BANK OF ENGLAND

Speech

The Impact of the US Slowdown on the UK Economy

Speech given by

Sushil Wadhwani, Member of the Monetary Policy Committee, Bank of England

22 February 2001

The Impact of the US Slowdown on the UK Economy

It is a great privilege for me to have the opportunity to meet with you and learn about your own evaluation of the prospects for your various businesses.

In the context of the international economy, this is a time of great uncertainty. The recent, abrupt slowing of the US economy has obviously led some commentators to worry that this might have a large and significant impact on the UK economy as well.

However, indicators of business or consumer confidence in the UK have not changed in a consistent direction in recent months, with some even having improved since the news of a sharper-than-expected slowing in the US first emerged (see Table1).

TABLE 1

SOME RECENT SELECTED SURVEY INDICATORS OF THE UK ECONOMY

INDICATOR	MOST RECENT VALUE	VALUE IN NOVEMBER 2000
OPTIMISM		
CBI Quarterly Industrial Trends Survey	- 3[1]	-9[2]
GfK Consumer Confidence	5.4	-1.5
CIPS Services	74.3	76.4
EXPORT ORDERS		
CIPS Manfacturing	53.7	50.4

Notes:

1 2001 Q1
2 2000 Q4

Moreover, many observers have argued that since the UK's exports to the US are worth only around 5% of GDP, the direct impact of a slowing over there might be relatively modest over here. Hence, it is not surprising that simulations using macroeconometric models **(1)**, which typically also allow for third-country effects, tend to suggest that the impact of a shock to US demand that reduces US growth by one percentage point for a single year might only reduce UK GDP growth by between 0.15 and 0.25 percentage points. Of course, there are additional effects associated with a fall in global equity prices to consider, but these have, so far, been relatively small. Since our November 2000 Inflation Report, UK equity prices are only down around 5%, **(2)** which, given past historical relationships, is unlikely to, by itself, have a large effect on GDP growth.

In the light of the above considerations, in preparing our February 2001 Inflation Report, the assumed temporary reduction in US growth in 2001 was expected to reduce UK inflation (with some time lag) by only around 0.25 percentage points, **(3)** an effect that was broadly offset by the 3½% decline in sterling since November 2000.

Given that the US economy has slowed significantly from an annual four-quarter rate of around 6% at the end of 2000 Q2 to a current quarterly rate that is "close to zero", the effects on growth and inflation discussed above might seem surprisingly low. Certainly folk wisdom has it that when the US sneezes, the UK catches a cold. Also, historically, the UK and US economies appear to have been highly synchronised. A recent IMF study **(4)** reminds us that the UK GDP growth cycle is more highly correlated with the US growth cycle rather than the corresponding continental European cycle (see Table 2) since 1960. This is at first sight surprising since the proportion of the UK's exports to North America have been less than one-third of our share of exports that go to Europe, with the gap widening further in recent years. Note also that despite the growth in the trade links between the UK and continental Europe, the UK business cycle has been even more correlated with the US relative to Europe in the recent 1990-97 period. Of course, correlations do not imply causation, and so we must not assume that the correlation will remain high. Nevertheless, it is also possible that the higher correlation between the UK and US business cycles is indicative of links between the two economies that go beyond trade.

TABLE 2

GROWTH CYCLE CORRELATION COEFFICIENTS BETWEEN THE UK AND OTHER COUNTRIES

	1960[1] -97	1990[2] -97
North America	0.58	0.78
Europe	0.38	0.12

Source: 1 Kontolemis and Samiei (2000), IMF Working Paper.
2 Own calculations, based on the data used in the IMF study.

Additional Links between the UK and the US

There are, of course, other very close links between the UK and the US, not all of which are well captured by our models. The UK accounts for about a fifth of the total stock of foreign direct investment (FDI) in the US, while around two-fifths of the stock of FDI in the UK is from the US. Relatedly, US-based foreign affiliate sales of UK multinationals are estimated **(5)** to be nearly $200bn, which is five times as large as UK exports to the US. It is possible that companies with significant exposure to the US economy find that a deteriorating cash flow position leads them to scale back on their investment plans in the rest of the world (ie including the UK) as well. On the other hand, one must also note the possibility that a slowing US economy makes the rest of the world (including the UK) a more attractive investment destination. Turning to other links, as my colleague, David Clementi has previously pointed out, the total exposure of UK banks to the US amounts to $110bn, or 8% of UK GDP and is considerably higher than the equivalent exposure to the rest of Europe. The value of UK residents' overseas investment in equity capital and securities is approximately equal to nominal GDP, with around 25% of overseas' equity holdings being held in the US assets.

Further, it is worth reminding ourselves that some of the industrial sectors that are slowing most in the US have also been disproportionately important in the UK as well. Specifically, it has been estimated **(6)** that, as a share of GDP, the market capitalisation of the so-called TMT sectors in the UK is comparable to that of the US, and much higher than continental Europe or Asia. During the 1990s, the financial and business services category punched well above its weight in that it accounted for over 25% of the growth of the UK economy, although it represented less than 15% of the level of GDP in 1995. Yet, historically, the fortunes of this sector have been linked to fluctuations in US GDP growth.

There is also growing anecdotal evidence that the US slowdown is beginning to be associated with excess capacity and margin pressure in a number of global sectors. The associated intensification of competitive pressure for UK business, domestically and internationally, can be expected to exert additional downward pressure on UK prices, a factor that is not always adequately allowed for in some models of the UK economy. **(7)**

Likely Impact on the UK Economy

The degree to which the UK economy will respond to recent US economic weakness must depend, in part, on whether the US economy is expected to recover quickly. This, of course, turns on the seemingly esoteric debate amongst economists about which letter of the alphabet best characterises the outlook for the US economy. Those in the 'V'-camp believe that the recent downturn is not much more than the result of an excessive build-up of inventories that occurred when growth slowed from its previously unsustainable level of around 6%. The economy should recover as these excess inventories are worked off, with lower interest rates and energy prices likely to make the recovery quite sharp.

Some other economists are a little more cautious, and expect something which more closely resembles a 'U' in that they believe that the US economy might see a period of virtually no growth followed by a relatively anaemic recovery. These economists argue that the recent downturn is not just a standard inventory correction, but also reflects the effect of the US corporate sector having over-invested, in part because expectations about returns did, for a while, soar to unrealistic levels. Adjusting to a more appropriate level of the capital stock can take rather longer than merely working off excess inventories.

There are also those who regard the 'U'-camp as too complacent, and believe that a 'L' is more likely. They usually point to 'imbalances' in the US economy in the shape of a large current account deficit, a low savings rate and an 'overvalued' stock market. At this stage, the possibilities begin to multiply. I have also met those who believe, in a 'V' followed by a 'L', and so on. It is important to recall that no one predicted the suddenness of the US slowdown late last year, and it therefore behoves us to be humble about our ability to forecast the precise course of the recovery. In discussing the role of confidence in precipitating recessions, Chairman Greenspan recently reminds us that **(8)**

"This unpredictable rending of confidence is one reason that recessions are so difficult to forecast ….. . Our economic models have never been particularly successful in capturing a process driven in large part by nonrational behavior."

In preparing our inflation projection, the MPC has assumed a 'V'-shaped recovery in the US in its central projection, but the risks must therefore clearly reside on the downside. We shall have to continue to closely monitor international developments.

We shall need to be equally vigilant about signs that the international slowdown might be beginning to impact on the UK economy. Our econometric models tend to let us down when there are large changes in confidence. Historical experience suggests that the effect of international developments on business and consumer confidence in the UK is also, in terms of its timing and magnitude, quite difficult to predict. Recall that during the international crises of 1997-98, which began with the devaluation of the Thai baht in July 1997, but spread relatively quickly to several other Asian economies, business optimism actually initially rose between 1997 Q3 and Q4 (see Table 3). It then started to erode gradually (from 1998 Q1 onwards), but fell precipitously during the autumn of 1998 (around the time of the troubles in Russia and parts of the hedge fund industry). Hence, it is possible that business and consumer surveys in the UK might become less optimistic in the next few months as firms find their export orders begin to fall off. However, it is also possible that buoyant public sector demand combined with current consumer perceptions that their own financial situation is strong keep the UK economy relatively well-insulated.

Although consumer confidence in the US has fallen sharply in recent months, the fact that consumer confidence in the UK rose by less than in the US during the 1990s probably means that it is likely to fall less.

Recall also that in the autumn of 1998, the collapse of confidence to recession levels proved to be unwarranted in the light of the subsequent resilience of the UK economy. Some anecdotal evidence suggests that, this time, businesses and consumers have stayed optimistic either because they expect the US slowing to be a relatively temporary affair (as in 1998), or because they expect policy to respond to signs of weakness in the UK in a sufficiently rapid manner. Of course, from a policymaker's perspective, the latter interpretation somewhat complicates the interpretation of the survey indicators.

TABLE 3

THE BEHAVIOUR OF 'CONFIDENCE' DURING THE 1997-98 INTERNATIONAL CRISES

		CBI INDUSTRIAL TRENDS	CIPS
		Business Optimism	Services Optimism[1]
1997	Q3	- 6	77.8
	Q4	2	79.7
1998	Q1	-11	75.3
	Q2	-22	72.3
	Q3	-44	63.7
	Q4	-58	67.0

1 End-quarter value

CONCLUSION

I have argued today that there are many uncertainties about both, the outlook for the US economy, and the size of the spillover effects onto the UK economy. Quantifying these effects is therefore, pretty difficult. **(9)** Our central projection assumes a relatively modest downward impact on UK inflation, so the risks from the international economy seem pretty firmly weighted on the downside. This might seem particularly relevant as we have, in any case, undershot the inflation target since 22 months, and, on our best collective projection, are likely to continue to undershoot for some time to come. Of course, not all the risks to the inflation projection go in one direction. The labour market is tight, with skill shortages at a relatively high level. There are some tentative signs that the extent of deflation in the retail sector is coming to an end, and also of a modest uptick of upward price pressure in manufacturing, which has plausibly been associated with the welcome fall in sterling versus the euro. We shall, of course, continue to monitor these risks alongside those emanating from the international economy. Hence, it is especially important that those entering into medium-term commitments (eg wage settlements) in the UK do so being fully aware of the potential downside risks from the international economy. Although I have focussed today on the risks associated with the US economy, one should also recognise that many emerging market economies are vulnerable to a US slowdown, and also that there are some signs of a weakening of the Japanese economy.

In forming our policy judgments, it is going to be more important than ever to have our ear close to the ground. Therefore, I am looking forward to hearing your evaluation of how your businesses might be affected by developments in the international economy

1 Eg, the National Institute's NIGEM, the IMF's Multimod or the Bank of England's model of the UK economy.

2 As of 16 February 2001.

3 This calculation excludes the indirect effect through the lower oil prices which appear to have been associated with the US slowdown. Including it would increase the estimated effect on UK inflation by about 0.1 percentage points.

4"The UK Business Cycle, Monetary Policy and EMU Entry" by Z G Kontolemis and H Samiei, IMF WP/00/21).

5 Morgan Stanley.

6 In work carried out by economists at HSBC.

7 For those who are interested in the intricacies of this debate, it is plausible that the fact that the current version of the Bank's medium-term macroeconometric model does not allow the GDP deflator to be directly affected by world export prices implies that it underestimates the disinflationary impact of the recent global slowing.

8 Monetary policy report to the Congress, February 13, 2001.

9 It is therefore not surprising that as a committee, we found it difficult to sign up to the same quantification of the likely effect - I was one of those who would have been more gloomy than what is embodied in the best collective projection, in part because I believe that standard econometric models do not adequately capture the links between the UK and the US economies.