



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

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Inflation and the Service Sector - Speech by Professor Timothy Besley

In a speech to the Cardiff Breakfast Club today, Professor Timothy Besley, a member of the Bank's Monetary Policy Committee, considers the long-term structural shift of the UK economy from manufacturing towards services and its implications for growth and inflation.

Market services – which are services excluding government – grew from a little less than 50% of gross value added in 1985 to more than 60% in 2004. Most of this was a relocation of economic activity from manufacturing to services.

Professor Besley says "...market services are a heterogeneous group of economic activities including goods produced and consumed as services (such as restaurants), those that facilitate the production and consumption of other goods (such as retailing) and those that are inputs into other kinds of production (like financial services). ... Business and financial services are an important intermediate input into other economic activities in the United Kingdom and are not just consumed directly."

He points out that "In recent years, we have seen all kinds of businesses outsourcing processes to achieve lower costs and to take advantage of gains from specialisation. Some of this is outsourcing of low value-added activities, in part to low-wage economies. But the growth of business services in the United Kingdom reflects in part outsourcing of high value-added activities, which are high up the production ladder allowing firms to take advantage of the specialised skills available in business services. The latter, in particular, can be a source of productivity improvements. Business services are also often used directly in the outsourcing process."

"The structural shift from manufacturing towards services is consistent with increasing prosperity and growth for the UK economy. What matters is not whether the output is in the form of services or manufacturing – it is the move towards the production of higher value-added activities that enables the UK economy to progress. One of the key challenges is to maintain the skill base and to develop the right kind of business environment to permit continual movements of production up the value chain. The stability created by sound monetary policy plays a key role in delivering a favourable environment for business."

Professor Besley then comments on the implications of this trend for inflation, saying “We have observed a tendency for consumer services price inflation to run ahead of consumer goods price inflation over the past ten years. This does not imply an inflationary bias in the structural change from the production of services to goods. Changes in CPI depend on the balance of demand and supply factors in the economy as a whole. However, the current strength of the service sector, as evidenced in the survey data to which I have referred, is germane to judgements about the current strength of the UK economy.”

He concludes, “I am not trying to downplay the important role played by manufacturing in the United Kingdom. But the general context is one in which prosperity is maintained in both services and manufacturing by improving the skills base and business climate to support movements towards higher value-added economic activities.”

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2007/speech299.pdf>