Monetary Policy Roundtable

On 15 December 2011, the Bank of England and the Centre for Economic Policy Research hosted the seventh Monetary Policy Roundtable. These events are intended to provide a forum for economists to discuss key issues affecting the design and operation of monetary policy in the United Kingdom.[1] As always, participants included a range of economists from private sector financial institutions, academia and public sector bodies. At this seventh Roundtable there were two discussion topics:

- what are the key headwinds facing the UK economy?; and
- how effective is the further round of asset purchases likely to be?

This note summarises the main points made by participants.[2] Since the Roundtable was conducted under the 'Chatham House Rule', none of the opinions expressed at the meeting are attributed to individuals. The views expressed in this summary do not represent the views of the Bank of England, the Monetary Policy Committee (MPC) or the Centre for Economic Policy Research.

What are the key headwinds facing the UK economy?

The UK economy had grown by 0.5% over the four quarters to 2011 Q3, according to the most recent vintage of data available at the time. This was much weaker than the United Kingdom's average growth rate of about 3% over 1993–2007. It was also disappointing relative to recent forecasts for growth. For example, the November 2010 *Inflation Report* had judged the probability of four-quarter GDP growth being at or below 0.5% in 2011 Q3 to be about one in seven. This provided the backdrop to any assessment of current headwinds.

One participant noted that the 2008–09 recession had been different from previous UK recessions. Those recessions had been characterised by monetary policy being tightened initially to tackle domestic overheating and a widening in the current account deficit. Growth had then recovered quickly. In contrast, in spite of a significant easing in monetary policy, output had recovered slowly following the 2008–09 recession, which reflected the high debt burdens of households and businesses as well as the continued tightness of credit conditions. The financial sector would be central to enabling deleveraging to take place without significant effects on output. To that end, the conflicting priorities facing banks would need clarifying — for example, whether they should focus on increasing lending or raising capital.

There were differing views on how similar current UK performance was to that of Japan between 1990 and 2005. One participant characterised Japan's experience — and that of the United Kingdom currently — as a balance sheet recession in which an asset price bubble had burst, leaving large liabilities behind. In this situation monetary policy became largely ineffective because debtors were focused on reducing their debt levels, meaning lower interest rates did little to boost spending. A possible lesson from this was that central banks should not raise false expectations that they could raise demand in these circumstances. But, more importantly, it was argued that governments should not try to reduce their budget deficits until households and businesses had mended their balance sheets. Premature fiscal consolidation in Japan had choked off the recovery in the late 1990s.

Other participants thought there were important differences between the current UK economic conjuncture and that of Japan between 1990 and 2005. First, part of Japan's problems had arguably stemmed from failing to tackle structural supply issues in the economy, unlike the United Kingdom. Second, in the years before the financial crisis, the UK corporate sector had in contrast run a financial surplus and overindebtedness did not seem to be a reasonable characterisation of many businesses. Third, while some UK households were currently facing difficult conditions, severe difficulties were arguably more common in the early 1990s when the proportion of homeowners in negative equity is likely to have been about double that of today. Finally, much of the current fragility of the UK economy seemed to be related to a lack of credit supply, rather than a lack of demand for credit which had been the experience in Japan. In these circumstances there was greater scope for the central bank to intervene.

Some participants suggested that in practice it was difficult to disentangle how much of the current low level of lending reflected credit demand versus credit supply in the

(1) Roundtables are held twice a year. The next Roundtable is scheduled for June 2012.
(2) This summary was originally published on the Bank of England's website on 16 February 2012. For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.

United Kingdom. In addition, it was much easier to criticise lenders for lending too little rather than criticise borrowers for borrowing too little. Directly questioning households and businesses might help more clearly apportion the extent of the credit demand and supply problems.

The merits of governments deferring fiscal consolidation while households and businesses adjusted their balance sheets were questioned by some participants. This might push up government bond yields, offsetting the effect on output of the more positive fiscal impulse. More generally, governments might have to run deficits for a number of years before the private sector resolved their balance sheet problems; it was unclear if governments would be able to continue borrowing over such a period (because investors or voters might not tolerate it) or how economies would eventually wean themselves off government borrowing.

To the extent that UK households and businesses were suffering from serious balance sheet problems, there were some suggestions for how these might be tackled. One suggestion was to have large-scale restructuring of liabilities. This was likened to a more extensive version of Chapter 11 bankruptcy procedures which were implemented by courts in the United States. Liabilities could be converted from debt to equity or written off to some extent. There were some questions about how well these procedures would work if their use became widespread — would there be the legal capacity and would there be destabilising effects on the economy from losses to creditors?

Another suggestion for tackling balance sheet problems was to raise the inflation target, say from 2% to 4%. Higher inflation would erode the real value of debt more quickly. But there were some difficulties with this proposal. First, it would erode the credibility of the inflation-targeting regime, which could make it harder to achieve the inflation target in future. Second, it was not clear how easily a central bank could engineer a relatively small increase in inflation over a sustained period. On the one hand, the private sector would still be trying to reduce its debt levels despite the change in the inflation target. So the weakness in domestic spending would make it hard to achieve an increase in inflation initially. On the other hand, if the central bank was successful in stimulating demand, it might have difficulties in limiting the increase in inflation to the new target.

Participants also discussed the headwinds facing the United Kingdom from the world economy. The key risk at the moment was judged to be from developments in the euro area. Participants had become more pessimistic about the outlook there, but found it difficult to quantify the potential negative impact on the UK economy of the most extreme possible outcomes. Developments in emerging market economies (EMEs) could have offsetting effects on the UK economy. For example, the growth outlook in some larger economies, such as China, seemed relatively positive. This should provide some support to world demand. However, this could have undesirable side effects. One was that commodity prices could increase further, beyond what was priced in by financial markets. This then would put further pressure on household real incomes in developed economies. Another possible side effect was that more investment might flow to EMEs rather than to developed economies, such as the United Kingdom, although underdeveloped financial market infrastructure might make it difficult to absorb a large increase in these flows.

How effective is the further round of asset purchases likely to be?

On 6 October 2011, the MPC announced the resumption of the asset purchase programme, also known as quantitative easing (QE), with a further £75 billion of UK government bonds to be purchased over a four-month period. This prompted the question of whether this second round of asset purchases (QE2) would have an impact similar to the first round (QE1), particularly on gilt yields, GDP and inflation; some of the key metrics of interest. The participants were broadly in agreement that this extension to the QE programme would be effective but considered that there was potential for a diminishing marginal impact relative to QE1.

The methods used to analyse the impacts of QE were the subject of much discussion. One participant noted that many micro-founded macro models failed to account for all of the transmission channels highlighted by the Bank, as portfolio rebalancing cannot hold without risk premia and market segmentation.[1] Portfolio rebalancing models, meanwhile, had not accounted for signalling and confidence effects, which might have been significant. The limits to the use of event studies were noted and questions were raised about the persistence of gilt yield falls following QE announcements, but other models (such as VARs) may be better placed to study this. Several participants suggested that the bank lending channel might be more important than had been assumed.

As a benchmark for analysing the impact of QE2, many participants found it useful to first assess the impact of QE1. One participant noted that the first announcements of QE1 accounted for most of the yield curve movements over the period, which was consistent with the notion that the confidence and signalling channels might be stronger than had been thought. Participants indicated that the gilt-OIS spread could be a useful metric for assessing the portfolio rebalancing channel. One participant suggested that the GDP and inflation

(1) Joyce, M, Tong, M and Woods, R (2011), 'The United Kingdom's quantitative easing policy: design, operation and impact', *Bank of England Quarterly Bulletin*, Vol. 51, No. 3, pages 200–12.

effects of QE1 might have been underestimated based on a counterfactual of a deeper recession. There was also debate about the spillover effects of QE to other countries. The general opinion was that QE1 had been effective, and that although the narrative about how it worked was important, the fact that it had worked mattered more.

Participants offered a variety of views about the likely effectiveness of QE2. One participant suggested that event studies would be less reliable as expectations of further QE had built up in advance of the announcement. Several participants indicated that the smaller movements in gilt yields and gilt-OIS spreads around the QE2 announcement were evidence of a weaker marginal impact of QE2. But participants noted that if the signalling and confidence channels are important, then this would be expected. One participant noted that the evidence was consistent with the later announcements of QE1. It was also consistent with the US experience from the second round of asset purchases in November 2010. There might also have been stronger portfolio rebalancing effects during QE1 as arbitrageurs were arguably more credit constrained and risk-averse than during QE2. One participant used the multipliers from the analysis of QE1 to suggest an upper bound for the effects of QE2 of a ½%–¾% GDP level impact and a ¼%–½% peak inflation impact.[1] There was no suggestion that QE2 would not work, only that the marginal impact might be somewhat weaker.

Participants considered the importance of the context of the QE2 announcement relative to the QE1 announcement. Safe-haven flows resulting from euro-area concerns might have had a more significant impact than QE2 on gilt yields, so disentangling the two effects might be difficult. If euro-area concerns were to ease, there was speculation that gilt yields might increase as safe-haven flows reversed. One participant noted that to the extent that such a move was associated with a stronger growth outlook, higher yields could be a positive indicator for the UK economy. The QE1 announcements were also the first time asset purchases had been used in the United Kingdom, so some uncertainty over the impact may have extended to the time taken to price QE into markets. Given this experience, QE2 might have been priced in more quickly and in advance of the actual announcement. There was some concern that inflation expectations might have begun to rise as QE2 was announced in the context of high inflation while QE1 was enacted as inflation was falling. But as earnings growth had remained subdued and indicators of inflation expectations had been stable, it was unclear that this was a cause for concern.

Many discussants argued that with weak growth and with a potentially smaller marginal impact of QE2, further announcements of QE would be warranted. There was broad support for expanding the range of assets to be purchased, amid concerns over market functioning and the potential limits to further expanding gilt purchases given the proportion of gilts already owned by the Bank. There was broad support for a policy of credit easing to head off the risk of a renewed tightening in credit conditions, but it was recognised that this verged into fiscal territory and that it would be more appropriate for the Government to undertake such interventions.

(1) Joyce, Tong and Woods (2011), *op. cit.*