



BANK OF ENGLAND

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Monetary Policy, Stability and Structural Change – Speech by Paul Tucker

In a speech today to the CBI in Guildford, Paul Tucker - Executive Director for Markets and a member of the Monetary Policy Committee - discusses some of the structural changes affecting the economy and how monetary policy confronts them.

Paul Tucker says, "either there have been some fairly profound changes in our economy or we have been blessed by extraordinary good luck over the past decade or so". He highlights that inflation has been less variable and changes in inflation have been less persistent than in previous decades. He also discusses the uncertainty about the extent to which demand pressures feed through into wages and prices - relevant at the present time as slack in the economy is absorbed and the degree of demand pressure and the implications for the inflation outlook become key judgments for the MPC.

Stressing the need to separate out cyclical variations from structural influences on firms' costs and margins, and in turn inflation dynamics, Mr Tucker says inflation expectations have become anchored on the inflation target and uncertainty about future inflation has fallen such that ".when shocks to the economy cause inflation to deviate from target, firms may nevertheless set prices on the basis that it will return to target fairly quickly." He adds that firms and households might also now expect the Bank to change interest rates fairly promptly in response to movements in demand conditions such that "the influence of such demand shocks on wage and price setting.. would plausibly be somewhat weaker than in the past."

But the change in the UK's monetary policy regime has occurred alongside structural change in the real economy. This makes it difficult to determine how these effects or their interaction are likely to play out in the future. In addition to intensifying global competition, Mr Tucker highlights changes in the labour market and their impact on inflation. Noting that the sustainable level of unemployment has most probably fallen, he says "we can be reasonably confident about the direction of change but not about its size". He cites the possible influence over the past few years of the improvement in the UK's terms of trade, which may have dampened wage pressures temporarily and so point to an upside risk looking ahead; and, working in the other direction, the growth in migrant labour, which if sustained might enable the economy to accommodate stronger aggregate demand than otherwise.

Mr Tucker also notes changes in the range of sources of finance available to firms and households, potentially making them less exposed to adverse credit conditions in an economic downturn. This might dampen the effect of shocks, which in turn implies less variation in output growth and inflation.

All these structural factors and others are relevant to the MPC's view of the macroeconomic outlook. Although discriminating between cyclical and structural influences is a challenge, Mr Tucker says it is unavoidable that policymakers should try to do just that. Looking at the current conjuncture, Mr Tucker says, "In my judgment, there is, on balance, most likely a degree of excess demand in the economy.[and] some corroborative evidence in the rise in output price inflation." He asks how that fits ".with earnings inflation having been relatively subdued." He suggests firms may have increased output by making greater use of their existing workforce and capital. "That would be consistent. with the pick up in private sector productivity growth over the past year or so. Looking ahead, it would also suggest a degree of upwards pressure on earnings growth". That and, most important, the MPC's February inflation projections provided the background to Mr Tucker's vote for a 25 basis point rise in the Bank's repo rate at the MPC's February meeting.

Key Resources

Monetary Policy, Stability and Structural Change

Speech by Paul Tucker at the Confederation of British Industry in Guildford

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<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2005/speech240.pdf>