Report to the Treasury Select Committee
Paul Tucker, Deputy Governor Financial Stability, Bank of England
26 February 2013

Voting record

My previous report was twelve months ago. It looked at the time as if, helped by the ECB's Long Term Repo Operations, the clouds from the euro area might be lifting. That proved short lived. As deep concerns re-emerged about possible exits from the euro area, conditions in bank funding markets deteriorated badly, including for UK banks. Domestic lending conditions tightened, adding to the headwinds facing the UK economy from public and private sector deleveraging. Net exports suffered amid a sharp softening in global demand for manufactured goods, and as safe haven flows drove an appreciation of sterling. Confidence ebbed.

The Bank responded with a package of measures. In June we made clear, via the Extended Collateral Term Repo, that we stood ready to provide liquidity to individual banks against a wide range of collateral. As well as helping to forestall a crisis, that enabled the FSA to free up bank balance sheets somewhat by relaxing regulatory requirements on banks' holdings of liquid assets. The third part of the package was the Funding for Lending Scheme (FLS), which I was strongly behind in order to insulate domestic credit conditions as far as possible from the deterioration in international wholesale markets. And the fourth part was additional QE of £50bn, taking the total to £375bn, for which I voted at the MPC's July meeting. (Later in the year, the Bank also welcomed the Government's decision to let the 'automatic fiscal stabilisers' work as the economy slowed.)

There is no doubting that, taking the Bank's package alongside the ECB's Outright Monetary Transactions announcement and the FOMC's QE3, central bank actions had plenty of traction on financial conditions. Gilt yields fell and, as investors adjusted their portfolios, investment grade sterling corporate bond yields fell by more. Bank funding markets reopened. The 'war' for retail deposits ended, helping to reduce the cost of credit for borrowers. Credit conditions have started to ease, especially for households and those firms with access to capital markets.

In more normal circumstances, those easier financial conditions would have provided a strong stimulus to real spending in the economy, through higher wealth and a lower cost of borrowing for many households and businesses. But during much of 2012 the transmission of policy into spending was dampened by pervasive fears about the international environment and general uncertainty about the recovery. Household saving rose, and firms delayed investment. Output has been flat.

The (relative) good news has been the rise in private sector employment – approaching a million over the past year or so – evidencing flexibility in the labour market as the economy rebalances. This has mitigated the social damage of the downturn and the erosion of the economy's human capital.

The outlook

Strong employment has also meant that, with output flat, productivity has weakened. That may be due in part to the financial crisis impairing the effective supply capacity of the economy, at least in the short run. Balanced recovery will need to include a relative shift in the economy towards the production of tradables and away from sectors that benefitted from an unbalanced composition of demand in the years running up to the crisis. It is possible that the banking system's continuing challenges are impeding the efficient allocation of capital. Alongside the desirability of wider measures to improve the strength of the economy over the medium term, the prospect of balanced recovery can be helped by the actions of the prudential supervisors, on the Financial Policy Committee's recommendation, to ensure that banks value their assets prudently and restructure their balance sheets and, separately, to lower barriers to entry into banking.

Meanwhile, credit easing, via the FLS, can help to support borrowing conditions in the nearer term. We must keep the effectiveness and terms of the Bank's schemes under review; particularly their effect on SMEs, given the improvements already underway in the household mortgage market.

I would also judge that the existing degree of monetary easing from QE is likely to gain more traction on spending than it had last autumn, given reduced tail risks from the international environment. I remain open to doing more QE depending on the outlook for demand and inflation.

If productivity and supply capacity were to recover strongly as and when demand recovers, underlying inflationary pressures should not emerge. Moreover, if output and so prospective incomes were to recover back towards a higher path, that would relieve some of the drag on the economy from the levels of household debt accumulated before the crisis when the outlook seemed rosier. But there is great uncertainty here. The MPC needs to adopt a watchful and probing approach.

The existing and prospective rises in administered and regulated prices and the recent depreciation in sterling's exchange rate are pushing inflation up, and are likely to keep it above the 2% target for the next few years. It is consistent with the MPC's Remit to look through a period of above target inflation, so as to avoid derailing the recovery, provided that medium term inflation expectations are anchored. Any perception of our wavering in our commitment to sound money would undermine our ability to sustain the stimulus otherwise warranted to generate a gradual recovery in activity.

As I said at the Committee's June 2011 hearing and repeated in my annual report a year ago, my position has been that we should not start to withdraw monetary stimulus until we have securely achieved what I called escape velocity: the economy growing, and being set to continue to grow, at a pace that gradually absorbs the slack in the labour market and within firms. As spare capacity is absorbed, we will need to track indicators of domestic inflationary pressure. In particular, recovery needs to be accompanied by unit labour cost growth falling back to be consistent with achieving the inflation target over the medium term.

Explaining monetary policy

Over the past year I have given nine on the record speeches and published five articles. Four covered monetary policy issues. I have given twenty to thirty off the-record talks on monetary policy and financial stability. I have made four visits to different parts of the UK – Northern Ireland, the East Midlands, Yorkshire and Humber, and the South East. I have had regular meetings with other central bankers, including at the ECB General Council, the BIS, the G20 Financial Stability Board and the European Systemic Risk Board. I have maintained extensive contacts with the business and financial communities here and overseas.