BANK OF ENGLAND

Speech

Remarks given by
Mark Carney, Governor of the Bank of England

Davos CBI British Business Leaders Lunch
24 January 2014

When a banker invites a regulator to a meeting on a mountainside, the regulator gets suspicious. At 5000 feet, "cliff effect" takes on a whole new meaning. That's one of the reasons why I am pleased to have so many distinguished witnesses here today.

While Douglas Flint may have had terminal velocity in mind for me, I am more interested in discussing the prospects of the global and British economies achieving escape velocity.

In physics, escape velocity refers to the speed necessary to escape from a planet's gravitational pull. The economic analogue is the momentum necessary for an economy to escape from the many headwinds following a financial crisis. A few quarters of above-trend growth driven by household spending represent a good start, but they aren't sufficient. It will take sustained growth, more balanced demand and a recovery in the supply side for advanced economies to break free into a more normal universe. Today, I would like to speak to the contribution of central banks to make this happen.

1. GLOBAL ECONOMIC OUTLOOK

Over the past year, the global economy has picked up and tail risks have decreased. After rising to an expected 3.5 percent this year, global growth could finally re-attain its pre-crisis trend of 4 percent in 2015.

Three quarters of this acceleration is expected to be driven by advanced economies, with the US and the UK leading the pack. And this isn't the best case scenario. Even in the euro area, risks have become two-sided, albeit around a modest growth rate of about 1%.

None of this is to suggest that current levels of economic activity are acceptable or that the world economy is no longer under strain. After the Great Moderation and the Great Recession, there are several reasons why it will be years before any superlatives are attached to this recovery.

First, for all the talk of austerity and deleveraging, the aggregate debt burdens of advanced economies have actually increased; with their total non-financial sector debt rising by 25% relative to GDP since 2007. Balance sheet repair in the public and private sectors will exert a persistent drag on major economies for some time.

Second, the need to rebalance demand from deficit to surplus countries endures. Given the adjustment pressures on the former, without progress on rebalancing, robust and sustainable global growth will remain an aspiration.

Third, confidence, while improved, remains subdued. Recognising that the end isn't nigh is far from marking the normalisation of business and consumer sentiment. Given past shocks and modest prospects, business investment in particular remains hesitant across the advanced world. On balance, corporations remain more focused on reducing operating expenditures than increasing capital expenditures.

This focus is helping to contain inflationary pressures in the near term. Indeed, across advanced economies, wage growth remains weak and labour markets soft.

Reflecting the combination of improving, but still subdued, demand and considerable, if uncertain, slack, monetary policy remains exceptionally stimulative. Recall that the recent decision of the Federal Reserve to begin tapering asset purchases meant only slowing the rate of additional stimulus. And that the 7% unemployment rate in the UK is merely the point at which the MPC begins to even think about adjusting policy.

The key question for central banks is the expected evolution of the supply side of their economies. This is unusually uncertain at present. We know that our economies are operating well below their, admittedly unsustainable, pre-crisis trends, but we don't know how much capacity was destroyed following the crisis.

We know that depressed business investment is limiting productivity growth in the short term, but we don't know to what extent and whether such shortfalls can be caught up.

From a longer perspective, we know that total factor productivity growth has slowed over the past decade, but given the incredible flourishing of innovation, we don't know whether this is due to lags, measurement errors or more fundamental factors. Statistical trend measures of labour productivity growth suggest it has slowed in the United States, the euro area (both core and periphery), the UK and even Korea.

By this point, buffeted by gloom and uncertainty, you may be considering joining the bankers in pushing me off the mountainside, so let me begin to outline how we can address these challenges.

We can start by recalling that the global economy has been in similar circumstances before. Everyone knows that the 1930s marked the depressing aftermath of a great financial crisis. Less well-appreciated was that it also marked a period of intense innovation that laid the groundwork for post-war growth, particularly in the United States. Alexander Field in his book "A Great Leap Forward" contends that the 1930s were the most technologically progressive decade of the 20th century. He notes the development of chemical-based materials like Teflon, Nylon and synthetic rubber; the development of the Television, and the expansion of the public road network that paved the way for advances in distribution and transportation.

In the 1930s, the collapse of demand meant mass unemployment and slow adoption of new technologies. It took a recovery in aggregate demand after the Great Depression, partly spurred by mobilisation for the Second World War, for many innovations to be applied and new markets to develop.
Demand was persistently weak in the 1930s because policy mistakes were legion. A protectionist backlash closed global markets and ended global finance. Policies favouring liquidation led to widespread bank failures. Monetary policy was tightened dramatically.

This time, thus far, is different. Protectionism is being resisted, banks recapitalised, and the global financial system rebuilt. In parallel, monetary policy is highly accommodative.

As the global economy gains momentum, staying the course on these policies will be decisive to achieving escape velocity. The United Kingdom is at the centre of these decisions. Let me expand.

2. FINANCIAL REFORM

In recent years, protectionism has been the dog that didn't bark. Although gently mocked, the G20 pledge to resist protectionism has been largely respected. In contrast, some major trade deals have been signed (such as between Canada and Europe), and other even more significant ones are in train. The UK can help spur on the Transatlantic Trade and Investment Partnership discussions on wide ranging free trade between the EU and the US.

In tandem with keeping the global trading system working is the re-founding of an integrated, open global financial system.

As the leading global financial centre, the UK will be central to completing the job of financial reform. The UK financial system is both a global good – it supports an open global system – and a national asset. To realise its potential, we need our system to be safe, fair and to act with integrity. Without those foundations, the innovation for which finance in the UK is renowned will be meaningless.

A safe system means resilient banks and markets that together can absorb rather than amplify shocks.

Much has been achieved in recent years to repair the core of the banking system. Minimum capital requirements for the world's largest banks have been increased seven-fold. These banks are on course to meet these new requirements five years before the deadline, having raised more than half a trillion dollars of new equity. In the UK alone they have raised £140bn. To ensure that this is sufficient, the Bank of England will begin annual concurrent stress tests of major institutions this year. The Bank is also working with international peers to tackle worryingly large differences in bank risk models through tighter supervision, more standardised approaches and better disclosure.

To make markets safer, funding and derivatives markets are being overhauled. Recognising that this will transform the use and importance of collateral, the Bank is reforming our market operations. We are also working to develop market-based sources of finance so that the real economy can be less reliant on banks. To make the system fairer, the days when banks privatised gains but socialised losses must end.

The Bank is at the forefront of international efforts to agree common standards to create classes of debt holders that can be bailed in to recapitalise failing institutions. By complementing this so-called gone concern loss absorbing capacity with cross border agreements, plans on resolution, and new derivative contracts with automatic stays, we can create the situation where the incentives of shareholders, management, bondholders, and citizens are aligned. Firms that take excessive risks will bear the full consequences of the market; consumers, businesses and taxpayers who rely on critical banking services will not.

It is not the Bank of England's role to champion the City. By making it safer and fairer we can put in place the conditions for it to thrive. But whether or not it thrives will rest on the efforts of individuals and organisations to re-establish the system's reputation for integrity.

While regulators will fix the mechanics of benchmarks in markets ranging from LIBOR to FX, only private individuals and institutions can reform the behaviour that has made such changes necessary. Changes to the structure of compensation will better align the incentives of bank staff and their shareholders, but not every risk can be anticipated. Even if such a package could be devised it would not internalise the impact of individual actions on systemic risks, including on trust in the banking system.

For the system to operate with integrity**,** penalties for misconduct cannot be seen as a cost of doing business. Rather, banks must recognise that only exemplary behaviour can confer social licence to global financial capitalism.

More fundamentally, integrity cannot be legislated, and it certainly cannot be bought. Only a perspective which takes into account the wider implications of actions can guide proper behaviour. And while regulators can promote competition, end the subsidy enjoyed by institutions that are too big to fail, and determine the appropriate split of remuneration between fixed and variable elements to limit risks to financial stability, only society, not regulators, can determine whether the absolute and relative levels of compensation are acceptable.

3. UK MONETARY POLICY

Measures to make the system safer, fairer and to operate with more integrity are re-founding a more resilient, open global financial system. This sets the stage for monetary policy to support a supply side recovery.

Ben Bernanke once said to Milton Friedman and Anna Schwartz, "You [were] right, we [the Fed] did it [caused the great depression]. But thanks to you, we won't do it again." Thanks in part to Chairman Bernanke's leadership, central banks have pursued the opposite strategy to the 1930s to great effect. While the human cost since 2008 has been considerable, it is dwarfed by the experience of the

Great Depression. Central banks haven't done it again, but that doesn't mean they should be satisfied. There remains still considerable, if uncertain, slack in their economies.

I say uncertain because obvious measures of slack, such as unemployment, are much lower than we would have expected given the scale of the fall in demand. Supply side performance in advanced economies has been surprisingly poor.

Before the crisis, the growth in potential supply was largely predictable (technically a stationary trend). As a consequence, central bankers responded to movements in demand around that trend. The issue now is the extent to which the fall in demand has itself eroded potential supply and whether that could be reversed as economies recover. In the US, the question is whether labour force participation rates will pick up. In the UK, the question is whether labour productivity will reverse any of its poor performance.

These questions mean it makes sense for policy to test the extent to which supply performance is 'endogenous' to demand.[1]

This is one of the main advantages of the forward guidance employed by both the Bank of England and the Federal Reserve.

Last August the Bank's Monetary Policy Committee made an easy call: we wouldn't even begin to think about raising interest rates until the unemployment rate fell to 7%. Given the weakness of the UK recovery and the flexibility of the labour market, we could expect that considerable slack would ensure that the MPC was not taking undue risks with inflation as policy encouraged faster output and employment growth.

To be clear, the Bank continues to be mindful of the risks posed by sustained exceptionally loose monetary policy. In some advanced economies like the UK, these risks relate mainly to housing markets. In emerging market economies, they centre on the volatility of capital flows. Across the financial sector, a low for long environment risks complacency, excessive risk taking and undisciplined underwriting. In all cases, authorities can and should look to macro-prudential policy tools to manage these risks so that monetary policy can remain focussed on its objective of establishing the conditions for a sustained recovery while maintaining price stability. Given the powers and remit of the Financial Policy Committee, the Bank of England is exceptionally well-positioned to coordinate macroprudential and monetary policies.

Since August, inflation has fallen back to target (for the first time in 5 years) and unemployment has fallen rapidly towards 7%, so what have we learned on the journey towards our threshold?

[1] My MPC colleague Ben Broadbent discussed these issues extensively in September 2013 in a speech at the London Business School, "Conditional guidance as a response to supply uncertainty".

With the wisdom of hindsight, there have been three main drivers of the recovery thus far: a marked reduction in extreme uncertainty, the repair of the core of the financial system and significant deleveraging by households. These have driven a recovery in consumer spending and housing investment, which together have accounted for almost all the GDP growth in the year to Q3. As my colleague Ian McCafferty outlined earlier this week, there are also early signs of a recovery in business investment.

The less good news is that the recovery has not – as measured at least – been accompanied by meaningful productivity growth.

Given the continued openness of the economy and the credibility of macro policy, it is hard to think of any reason why there should have been a persistent deterioration the UK's productivity performance. In fact there are several reasons to expect productivity growth to pick up as the recovery proceeds.

For example, until recently, the fragility of the banking system limited the reallocation of capital and labour from less to more productive activities. Indeed, whereas half of all productivity growth at the economy-wide level in the years prior to 2008 occurred through this channel, reallocation appears to have made no contribution to productivity growth in recent years. With the progress made in fixing the banking system, this negative should become a positive.

Second, it is possible that with the sharp fall in real wages during the recession employees effectively priced themselves into low-productivity work at a time of weak demand. To the extent that this allows skills to be retained and reduces costs of replacing particularly skilled employees as the recovery takes hold, the recovery could generate greater productivity as it proceeds.

Third, traditional pro-cyclicalities in productivity growth such as learning-by-doing and economies of scale should begin to operate.

Finally, accelerating business investment, evident in surveys and increasingly necessitated by the recovery itself, should increase output per hour.

Nevertheless, it appears that the recovery will need to be sustained for a period before productivity gains can resume in earnest. The latest data show that more than a quarter of a million jobs were created in a three-month period – the biggest increase since records began in 1971. As a result, unemployment seems to be falling at a pace that will reach our 7% threshold materially earlier than we had expected.

Crucially, unemployment remains above the level that is likely to be consistent with maintaining inflation at the target in the medium term. It is not just that nearly three quarters of a million more people are out of work than before the crisis; another three quarters of a million more people are involuntarily working part time.

The effect of this slack in the labour market is evident in wage inflation, which is at around 1% so that, even with weak productivity, unit labour cost growth remains below 2%.

The fact that underemployment is exerting downward pressure on costs also reflects better than expected performance on the supply side of the labour market. In the jargon, the extent to which high unemployment has caused hysteresis seems to have been less than in past recessions.

It now seems likely that the rate of unemployment consistent with stable inflation in the medium term is somewhat lower than the MPC assessed back in August.[2] In part that is because rates of transition into jobs, even for those who have been unemployed for more than a year, have been sustained at high rates, minimising the extent of skill atrophy. In addition, other measures of slack in the labour market, such as involuntary part-time working remain high.

This suggests that, even though unemployment is falling faster than expected, the recovery has some way to run before it would be appropriate to consider moving away from the emergency setting of monetary policy. It is widely recognised that our 7% threshold is not a trigger for raising Bank Rate. Last August, the MPC said that when the 7% unemployment threshold was reached, there should be no assumption of an immediate, automatic change to its policy stance. It would assess the prevailing economic conditions, including wider measures of slack and inflationary pressures, before deciding the appropriate stance for monetary policy.

That the attainment of the 7% threshold will not be associated with any immediate need to raise Bank Rate is reinforced by recent developments suggesting that UK inflation pressures are more contained. In particular, inflation has fallen from 5% in 2011 back to the target for the first time since 2009. Global inflation is subdued, with both euro area and US consumer price inflation now less than 1%; oil prices have fallen by 4% relative to a year ago; other commodity prices have fallen by more than 10%, and sterling has appreciated by almost 9% since last summer. All of these developments will hold back imported inflation pressures that have to a great extent explained the above-target inflation over the past five years.

The Bank's assessment of how to evolve guidance to changing circumstances will begin in our February Inflation Report. The MPC will consider a range of options to update our guidance, recognising both what we have learned about the behaviour of aggregate supply in the economy as well as the more benign inflation outlook.

[2] "Monetary policy, trade-offs and forward guidance" Bank of England Monetary Policy Committee, August 2013, p34. "Since the medium-term equilibrium unemployment rate depends on the composition of unemployment, it will change over time…That medium-term equilibrium unemployment rate is a different concept from the long-run equilibrium unemployment rate: the latter is the rate to which unemployment will trend towards in the long run once all of the short and medium-term effects have dissipated. That long-run equilibrium rate will reflect the institutional features of the labour market, such as the degree of labour market flexibility, and the extent to which potential employees are aligned with vacancies in terms of skills, location and occupation. Over time, the medium-term equilibrium unemployment rate should converge towards the long-run rate. Current estimates of the long-run equilibrium rate are significantly below estimates of the medium-term equilibrium rate."

The MPC has noted that when the time eventually comes to begin to move away from emergency settings of policy, any such move would be gradual. The degree of stimulus will remain exceptional for some time. That should help reassure British business that the path of interest rates will be consistent with a sustained recovery – that is, with escape velocity.

This recognises that many of the headwinds holding back the economy will remain for some time yet. Public and private balance sheets continue to be repaired. World demand remains weak and the appreciation of sterling will hold back the expansion of net exports. And there remain strains in the financial system despite good progress on post-crisis repair.

These persistent headwinds mean that, even in the medium term, the level of interest rates necessary to sustain low unemployment and price stability will be somewhat lower than before the crisis. In the jargon, the equilibrium real interest rate, which has been negative for much of the period since the crisis, will eventually turn positive again, but it is likely to remain well below historical norms.

Escape velocity won't come cheap.

The Bank of England is helping to build the foundations for Britain's future success: the conditions for recovery while maintaining price stability; a financial system that is safe and does not impose losses on the taxpayer. On those foundations, Britain's businesses can build again, through investment and innovation, the country's future prosperity.