Speech by

ANDREW SENTANCE

MEMBER OF THE MONETARY POLICY COMMITTEE

BANK OF ENGLAND

PROSPECTS FOR GLOBAL ECONOMIC RECOVERY

British Chambers of Commerce Annual Convention, London

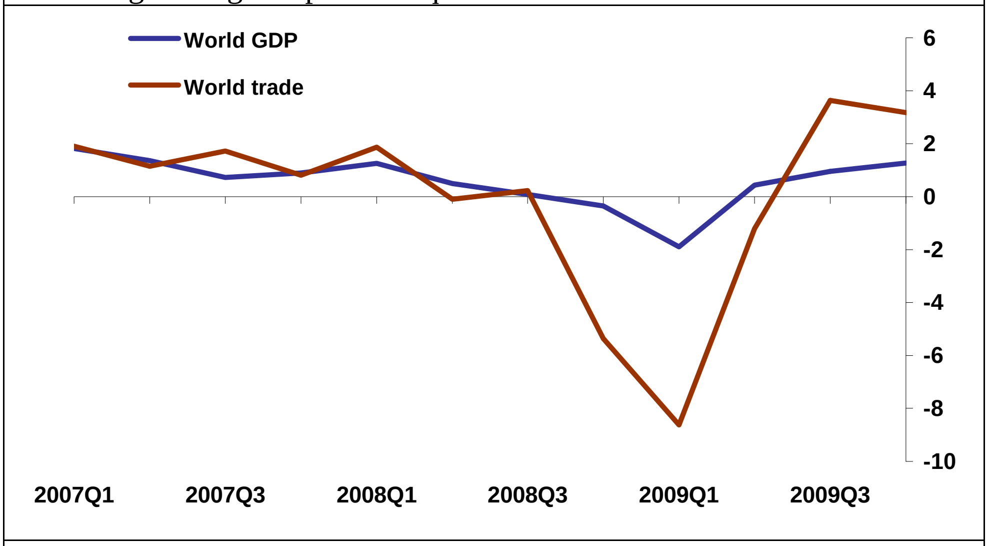
18 March 2010

I would like to thank Michael Hume and Abi 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.

Over the three-and-a-half years I have spent so far on the Monetary Policy Committee, one of the things that has struck me most forcefully is the way in which the UK economy is so heavily influenced by international developments. The global financial crisis and the recession which resulted from it have highlighted that very clearly. But even before we felt the full force of the crisis in late 2008 and early 2009, UK inflation was pushed up to over 5% by a surge in global energy and commodity prices. And looking back over the whole history of the MPC since 1997, most of the shocks to UK growth and inflation that the Committee has had to worry about have had a significant international or global dimension.[1]

These global influences on the UK economy partly reflect our economic history. Flows of overseas trade, investment and finance have played a major part in shaping the development of the British economy, creating a highly international business and financial environment here in the UK. But links to the global economy have also been strengthened by globalisation, which has reinforced international linkages across the world economy as the global economic system has become more integrated and interdependent.[2]

Chart 1: World GDP and trade bouncing back
Percentage change on previous quarter



Note: Based on world GDP at PPP and UK weighted world trade
Source: Bank of England calculations

[1] Key global economic disturbances over this period include the Asian crisis (1997/8), the bursting of the "dotcom" bubble followed by the impact of 9/11 and war in Afghanistan and Iraq (2001-3), and oil and commodity price volatility in the mid-2000s.
[2] I have discussed the impact of globalisation in more detail in earlier speeches. See, for example, "Monetary Policy in Turbulent Times" (21 April 2009) and "Energy and Environmental Challenges in the New Global Economy" (21 September 2009), both available on the Bank of England website: http://www.bankofengland.co.uk/publications/speeches/speaker.htm#sentance

The performance of the global economy is therefore critical to the prospects for UK recovery. And it is therefore very encouraging that the global economy has bounced back strongly following the sharp contraction in output and trade in late 2008 and early 2009. As Chart 1 shows, the growth of world GDP in the second half of last year has returned to around its pre-recession growth rate and world trade has also bounced back strongly. This recovery in the world economy appears to have continued into the early months of this year. For example, the volume of international air traffic, which is highly sensitive to world growth trends, was 6.4% up on a year ago in January 2010.[3]

Despite the gloomy headlines surrounding the release of the latest UK trade figures last week, the UK economy is benefiting from this revival in world trade and activity. The latest trade data show that since the second quarter of last year, the volume of UK goods exports, excluding oil and erratics, have risen 8.5%.[4] This is equivalent to an annual growth rate of 15% – around three times the trend rate of UK export growth since the early 1990s.[5] But imports have bounced back too, which is why the trade deficit is not shrinking at present. In the short-term that should not be a source of concern – rising imports at this stage of the cycle are usually a sign of a recovery in demand and a turnaround in the stock cycle. But over time, we should see rising exports helping to close the UK's trade deficit. The very positive responses on export orders and confidence shown by a range of recent business surveys suggest that there is a significant further boost to our international trade performance on the way – supported by the competitiveness benefits of sterling's depreciation since mid-2007.

This bounceback in the world economy is much stronger than we might have expected a year ago.[6] So what has been driving it? And how resilient might it prove to be?

In my view, three main factors have been driving the recovery over the last year – a bounce back in business and consumer confidence, strong growth in Asia and other emerging markets, and the impact of policy stimulus. These three factors will also have a key bearing on future global economic prospects, and I will discuss them briefly in turn.

---

[3] See http://www.iata.org/whatwedo/economics/ for data compiled by the International Air Traffic Association (IATA)

[4] The 8.5% increase relates to the seven-month period Q2 2009 to Nov-Jan 2010.

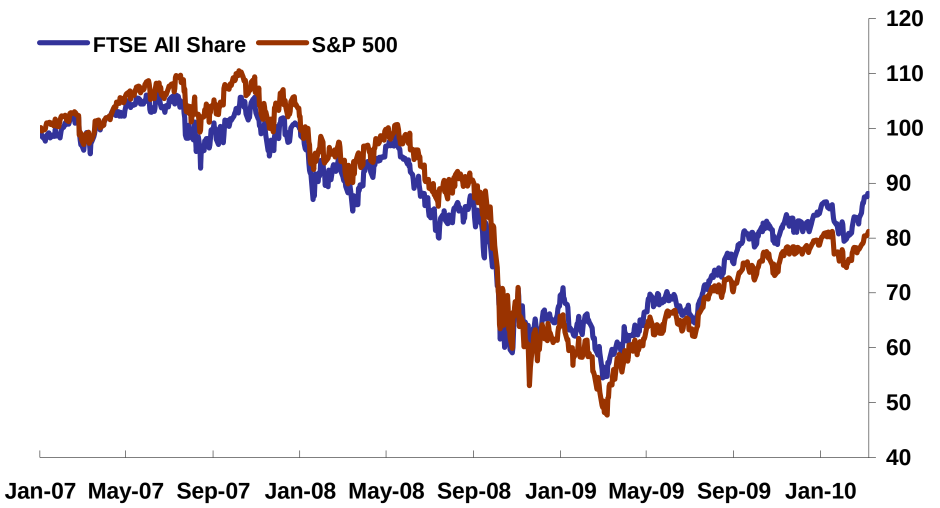
[5] UK exports of goods and services grew in volume terms by 5.4% per annum from 1992 to 2007; exports of goods excluding oil and erratics increased by 4.5% over the same period.

[6] This has been reflected in an upgrading of world growth forecasts for 2010. For example, the IMF forecast of GDP growth across the world economy this year has risen from 1.9% in April 2009 to 3.9% in its latest *World Economic Outlook* (January 2010).

Recovery in confidence

A key factor which plunged the world economy into recession was the massive shock to business and consumer confidence across all the major economies of the world when the global financial system appeared to be rocking and reeling in late 2008 and early 2009. Since then, confidence has gradually recovered as the financial system has stabilised and the shock waves from the traumatic events of eighteen months ago have subsided.

Chart 2: Equity markets recovering
Index, 1 January 2007 = 100

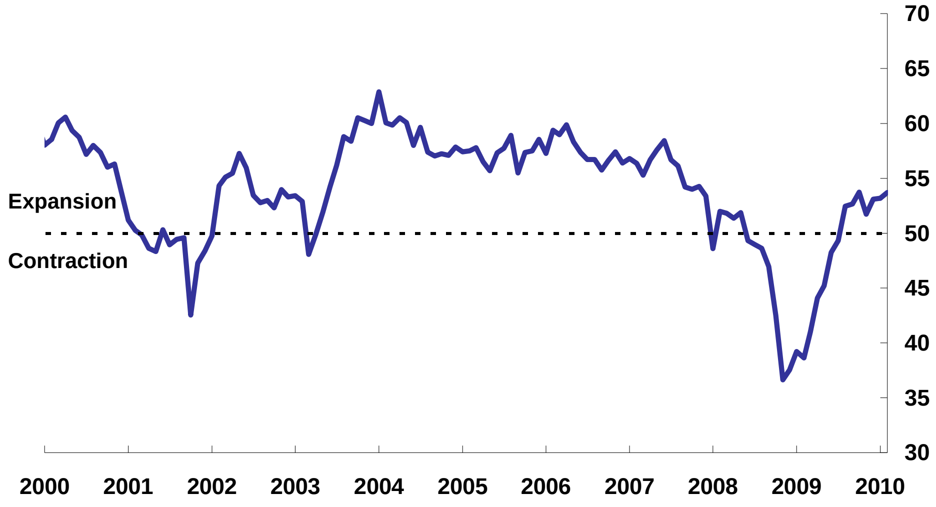


Source: Thomson Datastream

One indicator of this recovery in confidence is the performance of stock markets, reflecting an improving assessment of business prospects. As Chart 2 shows, equity markets in the UK and US have recovered by around 60% from their troughs about a year ago.

Alongside this improvement in financial market confidence, business survey indicators have also been improving across the global economy. Chart 3 shows a composite measure of surveys of purchasing managers from the major world economies. The very negative readings of around a year ago have given way to responses which are consistent with rising activity and the expectation of future growth.

Chart 3: Business surveys pointing to recovery
Global purchasing managers' index – manufacturing and services activity

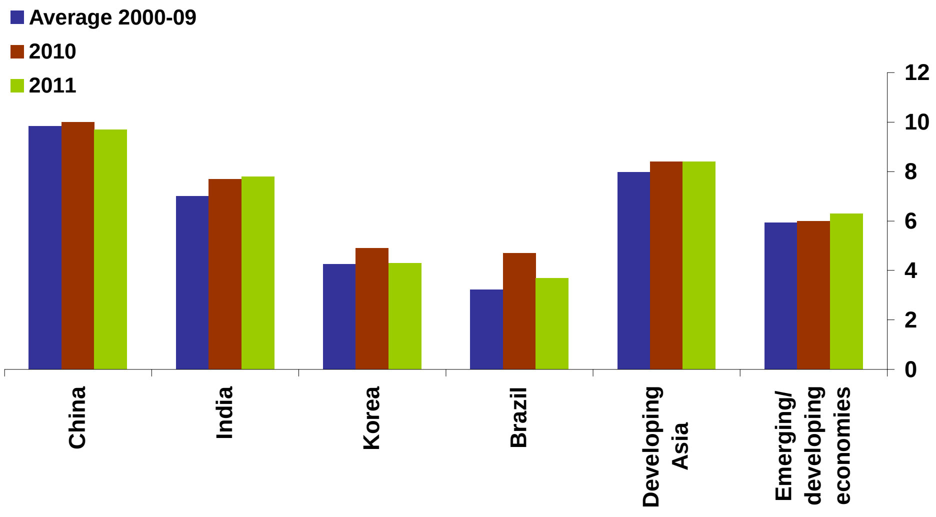


Note: Index number over 50 indicates expansion; below 50 indicates contraction

Source: Thomson Datastream

The natural momentum of a recovery is that, as growth continues and memories of the recession fade, both consumer and business confidence will continue to build. Over time, cutbacks in investment by firms and the deferral of major consumer purchases will begin to reverse. As a result, we should expect both consumer and investment demand to gradually strengthen as long as new shocks to confidence do not emerge.

Chart 4: Growth forecasts for Asia and Emerging markets
Annual percentage growth rate



Note: 2010/11 forecasts are based on Jan 2010 update excluding Korea which uses March 2009 consensus forecasts

Source: IMF World Economic Outlook, Consensus Forecasts

Growth in Asia and emerging markets

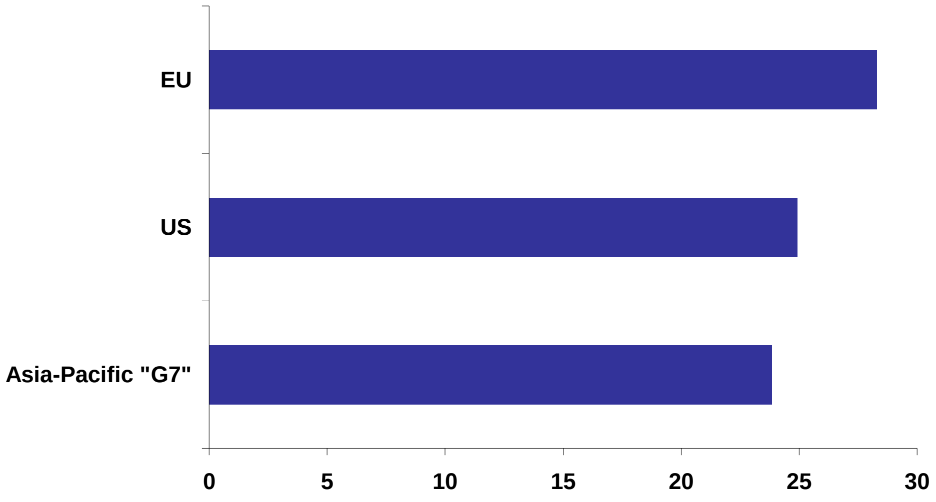
Alongside this general recovery in confidence, a key engine of the world recovery has been a strong rebound in Asia and many other emerging market economies. As Chart 4 shows, forecasts for growth this year and next in the major Asian markets - and in developing and emerging market economies as a whole - are for a continuation of the healthy growth rates seen in these economies throughout the past decade.

There are good grounds for believing that this strong performance in Asia and other emerging markets will continue to be an engine of world economic growth as the recovery continues. First, there are healthy supply-side fundamentals in the economies of Asia – a large potential labour supply, with the region accounting for about half of the world's population, and scope for continuing productivity catch-up with the more advanced economies. Second, governments in Asia and many other emerging market economies remain committed to market-oriented policies and continued integration into the world trading system, which has proved an important underpinning for rapid growth and development in the past.[7] Third, public and private finances are generally in good shape. The banks and other financial institutions in the major Asian economies were not directly affected by the crisis in the same way as the financial sector in the US and Europe. Government finances have also started from a stronger position, which means that fiscal policies can continue to support private sector demand and there is much less need for serious fiscal retrenchment as a result.

These strong demand and supply-side fundamentals help to mitigate concerns that the impetus from Asia and emerging markets will quickly fizzle out, or that it will be undermined by the re-emergence of global imbalances. And the increasing importance of Asia in the world economy means it is now a material influence on the growth of the world economy. As Chart 5 shows, the seven largest economies in the Asia-Pacific region, including India, China, Japan and Australia, now account for close to a quarter of world GDP – not far short of the contribution to world GDP from the United States and the European Union.

[7] See, for example, *The East Asian Miracle: Economic Growth and Public Policy*, World Bank, 1993

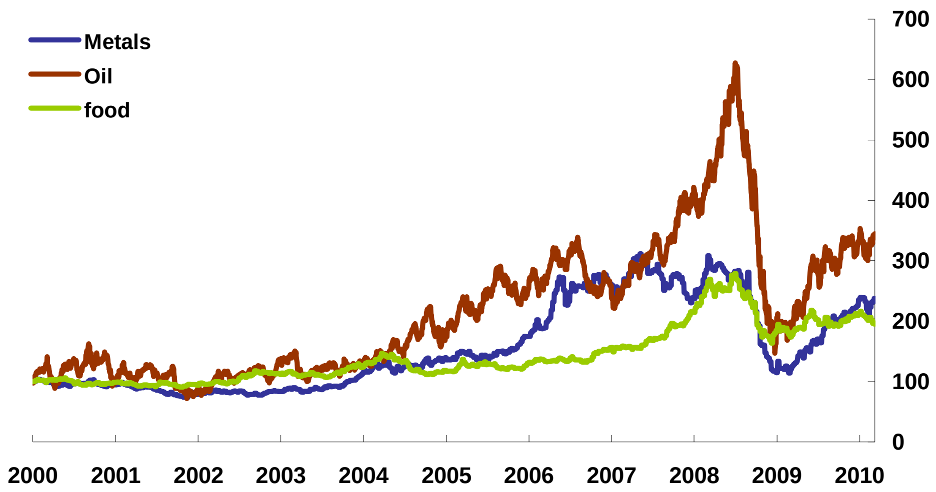
Chart 5: GDP in Asia Pacific, US and EU
Percent of world GDP



Note: Asia Pacific "G7" includes Australia, China, India, Indonesia, Japan, Korea, Taiwan. All data are based on market exchange rates.
Source: IMF World Economic Outlook, October 2009

Indeed, there is a worry that growth in Asia and other emerging markets may prove too strong, fuelling the growth of asset prices and putting upward pressure on global energy and commodity prices. As Chart 6 shows – the strong growth in developing economies and emerging markets in the mid-2000s was associated with significant upward pressure and volatility of oil, food and metal prices.

Chart 6: Oil and Commodities prices
Exchange traded commodities, index 1 Jan 2000 = 100



Note: Oil price is Brent forward price for delivery in 10-21 days time
Source: Thomson Datastream

Recent movements of the oil price have been very sensitive to news about the pace of global growth, and commodity prices have picked up more generally as growth has returned to the world economy. If the momentum of the global recovery is sustained, there is a risk of further upward price pressure from this direction, with a knock-on impact on broader measures of inflation around the world.

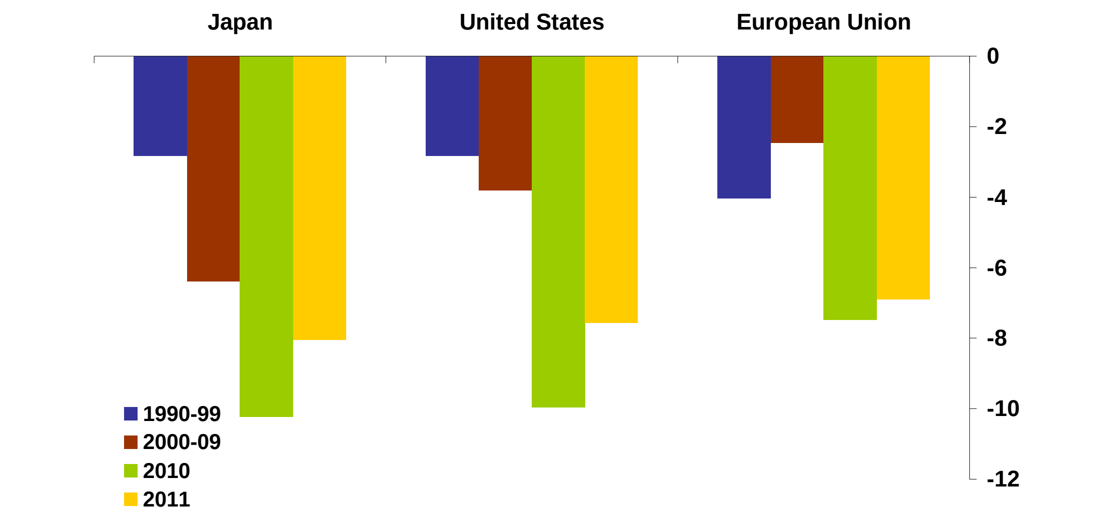
The role of economic policy.

The third engine of growth in the world economy at present is the stimulus provided by a range of policy measures. Economic policies have played a role in stabilising world economic and financial conditions in three ways: first, by direct interventions to underpin the stability of banks and the financial system more generally in many economies; second, through stimulatory fiscal policies; and third, through supportive monetary policies – very low interest rates and direct injections of money to support demand in a low interest rate climate, such as the MPC's policy of "Quantitative Easing".

However, the current level of stimulus from monetary and fiscal policy was designed to turn around economies in the wake of the traumas we experienced 12-18 months ago. As confidence builds and private spending recovers, it is likely to be appropriate to gradually withdraw at least some of this policy support for demand, without jeopardising growth prospects.

The need to re-adjust economic policy is most obvious on the fiscal side, where deficits are very high by historical standards, particularly in the US, Europe and Japan – as Chart 7 shows. These large deficits reflect the important role that public spending and tax policies have played worldwide in stabilising economic conditions during the recession. But to ensure sustainable public finances over the medium-term, these budget gaps will need to be closed over the recovery.

Chart 7: Public sector deficits
General government balance, percent of GDP



Note: EU 2011 forecast is based on European Commission Autumn 2009 forecast

Source: IMF World Economic Outlook, October 2009, European Commission

In many countries, policy-makers are rightly concerned about the negative consequences for demand of tightening fiscal policy too quickly and abruptly while the recovery is still fragile. But a tightening of fiscal policy which is pursued as part of a longer-term, credible and well worked-out plan is much less likely to have such negative demand-side effects, and may have offsetting benefits for the supply-side performance of the economy.

Progress in putting public finances on a sounder footing can increase confidence and reduce uncertainty about future economic prospects, providing a much better climate for a recovery in private sector demand. It can also support the supply-side performance of the economy by helping firms and individuals plan for the longer term. The effects of deficit reduction on financial markets should also be positive for private sector demand. Long-term interest rates are likely to be lower in a world in which government deficits are being reined in, and the risk of destabilising financial market movements is also reduced. Again, this is likely to provide a much better climate for private sector investment and long-term spending and planning more generally.

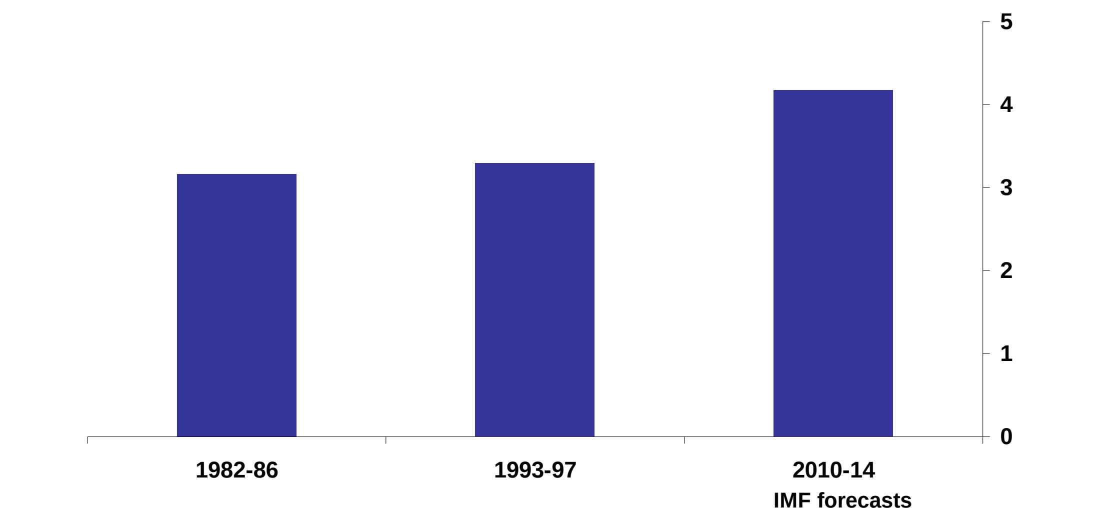
An additional mechanism through which the negative demand-side consequences of fiscal tightening can be offset is by maintaining a relatively loose or relaxed monetary policy. So the other arm of withdrawing policy stimulus – a tightening of monetary policy – needs to take into account the potential impact of deficit reductions on demand, activity and inflation. What this implies for the monetary stance and the level of interest rates will inevitably vary between countries and regions as different monetary authorities make their own judgements about the pace and extent of tightening appropriate to their own circumstances. Indeed, some monetary authorities in the Asia-Pacific region, where growth has been stronger and inflationary worries greater, have already begun to tighten policy.

Elsewhere, in the UK and many other major economies, the current settings of monetary policy still reflect the aggressive loosening of policy to counter the severe downside risks of the recession a year ago. As these downside risks recede and recovery becomes more firmly established, it will be important to reassess how much of that stimulus is still needed to keep the economy on a steady course consistent with low inflation.

Conclusion

The turnaround in the global economy over the last year has been quite impressive, given the scale of the shocks from the financial crisis. That should give us grounds for encouragement that continued growth in the global economy will provide a supportive backdrop for recovery in the UK – even if some of our important markets, such as the economies of the euro area, may be turning around more slowly. Indeed, the IMF's medium-term forecasts for the world economy over the next five years point to stronger global growth than we experienced in previous recoveries from the major recessions in the 1980s and 1990s, as Chart 8 shows.

Chart 8: Global recoveries compared
Average annual percentage growth in world GDP



Source: IMF World Economic Outlook, October 2009

But there are also many uncertainties affecting the current outlook for the global economy and I would highlight four key influences which will shape the recovery which does unfold over the next few years.

First, I have argued that an improvement in business and consumer confidence has been a key ingredient in the economic turnaround so far. And in the absence of further shocks to the global economic system, we should expect confidence among firms and households to continue to recover, supporting the growth of private sector spending and helping the recovery to build momentum. But given our experience in recent times, we cannot rule out new shocks which could set back recovery.

Second, a major financial adjustment is taking place in the major economies of Europe and the United States as banks adjust their lending behaviour and seek to rebuild their balance sheets. This adjustment will continue to dampen the recovery in demand on both sides of the Atlantic too some degree, though its impact should lessen as the process of financial repair and rebuilding progresses.

Third, world growth in the recovery so far has been particularly strongly driven by the performance of Asia and other emerging markets, and their dynamism has to a large extent offset slower growth elsewhere. In my view this is not a flash in the pan, but a structural feature of the world economy that we are now living in, and we should expect a continuing impetus to global growth from this direction. However, as we saw in the mid-2000s, there is also the associated risk of upward pressure on inflation from global energy and other commodity prices, if the momentum of world growth becomes too strong.

Fourth, the high degree of stimulus provided by fiscal and monetary policy to combat the recession will need to be withdrawn over a period of time. Returning budget deficits to a more sustainable level will require a prolonged tightening of fiscal policy in many countries, including the UK. Monetary policy can provide an offset by continuing to support the growth of private spending – though the appropriate degree of monetary stimulus will need to be continually reassessed in the light of the progress of the recovery at home and abroad and its impact on inflationary pressures.

Given the turbulence we have seen in the major economies of the world over the last two years, it is very natural to worry about setbacks to the recovery, both in the UK and overseas. In the past, economic recoveries have not been smooth and linear. So we should expect to see some variability in growth rates, both at home and abroad, as this recovery develops. However, looking through this data volatility, there are also good grounds for expecting the growth of the world economy to continue to provide a healthy support to the UK's economic recovery over the years ahead. And, over time, that is likely to bring a different set of policy challenges to the ones we have been facing over the course of the recession.