BANK OF ENGLAND

Speech

Speech given by
Mervyn King, Governor of the Bank of England

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WINCHESTER SPEECH

My Lord-Lieutenant, Ladies and Gentlemen

Thirty years ago, inflation reached 27% – the highest that any G-7 country has experienced in the past fifty years. A few months later, Southampton won the FA Cup for the first, and only, time. You will be pleased to know that I see no causal relationship. Later in 1976, Jim Callaghan, as Prime Minister, delivered a famous speech to the Labour Party Conference in which he said "We used to think that you could spend your way out of recession … I tell you in all candour that option no longer exists, and in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step". One of the economists who developed that insight – an American, Professor Edmund Phelps – was yesterday awarded the Nobel Prize. Low and stable inflation – 2.5% at present – is now the cornerstone of our economic policy.

In that 1976 Cup Final every one of the players came from the British Isles. Today, it is hard to find British players among the top Premiership teams – globalisation is everywhere. We are all eyewitnesses to the tremendous economic impact of the integration of hundreds of millions of people in China, India, and the former Soviet Union into the world trading system.

Globalisation has magnified world supplies of manufactured goods and capital as well as the labour force. Prices of all three have changed, and we have not been immune to those changes. Between 1995 and 2005 the prices of consumer goods imported into Britain fell by around one-third relative to the average price of other goods and services. But the greater supply of manufactured goods from newly-industrialised countries has come at the cost of a greater demand by those same countries for energy and raw materials of all kinds. The prices of oil, steel, copper, lead and nickel have all more than doubled.

And in a buoyant British labour market it is not just foreign-born footballers who have been in demand. Over the past two years, around half a million migrant workers (or possibly considerably more, we simply do not know) have arrived from the new member countries of the European Union and elsewhere in the world. It is unlikely that migration on that scale has had no effect on wages, or, indeed, on rents and house prices.

Some of you may be tempted to think that because the growth of the Chinese economy has affected key prices in our own economy, inflation in Britain is now largely determined overseas. Low inflation in industrialised countries, it is argued, is made in China. As with the Arthurian legends, epitomised by King Arthur's Round Table above us, that too is a myth. Despite large changes in relative prices, the average change in prices – inflation – has been remarkably stable. Indeed, it is striking that in a decade in which prices moved so much, overall inflation was more stable than in any decade for a hundred years. It was a decade that in my first speech as Governor, I described as NICE – a ***n***on-***i***nflationary ***c***onsistent ***e***xpansion.[1]

How can inflation be stable when individual prices move around so much? The explanation is that inflation is the result, in the old adage, of too much money chasing too few goods. Inflation arises when the total amount of money spending (or nominal demand) in the economy is greater than the value today of the available goods and services. When the Bank of England changes Bank Rate to keep consumer price inflation close to the target of 2%, we influence – albeit imprecisely and with a time lag – the amount of money spent in the economy and so the inflation rate.

In short, inflation is made at home.

Nevertheless, we cannot and do not control the price of every item in your shopping basket. That distinction between changes in individual prices and changes in the average level of prices is fundamental to an understanding of recent movements in inflation and the response to them of the Monetary Policy Committee.

[1] Speech at an East Midlands Development Agency/Bank of England Dinner in Leicester, October 2003.

Let's take a closer look at the NICE decade. Two factors were particularly important in delivering stability. First, companies and employees responded flexibly to sharp movements – both up and down – in input costs. That new-found flexibility, unlike in the 1970s, meant that firms absorbed cost pressures partly in profit margins, partly through efficiency improvements, and partly by resisting increases in the prices of other inputs. With a clear commitment by the Bank to meet the inflation target, raising prices (so losing market share) was a less attractive strategy for meeting the challenge of higher input costs than searching for ways of reducing other costs. And employees recognised that the consequences of higher world prices, such as for energy, on living standards could not be avoided by higher money wages. So wages rose more slowly when employers faced higher National Insurance contributions and energy prices than when the costs of imported inputs were falling.

Second, monetary policy supported a broadly steady path for total money spending – during the decade 1995-2004, the growth rate of nominal domestic demand fell within a narrow range of between 5¼% and 6¼% in all but one year – so that the new flexibility meant that price rises in some parts of the economy were balanced by price falls elsewhere, leaving inflation overall close to the target. When the prices of some goods fell, such as imports in the late 1990s, people had more disposable income to spend on other goods and services. That pushed up demand in those sectors and encouraged companies to raise prices. Conversely, when some prices rose, as with energy prices over the past two years, the resulting squeeze on income available to spend on other goods and services helped to bear down on inflation in those sectors. With steady growth of money spending, a change in relative prices can be consistent with stable inflation overall.

Monetary policy – a credible commitment to the inflation target and a broadly stable growth of total money spending – was then, and is always, the key to low and stable inflation. That point was made forcefully in a speech in February by the late David Walton, whose untimely death in June was a great loss to the Monetary Policy Committee.

Over the past couple of years our economic performance has not been quite as "nice" as in the NICE decade, but it was "not so bad".[2] In 2005, output growth slowed to 1.9% and inflation rose to 2.5%. Back in 1976, to describe this as "not so bad" would have been the understatement of the year. It followed a period of rather strong nominal domestic demand growth which, by placing pressure on the supply capacity of the economy, accounted for some of the subsequent pickup in inflation. At the same time, sharp rises in the prices of oil and other commodities reduced the income households had available to spend on more discretionary items and put downward pressure on those prices. Not surprisingly, that loss of spending power was one of the contributory factors to the standstill in consumer spending in the second quarter of last year. But since then consumer spending and output growth in the economy have picked up, and in the first half of this year were growing at around their long-run average rates.

After a prolonged period during which consumer price inflation was below its 2% target, inflation has been above target for much of the past year. So what are the challenges facing the Monetary Policy Committee as it tries to bring inflation back to the 2% target?

Since their peak in early August, oil prices have fallen by around a quarter. In due course, that will ease the pressure on petrol prices and fuel bills, including gas and electricity. The direct impact was seen in the producer price data published yesterday, and will be seen in CPI inflation over the coming months – making it less likely that I will have to write an explanatory letter to the Chancellor than was the case two months ago – although the anticipated fall in inflation for September may not persist for long.

Over the past year, profit margins, especially in manufacturing, have been squeezed and outside the oil sector the share of profits in GDP has fallen. The recent fall in oil prices will ease the pressure on firms' input costs allowing them to restore profit margins without an increase in output prices. Nevertheless, according to surveys, businesses are

[2] Not so bad: **n**ot **o**f **t**he **s**ame **o**rder **b**ut **a**lso **d**esirable. Speech at the Eden Project, Cornwall, October 2004.

more likely to raise prices than during the NICE decade. And in their own survey, the Bank's Agents found that half of those (largely manufacturing) firms which had experienced some erosion of margins were now intending to raise prices.

A change in oil prices does not in itself tell us where overall inflation is headed in the medium term. For that, we need to look at the balance between money spending and potential supply.

The growth of total money spending in the economy has picked up in recent quarters – nominal domestic demand rose by 6% in the year to Q2. And the growth rate of broad money and credit in the economy is now higher than at any point since 1990.

There is, however, great uncertainty about potential supply. The possibility of continuing migration from the new member countries of the European Union and elsewhere is likely to increase the potential labour force available to UK employers. And it appears that more people of pensionable age are choosing to continue to work. The difficult judgment facing the Monetary Policy Committee is to what extent that increase in labour supply, and hence potential output, will allow a faster expansion of total money demand without upward pressure on inflation.

Given the uncertainties about the supply potential of the economy, we will need to keep our eye on the ball and monitor closely the evolution of wage and cost pressures. But it is no easier for the Monetary Policy Committee to read those than for most English batsmen to read Shane Warne's deliveries, and it is just as difficult for someone who, in terms of MPC meetings is 114 not out as it is for those still playing themselves in. The new factor is that, although wage pressures have so far been subdued, it is still not clear that earnings have been sufficiently restrained to accommodate the past rises in energy prices and the fall over the past year in the prices of our exports relative to our imports without a squeeze on profits. Ultimately, both developments must result in lower real incomes.

At this point, let me save the economic commentators a degree of anguish. Nothing in this speech is meant as a hint about our decision in November, which will be based on an assessment of the outlook for inflation two years or so ahead. That decision will be taken only in November, and much can change between now and then. Rather, I have tried to explain the challenges facing the MPC when it decides on interest rates.

Although we can control our own inflation rate in the medium term, temporary fluctuations in output and inflation will occur. We saw that in 2005. Moreover, we cannot insulate ourselves from the real economic consequences of the extraordinary changes taking place thousands of miles away from our own island. They will affect what we produce, what we buy and, most important, our standard of living. But to say that we are exposed to changes in the rest of the world is a far cry from saying that monetary policy is impotent to control inflation.

It is highly appropriate that I have been talking this evening about the recent decisions of the Monetary Policy Committee in the shadow of King Arthur's Round Table. For the Round Table symbolised the equality of the knights. To quote one authority, "there is no head of the table at a round table, and so no one person is at a privileged position." Equally, the Monetary Policy Committee comprises nine members, each with one vote, and the decision is determined by a majority of those votes rather than by consensus. No individual has a monopoly of wisdom and the pursuit of a consensus may hinder the discovery of the truth. Of course, I would not claim that the Bank of England is the long-lost site of Camelot, nor that meetings of the MPC are characterised by jousting and feasting. But I hope you can see that in its deliberations, the MPC has adopted the spirit, if not the literal shape, of the Round Table.

ENDS