



BANK OF ENGLAND

Speech

Why Is Inflation So Low?

Speech given by

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Why is inflation so low?

In the 12 months to September, the sterling price of Brent crude oil jumped by 43 per cent. Steel prices were up by 34 per cent, and the price of houses rose 19 per cent. Retail gas and electricity climbed by around 6 per cent, and council taxes were up by an average 6 per cent.¹

This was happening at a time when the economy had been growing somewhat above its long-term trend – 3.6 per cent in the year to the second quarter – and the unemployment rate was hovering around close to a 30-year low. It seemed there was very little, if any, spare capacity left in the economy to absorb the rapid growth rate – suggesting that inflationary pressure would be building up across the economy.

All that sounds like an explosive mixture for the Bank of England, which through its management of monetary policy is responsible for maintaining a low and stable rate of inflation in the UK. And the inflationary risks might seem even greater if you allow for the fact that although nominal interest rates have been rising over the past year, they are still well below levels seen at this stage of the business cycle at any time in recent decades.

And yet the fact is that in the 12 months to September, inflation as measured by the Consumer Price Index clocked in at just 1.1 per cent, and it seems likely to remain fairly close to this level for the rest of 2004.

As you know, the target for CPI inflation – set annually by the Chancellor of the Exchequer – is currently 2 per cent. If the figure comes in more than one percentage point above or below that figure, the Governor of the Bank of England has to write a public letter to the Chancellor, explaining why the target has been missed and what the Bank's Monetary Policy Committee plans to do about it.

So we are now getting very close to the point where the Governor would have to exercise his letter writing skills.

Not only has the level of CPI inflation been surprisingly low this past year, it has also been astonishingly stable, even by the standards of recent years. If you track the path of the 12-month rolling standard deviation of CPI inflation (Chart 1), you find it moves pretty much in a straight line through 2004, despite the fact that the prices of some components of the Index have been leaping around all over the place.

Some newspaper columnists have decided that this is all too much: that the contrast between the big headline price increases and the low and stable rate of increase in the CPI is simply too big to be believable. They point to the fact that in December 2003 the inflation target was switched from RPIX, which includes a measure of house price inflation and council taxes, to the CPI, which does not. Something dodgy must be going on, they conclude.

¹ Data referred to are 12-month inflation rates for month-average sterling Brent crude spot prices, PPI iron and steel prices, the average of the Halifax and Nationwide house price indices, gas and electricity subcomponents of the CPI, and the council tax subcomponent of the RPI respectively.

So the two questions I would like to address today are these.

Is the rate of inflation really as low and stable as the Consumer Price Index suggests?

And what might happen to inflation over the next couple of years? The answer to this latter question, of course, is what will shape the course of interest rates in this country over the coming months.

Since we all spend our money on different things, every one of us could in theory construct our own personal measure of inflation. For example, I've hardly touched my car in the past year – a period when the cost of running the thing has risen by around 7 per cent in terms of fuel and maintenance.² But I have been splashing out a bit on audio-visual equipment where prices have been *falling* by roughly 10 per cent.³

The Office for National Statistics constructs an average measure by weighting together the inflation rates of a basket of more than 650 goods and services on the basis of the estimated spending habits of a representative household. So an individual's personal experience may well be quite different from that average figure.

Some elements of what you might call non-discretionary spending have been rising a good bit faster than the overall index over the recent past. If you lump together household bills, rent, mortgage interest payments, council tax and petrol – which together account for about 20 per cent of the Retail Price Index – you find that particular corner of the consumer price basket has risen by almost 11 per cent (Chart 2).⁴

However, most of us also need to buy food and clothing, where prices have actually been falling in the past year. If you add these two items to the non-discretionary shopping basket, the rate of increase comes down to around 5 per cent.

And it is plain wrong to suggest that the change in the target from RPIX to CPI – neither of which includes mortgage interest payments – has somehow disguised an underlying change in the overall pace of UK inflation. RPIX inflation has also been running at a low and stable rate – 1.9 per cent in the year to September, compared with the old target of 2.5 per cent.

If, as now seems likely, the pace of house price inflation is set to decrease in the coming months, the old and the new indices will draw closer together. Although some components of the consumption basket are rising in price, the impact is being offset by falls in the prices of other goods and services – which are reflected in both indices.

This surprisingly soft pattern of inflation in recent months is not just a UK phenomenon. For example, average inflation in the other countries of the G7 was just

² Weighted averages of CPI subcomponents: fuels & lubricants, and maintenance & repairs.

³ Weighted averages of CPI subcomponents: reception & reproduction of sound & pictures, and photographic, cinematographic & optical equipment.

⁴ 'Household bills' is a weighted average of RPI subcomponents: fuel & light and water & other charges.

over 2 per cent in the year to 2004 Q2.⁵ International as well as domestic factors are combining together to hold down the pace of inflation just about everywhere. Some of these changes are structural in nature – big changes in the way that particular markets work which have been in progress for many years and may well continue for some time to come. For example, the relative price of IT consumption within the UK economy has fallen by well over 90 per cent in the last thirty years, and continues to decline (Chart 3). The impact of rising global trade has pushed down prices in a wide range of goods and services, and there is no obvious reason why this should not continue to be the case.

But all that has been reasonably predictable. Given the surprising weakness in inflation this year, the question is whether any of these structural changes have for some reason accelerated in a way that was not anticipated. Or maybe price inflation is simply being held back by temporary or cyclical factors, which could unwind rapidly as the economy moves forward. In that case, the CPI could start to move ahead sharply over the next year or two.

One striking feature of the UK economy over the past half dozen years has been the particular weakness of goods price inflation. If you break down the Consumer Price Index into its services and goods components, you find that service price inflation has been averaging close to 4 per cent since 1997, whereas the price of goods has actually been showing modest declines through most of the period (Chart 4).

You would expect price inflation to run at a higher rate in the services sector, where productivity growth and price competition is less intense than the goods sector, which on average is more capital intensive and faces more competition from abroad. So with an overall inflation target of 2 per cent, goods prices taken as a whole were bound to be under pressure.

However, goods price inflation has been much weaker in the UK than has been the case either in the US or the euro area. There are at least two possible explanations. One is that the prices of consumer goods imported to this country have been soft. And the second – possibly related to this – is that structural changes within the UK are leading to a fall in costs or a squeeze in margins. Both these explanations help to explain what is happening to the CPI today.

Take clothing as a case in point. The clothing and footwear price components of the CPI fell by around 40 per cent between 1991 and 2003 as the share of imports in UK clothing consumption pushed ahead sharply. Increased competition from abroad – both directly through cheaper imports and indirectly through the impact of this competition on domestic producers – has led to dramatic price reductions. Those domestic producers who have managed to stay in business have had to cut their costs savagely in order to survive.

And at the same time, there have been big changes in the way that clothing is sold in the UK. The wholesaling side has been squeezed, and we all know about the way that the big supermarket chains are forcing their way into the clothing business. And with

⁵ As measured by year-on-year changes in consumption expenditure deflators weighted by UK trade weights. Also, see Rogoff (2003), for a discussion of trends in global inflation in recent years.

further trade liberalisation to come next year, the price of clothing should continue to pull down the cost of the family shopping basket.

Or consider the example of electronic equipment. The price of ICT goods coming into the UK fell by more than half between 1995 and 2002, and these products account for a particularly large share of the UK's total import of goods – more than a fifth on average in recent years.⁶

The fall in the price of imported ICT goods will have helped to lower costs and improve productivity in a wide range of industries. And affordable PCs have made it much easier for consumers to compare the prices of goods and services, and also to buy goods and services directly from the producers – whether it be an air ticket to Barcelona, or flowers for your Granny.

In addition, deregulation is also making a big and lasting contribution to holding down price inflation in the UK. Threatened and actual intervention by the Competition Commission and the European Commission led to substantial falls in the price of new and used cars in the UK during the past five years (Chart 5). Although prices have been broadly stable over the past two years or so, they have still been slightly softer than at this time last year – one of the reasons why overall CPI inflation has weakened in the past few months.

Structural changes have not just been confined to the goods sector. One spectacular example in services has been the package holiday industry, where a combination of deregulation and technology (in the form of internet bookings) led first to weak inflation and then to marked deflation across the whole business. This had a measurable impact on holding down consumer price inflation in recent years.⁷

Globalisation, changing technology, deregulation, structural change in the labour market: all of these have contributed to an era of low and stable inflation – not just in the UK but across the developed world. And of course there is another factor which has played a critical part, and that is the de-politicisation of interest rates. Central bank independence, a clear mandate to place low and stable inflation at the centre of monetary policy, better central bank communications and improved monetary control capabilities: all this has led in the UK, as in many other countries, to a dramatic change in the way that people think about inflation.

It wasn't so long ago that we in the UK took it for granted that high and volatile inflation was pretty much a fact of life, and we planned our affairs accordingly. In a remarkably short space of time, people have come to a very different view. Inflation surveys and the financial markets tell much the same story: that inflationary expectations over the long term are well anchored close to the Bank of England's target (Chart 6).

⁶ See Dury et al, 'What caused the rise in the UK terms of trade?', Bank of England Quarterly Bulletin, Summer 2003.

⁷ Insofar as weakness in 2003 may have also reflected more temporary factors such as SARS or terrorist fears, package holiday inflation potentially could push up on overall CPI inflation going forward.

And those changed expectations are themselves contributing to structural changes in the economy which have the effect of holding down prices. Consider the case of retail distribution. In the bad old inflationary days, retailing was a comfortable business to be in. Customers found it hard to compare prices in different stores. Revenues grew at a rate of inflation plus, and all you had to do was to keep your costs under reasonable control to make a very nice living.

Retailing today is a much more brutal business. Price comparisons are easier and customers are much more value conscious. The only way to get better prices for most products is to improve their quality in some way. Giant retailing groups are using their muscle power to deal directly with suppliers rather than going through a wholesaler, and they are widening their product ranges: I've already mentioned the way that food retailers are shifting into selling other goods and services. The big chains are also likely to be able to make better use of technology to hold prices down than their smaller competitors.

The results of this increasing competition are clear in the very mixed profits news that has been coming out of the retail sector lately. In a period when retail sales as a whole have been quite strong some household names have been having a terrible time – while others have been making big profits.

And of course all this is also helping to hold down product prices. Productivity within the retail sector has risen sharply since the end of 2001 (Chart 7), and profit margins across the distribution sector appear to have been squeezed somewhat. Consumers have picked up the benefits.

Another very important way in which changed expectations about price inflation feed through to the Consumer Price Index is through the labour market. In the old days, the starting point for wage negotiations would again be inflation plus – and since inflation was so volatile, labour negotiators would attempt to build in an extra margin to allow for the risk that inflation might shoot ahead of expectations.

Today, the picture is dramatically different. The so-called NAIRU – the non accelerating inflation rate of unemployment – fell steadily through the 1990s as a result of big changes in the labour and products markets: for example, the trade union reforms of the 1980s obviously had an important part to play.⁸ That is what has helped to make possible the current combination of low unemployment and a relatively low rate of earnings increases. And the NAIRU may still be falling, helped by policies like the New Deal.

These big structural changes in the economy help to explain why the pace of inflation really does remain low and stable in the UK, despite those alarming news headlines. But most of them have been under way for quite a period of time now. They don't help us to understand the weakness in CPI inflation over recent months.

Is this just a temporary or cyclical phenomenon, which will unwind in the coming months and push inflation back up or even beyond the 2 per cent target? Or is something happening that is likely to have a more lasting impact on prices? This is, of

⁸ See, for example, Wadhvani (2000), 'Monetary challenges in a 'New Economy''.

course, the \$64 000 question for the MPC, and I am afraid it's not one to which I have a clear answer.

One way to approach the question is to identify those components of the CPI which have been surprisingly weak, and to look for an explanation there. One is the price of food and alcoholic beverages, which represent about a tenth of the CPI. A fall this year was always on the cards in comparison with the rather fast pace of inflation in the second half of 2003. But the decline is turning out to be bigger than expected, especially in fresh foods. Perhaps there are temporary explanations – I don't know what this year's weather has been doing to the asparagus harvest. But structural changes could also be playing a part. For example, the further consolidation that has taken place in the supermarket business over the past year may well have increased the degree of competition in food retailing.

Car prices, as I've mentioned, have also been quite weak – sales took a dip from mid-summer and big changes in the distribution system are still working their way through the market place. Other areas of price weakness might also be explained by increased competition. Financial services are a case in point.

All this has more than offset the impact of recent rises in the price of petrol. But looking further ahead, it doesn't really help us to think about how the path of inflation might unfold in the next year or two, which is of course what matters for the Monetary Policy Committee. Interest rate increases can take a year or more to have their full impact on the aggregate level of activity in the economy. So we have to try to anticipate inflationary pressures before they take hold – and lean against them by adjusting interest rates in good time. The cost of waiting until the pressure points actually appear may well be that we would have to push interest rates higher than would have been the case if we had cut them off in advance.

Right now, however, there is a considerable degree of uncertainty about the outlook for inflation through 2005 and 2006. You could take the view that the pace of price increases is going to remain very muted. The factors that have led to surprising weakness in recent months could continue for a further period of time, in addition to the long-run structural trends in place. In terms of activity, house price inflation seems to be on the turn, and the pace of spending on the high street may cool off more rapidly than had been expected. Confirming the impression of softness in recent data, the preliminary estimate of GDP for Q3 suggests that growth has slowed, although business surveys still paint a somewhat less gloomy picture. But it now seems unlikely that economic growth in the third and fourth quarters of this year will match the very strong performance of the second – so the pressure of demand may turn out to be less intense than might have been expected.

Moreover, the trend of prices in industry's supply chain still looks quite muted. If you exclude the impact of oil, manufacturing input price inflation has been broadly flat in recent months: the prices of imported manufactures have picked up a bit, but at a modest pace. And unless oil prices spiral ahead even further – which of course remains a risk – they are not going to have a huge impact on overall inflation going forward. Remember that in real terms, the price of oil is still well below the levels of previous peaks. The UK has become very much more efficient in its use of energy, so the economy is less vulnerable to damaging price increases. And so long as people

continue to believe that inflation will remain low and stable, the secondary impact of rising oil prices – on wages, for example, or the price of industrial goods – should be limited.

But you could also take a very different view about the outlook for the next year or two. It's true that the pace of economic growth has moderated a little. But the impact of this on inflation could at least partly be offset by the recent weakness in sterling and a flattening in the market yield curve in the past few weeks, both of which – should they persist – could help to sustain the level of economic activity. Even with some moderation, the economy may still be growing at somewhere close to trend, and as I've already said there seems to be little or any slack left in the system. The pressure of demand in the rest of the world – the US, China, the euro area – could start to push up further on import prices. And rising cost pressures through the supply chain are not exclusively an oil story: output price inflation excluding petroleum products has been running at its fastest pace since mid-1996.

What seems certain is that events in the labour market will play a big part in determining how all this works out. Earlier this year, there seemed to be clear signs that the market was tightening and that private sector wages were starting to move ahead. This is what you would have expected. Unemployment was low, the economy was moving ahead at a good pace, and corporate profitability was stronger than it had been for five years. The business surveys pointed to a strong demand for labour, and the number of unfilled vacancies was rising.

But the tone seems to have changed somewhat in the last few months, even before the economy hit the 'softer patch' we've seen in the Q3 GDP data. The employment rate has slipped a little, and the level of inactivity has risen. The number of average hours worked has declined, and the business surveys have not shown much change. The market still looks tight, but for some reason it doesn't seem to be getting any tighter.

At the same time, the pace of regular pay growth in both the public and private sector appears broadly to have flattened out. Unit labour costs have dipped a little, and the labour share has if anything edged back a little.

It's very hard to come up with a convincing explanation for this apparent change of mood. Is something happening on the supply-side – perhaps a return of older workers to the jobs market, or the arrival of more immigrant workers? Or are we at risk of over-interpreting some odd data from what – after all – is a quiet period of the year for the jobs market?

Is it even conceivable that the longed for acceleration in productivity growth could at last be making a more significant contribution? Private sector productivity in the year to the second quarter rose at its fastest pace for nearly 10 years – but that may simply have been the reflection of a relatively fast pick-up in the growth of output at a time of modest employment gains during a period of cyclical economic recovery.

Whatever the answer, if we can get it right, we'll be a long way towards understanding the broader picture for price inflation over the coming year.

The message I would like to leave you with is this. Inflation is indeed low and stable in the UK, and is set to remain so despite some violent swings in the prices of individual goods and services. The likely path of inflation over the coming year is, however, uncertain. The MPC will keep an open mind, and will make its decisions according to how the data and business surveys unfold.

I think we are in for an interesting few months.

Chart 1
12-month rolling standard deviation of CPI inflation

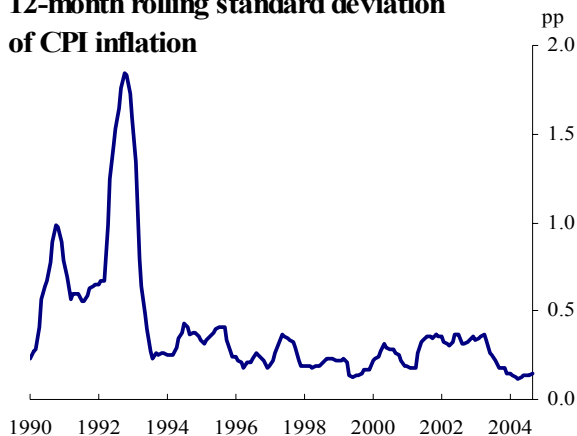


Chart 2

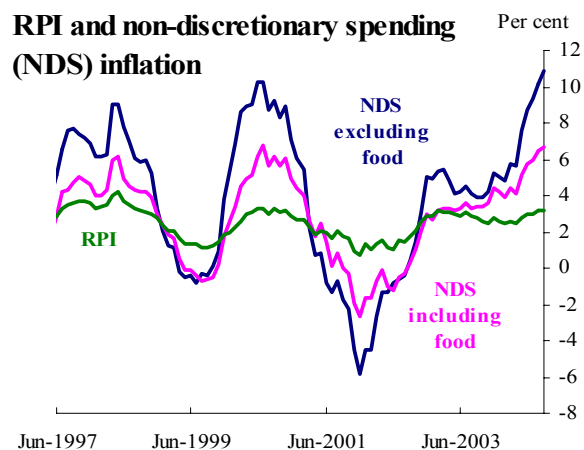


Chart 3
Relative price of IT consumption

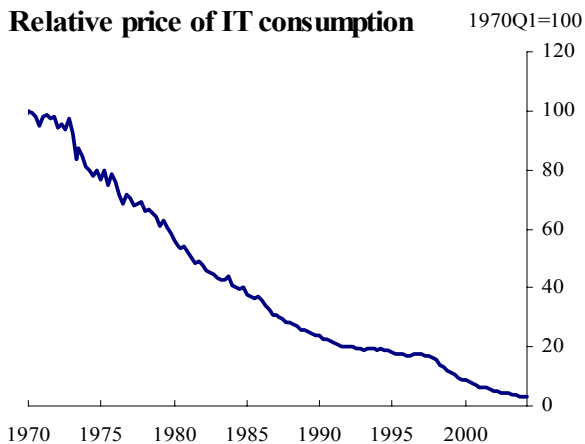


Chart 4

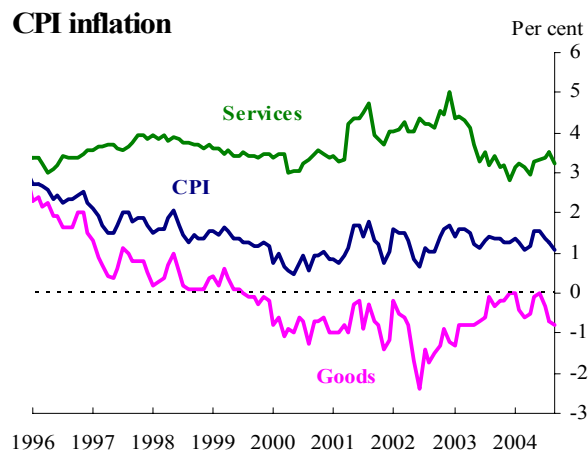
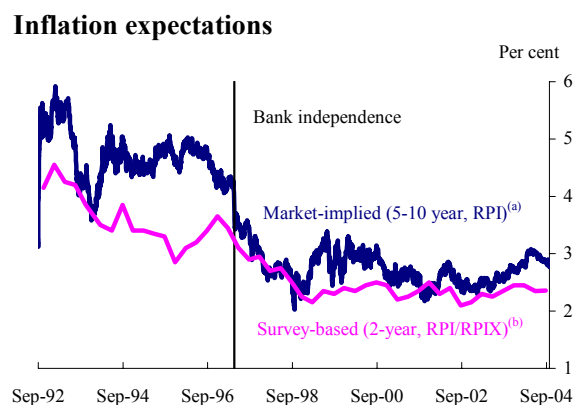
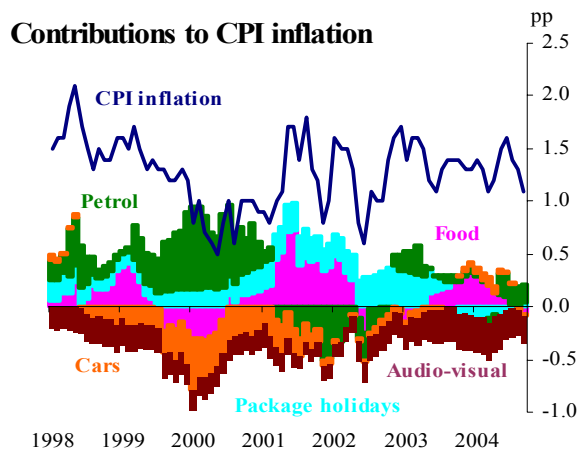


Chart 5

Chart 6

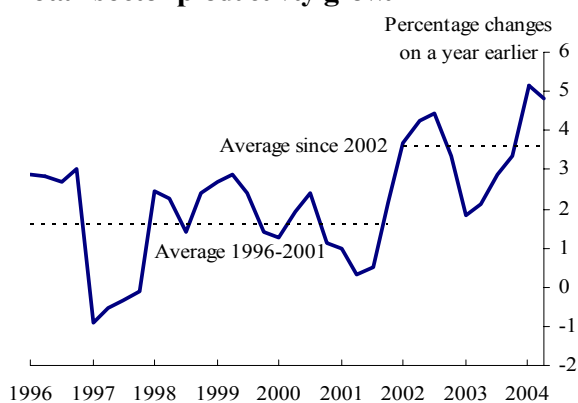


(a) The difference between five-year forward, five-year yields on conventional and index-linked gilts

(b) Consensus Economics survey expectations for 5-7 quarters ahead

Chart 7

Retail sector productivity growth



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