Monetary Policy Roundtable

On 14 June, the Bank of England and the Centre for Economic Policy Research hosted the eighth Monetary Policy Roundtable. These events are intended to provide a forum for economists to discuss key issues pertaining to 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. There were two discussion topics:

- prospects for household saving; and
- cost, demand or uncertainty: why has the level of business investment been so weak, and when will it pick up?

This note summarises the main points made by participants.(2) Since the Roundtables are conducted under '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.

Prospects for household saving

The onset of the financial crisis was followed by a marked decline in household consumption. This decline exceeded the fall in disposable income, and consequently the savings rate rose from its pre-recession low in 2008 to something close to its historical average in 2011, although with interest rates and inflation low relative to some periods in the past, this may not indicate a 'normal' level. Inflation adjusted, the current savings rate is in fact below that of both the 1980s and 1990s. While the 1980s and 1990s recessions were also associated with rising savings rates, the recent change has been longer-lived.

Speakers considered what might lie behind this increase, noting that under the consumption-smoothing hypothesis a recession should instead be associated with a fall in the savings rate. Several candidate explanations were put forward, including a permanent fall in income, a greater need to save for retirement and the need to offset declines in wealth by rebuilding balance sheets. The latter was thought to be amplified by the extent to which households are leveraged. Highly indebted households were thought to be more likely to undertake dramatic and persistent cuts to consumption. Additional possible explanations why the savings rate could be temporarily higher included: an increase in the uncertainty faced by households, a change in preferences leading to an enhanced desire to simply pay down debt more rapidly, and a decline in the supply of new credit. If these latter factors were the drivers, then the savings rate was likely to fall as the source of the decline moderated.

The importance of considering which age groups had been responsible for the increase in the savings rate in the current recession was highlighted, because potentially this could shed light on the cause of the rise. It was noted that an increase in the savings rate resulting from a tightening in the supply of new credit was likely to affect the young disproportionately. Savings rates of older groups, in contrast, should be less affected by a reduction in the supply of credit, as they are at the stage in their life cycle where they are more likely to have paid off mortgage and other borrowing and to have accumulated financial assets.

What evidence can be brought to bear on this? The microdata (ie from households) up to 2010 (the latest available) shows that the 1980s, 1990s and 2008 recessions saw a transitory increase in the savings rate across all age groups. It also shows that in the current recession in particular, younger age groups have seen the largest reductions in the level of consumption. But they have also seen the largest falls in income, leaving the impact on savings rates not markedly different from other age groups. Another feature revealed by the household data is that mortgagors have reduced consumption significantly, implying that leverage might be playing an important role. The implication may be that credit restrictions *per se* were not the driver, but a desire to rebalance — whether coming from raised uncertainty or a simple change in preferences.

Notwithstanding the household evidence, some favoured a reduction in credit availability as the explanation, rather than households actively increasing saving. This view was justified by data showing a decline in household borrowing since the crisis, with households' net acquisition of financial liabilities as a percentage of household disposable income dropping to very low levels, whereas households' net acquisition of financial and housing assets have remained broadly flat. Others thought that the increase in the savings rate had less to do with tight

(1) Roundtables are held twice a year. The next Roundtable is scheduled for Winter 2012.
(2) For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.

credit and more to do with the impact of uncertainty, supported by the apparent increase in savings rates across all age groups mentioned above.

To the extent that households intend to run down borrowing and accumulate savings relative to the pre-crisis period, then it is relevant that although the savings rate has returned to its long-run average, this was preceded by a significant period of lower-than-average saving. It therefore follows that a larger-than-average increase in savings might be needed to offset this and rebuild balance sheets. A speaker noted that while households had built up both debt and assets, debt as a percentage of wealth was still likely to be historically high over the next few years. To the extent that household consumption behaviour reacts to changing wealth, one speaker suggested that responses to falling house prices had much more impact than falls in the value of other forms of wealth, such as equities. Generally, it would be good to be able to look at individual household data to help shed light on behaviour in households with different compositions of debt and assets, but the available microdata were unfortunately not that helpful in understanding household-level debt and wealth distributions.

There was agreement that further increases in the UK savings rate remained a possibility, bearing down on consumption, despite a potential moderation in the real income squeeze. Previous recessions had seen a tendency for savings to increase when income began to grow. Current weak income growth might therefore likely have prevented complete adjustment to a higher desired savings rate. Current low interest rates have probably also resulted in less pressure to pay off debt rapidly.

The discussion at the Roundtable was mainly about the United Kingdom and cyclical behaviour, but one speaker reminded us that there are long-run factors at play regarding national savings and demographics and that some observers take the position that the UK savings rate is unsustainably low. When considering these trends it is instructive to note that UK savings lie below that of many other comparable countries. That might suggest a sustained rise in the savings rate was on the cards.

Cost, demand or uncertainty: why has the level of business investment been so weak, and when will it pick up?

Business investment fell dramatically during the financial crisis. And it remains below its pre-crisis level. Much of the Roundtable discussion focused on the relative importance of weak final demand, uncertainty and tight credit conditions in explaining the fall in investment.

Some speakers offered evidence from the *CBI Industrial Trends Survey* in answering this question. The survey showed most firms reporting 'uncertainty about demand' as a factor limiting investment. It was noted that this had almost always been the case in past recessions, and that the questions may conflate genuine uncertainty and low demand. One factor unique to the recent downturn was an increase in the number of firms reporting tight credit conditions, although this was still cited by a relatively small proportion of firms. One presenter reported an econometric estimation of the determinants of the survey measures of investment intentions. They suggested that weak expected demand and tight credit conditions were significant factors, but that uncertainty did not appear to cause much of the variation in investment. Another participant argued that although demand expectations had been the driver of weak investment in 2009, it was less clear that this was the case in 2012.

One speaker suggested to wide agreement that there were several obvious reasons uncertainty may have increased recently. These included the financial crisis itself, a succession of countries experiencing sovereign debt crises and ongoing uncertainty about the future of the euro. This higher level of uncertainty could have both temporary and longer-lasting effects on the level of business investment. Temporary effects may be due to the irreversibility of some types of investment. In these circumstances a higher level of uncertainty could mean firms need larger 'trigger' levels of demand before they invest, effectively meaning that they postpone investment. If driven by this mechanism, investment would rebound when uncertainty dissipated, or when those triggers were reached. But there were also other channels through which uncertainty may lead to a longer-term fall in investment. These included higher risk premia in required rates of return. Firms facing increased risk may choose to make less use of debt because of the consequences of defaulting in the event of a bad outcome, even though tax advantages may make debt cheaper than other forms of finance. Theory also suggests that the demand for capital falls with volatility in the presence of increasing marginal adjustment costs. But some participants cautioned against assuming that theory is unambiguous about the impact of uncertainty on investment. Long-run effects can be ambiguously signed, and much of the formal economic analysis is of permanent shifts in uncertainty, rather than temporary. There was also some discussion about the best policy response to increased uncertainty, with one suggestion that increased government investment could improve confidence.

In discussing the role of tight credit conditions over the past few years, there was debate about the extent to which Britain had been suffering from a decline in credit supply or a credit demand — in principle it is very hard to distinguish between the two drivers. One participant felt that surveys can give a misleading indication of whether demand or supply factors are behind movements in credit. The inability to distinguish between the two explanations complicates policy setting, as

the prescription for each would be different. Another felt that the increase in the cost of credit since the crisis, measured by corporate bond spreads, was a sign of a credit supply shock. But others argued that this cost would also increase with uncertainty, so it remains difficult to differentiate between this and tight credit conditions.

A piece of evidence discussed in detail was the build-up of a large surplus of cash and other financial assets by UK companies in recent years. One participant posited that with large amounts of cash, it seemed unlikely that a lack of available credit had been constraining firms' investment. An explanation for firms' financial surpluses could be that they had been holding cash as a form of precautionary saving in anticipation of future liquidity constraints. One participant felt that the increase in cash holdings was mostly down to an increase in financial activity by companies in recent years. Nevertheless, it was pointed out that companies' cash surpluses may not be inconsistent with tight credit conditions if those positions were mostly held by large international firms, while smaller companies were unable to borrow for investment. Another speaker showed survey evidence that small and medium-sized enterprises (SMEs) in the manufacturing sector were particularly suffering from a lack of available credit. They mentioned that this is consistent with the Bank's own *Trends in Lending* report. They felt one problem for SMEs was a lack of alternative sources of finance, as they were unable to issue in capital markets.

Although the level of business investment has fallen markedly, as a share of GDP, the fall is no greater than that seen in the 1990s recession, or even during the early 2000s. (It was pointed out, though, that care must be taken when looking at trends to take account of relative price changes — real and nominal proportions behave very differently.) Some participants suggested that the biggest puzzle related to the fall in investment was its persistence rather than its depth. Discussants debated what had driven the longer-term decline in real investment seen over the past decade, independently of the financial crisis, and when this trend would reverse. One suggestion was uncertainty, as discussed above. Another participant suggested that increases in corporate governance had led to overmonitoring and pressure on companies to pay out higher dividends instead of investing.

Another speaker discussed the long-term decline in investment with a focus on manufacturing. They argued that over the past ten years, there had been less investment in manufacturing as a share of its output in Britain than in other European countries. One reason given for this was the appreciation in sterling over this period. Another was that it was partly driven by low-cost competition from Eastern Europe and Asia, with many firms moving parts of their supply chains abroad. There was also some discussion about how important manufacturing investment was, given that it is a small proportion of the total. One participant argued that it was disproportionately important, both because manufacturing makes up a large share of exports and because its investment was often irreversible, so offered a sign of a possible market failure.

In conclusion, with regard to the question posed, there is no shortage of analysis of the weakness in investment: but it remains hard to know when the numbers will pick up.