BANK OF ENGLAND

Speech

Speech given by

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At CBI North East Annual Dinner, Gateshead

11 October 2005

Over the past half century the UK economy has been almost as volatile as the sporting fortunes of the North East. In my first speech as Governor, two years ago, I talked about the "***nice***" decade – a period of ***n***on-***i***nflationary ***c***onsistently ***e***xpansionary economic growth. Following the Great Inflation of the 1970s and 1980s, the performance of the UK economy since 1992 might be characterised as the Great Stability. Inflation and output growth have been more stable than in any decade since the Second World War. So it is not surprising that the view has gained ground that the economy can grow at a constant rate every single quarter, and that it is the job of the Bank of England to ensure that it does.

Such a view is not supported by the lessons of economic history. The business cycle has not been abolished, although monetary policy can affect its amplitude. There are two main reasons for rejecting the view that the Bank can and should control the short-run path of output.

First, developments, often outside the UK economy and whose consequences are rarely evident at the time, can produce large shocks to total demand. Since there are lags between changes in interest rates and their impact on spending and ultimately inflation, it is usually not possible for monetary policy to offset those shocks in the short term. And we rarely have accurate information on spending until several months and often years later. Hence there will always be some volatility in the economy when demand changes in an unforeseen way – whether consumer spending, business investment or other components of demand.

The second and less widely appreciated reason is that the growth rate of potential supply is itself changing over time. The economy's potential to produce goods and services depends on the availability of labour and capital equipment and our ability to use them efficiently, none of which evolves steadily. For example, migrant labour from Eastern Europe has doubled the growth of labour supply in the United Kingdom over the past couple of years. And the IT revolution not only changed the technology used in almost every business operation; it also lowered the price of new capital goods, leading to increased rates of capital accumulation. Technology advances over time but not at a steady pace. Innovations are unpredictable and take time to enter business processes.

And, as anyone who has invested in computers will know, it takes even longer to work out how to exploit them most effectively. So potential supply grows at a variable rate, and there is nothing that monetary policy can or should do to change that.

Uncertainty about the rates at which both demand and supply are growing poses two questions – the first long term and the second more immediate.

The long-term question is clear – will the Great Stability continue? Will the next ten years be as *nice* as the past ten? That seems rather unlikely. As I said two years ago in Leicester: "The strategy which the Monetary Policy Committee has pursued in recent years – stimulating domestic demand to compensate for weak external demand in the face of a strong exchange rate – carries the risk that there could be a sharp correction to the level of consumer spending at some point in the future." That risk has, at least in part, crystallised. Some of the influences that have in the past provided a boost to consumer spending may be going in to reverse.

Over the past decade the integration of China, India and other emerging markets in Asia into the world trading system has lowered the prices of clothes, electrical goods and other items that we import from them. The terms on which we trade with the rest of the world improved. That provided a boost to real disposable incomes and so to consumer spending. But the rapid growth of China and India also meant sharp increases in the prices of many commodities, such as copper, aluminium, iron ore and, particularly important, oil. In that sense the rises in oil prices over the past two years are very different from the oil price "shocks" of the 1970s. They reflect rapid growth in the demand for oil – faster than the growth of capacity – rather than an OPEC-inspired contraction of supply. What we have seen is not so much an "oil shock" but a consequence of the rise of China.

The lower prices for many consumer goods and the higher cost of oil are both the result of globalisation. Having benefited from the former we are now experiencing the latter. As a result, our import prices are no longer falling as rapidly as they were, and, indeed, over the past year even the prices of non-oil imports have risen. With the additional impact of higher oil prices, real disposable incomes are rising more slowly, and the longawaited rebalancing of the economy away from consumer spending to business investment and net exports is underway.

Moreover, the higher oil prices may reduce the growth of the supply capacity of the economy. So it is likely that in future the shocks to both demand and potential output will be more challenging for monetary policy than during the Great Stability. Both inflation and output may be somewhat more volatile than the calm waters to which we had become accustomed. And the MPC can do little to change that. Expectations of its ability to stabilise the economy must be realistic.

The immediate question for the MPC is how to respond to the rebalancing of the economy and the rise in oil prices. Over the past year the economy, led by consumer spending, has slowed sharply. At the same time inflation – on our target CPI measure – has moved above the 2% target. It has now reached 2.4%. Only a year ago it was 1.1%. The MPC has been surprised by both the slowdown and the rate at which inflation has picked up.

So why has inflation picked up? One reason, of course, is the direct impact of higher oil prices on the cost of petrol and heating and the indirect effect on the cost of producing goods and services that use oil as an input. No more than one half of the pick-up in inflation can be explained by oil prices. Other factors are at work, such as the pressure of demand on capacity over the past two years. And more and more spending is on services. The proportion of expenditure in the basket used to calculate the CPI accounted for by services – especially health, education and financial services – has risen from 36% in 1997 to over 46% this year. Since inflation of services is higher than that of goods it is not surprising that CPI inflation has risen as the share of spending on services has itself risen. Interestingly, the increase in the share of services is much less evident in the basket for the RPIX measure of inflation – from 38% to 41% over the same period.

Higher oil prices affect not just current inflation but also both demand and potential supply and hence future inflation. They mean a shift in spending power from oil consumers to oil producers. The purchasing power of wages and salaries must grow more slowly than would otherwise have been possible, by around 1-2% in the major industrialised countries, spread over a couple of years.

The adverse effect of the rise in the oil price on consumers' purchasing power cannot be avoided. Inflation will for a short while be above target. But attempts to claw back lost purchasing power by bidding up money wages would simply result in higher unemployment as the MPC acted to keep inflation in line with the target looking further ahead. It is reassuring that so far earnings growth has remained stable.

As consumption slows, some of the impact of higher oil prices on overall demand will be mitigated as the beneficiaries of higher oil prices – the oil-producing countries and the oil companies and their owners – increase their spending. And the pressure on government finances will be eased somewhat by higher oil revenues. But it is likely that this rebalancing of the composition of demand will mean some volatility of total demand.

Moreover, as long as firms struggle to find effective substitutes for oil, a rise in its price will make it more costly to employ capital equipment that uses oil. Some machinery may even be scrapped, reducing the effective stock of capital equipment. The fall in the real purchasing power of wages and salaries may lower labour supply. Together these effects reduce the growth of the supply capacity of the economy, although how important they are is unclear. Monetary policy, though, cannot offset movements in potential supply. But what it can and should do is examine all the evidence on the balance between demand and potential supply, and how this affects the outlook for inflation. That is what the Committee will be doing as it prepares its next *Inflation Report*.

The problem of where to set interest rates is compounded by uncertainty about the recent levels of demand and potential output. The extent of the slowdown is unclear, with mixed messages from official output data, business surveys and data on the labour market. So there is uncertainty about the rate of spending in recent quarters, let alone where it is likely to go in the near future. And there is uncertainty too over potential output, and hence the degree of slack in the economy. Will labour migration continue at recent rapid rates, or will the softening of the labour market lead to a fall in migration? How far will higher oil prices lower potential supply? Those are the questions which the MPC must try to answer, but we do so recognising that it would be unwise to place too much weight on any one estimate of the amount of slack in the economy. All central banks are struggling with the same problems, not just the Bank of England but the

Federal Reserve too. As one of its Governors, Don Kohn, pointed out only two weeks ago, "policymakers should be cautious about responding aggressively to estimated movements in economic slack". But most important of all is the need to keep an open mind on the future path of interest rates.

There has grown up in recent years a false sense of our ability to maintain a smooth and steady growth rate of output. So it is important to understand what monetary policy can do and what it cannot. I noted earlier that, in the past, the sporting fortunes of the North East were as volatile as those of the UK economy. What of the future? About the former, I suggest we wait to hear from Rob Andrew. For the UK economy, monetary policy cannot ensure that output will grow at a constant rate. But in the medium term it can deliver low and stable inflation. In that way, it provides a platform for you – and businesses throughout the country – to make the long-term decisions that are the source of our prosperity.