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Bank of England Quarterly Bulletin - 2011 Q2

The 2011 Q2 issue of the Bank of England *Quarterly Bulletin* is published today. In the foreword to the Bulletin, Spencer Dale - the Bank's Chief Economist - writes:

"The Bank faces significant challenges in assessing the current strengths and vulnerabilities of our economy. Monitoring and analysing economic and financial market activity play an important role in that assessment. This edition of the *Quarterly Bulletin* presents a number of articles that highlight various aspects of this process of monitoring and evaluating the state of the economy.

The *Bulletin* begins, as usual, by examining developments in financial markets. The **Markets and operations article** reviews developments in financial markets covering the period between the previous *Bulletin* and 20 May 2011. There were a number of significant events within this period, including the continuing political tensions in North Africa and the Middle East, and the Japanese earthquake and tsunami. But despite that backdrop, financial markets generally continued to operate normally with little sign of excessive volatility. In the euro area, uncertainty about how some member countries will resolve the fiscal challenges that they face heightened, with the yields on government bonds in Greece, Portugal and Ireland rising sharply relative to those in Germany. In a number of commodity markets prices fell sharply in early May, having risen earlier in the review period. Weaker-than-expected activity data contributed to financial market participants pushing out their expectations for the date at which Bank Rate would increase.

One issue central to the Monetary Policy Committee's current deliberations is the risk that the sustained period of above-target inflation might cause expectations of inflation to drift upwards and become ingrained in price and wage-setting behaviour. This edition of the *Quarterly Bulletin* presents two articles on this issue.

The first - **Assessing the risk to inflation from inflation expectations** - outlines a framework for monitoring inflation expectations to assess both the extent to which they remain well anchored to the inflation target and whether inflation expectations are affecting wage and price-setting behaviour. Using that framework, the current data suggest that long-term inflation expectations remain reasonably well anchored to the target. The signals regarding short and medium-term inflation expectations are more mixed, but there are few signs that they have become significantly de-anchored. And, even with short-term inflation expectations

remaining elevated, there is little evidence as yet that they are becoming entrenched in wage and price-setting behaviour. But because inflation expectations cannot be observed directly and there are significant uncertainties surrounding the different indicators used, this risk can be assessed only imperfectly and it remains a key area of concern for the Committee.

The accompanying article - **International evidence on inflation expectations during sustained off-target inflation episodes** - looks at some international evidence on inflation expectations during sustained periods in which inflation has deviated from target. It suggests that during such periods, short and medium-term inflation expectations have tended to drift in the direction of the deviation from target. Recent movements in UK inflation expectations have been more mixed, moving both upwards and downwards, reflecting volatility in inflation and in measures of inflation expectations.

The effectiveness of monetary policy relies on the public's awareness and understanding of the policy framework. In order to gauge the extent of this understanding, the Bank conducts a regular survey on attitudes to monetary policy and satisfaction with the Bank. The article in this edition - **Public attitudes to monetary policy and satisfaction with the Bank** - presents the findings from recent surveys and suggests that the public's awareness of the monetary policy framework remains high and has changed little over the past year. Even so, the level of satisfaction with the way the Bank sets monetary policy has deteriorated since mid-2010.

The Bank's Market Intelligence programme plays an integral role in providing information to support the Bank's two core purposes - monetary and financial stability. Information gathered from market contacts provides insights into a variety of rapidly evolving markets. One such market, the foreign exchange market, plays a vital role in the efficient functioning of our economy. The article in this edition - **The use of foreign exchange markets by non-banks** - draws on this intelligence, as well as economic theory and market data, to examine this market with particular focus on its use by non-bank market participants. It focuses on two of the main reasons why market participants use the foreign exchange market - to hedge themselves against currency exposures arising from their underlying business, and to seek additional profits by trading in the foreign exchange market itself. The majority of foreign exchange activity is reported to be related to hedging behaviour, with the non-financial corporate sector almost exclusively using the market for this purpose.

Two further articles analyse data issues in more detail. One examines **housing equity withdrawal** (HEW) which turned negative in 2008, for the first time since the 1990s. A common interpretation of this recent pattern has been that households have been paying down debt more quickly than in the past. But as the article explains, the move from positive to negative HEW appears largely to be the result of the weakness in housing market transactions; the pace of repayments is little changed. The other article - **Using internet search data as economic indicators** - discusses a novel source of data derived from the increasing and widespread use of the internet - data on the volume of online searches. The article evaluates features of these new data and explores the potential for assessing the current level of economic activity. It uses some

simple illustrative models to show that internet search data can contain valuable signals about the state of both labour and housing markets in the United Kingdom."

Note to Editors

Copies of the **Quarterly Bulletin** are available from:

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