Andrew Sentance: Key issues for UK monetary policy

Speech by Mr Andrew Sentance, Member of the Monetary Policy Committee of the Bank of England, at pro.manchester members' lunch, Manchester, 26 April 2011.

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I would like to thank Tomasz Wieladek and Adrian Chiu for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

It is a great pleasure to be giving this speech here in Manchester, ahead of my last meeting as a member of the Monetary Policy Committee, and I am very grateful to Pro-Manchester for hosting this event. Manchester is one of Britain's great industrial cities and it also played a key role in the development of economic thinking in the 19th Century, as the centre of the "Manchester School" of political and economic activists who promoted the virtues of Free Trade. The process of reducing barriers to trade and the development of an open trading system has been a key factor underpinning the unprecedented period of economic growth and rising prosperity enjoyed by many economies around the world since the middle of the 19th century. And over the past two decades, the global trading system has expanded to include China and India with their vast populations, as well as many other developing and emerging market economies. The rapid economic development of these economies as they have integrated into the global economic system has created a major engine of growth for the world economy.

However, this period of intense globalisation has not been without its downsides. Over my time on the Monetary Policy Committee since October 2006, we have seen how a highly integrated economic and financial system can also generate instabilities and transmit economic shocks rapidly around the world. The debates and the decisions of the MPC while I have been a member of the Committee have been dominated by the impact on the UK of the turbulence created by a global financial crisis, a major world recession and the inflationary impact of movements in globally traded energy and commodity prices.

There was very little inkling of the turmoil to come when I joined the Committee in October 2006. My time on the MPC started towards the end of its first decade, which was a period of relatively stable economic conditions – steady growth and low inflation, with unemployment around 5% of the labour force. For me, however, this honeymoon period did not last long. Less than a year after I joined the Committee, over the summer of 2007, we saw the first tremors of the financial crisis. And by the autumn of 2008 it was clear we were heading into a major world recession. In response to these shock waves from the global economic and financial system, the MPC cut the official Bank Rate to 0.5% – the lowest level in over 300 years of the history of the Bank of England – followed by direct injections of money through the programme of Quantitative Easing.

These policies, accompanied by similar measures around the world and government interventions to stabilise the financial system, succeeded in arresting the sharp downturn in demand in late 2008 and early 2009 and a recovery has been underway here in the UK and in other major economies since the second half of 2009. The bounceback in the global economy since the middle of 2009 has been particularly impressive, supported by strong growth in Asia and emerging markets, and stimulatory economic policies across the world economy. World GDP growth last year was 5% according to the IMF, well above the long-term average and much stronger than most forecasts were suggesting in early 2009 at the trough of the recession, when the IMF itself was forecasting that world growth would be less than 2% in 2010.

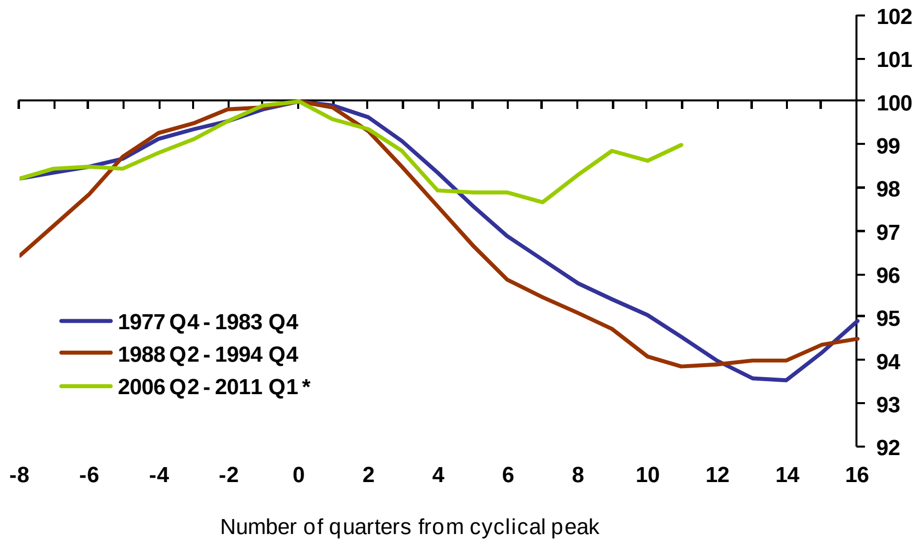
Here in the UK, we have also seen the economy begin to recover from recession over the last eighteen months or so. As is the case with all economic recoveries, growth has not been even from quarter to quarter or across sectors of the economy. For example, we saw a strong period of growth in the middle of 2010, followed by softer indicators towards the end of last year, with the bad weather making it particularly difficult to interpret the trend in economic activity over the winter. And it is not surprising to see a softening in indicators of consumer spending in the early months of this year in response to the recent rise in VAT and other inflationary pressures which have squeezed real incomes.

Despite these pressures, however, recent business surveys and employment data suggest that the UK's economic recovery has continued in the early months of this year after a disappointing fourth quarter affected by snow. The indicators from manufacturing industry continue to show strong growth on the back of buoyant export markets and activity is also expanding in the services sector, albeit at a relatively modest pace. Meanwhile, the latest Labour Force Survey estimates show that employment growth is picking up again, driven by private sector job creation. Looking back over the past twelve months, nearly 400,000 jobs have been created across the economy as a whole – which compares very favourably with the rate of job creation in the decade before the recession.[1]

Chart 1

UK employment in recessions and recoveries

Numbers employed rebased to 100 at cycle peak



*: Numbers employed for Q1 2011 proxied by that between Dec 2010 and Feb 2011.

Source: ONS Labour Force Survey

As Chart 1 shows, the performance of UK employment has been much stronger through the recent economic cycle than we saw in the early 1980s and early 1990s – reflecting the flexibility of the labour market, the resilience of businesses through the recession and the impact of the recovery in demand over the past eighteen months. According to the latest estimates, UK employment is about one per cent down on its peak level in early 2008, compared to a reduction of 5–6% at the equivalent stage of the previous two economic cycles. Unemployment appears to have peaked at just below 8% of the labour force whereas

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[1] Total employment grew by 1.4% in the year to Dec-Feb 2011, according to the latest Labour Force Survey, while private sector employment is estimated to have risen by 1.9% over the course of 2010. This compares with average employment growth of around 1% per annum between 1997 and 2007.

it rose to over 10% following the early 1980s and early 1990s recessions. And I am pleased to note that despite the recession, the number of people employed in the UK is now back above the level recorded when I joined the MPC in October 2006.[2]

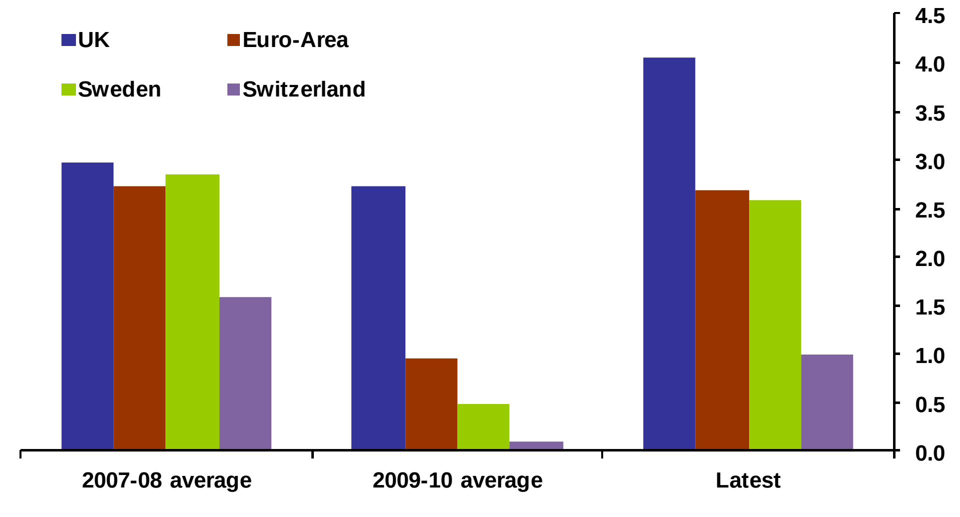
For me, it is not the growth or employment performance of the UK which has been disappointing over the period of economic recovery, but the persistence of relatively high inflation. The primary responsibility of the Monetary Policy Committee within our current policy framework is to maintain price stability – defined in terms of a 2% target for CPI inflation. Yet the current level of inflation is 4% and the most likely scenario is that it will rise further as we move through this year. And this is not just a one-off episode. Over the 55 months I have spent so far as a member of the Monetary Policy Committee, inflation has been above target more than five times as often as it has been below – 46 months compared to 9 months. Indeed, for the majority of my time on the Committee – in 28 of the past 55 months, CPI inflation has been 3% or more.

The official commentary of the MPC on this inflation over-run has been to emphasise one-off factors pushing up inflation, such as oil and commodity prices and the recent rise in VAT. Such factors do clearly contribute to the volatility of inflation, but they do not tell the whole story. Oil and commodity prices have similar effects across a wide range of countries which have a similar economic structure to the UK. But when we compare our recent inflation performance to other European economies – whether they are part of the euro area, or have independent monetary policies, as Sweden and Switzerland do, the UK's inflation experience looks noticeably higher through the recession and into the recovery.

Chart 2

Inflation in selected European economies

Annual percentage change in consumer prices



Source: Thompson Datastream

As Chart 2 shows, our consumer price inflation has been around 1.5–2.5% above our peer group of European economies through the recessionary period and this gap appears to be persisting into the recovery. The recent VAT increase cannot account for this inflation gap,

2 Total UK employment according to the latest Labour Force Survey was 29.23 millions compared with 29.07 millions in the third quarter of 2006.

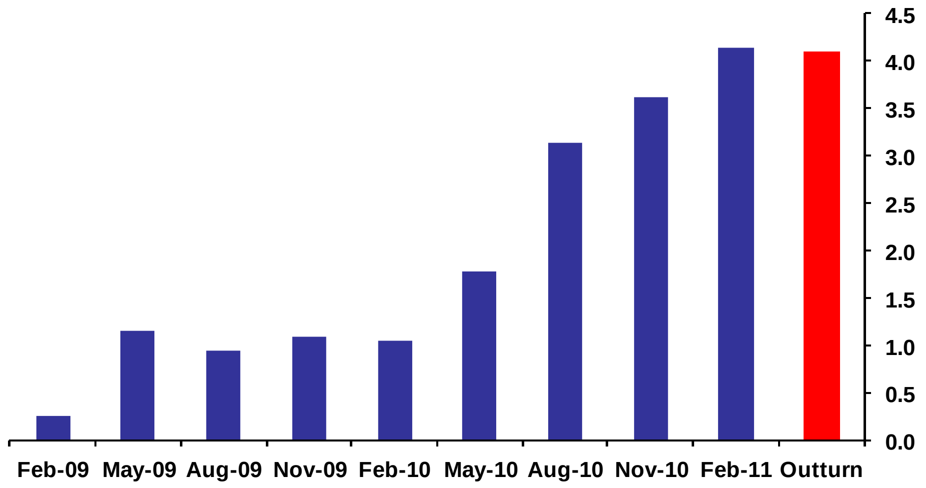
which emerged before VAT was raised to 20% in the UK. Indeed, the UK is not alone in raising indirect taxes to reduce its public sector deficit and VAT rates have been rising in other European countries as well.[3]

In addition to this contrast with other European countries, our experience of rising UK inflation has been at odds with the standard "output gap" model used by many central banks and economic forecasters to project inflation. The impact of depressed demand and spare capacity created by the recession should mean that inflation falls in a recession and the early phase of an economic recovery – and this was indeed the expectation of the MPC and other forecasters in 2009 and early 2010. As Chart 3 shows, the forecasts published in the Bank of England *Inflation Report* at that time were for CPI inflation to be around 1% or below in the first quarter of this year, whereas in fact the out-turn is above 4%. Short-term inflation forecasts have had to be radically altered as evidence of higher inflation has accumulated. And yet the settings of UK monetary policy have not changed at all in the light of this experience of much stronger inflation. The view that spare capacity and weak demand will bear down on inflation in the future still underpins the majority view on the MPC, despite the evidence that this is not what has happened over the recession and the early phases of the recovery.

Chart 3

Changing inflation outlook for 2011

Bank of England mean forecasts for CPI inflation in Q1 2011



Source: ONS and Bank of England

In my time on the Monetary Policy Committee I have earned myself a reputation as a "hawk" or even an "uber-hawk" because of my stance on interest rates. This reputation has been reinforced by my consistent minority votes since June last year to raise the UK Bank Rate. But I acquired my hawkish mantle much earlier, in my first year on the MPC, when I voted in

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[3] According to monitoring by TMF, an international tax consultancy, eight other European countries raised VAT rates at the beginning of 2011, including Switzerland, from 7.6% to 8%; Portugal, from 21% to 23%; Poland, from 22% to 23% and Slovakia, from 19% to 20%. Spain and Portugal also raised rates last year, along with Finland. In addition, the ONS estimate that UK CPI rose by 0.76% in January 2011 in response to the rise in VAT, whereas the difference between UK and euro area inflation in that month was 1.7%, and the gap with Swedish and Swiss inflation was 1.9% and 3.7% respectively.

a minority on a number of occasions to raise interest rates in response to the relatively strong growth and rising inflation we were experiencing before the financial crisis. Those minority votes, however, were the expression of modest differences in the timing of interest rate changes. The MPC was tightening policy over that period – from the summer of 2006 to the summer of 2007 – and I was in support of the broad strategy of gradual tightening that was being pursued. And I continued to support the broad strategy of the majority of the Committee as we relaxed policy – gradually at first, and then more dramatically from October 2008 onwards. So until I started to express my dissenting votes to raise rates last summer, I felt that my views were relatively close to the majority on the Committee and differences of view were mainly tactical – relating to the timing of Bank Rate changes.

I now feel somewhat differently about my position relative to the policy which the majority of the MPC has supported over the past year. Even though my position on interest rates has gathered support in recent months, it is nearly a year since I started to vote for a gradual rise in the UK Bank Rate, in response to a recovering economy and rising inflation. I don't think such a persistent difference of view with the majority on the Committee can be described as tactical. It reflects significantly different views on the outlook for inflation and growth in the UK and how we should respond as a monetary authority.

In the debates we have had within the MPC over the past year, there appear to be four key areas where these differences of judgement arise, and which – so far at least – have led me to a different conclusion on monetary policy from the majority on the Committee. These are not new issues in that they have featured throughout my time on the MPC and in many earlier debates on UK monetary policy. But the current economic situation has brought them into sharper focus.

Issue 1: The powerful influence of the global economy

The first of these key issues I would highlight is the way in which the MPC takes into account the powerful influence of global economic trends and their impact on the UK economy. The way in which the global economy affects the economic outlook for the UK has been a major theme of my speeches and interviews since my very earliest days on the MPC. The UK economy is very open to international trade, with imports and exports combined accounting for over 60% of GDP. We are also the second most important global economy after the US in terms of flows of international direct investment. The UK is home to one of the most important global financial centres in the world – London. And we have a very international business community, reflecting the UK's position as a major trading and commercial centre dating back to the late 17th century, when the Bank of England was founded, and the leading role that Britain played as the pre-eminent industrial power in the 18th and 19th centuries.

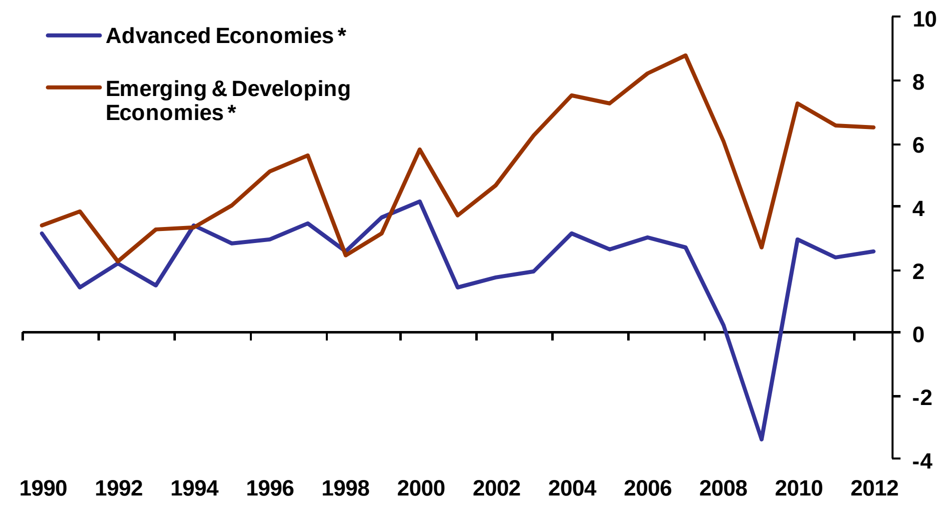
When I joined the Committee in 2006, it struck me that most of the shocks and disturbances that the MPC had had to deal with – even in the less turbulent times of its first decade – had emanated from the global economy. The MPC came into being in 1997 just as the Asian crisis was unfolding, and the response to that period of global turbulence was a key issue dominating the first two years' of the Committee's life. Then followed the dotcom boom and bust centred on the US economy and the global political turbulence following the 9/11 attacks, including the effects of war in Afghanistan and Iraq. Then, as the global economy recovered in 2003/4, the emerging issue was the upward pressure on oil and commodity prices and these global inflationary forces were a major preoccupation until the middle of 2008 and have re-emerged as a serious concern as the world economy has recovered from recession.

The global financial crisis from 2007 to 2009 was the most extreme of these international economic shocks affecting the UK economy. It had an impact on the UK through a number of different channels – global financial markets, the financial health of our banks and other financial institutions, world trade and economic activity, and through business and consumer confidence. Because the shock was much bigger than earlier shocks the MPC had faced, the policy response was more dramatic, featuring deep cuts in interest rates and direct injections of money into the economy through Quantitative Easing. In my view, this was entirely right and appropriate given the risks of a deepening recession and deflationary pressures.

Chart 4

Strong emerging market growth to continue

Annual percentage growth rates of real GDP



*: 2011 and 2012 growth rates are IMF forecasts.

Source: IMF World Economic Outlook

However, the trends in the global economy have now turned around. As Chart 4 shows, global growth in both the advanced economies and emerging and developing market economies – dominated by Asia – has recovered to rates very similar to our experience before the recession. And the upward pressure on global energy and commodity prices we saw before the recession have resumed. According to the forecasts produced by the IMF and other major forecasting organisations, this relatively strong growth is set to continue through 2011 and 2012 and the Bank of England's own *Inflation Report* forecasts also reflect the pattern of continuing strong world growth.

Against this background, it seems to me likely that the upward pressure we are seeing from global inflationary pressures is likely to continue for some time. Rises in energy and commodity prices are clearly part of this pattern, and they may continue. An oil price of $150 barrel and perhaps higher is quite conceivable.[4] And we should not be surprised to see these inflationary pressures transferred to more general increases in the prices of manufactured goods imported into the UK. In China and other Asian economies which are key producers of manufactured goods, domestic inflation and the pressure of demand from global markets is putting upward pressure on wages and the cost of production. This prolonged period of upward pressure on inflation from the global economy can be seen as the mirror image of the "China effect" which helped to hold down inflation in the UK and other western economies in the late 1990s and the first half of the 2000s.

[4] Between last autumn and this spring, the price of Brent crude rose from around $80/ barrel to over $120/barrel in the space of just six months. A continuing rise at just half this pace would take the price to $150/barrel by the autumn of 2011.

These inflationary pressures from the global economy are closely linked to the strong growth in Asia and other emerging markets, which is projected to continue for some time. This means we cannot simply regard them as one-off shocks which will fade away. And just as the MPC has adjusted to changes in global growth and inflation in the past, we need to be prepared to do so now – in a gradual and measured way. The argument that these recent developments in the global economy can be ignored by monetary policy because they emanate overseas is not consistent with the previous responses of the MPC to changes in the global growth and inflation climate. That includes the dramatic monetary policy relaxation in late 2008 and 2009 in response to the global recession triggered by the financial crisis.

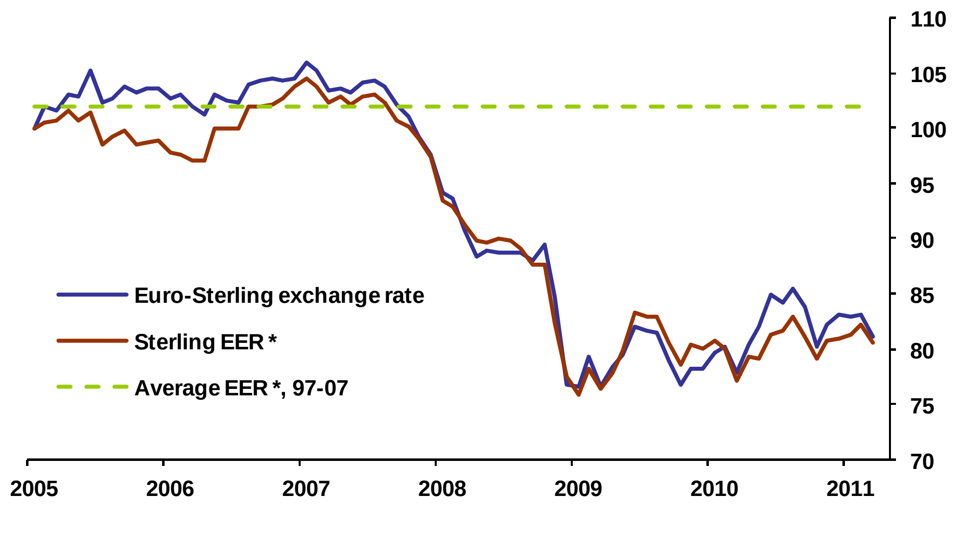
Issue 2: The role of sterling in UK monetary policy

One obvious way in which a tightening in UK monetary policy might affect our exposure to imported inflationary pressures is through its impact on the value of the pound. And this is the second key area where I see my view diverging from the majority of MPC members at present. In my view, the external value of the pound is a key channel of UK monetary policy and I would have expected the policy that I have been advocating – of gradually raising interest rates – to exert some upward pressure on the value of sterling on the foreign exchanges. That, in turn, would have provided some offset to the global inflationary pressures we have been experiencing over the past year. Instead, as Chart 5 shows, sterling has remained relatively weak, both against the full trade-weighted basket of the currencies of our trading partners, and particularly against the euro – which is the most important currency for UK trade, with the euro area accounting for around half of our total exports and close to half of total UK imports.

Chart 5

Sterling depreciation since 2007

Rebased to 100 in January 2005



*: Effective exchange rate

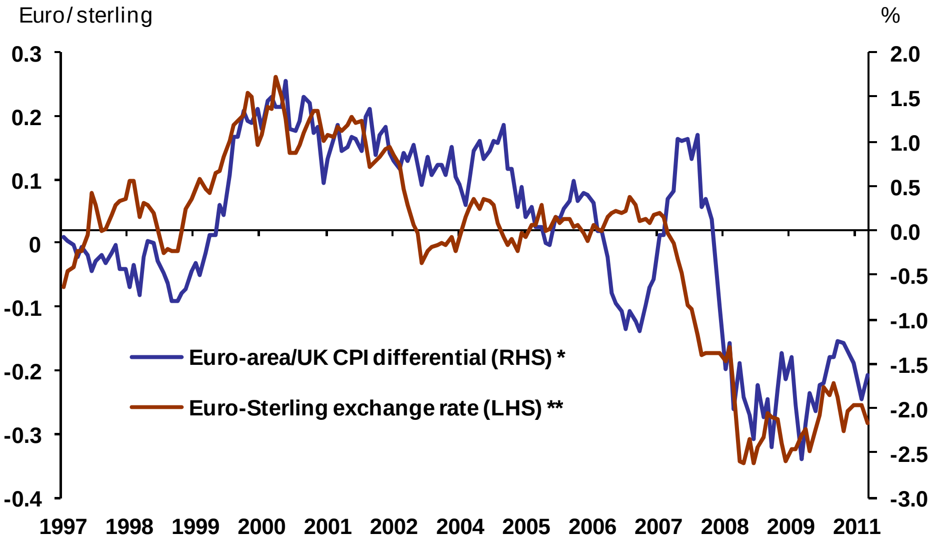
Source: Thompson Datastream and Bank for International Settlements

This weakness of sterling is one of the key reasons why UK inflation has been much higher than our peer group of European economies. As Chart 6 shows, the differential between inflation in the euro area and the UK is closely associated with the relative strength and weakness of the sterling/euro exchange rate. And there are good reasons for this. While the

UK has an independent monetary policy, it is a member of the Single European Market which covers all European Union economies. The benchmark prices of traded goods in the European market will be set in terms of euros, reflecting the fact that this is the currency in which most European producers will have their costs and revenues denominated. So when the pound falls against the euro, producers will tend to raise their prices in sterling terms to maintain euro revenues, creating a positive UK-euro area inflation differential, as we have seen recently. By the same token, the weakness of the euro against the pound in the first half of the last decade created a negative UK-euro area differential with UK inflation running below continental European countries.

Chart 6

Euro-Area/UK inflation differential and exchange rate



*: Euro-area CPI minus UK CPI. A negative differential implies higher UK inflation.

**: Expressed as the deviation from its average over the same period.

Source: Thompson Datastream

Chart 6 suggests that this inflation differential can be quite persistent as it takes time for prices to adjust. That is not surprising, as companies know that foreign exchange markets are volatile and so the initial response of prices to an exchange rate change is likely to be relatively small. But the longer it persists, the more likely it is that sterling prices will adjust to euro prices, creating the potential for quite long term impacts on UK inflation relative to the euro area. That is what we appear to be seeing at the moment, with the historic relationship shown in Chart 6 suggesting that UK inflation could run 1 to 2 percentage points above euro area inflation for a considerable while unless there is some noticeable appreciation in the value of the pound.

The counterargument to this view is that the recent substantial depreciation of the pound against the euro and other currencies is needed to support a rebalancing of the UK economy and sustain the growth of UK manufacturing and other internationally competitive sectors of the economy. But the extent of the depreciation of sterling since 2007 has been much greater than we have seen in previous rebalancing episodes, such as the mid-1990s – which raises the question whether sterling has fallen much further than needed.[5] And it is not clear

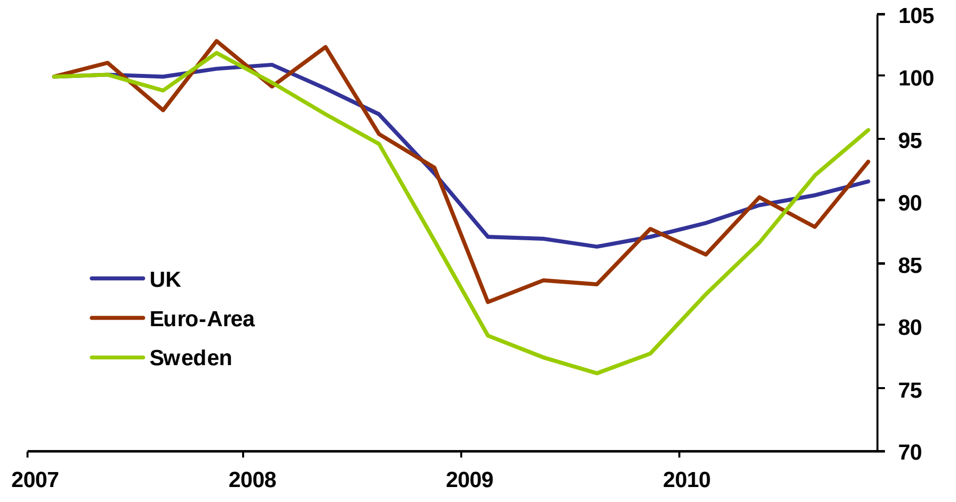
5 See Sentance (2011) for a comparison of the recent fall in sterling with previous episodes.

that the export-based manufacturing activities which could benefit from a large depreciation have the capability to respond quickly by scaling up output – particularly when their demand is already being boosted by a recovery in global demand.

Chart 7

Manufacturing output in UK, Euro-Area and Sweden

Rebased to 100 in 2007



Source: Eurostat and Thompson Datastream

Chart 8

Goods exports from UK, Euro-Area and Sweden

Rebased to 100 in 2007

Source: Eurostat and Thompson Datastream

The performance of UK manufacturing output and exports relative to other regions and countries which have maintained stronger currencies – such as the euro area and Sweden – supports this view. Chart 7 shows that there is very little difference in the current level of output relative to its pre-recession level in the UK, Sweden and the euro area – though the depreciation in the pound may have helped shield manufacturers from a bigger decline in output during the recession. Chart 8 shows broadly the same picture for the exports of goods, which are dominated by trade in manufactured products.

This picture is perhaps not that surprising when we think about the characteristics of the modern UK manufacturing base. Many UK manufacturers are niche producers linked into highly integrated global supply chains. Their products are not highly price sensitive, as they reflect the innovative capabilities, technical know-how and high level of skills which are needed to operate a successful manufacturing business in the UK or any other advanced economy where labour costs are high by global standards. In the short-term therefore there is limited scope for an expansion of UK manufacturing output without major investment in skills and capacity – which is consistent with the picture shown by business surveys of capacity utilisation in manufacturing such as the CBI's Industrial Trends Survey released today.[6]

This suggests that an expansion of the UK manufacturing base – along with other tradable activities – can only be achieved over a period of time with investment in skills and capacity. A relatively competitive exchange rate can help support that process, but the value of the pound also has other important macroeconomic effects which need to be taken into account by the MPC. Sterling's depreciation since 2007 has added significantly to imported inflationary pressures in the UK economy and this is particularly unhelpful at present when we are seeing a renewed surge of energy and commodity price inflation. And the resulting squeeze on disposable incomes is clearly a factor holding back the growth of consumer spending in the short-term, offsetting the boost to growth we might be seeing from improved trade performance.

Throughout the postwar history of the UK economy, policy-makers have had to strike a balance between the impact of the external value of the currency on the competitiveness of exports and its potential effect on inflation through import costs and the pricing climate. In my view, we have allowed the pound to depreciate more than is necessary or desirable to support the growth of manufacturing and exports. For example, allowing sterling to rise by about 10% from its current level against the euro (£1 = €1.13) would still leave it at a relatively competitive level by historical standards (£1 = €1.25). The very significant fall in sterling from mid-2007 to early 2009 probably helped to support manufacturing industry and exports and hence stabilise the economy in the depths of the recession. But now the world economy is recovering, exports and manufacturing activity are being strongly boosted by the growth of world trade. Meanwhile, worries about deflation have been replaced by the concern that the UK economy now faces a sustained period of relatively high inflation which is endangering our track record of price stability. In these circumstances, our approach to the value of sterling needs to strike a different balance from the view we took in the depths of recession.

Issue 3: The "output gap" and inflation

Alongside the influence of the international economy and our approach to the value of the pound, the third issue where I have found myself at odds with the majority view on the Monetary Policy Committee is on the influence of the "output gap" and spare capacity on the rate of inflation here in the UK. As I mentioned earlier on in this speech, the view that spare

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[6] The latest (April 2011) CBI Industrial Trends Survey shows 55% of companies reporting below capacity working, lower than the historic average of 59%.

capacity and the weakness of demand would push down on prices and costs underpinned forecasts that inflation would fall sharply in the wake of the recession. That has not happened in a world where other powerful influences on inflation – from the international economy, the value of the pound and the general pricing climate have operated in a much more inflationary direction. Yet the narrative adopted to support the policy position of the MPC, in the Committee's minutes and in recent editions of the *Inflation Report*, continues to put considerable weight on the downward influence of spare capacity and the "output gap".

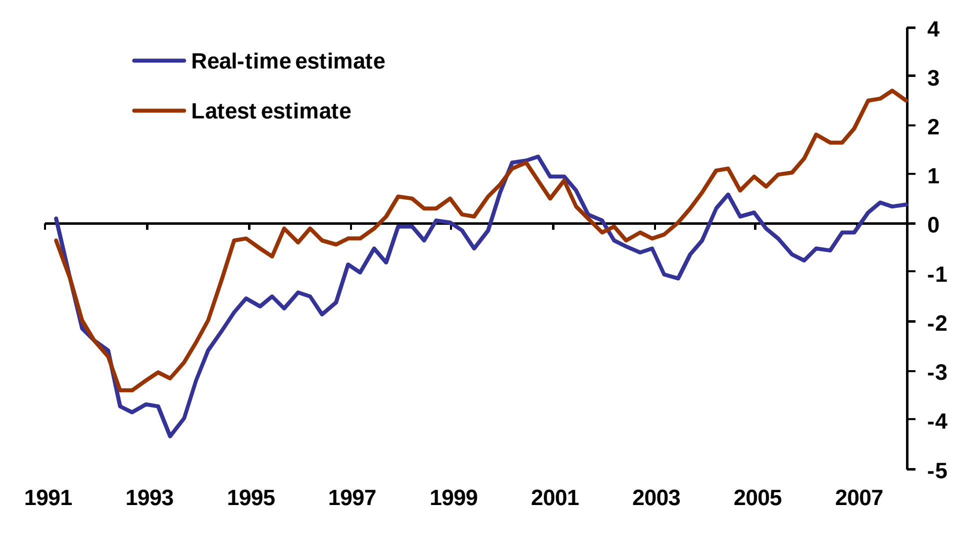
Estimates of the "output gap" generally rely on an assessment of the level of economic activity, normally measured by GDP, in relation to a longer run trend which aims to capture the capacity of the economy. That immediately highlights two major problems of using this concept in real time: GDP figures are frequently revised; and our view of the economy's capacity and its trend rate of growth has to be estimated as it cannot be measured directly. Both of these problems are particularly acute in the aftermath of a recession, when early estimates of GDP may be less reliable than normal and when we are more likely to see structural changes in the economy which may change our view of the level of capacity in the economy and its growth rate.

On the question of GDP data revisions, I well remember the experience of the early 1990s recovery, when I was working as Economics Director at the CBI. Initial estimates of GDP growth were much weaker than the picture that we now have of that recovery. And we have already started to see something similar happening over this recovery too. The first GDP growth estimate which signalled the economy was coming out of recession – for the final quarter of 2009 – has already been revised up from 0.1% to 0.5%. For this reason, I would caution against putting too much weight on the initial estimate of GDP growth for the first quarter of this year which we will receive tomorrow. Such early estimates of GDP need to be interpreted alongside the other evidence we already have about the performance of the economy – including business surveys and employment data.

Chart 9

OECD measure of UK output gap

Output gap as percentage of potential output



*: Positive numbers indicate above-potential levels of GDP.

Source: OECD

The combined impact of data revisions and reassessments of the trend in underlying capacity can be seen in the way estimates of the "output gap" change over time. Chart 9 shows how the OECD's estimate of the UK output gap has changed over the 1990s and in the 2000s prior to the recession. In general, the revisions have indicated that there was much less spare capacity in the economy than originally thought. The persistent "output gap" of spare capacity which was believed to exist in the mid-1990s has been revised away. And the OECD's current estimate is that the UK economy was operating much further above capacity before the recession than thought at the time.

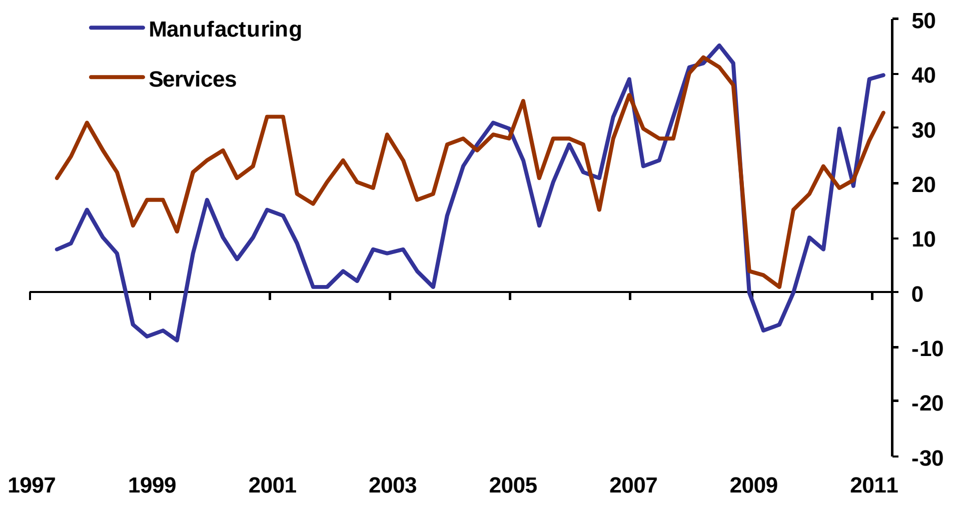
These difficulties in measuring or estimating the margin of spare capacity can be remedied to some extent by looking at direct measures of spare capacity in firms from business surveys and indicators of labour market slack from employment data. However, as I have argued in a number of recent speeches, these business survey indicators do not support the view that firms currently have a significant margin of spare capacity – particularly in manufacturing industry.[7] And there also appears to be less slack in the labour market than we saw in the aftermath of the recessions of the early 1980s and early 1990s, as I noted earlier.

Changes in demand conditions clearly do affect inflationary pressures. In a climate of stronger demand, firms will expect price increases to stick more readily than in weak demand conditions when discounting will be much more prevalent. But this pressure of demand is not well captured by simple "output gap" type measures which are too crude and prone to measurement error. Indicators of the growth of demand or changes in employment may be more useful, as they remove the need to make judgements about the sustainable level of economic activity.[8] But it is probably unrealistic to try and capture the pressure of demand on inflation in any one single measure, particularly in an open economy like the UK where both domestic and international factors have a bearing on the rate of increase in costs and prices.

Chart 10

Survey measure of businesses' price expectations

Balance of respondents expecting higher prices, BCC Survey



Source: British Chamber of Commerce

7 See Sentance (2011) for example.

8 For example, Orphanides and Williams (2005) argue that changes in the unemployment rate provide a better guide to demand pressure than the level of unemployment because of uncertainty about the equilibrium rate of unemployment.

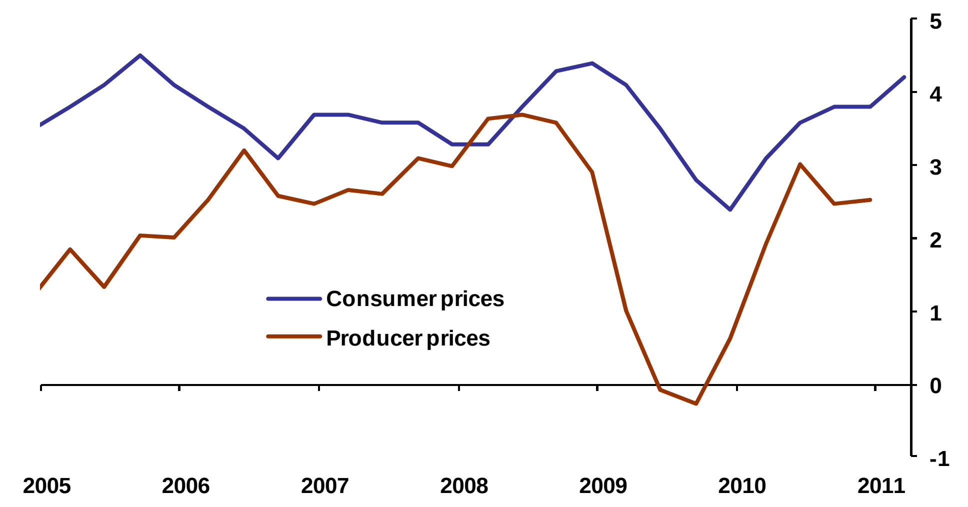
What we can observe more clearly is how the pricing intentions of businesses and the rate of price increases they are able to secure are responding to changes in the demand climate. And this evidence does not seem to support the view that the pressure of demand is bearing down heavily on inflation at present in the UK, even when allowance is made for cost increases. Chart 10 shows a survey-based measure of pricing intentions from the surveys conducted by Chambers of Commerce around the UK. This shows that expected price increases are currently running at relatively high levels in both manufacturing and services, and that there has been a significant turnaround in the pricing climate since the trough of the recession in 2009.

Another indicator which suggests that domestic demand pressures are exerting limited downward pressure on inflation at present is the rate of inflation in the services sector. In contrast to goods – which tend to be traded internationally – the services sector is more heavily oriented towards the domestic market. So if the margin of domestic spare capacity or weak demand in the UK economy is pushing down on inflation, we should see this reflected more clearly in measures of services sector inflation.

Chart 11

Resilient services inflation in UK

Annual percentage change in consumer and producer prices



Source: ONS

Instead, as Chart 11 shows, services inflation – whether measured by the prices charged by firms or the prices faced by consumers – has been remarkably resilient. After a short dip in the aftermath of the recession, price increases – whether measured by consumer prices or producer prices have returned relatively quickly to the levels we saw in the mid-2000s. And if we look at the services component of the consumer prices index, this 3–4% level rate of inflation has been a fairly consistent feature in the decade prior to the recession. There is not much evidence here of spare capacity and weak demand pushing down on services inflation. And whereas relatively high services inflation in the late 1990s and early 2000s was offset by flat or falling goods prices, this is no longer the case. So if services prices continue to rise at a 3–4% rate, and goods prices continue to be pushed up by external factors and the weakness of the pound, it is very difficult to see how the MPC will be able to return inflation to the 2% target, even over a number of years.

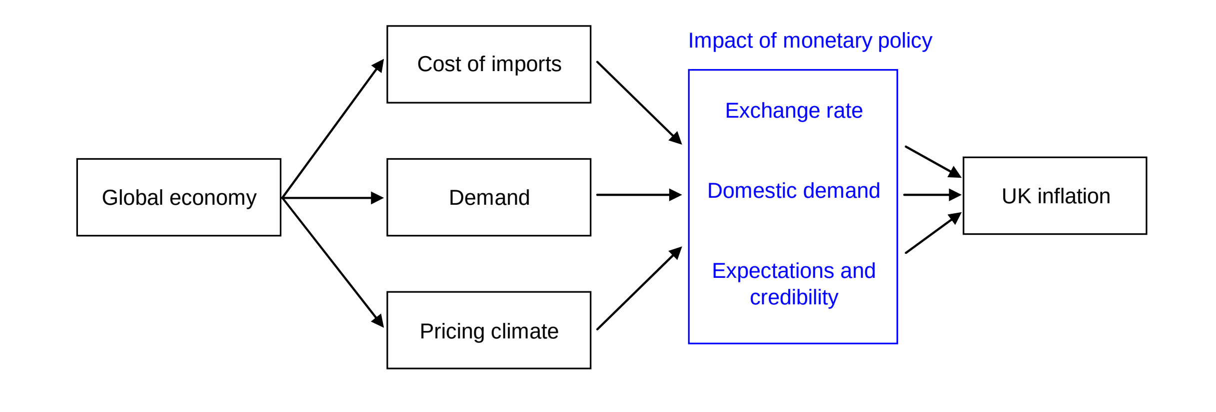
As a counter to these arguments, it is frequently suggested that a low rate of pay increases will help deliver low UK inflation, and pay freezes and low pay settlements negotiated during the recession may be a helpful factor in helping businesses to contain cost increases in the short-term. But I question how long we can sustain low pay settlements in the medium term when headline measures of inflation continue to run at such a high level and companies find that they can pass through cost increases to the consumer fairly readily. The most recent report from Income Data Services indicated that pay settlements had risen from 1.3% to 3% over the past year. And while pay increases are being held back in the public sector, the trend in the private sector is in an upward direction. If the private sector continues to grow – in line with the latest business survey evidence – and headline inflation remains high, it is hard to see why private sector pay settlements should not return to their pre-recession average of around 3.5% and possibly move higher.[9]

Issue 4: Inflation expectations and credibility

That brings me to my final key issue – the role of expectations and credibility in the framework for monetary policy. Chart 12 shows a diagram which I have used in a number of speeches now and which I believe sums up well the challenge that the MPC faces in trying to stabilise UK inflation in a potentially volatile global economy. The global economy affects inflation in the UK through the cost of imports, the impact of world demand on the UK economy and through the way in which international businesses perceive the pricing climate changing on global markets – which will have an impact on their pricing strategies here in the UK. All these factors can affect UK inflation – but monetary policy has three powerful counter-influences: the influence of monetary conditions on the exchange rate and the level of domestic demand, and the ability of the monetary authorities to anchor price expectations through their commitment to the inflation target or some other monetary anchor.

Chart 12

Monetary policy, the global economy and inflation



The world I have described in this speech is one where UK inflation has been pushed up by global factors and the very substantial depreciation of sterling. And there is not much evidence that the margin of spare capacity is creating much countervailing pressure, partly because the margin is not very large, but also because the way in which prices respond to demand pressures is much more complex than the simple “output gap” model suggests.

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[9] The Bank of England databank of pay settlements shows that private sector pay settlements averaged 3.5% in the period 2005 to 2008.

In these circumstances, the case for not adjusting monetary policy rests heavily on well-anchored expectations of inflation and the credibility associated with the Bank's inflation target remaining intact. The MPC entered the global financial crisis with a high stock of credibility reflecting the inflation performance of the previous decade. In 2007/8, we could reasonably assume that inflation expectations would remain well anchored at close to the target. And that gave the Committee freedom of manoeuvre to act with some unprecedented policy changes which have been effective in heading off the risk of deepening recession and a persistent deflation.

We now face a different set of circumstances in which inflation has been persistently high relative to the target, and is set to remain so for some time. There are clearly upside risks to the expectation of low and stable inflation in this environment, and this is beginning to be reflected in surveys of households and businesses and in the expectations of financial market participants. Unlike the period before the recession, individuals and firms can no longer look back with so much confidence on a track record of inflation close to the 2% target. And so a large burden of weight is being placed on the view that the Bank of England will return inflation to target before too long, despite not having delivered on promises to achieve just that over the past couple of years.

In my view, this policy would be much more credible and we would have a much better chance of anchoring inflation expectations if the MPC was willing to act to steer the economy in the direction of a low inflation trajectory. By adopting a very relaxed monetary policy in the recession and allowing a large depreciation of the pound, the MPC has sent the signal to the private sector that it has been prepared to accommodate price increases as the economy adjusts from recession to recovery. But the longer this process of accommodation goes on, the greater the risk that it becomes ingrained in expectations of relatively high future inflation and then credibility needs to be re-established with more abrupt interest rate changes and tighter policies in the future.

It may be that indicators of an upward drift in inflation expectations are only flashing amber at present. But if the MPC waits until they are flashing red, and if other pressures continue to push up UK inflation in the meantime, the Committee could face a very difficult situation later this year or next. A well-conducted monetary policy should aim to move policy in anticipation of events and in a smooth and orderly way if possible. And as I prepare to leave the Committee at the end of next month, I do worry that the MPC's credibility and commitment to the inflation target may already have been eroded by not adjusting policy settings soon enough – as the challenge for monetary policy has shifted from preventing deflation to curbing inflation and from halting recession to managing the recovery.

Concluding remarks

I started studying economics in the mid-1970s and my career as a working economist began in the mid-1980s. Throughout this time as a student and practitioner of economic analysis, we have seen UK monetary frameworks come and go, generally in the midst of an economic crisis. Since the Bretton Woods system of exchange rates collapsed about 40 years ago, the UK struggled to sustain a stable monetary policy framework for any substantial period. But in the mid-1990s, that changed. The UK established an inflation target framework in late 1992 which has evolved with time and proved remarkably durable. The relative success of inflation targeting in the mid-1990s paved the way for the Bank of England to take independent control of UK monetary policy with the MPC as the key decision-making body with the objective of maintaining price stability.

The MPC is now approaching its fifteenth year and has provided the UK with its most durable framework for monetary policy since the 1950s and 1960s. And it is a great credit to our current system that it has shown that it is capable of dealing with some formidable challenges. In my time on the Committee I believe our most significant achievement has been to help to stabilise the UK economy in the wake of the global financial crisis and provide a platform for economic recovery. I am very proud to have been able to contribute to the policy discussions and decisions which led to that outcome. But the rapidly changing world economy we now inhabit is always throwing up new challenges. And now the MPC faces the task of bringing inflation back to target in the face of continuing global inflationary pressures, with the recent experience of persistent above-target inflation providing an unhelpful backdrop.

A great strength of the MPC is that its members can honestly express differences of view in an open and transparent way, and that means we are not forced to agree and minority opinions are respected. Over time, that should make for a better decision-making process. So while I have not been in agreement with the majority view on the Committee over the past year, I hope that the arguments I have made have not been in vain. And I suspect the issues I have raised in today's speech – the impact of the global economy and the pound, the role of the "output gap" and the importance of expectations and credibility – will continue to be key issues for the MPC over the years ahead, as the Committee continues in its vital role of maintaining monetary stability in the United Kingdom.

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