BANK OF ENGLAND

Speech

Speech given by
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While I was growing up in the West Riding, Salts Mill was still thriving, although the year I left Yorkshire was the year in which the Salts Group was taken over. As the textile industry declined, so did the fortunes of Salts Mill and closure became inevitable. Since then the wheel of fortune has turned full circle. The remarkable vision and energy of Jonathan Silver and his family have converted the mill from a daily reminder of the decline of the Bradford textile industry into an extraordinary example of urban regeneration. Tonight I want to talk about the results of another spin of the wheel of fortune. In its time, Titus Salt's mill was the response to globalisation in the nineteenth century. Salt decided to specialise in importing alpaca wool from Peru and turning it into the finest fabrics in the country for sale at home and abroad. Today, almost every company in Britain is affected by globalisation. And the experience of every successful economy since the end of the second world war shows that our ability to embrace globalisation is the key to higher living standards.

Three aspects of this increasing integration of economies are particularly important for the Bank of England when it sets monetary policy: the impact of new sources of production overseas on prices in the high street; the influence of falls in import prices on the growth of consumer spending; and the role of migrant labour in easing wage pressure in a tight labour market. Let me take these in turn.

First, despite rapid growth of domestic demand over a number of years, inflation has remained low. Over the past year consumer prices as a whole have risen by a fraction less than the target for inflation of 2%, and the prices of goods hardly at all. Until recently, import prices have played a part in keeping inflation low. Falling import prices affected inflation directly, by lowering the prices of the imported goods that we consume, and indirectly, by increasing competitive pressure on domestically produced goods, and by lowering the cost of imported inputs such as raw materials and machines. So why have our imports become cheaper?

Some of the countries from which we import have experienced extraordinary rates of productivity growth. That has allowed them to reduce production costs and the prices at which they sell to us. Such a surge in productivity growth is not unprecedented. Between

1800 and 1850 there was a staggering increase in the productivity of textile manufacturing in Britain. All the processes involved in transforming raw wool into finished cloth – combing, spinning and weaving - were, one by one, mechanised. That led to a huge increase in the output of textiles and a large fall in their price, thus stimulating demand further. Between 1800 and 1850 the output of the UK textile industry increased seven-fold, and the price of textiles relative to other goods fell by three quarters. Over time productivity in other countries caught up, as technology and capital were exported from the UK. As other countries became more efficient at producing textiles, the industry in the UK went into decline. At its peak in 1821, the UK textile industry accounted for 14% of national income. In 2004, it represented only 1%. That decline meant a painful process of adjustment for those in the industry – not least in and around Bradford - but new jobs were created in other industries. Salts Mill in Bradford and Dean Clough in Halifax are examples of successful regeneration. Unemployment in Bradford, as in the country as a whole, is close to its lowest level for a generation. And our living standards are undoubtedly higher today than if we had attempted to retain the industrial structure of the nineteenth or early twentieth centuries.

East Asia is now the dominant producer of textiles. China has doubled its share of world textile exports over the past 15 years, and now accounts for one fifth of world textile trade. And that share is likely to increase further following the lifting of trade restrictions on textile imports from China at the beginning of this year which led to an immediate jump in imports into the US and Europe. China is now importing the technology and capital that will raise productivity towards levels of more traditional industrialised nations. The new technology adopted at Salts Mill and elsewhere led to cheaper textiles around the world; now the advent of China and India to the world trading system is reducing prices of imported textiles and other goods. As a result, the prices of imported goods have been falling, contributing to low inflation in Britain.

The second implication of economic integration, and one that follows directly from the first, is that falling import prices helped to boost real disposable incomes and hence consumer spending. Industrialisation in China and elsewhere has benefited British consumers. For much of the past decade, the terms on which we were able to trade with the

rest of the world moved in our favour. In other words, the average price of our exports rose relative to the price of our imports. And that enabled consumer spending to rise faster than national output. From 1997 until around 2002 consumer spending rose at an average rate of almost 4% a year, whereas GDP rose at an average annual rate of less than 3%. But over the past two to three years the improvement in our terms of trade has been less marked. At the same time real income growth slowed. The result, inevitably, was that consumption spending also moderated. And since the turn of the year a more pronounced slowing has become evident.

The third effect of increased economic integration is its impact on the labour market. An economy which is open to migrant labour exhibits a different inflationary process from one that is not. Changes in interest rates affect inflation in part through their effect on the balance between total demand and the supply capacity of the economy – a balance described by some economists as the output gap. An increase in spending raises the pressure of demand on supply and leads to upward pressure on wages and prices. But if the increased demand for labour generates its own supply in the form of migrant labour then the link between demand and prices is broken, or at least altered. Indeed, in an economy that can call on unlimited supplies of migrant labour the concept of the output gap is meaningless.

The UK is not in that extreme position, but the inflow of migrant labour, especially in the past year or so from Eastern Europe, has probably led to a diminution of inflationary pressure in the labour market relative to previous experience. Comprehensive and accurate statistics on all migrant workers are not available, but we do have some information that illustrates the increasing importance of inflows of migrant labour. The Home Office estimates that around 120,000 workers entered the UK from the new member countries of the European Union between May 2004 and March 2005. That is not far short of the average annual increase in the labour force over the past decade. Without this influx to fill the skill gaps in a tight labour market it is likely that earnings would have risen at a faster rate, putting upward pressure on the costs of employers and, ultimately, inflation.

The impact of globalisation in those three areas – on prices in the high street, on real incomes and consumer spending, and on wage costs – is central to monetary policy today. And some of that impact is starting to unwind. What does this mean for the future path of interest rates? The starting point is that inflation is very close to target and the economy is still growing at a rate not far from its long-run average. But final domestic demand growth has weakened for five consecutive quarters. Some easing was desirable in order to bring about a rebalancing of the economy after a prolonged period during which domestic demand had grown much faster than output, and should help to reduce our trade deficit which is now between 3 and 4% of national income. But inevitably it increases the uncertainty about whether the pattern of growth in the future will be as smooth as we have experienced over the past decade.

Those concerns have been fuelled by the sharp slowing of consumer spending in recent months. The weakness in sales of goods on the high street - from clothes to cars - has been marked. Nevertheless, consumption of services appears, at least so far, to be more resilient. So it is possible that we are seeing a temporary slowdown in spending on durable and semi-durable goods – such as household goods, cars and clothes – as households come to terms with the prospect of somewhat lower income growth in future.

The risks around that view are the key to policy. One downside risk to activity and inflation is the immediate outlook for consumer spending. If the weakness in spending on goods were to spread to services then the slowdown in consumption growth might be more protracted. Given the historically low level of national savings in the UK, and the increasing awareness of the need to provide for the future, it is possible that an increase in savings has already begun. While that would be a positive development for the UK in the long term, it would imply slower growth of domestic demand in the short run.

But there are also upside risks to inflation. First, broad money has been rising rapidly in the UK, and in recent months its growth rate has risen further. In the first quarter of this year it rose at an annualised rate of nearly 13%, more than twice as fast as in the US and euro area. And in real terms it is rising more rapidly than at any point since 1997. That represents an upside risk to domestic demand.

Second, the downward pressure on inflation from falls in import prices may have come to an end. Import prices, which had been falling for several years, started to rise in the second half of 2004 as the world economy grew strongly. And in the first quarter of this year imported goods prices were 3.7% higher than a year ago. There is a risk that import prices will continue to put upward pressure on inflation.

Third, the risks to labour costs seem to be on the upside. Private sector regular pay growth has been subdued, which is somewhat puzzling in the context of 30 year-high employment rates, and 30 year-low unemployment rates, which we would usually associate with a tight labour market. It is possible, indeed likely, that inflows of migrant labour have eased labour market pressure. But there is a risk that the effect of migrant labour on wage costs may diminish if the inflows over the past year represented a one-off adjustment to the new opportunities to work in Britain. And to the extent that those inflows helped to reduce upward pressure on wage costs in a tight labour market, then equally the reversal of the flows of migrant labour might reduce the downward impact of a softer labour market on wage costs.

Judging the balance of those risks is a difficult task, but what matters most is that the Monetary Policy Committee will react promptly to whichever of these risks appears to be materialising in the months ahead. As a true Yorkshire batsman would say: be ready to play on either foot , and keep your eye on the data.

If Titus Salt could join us today he would recognise not only his former mill, but also the way in which globalisation affects prices, productivity and industrial structure. He would appreciate too the importance of long run monetary stability that the inflation target aims to achieve and that enables you to focus on your businesses, which are the true source of rising living standards.

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