BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

18 June 2001

"Hanes Dwy Ddinas" or a "Tale of Two Cities" - Speech by Mervyn King

Speaking at the Cardiff Business School today, Mervyn King, Deputy Governor of the Bank of England, says that the past five years have been a period of remarkable stability for the UK, which reflects well on the new framework for monetary policy. But the small deviations of inflation from the target over the past four years give a misleading impression of the greater volatility of inflation that we might reasonably expect to see in future.

Mr King says there are two sources of uncertainty facing the UK at present, one domestic and the other international, and both are related to imbalances. In the UK, there is "a 'tale of two cities' in which some industries are experiencing the worst of times, with declining manufacturing output, and others the best of times, with the latest retail sales figures showing an increase in the volume of sales over the past twelve months of 6.4%". He notes that this is the first time since the 1870s that the external contribution to growth has been negative for a period of five consecutive years, and that negative contribution is likely to continue for the foreseeable future.

Mr King points out that imbalances on this scale are unsustainable, although it is far from obvious for how long they can continue. "But, for the time being, final domestic demand continues to grow at above trend rates, exacerbating the imbalances within the economy and adding to the risk of a large adjustment at some point in the future. The continuing shift of resources to meet the demand for better public services means that private demand must grow much more slowly over the next few years. In turn, that would enable the trade deficit to stabilise and eventually fall back."

Turning to international imbalances, Mr King says: "Whether the slowdown in the US will be more prolonged than is embodied in the current consensus view will depend critically upon personal consumption. And, in turn, that will depend upon expectations of future productivity and hence income growth in the US. If there were to be a reappraisal of the extent of the increase in productivity growth in the US, then there might be a further downward revision of asset prices and a lower path for consumption spending. So far, the evidence, both from consumption directly, and financial markets indirectly, suggests that no major reappraisal has occurred."

Mr King says there is one reason for caution about estimates of higher future productivity growth - the conventions used to measure output and hence productivity. The proper measure of output is net domestic product (NDP), which differs from GDP by an appropriate allowance for depreciation of capital goods. In normal circumstances, the growth rates of GDP and NDP are identical. "But the two can differ when the average depreciation rate of the capital stock is changing, and that is exactly what has been happening recently. There has been a shift toward greater investment in short-lived assets, such as IT and computer software, and as a result the average depreciation rate has risen. Part of the additional gross output is simply replacing the higher proportion of capital that wears out each year. It makes no sense to include the higher depreciation as part of increased output and hence higher productivity. A change in technology that raises output today at the expense of output tomorrow is not an improvement in productivity. Using estimates of growth rates of GDP will lead to an overestimate of the rise in productivity growth during the transition to higher depreciation rates." The measurement problem, and the overestimation of output growth, is even more acute when the price of capital goods is falling relative to that of final consumption goods. "Economists should be cautious about drawing strong conclusions about the future path of productivity growth," says Mr King.

The imbalances at home and overseas suggest that the Monetary Policy Committee "may be in for a slightly bumpier ride over the next four years than during its first four." Mr King believes that "Controlling inflation in future may prove more difficult than over the past four years, and the longer the imbalances persist the greater the risk that the subsequent adjustments to demand, output and inflation are larger than those experienced recently." Mr King also says that any rebalancing of the economy is likely to be associated with a fall in the real exchange rate. But the magnitude and timing of that are not only uncertain, but also difficult for the MPC to influence. "The only problems worse than those of an excessively strong currency are those of an excessively weak currency."

Mr King notes tentative signs of a pick up in goods prices and the retail sales deflator and says the MPC will monitor the price data extremely carefully. "But there is likely to be significant short-run volatility in the inflation figures over the coming months, and it would be unwise to read too much into the latest inflation figure because the rise from 2.0% to 2.4%, although the largest one month increase since October 1996, was largely accounted for by the jumps in the prices of seasonal food and petrol." Mr King concludes "The Committee will have to watch carefully developments in the economy as they unfold, and be ready to act promptly in either direction. There will always be unpredictable events to which the MPC will need to respond."

Key Resources

Hanes Dwy Ddinas or "A Tale of Two Cities" – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2001/speech134.pdf