

Andrew Bailey: Growth

Speech by Mr Andrew Bailey, Governor of the Bank of England, at the Mansion House Financial and Professional Services Dinner, London, 14 November 2024.

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My Lord Mayor, Chancellor, ladies and gentlemen

I am going to use my time this evening to talk about growth in the economy, why it matters, the current state of economic growth and its determinants, and what can happen in the future. These are, of course, very important issues.

I will start with some scene setting and context. Our decisions on monetary policy require us to assess the consequences for inflation of the pressure at the time on domestic economic resources. That pressure reflects the balance between demand and supply in goods and services, and in the labour market. We cannot just look at actual output and employment and their growth. We have to compare the actuals with a measure of potential supply, the productive potential of the economy. This way we can assess the utilisation of resources. But, we cannot directly observe productive potential. It has to be estimated, and from that we can produce an assessment of the degree of spare capacity in the economy.

This concept of potential supply capacity is crucial for the MPC in assessing inflationary pressures in the economy, but its overall significance goes well beyond that. As well as being the speed limit for how quickly the economy can grow without causing upward inflationary pressure, it also determines the growth of wealth in the long run, and is critical in many aspects of public policy, including fiscal policy.

So, what determines potential supply? In the shorter-term, it is the supply of labour and productivity (the efficiency of the use of the inputs). In the medium to longer-term, it is structural factors such as the size of the population, the rate of innovation, and changes in education and skills.

Enough theorising. I hope this much makes the point that growth in the economy matters.

Next questions are why does this matter now, and what has been going on? There are, almost needless to say, lots of facts and figures that could be put forward at this stage. I will stick to the almost bare minimum. Bottom line – it's not a good story.

I am going to give three figures for three time periods from Bank staff estimates: the average annual rate of growth of potential supply in the UK economy and the contribution to that growth rate of productivity and of labour supply. From 1990 to 2008, the average annual potential growth rate was 2.6%. Productivity contributed 2.2pp and labour supply 0.4pp. After the financial crisis, from 2009 to 2019, the potential growth rate fell to 1.3% pa, of which productivity contributed 0.3pp and labour supply 1.0pp. From 2020 – 2023 the potential growth rate fell further, to 0.7%, with productivity contributing 0.5pp and labour supply 0.2pp. Covid was clearly a major factor here.

Enough numbers. I think the point comes across. Potential supply growth has fallen since the financial crisis, with the main contributor to that fall being weaker productivity growth. Covid was then a major factor in causing a further fall. I think the issue now is not what Covid did at the time – it was clearly a huge shock to the economy. Rather, the more important question is whether and to what extent Covid has left a lasting impact on potential supply?

I am not going to spend any of the rest of my time seeking to diagnose what has happened to potential growth since the financial crisis. It is of course interesting and highly relevant, but time doesn't allow I'm afraid.

Before moving to a series of questions designed to help to set out what we should do about this situation, there is at least one other big question which deserves a short answer at least. Is the UK alone in this situation? Not entirely.

The UK looks rather more like other parts of Europe than this continent does relative to the US. The US has a better story to tell.

I will frame the rest of my remarks around five questions, which I think are relevant to thinking about what we do to tackle the issue of potential supply. The answers will be short, a lot more could be said, but not this evening – you will I hope be pleased to hear that Lord Mayor.

The five questions are: why does investment matter and what can we do about it; is labour supply an issue; are we measuring things properly and if we did, could we rest easy; does the openness of the economy, and the world economy matter here; and will AI ride to the rescue?

Why does investment in the economy matter, and what can we do about it? Productivity growth is linked to capital deepening – so it is linked to investment. The OECD produces data which show investment as a share of GDP. The UK has been almost continuously at the bottom of the G7 league table since the late 1990s. So, other things equal, the UK has a lower level of capital. Looking over the last ten years, business investment in the UK has been particularly weak by G7 standards.

We need to encourage business investment in the UK. Public investment is important as a foundation – we need better infrastructure and investment in education and the health services. So, Chancellor, I welcome the plans you have set out in the Budget, and the focus you have placed on public capital investment. But, to those who have pointed out that this will not – using the OBR's projections – raise the potential growth rate substantially, my response is "of course not".

The OBR do project an increase in potential growth, but that needs to be accompanied by stronger business investment as you have set out. And that business investment will depend on quite a few things including good public infrastructure. I have attended and spoken at quite a few of these dinners Lord Mayor, and I well remember a number of your predecessors exhorting Chancellors of the day to build Cross-Rail, as it was then known. Well, it wasn't always easy and it took rather more time and money than expected, but I will say this – we have the Elizabeth Line now and it's really good. It's worth remembering this story.

The second big need for investment is the financial system being organised to supply capital. This has also been a regular subject at these dinners, not least because of the tireless and continuous advocacy of Sir Nicholas Lyons. Pension issues are important here. The UK pension system is too fragmented. Chancellor, thank you for the work that you and Emma Reynolds are leading here and you have set out this evening. It is, I am afraid, heavy lifting and a lot of it. You need and must have our support.

As I have said recently, as well as addressing the fragmentation of pension funds, we have to encourage investment in the real economy. Requiring or trying to compel investment by Asset Managers is not the answer. But, saying that cannot take the issue off the table, far from it. The City has an important role to play here in working to help to solve this issue.

Next question: is labour supply an issue? Yes. It is along with productivity the main determinant of potential supply. In the medium to long-term, the dominant influence here is likely to be the ageing population. The UK is very far from being alone in this respect. There are shorter term trends and determinants as well in terms of labour supply – I will come to these in a moment.

The ageing population does mean the tide is running against us on labour supply. It makes the productivity and investment issue all the more important. I will also say this: when we think about broad policy on labour supply, the economic arguments must feature in the debate.

Third question: are we measuring things properly and does it matter? Oh no you are thinking, he's going to go on about data again. Don't worry – I am going to be brief. We probably are not measuring things properly – to some degree we never do or can, but we can't fall back on measurement and assume the issue away. There are three main areas of measurement, and all of them have issues: the overall size of the economy; the amount of investment; and the labour force.

The economy is probably bigger than we think it is. Why? Because we are not very good at measuring intangibles, and these are the new economy. The ONS is going to include the value of data as an asset in the overall size of GDP in the next few years. That makes sense. It's probably worth a percent or two on GDP.

Likewise on investment, we don't measure investment in intangibles well, and this is a growth area – think about IT. But, there is little reason I'm afraid to think this will vault the UK up the league table of investment, more likely all boats get lifted a bit.

And finally, the labour force. Oh dear. The travails of the Labour Force Survey are quite well known. It is a substantial problem – and not just for monetary policy – when we don't know how many people are participating in the economy. It would help if across the country we were better at answering the phone when the ONS call up. I do struggle to explain when my fellow Governors ask me why the British are particularly bad at this. The Bank, alongside other users, including the Treasury, continue to engage with the ONS on efforts to tackle these problems and improve the quality of UK labour market data.

So, measurement is an issue, but it doesn't take away the need to raise potential supply in the economy.

Question four: does the openness of the economy matter for potential supply? Yes. Openness to trade in goods and services affects productivity by facilitating competition, innovation and specialisation. There is also a strong positive relationship between openness to trade and foreign direct investment and its productivity. We can thank Adam Smith and David Ricardo for some of the earliest insights on this area.

Now, as I have said many times, as a public official I take no position on Brexit per se. That's important. But I do have to point out consequences. The changing trading relationship with the EU has weighed on the level of potential supply. The impact on trade seems to be more in goods than services, that is not particularly surprising to my mind. But it underlines why we must be alert to and welcome opportunities to rebuild relations while respecting the decision of the British people.

But, we should not focus just on the effects of Brexit. The picture is now clouded by the impact of geopolitical shocks and the broader fragmentation of the world economy. I will own up to being an old fashioned free trader at heart. It's a British characteristic I like to think. My point is this: amidst the important need to be alert to threats to economic security, let's please remember the importance of openness. Openness is an important determinant of productivity. There is nothing new about saying this, just to be clear.

Last question: will AI ride to the rescue and solve the low level of potential supply? I'm not going to give another speech now on AI, so this will be brief and high level. AI has the clear potential to become general purpose technology. In other words, it can enable widespread innovation across many parts of the economy. Previous examples of such general purpose technology were the steam engine and electricity.

Sadly, not long ago the British economic historian Nick Crafts passed away. I knew Nick forty years ago before I became a central banker. One of the things he taught us was that general purpose technologies take longer to spread into the economy and the productivity data than we assume they will. It was nearly forty years for electricity. I don't think it will be that long for AI, but Nick's point remains true. We are mostly experimenting with AI at the moment. There are strong grounds for optimism and of course risks to deal with, but AI isn't an immediate magic solution. It has lots of potential, and we must stick with it.

To conclude, Lord Mayor. Potential supply and growth matter a lot. We don't have a good recent inheritance, so this is a big issue that needs our attention. Investment and capital formation, and how to increase it matter. So does labour supply in the face of an ageing population and an immediate question of participation. We can and should measure things better and we could try answering the phone to the ONS. We must do what we sensibly can to preserve safe openness of the economy. AI has a lot of potential to change the picture, but don't expect that change to come very quickly. These are very important issues.

Now I have one thing left to say.

[TOAST] The Lord Mayor and Lady Mayoress

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