



BANK OF ENGLAND

# Speech

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## Three Questions and a Forecast

Speech given by

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### Three Questions and a Forecast

Two weeks ago the Bank of England lowered its interest rate to 4%. You have to go back to 1955, not only to find the year in which Newcastle United last won a major domestic trophy, but also the year when official interest rates were last lower than 4%. The intervening forty-six years were lean indeed. The absence of trophies at St James's Park was mirrored by a macro-economic performance marred by high and volatile inflation. During the 1970s inflation averaged over 13% a year, and even in the 1980s it averaged 7% a year. But over the past decade, and especially in the past few years, the new monetary policy framework has brought low and stable inflation. In turn, that has led to the most stable decade for output growth since the second world war, with 37 consecutive quarters of positive economic growth.

I know that some of you will be thinking that stability is fine in the abstract, but what use is it to a manufacturing business facing falling world demand for its products and an exchange rate that makes production unprofitable. So let me ask, and then try to answer, three questions concerning the current economic situation. First, why has the world economy turned down so rapidly? Second, is the UK heading for recession? Third, when will the imbalance between manufacturing and services come to an end?

#### 1. Why has the world economy turned down so rapidly?

Last year world GDP growth was 4.7%; this year it is likely to be little more than 1% or so. World industrial production is now falling. It grew by 6.5% in the year to August 2000 and then fell by 3% in the following year.

The speed and severity of the slowdown reflects a downturn in business investment, especially in information technology. In the United States, business investment grew at an average annual rate of over 10% between 1994 and 2000. This year investment fell, led by the IT sector, and the contraction has not been confined to the United States. Take one example, worldwide sales of personal computers fell this year for the first time since 1986.

Business investment is import intensive. Almost one half of spending on capital goods in the industrialised world is on imports. So the fall in business investment led to a sharp slowdown in world trade. Last year the growth of world trade was the fastest for over thirty years; this year trade is likely to grow at its slowest rate for nearly twenty years.

The link from investment to trade helps to explain why industrial production slowed at the same time in all the major economies. This should not have been surprising. Movements in output in those economies have been highly correlated for much of the post war period, and, contrary to some recent comment, the degree of correlation has remained broadly constant since the 1970s.

The role of the IT sector in the investment-driven slowdown is revealed by the remarkably similar falls in share prices of the high-tech sector across the industrialised world. Since their peak high-tech share prices in the US, in continental Europe, in the UK and Japan have all fallen by around two-thirds.

The key to a revival of world economic growth is an end to this IT-led downturn in business investment. For the moment, investment has been affected by the climate of uncertainty following the terrorist attacks on 11 September. According to the October CBI Industrial Trends Survey, the number of respondents citing uncertainty about demand as a factor limiting investment was the largest since the question was first asked in 1979. Business confidence has fallen to historically low levels.

Nevertheless, there are two reasons for believing that the world economy will not remain in the doldrums indefinitely. First, by its very nature, an investment downturn of the kind that we have seen is usually sharp but temporary. Excess capacity eventually disappears through depreciation and obsolescence, and new investment becomes profitable again. And that process is faster when the excess investment is in the form of IT capital which depreciates more rapidly than other types of capital.

Second, both monetary and fiscal policy have responded quickly to signs of a downturn. This year alone, the Federal Reserve has lowered interest rates on ten occasions, and by a total of 4½ percentage points. The Bank of England has lowered rates on seven occasions and by two percentage points and the European Central Bank on four occasions and by 1½ percentage points. Fiscal policy has also been playing its part. As ever, there are long time lags between changes in policy and their impact on the economy. That these time lags are alive and well can be seen clearly in the United States, where growth has slowed from around 5% in the middle of last year to around zero in the middle of this despite a substantial reduction in interest rates.

But the proposition that it takes time before monetary policy has its full impact on the economy is quite different from the proposition that monetary policy is ineffective. And the Monetary Policy Committee takes the view that the influence of policy easing will gradually come through and its effects will be seen over the next year or so. Of course, there are many

risks to this outlook. None of us knows how the present uncertainties will be resolved. Again, however, monetary policy stands ready to respond to any unexpected developments, whether on the upside or the downside.

## **2. Is the UK heading for a recession?**

Let me turn to my second question - is the UK heading for a recession? Some of you may think that the answer is obvious because manufacturing is already in recession. That is true. Output in manufacturing has now fallen for three consecutive quarters, and by around 3% over the past year. But the economy as a whole has continued to grow steadily. In the latest official data, released this morning, GDP is estimated to have grown by 2.1% over the past few quarters, and by 0.5% in the third quarter of this year, close to the historical average. Total output, in the judgment of the Monetary Policy Committee, is likely to continue to rise. Over the next year private consumption and investment may slow quite noticeably, and the small rise in unemployment in October, and signs of cooling in the housing market, are consistent with this picture. But public sector spending will help to maintain the growth of demand overall, and, in due course, the effect of the monetary policy easing this year, will feed through. That is why the Committee believes that a recession in the UK is not the most likely outcome.

But there are risks - in both directions. Projecting a slowing of consumption has, for some time, represented the triumph of hope over experience, and the data published today, showing a rise in consumption in the third quarter of 1.3% and of 4½% on a year ago, do nothing to change that. It would be very unusual for output to fall immediately after a year in which money and credit have grown, in real terms, as fast as they have over the past twelve months. On the downside there are clear risks from the world economy. Whenever the United States has experienced two consecutive quarters of falling output, GDP in the United Kingdom has fallen in at least one of those quarters. And in the October CBI Survey optimism regarding export prospects fell to its lowest level since 1980. So there are risks aplenty. But the most likely outcome is a continuation of growth, albeit at a slower pace for a while, with low inflation.

I would urge you, however, to consider the wider picture. Relatively small changes to quarterly growth rates are neither of critical importance in themselves, nor something over which monetary policy has much influence. No policy framework can abolish the business cycle. It is the large and persistent fluctuations of output which are damaging, and which the MPC can influence by the application of a pre-emptive monetary policy in pursuit of the inflation target looking beyond the next few months to the outlook two years or so ahead.

## **3. When will the imbalance between manufacturing and services come to an end?**

Despite the overall balance in the economy, with growth close to trend and inflation close to the target, there has been, for over four years now, a considerable imbalance between different sectors. The impact of, first, the high level of sterling against the euro and, second, the recent slowdown of the world economy have exacerbated the long-run difference between manufacturing and services, or, to be more precise, between the tradable and non-tradable sectors of the economy. Domestic demand has been strong and the trade position weak. This year net trade will make a negative contribution to economic growth for the sixth year in a row. Further negative contributions are expected over the next two years. That is unprecedented in our modern economic history, by which I mean since 1800. It cannot continue for many more years without leading to a trade deficit that would be painful to correct.

A reduction of this imbalance would be helped by a recovery of the world economy. But an unwinding of the imbalance between domestic demand and output is likely to involve a slowdown of consumption growth in order to release resources that could be directed to investment and an improvement in the trade balance. In turn, that is likely to imply a fall in the sterling exchange rate to a more sustainable level. When and how these adjustments will occur, and the imbalances unwind, is extremely difficult to know.

Over the past five years, final domestic demand has grown at an average annual rate of nearly 4%, much faster than the 2¾% growth rate of output. If the imbalances are to unwind over the next five years, then final domestic demand will have to grow more slowly than output. That would lead to a better balance between different sectors of the economy, and between different parts of the country. In recent years, those regions that have a higher than average proportion of manufacturing activity and a lower than average proportion of business and financial services, such as the North East, have found conditions more difficult than have regions where the reverse is true.

Differences between sectors must be seen in their long-run context. Productivity increases at a faster rate, on average, in manufacturing than in other parts of the economy. As a result, employment in manufacturing falls as a share of the total. In 1900 there were over one hundred blast furnaces along the banks of the Tees. Today there is just one - the Corus plant at Redcar. But that one produces more iron than all 106 combined a century ago. It is that sort of productivity growth which generates a rising standard of living, but which also means that the share of manufacturing in total employment continues to decline.

## **Conclusions**

Forty years is a long time. Inflation and interest rates are at their lowest level for over forty years. And unemployment is now lower in this country than in any other G7 country for the first time since Newcastle were the FA Cup holders.

The new monetary policy framework, based on a clear symmetric inflation target, has brought inflation down and enabled output to grow for almost a decade with falling unemployment. From time to time, sharp swings in the world economy will affect the UK. That has clearly been the case this year. But, given time, monetary policy will be able to promote stability. Now is the moment for prudence to be joined by patience as the watchwords of economic policy. By setting interest rates in a pre-emptive fashion, the Monetary Policy Committee is determined to prove that it really is a Committee for all sectors, all regions and all seasons