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News release

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Adjusting to Low Inflation - Issues for Policy - Speech by Kate Barker

In a speech to the Manchester Statistical Society today, Kate Barker, a member of the Bank of England's Monetary Policy Committee, notes the advantages of low and stable inflation. She briefly outlines the issues arising from the process of transition to a low inflation economy and then discusses the main policy concerns that such an environment introduces.

"Overall," Ms Barker said, "it is very clear that there are many benefits from the successful achievement of low and stable inflation, especially in terms of greater macroeconomic stability and improved efficiency. In addition, firms and households are able to plan with greater confidence, and there are efficiency gains from the greater transparency of relative prices."

"But," as she summarised in her closing remarks, "some of the consequences of the low inflation regime are starting to become more apparent and have given rise to the expression of a fresh set of concerns. Some of these however seem to be over-stated, certainly in a UK context where there is at present little risk of a generalised deflation."

"Other comments about the impact of low inflation turn on perceptions about what may have happened to real interest rates (for example, concerns about low annuity rates). There is little guide from theory or past experience to whether or not a change to low inflation should be expected to affect real rates. Though the expectation that low inflation may improve growth would suggest a possible rise in real rates, the inflation risk premium, certainly on bonds, is likely to have fallen, and the latter may prove more significant.

"Firms and wage-bargainers seem, on the available evidence, to have adjusted to the new regime, though surveys of inflation expectations suggest that households may not have completed their adjustment. The key problem for policymakers is how far households have appreciated the longer-term implications of the new regime, and to what extent they may have adjusted their debt/income ratio up too far because these implications have not been fully grasped.

Ms Barker concludes, "But a somewhat higher debt/income ratio is to be expected in these changed circumstances, and to resist this adjustment would run the risk of holding down growth unnecessarily. This higher ratio then may have increased the risks from policy error, or from an adverse shock to the household sector. But if this adds to the difficulties of policymakers, it also has to be remembered, as a counterbalance, that other adjustments to the new regime (lower rates of exchange rate pass-through, firmly based inflation expectations by firms and wage bargainers) are important factors adding to the stability of the economy."

Key Resources

Adjusting to Low Inflation - Issues for Policy - Full Speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2003/speech190.pdf