BANK OF ENGLAND

Speech

How Big is the Risk of Recession?

Speech given by

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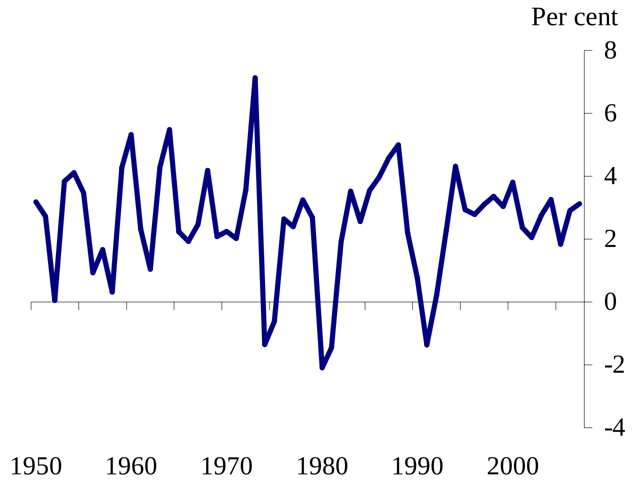
Good afternoon, ladies and gentlemen. I am delighted to be addressing this business audience in the South West of England today. I have spent most of my career working as an economist in the world of business. So as a member of the Monetary Policy Committee (MPC), I have been very keen to take the opportunity to get out of London and visit companies and business groups around the UK – to make sure I am in touch with business conditions throughout the country. The feedback we gather from business at the grass-roots level – through business surveys, the Bank's Agency network and visits like this – are an extremely valuable source of information and provide an essential input to the work that we do on the MPC.

This direct feedback from business is likely to be particularly useful at present. The UK economy has recently passed a turning point in the economic cycle. After a period of strong growth going back to early 2006, the pace of activity is beginning to slow. The Bank of England Agents' reports, the main business surveys and the data from the Office of National Statistics all point to some weakening in growth starting in the second half of last year. There has also been a softening in the global economy – albeit from a strong rate of growth – particularly in the US. The forward-looking indicators suggest we should expect some further slowing – both globally and in the UK – in first half of 2008.

Having passed a cyclical turning point, this raises the issue of how pronounced the cycle will be. Our experience since the early 1990s is that cycles in the UK have been mild. In the last decade and a half, annual GDP growth has fluctuated between just below 2% and just over 4% – a much smaller margin of variation than we had become accustomed to in the 1970s and 1980s.[1] As Chart 1 shows, this has certainly been the most stable period of growth we have seen in the UK over the post-war period. And data on economic growth going back to the nineteenth century suggests it is probably the most stable period of economic growth in our history as an industrial nation.

[1] The latest available estimates are that real GDP at market prices grew by 4.3% in 1994 and by 1.8% in 2005. In contrast, taking the period from 1970, GDP grew by 7.1% in 1973 and fell by 2.1% in 1980 – almost four times the recent range of fluctuation in growth rates.

Chart 1: GDP growth since 1950



Source: Office for National Statistics

But we cannot guarantee that this steadier pattern of growth can continue into the future. When the economy is close to a turning point, it is particularly difficult to predict the future course of the cycle. We need to remember that the recent period of stability in economic growth was preceded by a particularly volatile period for the UK economy – from the early 1970s through to the early 1990s – including three major recessions. Some commentators have begun to talk about a UK recession again, raising the spectre of a return to that era.

That would be a worrying prospect, and in my judgement an outright recession – in which economic activity falls year-on-year – is a remote risk for the UK economy at present.[2] But we should expect to see a significant slowdown in growth. And there remains a lot of uncertainty about how pronounced and prolonged this will be.

Later on in this speech, I will return to the current conjuncture. But to set my assessment in context, I will first look in more detail at the UK economic cycle. What are the forces driving the cycle in the UK economy? And how do we account for the relative stability of the UK economy over the last decade and a half, after the volatility of the preceding two decades?

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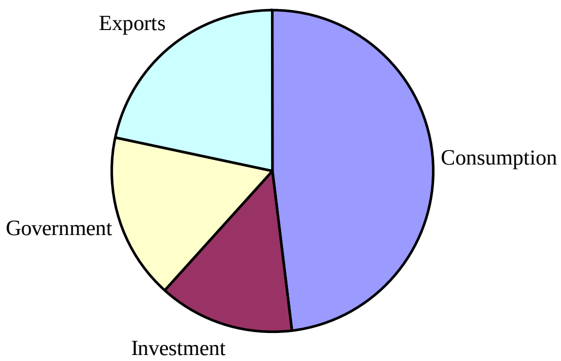
[2] Some commentators use a technical definition of recession which originated in the United States – two successive quarters of falling GDP. However, quarterly growth rates can be volatile and are subject to measurement error. In my view, a better definition is a fall in GDP year-on-year, which is what we observed in the three post-war UK recessions of the mid-70s, early-80s and early-90s.

The economic cycle

The economic cycle reflects the fact that economic growth is not a totally linear and predictable process. In fact, when we consider that the growth of the UK economy is the outcome of the consumption decisions which take place in 25 million households, interacting with the production and investment decisions of 4½ million business enterprises,[3] it is perhaps amazing that economic growth is as steady as it is!

We observe economic cycles because demand – or spending – fluctuates relative to the underlying capacity of the economy. When demand changes, companies respond to the fluctuating level of spending by gearing up or scaling down their production of goods and services, which is measured across the economy as a change in GDP.

Chart 2: Components of final demand



Note: Chart shows composition of Total Final Expenditure at current prices in 2006.

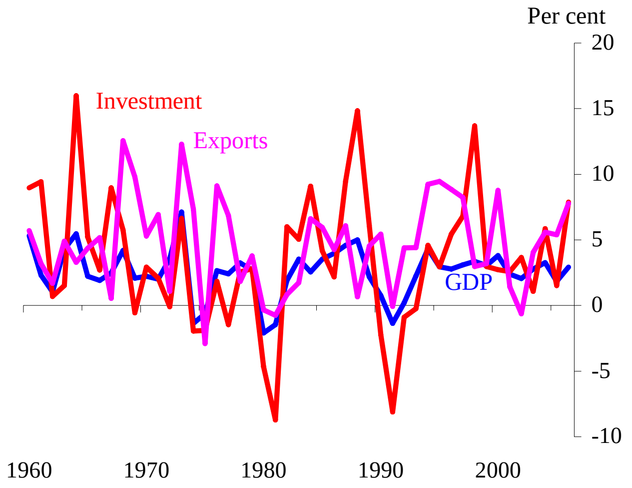
Source: Office for National Statistics

But what causes these swings in demand? As Chart 2 shows, there are four main components of spending: household consumption; investment – of which the largest component is business investment; government current expenditure; and exports.

[3] The number of households is the latest estimate by the Office of National Statistics and the number of businesses is the latest estimate from the Department for Business, Enterprise and Regulatory Reform. Over 99% of these businesses are small enterprises with fewer than 50 employees. The 6,000 large enterprises, with 250 or more employees, account for 0.1% of enterprises but 41% of total employment and 48% of total turnover.

Because consumer spending is the largest single component, changes in consumption are always an important factor shaping the economic cycle. But some of the other components of spending – in particular investment and exports – "punch above their weight" in driving the cycle because they are much more volatile, as Chart 3 shows.

Chart 3: Investment and export growth



Source: Office for National Statistics

However, significant swings in demand are not normally the product of one single demand component – they tend to be much more broadly based. This is partly because a slowdown or acceleration in spending triggered by changes in investment or exports can have second-round effects on consumption by affecting employment and wage growth, and hence household incomes. This is the "multiplier effect" which was a key element of Keynes' *General Theory*.[4]

Another reason why significant swings in demand tend to be broadly based is that a sustained period of strong growth or a marked slowdown does not normally reflect one single cause operating in isolation, but is usually the product of a combination of factors operating together. For example, oil price shocks played an important role in triggering the recessions of the mid-1970s and early 1980s. But it was not the only factor at work. Both recessions were preceded by periods of strong growth and a build-up of domestic inflationary pressures. In the early 1980s, the adjustment of the

[4] See Keynes (1936).

exchange rate to the removal of exchange controls and the build-up of North Sea oil production also played a part. A significant demand shift is more likely if there are a number of factors at work rather than just a single shock.

In addition, some of the big shocks which have affected demand in the UK economy in past decades have also had similar effects on demand in other countries. When this happens the impact on domestic spending can be amplified by changing conditions in export markets. Weak export performance has played a part in all the three major UK recessions, and periods of healthy UK economic growth have often been associated with strong world demand.

When I was at the CBI in the late 1980s and early 1990s, I was conscious of how disruptive the volatility of the UK cycle had become to the British business community. From 1970 until the mid-1990s, the UK had the most volatile economic cycle of any major economy.[5] Large swings in the economic cycle create difficulty for long-term business planning and investment, and have other adverse effects on the efficient functioning of the market economy.

The big swings in demand which are so troublesome for business can also create problems for monetary authorities like the MPC. If demand and output get significantly out of line with the underlying capacity of the economy, there will be consequences for inflation. A prolonged period of strong growth will create overheating and exert upward pressure on prices and costs across the economy. A period of very weak growth or recession exerts pressure in the opposite direction. To keep inflation on target, which is the remit of the MPC, it normally helps to avoid these large swings and keep spending and output in line with the underlying capacity of the economy.[6]

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[5] See Currie and Sentance (1994) for a detailed discussion of the UK cycle relative to other economies in the 1970s and 1980s and the reasons for excessive volatility.

[6] The concept of the "output gap" aims to measure deviation of output and demand from underlying capacity, and is important to the New Keynesian framework for analysing monetary policy and the business cycle popularised by Woodford (2003). Nelson and Nikolov (2002) relate this framework to the UK and conclude that inaccurate estimates of the degree of excess demand in the UK economy contributed significantly to outbreaks of inflation in the 1960s and 1970s.

Managing the shocks and uncertainties

Managing the economy to stabilise inflation when a wide range of factors are causing demand to fluctuate is a major challenge for the MPC and other monetary authorities. We could imagine a world where the monetary authorities, with perfect information and perfect foresight, act to set interest rates to keep demand exactly in line with the supply potential of the economy and hence inflation is always in line with the target. That is certainly a world which MPC members might dream about. But the real world we inhabit in our waking hours differs from this dream-world of monetary perfection in three important respects.

First, we are not perfect forecasters with complete information. There is always uncertainty about the future level of demand and also about the supply potential of the economy. And because monetary policy affects the economy with a lag, we could not fine tune the economy to eliminate all fluctuations in demand even if we wanted to. The real world also has a nasty habit of generating unusual shocks – such as the recent disruption to financial markets – which can be very hard to quantify and assess. That task is made even harder when we face a combination of shocks – as we currently do from both financial markets and food and energy markets. In the face of these shocks, the uncertainty around our projections of future demand will inevitably increase.

Second, when it comes to inflation, demand shocks are not the only thing we need to worry about. There can be other shocks to the inflation process in the economy which the monetary authorities need to take into account in setting interest rates. In the months ahead, we are expecting quite a bit of upward pressure on UK inflation from rising energy and food prices. The recent decline in sterling may add to these pressures by pushing up import prices more generally. While the MPC cannot do much about the short-term impact of these movements in commodity and currency markets, our interest rate policy does need to take into account the need to ensure that they do not have a sustained impact on inflation in the medium term. A headwind of slower growth of output and demand can be helpful in achieving that. By slowing the pass-through of costs into consumer prices and creating a margin of spare capacity, slower growth reduces the risk that a temporary rise in inflation will become more deeply embedded through its impact on wage growth and price expectations more generally.

Third, the economy can be affected by price changes or shifts in demand or supply conditions which require significant real adjustments to the structure of the economy. These adjustments do not always occur smoothly and seamlessly. In the early twentieth century, the economist Joseph Schumpeter argued that economic cycles were strongly associated with a process of "creative destruction" in which older and more established firms decline and release resources for the growth of their innovative and entrepreneurial successors.[7] This has certainly happened in the past in the UK. For example, the early 1980s recession saw a great deal of structural change in the UK's manufacturing base, and the subsequent recovery was strongly driven by services industries.

One such structural change which may now be beginning to take place is the "rebalancing" of the UK economy, away from the strongly consumer-led growth of the late 1990s and the first half of this decade, and towards a pattern of growth where investment and exports make a bigger contribution. A number of recent developments could be working together to produce this shift in the pattern of growth, including the recent fall in sterling and high real energy prices – which will squeeze real incomes if sustained. A more restrained approach to lending to consumers and for property investment following the recent financial market turmoil may also play a part. Consistent with this, some of the clearest signs of slowdown in the UK economy at present relate to consumer spending and property markets.

Stabilising forces

Monetary policy operates in a world where these shocks, uncertainties and structural shifts play a major part in shaping economic developments. When a number of these factors are operating together, as they appear to be at present, it is not surprising that the road ahead for the economy appears rather bumpy and uncertain.

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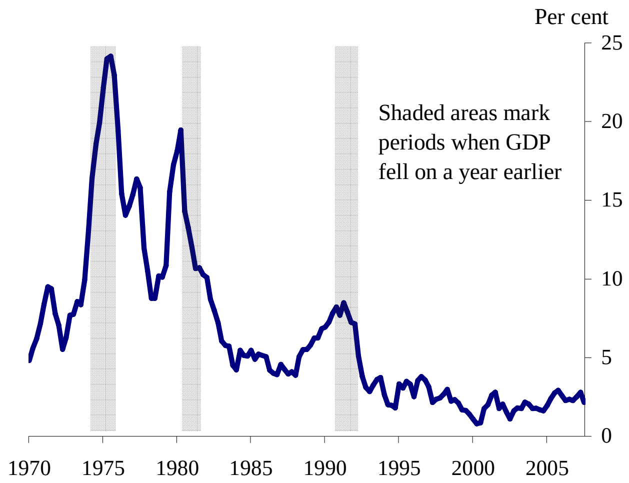
[7] Schumpeter's views on the role of entrepreneurship and innovation in economic development evolved over the course of his writings. Schumpeter (1939) and (1942) are probably two of his most important contributions.

However, while we appear to be set for a pronounced slowdown in the economy over the year ahead, a recession of the type we saw in the mid-70s, the early 80s and the early 90s does not appear to be on the cards. There are three associated differences from that era which mean we are much better placed now to manage the shocks and uncertainties we currently face.

First, and crucially, inflation expectations are much better anchored now than they were through the 1970s and 1980s.[8] Chart 4 shows that the three big post-war recessions started from a position of much higher, persistent and volatile inflation than we now see. The need to get on top of inflationary pressures and subdue high and unstable inflation expectations contributed greatly to the length and depth of these recessions.

Chart 4: UK inflation from 1970



Note: Series shown is annual growth in consumer expenditure deflator, which moves closely with CPI and has a long, consistent time series available.

Source: Office for National Statistics

By contrast, households and firms in the UK have now experienced a decade and a half of low and stable inflation, making it less likely that temporary fluctuations in inflation will trigger a wage-price spiral. The stability of wage settlements and earnings growth gives some confidence that this pattern of behaviour is not changing

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[8] Bank of England (2007) discusses the importance of reduced inflation expectations to the greater stability experienced since the early 1990s, as well as other potential contributory factors – good policy, good luck or other factors such as structural changes.

fundamentally, though there are risks suggested by rising measures of short-term inflation expectations which the MPC will need to monitor closely.

An important factor helping to anchor inflation expectations is that the current framework for monetary policy – based on an explicit inflation target and with a strong institutional underpinning – is now much more robust and stable. By contrast, the three major post-war recessions occurred against a background of policy instability and experimentation and at times there was no discernable monetary framework at all! In that environment, it was much easier to make policy mistakes which aggravated the boom-bust tendency of the economy – such as the Barber boom of 1973 and the Lawson boom of the late 1980s.

The third key difference from the bad old days of boom and bust is that the UK economy has now become more flexible in the face of shocks, particularly in the way the labour market operates. Improved labour market performance has reflected factors such as a reduction in union density and less adversarial industrial relations, accompanied by welfare reforms that have increased the relative rewards for working. More recently, migration has added significantly to the potential labour supply available to employers in the UK.[9] As a result of these changes, it is now more likely that real wages will adjust to offset adverse economic shocks, making big adjustments to the level of employment less likely.

Structural changes to other areas of the UK economy may have contributed to greater macroeconomic stability. These include more efficient financial markets, and more flexible business practices such as improved inventory management, greater use of outsourcing and more flexible working patterns. The UK economy has also benefited from other favourable influences from changes in the global economy, including the impact of globalisation on UK import prices, though some of these changes may turn out be more transient.[10]

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[9] See Nickell and Quintini (2002) for further discussion of how changes in the 1980s and 1990s increased labour market flexibility. For an analysis of the impact of inward migration on UK labour markets, see Blanchflower, Saleheen and Shadforth (2007).

[10] See Sentance (2007) for a discussion of the recent impact of changes in the global economy on UK inflation.

Policy challenges

Having said all that, monetary policy faces some big challenges at present, as the Bank's latest *Inflation Report* made clear last week. First, the scale of the demand shock from the recent financial turbulence is still unclear. Second, we face significant short-term inflationary pressures from energy and food prices, possibly reinforced by the effect of a weaker pound on import prices more generally. And third, the economy faces a process of rebalancing and structural adjustment towards a pattern of growth less dependent on the consumer and more dependent on other sources of demand.

The MPC faces the significant challenge of setting the right course for monetary policy against this background. We should not underestimate the economic cycle. It has been around since Biblical times. When Joseph interpreted Pharaoh's dream, as recorded in Genesis chapter 41, he predicted seven good years followed by seven lean years – the earliest record as far as I can see of an economic forecast, and one which proved remarkably accurate!

That is not what I expect for the UK economy in the years ahead, you will be pleased to hear! But I do expect the process of adjustment in the economy to result in a slowdown in growth, which may be more significant and sustained than we have seen in the recent past during the era of inflation targets and central bank independence. As with all cycles, that slowdown will be more noticeable in some sectors than others. Activities more dependent on the UK consumer and with strong links to property and financial markets may see a more marked change in demand. By contrast, UK manufacturing and other sectors more dependent on overseas markets will see an offsetting benefit from a more competitive pound, and could also find that the strength of demand in emerging markets helps to soften the impact of slower global growth in the US and Europe.

Monetary policy is a flexible tool, and the MPC meets every month to assess development and decide if a change is needed. In past, less turbulent, times there have been suggestions we should meet less frequently – like the Fed, which meets eight times a year. In my view, the current situation highlights the benefit of a monthly cycle of meetings. At each meeting, we will be updating our assessment as new data come in. And the information businesses provide – through business surveys and the Agency network – will be a vital part of that assessment.

The future course of interest rates will depend very much on what that data flow – relating to global developments as well as the UK economy – tells us about the likely outlook for inflation. Is the actual and prospective slowing in the economy sufficient to keep inflation on target? Are we in danger of a sharper slowdown than is needed? Or have we underestimated the upside risks to inflation – particularly through inflation expectations? We will be continually updating our assessment on these questions at each monthly meeting in the light of the available evidence.

Our mandate is to keep inflation on target. The experience over the period of inflation targeting in the UK is that this has resulted in a more damped economic cycle. Though we cannot guarantee that will always be the case, there are good reasons why we should not see a return to the excessive volatility of earlier decades. We do now have a strong and robust framework for monetary policy, inflation expectations appear reasonably well anchored, and the UK economy has shown itself to be much more flexible in the face of shocks than in earlier decades. The economic road may be getting bumpier, and there may be some unpredictable obstacles ahead, but keeping our focus on achieving low and stable inflation over the medium term is our best guide to steering the right course.

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