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Monetary Policy Roundtable

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Monetary Policy Roundtable

On 10 November 2016, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their fifteenth Monetary Policy Roundtable. These events provide a forum for economists to discuss key issues relevant to monetary policy in the United Kingdom.(1) As with previous Roundtable discussions, participants included a range of economists from private sector financial institutions, academia, public sector bodies and industry associations. There were two topics of discussion:

- **monitoring the economy**: the challenges of monitoring how the economy is developing post-referendum, given the limited data available; and

- **challenges for monetary policy**: the current challenges for monetary policy in a low global interest rate environment.

This report summarises the main issues raised by participants.

Monitoring the economy

An accurate assessment of the cyclical position of the economy is important for setting monetary policy. Economists at the Bank — and forecasters elsewhere — use a wealth of data and a variety of techniques to gauge economic activity in real time and anticipate its near-term trajectory as accurately as possible.

Some degree of uncertainty will always surround forecasts of the near-term outlook, however, particularly in the face of economic shocks. The outcome of the EU referendum on 23 June 2016 was widely regarded as one such possible shock. Following the referendum, many economists had revised down their expectations of the United Kingdom's growth potential over the longer term, and sterling had fallen significantly. In addition, the majority of forecasters expected GDP growth to slow substantially over the near term. The data available at the time of the Roundtable, however, showed the economy had instead continued to grow at a relatively robust pace well into the second half of 2016. Against that backdrop, the first session discussed approaches and challenges to forecasting near-term economic developments — or 'monitoring the economy' — both in general and specifically following the EU referendum.

Economists' assessments of the near-term outlook are informed by a wide array of data, ranging from the most recent official estimates provided by the Office for National Statistics (ONS) to a myriad of more timely survey indicators. To produce short-term forecasts, economists typically use a variety of statistical models, which translate the relevant incoming data into estimates of near-term output growth. These approaches tend to deliver a reasonably high degree of forecast accuracy in many circumstances, in part as they are able to flexibly exploit a broad range of high-frequency indicators. Judgement can also be added, to incorporate any information believed not to be captured by these statistical models. Some speakers noted potential pitfalls to applying additional judgements, however, such as inherent biases and herding behaviour.

Following the EU referendum, economists had become more uncertain of the usefulness of their short-term forecasting toolkit, at least when forecasting the consequences of this type of event. The reasons were twofold. First, very little data covering the post-referendum period would be available to inform forecasts for some time. Second, pre-referendum indicators were potentially unhelpful, since the usual dynamics of growth might have been disrupted by the referendum outcome, and qualitative evidence captured alongside forward-looking survey indicators ahead of the referendum suggested respondents had not, on balance, anticipated a 'leave' vote.

Participants discussed the alternative approaches they had considered while post-referendum data were still thin on the ground. A common first step in estimating the impact of significant events was to study similar past occurrences. But as one speaker noted, there had been no directly comparable events in the past. In the absence of precedent, forecasters had turned to structural models. In contrast with the statistical models commonly used for short-term forecasting, structural models are based on economic theory. These models are typically better suited for scenario analysis or projections spanning longer horizons; over short horizons they tend to be less accurate than statistical models as they impose a tighter structure on the data and typically do not exploit the information contained in high-frequency indicators. In this instance, however, with the predictive content of pre-referendum indicators perhaps limited, such models may have been able to assist in estimating the near-term effects of

(1) This report was prepared by Tamara Li and Andre Moreira of the Monetary Analysis Directorate of the Bank. The Roundtables are conducted under the 'Chatham House Rule' and so opinions expressed at the meeting are not attributed to individuals. This summary does not represent the views of the Bank of England, the Monetary Policy Committee or the CEPR.

the potential longer-term structural changes resulting from Brexit. Particular examples discussed included models that had taken a signal from asset price moves following the vote, incorporated assumptions regarding future trade openness and potential growth, or which had estimated the macroeconomic effects of uncertainty.

Soon after the referendum the consensus appeared to be that growth would slow sharply in the near term, as heightened uncertainty and expectations of decreased trade openness and lower potential growth weighed on spending, particularly business investment. Early survey releases covering the post-referendum period had seemed to corroborate such views. For example, in July the Markit/CIPS PMI surveys — which are highly correlated with GDP growth — had signalled outright falls in output. A similar pattern of marked falls appeared across other surveys of both business and consumer behaviour. By August, that weakness in survey indicators had led most economists to forecast a sharp slowdown in the second half of 2016. Within that, some speakers and attendees had expected a technical recession. The Monetary Policy Committee (MPC), while not as pessimistic as the average of other forecasters, had also marked down their forecast in August, expecting weak — albeit still positive — growth over the remainder of the year.

In contrast with those predictions, ONS data for the post-referendum period subsequently painted a more resilient picture. Official estimates of monthly output showed activity had held up well in the months following the vote. And by the time of the Roundtable the ONS had published its first estimate of third-quarter GDP growth, which at 0.5% suggested little sign of a negative referendum impact. Looking ahead, the available evidence indicated the economy was also on track to grow at a healthy pace in the final quarter of 2016. Despite those developments, an anonymous poll of the audience suggested a majority did not think the processes which had fed into the MPC's forecasts had been particularly flawed: four fifths of attendees thought that the MPC was right to forecast a sharp slowdown in August given the information available at the time.

Since near-term forecasts had appeared to be corroborated by early survey data, that warranted a discussion of the challenges to monitoring the economy arising from the data themselves. As suggested by one of the speakers, the debate was framed around two types of issues: those to do with the timeliness of data, and those to do with its reliability.

As most data are published with some lag, the timeliness of such information will always be an issue. In periods of stable growth the lack of real-time information on economic developments is perhaps less of a problem, but around turning points or in the face of shocks, forecasters might be left in the dark for some time. And some data sets are timelier than others, so the sequence of releases does not always match the sequence of underlying events. That can pose a challenge to interpreting the flow of data. For example, data relating to the pre-referendum period continued to be released after the event, alongside indicators of post-referendum activity. Within that, survey data are often released soon after the period they refer to, providing useful early signals, while official data are typically published with longer lags. After the referendum, it was not until mid-September that economists could see the first official estimates of July output, while third-quarter GDP would only become known in late October. In addition to official and private survey data, the MPC was able to access real-time intelligence from the Bank's Agency network. Indeed, a less downbeat view from the network had contributed to the MPC originally aiming off the negative growth rates suggested by some other survey indicators.

The reliability of data also presents a challenge as they are typically imperfect measures of the underlying economic developments. That reflects the use of limited samples, as well as other methodological issues. Consequently, some degree of uncertainty regarding the true state of the economy will always persist. Different types of data tend to be affected by distinct issues. Official statistics are generally the most thorough, but are subject to revision for extended periods of time. Such revisions, sometimes substantial, can arise both as a result of new source data or methodological changes. For example, the first official estimate of GDP is based on less than half the data which will eventually inform mature estimates, and the annual ONS *Blue Book* publication will often include revisions to GDP extending back several years due to changes in methodology. In contrast, the timelier survey indicators are generally not revised. But smaller samples and the predominantly qualitative nature of survey questions mean that there is not a direct mapping from survey indicators to the official ONS data. As a result, statistical relationships with official data can sometimes break down. It was generally agreed among the audience that this had probably happened following the EU referendum, where perhaps changes in sentiment rather than genuine economic news had driven the deterioration in survey measures.

In summary, the first session discussed several challenges faced by economists in producing short-term forecasts. Those included timeliness and reliability issues relating to data, which are always factors, but which were thought to have been more acute than usual following the referendum. In particular, the lack of timely data had led some economists to abandon their usual toolkit in the immediate aftermath of the vote. And the indicators that had soon emerged appeared to be affected by an unusual degree of volatility. More broadly, what the session had highlighted was the

uncertainty which inevitably surrounded even short-term predictions, and their limitations, particularly in the face of shocks which have no clear historical precedent.

Challenges for monetary policy

During the financial crisis, central banks in most advanced economies cut their policy interest rates to close to zero. Since then, policy rates have remained at broadly similar levels and market interest rates imply only a gradual rise in coming years. As a result, some central banks have been using less conventional policy instruments to provide additional stimulus to their economies. That includes financial asset purchases, commonly referred to as quantitative easing (QE). Against this backdrop, the second session focused on the challenges for monetary policy in a low global interest rate environment.

Most speakers agreed that the persistence of low interest rates, at least in part, reflected a gradual fall in the so-called global natural interest rate. That is the interest rate consistent with inflation remaining at its target level once demand and supply in the economy are in balance. The fall in the global natural rate may have been driven by a range of structural factors, including weaker expectations for global potential output growth, global demographic trends, and heightened risk aversion. Such factors were generally thought likely to persist for some time.

There was some discussion of how far headline policy rates could fall, and hence their so-called 'lower bound'. Negative interest rates were generally viewed as less effective at stimulating demand, particularly in economies more heavily reliant on the banking system for distributing credit. Banks are typically less able to pass through cuts in market interest rates below zero to deposit rates for fear of large-scale withdrawals of cash. That, in turn, typically limits the pass-through of any cuts to lending rates as banks seek to preserve the margins required to cover the cost of providing banking services. A lower global natural interest rate would suggest that central banks are likely to face this 'lower bound' constraint on the pass-through to retail interest rates more often than prior to the crisis and hence they may need to give further consideration to less conventional policy instruments, such as QE.

Many speakers discussed the scope for further QE purchases to provide additional stimulus to the economy, were it warranted. QE involves central banks buying assets such as government and corporate bonds. That pushes up the prices of both these and other substitutable assets and lowers their rates of return, which in turn tends to push down the cost of finance for households and businesses. The effectiveness of further QE purchases was thought potentially to be more limited than in the past, given that interest rates were already low even at long maturities and so the scope for them to fall further was limited. In addition, industry practitioners highlighted practical limits of increasing the size of existing QE programmes given the outstanding amount of bonds available for purchase. While they thought that there was still some scope for further QE extension in the United Kingdom, they viewed some other central banks as potentially constrained. In contrast, participants saw extending QE to new asset classes, such as a broader set of bonds or equities, as potentially more effective. Some warned that extending purchases to equities, essentially making central banks direct shareholders of private companies, could raise a question of appropriate corporate governance.

A range of other potential macroeconomic policy measures were also discussed. These included a change in the inflation target. A higher inflation target would imply that nominal interest rates could also be higher for any given amount of monetary stimulus to the real economy. That would allow for greater cuts in policy rates before any 'lower bound' became binding. Higher inflation would, however, carry its own costs, potentially including greater uncertainty for households about prices in the economy, and changes in their purchasing power, particularly for those households whose income was relatively fixed in cash terms. And for many central banks, a higher inflation target was thought to perhaps be difficult to transition to in the current environment of below-target inflation, and hence could undermine their credibility. Some speakers and attendees also thought that there could be scope for temporary fiscal stimulus in some economies, if required, reducing the reliance on further monetary easing.

Irrespective of the reasons behind low policy rates, most speakers warned of potential side-effects of a long period of low interest rates — a so-called 'low-for-long' environment. Over 60% of attendees thought that the benefits of any further monetary easing would be outweighed by the risks posed by a lower interest rate environment. While that may have reflected a belief that further monetary stimulus was not warranted by the outlook for activity and inflation, it could have also been associated with perceptions that additional measures may be less effective or that the risks associated with monetary easing were becoming higher.

In particular, some speakers noted that a low interest rate environment had the potential to constrain the profitability of the pensions, insurance and banking industries. And to the extent that balance sheets within these industries became impaired, that could affect the availability of financial services for households and companies. Some speakers thought that a low-for-long environment may have contributed to elevated asset prices which could be quick to reverse if interest rates rose sharply. More broadly, one speaker suggested that modern-day capabilities in modelling financial interconnectedness were still limited, which made it difficult

to assess financial stability risks and their interaction with monetary policy.

The challenges faced by monetary policy makers were also thought to extend to their communication strategies. One set of communication challenges was presented by the difficulties in considering and explaining any distributional consequences of monetary policy. In addition, industry practitioners emphasised the difficulty in deciphering central bank communication in a world where more than one monetary policy instrument could be used. In particular, they raised a concern that any decisions about QE were harder to communicate and assess, given that additional QE is not directly comparable to changes in policy rates. More broadly, communication strategies would continue to be important in setting out policymakers' expectations for the economic outlook, the risks around that, and therefore the potential implications for future policy.