BANK OF ENGLAND

Speech

The Current Downturn – A Bust Without a Boom?

Speech given by

Andrew Sentence, Member of the Monetary Policy Committee, Bank of England

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I am very pleased to have the opportunity to speak at this year's Monetary Policy and the Markets conference. Over the course of this year, extreme market volatility has posed some very big challenges for the setting of monetary policy in the UK and other major economies.

First of all, we have seen a giant rollercoaster in energy and many other commodity markets. The oil price, which started the year at around $90/barrel, rose to nearly $150 and has since fallen back to just over $40. The surge in energy and commodity prices has generated a rise in UK consumer price inflation to over 5% – its highest level for over sixteen years. It is also the sharpest upward movement in this measure of inflation in the history of this data series, which goes back to the late 1980s. This rise in inflation has squeezed real incomes, contributing to the slowdown in consumer spending over the course of this year – though, over the months ahead, we should see both these effects reverse as recent falls in energy and commodity prices feed through to consumers and firms.

Second, there has been extreme volatility and stress in financial markets, resulting in the most serious banking crisis in modern economic history. The disruption to financial markets and its knock-on impact on the cost and availability of credit, as well as on business and consumer confidence, has pushed many economies across the globe into recession in the second half of this year, including the UK. The financial crisis has also complicated the operation of monetary policy by creating a large and uncertain wedge between the rates set by Central Banks and lending rates more generally across the economy.

It is difficult to imagine a more turbulent market environment against which we have had to operate monetary policy. As separate developments, a rise in inflation to over 5% and a move into recession would have seemed remote possibilities at the start of this year. The fact that both have happened together, accompanied by a major financial crisis, is an indication of how unusual and unprecedented the events of 2008 have been.

Policy responses

Some dramatic steps have now been taken by policy-makers to stabilise the financial system and to head off the sharp downturn in demand which has emerged in the wake of the turmoil on financial and commodity markets. September and October saw dramatic moves by governments and financial regulators to restore order to the banking system in the wake of the collapse of Lehman Brothers. That has included direct government injections of capital into some major banks in the UK, the US and in other major economies.[1]

Monetary policy has also been relaxed dramatically. In the UK, Bank Rate has been reduced to its lowest level since 1951. The three percentage point reduction in the official policy rate matches the sharp reduction we saw in the wake of the UK's exit from the ERM in the autumn of 1992.[2] In the last hundred years, there are only two occasions when interest rates have fallen more sharply in a three-month period – in 1914 and in 1977. And in both of these episodes, the fall in interest rates was reversing a sharp rise in the months before the cut – which is not the case at present. Interest rates also started to be cut at an earlier stage of this downturn than was the case in previous UK recessions.

The stimulus to demand provided by this relaxation in monetary policy will be supported by the fiscal measures announced last month in the Pre-Budget Report. Fiscal and monetary responses in other countries affected by the current downturn should also help to support export demand as we move through next year.

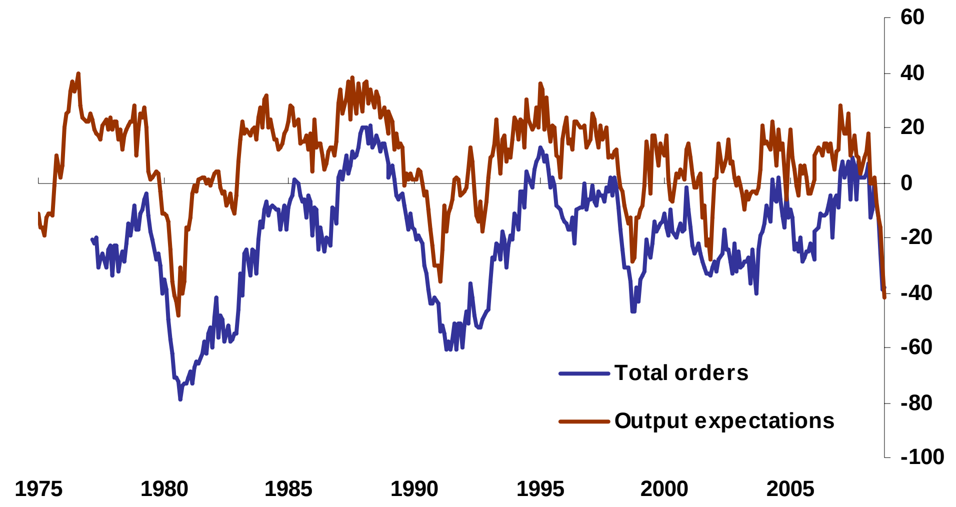
But it will take time for these policy measures to take effect. At the same time, the consequences of the recent financial market turbulence are also still feeding through. Following the contraction in GDP in the third quarter of this year, the latest business survey evidence suggests that the downturn intensified in the fourth quarter. This downturn is most noticeable in surveys of manufacturers – such as the CBI Monthly

[1] See the Bank of England's latest *Financial Stability Report* (October 2008) for a fuller analysis.
[2] This excludes the very short-lived increase in Bank Rate from 10% to 12% on 16 September 1992 which was reversed the following day.

Trends Survey, which is recording the weakest output expectations since the early 1980s, as Chart 1 shows.

Chart 1: Output expectations and orders

CBI Monthly Trends survey balances



Note: The survey covers manufacturing firms only

Source: CBI

This is consistent with an acceleration in the downturn driven by weak global demand and reinforced by a stock cycle in which lower demand from final consumers ripples down the supply chain. Both weak global demand and a rundown in stock levels throughout the supply chain are likely to affect manufacturing industry more than other sectors – and the survey evidence is consistent with this view. This stock cycle and the knock-on consequences of weak global demand may have further to run – particularly for durable purchases such as motor cars. Further reductions in output are therefore likely in the first half of next year.

Even if we do see a recovery beginning in the second half of 2009 – as suggested by the Bank's November Inflation Report forecast – this recession is likely to be comparable in length and depth with the previous three major post-war UK downturns in the mid-70s, early-80s and early-90s.[3] In each of these earlier episodes, the output

[3] The November Inflation Report forecast was for a recession that is slightly less deep than in the three major post-war UK downturns. However, recent survey data have been weaker than that forecast implied and so I now expect the recession to be of comparable depth to those previous downturns.

of the economy fell by at least 2.5% over a period of a year or more, resulting in a significant rise in unemployment.[4]

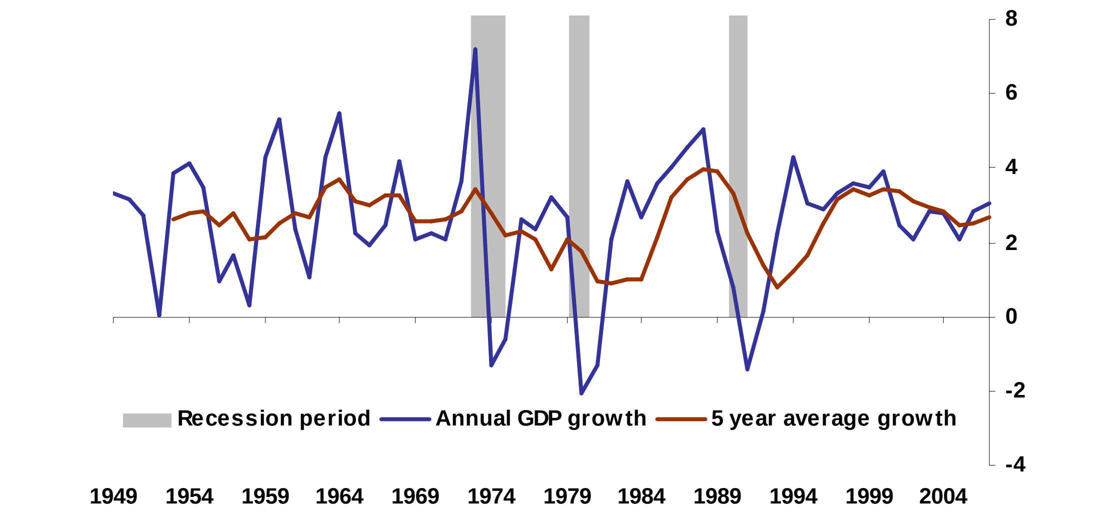
However, unlike those previous recessions, this one is being driven significantly by developments in financial markets, rather than the inflationary boom-bust cycles we have seen in the past. In my speech today, I want to discuss what difference this might make to the kind of downturn we can expect and the way in which policy responds to it.

Post-war recessionary cycles

Prior to the current recession, the major downturns we had previously seen in the UK generally had the characteristics of an inflationary "boom-bust cycle". A period of rapidly expanding demand puts strain on the supply potential of the economy, resulting in a pick-up in inflation. The impact of high inflation and the policies needed to contain it sow the seeds of the downturn which then follows.

Chart 2: Post-war UK GDP growth

Annual percentage change



Source: ONS

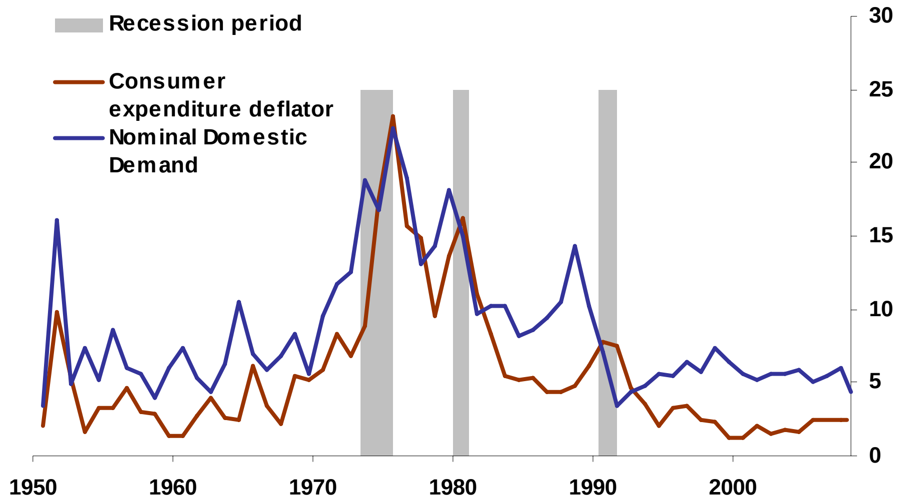
[4] Output declined by 3.3%, 4.6% and 2.5% from the peak level of activity in the periods 1973-75, 1979-81 and 1990-92. Claimant count unemployment rose by 540,000 in the three years from the peak of the 1973-75 cycle, and by 1.40 million and 1.34 million respectively in the equivalent three years in the following two recession. See also Sentance (2008b).

Chart 2 shows that the mid-1970s and early-1990s recessions clearly followed periods of very strong GDP growth. The 1974-75 recession followed the Barber Boom, which saw the single strongest calendar year of postwar economic growth – when the output of the economy rose by over 7% in 1973. The intensity of the boom was such that even though GDP then fell back in the next two calendar years, GDP in 1975 was still over 5% up on three years ago.

The Lawson boom in the late 1980s saw a more sustained boom – even if we did not see such a strong single year of rapid growth as in 1973. Growth averaged around 4% per annum in the five years to 1988, the peak growth year, and this represented the strongest five-year period of growth since the Second World War.

Chart 3: Inflation and domestic demand

Annual percentage change



Note: 2008 domestic demand data are an average of Q1-Q3, consumer expenditure deflator data are an average of Q1-Q2

Source: ONS

The early 1980s recession was not immediately preceded by such a strong surge in GDP growth. However, there was still a sharp pick-up in the growth of money spending and of inflation, as Chart 3 shows. Indeed, double digit growth in nominal spending and a sustained pick-up in inflation – followed by a squeeze on both demand and inflation – is a key common ingredient in all these previous recessionary cycles in the UK.

However, Chart 3 also shows that this pattern has not been repeated in the run-up to the current recession. Though inflation has picked up over the course of this year, this was due to a surge in global energy and commodity prices – and has not been driven by demand factors in the UK. Nominal domestic demand has been slowing recently, and other indicators of domestic inflationary pressure – such as wage growth – have also been subdued. GDP growth in the five years prior to this year's downturn (2003-2007) averaged 2.7% per annum – just 0.1% above the postwar average growth rate.

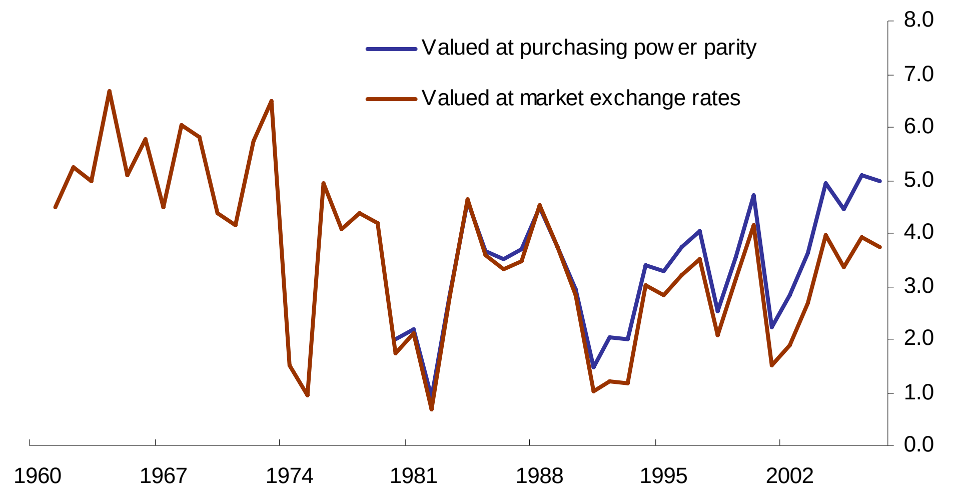
In one sense this is not surprising. The inflation target framework established in the 1990s, within which the Monetary Policy Committee operates, was designed precisely to avoid the inflationary boom-bust cycles that we have seen before in the UK. The MPC has been sensitive to signs of a pick-up in domestic inflationary pressures – raising interest rates in the late 1990s, 2003/4 and 2006/7 to head off this risk. The resulting record of low and stable inflation has helped to anchor expectations when inflationary threats have emerged – as they did with the sharp surge in energy and commodity prices this year.

A bust without a boom?

Viewed through the lens of the classic inflationary boom-bust cycle, therefore, we appear to be experiencing a bust without having experienced a preceding boom, at least in terms of short-term measures of the growth of UK demand and domestic inflationary pressures. But there have been some aspects of the recent period of economic expansion which are more characteristic of a boom-bust cycle, though perhaps in a different form to those we have seen in the past.

Chart 4: World GDP growth since the 1960s

Annual percentage change



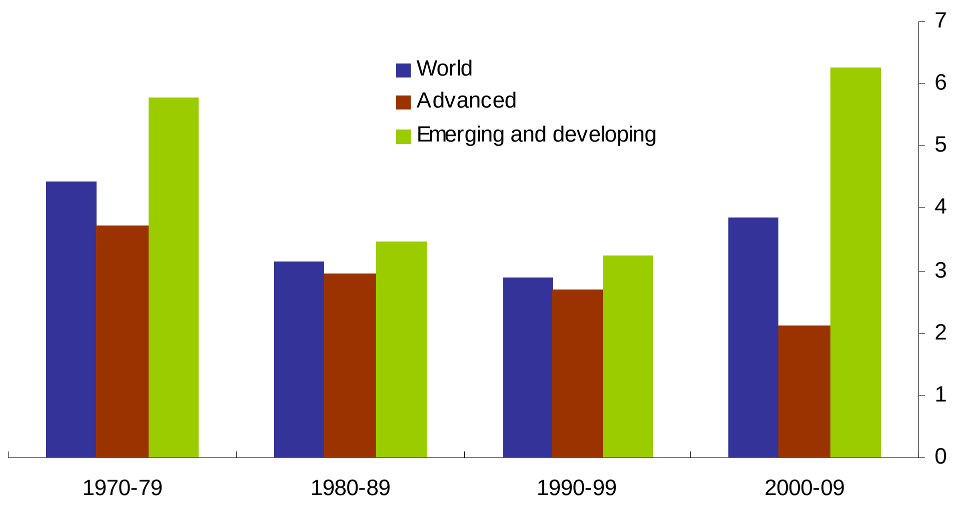
Note: GDP growth valued at market exchange rates is a spliced series of World Bank data from 1960 to 1979 and IMF data from 1980 to 2007

Source: IMF and World Bank

First, as Chart 4 shows, the last five years have seen a very strong period of world economic growth, contributing significantly to the upward pressure on global energy and commodity prices, as we also saw in the periods leading up to the recessions of the 1970s and 1980s. The upward pressure on energy and commodity prices reflects the fact that this growth has been particularly strong in resource-hungry emerging market economies.

Chart 5: GDP growth since the 1970s

Average annual percentage changes



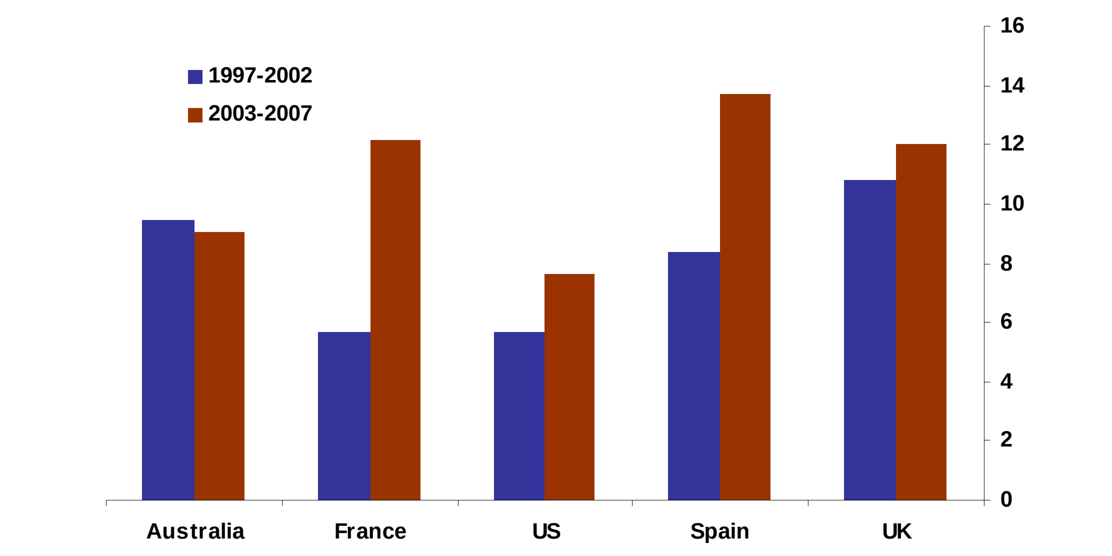
Note: 2008 and 2009 are IMF forecasts

Source: IMF *World Economic Outlook*, November 2008 Update

As Chart 5 shows, trend growth in the "advanced economies" – including the US, Europe and Japan – has gradually slowed since the 1970s. But the growth performance of the emerging market and developing country economies in the last decade is the strongest we have seen in the last forty years. This is not just a "China effect". It reflects the fact that all the major regions of the emerging/developing world – Asia, Africa, the Middle East, South America and the former Soviet economies – have performed strongly over the course of this decade.[5]

Chart 6: World house price inflation

Annual percentage change



Note: UK data are an average of the Halifax and Nationwide seasonally adjusted house price indices

Source: OECD, HBOS, Nationwide and Bank calculations

Second, we have seen across many countries strong sustained upward pressure on housing and property prices more generally, as Chart 6 shows. The origins of this global housing and property boom are controversial. Some economists have argued that this reflects a "search for yield" in safe assets which is a bi-product of the "global savings glut" and historically low long-term real interest rates. An alternative view could be that in a world in which product, labour and capital markets are increasingly globalised, inflationary pressures are more likely to show up in the most scarce commodity of all – land and property.

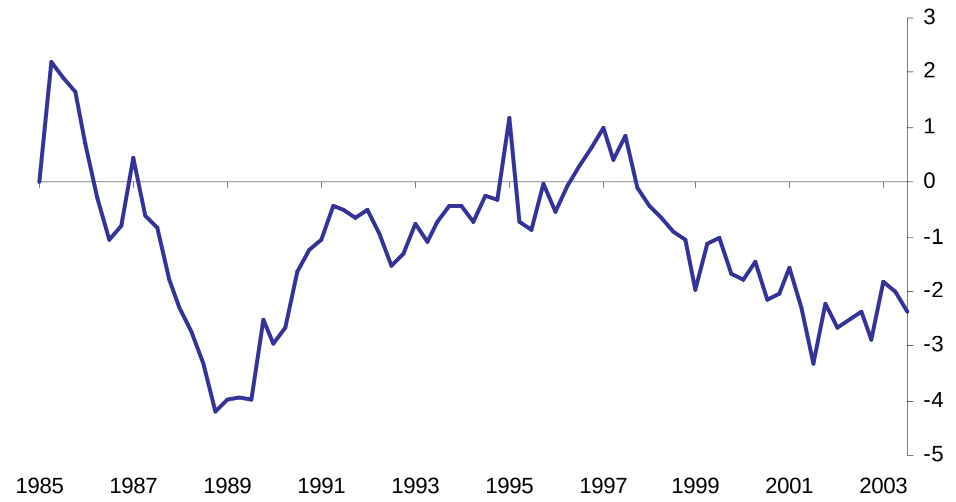
[5] For further discussion, see Sentance (2008a).

Rapid house price growth has not been confined to the US and UK. As Chart 6 shows, the last five years have seen stronger house price inflation in Spain and France than in Anglo-Saxon economies. However, the fact that this appears to be a global phenomenon – and house price growth has picked up in the last five years in many countries – is consistent with the view that world demand has been particularly strong in the recent economic upswing.

The third worrying boom-bust indicator has been the external account. In past economic cycles, a deterioration in the trade balance and the current account of the balance of payments has been a signal of excess demand growth, most noticeably in the late 1980s when a rapid balance of payments deterioration was a signal of suppressed inflation which became more apparent in the early 1990s.

Chart 7: Trade balance

Goods and services trade balance as a percent of GDP



Source: ONS

Could something similar have been happening in the 2000s? In the expansion of the UK economy in this decade, we have seen deterioration in the trade balance – as Chart 7 shows. Although not as dramatic as we saw in the late 1980s, this could still indicate that, at the prevailing strong exchange rate, the inflationary consequences of strong demand growth were damped down because the real incomes of wage-earners were boosted by low import prices resulting from the combination of the "China effect" and a strong pound. This effect could be reversed at a lower exchange rate or in the wake of recent cost shocks, though at the expense of higher inflation.

In the 1990s, Steve Nickell estimated that each 1% of GDP deterioration in the goods and services trade balance represents one percentage point of suppressed inflation.[6] According to Nickell's model, a high real exchange rate would also be reflected in a better inflation/unemployment trade-off in the short-term. So it would reduce the equilibrium unemployment rate for a while, but then unemployment would need to be higher when the exchange rate depreciates and workers feel a squeeze on their real wages.

It is not clear how significant this effect might have been in the early 2000s. However, this interpretation of recent unemployment experience would suggest caution about some of the supply-side optimism we have seen in recent years. To the extent that the reduction in unemployment reflected suppressed inflation and a high exchange rate, this may not be sustained into the future. The conclusion that would flow from this is that some part of the reduction in unemployment we have identified as structural may not be sustainable at a lower exchange rate, and that we have over-estimated the underlying supply potential of the economy as a result.

Financial liberalisation, globalisation and price stability

So, while we may not have seen a classic inflationary boom-bust cycle on the 1970s-1990s model, it would equally be wrong to deny that the current bust was preceded by a boom of some sort. We have indeed had a long expansion of economic activity in the UK – indeed, as Chart 8 shows – it is the second longest uninterrupted expansion since the mid-19th century!

[6] See Nickell (1990).

Chart 8: Longest business cycle expansions

The five longest business cycle expansions since the mid-19th century

Period	Duration	Average growth over period	Cumulative increase in GDP over period
1948-1973	26 years	3.0%	107.6%
1992-2007	16 years	2.8%	55.4%
1932-1943	12 years	3.8%	54.4%
1868-1877	10 years	2.6%	25.5%
1982-1990	9 years	3.2%	29.8%

Note: Periods of continuous growth measured on an annual basis from the first year of growth following one recession to the last period of growth prior to the next recession

Source: Bank of England Historical Database and External MPC Unit calculations

This has been against the background of strong global growth of demand, particularly in recent years, and has also been associated with strong inflationary pressures in energy and commodity markets, as well as a sharp escalation of property prices.

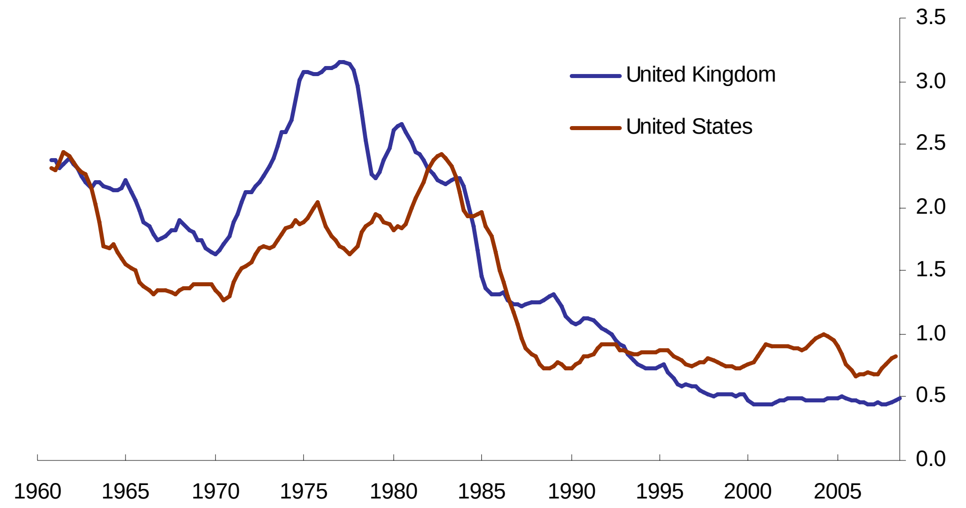
The final point I would make is that if we take a longer view of economic history, stretching back to the Industrial Revolution, financial and commodity booms and busts were the predominant drivers of economic cycles. The characteristics of the current cycle have much more in common with cycles experienced before the First World War and even pre-industrial economic history than they do with post-war inflationary cycles.

We are now appreciating that the earlier years of this decade saw an expansion of various forms of financial market activity which have subsequently proved unsustainable. The rapid correction we are now seeing is spilling over into the real economy – creating recessionary forces. This is not the unwinding of a classic inflationary boom-bust cycle that we have seen before in postwar Britain. But it is nevertheless creating equally severe consequences as it unwinds.

So why did this financial boom or bubble emerge? Various explanations have been given by economic commentators and indeed by other MPC members.[7] To me, this latest boom-bust cycle seems to me to be the product of three structural trends which have come together to produce an unintended consequence – global financial and economic instability. It is a product of three developments which are totally rational in their own right – financial liberalisation; globalisation; and price stability. Each brings great benefits. Financial liberalisation brings access to new innovative financial products, and a lessening of the dead hand of regulation. Globalisation opens up access to new markets and products across the globe. And price stability has appeared to offer a reduction in macroeconomic risks, as it has been associated – since the early 1990s – with much less volatility in the real economy, as Chart 9 shows.

Chart 9: Volatility of real GDP growth

Annualised volatility of quarterly growth in percentage points



Note: Five-year rolling averages

Source: ONS, Thompson Datastream and Bank calculations

It was in the 19th and very early 20th century when we last saw this combination of open financial markets, free trade and an underpinning of price stability provided by the gold standard. In these earlier times, financial and commodity markets were the key drivers of economic cycles. As we move into a world with a greater underpinning of price stability, accompanied by more open trade and financial flows, we need to

[7] See, for example, Bean (2008) and Gieve (2008).

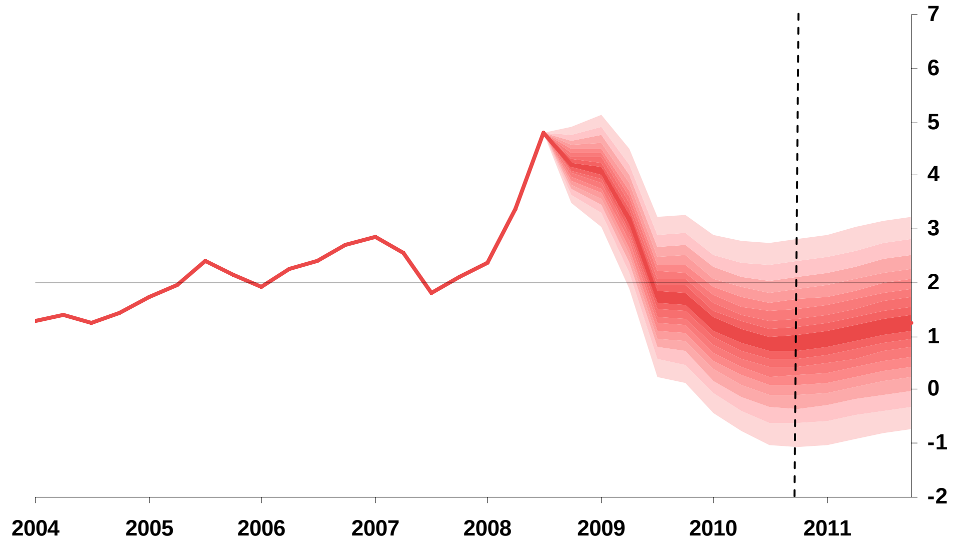
recognise the dangers of a return to the boom-bust cycle of the 19th century, replacing the boom-bust inflationary cycles of the late 20th century.

Policy conclusions

So what does his imply for monetary policy? In the short-term, the monetary policy challenge is clear. To act to counter the negative impact on demand from global slowdown and banking crisis, and to head off the potential deflationary risks created by an emerging large margin of spare capacity. The fact that the monetary transmission mechanism may be affected because of the disruption to the banking system doesn't mean that monetary policy is irrelevant as some have begun to argue; rather it gives added force to the argument for a significant relaxation of policy in the short-term, which the MPC has delivered.

Chart 10: CPI inflation

Annual percentage change



Note: Based on market interest rate expectations

Source: Bank of England *Inflation Report*, November 2008

The current monetary policy framework is giving us a clear steer in this direction, as Chart 10 shows. The November Inflation Report showed that there was a significant risk of inflation remaining below target over the medium term. That underpinned the significant relaxation of policy in the last three months.

However, it is also important to draw out the longer term lessons from the recent episode. The first general point is that we need to understand better the two-way interactions between the financial system and the macroeconomy which have become clear as this crisis has unfolded. I think it is quite plausible that in a world where inflation is generally low and stable, financial cycles may once again re-emerge as the main cause of macroeconomic volatility, just as they did in the earlier period of price stability underpinned by the gold standard. In analysing and understanding these cycles, we will probably need to pay more attention to measures of money and credit and the channels through which they affect the real economy and inflation, and incorporate these effects more explicitly in our models.

The second point is that we need to develop better policy instruments for maintaining the stability of the financial system, and avoiding the financial booms which inevitably precede the bust. I don't think it is reasonable to expect monetary policy to do this unaided – simply by "leaning against the wind" of an asset bubble. This would create confusion about the objectives of monetary policy and would be very difficult to operate in practice. However, there is also a danger of unintended consequences from heavy-handed regulatory interventions in the banking sector. So we need to take time to decide what a new regime for regulating the financial sector looks like, though it is a key economic policy issue in the wake of the current crisis. Both Sir John Gieve and Charlie Bean have made useful suggestions in recent speeches on how this might be done.[8]

Third, a common theme of the two explanations I have given for a "bust without a boom" is that the period we have classified as the "Great Stability", stretching back to the early 1990s, may still have featured an element of growth in demand in excess of longer term potential – either because a financial bubble was inflating or because globalisation was masking the domestic inflationary consequences. Unlike previous booms, this was a much more slow-burning "boom" – which showed itself in property price inflation and financial imbalances rather than through more traditional measures of inflation. Together with the possibility that supply-side potential could be adversely affected by the financial crisis itself, I do think this should make us more

[8] See Bean (2008) and Gieve (2008).

cautious about the growth of supply potential going forward. I made the case for this in my first speech as a member of the MPC in January 2007[9], and this is an issue that both monetary and fiscal policy-makers will need to return to in judging the appropriate settings for policy once we are through the immediate crisis.

[9] See Sentance (2007).

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