

Rachel Lomax: The state of the economy

Speech by Ms Rachel Lomax, Deputy Governor of the Bank of England, to the Institute of Economic Affairs 25th Anniversary Conference, London, 26 February 2008.

I am grateful to Gareth Ramsay for his help in preparing this speech, and to other colleagues at the Bank of England for helpful comments.

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When you met for this event a year ago, the UK economy had just posted its fastest rate of growth in nearly two years, buoyed by a strong world economy and ample global liquidity. Shoppers had been out in force over Christmas and the New Year, and the housing market was booming. The main concern was consumer price inflation, which had just picked up to 3%. Most forecasters were looking forward to another year of healthy demand growth, with the MPC's central projection at the top end of the range. The consensus view was that the surge in inflation would be short-lived.

And that, broadly, is what happened. CPI inflation fell back to around the 2% target by the second half of the year. Output growth for the year as a whole was in line with the MPC's forecast. Short term interest rates now stand where they were a year ago – at 5.25% – after briefly touching 5.75% last summer.

And yet the outlook for 2008 and beyond has changed dramatically. A year ago the prospect was for a modest decrease in growth, consistent with inflation staying around target. Now, inflation seems set to rise sharply in the near term. And our latest central projection is for output to grow at below trend rates over the next two years – even on the conventional assumption that Bank rate follows the market yield curve and falls to 4.5% during the course of this year.

There is still relatively little in the headline macro data to support such a marked change in view. CPI inflation, at 2.2%, remains close to target. And, on the output side, growth weakened a touch in the fourth quarter last year, but was still around the post war average. Indicators for the first quarter are mixed, but do not suggest that growth has stalled.

In other words, the change in our Inflation Report projections is a forecast. It is the judgments underlying that forecast – and the attendant risks and uncertainties – which will be the main focus of my remarks today.

So why have we changed our view?

Our latest forecasts reflect judgements about the possible future impact on the UK of two key developments. First, the continuing financial crisis in advanced financial markets which has been triggered by the slump in the US housing market; and second, the renewed build up in global inflationary pressures, associated with soaring energy and food prices.

These developments are symptomatic of profound changes in the global economy, as world growth has increasingly been powered by resource hungry emerging markets, and as financial markets in developed countries have taken off and, in the process, become more tightly linked to one another.

I will talk about both developments, before coming back to discuss the outlook for inflation and growth in the UK, and the implications for policy.

Financial crisis

The crisis in financial markets last August was triggered by a slump in the US housing market. This, of course, is acting as a direct drag on US activity. Any slowing in the US

economy stands to affect the UK in the traditional way, through influencing trade flows. The size of this effect will depend on how other trading partners are affected and how policy-makers react.

But the really striking feature of recent experience has been how the US housing crisis has reverberated through the highly integrated and sophisticated financial markets of North America and Western Europe.

Six months after global securitisation markets seized up, in response to uncertainties about the scale and location of losses arising from rising defaults on US sub prime mortgages, some credit markets are still not trading at all, and others remain very illiquid. And each week seems to highlight some new dimension of the ensuing disruption to core financial markets.

The crucial task of valuing and disclosing the impact of losses on core banking institutions is still work in progress: important announcements are being made almost daily, and beyond them lies the equally important task of repairing banks' balance sheets. The current shortage of liquidity makes the pricing of complex assets even more difficult. At the very least, this reinforces the need for transparency in providing estimates of losses, and descriptions of the best-efforts processes used to produce these estimates.

The process of price discovery for many complex asset classes is unlikely to be completed quickly. For assets directly related to US sub-prime, this is unlikely to be before the US housing market stabilises. Other structured credit markets are likely to remain illiquid until confidence in the banking sector has been restored, and large financial institutions are willing to take more risk.

Clearly the situation is still developing. And its impact on the wider economic outlook – global and domestic – will depend critically on what happens from now on. Here there are some major uncertainties.

There is a widespread – and in my view largely correct – view that the US housing crisis acted as the trigger for an overdue correction in financial markets, after a long period of plentiful liquidity during which risk premia of all sorts had become unduly compressed, asset prices had become detached from reality, financial innovation had run ahead of risk management, and unsound business models had led to a deterioration in credit monitoring and, in some areas, underlying credit quality.

Many people – including the Bank of England – foresaw that some form of correction in financial markets was highly likely, even inevitable. But it was another matter altogether to predict the precise nature and timing of the present crisis. The extent of the reverberations across different markets was certainly not fully appreciated.

But the “accident waiting to happen” description of the current situation, however plausible at a general level, lends itself to a wide range of predictions about the possible course of events from now on, from the relatively benign to the frankly apocalyptic.

The interesting question is: where do we go from here?

Might slowdowns in other housing markets have the same potential to impair loan books and dent overall growth as in the US? What is the likely impact of a further falls in global equity markets? What further scope for amplifying financial shocks lies buried in the highly leveraged and tightly interconnected world created by the heady pace of financial innovation over the past decade? And – going to the apocalyptic end of the spectrum – if the global macro economy does turn very sour, at what point might falling asset prices and mounting banking losses start to feed on each other to push economies into a deflationary downward spiral?

History does not give a clear steer. There have been financial and banking crises before, but not on the present global scale, and this must surely be the largest ever peacetime liquidity crisis. To take two extreme possibilities, is what we are seeing closer to a repeat of the US Savings and Loans crisis (whose real economy impact was small and shallow) or to Japan in

the early 1990s (characterised as a “lost decade” of growth)? Or is it something else again? How much does it matter that this is one of the first crises where a credit boom has died of “natural causes”, rather than being choked off by some external macroeconomic or policy shock?

The substantial equity cushions built up in the years of plenty should act as shock absorbers in the years ahead. Even the most pessimistic estimates of the total losses from sub-prime mortgages – around \$400 billion – compare with total global financial assets of at least \$110 trillion¹. But there may be more shocks to come. The focus of current concerns is how far other assets may be impaired, as a result of the broader economic impact of this period of financial stress.

This brings me to the other big uncertainty: how far will tighter credit conditions affect the wider economy – in the UK and the rest of Europe as well as in North America? It seems highly likely that growth was supported by easier credit over last few years. But to what extent? When it comes to quantifying the effect of changes in credit conditions, our work-horse economic models still cannot help us very much.

As far as the UK economic outlook goes, our central judgement is that financial stress will act as a significant drag on demand over the next two years. But there is a high level of uncertainty about this; and, as we now see it, the risks, as they affect output, are tilted to the downside. These are two fold: first, that the financial crisis will persist and possibly intensify; and second, that over time tighter credit conditions and asset price weakness will combine, and in the worst case feed off each other, to sap the strength of overall demand, and put downward pressure on inflation in the medium term.

Higher costs

Let me come now to the other major area of risk: the upward pressure on inflation from higher external costs.

The most recent build up of global cost pressures is just the latest episode in a remarkable period of soaring commodity prices. Oil prices have more than trebled since the start of 2004, and metals and food prices have more than doubled. Strong demand, particularly from China has clearly been one major factor. But there have been supply side issues too. And the strength of some commodity prices also reflects their status as an investment class at a time of low global interest rates.

Over the past year alone, oil prices have risen by around 60% in dollar terms and agricultural food prices by around 50%. Imported cost pressures in the UK will also reflect the fall in the effective exchange rate, down by 9% since the beginning of August last year – the largest such decline since sterling left the ERM in 1992. There are few reasons to expect this to be rapidly reversed. As a result of these developments, producer input and output prices are now increasing faster than at any time since 1990, and import prices have picked up sharply.

These cost pressures have not yet fed through fully into consumer prices, but from next month CPI inflation is likely to rise more sharply, in particular reflecting the impact of higher utility bills. There is essentially nothing the MPC can do about this immediate impact on the inflation rate. But its implication for policy depends on whether people recognise the temporary nature of the pick-up in inflation.

The MPC’s remit in setting interest rates is clear – to keep inflation at 2%. But we have discretion to decide how fast to return inflation to target, if it is thrown off course by a sharp shock, such as the current surge in world energy prices. So we are not required to raise

¹ This estimate is taken from the Bank of England Financial Stability Report, October 2007, Box 1 (Mapping the financial system). It comprises the estimates of total global securities markets, less bank deposits.

interest rates sharply to counteract the rise in inflation which we expect over the next few months. We can decide what is appropriate in the light of all the circumstances. And the purpose of the Open Letter regime is to give us an opportunity to explain how we propose to use our discretion.

Over the years the MPC has explained that it seeks to achieve its inflation objective in the medium term by varying interest rates to steer overall demand relative to supply. If price and wage setters do recognise that the imminent pick-up in inflation will be short-lived, then the implications of the spike for monetary policy, and for the necessary balance of demand versus supply, should be limited.

But if price and wage setters start to expect higher inflation to persist, then the Committee will need to restrain demand, and so generate some slack in the economy, in order to bring inflation expectations, and inflation itself, back down.

Clearly therefore it is a matter of intense interest to understand how people form and revise their expectations.

Unfortunately our understanding is very incomplete. One relevant area of active research is why inflation expectations seem to have been so stable over the past decade – the period of the so-called Great Stability.

One supposition is that well anchored expectations reflect the introduction of credible inflation targeting regimes – people have understood that central banks are focussed on keeping inflation low, and will take action to reduce it if necessary. Another view is that people's expectations reflect simpler rules-of-thumb based on actual inflation rates: if that's the case stable expectations could simply be due to the fact that, over the past decade and a half, inflation itself has been low and stable.

These alternatives are hard to distinguish empirically, on the track record so far. But it may make a great deal of difference which is true when it comes to forecasting what will happen to inflation expectations, if we have to deal with a future in which inflation is likely to be much more variable.

If people put their trust in the regime, or a "credible central bank", they are unlikely to revise their expectations about future inflation much, especially if the nature of the current situation is well and honestly explained, including how long it will take inflation to return to target. But if they forecast future inflation using simple rules of thumb based on past actual inflation rates, anything that dislodges inflation from target will affect what people use as their best forecast for future inflation.

Or to put it another way, if the credibility of the monetary policy framework itself has been key, then inflation expectations may prove rather resilient to short term shocks.

But if maintaining an excellent track record has been crucial, the situation may be more fragile.

In the context of the current outlook, the real risk facing the Committee is that a further period of above target inflation, prompted by a cost shock over which it has no immediate control, will lead people to revise their expectations about future inflation, and to act accordingly. This will make it more costly to bring inflation back to target.

What does all this mean for policy?

The MPC has frequently stressed that policy is not based simply on its central projections of the economic outlook – what matter just as much are the risks around it. The Bank has pioneered the use of fan charts to illustrate the probabilistic nature of any forecasting exercise. The fact that these fan charts reflect the Committee's *subjective* judgements about the uncertainties it faces means that they can be quite revealing about its thinking.

This is particularly true now. Policy needs to balance two significant risks – first, that financial stress will precipitate an unduly sharp slowdown in demand, which will bear down so heavily on inflation that it undershoots the target; and second, that temporarily high inflation will lead to inflation expectations persisting at too high a level.

I find it helpful to distinguish between two aspects of uncertainty, both of which are relevant to setting policy. First, the balance of risks around the central projection, and second the general level of uncertainty.

The Committee regularly comments on the extent to which it believes the risks around the central projection are skewed – that is, tilted to the upside or the downside. And it has sometimes explained changes in interest rates by reference to changes in the balance of risk rather than changes in the central projection. In the latest Inflation Report, we commented that risks on our latest inflation forecasts were balanced, but those around the forecast for output were tilted to the downside.

The width of the fan chart is an indication of the MPC's level of uncertainty about the outlook. It's significant that the MPC widened the GDP fan charts in November, and the CPI fan charts further out, and maintained these wider fans in February.

Another way of presenting the same information is this bar chart (conditioned on market interest rates as in the February Inflation Report). This brings out the significant probabilities ascribed to outcomes which are some way away from the central projections.

So, for example, there is a less than a one-in-three chance that GDP growth will be in the range containing the Committee's central projection – between 2 and 3% – in two years' time. We see a greater probability – around two-in-five – that growth will be somewhere below 2%. On inflation, there's only around a one-in-four chance that inflation will lie close to the central projection – that is, between 2 and 2.5%, but a more than one-in-three chance that it will be above 2.5%, and an almost 1 in 5 chance that it will be below 1.5%.

As this illustrates, one implication of widening the fan charts has been to increase the perceived risk of some rather unattractive outcomes – either that growth slows too sharply, or that inflation does not return to target following an upward spike. In particular both the upper tail of the inflation forecast – where inflation expectations might well come seriously adrift – and the bottom tail of the output forecast – where there could be a risk of setting off a deflationary spiral – are to be avoided, if at all possible.

In this situation, it is not unreasonable to suppose that the Committee will be more sensitive than usual to changes in the balance of risks.

Since neither of the key risks to the outlook is readily modelled or measured, monitoring them is not going to be easy. But we do have a framework for thinking about them, and a variety of timely surveys and indicators which can act as early warning signs.

On the impact of the credit shock, we will be monitoring our new quarterly credit conditions survey of lenders, and special surveys from our own Agents, as well as the full range of indicators of the price and quantity of credit.

On inflation expectations, we pay close attention to a wide range of information drawn from surveys, and financial market prices, recognising that they are all, in different ways, tricky to interpret. We also need to be mindful of the risk that any further increases in the prices of everyday items like food and energy will heighten public perceptions of inflation, and raise expectations about the future overall rate of CPI inflation.

Conclusion

The outlook for the economy looks very different now from a year ago. We are seeing some powerful global forces playing out, in financial markets, in commodity markets, and in the world's largest economies. Their impact on the UK is highly uncertain, partly because they

are hard to understand and to predict, and partly because much will depend on the way policymakers around the world respond.

The MPC will need to respond continuously and flexibly to its assessment of the changing balance of two key risks. On the one hand, there is a risk that demand will slow too sharply, but on the other there is a risk that a temporary shock to inflation will prove persistent.

A temporary pick-up in inflation – by itself – does not mean that the Committee needs to tolerate a significant weakening in demand. But if inflation expectations appear to be persistently elevated, then the Committee will need to tolerate more slack to keep inflation on target. And that means it will have less scope to respond to slowing demand – the risk posed by the current turmoil in financial markets.

Annex: Charts²

Chart 1: CPI fanchart from February 2007 *Inflation Report*, and outturns

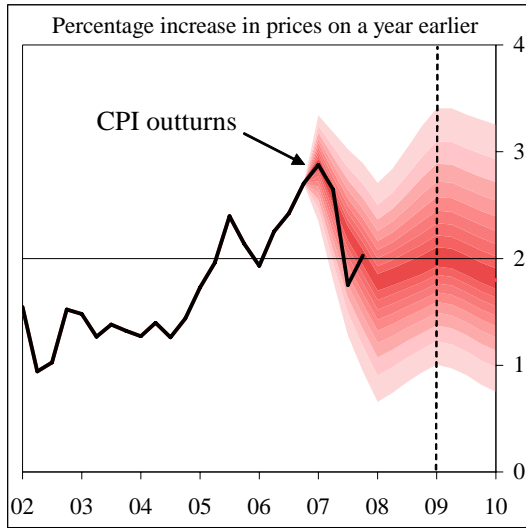


Chart 2: GDP fanchart from February 2007 *Inflation Report*, and outturns

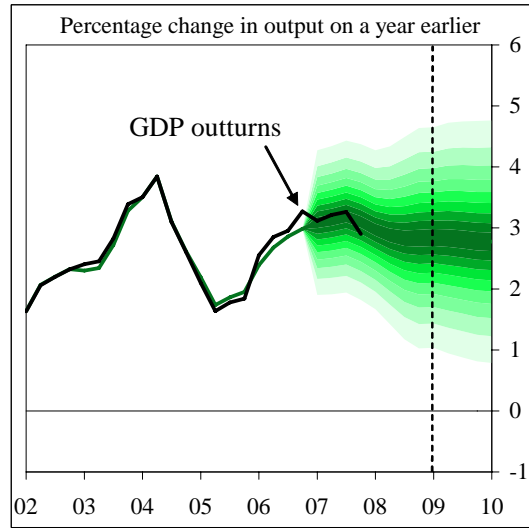


Chart 3: CPI fanchart from February 2008 *Inflation Report*

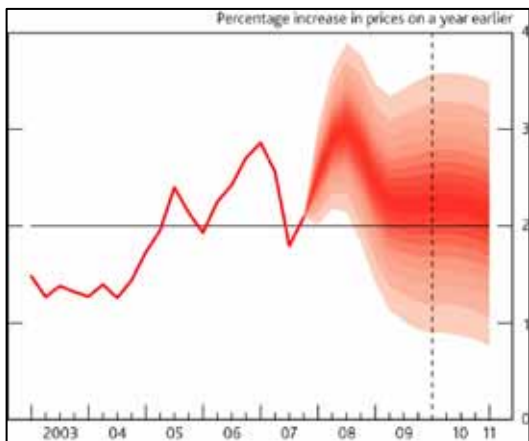
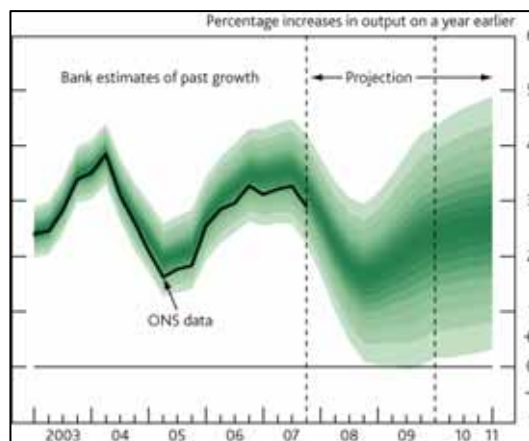


Chart 4: GDP fanchart from February 2008 *Inflation Report*



² All fan charts and probability bar charts shown are conditioned on market interest rates.

Chart 5: Commodity price developments

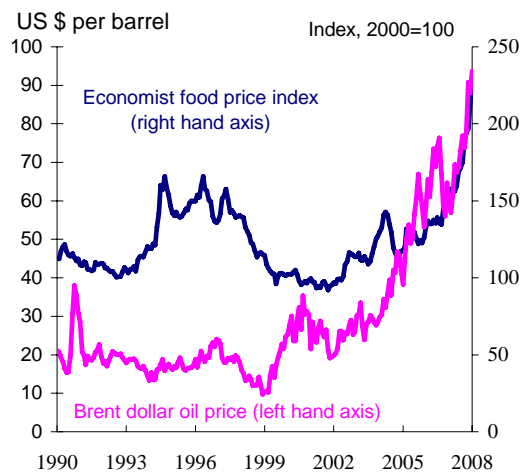


Chart 6: GDP growth probabilities from February 2008 *Inflation Report*

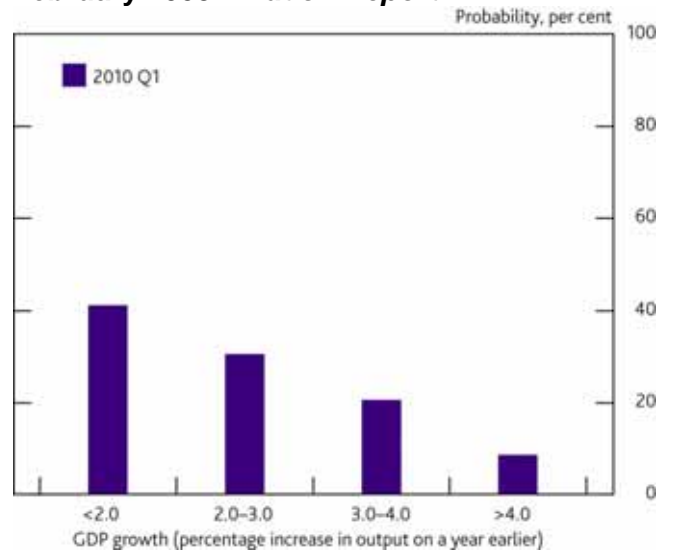


Chart 7: CPI inflation probabilities from February 2008 *Inflation Report*

