
The UK economy

Martin Weale and Garry Young

- Base rates will fall to 5 per cent by the start of 2000 and to below 4 per cent in 2001, the lowest for almost half a century.
- Inflation (RPI all items) will drop to 1.2 per cent in the final quarter of this year; excluding mortgage interest payments, inflation will decline to 2.1 per cent, below the government's 2.5 per cent target.
- The manufacturing sector is now expected to contract by 1.5 per cent in 1999.
- We continue to forecast growth of 1 per cent for the whole economy.
- Sterling is now projected to trade at 1.36 euros to the pound (equivalent to DM2.65) from 2001 in order to pave the way for entry into EMU; this rate would amount to a 5 per cent overvaluation.

Cuts in interest rates as UK prepares to enter EMU and inflation falls

Favourable prospects for inflation, the economic slowdown and the need to prepare for entry into EMU will allow further sharp cuts in interest rates. We now expect the Bank of England's base rate to fall to 5 per cent by the start of 2000 and below 4 per cent in 2001, taking base rates down to a low not seen since 1955.

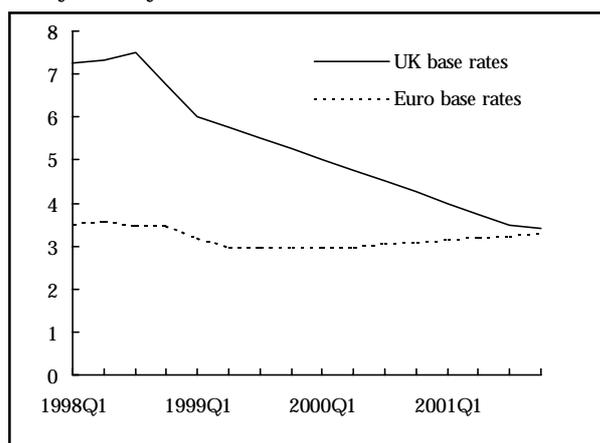
The outlook for inflation has improved considerably. We now forecast that headline inflation (RPI all items) will fall from 2.8 to little more than 1 per cent by the end of 1999. Underlying inflation (RPIX) will decline from 2.6 to 2.1 per cent.

Unlike 1998 when a deterioration in net trade slowed the economy down, the main contractionary force in 1999 will come from a pronounced deceleration in private domestic demand. Consumer spending is forecast to grow by only 1.3 per cent as households save more of their income. There will be a particularly sharp drop in business investment growth which will fall from 10 per cent in 1998 to 1 per cent in 1999.

Relaxation of monetary policy should prevent recession

However, the Bank of England's swift easing of monetary policy since last autumn, together with the significant boost to government expenditure on goods and services announced last summer, should prevent the slowdown from turning into outright recession. Unemployment will rise only moderately over the year, by under 100,000 on the ILO count.

Interest rates UK and Europe



The world economy

Ray Barrell, Dawn Holland, Florence Hubert, Nigel Pain, Dirk te Velde & Véronique Genre

- The prospects for the US economy in 1999 appear brighter than they did last October, but remain heavily dependent on the health of the stock market.
- The Japanese economy is now expected to decline in 1999 by a further half a per cent following the 3 per cent fall in 1998.
- There is a risk that Japan may enter a prolonged downward spiral without a prompt initiative to expand the money supply much more aggressively.
- The Euro Area is slowing down to growth of little more than 2 per cent in 1999.
- With consumer price inflation of only 1 per cent in the euro area, there is scope for a further half a percentage point cut in euro interest rates; we anticipate a quarter point reduction this spring.

Low oil prices help growth to rise in the US economy

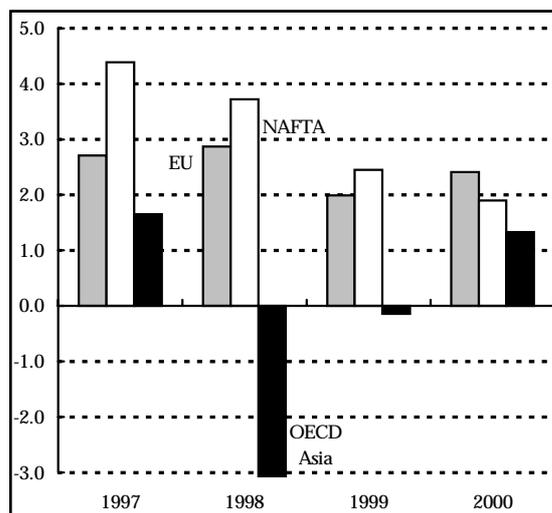
The US should expand by 2.2 per cent in 1999, helped by the substantial decline in oil prices which has a strong effect on the energy intensive American economy. Crude oil is now expected to fetch \$12 per barrel in 1999, almost a quarter lower than seemed likely at the time of our last forecast. Simulations on our model suggest that this sharp decline in oil prices will raise US growth by 0.5 percentage points while reducing consumer price inflation by 0.5 to 0.75 percentage points, more than offsetting any inflationary impulse from the recent fall in the dollar.

Prospects for Japan remain gloomy

With the yen appreciating and long-term interest rates rising sharply, the outlook for the Japanese economy remains bleak. Despite the boost from new fiscal measures, output will fall by half a per cent a year, and consumer prices will decline by nearly 1 per cent, pushing up real interest rates commensurately. The scope for further fiscal expansion is limited by the budget deficit already running at 8 per cent of GDP over the next two fiscal years. The government urgently needs to announce a plan to inject more money into the economy, generating expectations of higher inflation and bringing down the yen.

Economic growth in the Euro Area is now expected to fall from almost 3 per cent in 1998 to 2.2 per cent in 1999. Inflation as measured by the Harmonised

OECD GDP growth (per cent)



Index of Consumer Prices will run at 1 per cent—less in Germany and France—which should allow further cuts in interest rates by the ECB; we assume a further reduction of 25 basis points this spring, which would take the reduction in rates since last summer to just over a percentage point. Unemployment in the euro area will remain at over 10 per cent of the workforce in 1999 and 2000.

Analysing major recessions: an analytical summary of a new study of large recessions in the twentieth century

(the late Christopher Dow)

This article is based on a book published by Oxford University Press in December 1998 entitled MAJOR RECESSIONS: Britain and the world 1920–95. Sadly, the author, Christopher Dow died shortly before its publication. The following summary was written prior to the launch of the book. It is used here because, written by the author before his death, it best describes the aims and content of the work.

The book is about major recessions—perhaps the first to concentrate on big recessions. A major recession is here defined as a recession where output falls absolutely from one calendar year to another (usually for two or more years running). Five major UK recessions are identified in the period since 1920—all were about the same size when measured as shortfall below trend. (Before 1920 there probably were no major recessions on this definition.)

Table 1. The 5 major UK recessions 1920–95

Recession	Date	Duration	Extent of fall below previous trend
I	1920–21	1 year	11%
II	1929–32	3 years	13%
III	1973–75	2 years	8%
IV	1979–82	3 years	11%
V	1989–93	4 years	12%

Analysis

The book focusses on the UK. But major recessions occurred in most other industrial countries at about the same time; and the book makes many cross-country comparisons, and contains a long digression on the Great Depression of 1929–33 in the US. It contains a wealth of facts (over 100 tables and over 70 charts) which should make it useful as a reference book. Its aim, however, is not historical but theoretical; ie to explain how the system works.

Two main conclusions of the book are that the major recessions are caused by demand shocks; and can be explained by identifiable demand shocks, and swings in confidence that amplify the direct effects of shocks. A survey of world growth experience also indicates that while supply factors explain variations in long-term trends, they do not explain the abrupt short-term falls in output that occur in major recessions. The book thus goes against much recent theorising eg Real Business Cycle theory. It constructs measures of four types of demand shocks (see table 2) which are used to explain output fluctuations along with changes in expectations or consumer and business confidence.

The long interval without major recession

In the 41 years from 1932–73 there was no major recession (though there were what now seem minicycles). After WWII there was fairly rapid, and almost continuous, growth. The book suggests this was due to a combination of lucky accidents. WWII left high demand, later topped up by the Korean and then the Vietnam wars. Fast growth in Europe, and faster in Japan, created high demand for UK exports. And continuous growth created strong confidence and investment.

One must also ask why growth did not get out of hand, as at other times. Lending controls helped, as did the Bretton Woods system of fixed exchange rates.

Table 2. The causes of the five UK major recessions, 1920–93
X = important cause
ã = dominant cause

	<i>I</i> 1920–21	<i>II</i> 1929–32	<i>III</i> 1973–75	<i>IV</i> 1979–82	<i>V</i> 1989–93
Change in Exports	X	ã		X	
Terms of trade			X		
Fiscal policy	ã			X	
Monetary policy			X		
General comment					
Business confidence	X	X	X	X	ã

To encapsulate very briefly:

- *Recession I* (1920–2) was due to a collapse of confidence (which was worldwide and affected exports), and to taxes being kept high in order to balance the budget quickly after the war.
- *Recession II* (1929–32) was due chiefly to the huge recession in the US, and its effects on world trade. (The US Depression itself is attributed to a collapse of confidence after previous rapid boom, and to the collapse of the US banking system.)
- *Recession III* (1973–75) was due to a collapse of confidence after the Barber boom; to the rise in oil prices (and the fact that OPEC oil producers could not quickly spend new wealth); and to UK monetary policy, designed to curb inflation.
- *Recession IV* (1979–82) was due to exports, hit by the high exchange rate; and to the new government's tight budgets.
- *Recession V* (1989–93) was due not to specific shocks, but to a massive collapse of confidence after the preceding boom.

Each recession was thus different from the others.

Some general observations

- (1) Not only were major recessions all different; and they occurred at very irregular intervals (intervals between commencement dates were 8, 44, 6 and 10 years). There seems *no regular cyclical mechanism* at work: all depends on the accidents and timing of shocks.
- (2) In big recessions *confidence* is badly hit, and *investment* contracts a lot. Compared with small recessions, *unemployment* is strongly affected. The dominance of confidence effects is reflected in the *asymmetric shape* of major recessions, with rapid downturn and slow recovery.
- (3) After major recessions, unemployment tends to be long-lasting. Apart from lucky accidents, recovery only happens as confidence gets restored; and aside from such a gradual restoration of confidence, the economy (it is argued, contrary to many theories) possesses *no mechanism which brings unemployment back to some equilibrium level*.
- (4) Major recessions appear to affect not only actual unemployment, but probably also the path of capacity or 'full-employment' output. Thus major recessions, it is suggested, not only cause unemployed physical capital to deteriorate, but also partially destroy the intangible capital involved in building up a firm's trained labour force, its working arrangements, and its relations with suppliers and customers—arrangements that cannot quickly be rebuilt. Consequently *the capacity of the economy is reduced semi-permanently*—by perhaps 5% in a major recession which cuts output by 10%. Such a conclusion partially concurs with the proposition (much discussed since the 1982 article by Nelson and Plosser) that shocks have permanent effects. Minor recessions seem not to have comparable effects.
- (5) The basic explanation here given for major recessions is in terms of 'shocks' ie events not expected (or not fully expected) by market operators. Governments or economists are not in general cleverer than market operators. Hence major recessions are unlikely to be predictable; or well predicted. Reasons are given why this should be so (chapter 11.5)—chiefly that shocks are themselves not predictable, and the impact on business confidence appears not to be closely predictable. (Small recessions appear to be more easily predicted.)
- (6) The treatment adopted in this study is necessarily 'different in style from how most economists look at experience'. A sample of only five recessions is too small for the application of econometric methods. Resort has to be had not to

rigorous statistical methods applied to large-scale data, but to what are here called detailed 'case studies'. It is claimed that properly self-critical qualitative analysis has a good chance of detecting the major causes at work and providing useful guidance to policy.

Implications for policy

The last chapter emphasises both the real limitations to policy action, and the real possibilities of effective action that nevertheless exist. The economy is *not* best left to manage itself, and will perform worse unless well managed; but governments are not constructed to be ideal managers of a modern economy, nor are central banks ideal substitutes. Given that major recessions are unlikely to be foreseen, preventative action is largely restricted to (a) not positively provoking major recession and (b) general precautions, in particular avoiding excessive booms. When a major recession has once started, action is restricted to mitigating its extent and duration.

The book argues that both monetary policy and fiscal policy should be used to keep the economy growing in a stable way. It thus takes issue with the theses (a) that monetary policy should be dedicated solely to the control of inflation; and (b) that the use of fiscal policy to stimulate demand is ruled out by considerations about the scale of public debt. Nevertheless there are severe constraints to the use of both fiscal and monetary policy to influence demand. The task of macroeconomic management is seen as essentially one of moderating swings in consumer and business confidence—preventing undue exuberance beforehand, and after a recession nursing the revival of confidence.

The last words of the book are:

'Finding ways to avoid major recessions without losing control of inflation ought to be the major challenge for economic policy in the twenty-first century, in the sense that more good would be done if avoiding recessions got more attention relative to that now given to avoiding inflation. Widespread perception of the need for such a shift in macroeconomic purpose would do more than anything else to increase the chances of dealing with major recessions.'

The US stock market and the global economic crisis

Sushil B. Wadhvani, Tudor Investment Corporation (Written for the Clare Group)

The question whether the US equity market is overvalued is important from a policy perspective because a significant derating could cause a nasty recession.

In a Clare Group article, Sushil Wadhvani (Director of Research at Tudor Capital) investigates whether US shares are fairly priced. A simple Dividend Discount Model suggests that the market is two or three times overvalued. Allowing for share buybacks, takeovers for cash and temporary unsustainable earnings growth would still leave the market overvalued by 20–30 per cent.

Does the "New Economy" view justify the level of the US stock market?

On Wall Street, attempts to justify the current level of the market often rely on the 'New Economy' view that recessions are a thing of the past and that technical change justifies permanently higher earnings growth. This article offers several theoretical and empirical arguments for regarding the 'New Economy' view as implausible.

One influential argument is that the traditional premium earned by equities over bonds is too high. This is shown to be theoretically special. The fact that most wealth is held by middle-aged people with limited time horizons supports a larger premium. Another commonly heard argument on Wall Street is that low US inflation justifies a low risk premium. However, this relationship did not hold in the UK over the 1700–1939 period, or in Japan since 1992.

While the author does not pretend to know the precise level of over/under-valuation in the US equity market, he argues that:

- i) The equity risk premium has fallen, and is currently towards the lower end of its historical range (the author's 'best guess' estimate is that it is, currently, 1.7 per cent). It is, therefore, extremely unlikely to fall much further.
- ii) Surveys still suggest that investors expect double-digit returns, and are not therefore prepared for the lower returns implied by (i).
- iii) There is some chance of a global recession in the next two years.
- iv) Historical experience suggests that equity risk premium can change rapidly.

The combination of (i)–(iv) implies that there is above-average risk associated with being long in US equities now, although none of this precludes the market going higher in the near term.

Of course, the risks associated with being long in US equities also pose a risk to the global economy. If the market moves towards a more traditional multiple of earnings, those earnings themselves tend to be depressed, converting a 25 per cent fall, for example, into something rather larger in a potentially cumulative process.

The risk that a US market adjustment might cause/aggravate a recession in the US itself is a basis for reconsidering central banks' disregard of asset prices in setting monetary policy.

Asymmetric density forecasts of inflation and the Bank of England's fan chart

Kenneth F. Wallis, University of Warwick

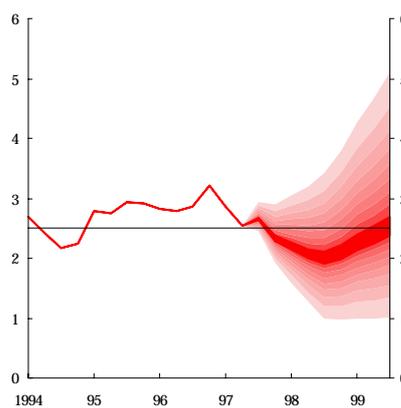
Does the Bank of England's fan chart accurately present inflation forecasts?

This article examines statistical issues surrounding the Bank of England's presentation of its inflation forecast in the "fan chart". Giving a full account of the probabilities of possible outcomes for future inflation recognises imprecision and uncertainty present in any forecast, and is a welcome development. But the way it is presented obscures bias in the Bank's central projection and misrepresents the overall balance of risks.

An important feature of the probability distribution is its skewness, represented by the two-piece normal distribution, and the *Inflation Report* often describes the balance of risks as being "on the upside". The statistical consequence is that the mode of the distribution, which is the Bank's preferred central projection, being the most likely single outcome, then underestimates the mean, which corresponds to the expected average value of inflation over a number of years. Monetary stability is usually defined in terms of the latter measure, however. In the August 1997 *Inflation Report* forecast, used as an example, whereas the Bank's most likely outturn two years ahead was on target, the implied long-run average was just over half a percentage point above the target: a persistent inflationary bias was implicitly projected. This helps to explain the phenomenon observed by the MPC in the minutes of its July 1998 meeting that, since its inauguration in May 1997, "inflation had been at or above the target, and month-by-month inflation had tended to turn out slightly higher than the Committee had expected".

The range of possible outcomes is described by the red bands or "rivers of blood" in the fan chart, reproduced in black-and-white below. These are prediction intervals for inflation with associated probability 10, 20, ... , 90 per cent, getting paler as the

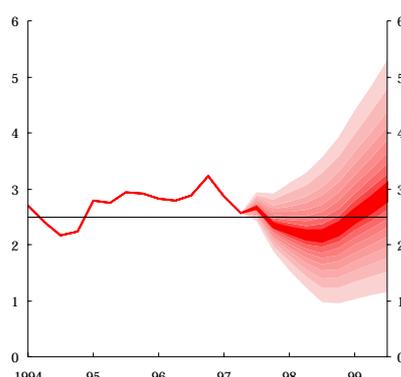
(a) The August 1997 Inflation Report fan chart



probability increases. Many readers might assume that it is equally likely that future inflation will lie above or below these intervals, but this is wrong. It is shown that inflation is more likely to exceed the upper limit of the fan chart than to fall below the lower limit, thus the fan chart under-represents the upside risks to the inflation forecast. It is argued that the fan chart should be based on "central" prediction intervals, in which the upper tail and lower tail probabilities are equal, as is conventional statistical practice. This alternative fan chart gives a clearer picture of the upside risks.

(b) Alternative fan chart based on central prediction intervals

(Increase in prices on a year earlier)



The Bank's choices could be justified if its loss function had an all-or-nothing form—it matters a lot to hit the target, but if the target is missed, it doesn't matter by how much. But this is unrealistic. In practice, the size of the error does matter, and the Chancellor's "open letter" thresholds of plus or minus one per cent give an indication of the tolerance level. More conventional loss functions lead to the statistical presentation recommended in this article.