Andrew Sentance: The challenges of the "New Global Economy"

Speech by Mr Andrew Sentance, External Member of the Monetary Policy Committee of the Bank of England, at the Jersey Chamber of Commerce, St Helier, 25 May 2011.

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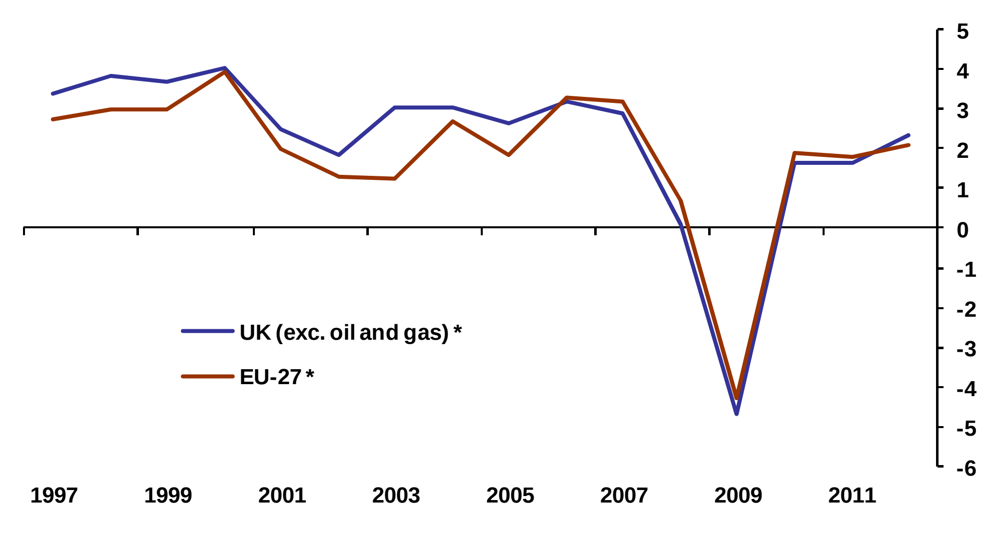
I would like to thank Adrian Chiu for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

It is a great pleasure to have this opportunity to speak here today at your Annual General Meeting lunch and I am extremely grateful to Ray Shead and the Jersey Chamber of Commerce for inviting me and helping to arrange this visit. For you here in Jersey, this event is a first – as I believe it is the first major speech which a member of the Bank of England Monetary Policy Committee has given in Jersey or any of the other Channel Islands. Hopefully I am blazing a trail for my MPC colleagues to follow in the future! For me, however, it marks the close of a chapter. This is my last public speech as a member of the Bank of England Monetary Policy Committee (MPC), as my term in office comes to an end this month.

I have spent just over four and a half years as a member of the MPC and it has been a most eventful period to be involved with economic policy-making. My period on the Committee has been dominated by the global financial crisis and the major global recession it triggered in late 2008 and early 2009. However, the global recession is now behind us, even if we are still feeling some if its after-effects. Since the second half of 2009, the world economy has been in a recovery phase and the UK and most other European economies have shared in this return to growth. Indeed, the growth of the UK economy has tracked very closely the average performance of the European Union through the recession and into the early phases of the recovery, as Chart 1 shows. And current forecasts point to a continuation of this pattern this year and next.

Chart 1 – UK and EU output growth, 1997–2012
Percentage change in real GDP



*:2011 and 2012 are IMF forecasts. Forecasts for the UK do not exclude oil and gas.
Source: ONS, IMF World Economic Outlook

In the UK, the rate of growth which we have seen over the early stages of recovery has not been spectacular, but that is not unusual in the early period of a return to growth after a major economic downturn. It is also not surprising that there have been variations in growth across different sectors of the economy and that confidence still remains fragile in the business community and among consumers. It is normally only 2–3 years into the recovery phase of the economic cycle that perceptions of improving economic conditions begin to catch up with the reality of a return to growth.

This strong correspondence between economic growth in the UK and elsewhere in the EU shown in Chart 1 should not be a great surprise. It reflects the close economic links which have grown up over the centuries and which have been reinforced by the development of the European Union and the Single European Market. But this close link between economic growth in the UK and elsewhere in Europe is an example of a much more general phenomenon. We now live in a highly integrated global economy. And economies which are very open to trade and investment – like the United Kingdom, and indeed Jersey – are strongly influenced by international economic trends.

During my time on the MPC, the growth and inflation performance of the UK, and hence our monetary policy judgements, have been heavily driven by global developments. Both the financial crisis and the recession which followed it were global economic events. No major economy in the world was unaffected by the financial turbulence and the dramatic downturn in world economic activity in late 2008 and early 2009. And on the inflation front, we have seen major global forces operating too, with the inflation rate in the UK and other countries being significantly affected by large price swings in global energy and commodity markets.

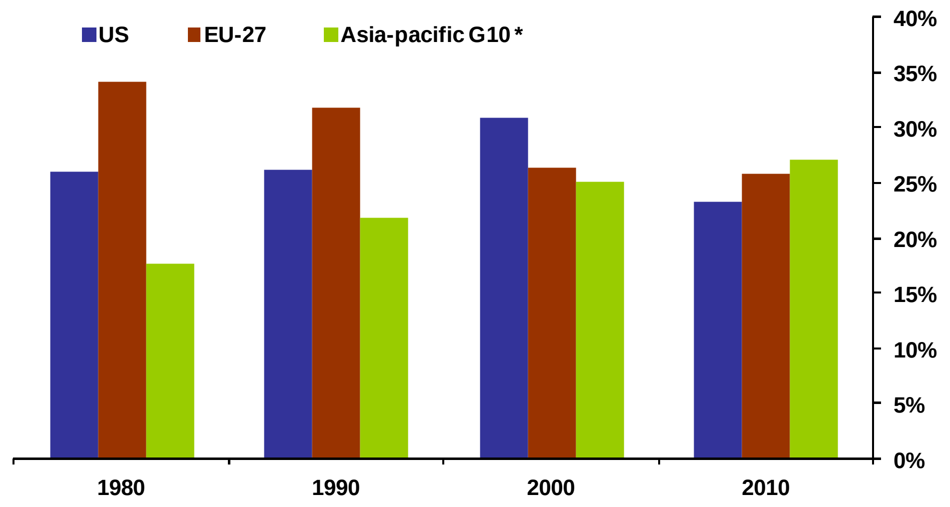
The global economy is now much more integrated and interdependent than at any time in the history of the world. Four main forces have come together in the past two decades to create the “New Global Economy” of the 21st Century. First, new technologies have had a major impact, notably the development of global information technology, media and communications networks. Second, barriers to trade have been reduced, with most of the world’s nations now participating in a liberal and open trading system. The World Trade Organisation now has 153 members, covering 97% of the world’s population. Third, political change has extended the global market economy to large parts of the world which were previously closed to international trade and investment – including China, India and the former Soviet Union economies. And fourth, there has been a tide of deregulation of markets – including financial markets – in many countries, and as markets have been deregulated, they have also been opened up to international competition.

In today’s speech, I want to highlight some of the key features of this highly integrated economic system and discuss some of the challenges it may pose in the future. In particular, I will discuss how the changing shape of the world economy affects the task of national monetary authorities, such as the MPC. In other words, how can economic policy-makers maintain stability when we are constantly in danger of being buffeted by powerful global economic forces?

The rise of Asia and the changing shape of the world economy

A key feature of the new global economy we now inhabit is the increasing economic strength of the Asia-Pacific region. Chart 2 shows that the top ten economies in this region – led by China, Japan and India – have already overtaken both the European Union and the United States in their share of world economic activity. This compares with the situation thirty years ago when these economies were collectively just half the size of the European economy, and about two-thirds the size of the United States.

Chart 2 – The rise of Asia
Percentage share of world GDP, at current market prices and exchange rates



*: Includes Australia, China, India, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan Province of China and Thailand.
Source: IMF World Economic Outlook

What has been the basis of the recent economic strength of the Asia-Pacific region and what might this suggest about its future development? Economic historians can point to estimates of world economic activity before the industrialisation of Europe and the United States which suggest that Asia accounted for about half of world GDP in the 18th century.[1] So in one sense the growing economic strength of Asia might be seen as a restoration of the balance of the world economy which existed before the industrial revolution. But a better explanation is needed of why this might be happening now and how far it has to run in the decades ahead. Japan has been an industrial power since the late 19th century. But the rapid progress of continental Asian economies in recent decades can be seen as the product of three overlapping phases of development. The foundation was provided by what became known as the "East Asian Economic Miracle" – the rapid development of four "tiger economies" – Singapore, Hong Kong, Korea and Taiwan – in the 1970s and 1980s. By pursuing export-led growth, based on high levels of savings and investment, enhanced levels of education and stable macroeconomic policies, these economies achieved strong productivity growth and began to catch up rapidly with western economies and Japan, particularly in the manufacturing sector.[2]

The second phase of development occurred when a wider group of economies – with much larger populations – began to pursue similar policies. In the 1980s and 1990s, Malaysia and Thailand sought to emulate the export-oriented success of the "tiger economies" while China and India pursued market-oriented reforms and opened up their economies to international trade. After the shock of the Asian crisis in the late 1990s, strong growth continued in the 2000s with China emerging as a major global economic and industrial power.

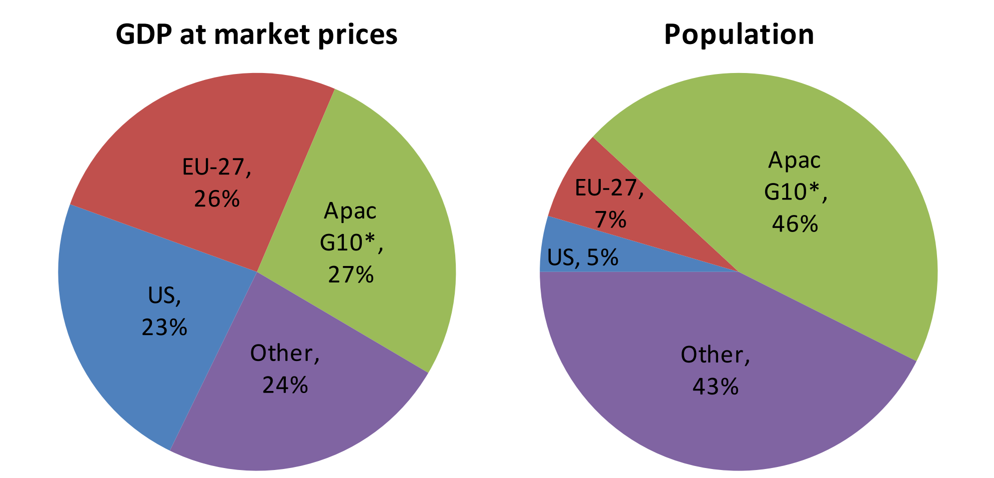
We are now in a third phase of rapid economic growth in Asia in which there is more emphasis on the growth of domestic demand and self-sustaining growth, particularly in the larger economies in the region. With an expanding middle class and rising living standards,

1 See, for example, Maddison (2007).

2 See World Bank (1993) for a detailed analysis.

domestic consumer demand can provide a much stronger engine of growth. And a number of Asian economies – including China – are also investing heavily in public infrastructure. The sharp fall-off in export markets in the recent global recession has given added impetus to the desire to expand domestic demand and this provided an important platform for the recovery of Asian economies from the global recession.

Chart 3 – Shares of world GDP and population
2010 figures

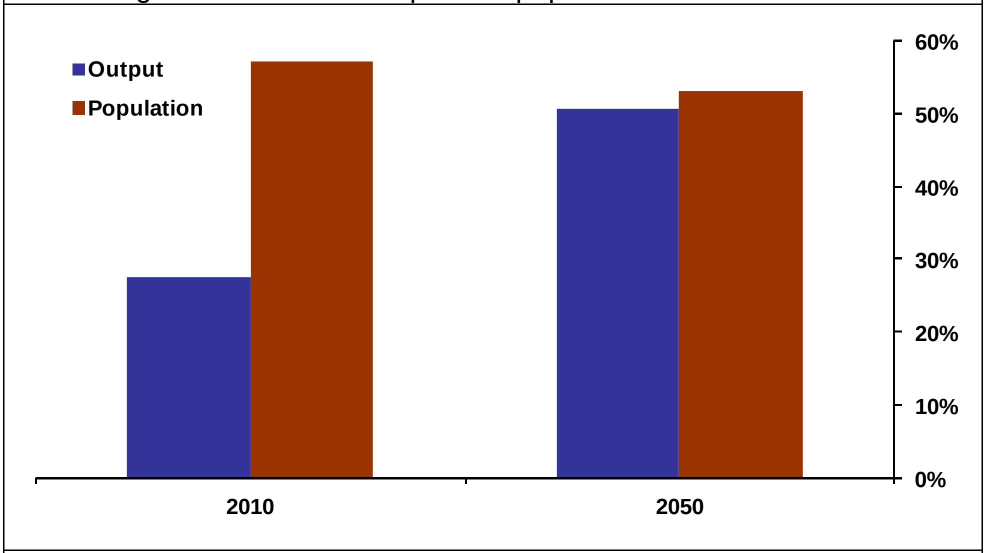


*: Apac G10: Asia-Pacific G10, including Australia, China, India, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan Province of China and Thailand.
Source: IMF World Economic Outlook, World Bank and Eurostat.

The pattern of the past thirty years has, therefore, been of a successful Asian model of development spreading out and encompassing a wider range of countries with larger populations and becoming more self-sustaining. The most likely scenario is that this pattern will continue over the next 20–30 years as the strong economic fundamentals which have supported high rates of growth in recent decades continue to enable productivity levels and living standards to catch up with the West. As chart 3 shows, the ten leading economies in the Asia-Pacific region are home to nearly half of the world's population. And yet they still account for only just over a quarter of world GDP. This shortfall largely reflects the relatively low average living standards in India and China, which together account for over a third of the world's population.

Chart 4 – Long-term economic and demographic projections for Asia

Percentage share of world output and population



Source: Asian Development Bank

Even if growth slows down somewhat from the very strong rates seen in recent years, the economic contribution of the Asia-Pacific region is likely to rise to match its share of world population. Chart 4 shows recent projections from the Asian Development Bank which point to the Asian share of world output rising to around 50% by 2050, much closer to its population share. To achieve this will require average GDP growth rates for Asia of 5–6% in the next twenty years and 4–5% in the period 2030–2050. This does not appear unreasonable in the light of the track record of rapid growth in the past two decades and the strong economic fundamentals of the leading economies in the region.[3]

What might this imply for the economic performance in the rest of the world economy – and in particular economies like the UK and Jersey? Fortunately, the economic performance of different regions and countries across the world is not a zero sum game. There are opportunities created by the opening up of new markets as well as competitive challenges to established industries. We have already seen quite a bit of economic restructuring in the US and Europe – particularly in manufacturing industry – in response to the development of low-cost competition based in China and other Asian economies. We should expect this process of structural change to continue as the leading Asian economies continue their development in the decades ahead. The key for economies like the UK, other European economies and the United States to prosper and succeed in this new world economic order is to have the right supply-side policies which help businesses to remain competitive and adapt to changing market conditions. To support high living standards, western economies will need to stay ahead of the game by upgrading their levels of education of skills and maintaining a business climate which is conducive to enterprise and innovation. Flexible labour markets are also a key ingredient in ensuring that a high level of employment can be sustained against the background of structural change and increasing global competition.

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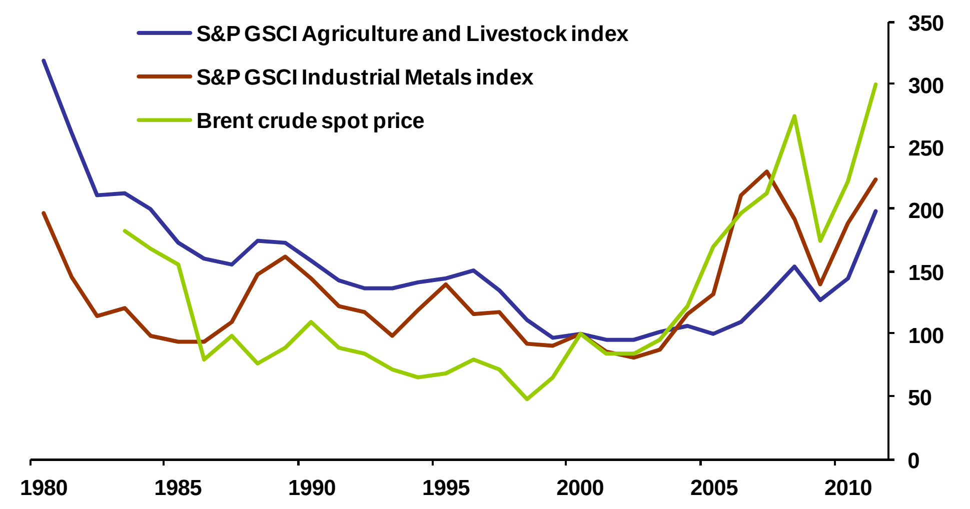
[3] See Asian Development Bank (2011). Note that the ADB analysis covers a much wider group of economies than Charts 2 and 3, which boosts the share of world population to over 50%. Llewellyn and Santovetti (2010) also provide a similar analysis of future economic prospects in Asia.

Pressure on energy and commodity markets

There are two other wider challenges raised by the changes we have seen in the global economy in recent decades. The first is the pressure that strong growth in Asia and other rapidly growing emerging market economies is placing on the markets for energy and other natural resources. We have already seen this pressure reflected in a strong upward move in global energy and commodity prices since the early 2000s, as Chart 5 shows. After a brief respite during the financial crisis, this upward pressure on energy and commodity prices has resumed as the world economy has bounced back from recession. The oil price is back above $100/barrel, and while there has been a modest correction in commodity prices over the past month, this seems likely to be a short-term pause in the upward trend rather than a fundamental readjustment.

Chart 5 – Real oil and commodity prices since 1980
Deflated by US consumer price index; 2000=100

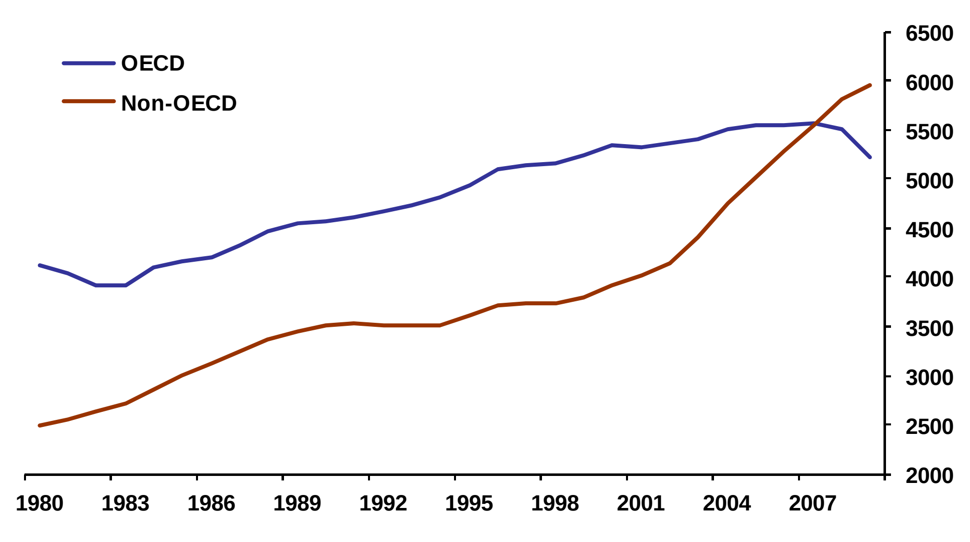


. Source: IMF and Thompson Datastream

It is no coincidence that this upward pressure began to emerge in the early 2000s and has continued for the best part of a decade now. The rapid growth we have seen in Asia and other emerging market and developing economies has been very resource-hungry. The effects of this can be seen in the pattern of global energy consumption, shown in Chart 6. Until the early 2000s, energy consumption in the advanced OECD economies and in the non-OECD developing and emerging market economies rose at a similar rate, with the OECD economies accounting for the majority of demand. In the wake of the strong growth in the 2000s, this position has been reversed with the non-OECD now the dominant contributor to world energy demand. For example, China's share of global oil consumption has risen from 6% to 11% in the past decade alone.[4]

[4] International Monetary Fund (2011)

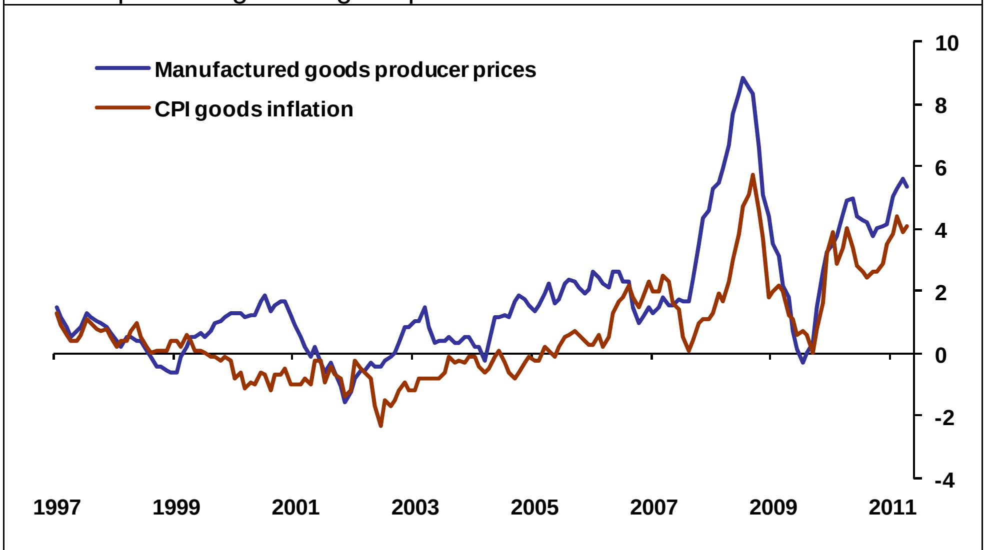
Chart 6 – Global primary energy consumption
Million tonnes oil equivalent



Source: BP Statistical Review 2010

This pattern of upward pressure on energy and commodity prices has been particularly noticeable since the mid-2000s and it has had a significant influence on inflation in many countries – particularly affecting the prices of goods. The so-called “China effect”, through which the shift of production to low cost countries held down the prices of global manufactures and traded goods in the late 1990s and the first half of the 2000s, has given way to a period of higher global inflation, driven by rising energy and commodity prices. Chart 7 shows how this has affected the rate of inflation in goods prices in the UK, which has picked up significantly in recent years – whether measured in terms of manufactured products at the factory gate or the goods which enter into the consumer basket.

Chart 7 – UK goods price inflation
Annual percentage change in prices

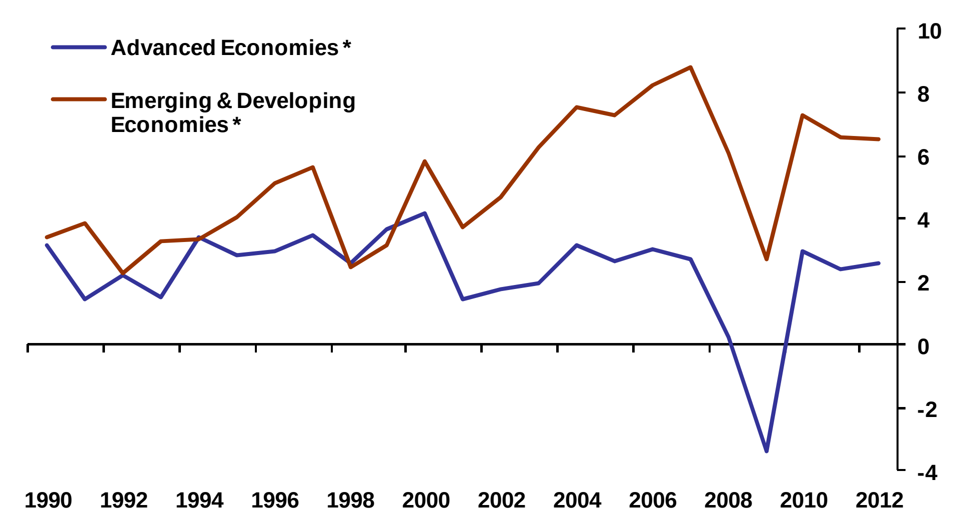


Source: ONS

One of the key challenges facing the MPC and other monetary authorities around the world is judging how far this surge in energy and commodity prices has yet to run and how far-reaching its consequences might be. The tendency so far in many countries, including the

UK, has been to treat this phenomenon as a series of one-off shocks. But the driving force behind it – strong growth in Asia and other emerging market economies – is proving quite persistent – as Chart 8 shows.

Chart 8 – Emerging market growth remains strong
Annual percentage growth rates of real GDP



*: 2011 and 2012 growth rates are IMF forecasts.
Source: IMF World Economic Outlook

This raises the possibility that some key commodity markets, including the market for oil, could be in a structural position of scarcity for some time yet, leading to further significant upward price movements. For example, in its recent World Economic Outlook, the IMF published an analysis suggesting that current trends in the oil market – with supply unable to keep up with strong demand – could lead to a further 200% rise in oil prices from current levels over the next 20 years.[5] Of course, there is great uncertainty around such predictions. But my judgement would be that this IMF analysis is likely to be directionally correct, even if we can't be precise about the exact timing and scale of upward price movements.

This upward shift in energy and commodity prices cannot carry on indefinitely, of course. Eventually, rising prices should choke off demand – both by encouraging more efficient use of resources and possibly by squeezing growth in consuming countries. Over a period of time, high prices may also encourage investment in new sources of supply. But while we are in this phase of strong energy and commodity price growth, there is also the risk that the inflationary trend could become embedded in the rate of increase of wages and prices more generally. That is a risk that cannot be dismissed lightly, given the experience of the 1970s when this did indeed happen.

Managing global volatility

Before discussing how monetary authorities should respond to this risk, I would like to highlight one other key feature of the modern global economy – which is the way in which the linkages and dependencies between different economies around the world have increased. The international trading system has supported the development of integrated global supply chains in many industries, with the power to transmit shocks to demand and business activity

[5] International Monetary Fund (2011)

very rapidly around the world. The financial system has also become a powerful mechanism for transmitting shocks and disturbances. And global media, communications networks and the internet result in the rapid transfer of news and information around the world.

The financial crisis and the recession which followed demonstrated very vividly the power and speed of these mechanisms to transmit economic volatility rapidly across borders and around the world. And the conclusion I would draw is that these interdependencies and linkages have greatly increased the potential for global economic shocks and volatility of various different kinds. In an ideal world, we would develop stronger international mechanisms for dealing with these potential sources of economic fluctuations. And there has been a renewed emphasis on various forms of economic co-operation in recent years, including the development of the G20. But the difficulties of establishing and operating frameworks for international co-operation mean that policy frameworks for managing global economic volatility are likely to remain inadequate and imperfect for some time to come. As a result, economies which are very open to international trade and business like the UK are likely to have to live with more economic volatility than we would ideally like.[6]

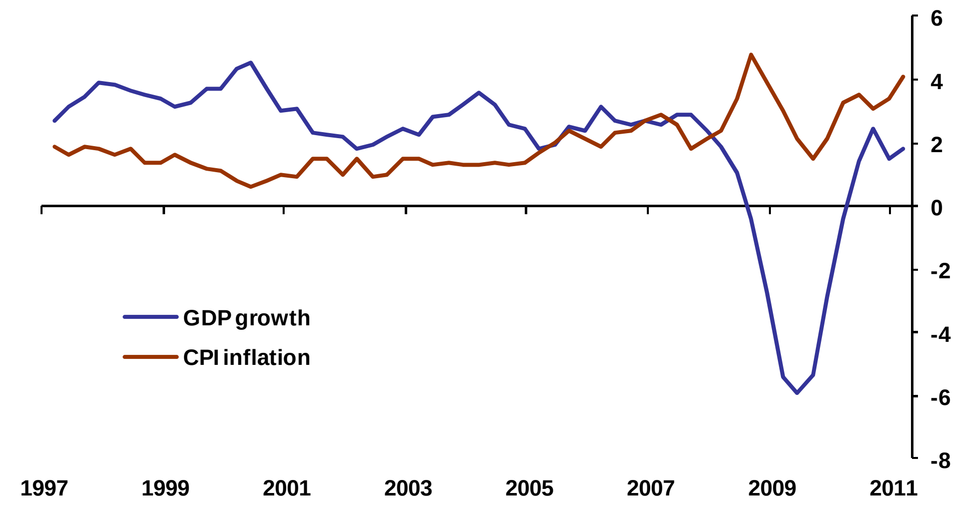
Implications for monetary policy

So, let me sum up my analysis so far. I have identified three potential challenges arising from the "New Global Economy" which is shaping the world of modern business and having such a powerful influence on open international economies like the UK and Jersey. The first is a shift in the centre of economic gravity in the world economy towards Asia – which is likely to become the dominant region in the world economy in the first half of this century. That creates market opportunities for other economies as well as competitive threats, and is likely to result in further structural change as businesses adjust to changing patterns of demand and supply. Supply-side policies – focussing on skills, enterprise and innovation – are the key to maintaining growth and employment in the face of these structural adjustments. The two other challenges I have identified – a prolonged period of upward pressure on energy and commodity prices climate and an increase in global economic volatility more generally – have more significant implications for monetary policy in an open internationally focussed economy like the UK. So how should monetary policy respond?

6 See Sentance (2009a) and Sentance (2009b) for a more detailed discussion. Hume and Sentance (2009) also provide an analysis of how global economic trends fostered the global credit boom of the mid-2000s.

Chart 9 – UK output and inflation since 1997

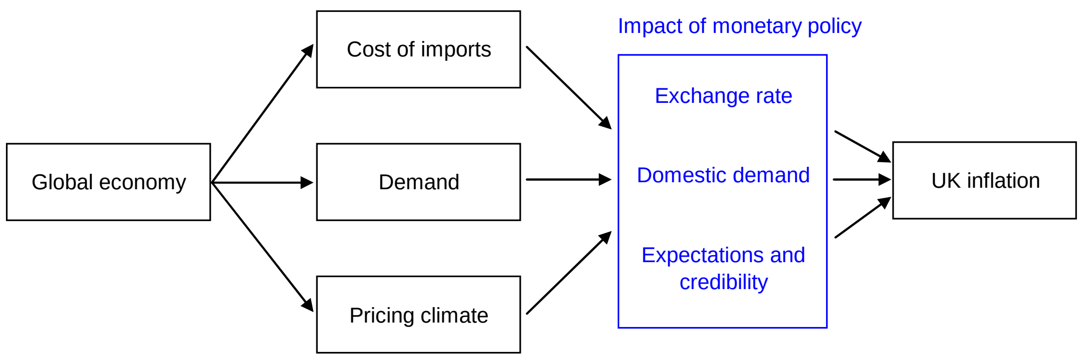
Annual percentage change in real GDP and consumer prices



Source: ONS

One reaction to my analysis could be that we have to accept a lot more volatility in growth and inflation, and simply grin and bear it. To some extent this will be true if the global shocks are big enough and very sudden, as we discovered in late 2008 and early 2009 when we felt the full force of the global financial crisis. But even in these circumstances, monetary policy played an important role in stabilising the economy and heading off a downward spiral in demand and the associated deflationary threat. In the decade before the recent global turbulence, there were also significant fluctuations in the international climate, including the impact of the Asian Crisis, the "dotcom" boom and bust in the US, and global geo-political turbulence in the early 2000s. In response to these fluctuations, the MPC did respond by adjusting monetary policy and succeeded in keeping UK growth steady and inflation low and stable, as Chart 9 shows, albeit in a more benign global environment than we have seen recently.

Chart 10 – Monetary policy, the global economy and inflation



In the future, we may not be able to achieve the high degree of stability for growth and inflation that we saw in the MPC's first decade. But our experience also suggests that we are not powerless to act in the face of significant global economic changes either. Chart 10 illustrates the main channels through which monetary policy can stabilise an open economy like the UK in the face of fluctuations in global demand or prices. The stabilising role of monetary policy operates through three main channels – the exchange rate, demand conditions and by influencing inflation expectations and enhancing the credibility of the monetary framework. And even though monetary policy will affect the growth of the economy in the short-term, the overall objective for UK monetary policy is and should remain price stability. That is because stable prices provide the best climate for growth, investment and business success in the longer term.

The price stability objective provides the ultimate benchmark to guide how policy should respond to changes in the economic climate. So it is not right to argue, as some people have done recently, that because inflationary risks and pressures arise from the global economy they should be ignored by the monetary authorities.[7] In the UK and in many other countries, monetary policy responds to global shocks and influences all the time. Nor is it correct to argue that inflation generated by import prices is outside the control of monetary policy. Monetary policy affects the exchange rate – which in turn can offset or reinforce our exposure to rising import prices. And the demand climate and the price expectations of firms can affect how much of this imported inflation comes through to the consumer. Yet in the UK, monetary policy has not only accommodated a large part of the recent surge in energy and commodity prices but also allowed a very significant sustained fall in the value of the pound, which has aggravated the rise in UK relative inflation relative to our peer group of other European economies.[8]

Rather than dismissing the impact of global influences on domestic inflation, monetary authorities need to assess how far they pose a threat to price stability – either in the direction of persistent inflation or persistent deflation. In the UK, we took the view in late 2008 and 2009 that the threat of deflation was the biggest risk in the wake of the global financial crisis, and cut interest rates to historically low levels, supported by direct injections of money into the economy through the policy of Quantitative Easing. But the world inflation climate has become much more inflationary now, both through the direct effect of rising energy and commodity prices and through a turnaround in global demand. While the global demand environment remains buoyant, we should not regard energy and commodity price movements as one-off shocks, as the inflationary pressure from the world economy may well persist for quite a while. And persistent above-target inflation carries other risks for price stability in the UK – to the credibility of our policy framework and to expectations of future inflation. Indeed, Chart 11 shows that UK services sector inflation has been running at around 4% for much of the past decade, and has not shifted downwards to offset rising goods prices. This raises the possibility that in the services sector, high inflation expectations have already become engrained.

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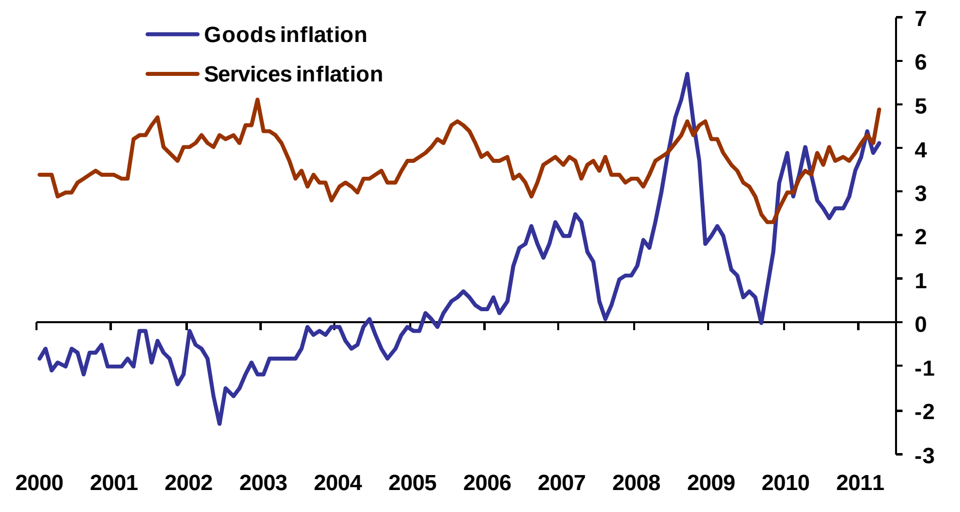
7 Kemp (2011) argues that if all monetary authorities treat energy and commodity price shocks as exogenous, there is a strong risk of an inflationary bias to global monetary policy.

8 As I have pointed out in an earlier speech (Sentance, 2011), UK inflation has persistently run ahead of the euro area, Sweden and Switzerland since the financial crisis,

Chart 11 – UK goods and services inflation
Annual percentage change in consumer prices



Source: ONS

For these reasons, I have been arguing for the past year that the MPC should embark on a policy of gradual interest rate rises and that delaying this process exposes us to greater inflationary risks in the future – which would not be good for economic growth in the medium term. Continuing to accommodate inflation makes it more likely that a future sharp policy correction will be needed, particularly if persistent high inflation becomes embedded in wage and price-setting. That not only poses a threat to the recovery further down the track, but it could erode the hard-earned credibility of the UK monetary policy framework – which would be very damaging for economic growth over the longer-term.

Here in Jersey you are in a monetary union with the UK. So you too have a strong interest in the MPC getting its policy judgements broadly correct. Though I am leaving the MPC at the end of this month, I do not think the issues I have raised today in this speech will go away with my departure. Global economic issues will continue to have a major economic impact on growth and inflation performance in the UK and here in Jersey – as many of you will know from your own business experience.

I hope I have shed some light today on some of the important changes in the global economy and how they affect the conduct of UK monetary policy. Despite the turbulence we are likely to continue to experience in the global economy, I trust you will be able to steer your businesses successfully through it. And as I come to the end of my shift at the helm of the UK economy, I hope that my colleagues on the MPC will not allow the UK economy to be blown too far off course by global inflationary winds before taking the necessary corrective monetary policy action, which is long overdue.

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