BANK OF ENGLAND

Speech

Monetary Policy in the UK: Challenges Ahead

Speech given by

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For a decade now, the British economy has grown at an average rate of close to 3% a year, just above its long-run trend rate. The spare capacity created by the recession of the early 1990s has gradually been used up. Unemployment has more than halved from over 10% in early 1993 to around 5% now, on the internationally standardised measure. And growth has been more stable than for decades. But overall this stability has concealed the contrasting fortunes of different sectors in the economy.

Since 1997 household spending on consumption has risen, on average, by 4% a year in volume terms. It is most unlikely that consumer spending can continue to rise at this rate. The trade deficit has widened sharply in recent years, reaching some 3% of GDP at the end of last year. And the increase in the trade deficit would have been even larger had it not been for an improvement in the terms of trade, the ratio of export to import prices, which rose by 8% over the past five years. The result of the widening trade deficit, and the improvement in the terms of trade, is that domestic demand has been able to grow faster than output. Over the past five years, domestic demand has risen by over 6% more than output - slightly more than the excess of demand over output in the late 1980s. In turn, net trade has made a negative contribution to output growth for six years in succession. A continuation of that trend would be unprecedented in Britain's modern economic history.

The strength of consumption and the weakness of net exports have led to an imbalance between manufacturing and services. Manufacturing profitability has fallen by more than half over the past five years, while in less easily traded services profitability has been broadly unchanged. We, on the MPC, understand the problems facing many of you. So, let me explain what we can and cannot do about them.

The need to rebalance the British economy is clear. Domestic demand is likely to be able to grow at no more than the rate of growth of total output; indeed, if the trade position is to improve it will have to grow by less. And within that figure, we need to allow room for the growth of public services.

How will this re-balancing of demand come about? That is not yet clear. There are four key prices that will determine the extent of the re-balancing that occurs. They are the sterling exchange rate, the oil price, real wages, and interest rates. It is these prices that will provide the incentives for the required shift in resources. Let me consider them in turn.

Of course there are many exchange rates for sterling against different currencies, but the relative strength of sterling and the dollar against the euro has been surprising. Over the past five years or so, sterling has risen by almost 40% against the euro. No doubt part of this euro weakness is accounted for by the strength of domestic demand in the US and UK, which, at least in the case of the US, has been driven by higher productivity growth. But the resulting current account deficits cannot be sustained at their present levels indefinitely.

Following the sharp slowdown of the world economy last year, it is those countries with the largest current account deficits, the US and UK, which are experiencing a more robust recovery than that in countries, such as the euro area and Japan, with current accounts close to balance or in surplus. In the short run, this pattern of growth could exacerbate current account imbalances. But it is encouraging that the slowdown has proved more short-lived than was feared. US GDP growth was positive in the final quarter of last year, following only one quarter of falling output, and is expected to be substantially positive in the first quarter of this.

Here at home, growth is expected to be positive in the first quarter, following one quarter of growth close to zero. And manufacturing output has now started to rise in both the US and UK. Surveys of business confidence have turned round markedly. Only last November, the Monetary Policy Committee concluded that it was very unlikely that business confidence would bounce back as it did in 1998. But the quarterly survey of the British Chambers of Commerce, published last Thursday, showed that manufacturing confidence had returned to levels last seen in 2000, and there were further improvements in the services sector. And the CBI survey, published this morning, showed the highest level of business optimism for eight years. So the recent news has been encouraging. It is still too soon though to be confident

that recovery is entrenched. The sharp inventory run down of last year appears to have come to an end, but investment has not yet picked up, either in the UK or the US. And consumption, which has remained strong, may well decelerate. So, as the G7 Ministers and Governors noted in their communiqué on Saturday, downside risks to the world economy remain. These risks, and the current account imbalances I referred to before, mean that we need to be prepared for the possibility of large changes in exchange rates, although no one can predict the magnitude or timing of those changes.

The second price I want to consider is the oil price. Yesterday the spot price of Brent crude closed at $26 a barrel, up 34% from the level at the time of the Bank's February *Inflation Report*. Volatility of oil prices has been a feature of the past few years. At the start of 1999 the price was $10, by the autumn of 2000 it was $37, six months ago $20, and today $26. Uncertainty about oil prices is likely to persist for some time. The recent jump in the oil price reflects uncertainty in the Middle East, rather than expectations of a sharp recovery in the world economy, as can be seen from the fact that the price of oil to be delivered at future dates, in two years time for example, is much closer to $20. Nevertheless, higher oil prices raise inflation in the short run, and depress consumption and activity further ahead.

The third price that matters for domestic demand is the average real wage rate. Real wages from the employers' perspective -your perspective- the cost of employing an additional person, have been growing at an annual rate of under 2% over the last couple of years, which is approximately equal to the underlying rate of productivity growth and so appear sustainable. But real wages from the employees' perspective, the real value of take home pay, have been rising at a much higher rate, around 4½% over the past year or so, partly as a result of the more favourable terms of trade, which seems unsustainable. This difference in growth rates is likely to reverse. The terms of trade will not, in all likelihood, continue to rise. And last week's Budget raised National Insurance contributions.

In the long run, the higher levels of both employer and employee National Insurance contributions will result in lower growth of real take home pay – that is simply the price of better public services. Real incomes need not fall but, for a short time simply grow more slowly than otherwise. Indeed, if productivity growth rose, then real wages growth need not fall at all. Profits may bear some of the brunt in the short run, but over the longer term the adjustment will be to wages because firms will need to earn the going rate of return on new investment. It remains to be seen whether the additional National Insurance contributions will lead to attempts by firms to push up prices to recoup the higher employers' contributions and by employees to push up wages to offset their higher contributions. The commitment of the MPC to keeping inflation on track to meet the target, and its track record since 1997, should help to anchor expectations of inflation to 2.5%, thus encouraging the adjustment to occur without a rise in inflation. It is certainly helpful that the increased contribution rates have been announced well in advance so that expectations of real wage rises can adjust.

In recent months the rate of increase of average earnings per person has been extremely low, partly because of a fall in average hours worked. For the economy as a whole, average earnings rose by only 0.9% in the year to February – the lowest figure recorded since April 1967. And in private services earnings actually fell. But this reflects the impact of significantly lower bonus payments this year than last, and is likely to unwind as the bonus season comes to an end. If output growth were to pick up during the course of this year, then some of the recent fall in average hours worked – which appears to reflect a degree of labour hoarding – would be likely to unwind, leading to an increase in earnings growth. So the MPC will continue to monitor carefully developments in both wages and prices.

The fourth and final price I want to discuss is the level of interest rates. The MPC sets interest rates in order to try to maintain an overall balance between demand and supply in the economy, thus keeping inflation close to the target. What will happen to interest rates depends, in part, on the response of the three other prices – the exchange rate, the oil price and wages – to developments in the economy. As resources shift from private consumption into both the public sector and net exports, there might be

considerable movements in the exchange rate, the oil price, and even wages. The path of interest rates that will be necessary to keep inflation close to the target will depend on what happens to those prices. That is why it is extremely difficult to predict what that path will be. The MPC will take decisions on rates one month at a time. But what should not be in doubt is that the MPC will take whatever steps are necessary in order to keep inflation on track to meet the 2.5% target.

The challenge for monetary and fiscal policy is to restore domestic demand growth to sustainable levels. This would permit the stabilisation and eventual reduction of the trade deficit, while maintaining low and stable inflation, and high and stable employment, at the same time as resources move from private consumption to the provision of better public services. It is possible, perhaps likely, that the transition to lower growth rates of consumption will occur smoothly. And lower inflation now than in the past may ease the adjustment - the future is not what it was. For the Monetary Policy Committee the challenge is to keep inflation close to the target during a period in which a significant re-balancing of the British economy will take place. That will be a challenge, not just for the MPC, but for all of us.