Rachel Lomax: Staying ahead of the curve - remarks on recent UK monetary policy

Speech by Ms Rachel Lomax, Deputy Governor of the Bank of England, to the Annual Luncheon of the British Hospitality Association, London, 1 July 2004.

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It is a great pleasure to be here today. Judging by the capacity crowd, the businesses you represent are in pretty good spirits.

What better way to start than by thanking you for your excellent hospitality. And what better place to celebrate an important double anniversary. Because that's what today is, for me.

It is exactly a year since I joined the Bank of England as Deputy Governor for Monetary Policy. And it is forty years, almost to the day, since I started my first job. I was a waitress: in a famous seaside town - the one that's noted for fresh air and fun.

It wasn't much of a job. But then I wasn't much of an employee, having no marketable skills, but plenty of attitude. I learnt how to carry several plates at the same time and a lot of interesting new words; and the job paid for a memorable holiday in Greece. Looking back on it, I'm sorry I left without giving notice: though I'm not sure my boss was.

My work habits have improved immeasurably since those far off days. And so I think has British hospitality.

The 'eating out experience' has certainly been transformed. At the very top end of the market, there are now over a hundred Michelin starred restaurants compared with less than thirty in my youth. The past decade has seen a huge investment in both hotels and visitor attractions. Three of the top five fee paying visitor attractions in the UK are less than five years old, with the wonderful London Eye now comfortably outstripping that doughty old trouper, the Tower of London. London doesn't have it all its own way of course - the ground breaking Eden Project now comes in at a well deserved number three.

Tourism has become more than good business. From the Welsh Valleys to the East end of London, it is increasingly seen as a catalyst for economic regeneration. With the success of the Manchester Commonwealth games, and Liverpool's ambitious plans for 2008 as European City of Culture, not to mention London's Olympic bid, there's no shortage of high profile events and projects to provide inspiration for the future.

Your industry is still a major employer, of course. You must provide more jobs than the NHS and the Armed Forces put together. I'd be the last person to underrate the importance of entry level and seasonal jobs; but you need highly skilled people too. So it's good news that thousands of people are already on tourism and hospitality related FE and work based courses. Your new Sector Skills Council will provide an even sharper focus on defining and meeting your industry's training needs.

Nowadays, your industry makes a major contribution to our national income, and to our exports. And it's not surprising that your fortunes are heavily influenced by the economic climate at home and abroad.

The decade of strong growth which you have enjoyed has been underpinned, at the national level, by an unprecedented period of low and stable inflation, and steadily growing output and employment. Unemployment has been falling for over a decade and has now reached a thirty year low. And household spending has been growing strongly year in year out since the mid 1990s.

What this means is that for many years your customers have been enjoying a very healthy growth in their spending power, in a labour market where jobs have by and large been plentiful.

Of course, averages never tell the whole story. And hindsight is a wonderful thing. At the time, it didn't always seem like plain sailing.

The Stock Market crash, the slump in transatlantic traffic after September 11 and, last year, Iraq war related fears have represented setbacks, especially for London based businesses. Over the past few years, overseas tourism has been affected by the economic slowdown in North America and much of Europe and, maybe also, by the strength of the exchange rate. On the other hand, though foot and

mouth hit the industry very hard in some parts of the country in 2001, domestic tourism seems to have held up well.

And that's probably because the UK economy has weathered the squalls of the past few years rather better than both the US and the euro area. Since 2000, we have grown more strongly than the euro area, and more steadily than the US; indeed we are alone among major industrial countries in not having experienced a single quarter of falling output for more than a decade.

As a result the UK emerged from the slowdown in the world economy with less slack than other economies. That is the key reason why we were the first to start raising interest rates last November, when world activity started to pick up and demand at home accelerated. Since then, a number of other countries, including the US, have begun to raise their rates to more normal levels.

When I joined the Monetary Policy Committee a year ago, both the Fed and the ECB had just cut their interest rates to exceptionally low levels, reflecting real concerns about the strength of the world recovery. Activity picked up sharply in the US last autumn, but the mood only changed decisively early this year, when a million new jobs were created in just three months. It is now clear that a broad based world recovery is well under way, led by the US and Asia, especially China, but spreading to other regions.

The news from Japan is more encouraging than it has been for over a decade. The UK's major markets in Europe are benefiting from strong demand for their exports; and the latest news suggests that domestic demand in most of these countries is finally picking up, though consumers probably still remain a little wary.

As the news from abroad has steadily improved, we have also seen a marked strengthening in demand at home. After a fairly weak first half, retail sales bounced back, the housing market took on a new lease of life and investment began to recover. It now looks as if the UK economy has been growing around or above trend since the middle of last year.

It was against that background that the Monetary Policy Committee raised interest rates in three further stages to 4.5%. Meanwhile inflation remains low, well below the Chancellor's target of 2%.

This might seem to bear out the old taunt, that central bankers are the sort of people who want to close the bar as soon as the party starts to go with a swing. It would be fairer to say that we want to be sure that the party remains under control. We don't want to encourage binge behaviour any more than you do, and for much the same reason; it makes life unpleasant for other people, and it leaves a nasty mess behind.

That points to taking action at the first sign of trouble, and preferably before. In current circumstances, strengthening demand is beginning to put upward pressure on costs. Evidence from our Agents round the country, as well as official statistics, suggests that the labour market is tightening, and firms are having difficulty in filling some vacancies, despite the inflow of workers from the rest of the EU.

These are straws in the wind, but if we delay taking action until inflation has taken off, it will be more difficult to bring it down again without causing the economy to slow sharply. That's why our interest rate decisions need to reflect a view of likely inflationary pressures that looks a couple of years ahead.

Our central forecast is that the economy will continue to grow strongly over the next year before easing back towards its longer term average, as both household and public spending slow down a bit. But any central forecast is subject to a wide margin of uncertainty, and there are a number of key risks.

The housing market is one. Obviously, there are many aspects of housing which have nothing to do with monetary policy. It is striking that fewer houses were built in 2001 than in any year since the Second World War; and over 12% fewer houses were built in the ten years to 2002 than in the previous decade.

It is not the MPC's job to control house prices, any more than it is our job to control share prices or the exchange rate; but just as we would not ignore the wider economic effects of a high exchange rate or a boom in the stock market, so we cannot, and do not, ignore the influence of soaring house prices on consumer spending and hence on the overall pressure of demand.

Much attention has been paid to the historically high level of house prices relative to earnings, and what this might mean for the future path of house prices. A less discussed question - of more interest to you - is how much influence the current strength of the housing market is having on household spending; and what impact a weakening in the housing market might have on consumers.

Healthy as household spending has been in the last few years, there has not a consumer boom on anything like the scale of the late 80s, when house prices last took off. Since early 1998, house prices have risen sharply relative to incomes; but household spending has only grown broadly in line with incomes. A buoyant housing market may still have had some influence on spending; and spending and house prices may have been influenced by some of the same factors. But spending and house prices do not seem to have moved together as closely as they have done in the past.

Does that imply that consumers would shrug off a downturn in the housing market? Not necessarily. The rise in house prices has meant that households have taken on a lot of debt, and higher interest rates will mean they have less money to spend on other things. While there are few signs of obvious financial stress at current interest rates, given the strength of the current jobs market and the current housing market, this could change, especially if several of these factors weakened at the same time and the economic climate deteriorated sharply.

That's a long way from our central forecast, but uncertainty about how consumers might react to higher interest rates has been an important reason for tightening policy gradually since last November.

We have also avoided springing surprises. I think that's important: people are more likely to believe what we say, if our behaviour is reasonably predictable. But we wouldn't be doing our job if we didn't constantly revise our views in the light of new information and new research. That is why every month has to be a fresh decision. And why I can honestly say that I don't know, any more than anyone else, where rates will be in a year's time.

Compared with a year ago, interest rates have risen from 3.5% to 4.5%. But the international outlook is clearly stronger now, the domestic economy is buoyant, and inflation remains low. That's how we like it: and the lesson you should draw from our readiness to tighten policy over the past seven months is that we are on the case.

I hope that will give you the confidence to focus on your main business; creating wealth and 'making people happy'.