



BANK OF ENGLAND

Speech

Speech given by

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Cost pressures and the UK inflation outlook

Good evening.

It is always a great pleasure to be back speaking to a CBI audience, and especially in the West Midlands which, as I grew up in Stoke, still feels like home despite my long years of exile in the South-East.

In my remarks this evening, I will want to set out the thinking behind my votes on base rates in recent MPC meetings, and to look at some of the key questions about the UK's economic prospects. This is in part a response to recent City commentary on the fact that, although concerned about downside risks to growth, I did not vote for a rate cut at the MPC's February meeting. The focus will be on one of the topics which is right at the core of the issues that the MPC discusses when reaching our decision month by month – the cost pressures which firms in the UK are facing now, how these are likely to develop over the next couple of years, and how the inflation rate may respond to these pressures. Recent rises, and continuing volatility, in the UK gas price, the sustained high level of oil prices and sharply higher prices for key base metals means that this topic is probably also on the minds of many of you.

Cost pressures in the global economy

The projection underlying the central case in the MPC's February *Inflation Report*, in line with most forecasters, was for world growth to continue over the next two years at the pretty robust rate seen over the past two. There are risks to this central case, of which the most significant are probably: the enduring concern about whether and how the US's current account deficit (estimated at over 6% of GDP in 2005) will unwind, and whether the fall in long-term real interest rates to unusually low levels in major economies might start to reverse, with the risk of provoking falls in asset prices. But on the whole recent data have been encouraging, and despite a slowdown in the fourth quarter of last year the euro area seems set to grow more strongly, improving the UK's export prospects.

Strong world growth is not just upside news for the UK through the effect on output, but may also have implications for inflation – as the continued strength of world

demand could lead to a tightening of the balance of global demand and supply. This is a difficult question to address. Even estimates for world output are fraught with uncertainty. As the weight of more recently industrialised countries in world GDP and industrial production has increased, the question of how to value this output becomes more significant. To some extent this is an issue of the correct exchange rate to use. Generally comparisons are made using purchasing power parity (PPP) exchange rates -- the exchange rate which would equalise the price of a similar basket of goods in each country. For countries such as China with very different price structures and consumption patterns from the developed world, PPP exchange rates estimates can cover a wide range. However, the IMF estimate that the combined share of China and India in world GDP has risen from 6% in 1980 to 19% in 2004.

There is even less certainty about the development of the global capacity to supply, although rapid increases in capacity in Asia might suggest that supply is likely to be keeping pace with demand. But other indicators suggest that there could be some upward inflation pressures. The increased scale of world activity has been putting upward pressure on energy and raw material prices. At the end of 2005, the level of world industrial production was about one quarter higher than five years previously. Annual oil consumption growth seems likely to run at rather over 1 million barrels per day over the next few years, having averaged around 1 million barrels a day in 1999 to 2003. In 2006, this is expected to be met by rising non-OPEC supply, given the recovery in the US from the hurricanes in particular, and according to the futures market, crude oil prices are expected to remain broadly around current levels. Beyond this year, however, some of the rise in demand will probably need to be met in part by rising OPEC supply, implying that there will be only a small recovery in the margin of OPEC spare capacity.¹ Expectations are therefore for a period in which oil prices are likely to be volatile and vulnerable to political uncertainties in producing countries, to supply disruption or demand changes caused by weather, or to the changed judgements about how quickly new supply can be brought on stream.

Metals are much less significant to overall price pressures than is energy. Nevertheless some sectors will have been affected by the fact that the index of base

¹ These comments draw in part on data in Davies (2005)

metal prices has more than doubled since the end of 2003. For the main constituents of this index, aluminium, and particularly copper which was affected by production issues, stocks declined in 2004 and much of 2005. Some estimates suggest there is little spare production capacity at present in copper, nickel or zinc.²

Steel prices declined in 2005 due to high stock levels and higher steel output in China. Stock levels are lower at the start of 2006, and demand is projected to grow by around 5% again this year, with China expected to account for 60-70% of the increase.³

Overall, while the outlook for energy and metals prices may contain some upside risk, a repetition of recent steep rises seems unlikely and inflation pressure from this source should therefore ease. The chief uncertainty in the short term is how far these price rises have been passed on into the final prices of goods (and to a lesser extent services). Further price pressures may also emerge given the signs of tightening capacity in the older industrialised countries – in the US, industrial capacity utilisation has picked up, and is now running just above its average since 1990 (Chart 1). Unemployment has been declining, and at 4.8% in February is well below the peak of over 6% in 2003. In the euro area, capacity utilisation is also judged to be close to the long-term average, with utilisation having picked up markedly in Germany (Chart 2). Unemployment in the euro area has also declined, to 8.3% from 8.8% at the end of 2004.

The pace of price increase for exports from the UK's main trading partners picked up in 2004/05 to average around 2.2% annually. This trend is expected to ease back over the forecast period – but the above discussion suggests there is potential for upside risk to this scenario. The UK's inflation forecast is quite sensitive to this projection. For example, if export price inflation in the UK's main trading partners declines more gradually over the forecast period towards its long-term trend inflation rate, this might add around a quarter of a percentage point to the inflation rate in early 2008 (although these mechanical estimates should not be taken too literally).

² For example, Goldman Sachs, Metal Watch, March 6, 2006

³ Estimates from the International Iron and Steel Institute

Response of UK inflation to cost pressures

The MPC is concerned with the question of how price-setters and wage-bargainers are likely to respond to these upward cost pressures. The behaviour of firms is likely to have altered since the move to inflation targeting in 1992, followed by the Bank's independence in 1997 and the subsequent relative stability of economic growth and success in achieving the inflation target. Inflation expectations in the economy, particularly since 1997, have so far been more firmly anchored around the inflation target. Prior to inflation targeting, UK inflation expectations were not well-anchored.⁴

However, while inflation expectations can be observed in the financial markets through the behaviour of index-linked bonds, and for employees (perhaps rather less well) through surveys such as GfK and the Bank/NOP survey, for price-setters this is not the case. Nor is there any recent survey of firms' price setting behaviour in the UK, which might shed light on whether this had changed - the most recent having been carried out in 1995⁵. Firms' expectations are mainly observed through their behaviour, which has been affected over the past decade by other factors in addition to the changes in the monetary regime, especially changes in the UK competition regime, and for many businesses the impact of stronger global competition.

If firms were generally less able or willing to pass on cost increases in recent years due to these factors, this might be expected to have resulted in a reduction in margins during periods of rising input prices. However, present ONS data suggests that while both services and manufacturing saw deterioration in their net rates of return from the late 1990s until around 2003, since then there has been a period of broad stability (Chart 3), at least up to the third quarter of 2005.

The response of wages is also important. On the CPI measure, inflation peaked at 2.4% in the third quarter of 2005, from a low of 1.3% a year earlier. RPIX inflation also rose at the same time, although much less sharply. According to the Bank's data base, settlements rose very little over the same period, and ONS data suggests that average earnings growth declined modestly (although the newer average weekly earnings series was higher in the third quarter of 2005 than a year earlier,

⁴ Nelson (2004)

⁵ Hall, Walsh and Yates (2000)

subsequently falling back a little). Overall, pressure on consumer discretionary spending from rising energy costs does not seem, so far, to have translated into higher pay.

UK growth projections

Against the background of robust global growth, how strong is the UK economy likely to be? Present evidence suggests that the UK economy is a little below capacity. Surveys of capacity utilisation (from the CBI and the BCC) have fallen back since 2004, but generally remain around their long-term average. However, the rise in unemployment in the fourth quarter of 2005 from 4.8% to 5.1%, falling employment in the same quarter and indications of easing skill shortages all suggest that there is some modest slack in the labour market. With inflation a little below target despite the continued contribution of higher energy prices, growth probably needs to move somewhat above trend in the near term to prevent inflation being below target in about 18-24 months time. And that is what the latest *Inflation Report* projections indicated.

The projection for growth was initially greeted with some scepticism from City economists - with several comments echoing the view that the MPC 'expects a strong return of the consumer, but other than Christmas there is no indication of that.'⁶ I have some sympathy with this view, although of course there is always a wide range of uncertainty about any forecast. But my own central projection would indeed be a little lower, chiefly reflecting more caution about the UK consumer.

The growth rate of consumer spending through 2005 was 1.7%, down from 3.9% in 2004, mainly reflecting slower growth of real post-tax labour income. In 2006, labour income may well pick up only modestly, reflecting slightly stronger upward pay pressure but a subdued employment outlook. Real incomes will be muted at least in the first half of the year as inflation continues to be boosted by energy prices – including the recently announced increases in the price of domestic gas, and the upward effect from higher industrial gas prices.

⁶ George Buckley, Deutsche Bank – quoted on Dow Jones newswire, February 22 2006

Expectations of a sustained rise in consumption growth rest in part on the recent strength of asset prices. The housing market has certainly been surprisingly strong over recent months, and at present most indicators suggest that this will continue. But while stronger than 2004/05, price rises are likely to be rather below the heady days of 2001/03, when annual increases averaged over 15% (although predictions here are highly uncertain). Both house prices and equities may have been driven up recently in part by the recent further decline in real long-term interest rates. Real ten-year forward rates fell from 1.65% at the end of 2004 to 1.04% around the middle of this month. While this is also very unpredictable, it nevertheless seems unlikely that these interest rates will decline significantly further.

Generally the factors driving consumption now seem rather less strong than in 2001/04, when real labour income rose by an average of 3.1% annually, and house prices, at least until mid-2004, were rising rapidly. In addition, some indications of increased concerns over high unsecured debt levels, and continued publicity around possible pension shortfalls may lead to an increase in the savings rate. Recent evidence suggests that the strength of consumption in the fourth quarter of 2005 may have faded a little. Retail sales fell sharply in January, with only a modest bounceback in February. Private new car registrations remain weak, although this may be a little misleading as consumers seek better value by purchasing 'nearly-new' cars which have been briefly in other uses such as the hire car market. And a range of survey indicators suggest that consumer services are also lacklustre. However, this downbeat picture has to be set against quite strong data in early 2006 for manufacturing output and business services output surveys.

While government spending is expected to continue to rise over the forecast period, slower consumption growth would imply that exports and investment growth need to improve if overall growth is to move decisively above trend. Export prospects are certainly brighter given the strength of global demand and the improved prospects for the euro area, although recent history suggests it is uncertain how successful UK exporters will prove to be in retaining their market share. But investment intentions are rather weak, and the present vintage of ONS estimates indicates that investment has risen less quickly over the past few years than would have been expected.

It is occasionally suggested that the desirability of continuing with the balance of growth more towards investment and exports (as it has been since late 2004), is a factor which could affect monetary policy decisions. However, as with other proposals for changing our focus, it is important to be realistic about what the MPC can achieve. It is widely recognised that monetary policy cannot affect the supply capacity of the economy (except to the extent that a more stable economy may boost supply growth at the margin). Other proposed policy goals, such as the expenditure structure of growth, or the level of some asset price, are however not in theory clearly unachievable. But the danger is that seeking to attain these goals could risk diverting policy so far from the proper task of achieving the inflation target, that the inflation target itself would become less credible.

Summary and conclusions

The key conclusions about the outlook which I would draw from the above remarks are as follows (recognising the many uncertainties around all these projections):

- The last two years have seen a number of significant inflation pressures from energy and commodity prices. It seems unlikely that these will continue to rise at so strong a pace, although the strength of the world economy suggests there may be some upside risks. Further, there is some evidence of a tighter balance between supply and demand in some of our major trading partners, which, together with uncertainty about how much of the energy and raw material price rises has fed through, means it is possible that the UK will continue to experience a stronger pace of import price inflation than the average since 1997. However, if inflation pressures do increase abroad then policy responses would be expected which could slow global demand during 2007.
- With indications of a soft start to the year for the consumer, I continue to think that the most likely outcome is for a slightly slower pace of UK growth in 2006 than the MPC's February central projection. Of course, the MPC as a whole believed that there was downside risk to this central projection. In fact,

over the twenty forecast rounds since I joined the MPC, we have identified a downside risk to the central projection for growth on fourteen occasions (and never identified an upside risk). However, analysis of the MPC's forecasting record from February 1998 to May 2003, a slightly different period, concluded that the mean projection, which includes any downward or upward risk, underpredicted GDP growth at the two-year horizon by an average of 0.3%.⁷ So perhaps this suggests a tendency to be a little too cautious.

This all adds up to a finely-balanced judgment for interest rates. Taking a forward-looking approach, if global inflation subsides in 2007 and UK output remains a little below trend, I believe there could be a greater risk of CPI inflation being below target in around two years' time than in the MPC's forecast. In the short run, the timing of the recently-announced rises in utility bills will probably keep CPI inflation a little above target over coming months, and there may be more upward pressure from imported goods prices. But these upward pressures are then likely to drop out of the index in around 18 months time.

But the short-run upward price pressures create an upside risk. I would consider that the base rate at present is probably around a broadly neutral level or slightly accommodative. Reducing the rate to a more stimulative level may risk sparking some second-round effects on wages. It is encouraging that these have so far not been much in evidence, and that inflation, excluding energy, has been subdued. Yet it is too early to conclude that this lack of pay pressure will endure, given that the immediate prospect is for a period of sustained slower real consumer income growth and above target inflation. Further, while inflation expectations have been stable in financial markets, and in most consumer surveys, yesterday's Bank of England/NOP poll for individuals' inflation expectations showed a rise which adds a little weight to the case for caution. In coming months, I will be looking particularly at global pricing pressures, at UK wages and at consumer demand, to see to what extent my concerns are being realised. These worries, which imply less growth and more inflation, are of course a little less Panglossian than is the present central projection.

⁷ Elder et al (2005)

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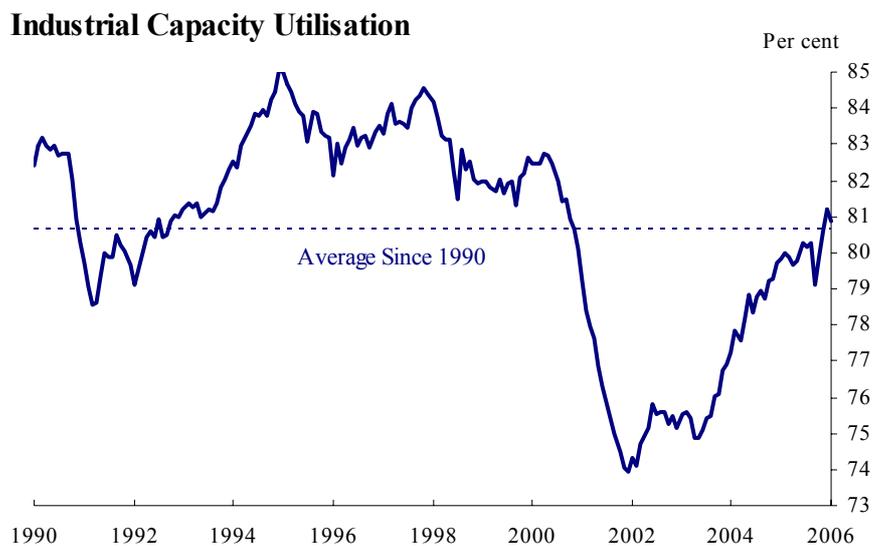
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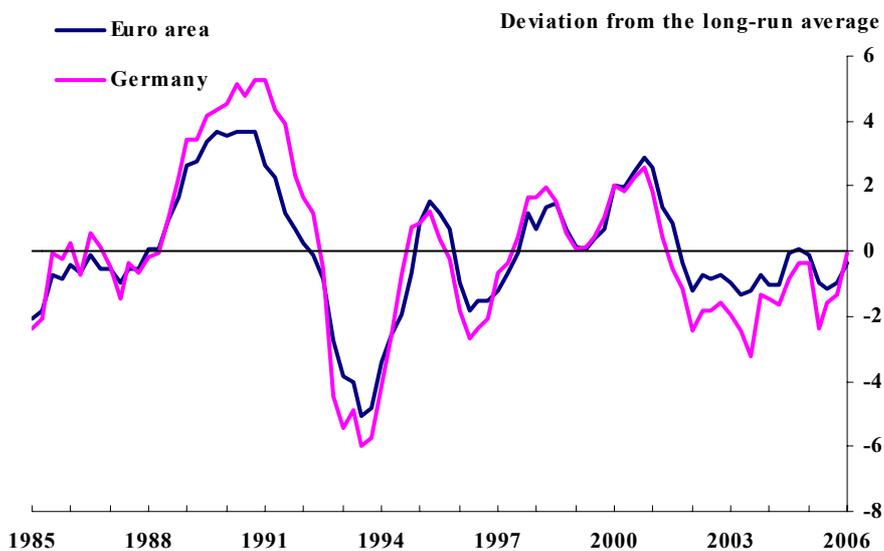
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Chart 1: Industrial capacity utilisation in the United States



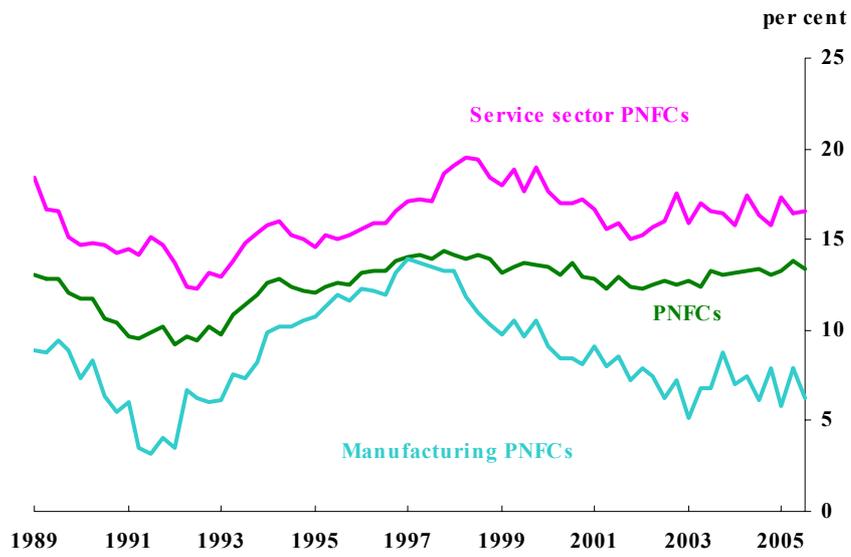
Source: Federal Reserve.

Chart 2: Industrial capacity utilisation in the euro area and Germany



Source: European Commission.

Chart 3: Net rates of return of UK private non-financial companies



Source: ONS.