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Do we have a New Economy? – Speech by Sushil Wadhvani

In a speech to be delivered at a CEPR/ESI Conference in Helsinki, Finland, Dr Sushil Wadhvani, an external member of the Monetary Policy Committee at the Bank of England, argues that although the outlook for the global economy is problematic, there have been some New Economy-style gains in the US and the UK.

SUMMARY

Recent Events

The acts of terrorism this week in the US were both tragic and unexpected. If these events did appear to lead to a significant deterioration in consumer confidence, monetary policy can reasonably be expected to respond. However, in the longer-term, the underlying strengths of the US economy are undiminished. Today, we are here to discuss the longer-term forces that have affected our economies in recent years.

Definition of a 'New Economy' (NE)

A NE is defined to be one where structural changes like a significant fall in the equilibrium rate of unemployment and/or a significant increase in the potential growth rate of the economy might have occurred. These could have been driven by many factors, of which Information and Communications Technology (ICT, hereafter) advances are only one. Such structural changes typically lead to a breakdown of the historical econometric relationships that help inform the setting of monetary policy, which then implies that the actual economy appears to be "new" relative to the description of the economy embedded in our models.

Some Cross-Country Evidence on Forecasting Errors

Since the early 1990s, forecasters have, on average, simultaneously underestimated GDP growth and over-estimated inflation in the US and the UK, which is suggestive of structural changes having occurred. However, since this is not true of the rest of the G5, whether or not you believe there is a NE depends crucially on which country is being discussed.

Evidence from the UK suggesting that structural relationships determining wages and prices appeared to break down in the 1990s is presented. In the context of the Bank of England's medium-term macroeconomic model (MTMM, hereafter), understanding why these equations broke down is very important to forming a judgment about where inflation is headed. This is illustrated by showing that alternative treatments of the past price forecast errors of this model could, mechanically, easily yield prospective inflation forecasts ranging between around 1% to around 5%.

Has the Nairu Fallen?

One possible explanation for the pattern of observed forecast errors in the US and the UK is a fall in the non-accelerating inflation rate of unemployment (NAIRU, hereafter). Others point to non-NE factors like lower import prices. Econometric evidence suggests that the NAIRU fell significantly in both the US and the UK, even after one allows for the beneficial influence of lower import prices. There is no evidence suggesting a comparable fall in the NAIRU in the rest of the G5.

The NE and Productivity Growth

Most studies now concur that the US has experienced a significant increase in its underlying rate of productivity growth, and that the production and use of ICT have both contributed to this rise. Some authors have argued that the rise in welfare has probably lagged behind the rise in productivity because the aggregate depreciation rate has risen. They suggest that one should use Net Domestic Product (NDP) rather than Gross Domestic Product (GDP) to measure productivity. However, the post-1995 acceleration in a measure of welfare (suggested by Professor Weitzman) is even greater than that in official, GDP-based measures of productivity, suggesting that the post-1995 US performance remains impressive.

Among the G5 countries, the US is the only country to have experienced a significant increase in labour productivity growth, even though the contribution to growth from ICT capital has risen elsewhere. This deserves further research.

Explaining why the Price Equations have Broken Down

The evidence presented for the UK suggests that one reason conventional price equations have tended to predict out-turns higher than actually materialised is, in part, because of an intensification of product market competition. However, non-NE factors like the higher-than-expected exchange rate have also played a role. A new price equation which allowed for such additional influences has the advantage of there being less need to choose between alternative treatments of past forecast errors, which, as was noted above, can lead to rather large differences in the inflation forecast.

In addition, the measure of capacity utilisation embodied in the Bank's model appears in recent years to have suggested rather higher levels of capacity use than would be implied either by survey measures or a

measure based on an alternative concept of the capital stock, and might therefore have overstated the degree of inflationary pressure.

The NE and the Current Conjuncture

With internet-related stock prices down very significantly, and a global economic downturn, there is much questioning of the NE. This is in part because some more extreme adherents of the NE made the extravagant claim that recessions were a thing of the past. Yet, historical evidence suggests that very significant volatility in share prices and corporate investment is not unusual around periods of rapid technological change. Given the existing investment overhang, and the vulnerability of equity markets, the global economy probably has a difficult period ahead of it. The tragic events this week obviously increase the near-term risks to the global economy.

However, this does not diminish the fact that, consistent with the NE view, some gains have been made in the US and the UK.

Key Resources

Do we have a New Economy? - Full Speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2001/speech141.pdf>