Mervyn King: Globalisation and relative price changes

Speech by Mr Mervyn King, Governor of the Bank of England, at a dinner for Kent Business Contacts in conjunction with the Kent Messenger Group/Kent Business, Kent, 16 January 2006.

* * *

Two weeks ago Trafalgar Square was packed with revellers celebrating the New Year. A century ago it was crowded with hop-growers and pickers. On May 16th 1908 - "Hop Saturday" - around 30,000 people working in the hop trade travelled to London to demonstrate against unfair foreign competition and to demand the introduction of a tariff on imported hops. It was the largest demonstration in Trafalgar Square for many years. Special trains were laid on to London Bridge from where the demonstrators marched to Trafalgar Square, accompanied by bands playing and banners flying. According to the Times, "One of the most conspicuous banners bore the words: 'And shall hops picked by Chinamen make England's hop trade die, here's 50,000 Kentish men will know the reason why'". Another, appropriately above the plinth of Nelson's column, read "England expects that every hop shall pay a duty". A resolution was proposed demanding the imposition of an import duty of 40 shillings per cwt on all foreign hops. Having carried the resolution, the assembled gathering sang "Rule Britannia", after which the massed bands played the National Anthem and a verse of "Auld Lang Syne".

Colourful and moving though the occasion was, the decline of the hop industry was inexorable and inevitable. Nothing could stem the tide of changes in technology and in tastes for new lighter - foreign - beers, and attempts by government through higher excise duties to reduce the consumption of beer. A willingness to adapt and embrace, rather than resist, change is the key to greater prosperity. That road may at times be hard going - as I know many of you will have experienced in your own businesses - but it leads ultimately to a more prosperous destination.

To follow the right road we need signposts. In a market economy those signposts are movements in prices. If a particular product becomes more abundant or less in demand, its price will fall relative to the prices of other products. That relative price change is the signal which encourages consumers to buy more or producers to supply less. Over recent years, three new signposts have appeared. They mark a process that has transformed demand and supply conditions across the globe: the integration of China, India and other emerging market economies into the world trading system.

The first signpost shows that prices of labour-intensive manufactured goods have fallen. China, India and the former Soviet Union between them have massively increased the supply of labour available to industry around the world. As labour-intensive goods have become more abundant, they have also become cheaper. The signpost points us in a familiar direction: the need to change what we produce. Were we still producing the same labour-intensive goods as before, with output concentrated in industries like agriculture (including hops), textiles, coal-mining and ship-building, we too would have seen the price of our own output fall, just as it did for hop growers a century ago. Instead we allowed output and employment to expand in those industries where we could exploit a comparative advantage. In Kent, the expanding sectors include financial services, transport (with 18 million tons of freight passing through the Channel Tunnel each year) the exploitation of life sciences, and higher education (with five universities in the county).

As consumers, we have benefited from falling prices of goods made in China and elsewhere in Asia. Between 1995 and 2005, the prices of imported manufactured goods fell by a sixth and, relative to the price of domestically produced output, by no less than a third. So over the past decade we have been able to increase consumption by more than the increase in production. Openness to the world economy has resulted in a higher standard of living.

The second signpost marks the rise in oil and other commodity prices. Rapid growth of production in China, India and other newly integrated economies has led to a substantial rise in the demand for oil and other raw materials. Between 1995 and 2004, net imports of oil to China rose by a factor of seven. Unlike earlier episodes of high oil prices, which were driven largely by temporary supply constraints, the recent increase in the demand for oil has been reflected in higher prices for future delivery as well as higher spot prices. Similar rises are apparent in the market for gas. The signpost marked higher energy prices points us towards ways of using less energy, to alternative energy sources and to new sources of oil production such as the Canadian tar sands.

The first two signposts point us in the right direction. But the path has not been easy to follow. We have seen movements - in both directions - in inflation, consumer spending and output growth. Interest rates too have moved both up and down in order to maintain overall stability of the economy by keeping consumer price inflation close to the 2% target. The reasons for those changes have been explained in the minutes of the Monetary Policy Committee meetings and in our *Inflation Report*. Tonight, I want to look a little further ahead, to the challenges for monetary policy posed by a third signpost - the recent fall in long-term interest rates. The development of an integrated world capital market means that these now depend on savings and investment decisions elsewhere in the world as well as here at home.

Investors seem to be willing to lend to governments at much lower interest rates than for many a year. In some cases they have lent money for fifty years at around 4%, and the interest rate on long-term UK government bonds is at its lowest level for over 50 years. Low and stable inflation clearly explains much of the fall in long-term interest rates which fell sharply when the Bank of England was made independent in 1997. But over the past three to four years long-term interest rates around the world have fallen further to remarkably low levels. In the UK, the annual interest rate on 20-year index-linked government bonds, after allowing for anticipated future inflation, is now around 1%. For most of the past 25 years, that so-called “real” rate of interest has varied between 2% and 4%. Long-term real interest rates of no more than 1% would normally be a signal to spend more, save less, and to invest in physical as well as financial assets. But it is not at all clear that rates will persist at such low levels. So is this particular signpost reliable?

There are broadly two types of explanation for the fall in long-term real rates around the world. The first explains low interest rates as the outcome of an increased propensity to save and lower willingness to invest in the world as a whole. The second explains them as the result of rapid growth in money and credit which, in a “search for yield”, drives asset prices up and interest rates down.

There is no doubt that in the past few years saving has been particularly high in the Asian economies. In part, this reflects their wish to build up large balances in US dollars to protect themselves from financial crises that several of them experienced in the 1990’s, and also to maintain competitive exchange rates to allow export industries to absorb surplus labour. For example, although China invests an extraordinary 45% of its national income each year, it saves even more than this - 49% of national income in 2004. The resulting current account surpluses have been saved overseas, much of them in US government bonds. So, rather surprisingly, capital is flowing from some of the poorest countries of the world to some of the richest. Moreover, the rise in oil prices has raised the incomes of oil-producing countries, which have also chosen to save much of their additional revenues in overseas financial assets. Those surplus savings have depressed long-term real interest rates. In the industrialised world, consumers have realised that this is a good time to borrow and spend, resulting in the “imbalances” evident in the current account deficits of both the US and the UK.

Whether long-term real rates around 1% are sustainable is an interesting question, and that uncertainty poses serious questions for monetary policy. On the one hand, the increased propensity to save across the world could start to unwind. As their people become more prosperous, domestic demand in China and elsewhere in Asia will become the primary driver of those countries’ growth, so they may want to save less. And business investment in the developed economies, which has been weak in recent years for reasons we do not fully understand, may pick up as in previous recoveries. The resulting rise in real interest rates and implied fall in asset prices would encourage the industrialised world to save more. That would mean a shift of resources in those countries away from domestic demand to net trade accompanied by a change in real exchange rates. The “imbalances” in the world economy would start to unwind. Where that would leave sterling and the outlook for inflation in the UK is impossible to know in advance.

On the other hand, it is quite possible that real interest rates could remain low for some time. Although there are signs of a pick-up in business investment in the US and Euro area, investment remains weak in the UK and a recovery of world investment spending is not assured. The growing recognition that increasing longevity will mean we need to save more for retirement may sustain or even lift world saving rates. And pension funds are now matching the risks of their assets with the risks of their future liabilities, thus raising the demand for safer long-term financial assets such as index-linked government bonds. Economists have long found it difficult to explain why, given the risks of equity investments, governments should need to offer high real rates of return on their bonds in a world of low and stable inflation. So perhaps the world capital market is returning to an era of low real rates more akin to the nineteenth and early twentieth centuries. If annual market rates on index-linked securities in the UK were to remain around 1%, then, with a 2% inflation target, the level of official interest rates required to balance overall demand and supply would, in the long run, be lower than was thought necessary in the past few decades.

Even if we knew that long-term interest rates were low because of a change in the balance of saving and investment in the world, judging the appropriate level of interest rates would be a challenge. But monetary policy is made more difficult by the fact that there is another, very different, explanation of recent low long-term interest rates. Rapid growth of money - as central banks have kept official interest rates very low - has helped to push up asset prices as investors "search for yield". Data from the IMF suggest that world broad money in 2003 and 2004 was growing at its fastest rate since the late 1980s. Across the world, the prices of all kinds of assets have risen - not just of government bonds, but also of equities, houses and other real estate, commodities and gold and other precious metals.

Moreover, risk premia have become unusually compressed and the expansion of money and credit may have encouraged investors to take on more risk than hitherto without demanding a higher return. It is questionable whether such behaviour can persist. At some point the ratio of asset prices to the prices of goods and services will revert to more normal levels. That could come about in one of two ways: either the prices of goods and services rise to "catch up" with asset prices as the increased money leads to higher inflation, or asset prices fall back as markets reassess the appropriate levels of risk premia. In neither case would it be easy to keep inflation close to the 2% target.

I do not pretend to know whether the signpost of low levels of long-term interest rates is primarily related to underlying preferences for saving and investment, or to the global growth of money and a possible under-pricing of risk, or, in all probability, to some combination of the two. Nor, since we do not know the causes of low long-term rates, can we be sure for how long they will persist. Monetary policy will, therefore, need to be alert to the information contained in a wide range of asset prices, to be forward-looking in its aim of maintaining low and stable inflation, and to be ready to respond to changes in the signposts.

The remarkable degree of stability that the UK economy has enjoyed over the past decade has been less evident over the past twelve months. Growth slowed and inflation rose above target. But after a period driving along a smooth new highway, a change to a more challenging road surface does not, as I said recently to the House of Lords Economic Affairs Committee, mean that the wheels are coming off the economy; rather, it tells us that there are somewhat more and somewhat larger bumps on the road. Monetary policy can try to avoid some of the worst bumps, but it cannot ensure a flat road surface. Nevertheless, growth has picked up and inflation has fallen back close to its 2% target. Our central view remains one of steady growth and low inflation. But there are risks to that central view emanating from the rest of the world and we shall watch developments in world capital markets carefully. By keeping inflation close to the target, and so doing what it can to maintain economic stability, the Monetary Policy Committee aims to allow you and other businesses to follow the signposts which guide a market economy.

I cannot finish without reminding you that tomorrow is the 300th anniversary of the birth of Benjamin Franklin, arguably the greatest of the American founding fathers. During his lengthy stays in England, Benjamin Franklin visited Kent many times. To celebrate his tercentenary the American Brewing Association has produced a new recipe for Franklin's favourite beer. The hops recommended for the recipe are Kent Goldings. Despite the fears of the demonstrators on Hop Saturday in 1908, the Kent hop industry has not disappeared altogether. The area under planting is certainly much smaller, but research in centres such as Wye College has produced the new hedgerow hops which are recognised worldwide. Employment in Kent, though, has moved into new and more productive sectors. Adapting to changes in the external environment is not easy for any of us- whether running a business or setting monetary policy - but if we do adjust the benefits will accrue, if not to everyone immediately then to the great majority over the years to come.