

Treasury Committee: Questionnaire for Dr Andrew Sentance

Monetary policy framework and individual role

1. What contributions have you made individually to the conduct of monetary policy on the MPC? What lessons have you learned from your period as a member?

When I joined the MPC in October 2006, it seemed to me that the main challenge facing the Committee was to judge the pace and extent of monetary tightening needed to contain demand growth and prevent a build-up of inflationary pressures. UK growth was being supported by strong global demand, which was adding to inflation through its impact on global energy and commodity prices. Meanwhile, consumption and the housing market had recovered from the weak performance in 2005 and a recovery in investment was boosting domestic spending. Responses to business surveys and the reports of the Bank's regional agents supported this picture of healthy demand growth at home and abroad, and it was clear from the regional visits I undertook in late 2006 and the first half of 2007 that the economy was growing robustly.

In response to this situation, I could not see any merit in holding back from tightening monetary policy. In addition to the need to contain demand, inflation was also rising and business surveys were showing elevated inflation expectations. In addition to restraining demand, I believed that raising interest rates sooner rather than later would reinforce the credibility of the inflation target and prevent a more sustained upward drift in inflation expectations. At my first meeting, I voted (in a minority) for a rise in interest rates and I supported the four rate increases from November 2006 to July 2007. In addition, I voted in a minority for higher rates on three further occasions – partly because I believed that raising rates more quickly could limit the extent of the rise eventually needed to moderate demand and keep inflation on target.

The situation changed as we moved through last summer and into the autumn: CPI inflation came back to target as expected; lending and borrowing conditions began to be affected by the turmoil in financial markets; and evidence began to accumulate that demand was slowing as the August and November *Inflation Report* forecasts had suggested. Against this background, I supported the strong majority view on the Committee that interest rates should be kept on hold through the autumn. As evidence of a slowing economy and continuing financial turbulence accumulated, I supported the reductions in rates in December and February, though I remain conscious of the upside risks to inflation expectations from rising CPI inflation in the short-term.

Over the last eighteen months, one of the factors I have emphasised in my contributions to MPC discussions and in speeches and presentations is the changing impact of the international economy on the UK inflation outlook and hence monetary policy.¹ In particular, the inflationary impact of energy and commodity prices contrasts strongly with the global disinflationary background to MPC policy decisions in the late 1990s and early 2000s. This makes the task of responding to the recent turbulence in global financial markets more complex and challenging.

2. What contributions have you made to explaining the work of the MPC and enhancing public confidence in its actions over the last three years?

My initial period of office on the MPC is shorter than the normal three years, as I was appointed for the remainder of David Walton's term, following his sudden death. However, over this shortened period, I have been very keen to contribute to public debate on UK monetary policy, through public speeches, interviews, regional visits, business briefings and educational activities.

¹ "The Global Economy and UK Inflation", Leeds, 24 September 2007, and "A Tale of Two Shocks: Global Challenges for UK Monetary Policy", London, 27 November 2007.

I have given public six speeches to date – on a variety of topics of relevance to current monetary policy issues. My aim in giving speeches has been to discuss issues of longer term relevance to monetary policy alongside analysis of the current conjuncture and associated policy concerns. The themes of my speeches in 2007 and early 2008 were: supply-side constraints on UK economic growth (January 2007); the changing pattern of savings globally and in the UK (March 2007); business attitudes to monetary policy (July 2007); global influences on UK inflation (September 2007 and November 2007); and economic cycles and the risk of recession (February 2008).² A further speech to the CBI is planned for April 2008. Speeches by MPC members attract widespread media coverage, but I have also given three major press interviews.

Given my business background, I have tried to make the most of the opportunity to visit businesses and give off-the record presentations and briefings to business groups around the country. As well as visiting businesses and business groups in London and the South-East, I have made ten 2-day regional visits – covering Scotland, Wales and Northern Ireland as well as most of the English regions. Over the last eighteen months I have made over 60 company visits and business briefings around the country, each of which provides an opportunity to gather feedback on business conditions and to communicate current monetary policy issues and concerns.

Alongside these business-orientated visits, I have also spoken at a number of schools and universities in support of the educational role of the MPC. I have participated in judging area finals of the Target 2.0 Schools Competition and will be judging the national final this year.

3. How have you used your business experience when undertaking your work as part of the MPC?

There are three main ways in which I have found my business experience helpful while serving on the MPC. First, in forming my judgments on monetary policy, I have put considerable weight on business information – in particular survey data and the reports from the Bank’s Agents around the country. I have a lot of experience developing and using business survey data, from my time at the CBI and later at the London Business School. Properly interpreted, business surveys can provide a timely and immediate guide to business conditions and prospects. Business surveys also contain a lot of information that is simply not available from official statistics – such as capacity constraints and investment intentions. I have also continued to receive airline industry data from the International Air Transport Association (IATA) and the Bank economists have started to use this in their analysis of the global economy and world trade.

Second, it has been extremely helpful to look back to previous episodes in my business career when thinking through some of the key issues we have encountered on the Monetary Policy Committee over the last eighteen months. In my July 2007 speech³, I contrasted some of the features of the UK economy I had experienced in my regional visits as a MPC member with the situation I encountered as a CBI economist in the late 1980s and early 1990s. I was struck in particular by the strong support for low inflation in the business community, the structural changes that had taken place across the UK economy – particularly in manufacturing industry, and the increasing globalisation of British business. My experience in the airline industry has also been helpful in analysing the impact of changing international conditions on British business and in thinking through how demand and cost pressures have interacted to determine the impact of the recent oil price shocks on consumer prices and inflation.

Third, my experience of communicating economic issues to business audiences has been very helpful in giving business briefings and in talking to companies on regional visits.

²All available at: <http://www.bankofengland.co.uk/publications/speeches/speaker.htm#sentance>

³“UK Monetary Policy: Good for Business?” Speech hosted by Dow Jones, London, 10 July 2007

4. What other work commitments do you maintain in addition to membership of the MPC, and how do these benefit your work on the MPC?

I have two other significant work commitments alongside the MPC. First, I am a part-time Professor at the University of Warwick, based at the Centre for the Study of Globalisation and Regionalisation. The focus on my work at Warwick is the economics of climate change, rather than monetary policy. However, Warwick has a very strong Economics Department, and I have also used my visits to Warwick to keep in touch with academic thinking on monetary policy. Warwick also has a strong tradition of developing research in conjunction with the business community, and so my position there also brings me into contact with the world of business. Second, I am a Member of the Commission for Integrated Transport (CfIT), which provides independent advice to the government on transport policy issues. I was appointed to the Commission while I was at British Airways, but my continuing involvement keeps me in touch with a wide network of business executives and economic advisers in the transport sector. CfIT also has a strong regional focus to its work, and we have visited the devolved administrations in Scotland and Wales while I have been a member.

Interest rate decisions and economic policy

5. Of the votes that you have cast in the MPC, are there any which, with the benefit of hindsight, you wish you had cast differently?

No. At this stage, I am comfortable with my votes on the MPC over my period of membership.

6. How have you worked to combat the uncertainty around the economic outlook over recent times?

Dealing with uncertainty is central to the practical conduct on monetary policy. There are two key areas of uncertainty which affect the judgments made by members of the MPC.

The first is uncertainty about where the economy is now or has been in the recent past. This is less an issue in terms of measures of inflation, but is much more significant when it comes to the measurement of demand and output and some key elements of business costs – notably wages. In terms of demand and output, my response is to attach particular weight to data from business surveys and the Agents’ reports in my policy judgments. In 2006 and early 2007, these data sources were giving a stronger reading for economic activity than official data sources, and my view was that the business data was closer to the truth. This judgment was also supported by work carried out by Bank of England economists on data uncertainty⁴ which has resulted in a different presentation of the GDP growth fan charts in the *Inflation Report*. I am a strong supporter of this data uncertainty work, and served on the internal steering group which oversaw it. Another recent area of data uncertainty relates to the discrepancies between the AEI and AWE measures of wage growth and I welcome the work that the ONS has recently commissioned from Martin Weale to help understand this and reconcile the two data sources.

The second area of uncertainty is about the future. The MPC has at its disposal a formidable array of modeling and forecasting tools and the services of over 100 economists to help us with our analysis. But as our *Inflation Report* fan-charts suggest, there will always be a substantial margin of uncertainty around our GDP growth and inflation projections. Weighing these risks and uncertainties is a key factor in our policy judgments. And highlighting their relative importance in both the *Inflation Report* and the minutes is a key communication challenge for the Committee.

⁴ A. Cunningham and R. Jeffery “Extracting a better signal from uncertain data”, Bank of England Quarterly Bulletin, 2007, Quarter 3

Economic models and forecasts are useful tools, but will always be imperfect characterisations of a complex real economy. They do, however, provide benchmarks against which we can evaluate the latest data and assess how the balance of risks and uncertainties may have changed. Over my time on the Committee, I have found it very important to scrutinise the latest data - particularly the feedback from businesses through surveys and Agents' reports - to inform and update my assessment of the economic outlook. As I made clear in my latest speech⁵, that data flow and business feedback will be particularly important in the current conjuncture.

7. To what extent do you think that the current turmoil in financial markets will affect business investment?

There will clearly be an impact – but the jury is still out on the issue of how significant it will be. Investment intentions data have weakened since the middle of 2007, particularly in the services sector. However, this is not just a reflection of the current turmoil in financial markets. It may also reflect the lagged impact of past UK policy tightening and slower growth overseas.

The impact of the financial turmoil on investment intentions will be a combination of three main channels of influence. The first is the impact on the general business climate and confidence about future demand. In 2006 and the first half of 2007, business confidence at home and abroad was very supportive of investment – and this was reflected in strong data for both capital expenditure and investment intentions. This confidence has clearly been dented in recent times and has given way to a more cautious approach. This has been particularly true in businesses close to the financial and property sectors but it has been less noticeable in manufacturing industry – where the latest CBI Industrial Trends Survey showed uncertainty about demand was still a less significant constraint on investment than on average over the last decade.

The second channel of impact is through financing costs. The LIBOR spread over the expected policy rate has widened, potentially adding to short-term financing costs – though reductions in policy rates have provided an offset. However, investment should be geared around longer term financing costs, and the impact here has been more muted. The latest CBI Industrial Trends Survey shows that 4% of manufacturers regard the cost of finance as a constraint on investment, in line with the average for the last year and only slightly up on the average for the last decade.

The third channel is the availability of external finance. Historically, this has not been an important constraint on investment, normally cited by around 5% of companies responding to the CBI's Industrial Trends Survey. Banks have reported in their responses to the Bank of England's credit conditions survey that they are tightening the availability of credit and smaller companies and new business start-ups may be particularly affected by this. However, the impact of credit tightening on the availability of finance is not yet apparent from business contacts or survey evidence. The latest CBI Industrial Trends Survey showed just 4% of companies reporting inability to raise external finance as a constraint on investment - below historical averages. However, this may reflect lags in company perceptions of bank lending policies

The combined impact of these factors remains to be seen, and I will be monitoring investment intentions data and other relevant evidence in the months ahead. Certain categories of business investment – such as commercial property and capital expenditure by smaller firms – may be more vulnerable than others and they need to be monitored particularly closely.

8. When considering the UK economy, how much emphasis do you place on the international economic environment? How concerned are you about global imbalances?

Over my first term on the MPC, I have placed a great deal of emphasis on understanding how changes in the international environment are affecting the outlook for inflation. I devoted two

⁵ “How big is the risk of recession?” Exeter, 21 February 2008

speeches to this issue last Autumn. In my view, disturbances from the global economy have been the main source of shocks to UK growth and inflation over the period since 1997, and this has remained true in recent years.

In the late 1990s and early 2000s, the shocks from the international economy were predominantly in a disinflationary direction. This allowed the MPC to relax policy by stimulating domestic demand and interest rates fell to a low of 3.5% in 2003. Since then, the predominant direction of the shocks from the international economy has been inflationary – strong growth of global demand and rising energy and commodity prices. The picture has become more complex recently, as we face twin shocks working in opposite directions – rising energy and food prices, accompanied by the negative impact of financial turbulence. The monetary policy challenge at present involves understanding the net impact of these twin shocks on the medium term inflation outlook, which depends on how severe the negative demand shock is and how far inflation expectations will be influenced by a period of above target inflation in the short-term.

Global imbalances have provided an undercurrent to this situation but they are not the whole story. These imbalances reflect an excess of savings in Asia – and more recently among commodity producing countries as well. The counterparts to excess savings in these parts of the world are the current account deficits in more mature economies, including the UK and the US, where saving is inadequate to finance the current level of investment.⁶

However, global financial imbalances are part of a wider economic picture. The global economy is changing shape. Asia and emerging markets are growing strongly and becoming a more significant force in the global economy more generally. Earlier this decade, the shift in production towards low-cost economies (the “China effect”) was considered to be a disinflationary influence on UK inflation. More recently, strong demand from these countries has added to recent inflationary pressures in global commodity markets. This highlights the fact that the continuing transition to a world economy where China, India and other emerging economies play a larger role is unlikely to be smooth. And monetary policy needs to be prepared to deal with further shocks to output and inflation from the global economy as this transition takes place.

9. To what extent do you think consumers have been affected by the recent disturbances in financial markets?

Consumer confidence has fallen recently – quite sharply – though this is not solely due to the recent disturbance in financial markets. Financial market turbulence has been accompanied by a weakening housing market and a slowing economy. Also, media reports of the risks of recession in the United States may have spilled over into a concern that the United Kingdom could follow a similar course – though in my view these concerns are overstated. Consumer sentiment is being affected by a combination of these factors – some of which may prove to be temporary.

So far, consumer spending has proved more robust than sentiment – though there are indications of a slowdown in the Q4 national accounts data and in the growth of retail sales values. I would expect consumer spending to weaken further in the first half of this year, as real incomes are squeezed by higher energy, food and import prices, and consumers adjust further to the uncertainty created by the recent financial turmoil. Notwithstanding this, I am not expecting a consumer adjustment on the scale of the early 1990s recession or earlier recessionary periods. As long as inflationary expectations remain well anchored, monetary policy can respond to negative demand shocks. And the supply-side of the economy now has more flexibility to absorb shocks than in previous recessionary periods in the UK, particularly because of improvements in labour market performance.⁷

⁶ See my speech “The Changing Pattern of Savings: Implications for Growth and Inflation”, Edinburgh, 15 March 2007, for more detail.

⁷ See my recent speech “How big is the risk of recession?”, Exeter, 21 February 2008, for more discussion.