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BANK OF ENGLAND

News release

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Current Monetary Policy Issues - Speech by Rachel Lomax

Speaking to the Hull & Humber Chamber of Commerce tonight, Rachel Lomax, Deputy Governor for Monetary Policy focuses on the turmoil in financial markets and the renewed surge in energy prices, and discusses the difficult policy decisions now facing the MPC.

On financial market developments, she argues that the problem is one of uncertainty: about the eventual size of losses from defaults on US sub prime mortgages, and about where these loans have ended up. The impact of the turmoil on UK monetary policy will depend on the answer to three questions: how far the liquidity squeeze will turn into a credit crunch; how well placed households and firms are to weather such an event; and whether there will be a significant impact on credit conditions in the longer term?

She argues that while it too early to answer these questions with any great confidence, there are signs that credit conditions facing both firms and households have already tightened and may tighten further. "This should act as a brake on consumer spending and investment. But the size of this effect is highly uncertain. and much may depend on whether recent developments shake consumers' confidence in future income growth and employment - and so far that does not seem to have happened".

On energy prices, she notes that the oil price is almost back to its 1979 high, after correcting for inflation. Rising energy prices have a smaller impact than they did 20 or 30 years ago. This is partly because the focus of monetary policy has very clearly been on controlling inflation. Today higher energy prices are an important influence on interest rate decisions.

She argues that the UK economy is well placed to weather these headwinds in terms of output, because output has been growing strongly. But growth does now seem to be slowing. It is less clear whether the scale of the slowdown is more or less than is needed to keep inflation on target. The MPC latest projections are centred on a relatively mild slowdown by historical standards, on the assumption of a gradual and modest easing in interest rates. But they are subject to a wide margin of error. And there are uncertainties about the underlying strength of inflationary pressures.

She concludes that the MPC faces a tricky period as they try to weigh the risk of an unduly sharp downturn, against the threat to inflation posed by a sharp surge in global energy prices.

There are always risks in signalling that policy will be eased at a time of rising energy prices. This is all the more so after a year when inflation has been above target. But the Committee needs to be very alert to the risk that the economy may be slowing too abruptly. At current interest rate levels, monetary policy may be on the restrictive side.

The MPC's monthly decisions are always grounded in a careful analysis of all the evidence. Given the uncertainties they face, now is a time to pay extra attention to the emerging data, including reports from the Bank's Agents.

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2007/speech329.pdf