

Rachel Lomax: UK monetary policy – the international context

Speech by Ms Rachel Lomax, Deputy Governor of the Bank of England, at the APCIMS Annual Conference, London, 17 October 2005.

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Those of you who have logged on to the Bank of England's website recently will have noticed that it has turned a cheerful shade of orange. It is a lovely website and we are very proud of it. But perhaps now was not the best time to major on pictures of happy shoppers clutching bulging carrier bags! The fact is that website design – like monetary policy - is beset by information problems and lengthy lags. These make it very hard to get the timing of changes just right.

When the organisers of this conference pressed me for a title some weeks ago, I decided to talk about the international context for UK monetary policy for two reasons. First, I was fresh from a summer spent reading this year's top business books, whose key theme is the dizzying pace of change in the global economy. But second, I wanted look beyond the shopping story that – understandably – tends to dominate the press, to some of the other factors that have to be weighed when the MPC sets interest rates.

But let me start with the recent weakness in retail spending. Judging by the latest indicators, this looks like persisting, at least in the near term. But while spending on retail goods has been virtually flat since last autumn, total consumer spending, including services and utilities, has continued to grow, though quite slowly. And while the prospects for consumption are clearly important, so too are those for other key drivers of the economy, such as business investment and net exports. The question is: if consumers decide to save more, are the conditions in place for other sources of demand to take up the slack? The answer depends in part on what is happening in the rest of the world.

Plainly, developments in the rest of the world will influence domestic monetary policy. The UK is a very open economy, exposed to trends and shocks that affect supply as well as demand, and our financial markets are fully integrated with global markets. Sterling is one of the world's most liquid currencies, and the FTSE 100 is heavily weighted with multinational companies.

Let me give one example of what this can mean in practice. Over recent years, the progressive shift toward sourcing from low cost producers has been depressing import prices, and improving the terms on which we trade. This has exposed domestic producers to intense competitive pressures, but it has been unambiguously good news for consumers. And it has probably meant that the MPC has been able to set somewhat lower interest rates to meet its inflation target.

The establishment of global markets in key asset classes has created complex linkages between economies as well as facilitating better risk sharing. On the one hand, the transmission of shocks has been speeded up – a generation ago, for example, who would have supposed that devaluation in Thailand would have set off a chain reaction that rippled through financial markets from New York to Tokyo?

On the other hand, the absorptive capacity of financial markets has massively increased. This has helped to cushion the impact of major shocks on the wider economy. But it has also facilitated the financing of huge current account imbalances. These have been the number one issue on the IMF's worry list for the past few years and now constitute a significant source of risk to the world economic outlook.

So you might expect the MPC's policy rate to respond to changes in the world economic outlook, though you might speculate that the relationship could be quite complex. What does recent experience show?

Between 2000 and 2004, there was, on the face of it, a very close relationship between fluctuations in world GDP and the policy rate; as all main regions of the world slowed after the stock market crash and the ending of the IT boom, the MPC first cut its policy rate sharply – and then held it down until the world economy had clearly turned the corner in the second half of 2003.

But it would be quite wrong to infer that the MPC ignored domestic demand during this period – though the data have now been so heavily revised it is difficult to generalise about past decisions. The important point is that the MPC's approach then, as now, is to form an overall judgement about demand relative to supply and, as far as it can, to set the policy rate to keep the two in balance, so

that inflationary pressure is broadly constant. So with external demand very weak – and recall that by the end of 2001 world imports were actually falling – the logic of that approach pointed to leasing policy to encourage a faster growth in domestic demand.

This approach worked well in the sense that it helped to ensure that the UK went on growing steadily through the world slowdown, while consumer price inflation remained close to the Chancellor's target. But there were side effects. One was a marked increase in the UK's trade deficit. Another was the creation of a monetary climate conducive to strong rises in house prices and consumer borrowing relative to disposable incomes – an experience shared with other countries such as Australia and more recently the United States. Together with structural and demographic trends, this has helped to push the ratio of both house prices and consumer borrowing to household disposable incomes to levels well outside the range of previous experience.

If, against the background of a much flatter housing market, households now go through a period of rather subdued spending, strong external demand would help to support activity and rebalance the economy. But is that in prospect? And what are the risks?

On some measures, last year – 2004 – saw the strongest growth in the world GDP in 30 years. While there has been some reduction in growth this year, most forecasters' central expectation is that it will not prove very marked.

From a UK perspective however, the external conjuncture has been significantly less supportive than this implies.

The key point is that the upturn in world growth has been very unbalanced, being driven largely by the US and China. Measures of world activity which give a high weight to these two countries paint a pretty buoyant picture, especially those which use purchasing power parities. However, less than 2% of UK exports go to China and rather less than 20% to the US. Fully 50% go to the euro area, which has grown only sluggishly, and whose growth forecasts have persistently been revised down. And Germany, Italy and the Netherlands – countries which between them take around 25% of UK exports – have underperformed the euro average. As a result world GDP weighted by countries' importance in UK export markets has shown much a weaker recovery.

World price pressures have also been stronger than in recent previous cycles. This largely reflects the sharp rise in the price of oil since early 2004 – a development which seems to have taken almost everyone by surprise. This is a complex story. On the demand side, the relative importance of China and the US in powering the world economy may help to explain why world oil demand grew quite so strongly relative to world GDP last year. This year, however, the sharp rise in prices owes at least as much to supply factors.

Allowing for these caveats, this is still a much stronger world economic background than, say, 2001. But there are several important risks to this outlook.

The first concerns oil prices. So far the world economy has apparently taken a tripling in oil prices in its stride, thanks to the much lower oil intensity of output, and the greater flexibility in labour markets, in most advanced economies compared with a generation ago. It is also true that the short term capacity of oil producing countries to spend their increased revenues is now much greater than it was in the 70s. This helps to explain why consensus forecasts for world GDP growth next year have remained remarkably steady.

But there is a very high level of uncertainty about future oil prices. Judging by the oil futures curve, the central view is that prices are likely to remain high, at around \$60 per barrel for the next few years at least. This is in contrast to 2000, when the oil futures curve was downward sloping. But the range of current Consensus forecasts is very wide – from around \$45 and \$75 per barrel. And oil option prices – admittedly a very imperfect measure – suggest that there is a 15% probability of oil prices rising above \$80 a barrel and a 5% probability of them falling below \$40 in six months time.

If oil prices rise no further their impact on headline inflation should be temporary. But a series of positive oil shocks might have the effect of pushing up headline inflation for an uncomfortably long period. In contrast to the 1970s and 1980s, inflation expectations in major oil consuming nations have been well anchored for the best part of a decade. But there's no room for complacency. The unfamiliar experience of higher inflation might well dislodge those expectations, if there was any wavering in central banks' perceived commitment to keep inflation low. This could also prove damaging to consumer and business confidence.

I claim no special insight into the oil market, and especially into its likely short term movements. But it is hard to miss the longer term challenges which the rapid economic development of China – and India – pose for resource markets, and especially energy markets. China is now the world's second largest oil importing country after the US, and last year alone it accounted for nearly a third of the net increase in world oil demand. In per capita terms, its own oil resources account for less than 10% of the world average. Yet its oil demand is set to grow strongly in the longer term. Oil supply is traditionally slow to respond to changing prices – lead times for developing new fields are often around 3-7 years; and there are constraints on refinery capacity which may influence petrol prices.

This is bound to have implications for the UK and for our European markets. Over the past decade, we have benefited from the downward pressure on imported goods prices exerted directly and indirectly by low cost production in Asia. Even if these trends continue, as in principle they could for some time, it is becoming increasingly clear that consumers may also need to contend with upward price pressures as world energy markets adapt to meet the needs of emerging Asia.

The second key area of risk is global imbalances. These pose risks to foreign exchange markets and to world activity. Higher oil prices have intensified the scale of the problem. Yet we seem no closer to a denouement – indeed, as the US current deficit topped 6% of GDP, the dollar has tended to strengthen. What does this mean for the UK? I find it extremely hard to predict how sterling's effective rate would be affected, were there to be a major re rating of the dollar. But a resolution of global imbalances which was accompanied by global recession would represent a major challenge for us – one to which, I suspect, we are now less well placed to respond than we were in 2001.

Finally, there is the puzzling matter of long term interest rates; last year, as central banks raised their policy rates, long term nominal and real rates fell to levels not seen in 40 years (though of course, US rates have now ticked up a bit recently). At the same time, risk premia of all kinds – bond spreads and term premia – have been sharply compressed.

This state of affairs has caused a great deal of head scratching, and nowhere more than in central banks. Plausible explanations for low risk free real rates include the possibility that there is a global savings glut. It is also argued that there has been an investment 'strike' almost everywhere except China and maybe the US, perhaps reflecting a persistent overhang from the East Asian crisis or the last IT cycle. These are speculative explanations, and it is not easy to discriminate between them. However, they all seem to point to a more or less prolonged period of low rates.

More worryingly, compressed risk premia of all kinds may reflect a belief that the world is no longer such a risky place, a belief fostered by the period of low inflation that many economies have enjoyed in the past decade. Hopefully, low inflation is here to stay. But in some countries, notably the US and the UK, low inflation has been coupled with an unusually low degree of output volatility; and this may have encouraged an exaggerated notion of the role that central banks can play in achieving exceptionally benign outcomes, in different circumstances.

Unrealistic expectations invite disappointment. And disappointment – if it dawns suddenly – is liable to have a disruptive effect on financial markets and potentially on real economies.

That is the dark side. But for now, low real interest rates are supporting activity, and the main puzzle is why companies are not taking more advantage of favourable financing conditions to increase their investment – though once they do, past experience suggests that spending could rise quite quickly.

Let me sum up. The immediate prospects for the world economy are still robust, despite the sharp rise in oil prices. The outlook for UK weighted activity is less rosy, with relatively subdued growth in the euro area – though even here the latest business surveys are brighter than they have been for some time. The UK is fully exposed to the impact of more adverse world pricing trends, notably higher oil prices. And there are some significant risks, with considerable uncertainty about oil prices. This outlook could provide some support for a rebalancing of the UK economy. But there is no guarantee of that.

The MPC may face some hard choices in the coming months. Looking back on my summer reading for inspiration – that list of the year's top business books – I am reminded of the mission statements of two of the companies under scrutiny. One was Disney – whose aim is, famously, to 'Make People Happy'. The other was Google – whose mission statement urges, somewhat austere, 'Don't be Evil'.

One thing is for sure: the MPC must not set out to rival Disney. So let Google be our guide, as we search for a way through the policy maze.