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News release

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Setting UK Monetary Policy in a Global Context - Speech by Andrew Sentance

In a speech to the European Policy Forum in London, Andrew Sentance - External Member of the Monetary Policy Committee - discusses the global forces that affect UK inflation and how monetary policy can respond to them. He questions the extent to which UK inflation is driven by the domestic output gap relative to global influences on demand and pricing.

Andrew Sentance argues that the United Kingdom's experience of the financial crisis and its aftermath has challenged both the view that monetary policy can keep economies on a steady growth and low inflation track at all times and the notion of a simple trade-off between growth and inflation. He argues that the openness of the UK economy to international trade and investment means that "...the international dimension is a key ingredient to the setting of UK monetary policy".

He discusses how the high degree of interdependence across economies around the world and a highly integrated global financial system meant the financial crisis spread internationally and was transmitted across sectors by highly integrated global supply chains. He argues that a new feature of the global economy that flows from this high degree of interdependence is "...the way growth and inflation respond to demand pressures".

Andrew Sentance notes that the global economy has driven the main developments to which the MPC has had to respond over recent years and greatly complicates the task of maintaining low and stable inflation. He discusses three channels through which global economic developments impact the UK economy and hence influence the rate of inflation: import prices, demand and the pricing climate. Trends in emerging and developing economies appear to have shaped global price developments over the past decade, a pattern which looks set to continue. And he argues that global conditions and capacity pressures have a significant impact on UK inflation that may have become increasingly important in affecting pricing behaviour relative to domestic factors. At the same time, Andrew Sentance stresses there are significant ways through which monetary policy can help to stabilise demand and inflation in the face of powerful global forces - through the impact of interest rates on the exchange rate, on domestic demand and on inflation expectations.

On the current conjuncture, he says, "...recovery in UK domestic demand is most welcome in helping to lift the UK economy out of recession. But coupled with a resurgence of global inflationary pressures and the additional inflationary impact from the depreciation of the exchange rate, it has also provided a climate in which businesses have been able to pass through price increases without too much fear of losing business. The danger that this poses is that this begins to affect business perceptions of the pricing climate and price expectations more generally." He highlights the significant change in the 'price expectations climate' since the immediate aftermath of the recession when the main concern was that deflationary pressures might take hold. He says, there are ".upward risks to inflation expectations in the current climate".

In judging the outlook for inflation and the implications for monetary policy, Andrew Sentance says, "... it would be a mistake to label all the global factors affecting inflation as one-off short-term disturbances and to see the medium-term influences purely in terms of domestic factors... Properly taking into account the influence of the international economy is the key to the art of successful management of UK monetary policy." He concludes that "... the MPC needs to steer a middle course when it comes to global pressures on inflation. We should be prepared to look through genuine one-off shocks. But when it is clear that global inflationary pressures, coupled with a substantial decline in the exchange rate and reasonably healthy growth of domestic demand are all contributing to a sustained period of above-target inflation, then the time has come to act... If we do not start to raise UK interest rates gradually soon, we risk having to do so more aggressively in the future - which could create a big shock to business and consumer confidence further down the track".

Key Resources

Setting UK Monetary Policy in a Global Context – Full speech