Spencer Dale: 2009 – a review of the economic year

Remarks by Mr Spencer Dale, Executive Director and Chief Economist of the Bank of England, at the Chairman's Annual Breakfast, Essex Institute of Directors, Billericay, 2 December 2009.

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Introduction

Thank you for the invitation to speak to you this morning.

On the occasion of the Chairman's Annual breakfast, I thought it would be fitting to look back over the events of the past year. A year which started with our country – together with much of the rest of the world – in economic freefall. A year in which many firms and families suffered significant hardship, as output fell markedly and unemployment rose. But a year which is ending with signs that the economy is stabilising and has turned a corner on the road to recovery.

Financial crisis and collapse in confidence

The financial crisis obviously predates the beginning of this year. The first signs of the instability can be traced back to at least the summer of 2007, when the emerging sub-prime mortgage crisis in the United States and the resulting pressure on banks' balance sheets around the world led to a sharp tightening in the availability of credit. But the severity of the crisis increased dramatically following the failure of Lehman Brothers in the autumn of 2008. Confidence in the very essence of banking – as well as in individual financial institutions – was shaken to its core and the most severe banking crisis for almost a century was triggered.

As we now know, this led to a deep and highly synchronised global recession. Output in virtually every corner of the world fell sharply. Global trade flows contracted by a staggering 15% in the two quarters following the failure of Lehmans. Over the same period, output at home is estimated to have fallen by 4 1/4% – the largest fall in UK GDP over a two-quarter period since quarterly records began.

The speed and severity of the downturn cannot be explained solely by the tightening in credit conditions. The impact of the banking crisis was greatly amplified by the accompanying collapse in business and household confidence.

Firms' concerns about their ability to access the working capital needed to run their businesses was compounded by the bleak and uncertain prospects for demand. In response, production was slashed and business spending was severely curtailed. Stock levels were run down at an unprecedented pace, as companies met demand from existing inventories and economised on working capital. Faced with growing spare capacity there was little incentive for businesses to invest in new plant and machinery, and capital expenditure contracted by almost 20% in the first six months of 2009 alone. The retrenchment of companies was also evident in the labour market as firms laid off employees, reduced working hours and bore down on earnings. Wage freezes became commonplace.

Similarly, households pulled back sharply on their spending and increased their savings. This retrenchment by households was partially driven by the slowing in earnings growth and the fall in asset prices. But it was amplified by the pronounced rise in fears of unemployment and the increased uncertainty about the economic outlook.

Risk of vicious downward spiral

The fall in households' and firms' confidence proved mutually reinforcing and, to some extent, self-fulfilling: both households and firms expected conditions to weaken sharply and both cut back on spending. The contraction in consumer expenditure helped to validate firms' concerns about future demand. Likewise, the falls in employment and squeeze on incomes reinforced households' fears about future earnings prospects. And the worsening economic environment in turn exacerbated the weakness of the banking system. As the quality of banks' loan books deteriorated, the supply of bank credit tightened even further.

Individually, this pulling back on the part of households, firms and banks made sense. But, collectively, it threatened a vicious downward spiral: the fact that each part of the economy was retrenching at the same time risked a collapse of aggregate spending in the economy. In turn, this raised the spectre of price deflation and all its associated ills.

Policy response

In such situations, it falls to policy to break the ensuing vicious cycle.

This lesson had been sorely learned from the Great Depression. The magnitude of the shocks hitting the world economy over the past year or so – as measured for example by the initial contraction in global industrial production – appears comparable with the Great Depression of the 1930s.[1] But, in the Great Depression, global industrial output declined fairly continuously for three full years. In contrast, global industrial output on this occasion seems to have broadly stabilised in a little over a year.

There are many differences between now and the 1930s. However, I have little doubt that one of the key factors contributing to the quicker stabilisation of activity this time around has been the speed and decisiveness with which policy throughout the world responded to the twin threats of a failing banking system and falling confidence.

At home, the Monetary Policy Committee cut interest rates from 5% to 0.5% in just six months. And with interest rates close to their lower bound, the Committee in March of this year voted to start a programme of asset purchases financed by the issuance of central bank reserves, otherwise known as "quantitative easing".

These extraordinary actions were intended to reduce the risk of inflation falling below the 2% inflation target that the Bank of England is mandated to meet. They do so in a number of ways. The reduction in Bank Rate by lowering interest payments on loans has improved many companies' cash flows at a time when turnover is weak and working capital is scarce. A similar effect has operated for households: borrowers with floating rate mortgages in particular have seen their monthly repayments fall sharply. More generally, by reducing the returns on saving, the fall in interest rates has encouraged households and businesses to spend.

The MPC's programme of asset purchases has further stimulated demand by injecting additional money directly into the economy. The Bank's purchases of government bonds encourage investors to diversify into alternative assets, such as corporate bonds and equities. The Bank is also operating directly in commercial paper and corporate bond markets to improve the functioning of those markets. Both actions have helped to boost the prices of corporate assets, reducing yields and lowering the cost to companies of raising funds in capital markets. This in turn should help to stimulate increased spending.

The dramatic easing in monetary policy occurred alongside a range of Government policies. Most importantly, the Government's actions to provide both capital and liquidity were

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[1] See Eichengreen and O'Rourke (2009). Romer (2009) makes a similar point.

instrumental in stabilising the banking system. The temporary reduction in VAT and the car scrappage scheme have boosted household spending and provided short-term support to retailers and the car industry. And the Government's Business Payment Support Service has reportedly enabled almost a quarter of a million small and medium-sized firms to delay tax payments.

There are encouraging signs that these policy actions have been successful and the risk of a severe adverse feedback loop – as households, companies and banks simultaneously try to retrench – has been avoided. The banking system has stabilised. Measures of business and household confidence have recovered significantly. And the most recent ONS estimates for the third quarter suggest that the contraction in consumer and business spending may be beginning to abate.

Corporate liquidations and unemployment: better than feared

The prompt and large policy actions are likely to be one reason why corporate failures have, to date, not increased by as much as might have been feared. Although output has fallen by more than in either the 1980s or 1990s recessions, liquidations have risen by less than at the same stage of those downturns. Companies have benefited from the fall in debt servicing costs associated with the sharp reduction in Bank Rate and by the Government scheme allowing them to defer tax payments. And by supporting corporate credit markets, the Bank's asset purchase programme has also helped some firms to bypass banks and access capital markets directly. I fully recognise that the asset purchase programme has not been as of much help to many small and medium-sized enterprises – many of whom are represented here today – who are not able to access capital markets and are largely reliant on bank credit. However, I would contend that even the SME sector has benefited indirectly from the programme of asset purchases, such as from the accompanying fall in Libor rates.

In a similar vein, although there has been a substantial fall in employment over the past year or so, the extent of the job losses to date has, if anything, been less than we might have feared given the falls in output. This may partly reflect the greater degree of wage flexibility that has been apparent in this recession compared to that in either the 1980s or 1990s.[2] A substantial element of the workforce appears to have been able to protect their jobs by accepting slower wage growth.

By comparison with the past, these relatively limited increases in liquidations and unemployment are likely to have been important in mitigating the severity of the downturn. Large numbers of corporate failures are very damaging to the economy, with the loss of the skills and experience that firms have built up over the years, as well as of their investment in machinery and equipment, and with the shedding of jobs. Indeed, the relatively muted increase in company liquidations in this recession may have helped to limit the falls in employment. Moreover, the fact that more of the burden of firms' adjustment to the recession has been spread over the workforce as a whole in the form of lower wages, rather than being concentrated on those losing their jobs, is likely to have lessened the fall in consumption. This is both because households may find it easier to borrow to smooth their consumption if they still have a job and because it may have limited the extent to which households increased their savings as a precaution against the possibility of future job loss.

Structural adjustments

But the response of policy and the emerging recovery should not obscure the fact that structural adjustments need to occur in our economy. The banking system faces a significant

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[2] For more information see the box on page 29 of the August *Inflation Report*.

challenge to wean itself off the current substantial levels of official support and to return to a position in which it can lend normally. Households may need to re-evaluate their financial positions in the face of the more uncertain economic environment. And the need for a substantial reduction in the fiscal deficit is clear.

Monetary policy cannot and should not prevent those adjustments from happening. They are necessary for the long-run health and stability of our economy. Rather, the job of monetary policy is to ensure that these adjustments occur in as orderly a manner as possible and within an economic environment which is consistent with hitting the 2% inflation target.

Prospects for 2010 and beyond

So what does the next year hold in store?

The economy appears to have turned. Although output is estimated to have contracted in the third quarter of this year, there is a range of evidence from business surveys, from the Bank's regional Agents, and from recent indicators that the economy has begun to stabilise and that we are likely to be moving into a period of renewed expansion.

Whenever an economy is in recession, especially a recession as deep as this one, it can be hard to see where growth will eventually come from. However, as I have discussed, the easing in monetary and fiscal policy is providing considerable support to the emerging recovery. That stimulus is reinforced by the substantial depreciation of sterling. Sterling is around a quarter below its mid-2007 level and – as many of you here today will know from your own experiences – this has helped to improve the ability of UK companies to compete in both overseas and domestic markets. Output will also receive a further fillip as the adjustment of inventories by companies runs it course.

However, the on-going structural adjustments that I mentioned are likely to give rise to a number of economic headwinds that may impede the recovery. Credit conditions are likely to remain tight for some time as banks repair their balance sheets. And the need for public and household finances to adjust to the changed economic environment will weigh on spending.

Balancing these factors, my view of the outlook for GDP growth is in line with the projections contained in the Bank's *Inflation Report* published last month. It is likely that, as the recovery takes hold, output will grow at rates above its historical trend for a while. But this growth needs to be seen in the context of the sharp fall in the level of output over the past eighteen months and the margin of spare capacity that was opened up as a result. The recovery in the level of economic activity is likely to be relatively slow.

CPI inflation looks set to increase sharply in the near term, reflecting higher petrol price inflation and the reversal of last year's temporary reduction in VAT. Indeed, it is quite possible that the Governor will have to write a letter to the Chancellor early in the New Year explaining why inflation is more than one percentage point above the inflation target. But monetary policy can do very little to affect these short-term movements in inflation. Further out, the downward pressure from the persistent margin of spare capacity is likely to cause inflation to fall back below the 2% inflation target, although this pressure should gradually fade as the economy recovers.

Implications for policy

What implications does this have for the stance of monetary policy?

At our most recent meeting in November, the Monetary Policy Committee voted to maintain Bank Rate at 0.5% and to increase the scale of asset purchases to £200 billion. However, you may have noticed that there was a split vote amongst the Committee last month, and that I voted to maintain the scale of the asset purchase programme at £175 billion.

It is important not to make too much of this difference. I fully recognised the potential benefits of a more expansionary policy given the downside risks to the economy. However, I was also wary of the potential risks of such a policy. My main concern reflected the considerable uncertainty about the degree of spare capacity in the economy and the behaviour of inflation when output is growing at above trend rates. These uncertainties are always present, but come to the fore in situations like the current environment in which there is a very substantial degree of economic slack. In order to keep inflation on track to hit the inflation target this slack needs to be eliminated. However, given the uncertainties about the precise margin of spare capacity and the behaviour of inflation as this spare capacity is being closed, my preference was to aim to grow the economy a little less rapidly.

I was also concerned that further substantial injections of liquidity might result in unwarranted increases in some asset prices. I should stress that I do not think there is any strong evidence to suggest that any of the increases in asset prices seen to date are out of line with the improving economic outlook and the desired impact of our asset purchase programme. Rather, I was conscious that the current stance of monetary policy – in which Bank Rate is very low and substantial amounts of liquidity are being injected into the economy – increases the likelihood that asset prices may move out of line with their fundamental values and that this could be costly to rectify were it to occur. It is a risk that we need to be alert to.

However, as I suggested, it is important not to make too much of these differences; all MPC members – myself included – were of the view that a significant degree of monetary stimulus needed to be maintained in order to meet the inflation target.

Conclusion

The economy has come a long way over the past year. At the time of this annual breakfast a year ago, output was in freefall, the banking system was in near meltdown, business and consumer confidence had evaporated, and there was a very real risk of a serious economic depression. Monetary policy has played a critical role in the stabilisation of the economy. We have turned a corner on the road to recovery. But there is a long way to go with many challenges ahead as the economy moves into better balance. In facing these challenges, the Monetary Policy Committee will do whatever it takes to ensure that inflation remains on track to hit the target.

References

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