BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

24 February 2016

The UK Economy Post Crisis: A Series of Unfortunate Events? - speech by Sir Jon Cunliffe

In a speech to the London South Bank University Centre for International Business Studies on Wednesday, Jon Cunliffe constructs a big picture view of how the UK economy has evolved since the Great Recession and what it means for monetary policy going forward.

"As a policymaker, occasionally it is worth standing a long way back and asking "What did I expect to happen last year and the year before? And what can I learn from what actually happened? And, crucially, 'Have I been lulled by the ever-turning kaleidoscope of data and missed a change in the big picture?"

The recovery since the Great Recession of 2008/09 has been the slowest in modern history, slower even than that after the Great Depression. One title for the story of the last eight years is "a series of unfortunate events".

In this big picture story, the UK is hit by a massive financial crisis as it was beginning to recover, the economy was hit by the euro-area crisis via confidence as well as financial market effects. Three years on, the economy picks up with a burst of strong growth, but pay growth and incomes respond much less, reflecting the fact that productivity growth does not recover. In the latest chapter, just as we see signs of income growth and productivity growth coming back to life, a deflationary shock from a collapse in oil prices, allied to a slump in emerging markets causes the economy to slow. Markets worry that the next chapter will be another unfortunate event.

"I would call this the 'slow healing' story. Recoveries from financial busts tend to be slow and painful and can take even longer if in the meantime you are hit by other bad surprises. Indeed, that is why it is worth doing all that you can – in advance and in good times – to avoid financial crisis," Jon says.

There is another story, however, in which rather than being on a slow healing path, there are deep secular and structural forces pushing down on economies. This could either be from low demand, resulting from there being more savers than opportunities to invest, due to factors such as demographic changes, inequality and preferences for low-risk assets. A different take could be one of low supply growth. In this view, productivity growth started to slow in the 1970s after the benefits of the second industrial revolution had finished working through, and technological changes since have not had an equivalent impact on productivity.

“I have set this out as two very different pictures of what is happening – slow healing and secular stagnation. Given enough unfortunate events and enough repeated disappointment on the pace of recovery, they could look and feel the same for a long time.”

Turning to the UK specifically, Jon recalls that on joining the MPC in 2013, the data seemed to point quite firmly towards the healing story.

The reality has confirmed only part of that story. Over 2014 and 2015, growth drifted down and by more than forecast, while inflation was pushed down to around zero by the strength of sterling and the very sharp fall in the oil price. There are continued signs of strength in the economy: consumer confidence is near record levels and business investment intentions are strong. But despite stronger growth and signs of a tightening in the labour market, pay growth has fallen back to the 2% range and forward-looking surveys do not suggest any significant recovery in pay growth is around the corner. Meanwhile, risks from the rest of the world economy have shifted and increased.

Jon believes there is still mileage in the slow healing story to explain the drift down in UK prospects and the failure of pay and productivity to recover. Some of the effects of the financial bust and recession have passed: consumer confidence picked up sharply at the start of 2013 and remains at around a historically high level since mid-2014, as have investment intentions.

But there are signs that the economy may still be affected by scarring effects in the labour market: long-term unemployment and the proportion of part-time workers who say they want full-time jobs remains elevated. “To the extent that workers do not yet feel confident in asking for a pay increase, that might be one reason why wage growth has been relatively unresponsive to the sharp fall in unemployment.”

On top of these scarring effects, current low inflation seems to be having an effect on pay though inflation expectations remain anchored. Third, fiscal headwinds as the government repairs the damage to the public sector balance sheet from the crisis and deep recession, will drag on growth for a number of years. Fourth, headwinds from weakness in the world economy are also likely to endure.

“Overall, the healing story is, for me, the story behind the MPC’s latest forecast to which I subscribe. Growth picks up slowly over the next few years, driven by domestic consumption and business and housing investment. As the deflationary shocks from oil prices and the past strength of sterling wane, the closing of the output gap and consequent domestic cost pressures push inflation slowly back up to target. The forecast is premised on a market yield curve in which interest rates rise gradually though to levels substantially below their pre-crisis average. The forecast recognises the risks to this picture from another unfortunate event in the form of a harder landing in emerging markets."

In terms of what this means for policy, Jon says: "My central expectation remains that as the effects of the crisis continue to heal and as the deflationary effects of past sterling strength and oil price falls wane, domestic cost pressures will gradually push inflation back to target."

"And I will be looking very carefully at the risks of another unfortunate event for the UK economy from a hard landing elsewhere in the world. If economic growth falters and pay and productivity remain stuck at current levels, then the healing story will become increasingly less convincing."

To conclude, Jon says that looking back over the last two years, he thinks the slow healing story can still explain where we are and provide a guide to our future prospects.

"But the story has had to be adapted in the face of more UK and world weakness than I had expected, and this weakness might be signalling that there are structural factors at work. "

"Nonetheless, my central projection remains that the UK economy will continue to grow solidly and that inflation will return to target over the next few years. But, as always, policymakers need to be alive to the possible meaning of disappointments, to be very sensitive to the possibility of changing temperatures around them, and to the risk of unfortunate events. We have a range of tools at our disposal and should be ready to use them whichever risk materialises."

ENDS