for the 20 years preceding the crisis. The current yield curve sees bank rate rising slowly over 3 years and levelling off at under 2% for the next 30 years.

The average policy loosening cycle in the UK was around 2% over the pre-crisis period. If that remained the case, we would clearly have less room for manoeuvre in the face of a sharp downturn, particularly if that happened in the near future.

However, raising rates faster, and perhaps to a higher level, than warranted to meet the inflation target in order to have the room to cut them in a downturn, assumes that the impact of policy on activity is asymmetric and that monetary policy will have less impact on the economy when it is tightened than when it is loosened.

Or, alternatively, it assumes that the cost of moving policy more vigorously to create greater headroom above the zero lower bound is justified in risk management terms – that the cost of a tighter policy setting than required is justified by benefits of avoiding the risk of having to use exceptional policy tools at the lower bound.

I have however seen little evidence in the UK that monetary has a consistently asymmetric impact in normal times.[20]

As to the risk management argument, I do think the experience of the last 10 years shows that there are policy tools which, while not the primary instrument, remain available close to or at the zero bound. It was partly for this reason that the MPC's recent statement on the unwinding of QE made clear that QE remained a weapon in the Committee's armoury.[21]

[20] Such evidence that exists for other economies suggest the opposite is true – that monetary policy has greater impact when it is raised than when it is lowered. Tenreyro and Thwaites (2016)
[21] As it stated in the June 2018 MPC minutes: In the event that potential movements in Bank Rate are judged insufficient to achieve the inflation target, the reduction in the stock of assets could be amended or reversed.

A sharper tightening of policy has also been suggested to avoid financial stability risks. Low policy rates, it is argued, generate leverage in the economy and can lead to asset price bubbles. These concerns have particular relevance for me given my responsibility as the current Deputy Governor for Financial stability. On the face of it, this ought to bias me more to err on the side of a faster and sharper approach to policy.
The evidence certainly seems to suggest that previous occupants of my post may have had such concerns about the impact of monetary policy on financial markets. Since the post was established in 1998, previous Deputy Governors for Financial Stability have never voted against a rate increase, and have frequently been in the minority in calling for one.[22]

The difference, however, is that it was only in 2013, six months prior to my arrival, with the formal establishment of the Financial Policy Committee that the Bank was given specific macro-prudential tools to manage risks to financial stability. And since the establishment of the FPC, we have used those tools not just to increase the resilience of the financial system but also to restrain the build up of leverage in the economy more generally.[23]

I am very clear that monetary policy can and should serve as the last line of defence against risks to financial stability, even though that can come at a significant cost to the broad economy. That cost is outweighed by the costs of financial instability to the economy, and the impact on the bank's ability to meet its inflation objective, as was cruelly underlined in the years following the crisis.

But it should be the last line of defence. Unlike my predecessors, and in contrast to many other jurisdictions, I and my successors can look to the FPC and quite a number of lines of defence before needing to deploy monetary policy against risks to financial stability.

And finally there is the general, normative, argument that there is simply something wrong when real interest rates are below zero including in the medium and long term (**Chart 9**).

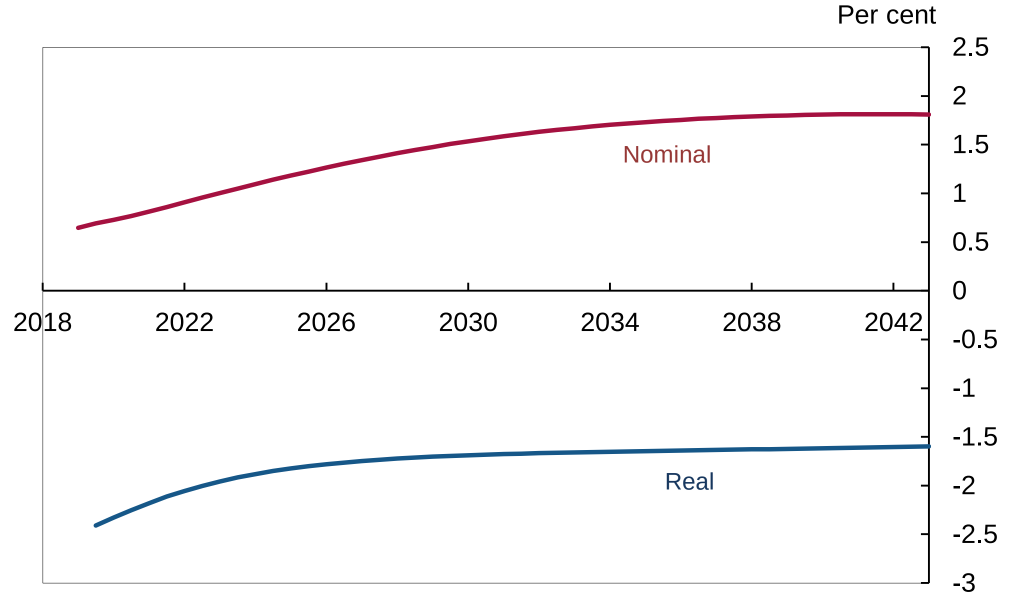
There is a natural and deeply ingrained view that money should have a time value, a return that makes it worth saving and investing.

I understand that view well.

[22] Previous Deputy Governors for Financial Stability (David Clementi, Andrew Large, John Gieve, and Paul Tucker) voted to increase interest rates 26 times – 15 times as part of the majority while 11 times they were in the minority.
[23] The countercyclical capital buffer (CCyB) increases banks' ability to absorb losses in a stress. The FPC sets the UK CCyB at a rate to reflect the prevailing risk environment. It is currently set at 1% consistent with the FPC's published strategy that it expected to set a UK CCyB in the region of 1% in a standard risk environment. In 2014, the FPC introduced limits on the flow of mortgages with a high loan to income (LTI) in order to guard against the buildup of highly indebted households.

But the current low real interest rate environment at the medium and longer terms that are of interest to households and businesses are not, to my mind, primarily the product of central bank policy. Persistent longer term trends have been pushing down with increasing force on real long term interest rates for two to three decades now.[24] Low productivity assumptions are an important more recent part of this story alongside demographic and income distribution trends.

Chart 9: Yields on UK government bonds



That pressure has been amplified in recent years by headwinds from the crisis. It may also have been amplified by the very structural uncertainties about the macro-economic 'model' in advanced economies and fears about secular stagnation that have been much of my subject today.

I expect that if the slow healing continues, and some of the more extreme concerns about secular stagnation of our economies fade, we will see larger term premia and some increase in medium and long term returns. That to me argues for the policy strategy that best and carefully nurtures the slow healing that I now believe is increasingly taking hold. In that respect, I think, looking to the medium term, there remains a case for a little 'stodginess' yet.

[24] As described in Rachel and Smith (2015), global preferences for saving and investment have shifted due to forces such as demographic change, changes to income distribution, increased precautionary saving in emerging markets, the falling relative price of capital and low public investment.

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