

**Meeting the Challenges of Economic Recovery**

Speech given by

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

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Good evening, ladies and gentlemen. It is a great pleasure for me to be speaking here in Aberdeen on the eve of your major Economic Summit tomorrow for the Aberdeen City and Shire. I am particularly pleased to be returning to this part of the world after a long absence. Around thirty years ago, my family lived in Aberdeen – when my father was working with a major engineering company supporting the oil industry. Before that, I had spent four months living and working in Aboyne on Deeside in my gap year between school and university in 1977.

Clearly, a lot has changed since those days. I moved to Aberdeen with my family in the late 1970s just after the Labour government of the day had held a referendum on Scottish devolution. Thirty years on, you now have a well-established devolved government in this country. The modern Scottish Parliament recently celebrated its tenth anniversary – re-establishing a Scottish parliamentary tradition which goes back to the 13th century.

Alongside these political changes, the last thirty years has been a period of massive economic change – both across the United Kingdom as a whole and in Aberdeen and the surrounding region. When I first spent some time in this area in 1977, North Sea Oil production was only just getting underway.1 Now, North-East Scotland is the fifteenth most successful economic region in the European Union, and the third richest in the UK, measured in terms of value-added per head of population.2 This fact appears to be a fairly well-kept secret outside this part of the world – and maybe you should make more of it. It is a record of economic success that Aberdeen and the whole North-East of Scotland should be very proud of.

At tomorrow’s Summit, you will be discussing how the City and Shire of Aberdeen can sustain and improve this strong economic position. I very much hope that this is a very productive day of discussions, and you certainly have a very impressive agenda. Though I am not in a good position to advise you on the detail of your Summit discussions, I would just like to make three general points which I hope will provide a helpful backdrop to your sessions tomorrow.

1 Oil production started in the Argyll Field in June 1975, followed by the Forties Field in November 1975.

2 Source: Aberdeen City and Shire Economic Future website.

First, in my experience, successful regional economic strategies rely on very active co-operation between the public and private sectors. The public sector is crucial in providing the infrastructure which underpins economic growth – including the transport and education systems – as well as fulfilling many other key roles, including local and regional planning. However, public investments and other policy interventions will only be effective if they are based on a sound understanding of the needs of the business community and the policy initiatives which will genuinely enhance economic competitiveness. Ultimately, it will be profitable and competitive businesses which will underpin job creation, prosperity and the broader success of the economy in this region and elsewhere. Successful co-operation between the public and private sectors will be crucial for the future success of your efforts to promote the economic prospects of Aberdeen City and Shire.

Second, your future strategy needs to be consistent with the Low Carbon Economy of the future, in which greenhouse gas emissions are cut substantially in relation to current levels. The Committee on Climate Change has recommended an 80% cut in carbon dioxide and other emissions which contribute to global warming by 2050. That is a particular challenge for this City and its surrounding economy, which has developed recently on the basis of the extraction of fossil fuels. However, the capabilities of the technology and service industries which have helped to extract oil and gas from the North Sea can also serve to meet the requirements of a Low Carbon Economy – for example, by developing offshore wind power and the capture and storage of carbon emissions. I am sure that the need to embrace the challenges of a Low Carbon Economy will be an important feature of your discussions tomorrow.

Third, I am very conscious of the pressures which the current financial crisis and recession has created for businesses and individuals. However, in your discussions tomorrow, I hope you will be able to look through these short-term challenges and focus on the medium and long-term issues which will shape economic prosperity over the medium to long-term. Indeed, one thing that has encouraged me greatly in this recession is the confidence which businesses are showing in their medium and longer- term economic prospects. Though a lot of businesses are having to take drastic

actions to survive in the face of a sharp fall-off in demand, at the same time we are seeing many companies seeking to safeguard their long-term investments and maintain workforce skills built up over many years. In my view, this reflects both a feeling of confidence about the underlying viability of their business and a desire to be well-positioned for the recovery when it comes. On both counts, this is a good sign of the resilience and underlying strength of the British economy – and I hope your Summit discussions tomorrow will help to provide an additional underpinning for longer-term confidence among businesses in the City and Shire of Aberdeen.

In previous recessions, there have not always been such good grounds for confidence in the longer-term prospects for the UK economy. I think back particularly to the recession of the early 1980s, which was just beginning when my family lived here in Aberdeen. That recession followed a dismal period for the UK economy and British industry, which saw businesses struggling with double-digit inflation, bad industrial relations, low productivity and a legacy of underinvestment in skills, new technology and product development. These were widely regarded as symptoms of a wider economic malaise – the “British disease”. When the early-1980s recession hit, these structural problems led many businesses to lose confidence, not just in shorter-term economic prospects, but in the long-term future viability of their UK businesses. This was particularly the case in UK manufacturing industry, and was reflected in the widespread plant closures, business failures and a significant contraction in the UK manufacturing base at that time.3

Over the decade and a half that followed, these underlying economic problems were addressed. Over the 1980s and early 1990s, inflation was brought under control and we now have a well-established framework for sustaining low and stable inflation, underpinned by an independent decision-making body – the Monetary Policy Committee of the Bank of England. The UK labour market has become more flexible, following on from changes to industrial relations and other reforms. We are seeing some of the benefits of increased flexibility in the current recession, as companies have sought to minimise lay-offs by negotiating temporary changes to pay

3 Sentance and Emerson (1995) argue that UK manufacturing capacity dropped by around 10% between the late 1970s and early 1980s.

and hours of work. This co-operative approach is not only helping individuals and companies manage through the recession. But it should also help to reduce the loss of skills and experience that comes about through job losses and prolonged unemployment – providing a stronger skill and employment base for the economy when the recovery comes.

Britain also now has a much more productive, competitive, innovative and flexible core of manufacturing and international trading businesses than in the 1970s and 1980s. I have been particularly impressed by the manufacturing businesses I have visited all around the United Kingdom in my last two-and-a-half years on the Monetary Policy Committee. British manufacturing has learned the benefits of investing heavily in technology and skills, using lean manufacturing techniques coupled with flexible employment patterns. Like many in this audience I am sure, I wish we had more of these companies here in Scotland and elsewhere in the UK. But in my view, the productivity and competitiveness of our manufacturing base has improved out of all recognition over the last three decades.

These three features of our economy – a track record of low and stable inflation, a more flexible labour market and a productive and competitive base of manufacturing and international trading businesses – should give us grounds for encouragement about the ability of the UK economy to weather the storms of the current recession. There are nonetheless some very considerable challenges ahead when the economy starts to recover, which I hope will very soon be the case. These challenges share some common characteristics with the situation the UK economy faced in the 1990s economic recovery. But they also reflect the unusual nature of the current global financial crisis, which has been the main driver of this recession.

The first and most obvious challenge is the potential constraint on lending because of the reluctance of banks to lend as they seek to rebuild their financial reserves. In the case of the UK, there are two aspects to this. First, there is a gap in the supply of lending which has been created by the withdrawal of some foreign banks which were very active in providing finance in the UK before the crisis – particularly in terms of

lending to business. A number of these banks have retreated to their home markets and are reluctant to provide new lending within the UK.

The impact of this adverse shift in the supply of new lending could be offset by an increased supply of credit from UK-based banks – but they too are likely to be much more cautious about future lending in the wake of significant losses arising from the financial crisis. These losses have weakened their capital base and there are worries that further losses may emerge as a result of the recession. In one sense, it is a sensible reaction for banks to restrain lending in the current situation. It would be unreasonable to expect banks to lend as freely as they did in the mid-2000s when it is now clear that they were seriously underestimating credit risks. However, if the pendulum swings too far in the other direction – and sound businesses and households with a good credit record are unable to access lending – that risks impairing the growth of the economy during the recovery.

A second challenge we will face in the coming recovery is the need for the UK economy to rebalance its sources of growth after a period when economic activity has been strongly driven by financial activity and by a sustained period of rising public and private consumption.

There are a number of aspects to this process of rebalancing. The first is in terms of the sources of demand. Growth in the UK economy in the late 1990s and early 2000s was strongly driven by private consumer spending, and this has been reinforced more recently by rising spending on public services. Normally, public and private consumption in the UK runs at just over four-fifths of economic activity, leaving just under one-fifth to be reinvested in the productive capacity of the economy.4 As Chart 1 shows, the proportion of national output devoted to private and public consumption rose significantly above its historic average level in the late 1990s and early 2000s – with 85-86% of national resources being devoted to consumption compared with a historic average of 82%. More recently, the consumption ratio has risen further – to

4 In the fifty years from 1955 to 2004, the total of private consumer spending and public spending on current goods and services averaged 82% of UK GDP when measured at current market prices.

nearly 88% – the highest ratio of consumption to national output in the UK since the early 1950s!

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| --- | --- | --- | --- | --- | --- |
| **Chart 1: Public and private consumption as a share of GDP**  % | | | | | |
|  |  |  |  |  | **89** |
|  |  |  |  |  | **88** |
|  |  |  |  |  | **87** |
|  |  |  |  |  | **86** |
|  |  |  |  |  | **85** |
|  |  |  |  |  | **84** |
|  |  |  |  |  | **83** |
|  |  |  |  |  | **82** |
|  |  |  |  |  | **81** |
|  |  |  |  |  | **80** |
|  |  |  |  |  | **79** |
| **Q1 1980** | **Q1 1986** | **Q1 1992** | **Q1 1998** | **Q1 2004** |  |
| Note: Measured at current market prices.  Source: ONS | | | | | |

For a time, it may be possible for an economy to spend more than it earns, and to borrow abroad. But that is more likely to be the case when the additional spending is the result of investment which will yield a future return, rather than a high level of current consumption of goods and services. Some of the recent rise in the consumption ratio is short-term and reflects the recession itself. Public spending is being sustained through the recession and consumer spending is normally one of the more resilient components of demand in a downturn. In a recession, the stability of public and private consumption helps offset the volatility of investment spending and acts stabilise the economy.

But there is a longer-term element to this imbalance in the amount the UK economy consumes in relation to the amount it produces. This reflects the very strong consumer-driven growth we saw in the UK between the mid-1990s and the mid- 2000s, which has been reinforced by recent rises in public spending. The second half of the 1990s and the first half of this decade saw private consumer spending growing at over 3.5% per annum. This was a full one percentage point over the longer-run trend and represents the strongest ten-year period of household consumption since the

Second World War.5 As a result of the boost to domestic demand created by rising consumer spending, the UK economy was one of a number of major economies – including the United States and Spain – which developed a significant current account deficit in the mid-2000s, reflecting the fact that our national spending habits had outpaced the productive potential of our economy over this period.6

In the wake of the current financial crisis, we should expect to see a move in the opposite direction – subdued growth of private and public consumption as the economy rebalances. An important contribution to this demand side rebalancing will be the reduction in the very large public sector deficits which are now projected for the UK – reaching around 12% of GDP this year and next.7 Fiscal consolidation will require restraint on the growth of public spending and, if taxes have to rise, it will have an impact on private consumer spending too.8 Given the scale of excess consumption which has built up over the last decade, and the large fiscal imbalances which are now apparent, tight fiscal policies are likely to need to be sustained for 5-10 years.

We have been here before – in the 1990s economic recovery. Then, the UK experienced a similar period of demand rebalancing but from a less extreme position, both in terms of the level of consumption in relation to GDP and the size of the fiscal deficit.9 Just as in the mid-1990s, a competitive exchange rate is likely to help with the rebalancing of the UK economy – supporting UK manufacturers and other businesses trading internationally in export markets, as well as giving UK producers a competitive advantage over importers.

5 The strongest post-war ten-year period for final household consumption was between 1996 and 2005 when real growth averaged 3.7%. See Sentance (2007) for a fuller discussion.

6 See Hume and Sentance (2009) for a fuller discussion of the evolution of current account imbalances

over the period since the mid-1990s, and their linkages to the global credit boom which emerged at the same time.

7 The 2009 Budget statement projected Public Sector Net Borrowing at 12.4% of GDP in 2009/10 and 11.9% in 2010/11.

8 Tax rises directed towards the corporate sector could also squeeze investment, which would harm the

longer-term growth potential of the economy.

9 The budget deficits in the early 1990s (as measured by Public Sector Net Borrowing) peaked at 7-8% of GDP. Also, see Sentance (1992) for a discussion of the rebalancing challenge in the UK in the early

1990s.

Another aspect of the rebalancing of the UK economy which we are likely to see over the next few years is a reduction in dependence on financial and business services as a source of growth. The late 1990s and early to mid-2000s saw not only a global credit boom, but also a broader expansion in the size of the financial sector and related business activities.10 As Chart 2 shows, the share of financial and business services in UK GDP rose from around 17% in the mid-1990s to about 25% at present. As the financial sector and related activities adjust to the changed circumstances in the wake of the current financial crisis, we cannot expect these sectors to be such a powerful engine of growth in the coming recovery. Other sectors will need to take up the running.

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Chart 2: Financial and business services as a share of GDP**  % | | | | | | | | | | | | |
|  |  |  |  |  |  |  |  |  |  |  |  | **27** |
|  |  |  |  |  |  |  |  |  |  |  |  | **25** |
|  |  |  |  |  |  |  |  |  |  |  |  | **23** |
|  |  |  |  |  |  |  |  |  |  |  |  | **21** |
|  |  |  |  |  |  |  |  |  |  |  |  | **19** |
|  |  |  |  |  |  |  |  |  |  |  |  | **17** |
|  |  |  |  |  |  |  |  |  |  |  |  | **15** |
| **1985** | **1987** | **1989** | **1991** | **1993** | **1995** | **1997** | **1999** | **2001** | **2003** | **2005** | **2007** |  |
| Note: Measured at current market prices.  Source: ONS | | | | | | | | | | | | |

In summary, therefore, the activities which provided the momentum behind the growth of the UK economy over the last decade – strong consumer spending and the growth of financial services and related activities – are likely to be much weaker sources of growth as the economy rebalances over the coming recovery. Other internationally trading sectors will need to pick up the baton from financial services – notably manufacturing industry. And the prospect of weaker consumer demand means that the UK recovery is likely to be more dependent on overseas demand and

10 See Hume and Sentance (2009)

the growth of investment. And though a competitive pound should provide UK producers with a competitive edge, a sustained return to growth here in the UK will depend on a broader recovery in the global economy.

This process of structural change in the economy is a necessary fact of economic life. But it is not smooth and painless. We know, from the experience of the UK economy in the 1980s and 1990s when shifts in the structure of the economy were also taking place, that it takes time for dynamic new industries to become established and replace jobs lost in the recession. We should therefore brace ourselves for a period when unemployment is probably higher than its natural or normal level for a while. Local and regional initiatives – such as the Aberdeen City and Shire Economic Future – can play an important part in helping the economy adjust, so that the growth of new sources of employment can replace lost jobs in contracting or slower growing sectors.

A third challenge which I see for the coming UK recovery is that it is likely to occur against a background of continued global volatility, reflecting the highly integrated nature of our global economic system. In a paper which is released today alongside this speech, my Bank of England colleague Michael Hume and I argue that the global credit boom – which has burst so spectacularly over the last eighteen months – was nurtured and encouraged by a number of aspects of the globalisation we have seen over the last two decades.11 The globalisation and the liberalisation of the financial sector itself contributed to the expansionary attitude of many banks and their tendency to underplay the risks attached to their lending and financial asset holdings.

More generally, globalisation played an important part in creating the economic climate in which the global credit bubble of the 2000s inflated. As China and India and other low-cost producers joined the world trading system, their low production costs and plentiful labour supply acted to dampen inflationary pressures across the global economy in the late 1990s and the first half of this decade. The relaxed monetary policies which ensued across the global economy in the first half of this decade – led by the United States – helped to prolong and sustain a global credit boom which had started in the late 1990s through the early 2000s and into the middle years

11 See Hume and Sentance (2009) for a detailed analysis of the recent global credit boom and its relationship to globalisation, global imbalances and the macro-economic environment in the 1990s and 2000s.

of this decade. Subdued inflation accompanied by sustained economic growth also helped to perpetuate the view in the financial sector that a new era of macro-economic stability had arrived, contributing to the downplaying of lending risks.

Of course, many other factors played a part in the evolution of the global financial market development of the last decade. But the globalisation of economic and financial activity may also have inadvertently increased our exposure to volatility originating in global markets. And the globally integrated economic system in which the current financial crisis developed may have other shocks in store for us in the future.

What conclusions should you draw from this analysis, as you enter your day of discussions at tomorrow’s economic Summit?

The first conclusion I would like to suggest is a positive one. As I emphasised earlier, some of the more fundamental changes which have taken place in recent decades should underpin longer-term confidence for the future. We have successfully created a climate of low and relatively stable inflation, and as a member of the Monetary Policy Committee, I am personally committed to seeing that continue to be an underpinning of a stable business climate. The UK economy is not going back to the bad old days of the “British disease”, in my view. We have an internationally competitive manufacturing base – albeit one that may need to expand to underpin future growth – and our flexible labour markets should serve us in good stead, both to help sustain employment through the recession and to facilitate the shift in employment which needs to underpin the rebalancing of the UK economy over the course of the recovery.

However, there are significant challenges which could potentially act as headwinds to the recovery in the UK economy. First, the recovery of the UK economy will need to take place with a banking system which will not be firing on all cylinders. Second, the rebalancing of the economy means we cannot rely so heavily on the sources of growth which have powered the UK economy in the past decade – consumer spending and financial and business services. There will, however, be compensating

opportunities for businesses which can successfully trade on overseas markets – particularly where they can tap the potential of the dynamic emerging markets of Asia, including China and India.

Third, we should not be surprised to see continued volatility affecting our economic lives as a result of global economic developments. The backdrop to my time on the Monetary Policy Committee has been unprecedented global volatility – both affecting inflation, through oil and commodity prices – and economic growth – with the recession induced by the current financial crisis. We should not expect that we have seen an end to this global volatility which has its roots in the integration of world markets and the challenge of absorbing China, India and other emerging markets into the global economic system.

Over the last nine months, the Monetary Policy Committee has been focussed on providing support to demand – through dramatic and unprecedented cuts in interest rates over the autumn and winter – and more recently through our current policy of “Quantitative Easing”. This programme of substantial asset purchases aims to boost the money supply to support spending in the economy, going beyond the stimulus that can be provided by very low interest rates. I am confident that these policies will help to support economic recovery – through their effect on asset prices, financial conditions and ultimately spending by households and firms.

It is encouraging that in recent months we have seen some promising signs that the recession – here in the UK and globally – may now be bottoming out. And we should be able to look forward to a recovery beginning either later this year or early in 2010. The big shocks to global consumer and business confidence which we saw last autumn are now beginning to wear off. At the same time, the very big policy stimulus that has been provided by fiscal and monetary authorities around the world should now be beginning to be felt. The shift in the economic data is consistent with this change in the balance of forces affecting the economy, though we cannot yet predict the exact timing and strength of the recovery which will eventually emerge.

One thing is essential, however. When the recovery does come, it needs to be underpinned by a continuation of the low and stable inflation we have generally experienced in the UK since the 1990s. That is a key responsibility for the Monetary Policy Committee. An underpinning of low inflation should help ensure that recovery can be sustained – which in turn is a key issue for business confidence and future prosperity in the longer term.

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