



BANK OF ENGLAND

Speech

Speech given by

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Good evening! I understand that the Queen has also been in Colchester today. That continues a royal connection that dates back to at least 43AD when eleven British kings surrendered here to the Emperor Claudius – after, it should be said, he had first granted them enormous loans. Seventeen years later the Romans foreclosed on those loans, triggering Boadicea’s rebellion in the process. Moreover, the Romans were so confident of their hold on East Anglia that at the time of the rebellion they had only 200 soldiers posted here – no match at all for the thousands of bloodthirsty Iceni who descended on them. Perhaps there is a lesson here for the bankers in the audience. In any case, it is certainly a reminder that policymakers should always plan for the unexpected. And it is to some of the uncertainties in the economic environment that I shall address my remarks tonight.

On the face of it, the economic outlook appears quite benign. In our latest *Inflation Report*, published a fortnight ago, the Monetary Policy Committee’s central projection is for GDP growth to remain near trend over the next two to three years, with decelerating household and public spending offset by stronger external demand and a continuation of the recent recovery in investment. That is a rather better balanced picture than of late. CPI inflation is currently just 1.2%, but under our central projection is set to move up next year towards the Chancellor’s 2% target, reflecting the pressure of demand on capacity and higher prices for oil and other inputs working their way along the supply chain.

But, as the Romans in 60AD failed to recognise, the chances of everything working out exactly as expected are remote, and tonight I want to discuss just three of the many uncertainties that cloud the current outlook. The first relates to the evolution of global current account imbalances and the associated implications for exchange rates. The US current account deficit has increased steadily since the early 1990s and presently exceeds 5% of GDP. For much of the late 1990s, that deficit was associated with high rates of investment prompted by a pickup in US productivity growth and profitability driven by the revolution in information technology. And private investors overseas were willing to acquire extra holdings of US corporate assets as a counterpart. But, more recently, the current account deficit has been associated with lower savings by US households and a large public sector deficit there. And the counterpart has been an accumulation of public sector debt, particularly by Asian central banks seeking to keep their currencies competitive against the dollar.

The present situation could be maintained for a while yet, but overseas investors are unlikely to continue accumulating dollar assets at the current rate indefinitely. Moreover, at some stage action will have to be taken to close the US fiscal deficit and, when that happens, the real value of the dollar will need to fall if a sharp slowdown is to be avoided there. In the mid-1980s, the elimination of the twin US fiscal and current account deficits – then around 3% of GDP – was accompanied by a fall of around 30% in the real trade-weighted value of the dollar. To date, the real trade-weighted value of the dollar has only fallen 15% since its peak in February 2002, so a further – possibly substantial – decline may accompany closure of the current account deficit.

But the timing and nature of this adjustment is very hard to predict. And the implications for UK prospects depend critically on what then happens to demand in our major export markets and, especially, the impact on sterling. Since 1997, when the pound has risen against the dollar, it has often also fallen against the euro, and vice versa. Consequently the trade-weighted value of the pound has been relatively stable, despite very large swings in the exchange rate of the dollar against the euro. If that pattern is maintained, then the deterioration in overall UK competitiveness from further dollar depreciation would be limited. But there can be no guarantee that this pattern of “sterling-in-the-middle” will continue.

My second uncertainty relates to the prospects for domestic demand. During the global slowdown that marked the early years of this millennium, growth in the United Kingdom was sustained by robust household and public spending. But, as external demand and investment have started to recover, so it has been necessary for the MPC to moderate the growth in consumer spending a touch in order to maintain total demand in line with supply and thereby keep inflation on track to meet the target. Despite last week’s announcement of a 0.4% fall in retail sales in October, our central projection is for consumer spending to continue to grow steadily over the next few quarters, albeit at a lower rate than seen in recent years. But with housing market activity and house price inflation slowing, is there a danger of a sharper slowdown in spending growth?

It should be stressed that there are considerable uncertainties about both the path of house prices and their impact on consumer spending. An average house today costs about six times average annual earnings, whereas the historical multiple is somewhat below four. Now there are good reasons why house prices should have risen relative to earnings. The transition to a low inflation, low interest rate environment has shifted the real burden of repayments for a typical mortgage into the future, so making it easier initially for cash-strapped households to service a loan of a given size.

Demographic and social developments mean the number of households has been rising, while until recently the rate of house building has been low. And disillusion with the performance of the stock market and concerns about the value of pension promises may have boosted the demand for property as a vehicle for retirement saving. Nevertheless, it is difficult to rationalise the full extent of the increase in house prices and it is likely that the ratio of house prices to earnings will probably continue to ease for a while, though a return to historical norms seems unlikely.

But while the prospects for the housing market look softer than in the recent past, that need not imply a substantial slowing in consumers' expenditure. Historically, house price inflation and household spending growth have moved together, but that probably simply reflects the impact of changes in households' expectations of their future incomes. Thus, during episodes like the late-1980s, excessive optimism drove up both house prices and consumer spending, while the subsequent correction to that exuberance put them into reverse.

During the past few years, however, this correlation between house price inflation and consumer spending growth has largely disappeared, with spending growth turning out weaker than might have been expected on the basis of past relationships. Instead, consumer spending has grown pretty much in line with income. This weakening of the correlation between spending and house prices probably reflects the fact that the latter have recently been driven not by optimistic income expectations, but by other factors. In that case, it is reasonable to expect the impact on spending of slowing house price inflation to be equally muted.

Such thinking underlies our projection for continued moderate growth in consumer spending over the next few quarters. But it must be recognised that there is

considerable uncertainty here, both about the extent and duration in the slowing of house price inflation and the strength of the connection with consumer demand. So there is a risk that spending could slow more sharply than the MPC expect.

My third uncertainty relates to the prospects for inflation. Now conventional economic wisdom suggests that higher activity will lead to higher inflation and, furthermore, that any attempt to hold activity above its sustainable level indefinitely is likely to result in inflation accelerating. But, over the last decade, consumer price inflation has been both subdued and unusually stable, fluctuating between just 0.8% and 2.6%, while the unemployment rate has fallen from double-digit levels to just 4.6% today. So, as unemployment has fallen, inflation has remained low and stable, suggesting that any positive relationship between activity and inflation has all but disappeared. What has caused this flattening of the relationship between activity and inflation? And can we rely on it continuing?

Part of the explanation almost certainly lies in the various structural reforms to the labour market enacted over the past twenty years, including changes to union legislation and to the tax and benefit system. They have facilitated job creation and encouraged the unemployed and inactive to search for work. That has allowed the unemployment rate to return to levels last seen in the mid-1970s without generating the excessive upward pressure on wages that we saw then. And, more recently, it appears that inward migration, from the EU accession countries and elsewhere, has helped to relieve labour shortages in some sectors of the economy.

But that is only part of the story. There have also been important developments in product markets. First, the international terms of trade – that is the price of the goods and services we export relative to the price of those we import – has moved in our favour. That means that if earnings were merely to rise in line with the price of UK output, the purchasing power of UK workers – who buy imported goods as well as goods produced here – would nevertheless be rising. That in turn has reduced the pressure for higher wages.

Now it is tempting to think that this is just a reflection of the fact that the prices of some goods, particularly clothing and footwear and electronic goods, have been

falling sharply as manufacturing production has shifted from the industrialised countries to East Asia. But it turns out that there is more going on than this. It also appears that the relative prices of some of the services that we export have risen too. In other words, the evolving pattern of global comparative advantage has been particularly favourable to the United Kingdom.

Second, an intensification of competitive pressures, particularly in the distributive and retail sectors, has put downward pressure on prices and margins. Deregulation in the car market has pushed the prices of motor vehicles down. And the buying power of the big supermarket chains has forced their suppliers to keep costs down. Though that has certainly been tough on producers, it is has (usually) been of considerable benefit to consumers.

A third possible explanation for the extraordinary stability of inflation over the last decade lies in the change in the UK's monetary policy regime, beginning with the adoption of an inflation target following the exit from the Exchange Rate Mechanism and reinforced by the Chancellor's decision in 1997 to pass operational responsibility for setting interest rates to the MPC. That has resulted in less persistent movements in inflation, and financial markets and surveys both suggest that inflation expectations are well anchored around the target. In such an environment, a temporary burst of price inflation is less likely to lead to demands for higher nominal wages to compensate. And, in an environment with low and stable inflation, businesses do not need to change their prices as often, reinforcing that stability.

The \$64,000 question, though, is whether these benign trends will continue, accelerate or indeed reverse. Our central projection assumes they will continue, but at a somewhat reduced rate. But that judgement could easily be wrong.

The reports from our regional Agents continue to indicate that businesses in many parts of the country are finding it hard to find workers with the requisite skills. Margins cannot be squeezed indefinitely without driving producers out of business. And it would be unwise to bank on the terms of trade continuing to move in our favour. All this might suggest an upside risk to inflation.

But equally there may be scope for considerable further restructuring in the retail sector. And the United Kingdom might start to see the sort of upturn in productivity growth already witnessed in the United States. That would suggest that inflationary pressures could remain subdued.

I hope what I have said tonight makes clear that considerable uncertainties surround the outlook going forward. And that is why it does not make much sense to ask whether interest rates have peaked. That will depend on whether or not the various risks – including those outlined above – materialise. So if you are expecting to discover the future path of interest rates tonight, I am afraid that I will have to disappoint you. Neither I nor my colleagues on the MPC know how the data will unfold over the coming months and quarters, and it is the data that will determine where interest rates go next. But what I can at least promise you is that the MPC, unlike the Romans, will be ready to do battle.