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A Tale of Two Shocks: Global Challenges for UK Monetary Policy - Speech by Andrew Sentance

In this speech, Andrew Sentance, an external member of the Bank's Monetary Policy Committee, discusses the challenges currently facing the Monetary Policy Committee. Speaking in London to an audience of University of Warwick alumni, Dr Sentance explains that "over the last six months, two major global shocks have come along to complicate our task" of setting interest rates and that "these upside inflationary risks from oil and other commodity prices need to be weighed in the balance against the downside risks to growth - and hence inflation - from the recent financial turmoil."

Dr Sentance reviews four key pieces of evidence that the MPC will be looking at in the months ahead in coming to its monetary policy decisions: the extent of slowing in UK domestic demand growth, in response to past rate rises and to recent financial turbulence; momentum from the global economy; price pressure generated by rising oil and commodity prices; and the influence of other domestic factors - price expectations, capacity pressures and wage growth - on the medium-term inflation outlook.

Although the MPC has been expecting some slowing in UK growth in response to higher interest rates, Dr Sentance argues that "the likelihood is that the recent financial market turmoil will tend to reinforce this slowdown in the short term - particularly through its effect on the cost and availability of finance for riskier borrowers in both the household and corporate sectors, and by adding to uncertainty about business conditions. But the timing and scale of these impacts is highly uncertain."

While slower US growth would reduce world demand, Dr Sentance says that the UK economy is influenced more by events in the euro area, where recent data point to continued healthy growth in the second half of the year. The MPC will be watching data and indicators of UK export orders for any more pronounced weakening in world demand.

Rising prices of oil, other commodities and food, may put upward pressure on CPI inflation unless other prices adjust downwards. Dr Sentance argues that "short-term external shocks such as recent rises in energy and food prices should not affect the path of inflation over the medium term, as long as price expectations are not destabilised and demand and cost pressures do not turn a temporary rise in inflation into a more sustained increase," adding that "in the months ahead, the Monetary Policy Committee will need

to monitor closely the full range of indicators of pay growth to establish whether inflation expectations are shifting."

Summarising the challenge for monetary policy, Dr Sentance notes "these shocks are operating in opposing directions in terms of their impact on inflation. So judging the appropriate monetary policy response will not be easy." And he warns "in the wake of recent shocks from global financial and commodity markets, we cannot guarantee that the economic road ahead will be easy or smooth. On the MPC, we will be focused on our remit of keeping inflation on course to meet the 2% target. But against a background of global financial turbulence and a sharp rise in the oil price, it may be a bumpy ride."

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2007/speech330.pdf>