



BANK OF ENGLAND

Speech

Economic Imbalance and UK Monetary Policy

Speech given by

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Delivered in the Scott Policy Seminar Series of the Northern Ireland Economic Research Centre (NIERC)

19 September 2001

I thank Amit Kara and Edward Nelson for helpful discussions and advice in the preparation of this talk. The views expressed are personal and should not be interpreted as those of the Bank of England or other members of the Monetary Policy Committee.

1. INTRODUCTION

It is a great pleasure to be asked to contribute to the Scott Policy Seminar Series. This talk was prepared largely before the devastating events of Tuesday, September 11, 2001 in the United States.

My theme today is UK monetary policy—in the context of emerging imbalances in the world economy and within the UK. It seems to be the consensus that the MPC, after a remarkably successful period since the start of the new arrangements in 1997—with above trend growth, falling unemployment and stable inflation close to the government's target—now faces considerably greater difficulties and challenges in the period ahead.

Economic commentaries are full of stories about the 'two-speed economy' and about the imbalances between manufacturing and services, the traded goods sectors and the non-traded, as well as worries about consumer indebtedness and the balance of payments which raise the spectre of a late 1980s style 'boom and bust' for the UK economy.

There is no doubt that the talk of imbalances reflects genuine worries about the world economy—especially about the US, but also about Japan, now sinking again into recession, and about the slowdown in euro area—and about the UK. But the pessimism needs to be tempered. One obvious point is that the last four years of relative UK success have also been years of major international shocks and uncertainties—most notably the Asia crisis and the Russian default and its aftermath. Monetary policy, on the whole, managed to adjust to offset some of the problems, which looked particularly dire at the time. Might it not be the same this time?

Clearly, however, the shocks and uncertainties are very different now. That does not mean that policy actions, at home and abroad, can have no influence. But it does mean, if light is to be thrown on the issues, that it is necessary to pick apart the different impacts and uncertainties to see what each might imply for monetary and other policy. Only then, I shall argue, can a reasonable overall assessment be made.

There is a lot going on. A rough classification, which does less than justice to the interactions between the parts, might be as follows:

A International

- 1 The world slowdown and the risks of world recession.
2. The international ICT shock and associated stock market falls.
3. Imbalances within the US and the international economy and the implications for (possibly large and sudden) changes in major exchange rates.

B Domestic

4. Within the UK, the implications of the ‘high’ exchange rate, against the euro particularly, which has been one of the major sources of imbalance—for example between the more exposed sectors of manufacturing and the more sheltered sectors of services. Added to this is the worry that the exchange rate might change quite substantially as events in the world economy unfold or because of developments within the UK.
5. Also within the UK, the fact that domestic demand has been growing substantially more rapidly than GDP, with the difference accounted for by a deterioration of net trade. A consequence has been a worsening in the current account of the balance of payments—partly masked, however, over the last few years by the rise in the exchange rate and an ‘improvement’ in the terms of trade.
6. Related to this, the surprising buoyancy of consumption and retail sales despite a falling stock market—reflected in an extremely low savings rate (comparable to that in the late 1980s boom). Consistent with this has been strong growth in credit to households and a high and rising level of household debt. Meanwhile, the housing market has picked up again—after a pause in the second half of last year—with house prices now about 11% higher than a year ago.

UK monetary policy needs to be set with one eye on the various impacts from the world economy and with the other eye on developments and tensions within the UK itself. It is worth reiterating that the Monetary Policy Committee's statutory duty is to try to meet the government's 2.5% target for RPIX inflation; and that the target is symmetric.

2. INTERNATIONAL IMPACTS

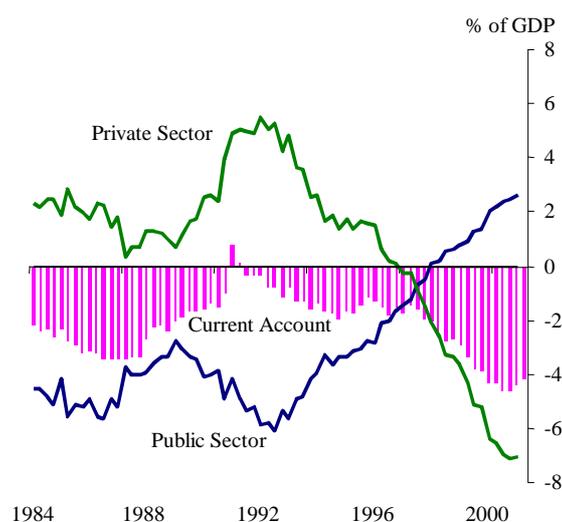
Much has been said and written about developments in the world economy, so I can be brief. In the first half of last year the world economy was booming, with industrial countries (OECD) growing at about 5.0% per annum and domestic demand in the US rising at about 6.5% per annum—a rate which clearly looked unsustainable, though the turning point was hard to predict. A US slowdown appeared not only inevitable, but desirable. It is worth recalling that consensus forecasts at the time involved a 'soft landing' with a moderate slowdown in the US balanced by a pick up in growth in the euro area and in Japan.

In the event, the US has slowed much further than that, with GDP growth barely positive in the first half of this year. There are obvious linkages to other countries via the trade flows.² The slowdown has been associated with a major shock from the ICT sectors and a large stock market fall in the technology sectors. The ICT shock is effectively global, and there are substantial linkages via financial markets as well. Far from taking up a locomotive role, the euro area countries as a group have also slowed, with Germany in particular facing strong recessionary forces, and the latest data suggesting a substantial slowdown in France and Italy. Japan, strongly affected by the ICT shock in the midst of serious domestic difficulties, is, according to most forecasts, facing the prospect of renewed recession.

² Trade as a proportion of GDP is of the order of 10% for the US, for Europe (excluding intratrade) and for Japan. It is widely argued that these figures tend to understate the international linkages. A revealing statistic is that US import growth which was about 16% per annum in the first half of 2000 is estimated to have fallen to about -6% per annum in the first half of 2001. The fall in US export growth was almost as large: from about 10% per annum to about -6.5% per annum.

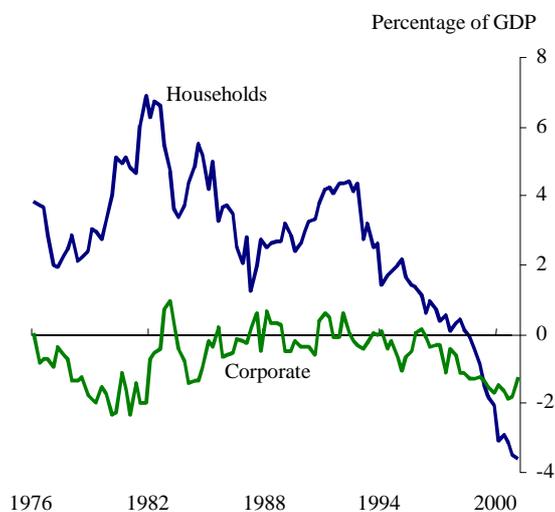
The brunt of the slowdown in the US has been borne by the manufacturing sectors (and more generally by the corporate sector). Consumer demand has held up reasonably well compared with expectations—so that outright recession has been avoided so far—but at the expense of a continuation of domestic and foreign imbalances. The private sector deficit is running at over 6% of GDP—well out of line with previous post-war experience. The main counterpart is the US’ external current account deficit which, at about 4.5% of GDP, is substantially higher than the imbalances of the mid-1980s. (See Charts 1 and 2.) Most commentators agree that one of the main downside risks for the US and the world economy is a major reaction of the private sector (households and corporations) towards financial prudence as balance sheets get stretched. (Such a reaction would be the more likely if further stockmarket falls were to materialise.)

Chart 1: US sectoral balances



Note: Private sector balance series are those prior to the recent US national accounts revisions.
Sources: Bureau of Economic Analysis, Bank of England.

Chart 2: US household and corporate sector balances



Source: Federal Reserve Board

As the extent of the US and world slowdowns has become manifest, monetary policy has reacted in an offsetting way. Starting in January, the Fed has cut US short-term interest rates by 3.50 percentage points—and there may be more to come. Here, interest rates have been cut by 1.25 percentage points. In the euro area, interest rates so far have been cut by three quarters of a percentage point. In Japan, the zero interest rate strategy, briefly abandoned, has been reinstated.

Prospects remain, however, extremely uncertain. Consensus forecasts have tended to suggest a moderate recovery in the US in the second half of this year, and a resumption of moderate growth in the US and trend growth in the world economy in 2002, but the risks are obviously great. Monetary policy needs to be set on the basis of forecasts which are highly uncertain: that is, on the basis of an assessment of the balance of risks.

The impact on the UK

How should monetary policy in the UK react to shocks from the world economy? To clarify thinking, it is useful to put aside problems regarding the composition of UK demand and output—such as those emanating from the exchange rate—and imagine that

UK policy makers simply have to react to shocks from abroad in a situation which is otherwise benign—with inflation close to target and output growing at potential.

We are concerned mainly with two types of impact or shock. The first is a (substantial) fall in world demand (weighted towards particular sectors, especially ICT)—impacting, in the first instance, on exports. The second, to be discussed only briefly, is a shock to world exchange rates and, in particular, a fall in the dollar relative to the euro. (Here, we assume that this change leaves the UK effective exchange rate more or less unchanged—a change in the effective rate for sterling, which might also be triggered by international developments, is discussed in the next section, below).

Taking the downward impact from international demand first, the impact on the UK would be a fall in demand and output as net trade worsened, with excess supply and an output gap likely to be created, tending to increase unemployment. In turn, this would indicate reduced inflationary pressure looking forward so that, if uncorrected, inflation would tend to fall below target. The policy response via the MPC's *reaction function* is entirely predictable: interest rates would be set lower than otherwise. Broadly speaking, the MPC would be trying to stimulate other components of demand to compensate for the reduced demand from net trade and the negative impact on domestic demand of the global slowdown,³ so as to keep prospective inflation in line with the government's target of 2.5%. That is what the symmetrical set-up of the monetary arrangements in the UK implies.

Of course, things are unlikely to be so simple in practice, due to major uncertainties, not just about the shocks that are occurring and will occur, but also about how the economies respond to those shocks and to policy changes such as movements in short-term interest rates. But some important points follow.

³ As the MPC has discussed, net exports are only one potential channel through which international shocks are transmitted to the UK economy. From paragraph 7 of the February 2001 MPC Minutes: 'some members thought that there could be an impact on foreign direct investment in the United Kingdom by the many US firms with affiliates here whose home profitability and cash flows would be under pressure.'

The first, and most important, is that the system is intended to be *stabilising* and *offsetting*. Over the medium term, policy is meant to undertake the adjustments needed to meet the inflation target and—since meeting the inflation target implies running the economy at productive potential—the economy should grow at about its potential rate. If the system is credible and transparent, then not only should inflation expectations be stabilised around the target rate set by the government, but also it should be expected that large deviations of output from potential will not be permitted. It is also the case that if the objective is understood, then the policy actions taken to achieve the objective should be reasonably predictable.⁴ Such a set of beliefs by the private sector in the efficacy of policy over the medium term would itself be a major contribution to macroeconomic stability even if—as is now the case—individual sectors are suffering major adverse impacts.

The second point is that, in the face of the sort of shocks that have arisen from the international environment, such a policy is almost bound to appear *unbalanced*. In the UK context, supporting demand to offset negative impacts from net trade and investment, means supporting consumption (and the housing market, due to the effect of interest rate cuts on the cost of housing finance). To an extent the ‘two-speed economy’ is just what one would expect to observe from the offsetting strategy outlined.

Third, there are of course risks which need to be weighed. One, which was referred to by the Governor in his Mansion House speech on 20 June 2001, refers to the possibility that, in the event, the US and world economies might recover rapidly. Then an over-zealous stimulation of domestic consumption by the UK authorities could, if not reversed in a timely manner, lead to inflationary pressure further out, requiring a more painful correction later on. Other risks arise from the possibility that the world recession is prolonged. Then, the cumulative effects of the ‘imbalance’ could lead to a large current

⁴ Mervyn King, in a lecture at the London School of Economics, famously suggested that if the MPC was doing its job well, then interest rate decisions would become boring as they would be anticipated by the private sector (King, 1997, p. 440). In fact there are bound to be surprises since assessments and judgements are likely to vary even on the basis of similar information. It remains the case, however, that there is no virtue in surprising markets though it may be necessary if it is judged that markets have ‘got it

account deficit and, possibly, a sharp change in the exchange rate. This issue is further discussed in the context of the domestic imbalances below.

Clearly, it is likely that policy *will* need to adjust as events unfold and as further information becomes available. But this leads to a further important point about the overall context. As is especially obvious in the case of the United States, policy makers in other countries too are trying to mitigate the effects of domestic and international shocks. In the United States, short-term interest rates have been cut aggressively precisely to generate the anticipation that the slowdown will be relatively short-lived, and that the US economy will soon return to full potential with stable inflation. The anticipation of such an outcome makes it more likely that it will be achieved. There has been and there still is considerable uncertainty about how far policy will have to adjust, but little doubt that if the problems appear bigger, then further action will follow. (Thus, bad news about US prospects leads to the market anticipation of lower interest rates.) The more other countries succeed in putting in place offsetting strategies, the smaller the impact on the UK. The decision of the ECB to lower interest rates in August in the face of weakening prospects in the euro area is greatly to be welcomed, not just from the point of view of the euro zone itself, but also from the point of view of the UK.

What this indicates is that the biggest risk from the world economy is that policy makers might, in some sense, fail. I would hesitate to put a probability on this. In the US, the main danger arises from the domestic and external imbalances. These pose a risk not just to the looked-for US recovery—in the bleakest scenario, monetary policy might simply be too weak, at least in the short term, to offset a major reaction by consumers—but, as has been suggested in a recent meeting of the Financial Stability Forum, to financial instability in the world economy. One possibility which cannot be ruled out would be a major fall in the exchange rate of the dollar versus the euro.

No one wants financial instability, and it is profoundly to be hoped that it will be avoided. Clearly, however, one of reasons for the UK's two-speed economy, and the intense

wrong'. A complication is that market commentators are trying not just to assess the situation and the appropriate policy response, but are also trying to predict how the MPC will assess the situation.

pressure on large parts of manufacturing industry, has been the weakness of the euro relative to the dollar. A fall in the dollar relative to the euro with sterling somewhere in between, if achieved in an orderly way, would do much to ease some of the imbalances in the UK. So far, however, despite a large cut in interest rates in the US as compared to the euro zone, the recovery of the euro has been fitful and modest. The looked-for revival of the euro still seems some way off.

This takes us to the situation in the UK.

3. DOMESTIC ISSUES

One, imperfect, indicator of the ‘two-speed’ economy is the divergent rates of growth of manufacturing and services in the recent past. Over the past year manufacturing output (measured by industrial production, which is available monthly) has fallen by 3%, whilst services (which now account for about two-thirds of GDP) grew by 3.4% from mid-2000 to mid-2001. The comparison is even more dramatic for the first half of this year: manufacturing output in July 2001 was more than 4% below its December 2000 peak, while in 2001 Q2 services output was 1.7% higher than 2000 Q4. (See Table 1.) And as is well known, retail sales, an indicator of what is happening to consumption, have been continuing to grow very fast over the summer—the latest figure (for August) is an increase of 6.3% over a year ago.

Table 1: Indices of production in the UK					
	Index 1995 = 100				
	2000 Q3	2000 Q4	2001 Q1	2001 Q2	July 2001
Total GDP	115.5	116	116.5	116.9	—
Manufacturing	104.2	104.8	104.0	101.8	100.7
Services output	120.3	121.1	122.2	123.1	—

Sources: GDP, ONS series YBEZ; services output, ONS series GDQS; manufacturing output, ONS series CKYY (quarterly averages except July figure).

Some of this is due to the US downturn and the ICT shock—and I have argued that an offsetting strategy is desirable. But the imbalance is more long-standing than that, and has a great deal to do with the exchange rate.

The exchange rate

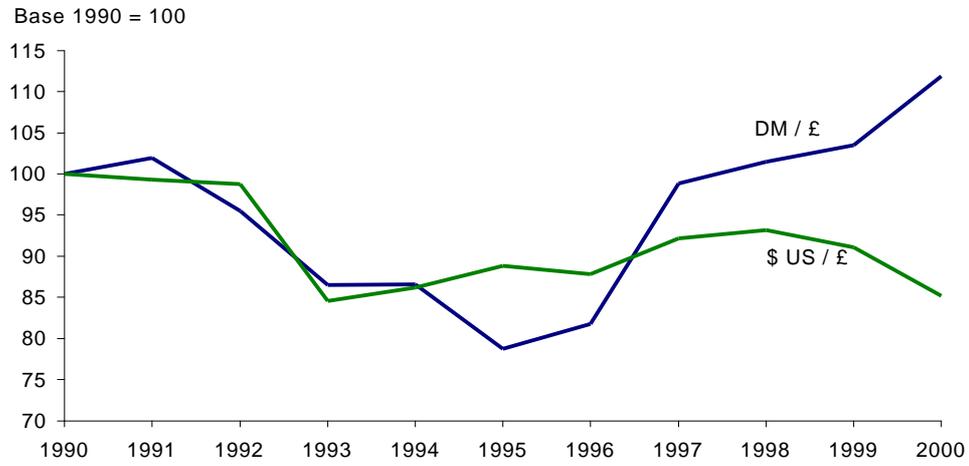
Chart 3 shows what has happened since 1990 to the UK's nominal exchange rate—against the dollar and against the Deutschemark (which of course tracks the euro since the beginning of 1999). Chart 4 shows indicators of cost competitiveness. The picture is one of a major shock to competitiveness starting in about 1996 relative to Germany and Europe and a much smaller shock relative to the dollar. The shock to competitiveness, bearing on euro exposed sectors of the economy, has been very large.

The MPC cannot target both inflation and the exchange rate but, of course, exchange rate developments do have a major bearing on interest rate decisions. The exchange rate has a direct influence on prospects for RPIX inflation via import prices as well as indirect effects on demand, output and unemployment (and hence onto inflation).

During the period when the exchange rate was rising, overall RPIX inflation was held down by the dampening of import price inflation—as can be seen in Chart 5, which compares RPIX inflation to domestically generated inflation (DGI), as measured by growth in nominal unit labour costs. DGI has tended to be higher than the target rate for the RPIX series, and higher than what is consistent with the long-term maintenance of RPIX inflation on target. Importantly, however, more recently the picture has changed, and indicators of domestically generated inflation have been broadly consistent with the inflation target. In the period when the exchange rate was rising, real household incomes were boosted by the exchange rate rise—the effect on real incomes coming through via a lower cost of living than otherwise due to lower import prices.

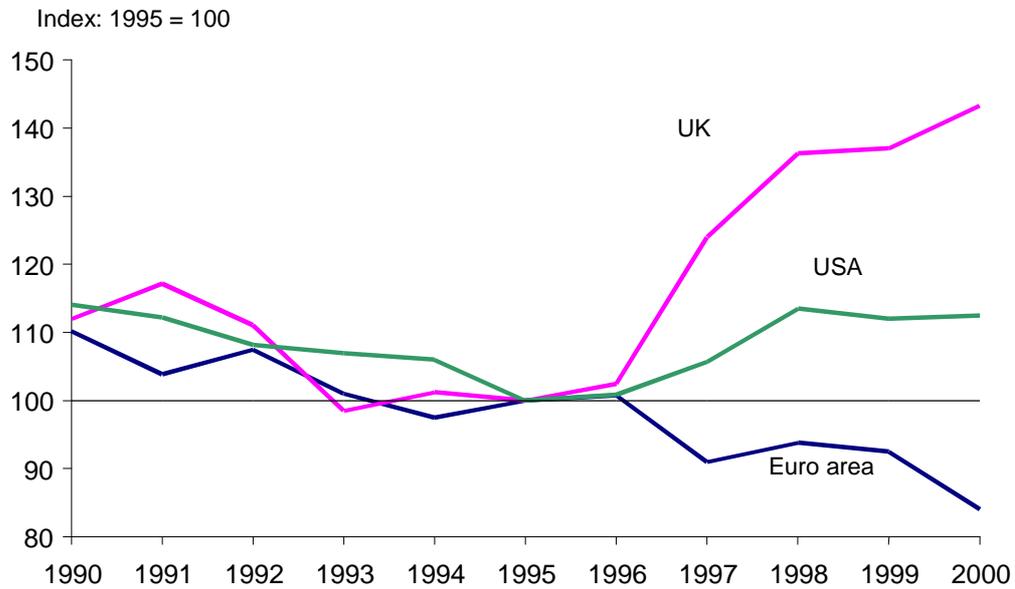
It may be useful to think of the impact of the exchange rate rise in terms of three different channels—though they are all closely interrelated. First, there is a favourable impact on

Chart 3: UK nominal exchange rate



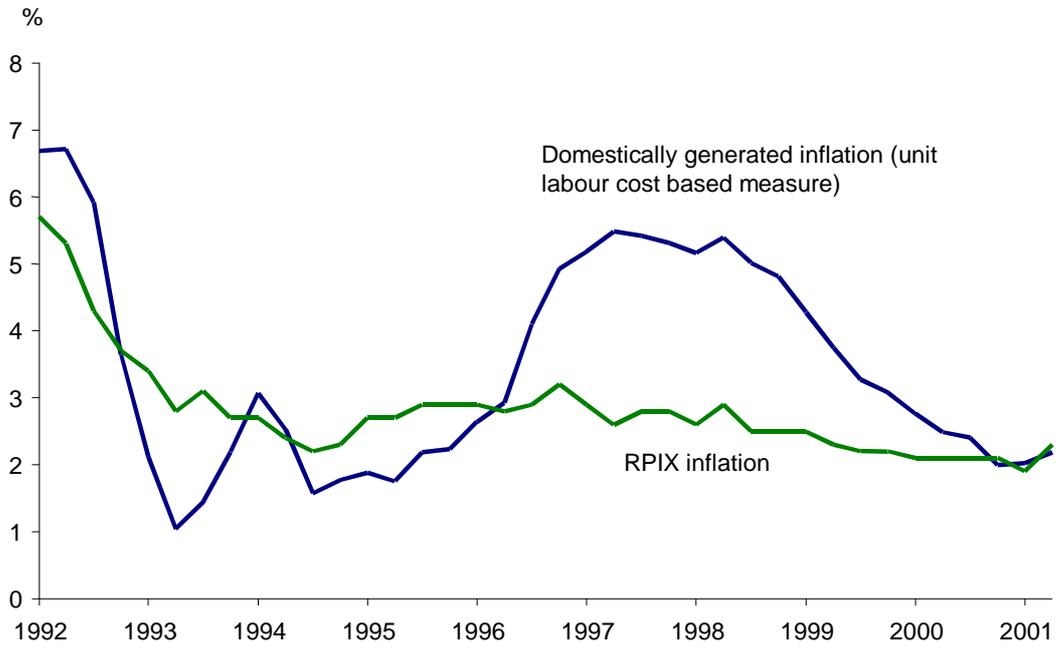
Source: OECD, average of daily rates

Chart 4: Competitive positions (relative unit labour costs)



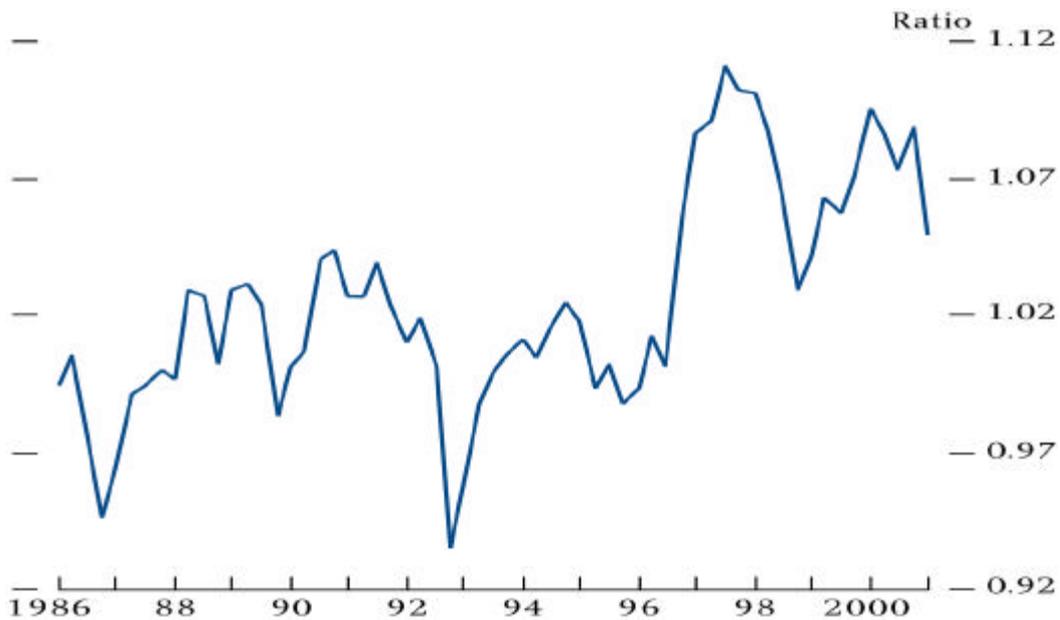
Source: OECD

Chart 5: UK RPIX inflation and domestically generated inflation



Sources: ONS, Bank of England.

Chart 6: UK import prices relative to world export prices



Sources: ONS, Bank of England

prices, because import prices, measured in sterling will be lower. Second, because of this, households' living standards improve. (The weight of import prices in the Retail Price Index and in RPIX is about one quarter). Other things equal, real personal disposable income will be higher, supporting consumption. But, third, consumers and businesses will substitute cheaper imports for home produced goods—putting downward pressure on volumes and margins in the import competing sectors—and exporters will be under similar pressure, affecting volumes and margins, since their costs, relative to overseas competitors, will have increased. In short, the traded goods sectors will come under severe pressure. The volume effects on exports and on production in the import-competing sectors, and hence on net trade, feed through to lower demand and output in the domestic economy. If we think of the (real) exchange rate change as happening suddenly and then being maintained for some time, then one can summarise the impacts as involving a step fall in the price level (which raises real income and demand in the short term) which is then followed by lower demand and output and reduced inflationary pressure as the volume effects come through.

Broadly speaking, this is the picture of the recent past since 1996. One important detail is that import prices have not reacted to the exchange rate change as much as might be expected on the basis of such simple figuring—see Chart 6, which suggests import prices are still about 6% higher than might be expected on the basis of sterling-adjusted world export prices. This suggests that, in some sectors at least, foreign suppliers have raised profitability and margins in the UK. At present exchange rates, this could lead to further downward pressure on import prices as these margins are eroded by competition: it also suggests that a (moderate) fall in the exchange rate from the present level might have relatively limited consequences on inflation in the short term, as some of the impact will be absorbed by foreign suppliers.⁵

⁵ Consistent with this, work in the External MPC Unit of the Bank of England finds 'threshold' patterns in the degree of pass-through of exchange rate movements to import prices in the UK.

An exchange rate fall

I have already referred to the possibility that there could be a move down of the dollar relative to the euro, with the UK effective rate somewhere in the middle and relatively little affected. Most analysts would welcome such a change in the dollar/euro rate as a move towards the ‘economic fundamentals’—though forecasts based on the ‘fundamentals’ have had a poor record in recent years, as most economists know to their cost.⁶ I do not want to say much about this except to say that, taken by itself, a moderate move would be extremely welcome: some of the pressure would be taken off the sectors most exposed to competition from the euro area—with, of course, a downside for those exposed to the dollar area. Within much of the export sector, there would be a move in relative profitability in favour of exports to the euro area and against exports to the dollar area and, since it is the euro exposed sectors that are most under pressure, this would be a move towards ‘balance’.

Here, I am concerned with a fall in the effective rate—say by 10% from the rate assumed in the August *Inflation Report* (which was 106.7). Another way of getting a feel of the magnitude is that the present rate against the DM—which is about 3.2—would fall to about 2.9. It goes without saying that the implications for monetary policy would depend on the context—all the other things that were going on at the same time.

Taken by itself, the implications of such an exchange rate fall would, broadly speaking, be the reverse of the effects discussed above. The impact effect, assuming full pass-through to import prices, would be a rise in import prices of 10%, implying a rise in the price *level* of about 2½%.⁷ There is an analogy here, as far as the private sector is concerned, with the effects of a rise in indirect taxes (such as a rise in VAT of about 2½% of GDP). Measured inflation would rise as the impact came through, but then fall back. With an unchanged nominal wage path, real wages would fall—by 2½% relative

⁶ The Bank routinely calculates how much of a change in the sterling exchange rate and of a change in the dollar euro rate can be explained by changes in fundamentals, such as interest rate differentials. The answer, unfortunately, is ‘not much’.

⁷ Of course, in practice, there would be substantial lags in the responses, complicating the picture.

to what they would have been otherwise. The effect on the labour cost competitiveness of exporters would, however, be the full 10%, allowing a reconstitution of margins of up to 10% of the selling price, or lower selling prices in foreign currency.⁸ This sort of figuring makes it clear that a depreciation of sterling, by, say, 10%, would make a major difference to hard pressed exporters—especially those exposed to euro area competition

From a monetary policy point of view, however, the situation is more complex and the impact effects are far from the end of the story. First, although the impact effect on real demand could well be negative (due to the effect on real incomes⁹), volume effects on net trade would soon come through, which would need to be offset by higher interest rates than otherwise to maintain a given output gap. Second, the assumption that prices rise and real incomes fall without an effect on inflation further out is extreme. There are a number of ways of putting the general point. Measured inflation would rise during the pass through period, and if this affected inflation expectations and wage settlements then an inflationary spiral could result. Alternatively, the implied squeeze on real incomes could be resisted, leading directly to wage and price inflation. In either case the inflationary pressure would need to be checked for a time by higher interest rates (and a larger output gap) than otherwise. The MPC has, however, some ‘constrained discretion’ about how quickly to bring inflation back to target in the face of such shocks. Clearly, the task of the MPC would be the easier the less the extent of real wage resistance and the smaller the effect on inflation expectations.

I expect that you will have noticed that what I have just said dodges what many will see as the most interesting question. Should a price level change arising from an assumed permanent change in the real exchange rate (or, for that matter, an indirect tax change) be accommodated or resisted? (There is general agreement, of course, that a non-accommodative policy should be taken to the second round effects.) If it were possible to

⁸ For a seller all of whose costs are UK costs, the margin on sales could, if the price were unchanged in foreign currency, increase by the full 10 percentage points. Typically, however, exports have an imported component, and the cost advantage applies only to UK value added. Whether the cost advantage would lead to higher margins or lower prices would depend on conditions in the industry and on the competitive situation.

distinguish clearly between the real impact (affecting some, but not other price level measures¹⁰) then it seems clear that under an inflation target regime—as opposed to a price level target regime where the price level includes import prices—the level effect should be allowed to come through.¹¹ In practice, however, it is not easy to distinguish between level effects and inflation effects, and the key issues are likely to centre on the reaction of expectations and of real wage resistance. All this argues for a high degree of transparency and explanation on the part of policy makers if such impacts occur.

The above account of the effects of an exchange rate fall is clearly oversimplified and lots of qualifications could be made. (For example, the exchange rate would depend on the monetary policy response and on market anticipations of the MPC's reaction function.) Nevertheless, an exchange rate move could quite easily present itself as an exogenous (and possibly unexplained) shift at (say) the beginning of an MPC inflation-forecasting round, in which case questions such as the extent of pass-through to import prices, the reaction of wages and the effect on expectations would be at the centre of discussion.

Were an exchange rate fall to occur under conditions something like the present, one question that would certainly be in my mind would be the likely effect on import prices. As we have seen, there are some indicators that suggest they are presently 'out of equilibrium' in the sense of being abnormally high in relation to world export prices. A depreciation of about 5–6% would bring them back in line with historical averages—suggesting that, at least for a relatively small depreciation the pass-through to inflation

⁹ The depressing impact of euro depreciation on real incomes (together with higher food and energy prices) is one of the explanations commonly heard for the slowdown in domestic demand in the euro area.

¹⁰ Clearly, consumer price indices would be affected but the GDP deflator (the price of domestic value added or production) would not be. RPIY, which excludes tax effects, would also be unaffected. There is no mechanical impact on nominal wage inflation either. In the indirect-tax increase case, the GDP deflator at market prices would be affected whilst that at factor cost would not.

¹¹ Meltzer (1977, p. 183) observes that 'a one-time change in tastes, the degree of monopoly, or other real variables changes the price level... [W]e require a theory that distinguishes between once-and-for-all price changes and maintained rates of price change.' Meltzer argues that Friedman's proposition that 'inflation is always and everywhere a monetary phenomenon' does not refer to the movements in measured inflation that are due to once and for all price level changes.

and the implied downward effect on living standards might be attenuated. This is an issue that requires more research.

Finally, before moving on to look at other aspects of the UK imbalances, let me stress that I have been discussing the potential effects of an exchange rate fall, were it to occur. It is certainly not a forecast. (Since I am concerned about the imbalances in the UK, I would, in fact, certainly welcome such a fall if it occurred in an orderly way.) But it has been argued, by those who argue that sterling is fundamentally overvalued that a sharp fall will occur—say, sometime over the next couple of years—though the timing is extremely uncertain. Should monetary policy now react to that future possibility—and the possible upward effects on inflation when it happened? I for one would be content to wait to assess the situation if and when it happened.¹²

3.2 Consumer demand and savings

I turn now to my third major topic—what is happening in the UK to consumer spending and savings, and the question of whether the buoyancy of consumer spending poses threats to the future. The view that it might is easily understandable, given some of the similarities to the situation in the late 1980s, when savings fell dramatically before rising equally dramatically as boom turned to bust.

In fact though there are similarities (Chart 7), there are equally important differences. (See Table 2.) For example, house price rises have been much less dramatic and debt servicing—as stressed in the August *Inflation Report*—is much smaller than in the late 1980s (reflecting, amongst other factors, considerably lower interest rates). But the main difference that I would stress is that, whereas the late 1980s were clearly a situation of excess demand, and the deterioration in net trade was largely a consequence of that, the situation now is one where domestic demand is being kept up to compensate for the deterioration in net trade. From a policy point of view, it is fully recognised that

¹² In the MPC forecasting process, exchange rates are projected forward on the basis of a simple average of two forecasting assumptions. The first is that exchange rates will evolve according to the predictions of uncovered interest parity (UIP), and the second assumes the exchange rate is a random walk—i.e. that the best predictor of the exchange rate is the present exchange rate. The assumption of an asymmetric

consumption growth would have to slow if the external situation were to improve or if other components of demand, such as public expenditure, were to expand faster than envisaged. The focus of policy is on meeting the inflation target. Putting it at its simplest, this implies aiming to keep overall demand rising broadly in line with potential, which in turn implies that there will be imbalances if some parts of the economy are adversely affected by the exchange rate and by shocks to the world economy.

But this certainly does not mean that there are no risks in the present situation. One, which is frequently mentioned, is that a continuation of strong consumer demand, spilling over into a deterioration in the external current account deficit, could trigger a sharp fall in the exchange rate. Were that to happen, monetary policy would need to adjust—and I will say more about this in my closing remarks. But the main risks, I would argue, concern the course of consumer demand itself. Forecasting the likely path of consumption is difficult in present circumstances and it is worth recalling that some of the largest policy errors in the past (notably during the late 1980s) have been due in large part to misforecasting the behaviour of consumers.

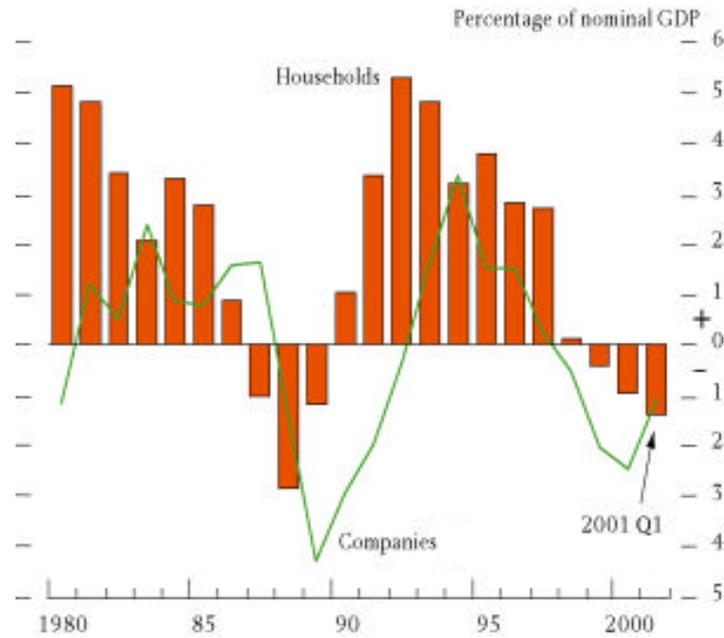
So one possibility is that the strength of consumer demand looking forward is being underestimated. Given what is happening elsewhere in the economy, this would involve stepped-up borrowing and show itself as a continuation or further fall in household savings. If the buoyancy of consumer demand were great enough (and other things did not change enough to compensate), this would be a situation of excess demand, a tightening labour market, and rising inflationary pressure. It would need to be checked by a rise in interest rates. It is important to be clear that the problem would not be the continuing or increasing ‘imbalance’ itself, but the excess spending leading through to inflationary pressure.

Given that savings are already low and borrowing has been high, such a scenario may not appear very likely. But consumer behaviour has surprised in the past, and the example of

downside risk of the type described would result in an upside skew to the inflation forecast arising from the exchange rate—an assumption that has been adopted from time to time.

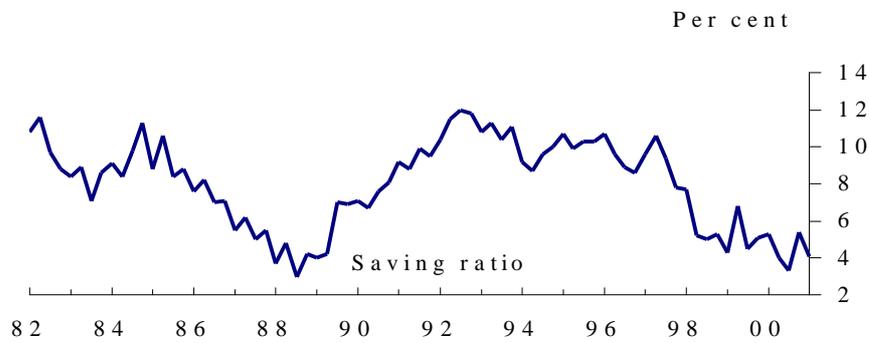
the US does suggest that imbalances can go on, and can go on getting worse, for a long time.

Chart 7: UK net financial balances of households and companies



Source: *Inflation Report*, August 2001

Chart 8: UK household saving ratio



Source: *Inflation Report*, May 2001

	Average per year for:	
	1986–1989	1997–2001
Real GDP growth	3.8	2.7 ¹
Consumption growth	5.3	3.9 ¹
Current account balance, % of GDP	–2.5	–0.5 ²
Change in current account over period	–3.8	–2.3 ³
Savings ratio	5.6	6.0 ⁴
Change in savings ratio over period	–3.5	–4.6 ⁴
Current account balance, % of GDP	–2.5	–0.5 ²
Change in current account over period	–3.8	–2.3 ³
Unemployment rate	9.6	6.3 ³
Change in unemployment rate over period	–4.2	–2.7 ³
RPIX inflation	4.6	2.4 ¹
Nominal wage inflation	8.3	4.6 ¹
House price inflation (Halifax)	15.7	7.1 ¹

1. To 2001 Q2. 2. To 2001 Q1. 3. 1997–2000. 4. Includes 2001 OECD projection.

The downside risk for consumer demand is equally apparent. The savings rate is, as shown in Chart 8, historically low. In the late 1980s, low savings were followed by a major slowdown in consumer demand. The growth rate of private consumption fell from 7.5% in 1988 to minus 1.7% in 1991. I have argued that the situation is *not* like the late 1980s; but it is clear that a ‘correction’ of the imbalances—a reversion of saving behaviour towards a longer term norm—could involve a substantial slowdown in consumption spending, perhaps involving an excessive degree of slowdown and implying an undershoot of the inflation target unless corrected by policy action.

Uncertainty is, of course, always a feature of the policy environment. A complicating factor, however, is that the two risks, of excessive consumption or consumer retrenchment, are not independent. If consumers have some ‘normal’ relationship

between their assets and liabilities on the one hand and their flows of income and expenditure on the other, then a period of balance sheet deterioration (a build-up of debt or run-down of assets) is likely to be followed by retrenchment and the greater the deterioration, the greater the retrenchment subsequently. What this means is that abnormally high consumption in the short-term would increase the risk of abnormally low consumption subsequently.

At present, consumer demand appears to be strong, but is expected to slow. A continuation of high spending carries the risk of a greater fall in demand later. This poses awkward questions of timing for interest rate policy.

4. THE OVERALL PICTURE

My discussion so far has focussed on three rather different issues that bear on UK monetary policy at the moment—namely, the international impacts from the world economy, issues surrounding the exchange rate and the effects of a possible future fall in the sterling exchange rate, and the buoyancy of consumer demand in the face of the adverse developments in those parts of the economy most exposed to international shocks and the high exchange rate. Monetary policy needs to take all of them—as well as many other things—into account. I have purposely tried to separate the issues. Now it is time to put them together. Evidently, there are major uncertainties—but that is not a very helpful remark. I want to argue that there is some structure to the overall picture and it is possible to get a feel for what might go with what. The main reason for this is that policy is not passive in the face of the shocks that might eventuate, and so reaction functions are, to an extent, predictable.

Let me illustrate this in the simplest possible case. In the August *Inflation Report*, the forecast for inflation is presented (as always) as a fan chart indicating the assessed probabilities of different outcomes. For the rate of inflation in the year to 2003 Quarter 3 the range of possibilities displayed is from 1% to 3.6% per annum—which is intended to indicate that there is a 90% probability that inflation at that horizon will be in that range.

The most probable outcome is, however, close to the 2.5% target. All this is conditional on a particular assumption about interest rates—that they will remain at 5%. But what is the best expectation about inflation in Q3 2002? Clearly, if the MPC is doing its job, the best expectation is that it should be close to 2.5%. And, I am happy to say, there is now a lot of evidence that the expectations of the public about future inflation are in fact converging on 2.5%. There is, it is to be hoped, much less uncertainty about future inflation than is displayed in the fan chart, and that is because the likely reactions to shocks that would push inflation up or down would be for the MPC to move interest rates up or down to bring it back in line with the target. And, since meeting the inflation target implies that output should grow broadly in line with productive potential, expectations of growth should also be stabilised.

Let me apply this line of reasoning to some of the uncertainties I have discussed.

I have already mentioned the importance of policy responses to the slowdown in the US and in the world economy. Although I have concentrated in this talk largely on the underlying situation as it existed around the time of the last *Inflation Report*, we are all aware of the appalling events of Tuesday last week and of the huge shock to confidence and expectations that is reverberating round the world economy. This serves to reinforce the point about policy responses and, whilst it is still far too early to make a balanced assessment, it is notable that interest rate declines are already priced into financial markets. The threat to US consumer confidence and to demand that was already present has been much intensified. The fact that policy can be expected to respond—in the US and elsewhere—does not of course mean, in a world of uncertainty and lagged responses, that large shocks can be or will be completely offset.

Turning to the UK, I will close with a few remarks about the exchange rate and about the consumer imbalances and their possible interaction.

Consider first a substantial fall in the exchange rate (say a 10% fall as discussed earlier) which comes out of the blue—say because of a change of sentiment in the international

economy. To make the obvious point, the monetary policy reaction that can be anticipated depends on the circumstances when it occurs. If it occurred in a situation where demand was already high (and expected to remain so) and the labour market was tight, then everything would point to a rise in interest rates—which would be necessary to avoid excess demand and also to check the inflationary effects via import prices. My own view is that the likelihood of a substantial exchange rate fall in such circumstances would perhaps not be very great, in part due to the anticipation of the predictable interest rate response. If it were to occur, there are many, including myself, who would welcome the trade-off between a lower exchange rate—taking some of the pressure off the exposed sectors of the economy—and higher interest rates.

In a situation of low demand and thus a tendency for inflation to undershoot the target, the same trade-off between exchange rate falls and higher interest rates (than otherwise) would exist, but the situation would appear more benign. Inflation expectations would be less likely to be disturbed, and it would be more likely that wage pressure would be avoided. Putting it simply, an exchange rate depreciation would, were it to occur, seem easier to manage with some spare capacity in the economy than at the top of a boom.

The situation in the UK at the moment, however, is not straightforwardly one of either excess demand nor of deficient demand. Since the August *Inflation Report*, consumer spending appears to have been stronger than expected and the labour market has remained tight. There is the possibility that this situation continues or intensifies. The *Inflation Report* makes clear, however, that the main risk from the low saving rate and the consumer ‘imbalances’ identified by the Committee is on the downside. Indeed, there is the distinct possibility that the longer the consumer boom goes on, the greater will be the subsequent correction.

Forecasting is a hazardous business. But let us suppose that the present strength of consumer demand were to give way to a considerably sharper slowdown than suggested in the central projection of the August *Inflation Report*. By itself, this would mean that interest rates would have to be cut to keep prospective inflation on target. If at the same time the exchange rate were to weaken substantially the need for further interest rate cuts

would be mitigated or reversed. From an economic point of view, this combination of events would look particularly favourable, offering simultaneously an improvement in both consumer and external imbalance problems.

I hope I have indicated some of the issues and risks that concern us in formulating monetary policy. There are worrying imbalances in the economy and the risks and uncertainties are very great. My theme, however, has been that these risks need to be considered alongside the likely policy reactions which are embodied in the monetary policy framework and the government's target for inflation. Taking account of likely policy reactions does not remove the risks, but it does change them. Thus a risk of a large fall in consumer demand is turned into a risk of lower interest rates. And the risk of a substantial exchange rate fall is not, over the medium term, to inflation but to higher interest rates. The combination of a tapering off of consumer spending and a fall in the exchange rate would, I have suggested, be rather benign, with offsetting effects on the prospects for inflation.

None of this suggests that economic conditions will be easy over the next few years and we may, as others have suggested, be in for a bumpy ride.

References

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