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The UK's Inflation Problem: Selling England by the Pound? Speech by Andrew Sentance

In a speech to the Institute of Economic Affairs 'State of the Economy Conference' in London, Andrew Sentance - External Member of the Monetary Policy Committee - discusses the outlook for inflation in the United Kingdom, explains why he thinks that inflationary pressure is greater than suggested by the MPC's latest Inflation Report forecasts and why higher interest rates are now needed.

Andrew Sentance begins by asking: "Why has inflation turned out persistently above target, despite the widespread expectation that it would be pushed down by the financial crisis and the global recession?" The answer, he argues, is that ".too much faith is being put on the impact of a large 'output gap' pushing down on inflation and not enough weight has been put on the upward pressure from the global environment and the exchange rate".

Andrew Sentance goes on to explain why he thinks that the 'output gap' has not dampened inflation as much as is commonly thought. First, he suggests that the degree of spare capacity created by the recent recession is less than might have been expected given the experience of previous recessions. He says: "In both the early 1980s and early 1990s recessions, the unemployment rate rose to over 10%.... By contrast, the current unemployment rate is still below 8%, and it should drop back gradually as the recovery proceeds".

Consequently, he indicates, pay pressures during this recovery are now beginning to build. Second, in making pricing decisions, businesses look not just at the level of demand, but at its growth rate, and he notes that "...domestic demand in the UK economy has bounced back strongly following the recession in both real and nominal terms". Third, he argues that the 'pricing climate' is more complicated than a simple view based on measure of the 'output gap' would suggest. In comparing the current recovery with those following the early 1980s and 1990s recessions, he says: "Businesses appear to have taken a stronger signal from the stimulatory policy and its impact on demand growth, and looked through what they might reasonably have expected to be a temporary shortfall in demand. The danger of this is, of course, that businesses come to expect higher inflation on an ongoing basis and the higher rate of inflation becomes deeply ingrained."

Fourth, and most importantly, Andrew Sentance says that in an open economy like the UK the 'output gap' model of inflation pays insufficient attention to the global forces shaping UK inflation. "A key driver behind the

upward pressure on prices in global markets has been strong global economic growth, particularly driven by Asia and other emerging markets", he says. Moreover, "Forecasts of future global growth are now being revised up again.". Dr Sentance concludes that "...global inflationary pressures look set to continue and with them above-target UK inflation".

Finally, Andrew Sentance considers the role of the exchange rate, and the appropriate response of monetary policy to global inflationary pressure. He says that: "...the recent fall in the external value of the pound between 2007 and 2009 is probably the largest depreciation we have experienced in a relatively short period over the past two centuries - with the exception of the departure from the Gold Standard in the early 1930s." And, he argues, while some depreciation of the exchange rate is a helpful boost to export demand, ".there must be a concern that we have let the pound fall much further than this rebalancing requires". He concludes by saying that, while the exchange rate should clearly not become the centrepiece of UK monetary policy, the value of sterling "...needs to be one of the key areas of focus for the MPC as we seek to steer ourselves out of the current phase of high inflation". A modest appreciation of sterling, he argues, ".would mitigate the impact of global inflationary pressures in the short term and help to steer inflation back to the target over the medium term".

Key Resources

[The UK's Inflation Problem: Selling England by the Pound? – Full speech](#)