BANK OF ENGLAND

Speech

Speech given by
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One hundred years ago the three largest employers in Glasgow were the North British Locomotive Company, and the shipbuilders Fairfields and John Brown and Company. Today the largest employers are Glasgow City Council, the National Health Service, and Strathclyde Police.

It is not just Glasgow which has experienced the shift of economic activity away from manufacturing, especially engineering, towards services. One hundred years ago the ten largest British companies, ranked by market capitalisation, were all railway companies. In eleventh position was the Bank of England, then of course in private ownership. Now the ten largest companies include five in financial services and only two in manufacturing.

Such radical changes to our industrial landscape reflected a shift of investment to those economic activities in which the United Kingdom had a comparative advantage. They led to a rise in productivity - and living standards. Productivity growth for the economy as a whole is the result of the continuous efforts, under the pressure of competition, of thousands of businesses to improve their efficiency – perpetual change, indeed perpetual revolution. For much of the post-war period, policy-makers have debated how to encourage this entrepreneurial revolution.

What type of economic environment is most conducive to productivity-enhancing change? The story of macroeconomic policy in this country over the past thirty years has been the search for stability. Greater stability is one of the achievements of the reforms to the Bank of England over the past decade, even if some part of the gain was probably due to good fortune. During this period the UK has experienced a degree of stability of output and inflation never before recorded. But has it come at the cost of weaker pressures to revolutionise products and production processes – the sources of productivity gains? The "boom and bust" cycles of the early 1980s and early 1990s were associated with rapid increases in productivity which, measured as output per hour worked in the private sector, rose by 2.7% a year in the 1980s and the early 1990s – above its long-term average. So should we conclude that stability, though desirable for its own sake, hinders the changes of industrial structure that are necessary for productivity improvements? Some economists have concluded just that. Indeed, they have gone further and argued that only waves of innovations, and their resulting destruction of existing capacity, can lead to significant increases in our standard of living. It is in rushes of "creative destruction", as the Austrian economist Joseph Schumpeter described it, that the economy progresses.

My answer will be rather different, and is in three parts. First, creative destruction – the process whereby new firms and sectors expand while others contract – is constantly taking place below the surface. Those changes are indeed the main source of productivity growth. Of course, change is painful for those directly affected, as many of you know only too well. Second, such changes are occasionally so dramatic as to cause fluctuations in the level of output of the economy as a whole. But this is rare. Third, most business cycles over the past fifty years have owed more to the twists and turns of monetary policy, and the failure to control inflation, than to waves of innovations.

Let me take those three points in turn. First, below the surface, the pace of economic change is striking. Turnover in the labour market is high. The labour force in the UK comprises around 30 million people. About four million move from one job to another each year. Seven million move into or out of work. So each month there are on average almost a million job changes of one sort or another. That dwarfs the net change in unemployment which, over the past year, has averaged around twelve thousand a month.

Structural change also means the rise and fall of particular industries. Scotland illustrates the pace of change. It is exactly 100 years ago since the first British-made two-door saloon car was built on the banks of the Clyde at Alexandria. Unfortunately, the company concerned – Argyll – collapsed in 1907. Over the subsequent century motorcars and the British motor car industry have changed out of all recognition. Shipbuilding is another example. At the beginning of the twentieth century, the Clyde yards built 20% of the world's ships, and the UK produced more ships than the rest of the world combined. By the 1960s, the UK's share of world production had fallen to less than 5%. During the 1980s and 1990s, a new specialisation developed in Scotland with the emergence of Silicon Glen. About half of all semi-conductors produced in the UK are now made in Scotland. More recently, the Scottish IT industry has successfully diversified into other hardware and software products. Such changes below the surface are the essence of productivity growth.

Second, sometimes structural change can cause movements in the economy as a whole big enough to create waves above the surface. Shipbuilding on the Clyde and Silicon Glen are examples of "clustering", where firms in a similar industry locate close to each other. This enables them to learn from each other, use the same suppliers, use the same infrastructure, and hire from a pool of workers with the requisite skills. But it also means that when an industry is hit by a shock, the whole community is affected. When the world downturn in IT investment occurred in 2001, the economic impact on Silicon Glen was larger than on the rest of the UK, though less than on Silicon Valley. IT investment as a share of total investment is about twice as large in the US as in the UK. When the excessive optimism about the impact of new technology on profits subsided at the end of the 1990s, the resulting downturn in investment affected the US economy as whole: the US experienced a recession in 2001, whereas the UK did not.

Third, most economic cycles are not driven by waves of innovation and the reactions of investors to them. In particular, the boom and bust cycles of the 1970s and 1980s were, if not driven, then certainly exacerbated by the failure of monetary policy to keep inflation and inflation expectations under control. Only a recession could then bring them both down. As I mentioned at the outset, productivity in those recessions did benefit from the demise of the least efficient firms – the so-called batting average effect – but at the cost of falls in total output. Remember too that the abolition of foreign exchange controls and the opening up of the UK economy to greater competition from abroad provided an environment conducive to the beneficial process of creative destruction taking place below the surface. Those structural changes, together with the batting-average effect, were sufficient to offset the disincentive to make long-term investments in both capital and people resulting from high and variable inflation. At the level of the economy as a whole, the evidence suggests that variability in output growth, and the higher uncertainty it generates, is associated with lower growth.

From those three points, I draw two conclusions. First, openness of an economy – to ideas, innovation and competition from abroad – is a spur to productivity growth. And we can draw comfort from the fact that all major political parties in Britain support the principles of openness, competition and free trade. Indeed, whatever criticisms they might otherwise attract, politicians in this country, together with our business and trade union leaders, deserve praise for their clear support for a liberal approach to international trade and integration, something which cannot always be said about their counterparts overseas. It is vital to continue the long and tortuous process of lowering barriers to trade in the Doha round of trade negotiations.

Second, stability is a spring-board for enterprise, not a hindrance. The most useful contribution which the Bank of England can make to encourage investment and innovation is to provide a backdrop of macroeconomic stability.

In order to maintain that stability – the Bank of England has now raised interest rates four times since November. Although UK interest rates have been the highest in the G7 for well over three years, alone among the G7 we have not experienced a single quarter of falling output for over a decade. Indeed, it is the relative strength of the UK economy that explains those differences in interest rates. But a synchronised recovery in the rest of the industrialised world is now underway. The US economy has created over one million jobs this year. Even in the euro area and Japan, where domestic demand has been weak, growth in the first quarter was the fastest for several years. As a result, the world interest rate cycle has now turned. Over the past three months expectations of interest rates among all the major industrial countries have risen as recovery has become more firmly established.

But what are the prospects closer to home? A reasonable **central** view is that growth of the UK economy is likely to be robust over the next year, and then to ease back towards its long-term average. That continued strength – if left unchecked – is likely to put upward pressure on inflation, taking it over the target in the medium term. The uncertainty over the pace of growth in recent months, especially in manufacturing, complicates the judgments we have to make. The official data are invaluable, but they are complemented by the information we receive through our Agents around the UK and from visits such as this. As Robert Louis Stevenson remarked:

> Here he comes big with Statistics,
> Troubled and sharp about fac's.
> He has heaps of the *Form* that is thinkable -
> The *stuff* that is feeling, he lacks.

My visit to Scotland is a welcome opportunity to ask you and other representatives of local businesses for your views on what is happening on the ground. As far as we can tell, there does not appear to be much spare capacity in the UK economy. The labour market has tightened further as employment has risen at well above the rate implied by growth of the labour force. Cost pressures are increasing, and pay growth has picked up.

There are, of course, many risks around the central view. Some of these come from the behaviour of house prices which have risen by over 20% in the past 12 months and more than doubled over the past five years. This sustained increase has repeatedly confounded expectations and taken the ratio of house prices to earnings to record levels. Demographic factors, a shortage of housing supply and low levels of inflation and interest rates, all mean that the sustainable ratio has probably risen somewhat over the past decade. Nevertheless, it is now at levels which are well above what most people would regard as sustainable in the longer term. There are some early signs, from surveys, of a slowdown in the housing market. After the hectic pace of price rises over the past year it is clear that the chances of falls in house prices are greater than they were. So anyone entering or moving within the housing market should consider carefully the possible future paths of both house prices and interest rates.

For the Monetary Policy Committee, the significance of the strength in the housing market is its implication for household spending and hence the outlook for inflation. So it is the strength of our economy, and especially domestic demand, which explains why the MPC has been raising interest rates. How far interest rates will need to rise in order to keep inflation on track to meet our 2% target for CPI inflation in the medium term is impossible to say with any degree of confidence. There is no pre-determined plan. We examine the outlook afresh each month and keep an open mind. And the MPC will remain focussed on meeting the inflation target in order to deliver stability.

The changes to both Glasgow and the British economy over the past century have been dramatic. And it is those changes – driven by the decisions of businesses like yours – which are the basis of higher productivity and higher living standards for us all. Stability of the economy as a whole goes hand in hand with perpetual revolution in individual enterprises.

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