



BANK OF ENGLAND

Speech

Monetary Policy and the Current Recession

Speech given by

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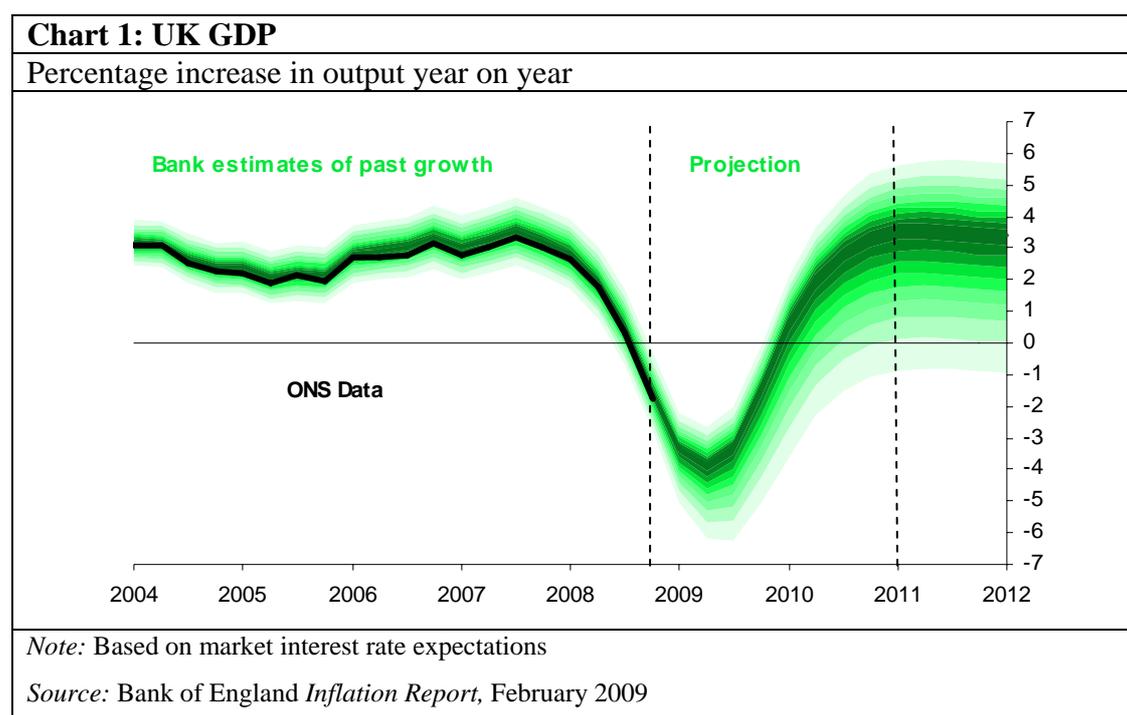
At the Institute of Economic Affairs' 26th Annual State of the Economy Conference

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I would like to thank Michael Hume and Abigail Hughes for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

I am delighted to have the opportunity to speak at this year's IEA State of the Economy conference. But I don't think anyone could express much delight or pleasure about the short-term prospects for the UK economy or other major economies around the world at present. The economic backdrop to this year's conference must be one of the most gloomy since this series of conferences began in the late 1980s.

The UK economy is in recession – along with other major economies. The British economy has already experienced two quarters of falling GDP in the second half of last year and business surveys suggest this contraction is continuing in the first half of this year. The February Consensus Forecast was for a contraction of UK GDP of 2.6% in 2009 as a whole. The Bank of England's central projection published in this month's *Inflation Report* is a little weaker than this, with GDP projected to fall on average by about 3% in 2009.



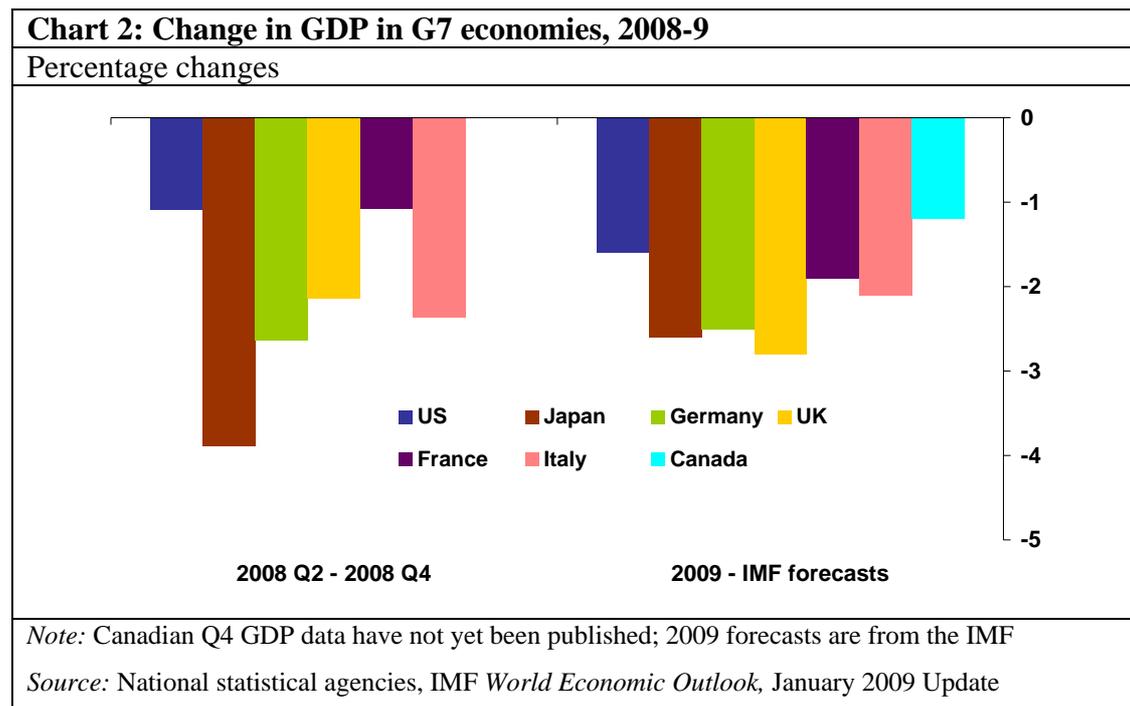
That central projection, shown in Chart 1 as the darkest shaded part of the fan, suggests that the UK economy will stabilise around the middle of the year with a weak recovery beginning in the second half of 2009 and gathering momentum in 2010. But, as the fan chart illustrates, there is a wide degree of uncertainty around

this forecast. And against the backdrop of the current global financial crisis, the risks are still weighted towards the downside at this stage.

Today, I want to talk about the current UK recession and the challenges it poses for monetary policy. And in doing this, I would like to try and put the current recession in its historical context. There are three questions which I will address. First, what have we learned so far about the characteristics of the current recession? Second, how does it compare with previous UK recessions? And third, what are the key challenges for monetary policy in the current economic climate?

The pattern of the current recession

The current recession is being driven by a highly synchronised contraction in demand and output across the global economy. Chart 2 shows the cumulative fall in GDP in the G7 economies in the second half of last year, alongside the latest IMF forecasts for 2009 growth in the same economies. Though the UK has had a sharp contraction in GDP over the past two quarters – of over 2% – it is not the worst affected economy. Japan, Germany and Italy have seen sharper falls in output, while the declines in the US and France have been less marked. As Chart 2 shows, all the G7 economies are forecast to see significant declines in GDP this year and many other economies – including China and other Asian economies – are experiencing a similar pattern of sharply slowing growth or contracting output.



The downturn began to be evident over the late summer and early autumn of last year, and most major economies saw a small fall in GDP in the third quarter of 2008. But the fall in output accelerated sharply in the fourth quarter in all the major advanced economies. In the UK, GDP fell by 1.5 percent, according to the ONS's first estimate, and business surveys suggest that a similar rate of decline is also likely in the first quarter of this year.

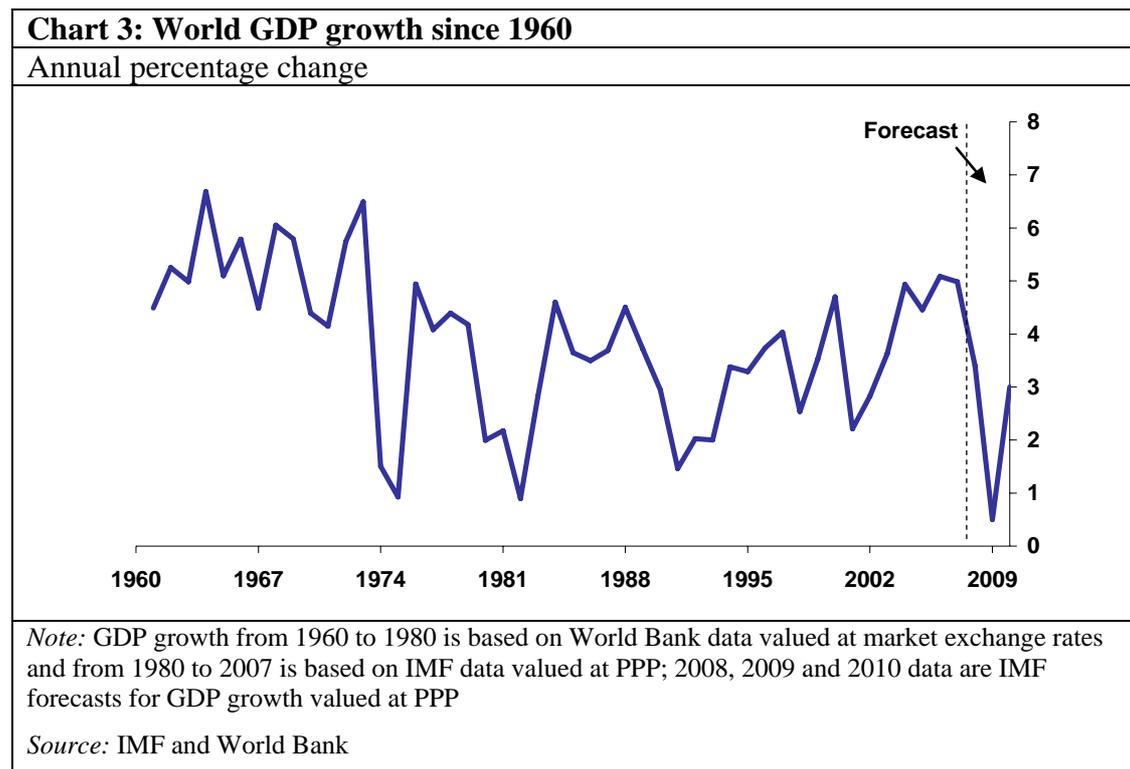
A number of factors have come together to create this sharp slowdown in global demand, but they can all be linked in some way to the global financial crisis. First, the disruption to credit markets and bank lending has restricted access to credit of various sorts, including trade credit and working capital. This has had a particularly significant impact on the housing market, property and construction – but its effects are now being felt more widely across the economy as a whole as the downturn in lending affects consumer spending and investment.

The pressure on company finances was aggravated in the first half of 2008 by the sharp rise in oil and other commodity prices. This cost pressure added to the squeeze on margins against the background of slowing demand. It also added to the working capital requirements of companies at a time when credit was being restricted. Though this energy and commodity price surge has now been reversed, it added to the strains

on the corporate sector over the summer and autumn of last year and reinforced the corporate drive to rein in capital spending and cut costs.

The final ingredient which tipped the world economy over the edge last autumn was the collapse of Lehman Brothers and the near-collapse of other major banks in the US, UK and elsewhere. This triggered a sharp fall in business and consumer confidence around the world. As a result, firms have held back capital spending and consumers have become much more cautious about major purchases, leading to a build-up of stocks of unsold goods in many sectors – such as the car industry. The global integration of manufacturing supply chains has transmitted this demand and confidence shock around the world much more rapidly than in past recessions.

Though this recession is unusual in being driven by a global financial crisis, there is a somewhat familiar pattern to the components of demand and the sectors of the economy which are being affected. Cutbacks in capital spending often play a large part in demand downturns, and that has certainly been true in the current episode. That helps to explain why Germany and Japan have seen such sharp falls in output, as these economies are major capital goods producers. Another element familiar from previous recessions is the role played by the stock cycle.



One further feature of the current recession which is common to earlier UK recessions is the generalised downturn in the global economy. As Chart 3 shows, previous UK recessions – in the mid-1970s, early 1980s and early 1990s, were all associated with a period of 2-3 years of weak global growth. On this occasion, the global downturn is particularly highly synchronised – which helps to explain why the current IMF forecast points to the weakest single year of global growth since the end of the Second World War – though their current projection is for a sharper bounceback than we have seen in previous global recessions.

Comparisons with past UK recessions

These similarities with past recessions suggest it might help to look more closely at the performance of the UK economy in previous downturns. After all, it is nearly two decades since the last UK recession, and so recollections of that episode are quite remote. The two recessions in the mid-1970s and early 1980s are even more distant memories.

In terms of recent experience of recession, we are in a very different position from the situation in late 1990, when the economy last turned down as sharply. Then, one in

four of the previous sixteen years had been recession years, with GDP falling on a calendar year basis. Sitting here in early 2009, we have to look back eighteen years to find a single year of declining GDP.¹ The fact that we have to look back nearly two decades to find the last recession and three decades or more for its two predecessors inevitably makes it harder to put the experience of the current recession in perspective. That, in turn, may account for some of the more apocalyptic and hyperbolic views of the current conjuncture.

Chart 4: UK post-war recessions				
	Growth peak	Period of falling GDP	Drop in output during recession	Pre-recession GDP level recovered
Mid-70s	1973Q1	1973Q3-1975Q3	-3.32	1976Q4
Early-80s	1979Q2	1980Q1-1981Q1	-4.61	1983Q1
Early-90s	1988Q1	1990Q3-1991Q3	-2.54	1993Q3
Late-2000s	2007Q3	2008Q3-?	?	?

Note: * Based on annual growth rate ** Fall in GDP during recession, compared with pre-recession level
Source: ONS

To refresh your memories, the table in Chart 4 sets out some of the key statistics and chronology for these earlier recessions. The current Bank of England *Inflation Report* central projection suggests a recession which is towards the deeper end of the scale – a 4% drop in GDP from the pre-recession level. Though this is not as deep as the early 1980s recession, it is more on a par with the mid-70s and early-80s recessions than the 2.5% GDP drop we saw in the early 1990s.

Another similarity between our current experience and the more distant recessions in the mid-1970s and the early-1980s is the speed with which the economy has moved from reasonably healthy growth into recession. Many people have commented that in

¹ The five years of declining calendar year GDP in the UK since the Second World War are – 1974, 1975, 1980, 1981 and 1991.

the current cycle, the economy has moved in less than a year from reasonably healthy growth in late 2007 and early 2008 to outright recession. But that was also very much the pattern we saw in 1973/4 and 1979/80, as Chart 4 shows. In early 1973, GDP growth peaked at a staggering year-on-year growth rate of 10% – with the Barber boom in full swing. And yet by the year-end, the UK economy was in recession as the first oil price shock took its toll, a wave of industrial unrest swept the country and workplaces were on a three-day week. Similarly, in 1979/80 it took the economy just a year to move from healthy growth in the first half of 1979 to full-blown recession in early 1980.

By contrast, the last recession saw a long drawn out slowdown from the peak of the Lawson boom in early 1988 to recession in late 1990. In the current economic cycle, the onset of recession has emerged much more rapidly than this, but this should not be so surprising if we look back to earlier recessions.

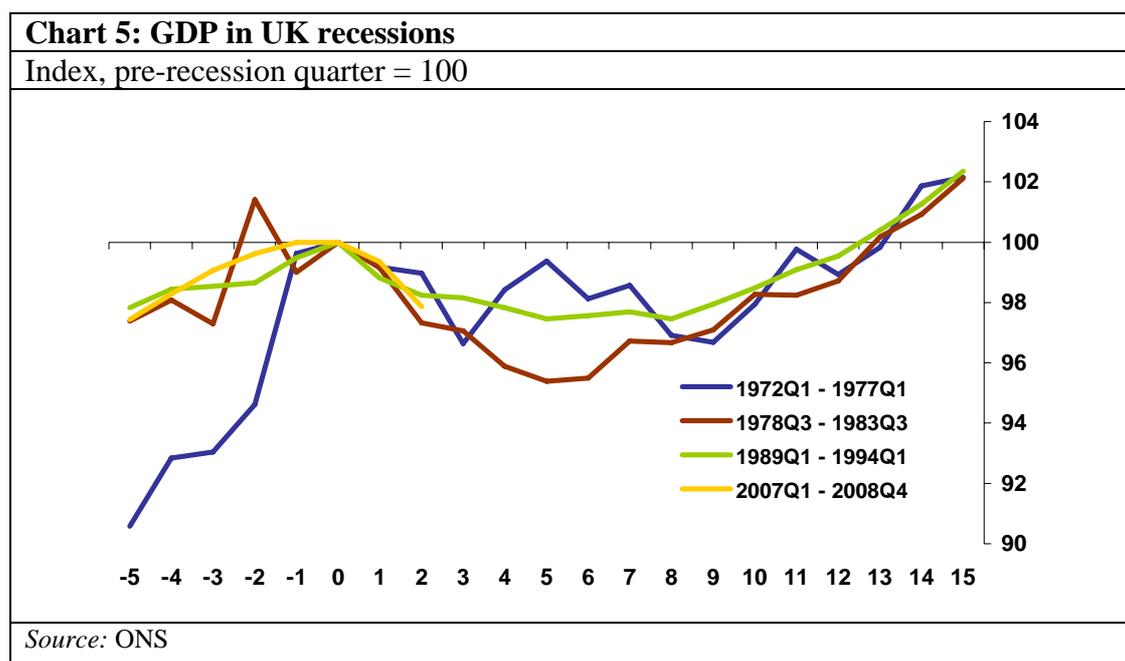


Chart 5 aims to provide a graphical perspective of the path of output in the current downturn, set alongside earlier recessions. It aligns our current position in the cycle – after two quarters of falling GDP – with comparable points in earlier recessions. The comparable stages of previous recessions to the current quarter – Q1 2009 – are the first quarter of 1974 and the three-day week, the third quarter of 1980 when unemployment was approaching two millions, and the first quarter of 1991 when

unemployment rose above two millions once again after dropping sharply in the late 1980s boom². These were all dark times for the UK economy.

One conclusion you could draw from this chart is that it is probably too early to tell how deep and long the recession will be. But the GDP profile is not obviously tracking lower than previous recessions yet. Based on the business survey evidence for the current quarter, the fall in GDP over the first three quarters of this recession is likely to be around 3½ percent – very similar to the declines in output seen at an equivalent stage of the mid-1970s and early-1980s recessions. In these previous recessions, and in the early 1990s, most of the fall in output took place in the first few quarters. It remains to be seen whether this pattern is repeated this time round.

At times of recession, business surveys provide very useful indicators of the short-term path of the economy. They are available more quickly than official statistics and also provide an indication of future intentions as well as past performance. Though firms can be caught out when the economy passes a turning point, these survey indicators are very useful in tracking the evolution of the recession and indicating whether the downturn is levelling out or intensifying – which is a key issue at present.

We have a vast array of business surveys these days, and they are extremely useful to the MPC in tracking the short-term performance of the economy – alongside the Bank of England Agents' reports. However, most of these surveys do not have time series which cover earlier recessions. The main exception is the CBI Industrial Trends Survey, which celebrated its fiftieth anniversary last year. Though this is just one survey, covering the manufacturing sector rather than the whole economy, swings in manufacturing activity do play a key part in economic downturns – as we have seen recently with a drop in manufacturing output dropping of over 5% in the last quarter of 2008 alone. I know from my own experience working at the CBI in the last recession that this survey data helped the CBI economics team to produce more timely forecasts of the downturn than other forecasters.³

² Unemployment figures given relate to the definitions in current use at the time, which relate to claimant count unemployment, rather than the Labour Force Survey measure now used.

³ In November 1990, the CBI forecast envisaged a decline in GDP of 1 per cent in 1991, which was close to the 1.4% reduction now estimated by the ONS – though earlier estimates of GDP were more downbeat. Many other forecasters were still forecasting a **rise** in GDP of around 1 per cent at the time.

I argued earlier that falls in business confidence, a stock cycle and cutbacks in investment had played a key role in the move into recession in the second half of last year, and that this was a familiar pattern from earlier recessions. It should therefore be instructive to compare recent survey indicators with their counterparts from earlier recessions.

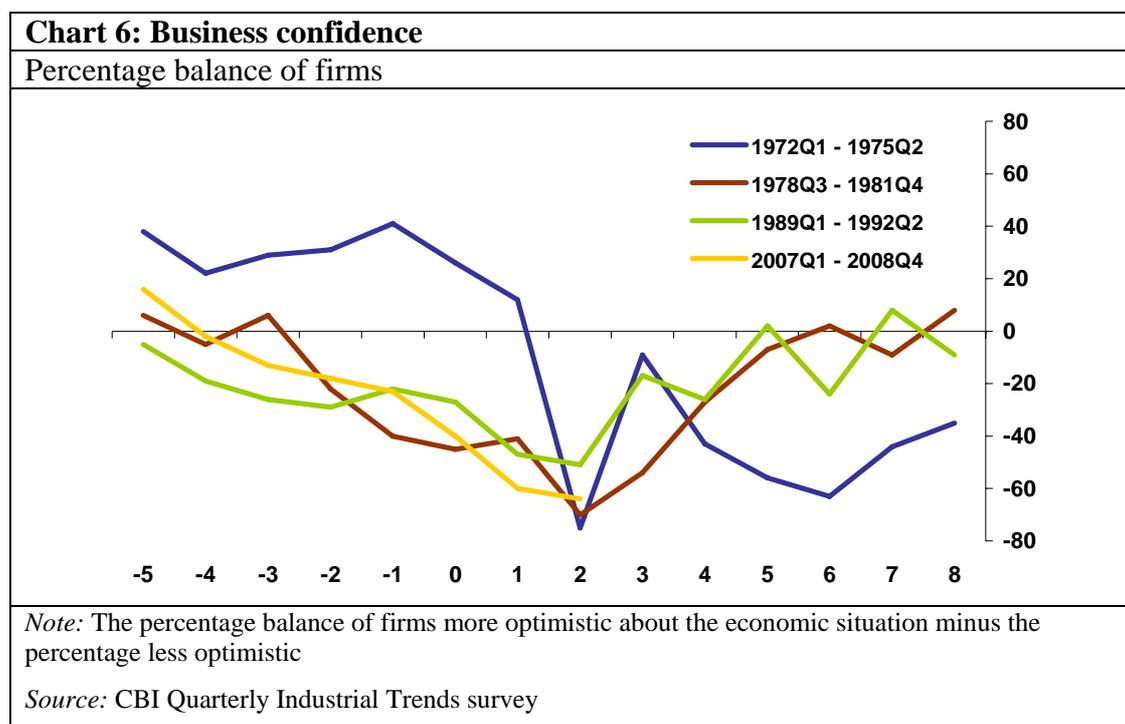
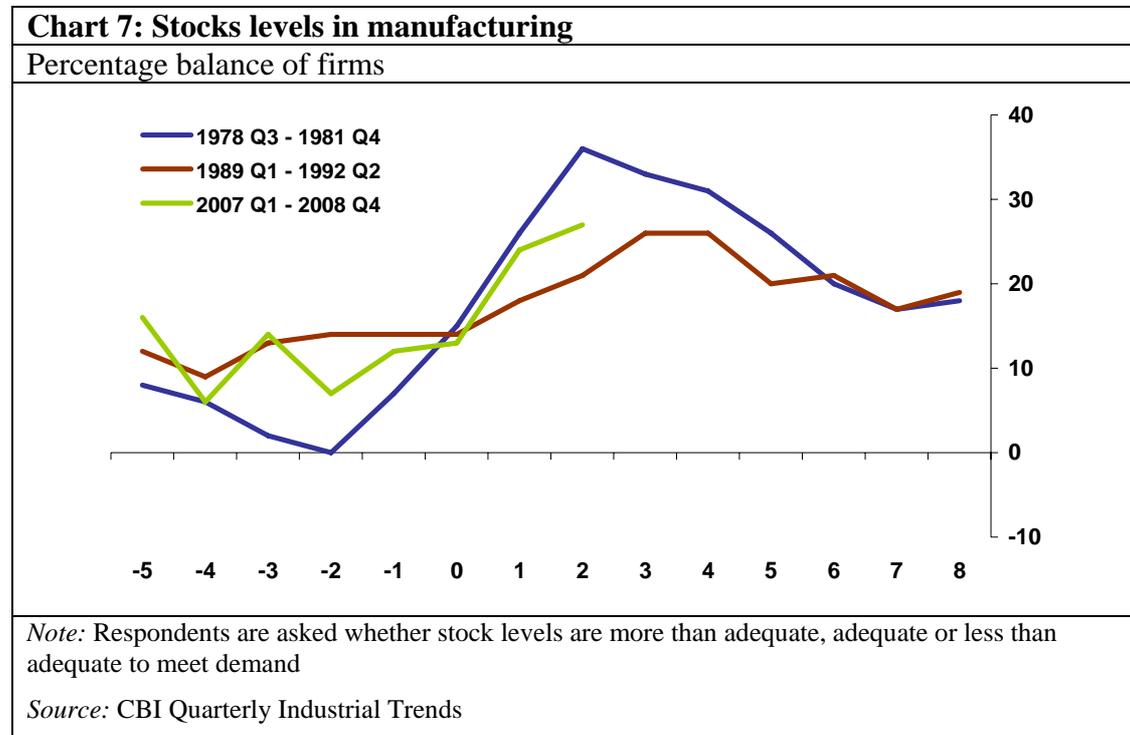


Chart 6 shows that in the run-up to recession and in the first two quarters of the current downturn, the CBI confidence indicators have tracked very closely their performance in the last two recessions – and the latest responses to the survey are very much in line with the very low levels seen at the same stage of the mid-70s recession.

As the economy bottomed out in earlier recessions, these business confidence responses became less negative, though this improvement was not initially sustained in the mid-1970s as the recession took a further dip as the world economy turned down in late 1974 and early 1975. So if the UK economy is bottoming out towards the middle of this year, as the *Inflation Report* central projection suggests, we should

At the end of 1991, David Smith, Economics Editor of the Sunday Times, concluded that the CBI had produced the most accurate forecasts of the UK economy for 1991 (see Sunday Times, 29 December 1991: “Forecasters with egg on their faces”).

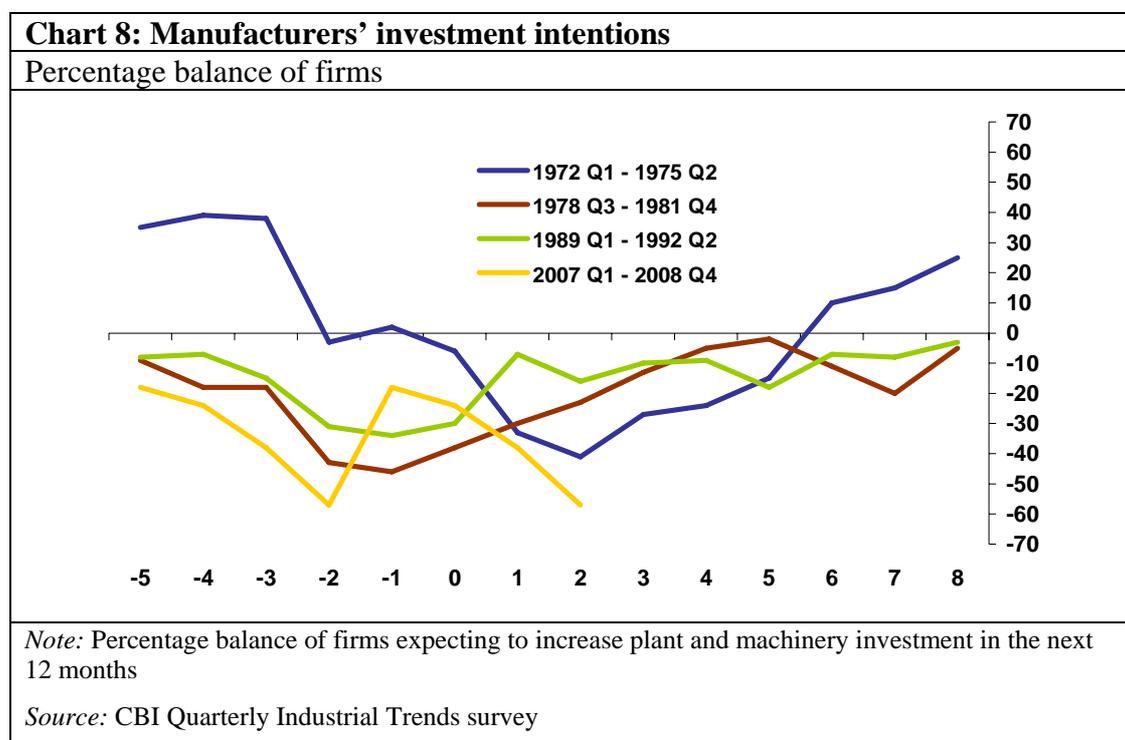
expect to see an improvement in business confidence measured by the CBI Industrial Trends Survey and other business surveys. Continued extreme weakness of business confidence into the second half of this year would be a signal that the recession was going to be more prolonged and possibly deeper than previous downturns.



The CBI Industrial Trends Survey also helps us to track the impact of the stock cycle and calibrate it against the experience of earlier recessions. Chart 7 shows manufacturers' responses to the survey question about whether stock levels are adequate, more than adequate or less than adequate to meet demand. According to the latest surveys, the build-up in stocks shown by this evidence is more noticeable than in the early 1990s, though not quite as dramatic as we saw in the early 1980s recession – suggesting improvements in inventory management over the last few decades.

Again, past experience suggests we should expect to see some levelling off and eventual decline in these responses about excessive stock levels as we move through the year if the pattern of earlier recessions is repeated. An end to aggressive de-stocking, which tends to reinforce the downturn in output in the early quarters of a

recession, would reduce the negative influences on GDP – helping to stabilise output and provide a platform for recovery.



Investment always plays a key part in recessions as decisions to postpone capital spending in the face of increased uncertainty and a lack of confidence adds to the downturn of demand. This recession is no exception, and the investment intentions responses from the CBI Industrial Trends Survey are shown in Chart 8, again aligned with equivalent data from earlier recessions. So far, these investment intentions have been generally more negative than we have seen in earlier recessions, and the latest responses were record lows in the history of the CBI Industrial Trends Survey. This could reflect both the very sharp synchronised deterioration in the demand climate worldwide and the financial constraints imposed by banks, as the responses on the lack of availability of external finance are now at record highs⁴.

Again, however, there is a consistent pattern from earlier recessions of investment intentions becoming less negative as the economy bottoms out and begins to move

⁴ In October 2008, 16% of firms reported external finance as a constraint on investment, and in January 2009 the proportion was 15%. These are the highest responses since 1979 when the question was first asked.

into the recovery phase. As in the case of business confidence and stock levels, this will be a key indicator to watch as we move through this year.

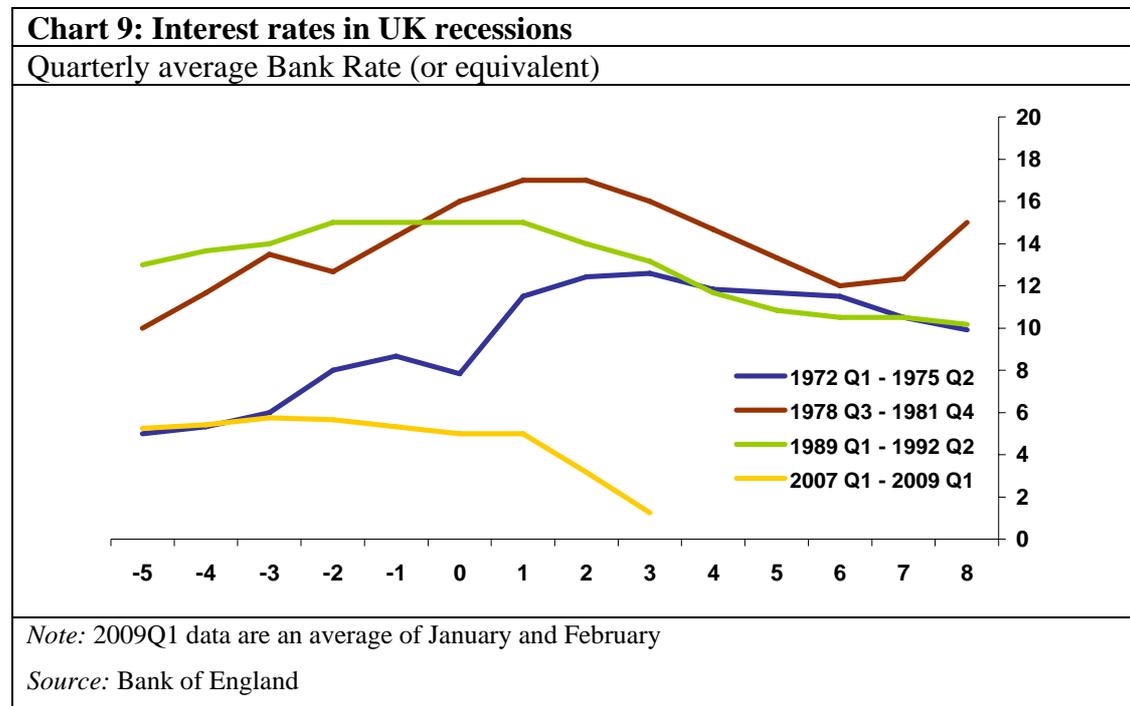
So far, these survey indicators seem to be broadly consistent with the central projection for GDP growth set out in the Bank's latest *Inflation Report* forecast. The global financial crisis and the synchronised global downturn is producing a recession which is relatively severe compared to past precedents – but not yet clearly worse than the mid-1970s and early-1980s downturns in output. The pattern of past recessions suggests we should expect to see key survey indicators for business confidence and investment intentions improving as we move through the year, together with indications that companies are becoming more comfortable with their stock levels. Uncertainty about whether this will occur in the current climate of global financial volatility and impaired bank lending underpins the downside skew to the risks around the central *Inflation Report* projection.

Monetary policy challenges

As the recession took hold last autumn, a key challenge facing monetary policy-makers around the world was to adjust the settings of monetary policy to a radically changed economic situation. Last summer, the MPC and other monetary authorities faced an uncomfortable combination of slowing growth and rising inflation – driven by sharply rising global energy and other commodity prices. There was a need to reinforce expectations of low and stable inflation when headline measures of inflation were rising sharply, and consumers could see this very visibly – through rising food and petrol prices and higher energy bills.

Those inflationary concerns receded rapidly over the autumn as it became clear that global energy and commodity prices were falling sharply and that the weakness of demand – at home and abroad – was set to become the dominant influence on the domestic rate of inflation. Consistent with the remit of the Monetary Policy Committee to keep inflation in line with the 2% target over the medium term, interest rates have been brought down from 5% to 1% in the space of four months. Notwithstanding the current pressures within the banking system which are affecting the availability of credit, we should expect this relaxation of monetary policy to

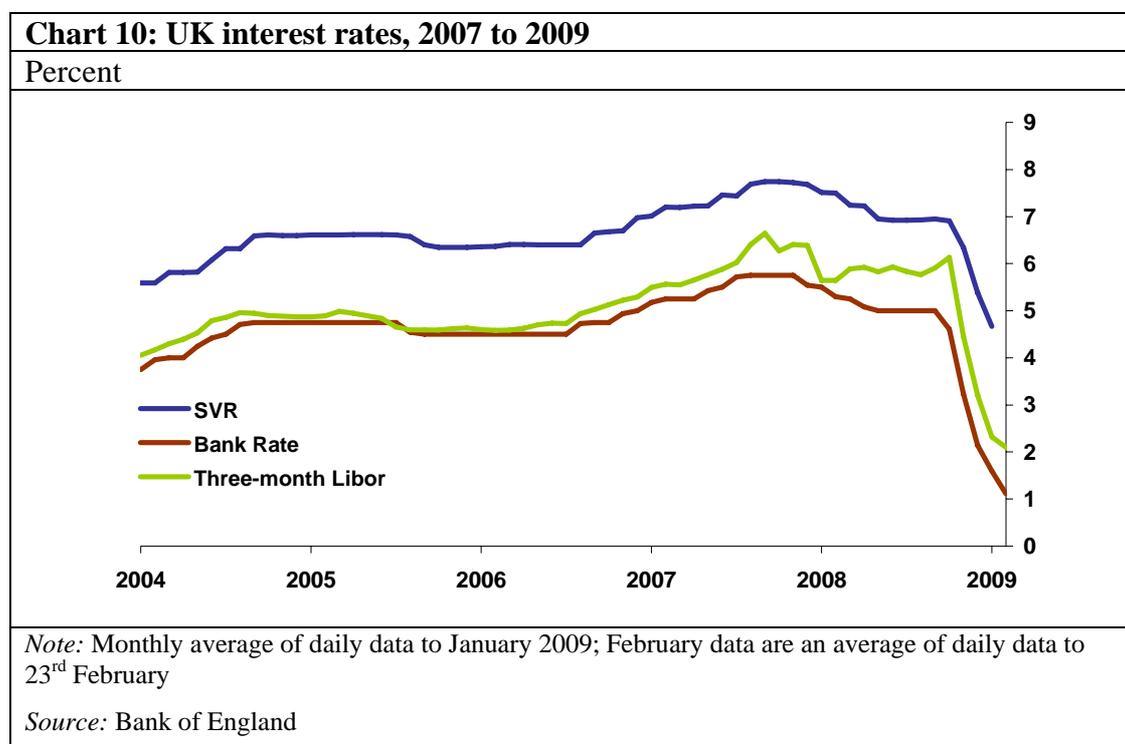
provide support to spending as we move through the year – and help offset some of the other negative recessionary pressures on demand and output.



Judged in terms of the movement of short-term interest rates, monetary policy has been relaxed in a much more timely fashion than in earlier UK recessions – as Chart 9 shows. Indeed, in the early 1980s recession, interest rates were rising early in the recession – reaching a peak of 17% at the time when output was contracting most sharply. Relative to previous recessions, the timing of interest rate reductions has been earlier in the current downturn and the scale of the reduction has been greater. This has brought UK interest rates down to their lowest level for at least 300 years.

The ability of the MPC to reduce interest rates so quickly and significantly as the economy moved into recession reflects the fact that we are not having to hold back monetary easing because of concerns about inflation, as has been the case in all three previous recessions. We also have the benefit of a stable and transparent monetary policy framework which has been in place for over a decade. That contrasts with the situation in previous recessions – when the monetary policy framework used to steer

the economy through recession was untried and untested – and lacked credibility as a result.⁵

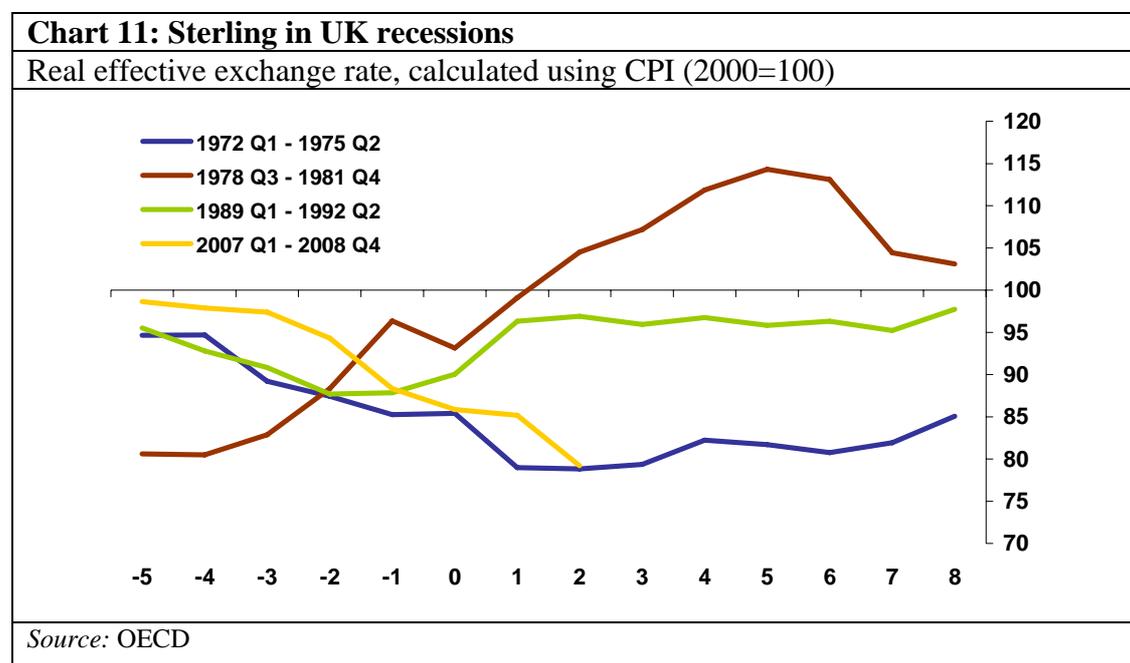


This lower cost of borrowing is now feeding through to consumers and firms, as Chart 10 shows. LIBOR – which underpins the pricing of a large part of bank lending to business – has fallen from over 6% last autumn to around 2% now. Mortgage rates have also come down for many borrowers, especially those on tracker mortgages. The standard variable mortgage rate has also fallen significantly since last autumn, as Chart 10 also shows. While there were concerns late last year about whether borrowers would indeed benefit from lower interest rates, there is now much more evidence that firms and households are seeing lower borrowing costs.

It will, however, take some further time for this monetary relaxation to have its full impact on the level of demand. In normal times, there is a lag of around 6-9 months

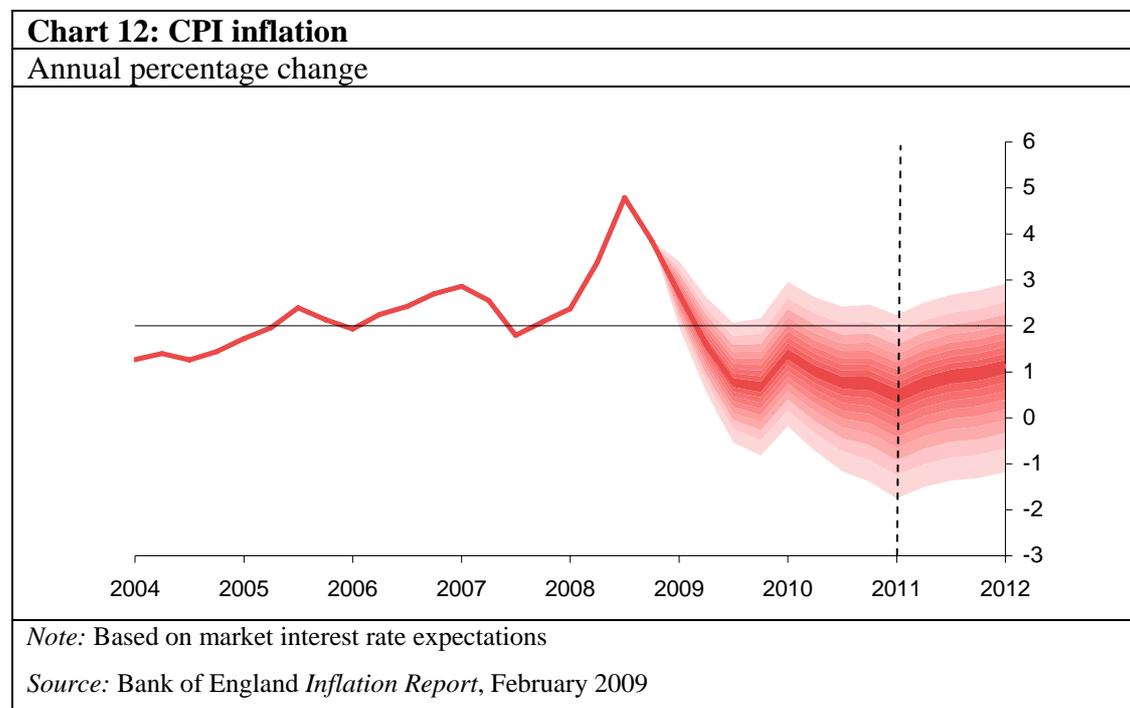
⁵ In both 1979 and 1990, a new monetary framework was put in place just as the economy moved into recession. In 1979, the incoming Conservative Government introduced a framework of monetary targets as part of its Medium Term Financial Strategy. In autumn 1990, sterling entered the ERM at a rate of DM2.95. Neither policy framework proved durable. In the mid-1970s, there was little attempt to use monetary policy to control inflation, with greater reliance being placed on incomes policy. This too met with little success.

between a change in interest rates and spending in the real economy. So it is too early yet for us to assess how far this relaxation in monetary policy is providing support for consumer spending and other elements of private sector demand. But by the middle of the year, this should be more apparent and some of the current mood of consumer pessimism associated with the onset of recession may have dissipated. Together with the boost to household disposable income from lower energy and other commodity prices, this should help support a more general turnaround in the economy as we move into the second half – which is reflected in the Bank’s central projection and many other forecasts.



In addition to the impact of lower interest rates on domestic demand, growth in the UK economy should receive additional support over the course of this year from a competitive pound. As Chart 11 shows, both in terms of the recent change in the value of sterling and its level in real terms, we are seeing a boost to competitiveness which we did not see in the early 1990s and early 1980s recessions. It is true that manufacturers and other sectors trading on overseas markets did benefit from a similar competitive boost in the mid-1970s. But British industry was then being held back by a set of problems which became known as the “British disease” – low productivity, bad industrial relations and lack of non-price competitiveness.

The manufacturing firms I have visited over my period of two and a half years on the MPC should be well placed to benefit from a more competitive level of the pound. The modern face of British manufacturing is based on investment in high-tech capital equipment, innovation and skills and benefits from a much more flexible labour market than we had in the 1970s and 1980s. Until recently, the main concern about the ability of these firms to expand and deliver a bigger contribution to the UK economy was lack of capacity. But that is not the issue now, with 70% of manufacturing firms working below capacity according to the January 2009 CBI Industrial Trends Survey. Over a period of time, a competitive pound puts British manufacturing in a much better position to win new markets at home and abroad - mitigating the negative impact of the recent sharp downturn in global demand.



Though a considerable monetary stimulus is in the pipeline from lower interest rates and a competitive pound, the latest *Inflation Report* projections show that inflation is very likely to be below the 2% CPI target over the next two to three years, as Chart 12 shows. If the recession is prolonged and deep, there is an increased risk of deflation. On an objective assessment of probabilities, a persistent and prolonged deflation still remains an outside risk, in my view. But there is a strong case for providing additional stimulus to the economy to head it off more decisively, as well as helping to limit the potential long-term damage to the UK's supply capacity from a prolonged

and deep recession. With interest rates approaching the zero lower bound, that would point to the potential use of “quantitative easing” – expanding the money supply directly.

Because we have little experience of the deployment of quantitative easing, any move to adopt this form of stimulus will be a step into the unknown. It is therefore important that the MPC operates such a policy under a clear and transparent framework, agreed with the Chancellor, as with our existing interest rate policies.

It is also important to emphasise that the operation of quantitative easing does not change the objective of policy – which is to maintain price stability, as defined by the inflation target. However, the ability to deploy quantitative measures to expand the supply of money would give the MPC an additional tool to limit the downward pressures on demand resulting from the financial crisis and the global recession. That, in turn, should boost confidence in the eventual recovery in the UK economy and head off deflationary risks.

The recession and the current monetary framework

The theme of my talk today has been the challenges for monetary policy posed by the current recession. I have argued that while the downturn is being driven by a financial crisis of a type we have not seen in post-war economic history, our experience of the current recession in the UK is not – so far – out of kilter with earlier post-war recessions. The pattern of a quick move from healthy growth to outright recession is similar to the experience of the mid-1970s and early-1980s, and the severity of the downturn in output so far also calibrates reasonably well with these earlier episodes.

Policy-makers in the UK and around the world are deploying the tools we have available to counter the negative impact of the global financial crisis and the big shocks to confidence last autumn. That includes a very significant relaxation of monetary policy, which we have been able to use more aggressively than in past recessions because of the absence of underlying inflationary pressures. Measures have

also been taken by governments around the world to recapitalise and stabilise the banking system and relax fiscal policy.

So while the short-term prospect is not good and we will see further falls in output and rises in unemployment, I believe there are good grounds for expecting a recovery both here in the UK and in the global economy more broadly as we move through this year and into 2010.

But there is another challenge to monetary policy which has surfaced as the recession has taken hold. Surely this was a recession which was not meant to happen. Previous UK recessions were associated with inflationary boom-bust cycles which our monetary policy framework aims to prevent. Should not our current monetary policy regime more effectively shielded us against this recession too?

In my last speech, in December last year⁶, I tried to answer this question, by drawing a distinction between previous inflationary cycles which have precipitated earlier postwar recessions and the financial cycle which has led to this current recession. While sound monetary policy is well-placed to control inflation and prevent inflationary cycles, unfortunately it cannot remove all forms of economic volatility.

Despite the current recession, I still believe that the operation of monetary policy under the current framework of inflation targets has helped greatly to stabilise the UK economy compared with the inflationary boom-bust period of the 1970s, 1980s and early 1990s. Monetary policy can – over a suitable period of time – maintain price stability broadly defined. But we must beware of asking domestic monetary policy to do too much. Monetary policy cannot also single-handedly maintain the broader stability of the financial system or avoid all recessions. Economies experienced cycles and recessions going back to biblical times – long before inflation became a problem in the 1970s. And we can see in the current episode two of the key drivers of those earlier cycles at work – commodity price movements and financial instability.

⁶ “The current downturn: A bust without a boom?” Speech to MPR Monetary Policy and the Markets Conference, 9th December 2009

The period of the “great stability” – which goes back in the UK to the early 1990s – was associated with an unusual degree of stability of both inflation and output growth. Some of this reflected the better conduct of monetary policy. But it was also a product of the circumstances of the time – what is sometimes characterised as “luck”. Looking ahead, we should not always expect inflation to track as closely to the target as it did between 1997 and 2007, particularly when faced with the recent shocks we have seen in the global economy. Our recent *Inflation Report* forecast is – I believe – partly an honest admission of that difficulty in the current climate. And even if monetary policy is successful in stabilising inflation and maintaining price stability over the medium-term, which it should be able to achieve, occasional recessions will still come along – often when they are least expected or from a direction which we had not foreseen. However, good monetary policy should help ensure that additional macroeconomic volatility is not generated by high and unstable inflation rates – and that the frequency of recession we experienced from the early 1970s to the early 1990s, when one calendar year in every four was a recession year, is not repeated.

As I argued last December, the current recession comes on the back of the second longest sustained period of economic growth since the mid-19th century and that in itself is no mean achievement. I would hope that when we have recovered from the current recession, we can embark on another long economic expansion in which prosperity rises and employment prospects become more secure. But if we do, we should always remember that such sustained economic expansions do eventually come to an end. And they can be brought to an end by behaviours which are themselves encouraged by the experience of a long period of growth. The long expansion we saw in the 1950s and 1960s resulted in a sustained build-up in inflationary pressures which was responsible for at least two of the previous three UK postwar recessions. And the financial excesses of the recent period of sustained global economic growth have sowed the seeds of the current recession.

There are clearly lessons to be learned from the current financial crisis which has driven the current recession. There are important lessons about the operation of banking regulation in a global and liberalised financial system. There are very important lessons to be learned by banks themselves about their own attitudes to risk and mechanisms for managing complex financial instruments. There are lessons to be

learned about way in which we seek to manage a more integrated global economy and the financial imbalances it has thrown up.

If there is a general lesson for monetary policy-makers from this financial crisis and the resulting recession it is a sense of humility. Like the bankers, we are not the Masters of the Universe either. But neither are we powerless to influence the course of economic events. Monetary policy can still make a substantial contribution to economic stability in the UK and elsewhere. In the short-term, that means supporting the UK economy with monetary easing in this difficult recession. And in the long-term it means keeping the focus of monetary policy on price stability – which makes a vital contribution to broader economic stability. That was an important lesson we learned in the wake of the previous three UK recessions and we must not forget it in this one.