Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, to the CBI Dinner, Manchester, 20 January 2005.

* * *

Now that the Christmas celebrations are over, and the decorations have been taken down, it is time for a much-loved New Year tradition - speculating on how much we all spent over the Christmas period. With over 200 coaches bringing shoppers from all round the country to the Trafford Centre over the weekend before Christmas, New Trafford seems to be as popular and entertaining as Old Trafford. Tonight, though, I want to look beyond the immediate prospect for consumer spending and ask whether the level of saving in this country is adequate to provide for our future needs. But, first, a few words on the immediate outlook.

Tomorrow the ONS will publish its first estimate of retail sales in December. Among the more lurid headlines reporting sales over the holiday period was “Retail Festive Slump”, followed shortly by reports of “Record Levels of Sales”. To interpret the experience of a few retailers - whether positive or negative - as a national trend is highly misleading. Of course, exactly the same happens each year. Last year newspapers reported “Confirmation of a Disastrous Christmas” and “Shoppers Played Scrooge in December”. A week later the ONS said that the volume of retail sales in December rose at a rate more than double the increase expected by City economists, and the headlines became “Spending Spree Signals Rate Rise”.

The most important lesson from past experience is that, whatever the number turns out to be, it is foolish to put much weight on any one month’s figure, especially at Christmas. There are two reasons for being particularly careful about the interpretation of data for retail sales in December. First, the figure that will be published by the ONS tomorrow will be dwarfed by the seasonal adjustment that is applied to the recorded data. That adjustment changes from year to year, often leading to revisions of the figures for earlier years. Typically retail sales in December are around 20% higher than in November. So even small errors in the estimate of the seasonal pattern of sales imply large errors in the estimate of the seasonally adjusted figure. As a result the monthly data can be volatile and little economic significance should be attached to the number for any one month. Second, retail sales are only part of household spending, around 40% or so. It is quite possible, indeed likely, that spending on services, such as leisure and holidays, behaves rather differently from sales of goods on the high street. So retail sales are not always a good guide to movements of consumer spending as a whole.

For those reasons we should recognise that the true meaning of the Christmas story will not be revealed until Easter - or possibly much later. The Monetary Policy Committee is more concerned to discern the meaning of the path of consumer spending over a longer time horizon. For some years the volume of consumer spending rose much faster than its post-war average. From 1997 to 2001 it rose at an average annual rate of about 4%, and calendar year growth was last below 2% in 1995. We are not so much a nation of shopkeepers as a nation that keeps shopping. Behind this growth was a steady rise in real incomes, driven by increases in employment and falls in the prices of imported goods. Those price falls followed the rise in sterling in the second half of the 1990s, and the increase in cheap imports of manufactured goods, such as textiles, toys and electronic goods, from China and other emerging market economies. Over the past three years, however, consumer spending has decelerated and its growth has fallen to a more sustainable rate, close to its post-war average.

The slower pace of consumption growth was the result of real income growth returning to a normal rate. It is striking, as the Monetary Policy Committee has said before, that for a number of years, and despite the volatility of house price inflation, the saving ratio of households has been rather stable. Some commentators are exercised by the possibility of a rise in household saving and hence a further slowing of consumer spending. Their concern is that since consumption is the largest component of total demand, the path of consumer spending is crucial to the outlook for output and inflation. Such concerns about the short run are indeed analysed carefully each month by the Monetary Policy Committee, and the results of that analysis feed into our monthly interest rate decisions. Visits like this give me the chance to listen to you and learn from you and other businesses about what is happening on the ground - not just in the retail sector but in manufacturing and services more broadly. And my visit is the tip of an iceberg because we have a permanent Agency in the North West - staffed by members of the Bank who live and work here.

But I want to step back from the immediate conjuncture and look further ahead. More relevant for our future prosperity is the question not of whether we might save too much but whether we are saving too little. The level of income that will sustain us in the future depends critically upon how much as a nation we set aside today. In other words, what is happening to the **national** saving rate - the proportion of the net national product that is not consumed by either the private or public sector?

Since the late 1960s the national saving rate has been declining fairly steadily, from over 10% to around 5%. Although saving rates elsewhere in the G7 have also fallen, they were higher than in the UK for most of the post-war period. Recently the gap between saving rates in the UK and the rest of the G7 has narrowed considerably, not as a result of higher saving in the UK but lower saving elsewhere. In large part this reflects changes in fiscal policy. There is ample empirical evidence that higher government borrowing lowers national saving. And for twenty years or more the G7, while lecturing each other and the rest of the world on the need for fiscal discipline, has continued to borrow more and more. The ratio of net public debt to GDP in the G7 has more doubled since 1980 from around 25% to around 60%. The UK is the only member of the G7 in which the ratio is lower than in 1980.

The UK has a clear framework for fiscal policy. Although rules and frameworks cannot guarantee that governments will pursue sustainable fiscal policies, as the large deficits in the early 1990s illustrated, they make deviations from medium-term sustainability more transparent. But in the rest of the G7 the absence of a clear framework, as in Japan and the United States, or the lack of credibility in the stated framework, as in the failure to enforce the Stability and Growth Pact in the euro area, has made it easier to let the fiscal position slip. As a result, the G7 fiscal deficit is now close to its 25-year peak, and the average national saving ratio has halved.

At home, the Government's fiscal rules constrain the path of fiscal deficits. They limit borrowing, over the economic cycle, to the level of public investment and place an upper limit on the debt to GDP ratio of 40%. In assessing the fiscal position it is important to look forward and not just backward at the realised deficits over the past cycle. Of course, it is also important to recognise the many uncertainties surrounding the future path of the public finances.

Central bankers probably talk too much about fiscal policy. Certainly, there are politicians, especially in Europe, who believe central bankers confuse the deficits which dot the fiscal landscape with all manner of economic evils, rather as Don Quixote confused the windmills which dotted the landscape of La Mancha with the terrible giants sent by some evil force. So I do not want to overstate the case and tilt at windmills, especially in the light of the fact that this month sees the 400th anniversary of the publication of Cervantes' great novel. But it will clearly be important that the prudent approach to fiscal policy that has served the UK so well in recent years is continued - over the next cycle and beyond. In that way our national saving rate can be maintained or even raised.

The market response to inadequate saving is higher real interest rates. Since the UK is a part of an open international capital market, long-term real interest rates in this country reflect the balance between investment and saving, including the stance of fiscal policy, not just at home but throughout the world economy. Surprisingly, in the light of the fall in G7 saving, UK long-term real interest rates - as measured by the forward rates implied by the yields on index-linked gilts - are near their lowest levels for twenty years. US and euro-denominated rates are also low relative to past experience. There may be other factors that have offset the effect of fiscal policy on real interest rates, such as demographic developments and higher saving and more open capital markets outside the G7. But there remains a risk, as discussed in the Bank's recent Financial Stability Review, of an unwinding of low long-term real interest rates as the stimulus from highly accommodative monetary policies across the G7 economies is gradually withdrawn.

What do these arguments mean for monetary policy today? They imply, I believe, three main challenges for central banks. First, the factors that affect the level of real interest rates in capital markets around the world also determine whether a given official interest rate is an expansionary or restraining influence on demand. When driving a car we normally know whether our foot is on the accelerator or the brake. That is less obvious in the case of monetary policy - hence the debate among economists about the level of the so-called neutral interest rate. Uncertainty about the extent to which monetary policy is applying the accelerator or the brake justifies central bankers' continued interest in the monetary and credit aggregates which contain information about the pace of nominal activity and hence future inflation.

Second, over the next few years the transition to a higher national saving rate is likely to imply a switch of resources from consumption in the private and public sectors to investment and net exports. It will

not be easy to achieve that while keeping inflation on track to meet the target and maintaining steady growth in output. It is very likely that, when the ONS publish next week their first estimate of economic growth in the final quarter of last year, it will show that the UK economy has now had 50 consecutive quarters of positive economic growth. No other G7 economy avoided falls in output over that period. But we should recognise, as I hope the English cricket team does tomorrow, that reaching a half-century is no time for complacency but for renewed concentration.

Third, the ability to buy goods from abroad at ever lower prices has kept down inflation at home and sustained faster growth in real incomes and consumption - just as Richard Cobden and John Bright, and the other founders of the Manchester School, argued more than 150 years ago. And it is not just consumers who are paying less for these items. Retailers are too. But the inflation rate of goods and services produced in the UK has been rising modestly for two years or so. That has been offset in large part by a fall in import prices. Although we can influence the former we have little control over the latter. There would be risks to output and inflation in the medium term if we were to allow inflation of domestically produced output to rise above target unless we were confident that falls in import prices would indeed continue for some years.

The lesson that we should not place excessive weight on one month's figures is as true of inflation as it is of retail sales. In December CPI inflation was 1.6%. Three months ago it was 1.1%. Six months ago it was 1.6%. Yet the broad outlook for the economy - a central view of continuing steady growth with low inflation - changed rather little during the period. The MPC cannot fine tune short-run movements in output and inflation.

When the MPC published its Inflation Report in November, some commentators said that inflation was seemingly stuck at around 1%, and that if growth were to continue at around trend then it was difficult to see why the Committee's central view was that inflation would pick up to the 2% target looking ahead around two years or so. Since then inflation has risen by half a percentage point in only three months. Stating the point in that way shows how silly it is to place so much weight on small changes in inflation and small deviations of inflation from target.

The appropriate response by central banks is to examine all the economic data, and to focus on the outlook for inflation in the medium term. That is exactly what the MPC will continue to do. And by keeping inflation on track to meet the 2% target, the MPC will be making its contribution to future prosperity, both in the Trafford Centre and the country as a whole.