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Economic Bulletin

STOP INJECTING RECOVERING ADDICT WITH ULTRA-LOOSE MONEY

- Economy would be between 17% and 21% larger without impact of Recession.
- Recovery taking longer than any peace-time recession since 1919.
- Ultra-low interest rates have enabled zombie companies to survive, thereby propping up employment rates and explaining low productivity.
- 5 recommendations for getting back to normal monetary policy.

1. INTRODUCTION

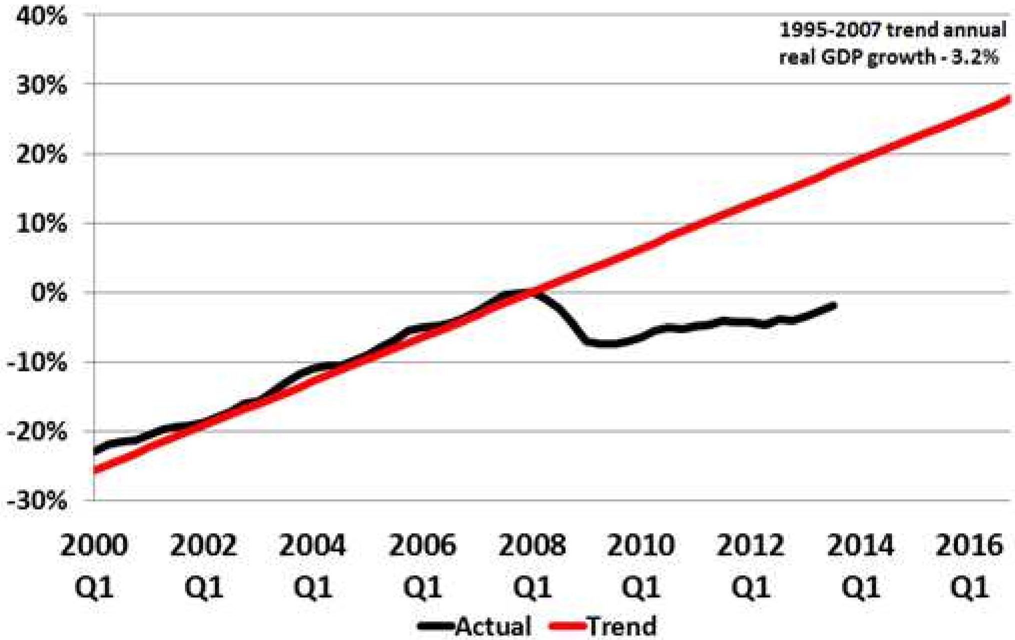
The economic situation at the beginning of 2014 has changed markedly since the beginning of 2013. A year ago, the UK was thought to have experienced a double dip recession and was facing the prospect of a triple dip recession. Subsequent data revisions from the ONS have uprated previous estimates of quarterly GDP figures and it is now clear that there was no double dip recession. Moreover, the second half of 2013 saw strong GDP figures with both quarters reporting 0.8% growth. The Bank of England, the Office for Budget Responsibility and many others forecast that this strong run of data will continue into 2014. David Kern, Chief Economist at the British Chambers of Commerce expects GDP in Q4 2013 to have grown by an even stronger 0.9%. Another strong GDP figure will add to Government claims that the recovery is under way and will increase pressure on Labour to come up with a clear economic policy.

Employment grew strongly throughout 2013 despite the continued 6 year stagnation in productivity. Even with relatively robust output growth, productivity fell again in Q3 2013. Whilst labour market improvements are to be welcomed, the weakness of productivity raises concerns about the durability of the recovery. Furthermore, excessively loose monetary policy may now be preventing more sustained productivity growth and generating future problems.

2. PRE-CRISIS CONTEXT

Despite stronger growth throughout 2013, it is clear that there is further to go before output returns to its pre-crisis peak. In Q3 2013 output was still 2% below the pre-crisis peak of Q1 2008. If the economy had continued to grow at its trend rate between 1995 and 2007, the economy would be over 21% larger which means GDP in the year to Q3 2013 would have been £327 billion higher. This is approximately £5100 for every person in the UK.

Chart 1: Real GDP relative to 2008 Q1 peak, compared to continuation of 1995-2007 average trend

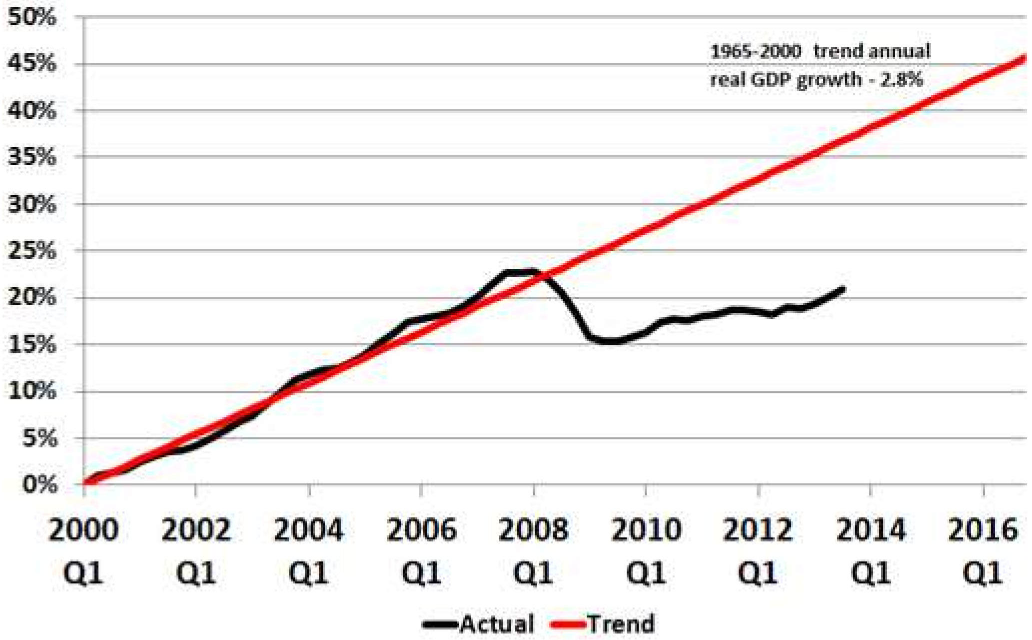


However, comparing current growth rates with the period between 1995 and 2007 may not be appropriate given the sustained positive output gap over that period. Significant rises in government spending as well as rapid financial services growth were two of the main drivers of expanding GDP and the creation of boom conditions. Therefore, despite the significant spare capacity in the economy after such a large recession, it may not be reasonable to compare the current rate of growth with the trend rate of growth during the boom.

Taking a longer term view of GDP shows that between 2003 and 2008, GDP growth was certainly above the historical trend rate. However, up until 2013, the economy had underperformed even compared to this historical trend.

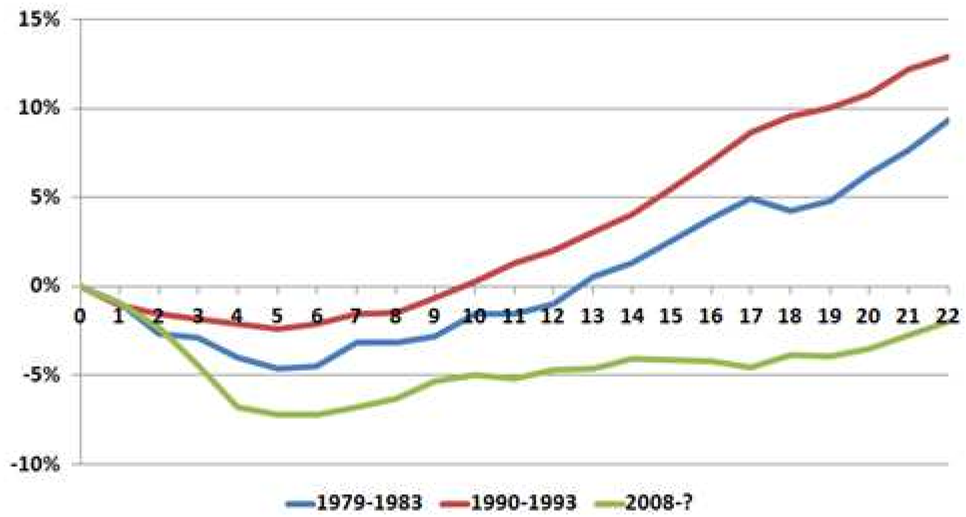
Between 1965 and 2000, the average annual growth rate was 2.8%. The chart below compares the actual growth rate relative to Q1 2000 with the average annual growth rate between 1965 and 2000. This shows that since the beginning of the crisis, the economy had fallen well below the historical trend. However, if growth in Q4 2013 reaches 0.9% as the BCC forecasts, then overall growth in 2013 will exceed the historical trend. This is obviously to be welcomed. Nevertheless, if the economy had grown at the historical trend rate from 2000 onwards, then it would be 17.4% larger than today.

Chart 2: Real GDP relative to 2000 Q1 compared to continuation of 1965-2000 average trend



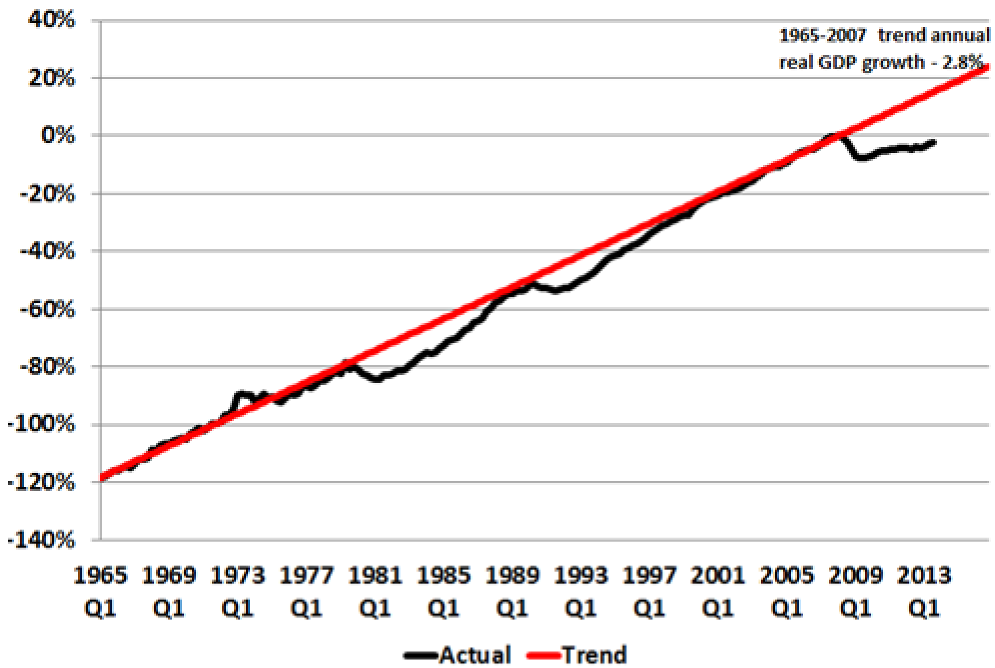
By looking at previous recessions, it is clear the recovery from this recession has significantly underperformed by comparison. During the recessions in 1979, 1990 and 2008, output appears to bottom out 5 quarters after the beginning of the recession. However, in 1979 and 1990, output had returned to its pre-crisis peak after 12 and 9 quarters. By comparison, 22 quarters after the beginning of the recession in 2008, output remains 2% below its pre-crisis peak. 22 quarters since the onset of the 1979 and 1990 recessions, output had already grown above the pre-recession peak by 9.4% and 12.9% respectively.

Chart 3: GDP relative to peak prior to recession against no. of quarters



The chart below reinforces the fact that following previous recessions, there has been significant growth and a reversion to the long term trend growth rate. After the 2008 recession, there had been no significant reversion to the trend until 2013 where we can now see the welcome beginnings of such a return to trend growth. Bank of England data shows that the recovery is taking longer than any peace-time recession since 1919.

Chart 4: Long-term GDP, percent relative to 2008 Q1



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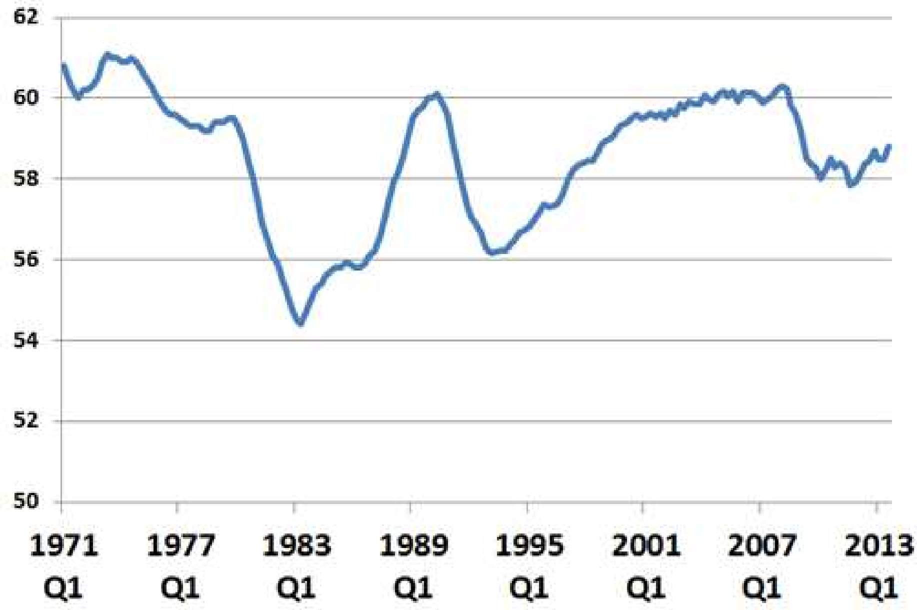
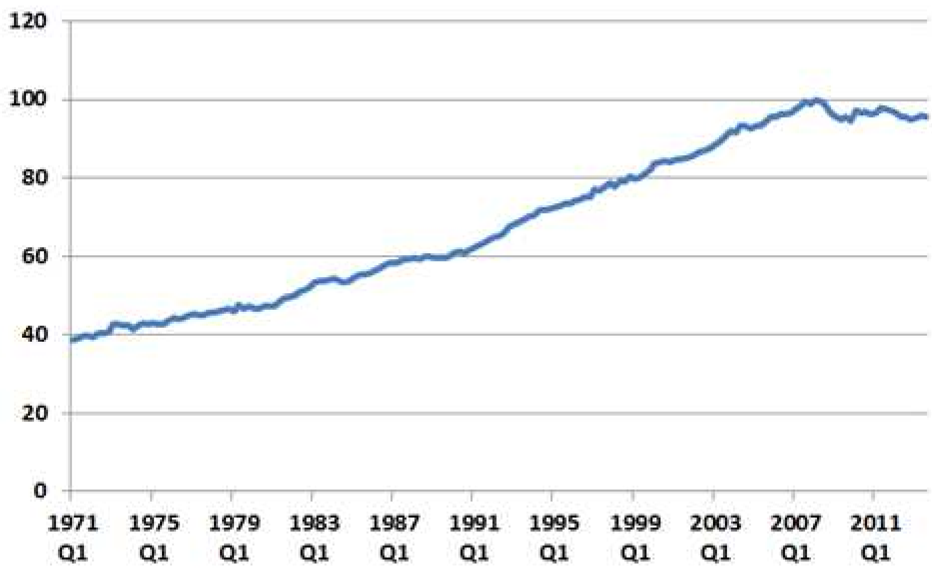
Labour markets remain a source of good news. The employment rate fell as would be expected from Q1 2008 but the fall was significantly less severe than following the 1979 and 1990 recessions. The employment rate has continued to increase through 2013.

Chart 5: UK Employment rate 1971-2012



However, weak output growth coupled with relatively strong employment growth implies that labour productivity growth has been poor. In the last 6 years, productivity has stagnated and remains more than 4% less than the pre-crisis peak in Q1 2008. In 2013, productivity seems to have edged up slightly but it fell again in Q3 2013. Without improvements, it is difficult to forecast a durable rise in growth.

Chart 6: UK Productivity Index – output per hour worked (2008 Q1 = 100)



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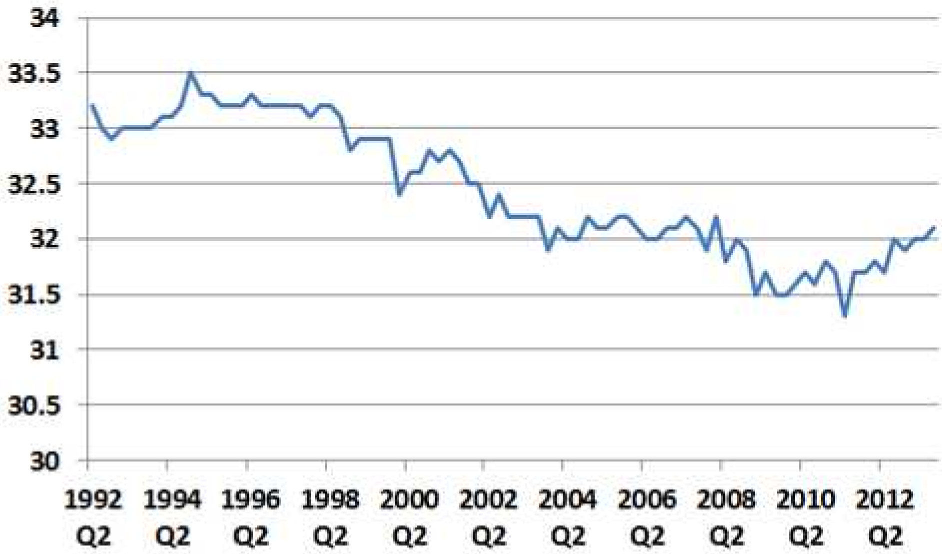
Some argue that the main cause of this poor productivity is 'labour hoarding' as firms hold on to workers hoping for a swift recovery. After 6 years since the pre-crisis peak this seems unlikely to be the main cause of low productivity and high employment growth. It also seems inconsistent with a credit crunch whereby firms without sufficient access to working capital look to cut as many variable costs, such as labour, as they can. There is no point in having hoarded labour to expand once the economy has recovered if you go out of business before the recovery even arrives. The Labour Party has partly sought to portray the rise in employment as down to workers accepting fewer hours and young people only finding part time jobs. However, this seems inconsistent with the fact that the average number of hours worked has remained surprisingly strong and has almost returned to the pre-crisis peak.

Chart 7: Average Hours Worked



It has also been suggested that the reduction in the size of the UK's financial services and oil and gas sectors as a percentage of GDP means a shift in employment to more labour-intensive, slower growth sectors. A more persuasive explanation has been given by George Buckley at Deutsche Bank who explains that poor capital allocation and unprecedented ultra-loose monetary policy has allowed the proliferation and survival of large numbers of zombie companies. This has meant that the normal process of unproductive companies exiting the market and new, dynamic start-ups taking their place has been inhibited.

Other studies demonstrate the impact of unprecedented monetary stimulus including almost 5 years of Bank Rate at 0.5%, £375 billion of QE, forward guidance, the Funding for Lending Scheme and other such programmes. For example, a report by McKinsey shows the significant burden on household budgets through lost interest income. It is time therefore to consider whether such expansionary monetary policy is now actively holding back productivity and GDP growth and preventing the proper functioning of financial markets as George Trefgarne warned.

Whilst monetary policy was certainly useful to help cushion the immediate impact of the crisis, it is no substitute for long term supply side reforms to improve underlying productivity. A recent study by Castle and Hendry (2013) reaffirms the key relationship between productivity and real wages.

Those who support extending our current monetary policy looseness argue that household budgets would not be able to cope with rising interest rates. In addition, with inflationary pressures having eased given the return of CPI to the 2% target as well as a level of output which remains below the pre-crisis peak, then it may not be the most obvious time to return to a more normal monetary policy.

However, as Jeremy Warner argues, it is quite likely that the risk to balance sheets of rising rates has been overstated. Moreover, we have very quickly forgotten that it was the aggressively expansionary monetary policy in the early 2000s which led to the real estate and housing booms and subsequent busts. Therefore, maintaining the current extraordinary monetary policy conditions may be creating the conditions for future problems in financial markets and the broader macro-economy.

More generally, do we really think it is sensible to permanently subsidise the heavily indebted at the expense of those who are prudent and save?

3. 5 PROPOSALS FOR MONETARY POLICY NORMALISATION

The Bank of England's Monetary Policy Committee should take 5 steps to start the process of normalisation.

1. Explicitly rule out reducing the 7% unemployment threshold at which point it begins to consider rate rises in its next forward guidance communication.

2. Upon reaching the 7% unemployment threshold, immediately begin the programme of gradual Base rate rises. Even earlier rises may be desirable but may be held back due to the Bank's previous forward guidance specifying the 7% threshold.

3. Outline precisely which macro-prudential tools it proposes to use to combat asset price bubbles and specifically to prevent overheating in the housing market. This should be in more detail than the Powers of Recommendation and Powers of Direction that it has previously alluded to in its September Quarterly Bulletin.

4. Publicly state that it will carry out no further increases in Quantitative Easing provided both GDP growth and CPI remain positive.

5. Outline a schedule for the drawing down of the Asset Purchase Facility. This should explain how quickly after the first interest rate rise it expects to reduce its £375 billion stock of bonds. This should be done with a bias towards a faster drawing down of the Facility but without causing undue secondary market volatility.

Such steps will help to maintain a low inflation rate and anchor inflation expectations which will help to create an economic environment which is more conducive to business investment. In addition, the normalisation of monetary policy will help to prevent further damaging asset price bubbles, specifically in housing. It should also lead to a sweeping out of zombie companies and thereby improve productivity.

At next month's Inflation Report press conference, the Governor of the Bank of England will have the chance to be bold and carry out these steps. Will he take the opportunity?

4. MUST BE READ

- **Jeremy Warner**: Falling inflation is welcome – but can't be used as an excuse for keeping rates at zero
- **John Taylor**: Causes of the Financial Crisis and the Slow Recovery: A 10 year perspective
- **Michael Stothard and Chris Giles**: Zombie companies stalk UK economy

Adam Memon and Tim Knox
Centre for Policy Studies

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