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News release

2 March 2005

A Matter of No Small Interest: Real Short-term Interest Rates and Inflation since the 1990s - Speech by Marian Bell

In a speech this evening to The Institute of Directors and Milton Keynes Chamber of Commerce at Cranfield University, Marian Bell, a member of the Bank of England's Monetary Policy Committee, discusses how in recent years persistently low inflation and steady growth in nominal demand has been accompanied by historically low short-term interest rates, both in the UK and other major industrialised economies.

Ms Bell notes that one explanation for persistently low short-term interest rates in the major economies is low inflation itself. The lower inflation, the lower nominal interest rates can be for a given real return. But this does not seem to explain the whole story as even adjusting for inflation, 'real' short-term interest rates have been low.

She presents data which suggest that the average real short-term interest rate over an economic cycle has been positively correlated with the level of inflation for a variety of developed economies over the last decade or so.

She discusses a number of factors that might account for this relationship, including a reduced tax wedge between real and nominal interest rates at lower levels of inflation, a reduction in macro-economic volatility and, related to that, a reduction in the risk premium. Ms Bell quotes research that suggests that the relationship between real interest rates and inflation is affected by a change to a more anti-inflation policy regime.

Ms Bell concludes that experience across a range of economies since the late 1980s suggests that the real natural rate of interest consistent with an economy growing at its potential and stable inflation might have fallen, "Shifts in the inflation regime and greater associated macro-economic stability might have played a role, both in lowering the risk-free real natural rate and enhancing the role of risk premia. Since the observed relationship between real interest rates and inflation is a relatively recent phenomenon which was not apparent in the 1970s, this explanation for the decline in real rates is appealing. But ... it would be risky for policy makers to assume that any apparent shift-down in the real natural rate of interest is a permanent rather than a temporary phenomenon".

Ms Bell adds, "Relative price movements give the signals about demand and supply that lead to an effective allocation of resources and facilitate the smooth operation of the real economy. But relative price movements and price shocks cannot cause general inflation or deflation in the medium term. So long as monetary policy is not expansionary, a faster rate of increase in the price of some goods or services will in time be offset by slower increases in the price of others, as real incomes are squeezed. It is therefore important that monetary policy is set neither too hot nor too cold. Over the medium term that means ensuring that inflation expectations remain anchored to the target and getting the real interest rate right. Judging that in the face of uncertainty over the real natural rate of interest will continue to mean taking a pragmatic approach to policy".

Key Resources

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http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2005/speech241.pdf