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Wadhvani Says that Inflation is Likely to Remain Subdued

In a speech delivered to Agency contacts in Norwich on “The Current Policy Conundrum”, Dr Sushil Wadhvani, an external member of the Monetary Policy Committee at the Bank of England, argued that disinflationary forces in the economy are still strong.

He argued that the weak global economy, falling commodity prices, more subdued import prices, falling capacity utilisation, and survey evidence that pipeline pricing pressures were diminishing all pointed to a reduction in underlying inflation. In addition, current measured inflation had been distorted by transient factors of which the most important was the highest rate of seasonal food price inflation (24%) since 1984.

Dr Wadhvani then reviewed the arguments that the current “imbalances” in the UK economy were an impediment to interest rate cuts. For example, it is sometimes argued that since the trade deficit might lead the exchange rate to decline, which would then lead to inflation, interest rates should be set higher today to prepare for this eventuality. Dr Wadhvani argues that such a pre-emptive strategy is potentially damaging as it would be likely to drive the current exchange rate higher, thereby potentially exacerbating the trade deficit. Moreover, raising interest rates pre-emptively today may, in any case, be unnecessary as fall in the pound might occur at the same time as a downgrading of growth expectations, and it was therefore better to “wait and see” whether and why the exchange rate fell.

Dr Wadhvani concluded his speech by noting that the risk that the global economic slowdown might prove worse than generally expected, combined with the “imbalances” in the UK economy, suggested that we might have a bumpy ride ahead of us.

Key Resources

The Current Policy Conundrum – Full speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2001/speech137.pdf>