BANK OF ENGLAND

Speech

Challenging Times for Monetary Policy

Speech given by

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At NAPF Meeting, Belfast

19 October 2005

I am grateful to Alison Stuart for help in preparing this speech. I have also benefited from comments and discussions with many colleagues at the Bank. The views expressed here are personal and should not be interpreted as those of the Bank of England or of other members of the Monetary Policy Committee.

Challenging times for monetary policy

These are challenging times for monetary policymakers in the UK. Over the past year, growth in the economy has slowed down and the pace of inflation has picked up - in both cases more rapidly than most people expected. And oil prices have roughly doubled in dollar terms over the last eighteen months, with very uncertain implications both for the level of activity in the economy and the pace of consumer price inflation.

So what I would like to do today is to spell out how things look to me now as a member of the Monetary Policy Committee. In particular, I would like to discuss the implications of higher oil prices for monetary policy. I should emphasise that what follows is very much a personal view.

It's important to start by reminding you of the MPC's mission, as defined by statute. Our job, according to the 1998 Bank of England Act, is "...to deliver price stability (as defined by the Government's inflation target) and subject to this objective, to support the Government's economic policy, including its objectives for growth and employment."

So we are not in business to rally shoppers back to the High Street. And it's not our job to try to fine-tune the economy. We don't have the tools, or the knowledge, or the mandate to achieve such a task.

No, our job is to set monetary policy in such a way as to deliver low and stable inflation over the short, medium and long term.

It's also important to remember that we are set a symmetric target - that is, we have to worry just as much about undershooting the target - currently 2 per cent a year as measured by the Consumer Price Index - as we do about overshooting the mark.

And monetary policy has always to be forward looking, since it can take many months for the full impact of a change in interest rates to pass through into the economy. We can't do much to alter the course of inflation over the next two or three months. Instead, we have to think about how the pressures of demand across the economy might be building up on potential supply a year or two ahead. As you may imagine, this is a very inexact science.

All this is particularly relevant in the current circumstances, for reasons which I will explain.

Back in August, I was among the small majority of MPC members who voted for a rate cut. For me, this was easily the most difficult decision in more than two years on the Committee.

Inflationary pressures had been building up in the previous months, and not just as a result of the rising oil price. When we went into the meeting, we knew that CPI inflation in the year to June had been bang on the target level at 2 per cent, and that figure seemed likely to rise further in the subsequent months. As it happens, the figure published just yesterday for the month of September shows annual inflation of 2.5 per cent. Although economic growth had obviously slowed, things weren't falling off a cliff: business and consumer confidence had remained steady, the world economy had continued to grow at a reasonable pace and the monetary and credit data were consistent with a pick up in household spending and GDP growth over the rest of the year.

Since our central projection pointed to a marked recovery in economic activity in 2006 and beyond, all this argued for keeping rates on hold.

But against that, the economy appeared to have been growing below its long term trend for twelve months or so, and there was evidence that some spare capacity was building up as a result. The labour market, for example, looked noticeably softer than it had done some months earlier. That would tend to pull down on inflation going forward.

The main reason for the economic slowdown had been the weakness in household spending, which accounts for around three fifths of the total economy. Thanks to data published since August, we now know that household spending in the first six months of the year grew at less than half its long-term average. Back at the August meeting, I worried that we may have underestimated the impact of our earlier rate increases on highly indebted households. Maybe the impact of the slowdown in house price inflation on consumer spending had also been greater than we had expected.

And from everything I could see, conditions on the High Street and elsewhere still seemed very fragile. Consumers were having to come to terms with sharp rises in the price of petrol and in their utility bills. Business investment prospects also looked uncertain, as did the outlook for exports.

So for me there was a risk that our central projections for economic growth in 2006 and beyond might turn out to be too optimistic, and that as a result inflation could start to drift below the target some time next year. Since policymaking has to be forward looking and the target is symmetric, that called for action so far as I was concerned.

Three months further on, short-term prospects for demand don't seem to have changed that much. According to the most recent official figures, GDP growth in the second quarter grew at an annual rate of just 1.5 per cent, the lowest figure in 12 years. But quarter-on-quarter output growth recovered a little from 0.3 per cent in the first three months of the year to 0.5 per cent in the second, and the underlying pace of growth may have been broadly similar in the quarter that has just ended.

There are few signs yet of a recovery in consumption, and retail sales - which account for more than a third of household spending - are still looking flat. But the housing market seems to have been stabilising in recent months, which could put a bit more of a spring into the steps of consumers. And though there is a little more slack in the jobs market than we might have expected earlier in the year, unemployment and inactivity rates have not changed much. This should also help to support household spending.

Although the latest figures for industrial production look rather dismal, that was a result of a particularly sharp fall in oil and gas production. Manufacturing output contracted slightly in August and some business surveys suggest that manufacturing might just about be turning the corner. Surveys of the services sector also look quite buoyant, if you exclude the retailers. And there has been rather more positive news over the summer about both business investment and trade. Indeed, net trade appears to have made a small but positive contribution to economic growth in the first half of this year, only the second time that this has occurred since 1997, and exports of goods have strengthened since the Spring.

In some ways the picture here in Northern Ireland looks rather different. That's not surprising, because the structure of the economy is also rather different from other regions in the UK – a result of history, a land border with the eurozone, a high concentration in agriculture and manufacturing, and a large public sector workforce. Over the past few years growth here has been stronger than in the rest of the UK. Exports have also performed better, no doubt reflecting the fast growth of major trading partners such as the Republic of Ireland and the US and the expansion of the pharmaceuticals sector. Firms' investment intentions also remain fairly upbeat.

Yet in recent quarters, as in the rest of the UK, growth appears to have slowed. Producers are clearly facing cost pressures from higher oil prices just as they are everywhere else. Perhaps more surprising is the slowdown in consumer spending. Given the continuing relative strength of the housing market, with house prices still rising at around 16 per cent per year, one might not have expected to see the same extent of belt tightening in Northern Ireland as in the rest of the UK. But this perhaps illustrates that there isn't a single clear explanation for the slowdown of consumer spending. Along with the pressure affecting the rest of the UK, higher petrol prices may well have hit rural budgets particularly hard at a time when other costs have also been rising.

But for the MPC, of course, the big issues are about the likely pace of inflation in 2006 and beyond, and it is to those that I would now like to turn.

Question number one is: what would be happening to the pace of inflation today absent the rise in oil prices? It's impossible to provide a precise answer, since you can't unpick the impact of energy costs on a whole range of goods and services. All the same, it is clear that a number of things other than just oil have been pushing up on the pace of CPI inflation from what with hindsight looks like the freakishly low point of just over 1 per cent last autumn. Let me mention a few, in no particular order.

First, revisions to the official data suggest that over the winter of 2003-04 the economy was growing well above its long-term trend, and noticeably more strongly than we had thought at the time. That extra pressure of demand on supply may well have acted to push up prices over the past year.

Second, the prices of imported goods have been rising, after a period of several years in which they had actually been falling and acting as a significant drag on price inflation. Excluding oil and erratics, the price of imported goods rose by nearly 2 per cent in the most recent three months compared with a year earlier. This reflects rising inflation pressures overseas after a period of rapid increases in world output as well as the indirect effects of higher oil prices as they work their way down the supply chain.

Third, prices in the services sector have risen significantly over the past year. As measured by the CPI, service price inflation is now rising at an annual rate of 4.5 per cent, up from 3.2 per cent a year ago. This is partly an energy story - the prices of transport services have risen noticeably over the period. But there are other things going on as well. For example, prices of financial services and rents have also moved ahead.

It's hard to be sure, but my very rough guess is that CPI inflation, which was running at an annual rate of 2.5 per cent in September, would not be far below the 2 per cent target even with no contribution from higher oil prices.

Going forward, though - and still leaving the direct impact of oil out of the equation - there's reason to think that the pressure of inflation might start to abate in the coming months. For one thing, the economy is probably still growing a little below its long term potential, which implies that there is an extra margin of spare capacity to pull down on price inflation.

To find evidence of this, look at the labour market. It's true that private sector wage settlements have been ticking up a bit in recent months. But short-run measures of regular pay still look relatively weak, and regular pay drift - which you might expect to respond more quickly in response to unexpected changes in the economy - continues on a downward trend. One way or another, it looks as though earnings growth in the third quarter of this year will turn out to have been measurably lower than the MPC was expecting back in August.

But it's at this point that we have to turn to big question number two about the pace of inflation in 2006 and beyond which is: what are the likely implications of the higher oil price?

There is absolute uncertainty in one critical respect: we have very little idea about the future path of the oil price. This is a big problem, since the economic impact would be very different if prices were to continue to rise, as opposed to moving sideways or falling. Most people think that prices are unlikely to fall much in the near future, given the continuing pressures of demand for oil from around the world and against a background of tight supply constraints – a problem that has been exacerbated by hurricanes Katrina and Rita. But then most people completely failed to identify the conditions that led to the leap in oil prices in the first place, so that's not much help.

At its current level, the price of oil will continue to push up on CPI inflation for several more months to come. The key challenge for monetary policy in these circumstances is to choose a path for interest rates that keeps inflation expectations well anchored around the target level. The lesson from previous oil price shocks in the 1970s is that it is critically important to prevent the initial impact of higher energy prices from being translated into second round effects - an upward spiral in wage settlements and a general expectation of higher inflation that encourages price setters to take pre-emptive action. People need to be *fully* convinced that higher oil prices will not be allowed to translate into higher inflation, otherwise policy is in trouble.

So there are choices. The Committee could choose not to fight against the first round effects of higher oil prices, and allow CPI inflation to rise temporarily a little above target. Instead, it would stand ready to tighten policy immediately there were any signs of second round effects of higher energy costs passing through into the economy. To an extent this is where things now stand, with inflation currently running ahead of the target. The risk here is that if inflation expectations picked up and wage settlements started to rise, then monetary policy would need to tighten that much more sharply in order to bring inflation back to target.

Alternatively, policy could tighten earlier in response to the higher oil prices, with the aim of bringing inflation back to the target more quickly and pre-empting any rise in inflation expectations. But this would push down on growth and employment at a time when the economy already seems to have slowed down to a marked extent, and when the labour market appears to be easing. That could risk unnecessary pain, a further slowdown in growth, and inflation drifting below the target.

The choice depends on whether oil prices continue to rise and how inflation expectations evolve, as well as on your view both of the amount of spare capacity in the economy and the degree of flexibility to adjust to the oil price shock. In particular, the ability of the labour market to adapt to changing cost pressures is critically important.

The reason is this. As the MPC's minutes for September made clear, whatever policy choice is taken, the purchasing power of households' wages after-tax will have to be lower than otherwise would have been the case as a result of higher energy costs.

High oil prices act like a tax, transferring wealth from the consumers of energy to the producers and the government. Faced with a sustained increase in energy costs, businesses may seek to push up prices even if that leads to a fall in demand. They may also work their equipment less intensively, thereby reducing potential supply. Unless the purchasing power of households' wages after-tax is eroded, there are only two ways out. Either monetary policy would need to tighten further to rein back inflation, in which case unemployment would rise. Or if monetary policy did not respond in a timely way, then we could end up with inflation expectations accelerating, wage demands picking up, and eventually interest rates jumping to even higher levels to push inflation back to target. In the worst experiences of past decades, there has been a combination of all these bad outcomes.

Of course, much has changed in the last thirty years. We now use less than half as much oil to produce a unit of output as we did then. And the UK labour market is much more flexible than it used to be.

Nevertheless, you may be sure that the MPC is determined to contain any second round effects.

With this in mind, we are paying even more attention than usual at the moment to the various measures of inflation expectations - both those which can be calculated from prices in the financial markets, and those which come from a range of different polling sources. So far as we can tell, inflation expectations for the short term may have risen a little in the past few months - hardly surprising, given all the news about petrol prices. But expectations for this time next year and beyond appear to remain firmly anchored to the target. That's good news.

We can also take some comfort, as I've already suggested, from the apparent easing of conditions in the labour market. Whole economy average earnings growth has not picked up as smartly as the rise in CPI inflation over the past year, and there are few signs so far that higher oil prices are being translated into higher wage settlements.

Looking at the big picture, I still think it possible that our central projection back in August of a smart acceleration in economic growth from next Spring may turn out to have been too optimistic. In the rather portentous language of central bankers, the risks are on the downside. Consumers still seem to be quite cautious, and business conditions are mixed. If that's right, our projection for the pace of inflation going forward may in turn prove to be too high.

But a great deal depends on how the economy adjusts to the rise in the price of oil, and on the direction of energy costs in the months ahead. All I can promise you is that each month the Monetary Policy Committee will do its very best to exercise its independent judgement in order to meet its mandate.

I started by saying that these are challenging times. And I would like to end on a positive note.

Some slowdown in the pace of consumption growth was inevitable after the rapid expansion of past years. If that can be accompanied by a pick up in investment and net trade, so much the better.

In the meantime, we have a highly flexible labour force, a competitive economy, and a proactive monetary policy. For someone of my generation, the idea that we could have seen a doubling of oil prices in eighteen months accompanied by a still expanding economy and consumer price inflation running at an annual rate of just over 2 per cent is absolutely astonishing. It's up to all of us to ensure that these achievements are sustained.

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