BANK OF ENGLAND

Speech

Stability and Change

Speech given by

Sir John Gieve, Deputy Governor, Bank of England

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1. I am delighted to be here today. The Bank of England has long connections with this region. We first set up offices in Manchester and Liverpool back in 1820s. That was a time when North West of England was a key hub in an emerging international economy, with the Port of Liverpool providing the gateway for industry in Lancashire and Cheshire to trade with the rest of the world, particularly textiles.

2. The structure of the economy in the North West has of course changed markedly since those days and the region is now more associated with the aerospace, defence and pharmaceuticals industries than with textiles. Here as elsewhere, recent years have been a time of rapid change in the structure of industry and the economy. We may have been talking about globalisation for years but that doesn't mean it is complete; in fact it is still gathering momentum.

Macroeconomic stability: a platform for change

3. In the face of that rate of change, it may seem paradoxical that among central banks the last 10 years have been known as the "Great Stability".

4. The UK is an example of that. Since 1992, when an explicit target for inflation was first introduced here, inflation has been stable and very close to its target. Not only has inflation been low, but we have avoided the large swings in output and employment that have characterised previous periods in UK economic history. We have seen employment grow from around 56% of the population at the trough in 1993 to over 60% now and unemployment fall back to levels not seen since the mid-1970s. GDP growth has been between 1% and 4.5% per annum throughout. To someone like me who was in the Treasury in the 70s and 80s when we experienced real booms and busts, the last 10 years have looked like a golden age (Chart 1).

5. Of course we hoped that the reform of economic policy would bring greater stability, but the speed and extent of that success has been unexpected. When the MPC was created in 1997 and given responsibility for meeting the inflation target, it was told that whenever inflation was more than one percentage point away from the target the Governor would have to write a letter to the Chancellor explaining why this had occurred. The Bank's current chief economist estimated that the Governor would

need to write a letter on average one month in every two.[1] Even the current Governor thought that 'given past experience of inflation volatility it is likely, even allowing for the change in policy regime, to restore the lost art of letter writing to British life'.[2] It is remarkable that not a single letter has needed to be written – yet.

6. But stability at the macroeconomic level does not mean stability for individual firms or industries. Indeed one of the virtues of macro stability is that it allows – indeed forces – firms to focus on the real long term business challenges and opportunities they face rather than how to survive or profit from the short-term cycle. It is not a paradox therefore that the Great Stability has also been a time of great change in industry in ownership, structure and technology.

7. The Engineering Employers' Federation has itself stated that 'manufacturing prospers best in a stable macroeconomic environment with low inflation, low interest rates and stable exchange rates'.[3] That is not because they are a recipe for a quiet life but because they allow businesses to focus on what really matters – their products, their technology, their customers and their competition. In the last few years, macroeconomic stability has provided business with a platform for rapid changes in ownership, location and product mix, and for the transformation by IT of all business processes in the factory, the warehouse and the office.

Globalisation and UK manufacturing

8. Looking wider than the UK, one of the most striking changes of the last few years has been the integration of China, India and countries from the former Soviet Union into world markets and the sharper competition that is bringing first into goods markets and, increasingly, into services also. The EEF report, 'Where now for manufacturing?', published at the end of 2004, highlighted the 'huge increase in the importance of lower-cost countries as competitors'. Just under half of companies surveyed by the EEF saw China as the biggest competitive threat to their activities and

[1] Bean, C (1998), 'The New U.K. Monetary Arrangements: a view from the literature', *Economic Journal*, November.

[2] 'The Inflation Target Five Years On', Quarterly Bulletin

[3] 'Manufacturing in the UK', Engineering Employers Federation, May 2005.

nearly 60% identified China as a major competitive threat over the next five years. That was sharply up on the equivalent figure of 18% in 2001, illustrating that the change was occurring faster than companies then foresaw.

9. One of the consequences of the globalisation of production is that a reduced proportion of output in the developed economies is in manufacturing. This is true of the UK, where manufacturing accounts for less than 15% of GDP, but also of France, Spain, the Netherlands and US (Chart 2).[4] Some have felt the blunt end of this competition from Asia. But the emergence of China and others has also created opportunities. It has encouraged UK manufacturers to specialise in those products for which they have a comparative advantage over their competitors, prompting a change in structure and focus of the UK manufacturing sector. The fact that globalisation encourages this type of specialisation is one of the great benefits of having an open trading system, felt by both consumers and manufacturers. The EEF, for example, remains 'upbeat about the future of UK manufacturing', especially when it comes to high value-added activities.

Globalisation and UK inflationary pressures

10. The changes we have seen in UK manufacturing have occurred, in part, due to the impact globalisation has had on the relative prices of different goods and services. These changes have also had a big impact on the sources of inflationary pressure over the past decade, both here and internationally.

11. First, as in other developed countries, the prices of goods imported into the UK have fallen relative to goods and services produced domestically. Second, most markets for goods and many markets for services are now internationally 'contestable'. In other words, companies are under continual pressure to keep prices down because of the threat of competition from potential rivals from around the globe and this has limited the extent to which domestic producers can raise prices even in markets where import penetration is low. Third, factors of production have become more mobile. For

[4] The weight of manufacturing in UK gross value added was 14.7% in 2003. (United Kingdom Economic Accounts, 2006q1).

example, increased labour migration into the UK has helped employment to grow with low wage inflation. And the ease with which production can be switched across countries has contributed towards lower costs in a wide range of services and goods which are still home grown.

12. It is difficult to quantify the impact of these factors on inflation. It depends on the importance of imported goods in the consumer price index and on whether lower import prices are passed on to consumers.[5] In the UK in the ten years from 1994 to 2004, the price of imported goods fell on average by one per cent per annum, so the direct effect of this on the consumer price index was quite marked. This shows up in the striking contrast between goods and services consumer price inflation (Chart 3).

13. But the impact of greater competition does not stop with prices. Business tells us that greater competition between companies is encouraging them to protect their profits by cutting costs. This involves control of wage growth and the search for productivity improvements. This has been complemented by greater contestability in the labour market due to both greater migration and the potential for out-sourcing and relocation of production should wage demands become excessive.

14. My view therefore is that the disinflationary pressure from globalisation may well have been more substantial than the direct estimates suggest, and this helps to explain why inflation has fallen throughout the world over the last 15 years from 30% in the early 1990s to about 4% in 2003.[6] This decline has been particularly marked in Africa, Latin America and the transition economies but is also significant in the UK and other developed countries.

15. None of this makes monetary policy any less important. Ultimately inflation in the UK is a product of our monetary policy. Inflation would certainly reappear if we relaxed. But the disinflationary pressures from the Far East and elsewhere have made our job

[5] This is discussed in detail by my former MPC colleague, Stephen Nickell in 'Why Has Inflation Been So Low Since 1999?'

[6] Estimates from Kenneth Rogoff, 'Globalization and Global Disinflation', paper prepared for the Federal Reserve Bank of Kansas City conference on 'Monetary Policy and Uncertainty: Adapting to a Changing Economy' Jackson Hole, WY, August 28-30, 2003. The Bank for International Settlements has also emphasised the 'increasing global character of the inflation process', see BIS Annual Report 2006.

easier. In the UK, interest rates are set to deliver the inflation target. If there is disinflationary pressure from the rest of the world then that allows us to set lower interest rates (and accommodate a higher rate of price increases in services) than would otherwise have been the case. Thus the consequence is lower interest rates as well as low inflation.

Prospects for UK inflation

16. That leaves the question whether that benign trend is likely to continue in the future. Over the past year, the downward trend in the prices of imported goods has stopped and import prices have started to rise, even after excluding oil and erratic items (Chart 4). The MPC's current view, as expressed in the latest *Inflation Report*, is that import price inflation will moderate over the coming period, but that it will not prove as much of a downward force on inflation as in the late 1990s and early 2000s. We have, for example, seen signs of costs rising in China and the Far East. Looking further ahead, there must be a risk that this begins to spillover into higher import price inflation.

17. And while globalisation has helped to hold down prices of most goods, the demand for energy and other raw materials coming from the newly emerging economies has contributed to higher prices of energy and some commodities. The direct effect on the CPI of higher petrol prices has been much more limited here than in the US for example because so much of the price of our petrol is accounted for by duty. Nonetheless since the beginning of 2004, petrol prices have gone up by over 25% and gas prices by more still. The prices of petrol, utilities and transport services added about 1 percentage point to CPI inflation in May. And this does not include the effect on other goods and services where oil or gas is a component cost.

18. In the past we have seen wages pick up in response to hikes in the oil price and all central banks have been – and remain – watchful for those "second round effects" now. So far we have seen few signs of them. Part of the reason for that has been that the oil price increases have been offset by lower price increases elsewhere. Most recently CPI inflation peaked at 2.5% during 2005 and has recently returned to that level (Chart 5). Given the relatively small immediate impact of higher oil and gas

prices on CPI inflation, it is less surprising that this has not had major knock on effects.

19. Indeed it is not clear how far it is possible to predict the movement of prices overall by adding up the movements of different components. You might expect overall inflation to be made up of a “core” of domestically produced and consumed goods and services which would be relatively stable and responsive to policy at home and a more unpredictable and uncontrollable component arising from oil and other world markets. But that doesn’t seem to match our recent experience.

20. The CPI in total seems to have been more stable than the CPI adjusted to exclude the impact of energy and import prices. The rise in these external components of our inflation rate has been offset by lower price increases of domestically produced goods and services. Services inflation, for example, has weakened from 4.6 per cent in August to 3.4 per cent in June. This might be because UK price setters have chosen to take a hit to their margins or squeeze other costs rather than pass on higher oil and other import prices to their consumers. In other words, they have taken account of the effect of higher import prices in depressing the real incomes of their customers and curtailed price increases on their own products to avoid losing sales.

21. This all suggests that in an economy with well-anchored inflation expectations, relative prices adjust quickly to maintain the overall rate near target; with domestic price inflation, for example, moving in the opposite direction to import price inflation. In effect, where the target is credible, the market adjustments to relative prices will do most of our work.

22. That is another reason for paying very close attention to inflation expectations. The MPC has been successful over the years in maintaining inflation expectations at a rate broadly consistent with the inflation target. Anchoring expectations in this way is important because it prevents the wage-price spirals that were a key part of the inflation process in the past. If wage and price setters believed that inflation was going to rise above the target, then they would make some allowance for this in setting current wages and prices. That would add to current inflationary pressure, requiring higher interest rates to control it. While there was some evidence of a pickup in the

general public's inflation expectations at the beginning of the year, probably in response to higher gas prices, they have fallen back a little since then and do not yet appear to have had any effect on actual wages or prices.

Conclusion

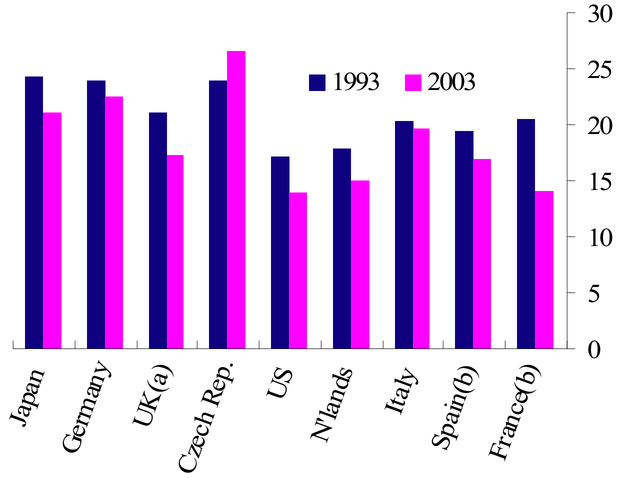
23. To sum up, by delivering the inflation target the MPC seeks to produce a platform of stability. That doesn't produce a quiet life for businesses – on the contrary it can make the pace of change quicker because it makes the underlying business imperatives clearer. In recent years, we have been helped in keeping inflation low and stable by the integration of new economies into the world market and the disinflationary pressure that has produced. As a result of that stability, the market and the public now expect inflation to remain around target and that appears to have helped to damp the impact of the recent oil price hikes on the overall inflation rate; the total impact has been modest and there are no signs yet of spillovers into wages and prices.

24. We do not know yet whether the benign international context will continue or what other shocks may occur. We are seeing renewed rises in energy prices this year which have helped push inflation back above target. Our role is to continue to assess the situation as it develops, monitoring economic data, financial markets, and listening to our regional agents and their business contacts. We will not hesitate to change interest rates if it is necessary to keep inflation on track. That will allow you to concentrate on the real business issues of the future.

Charts

Chart 1: Volatility of UK GDP Growth

Chart 2: Manufacturing share of the economy in developed countries[1]



[1] **Manufacturing contribution to gross value added**

(a) 2001 (b) 1992
Source: OECD in Figures. 2005 edition.

Chart 3: CPI inflation of goods and services

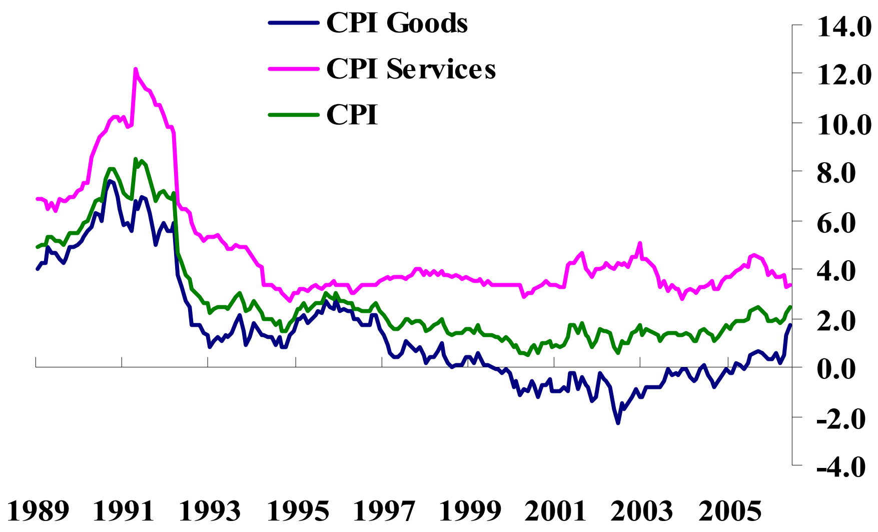


Chart 4: UK Import Prices

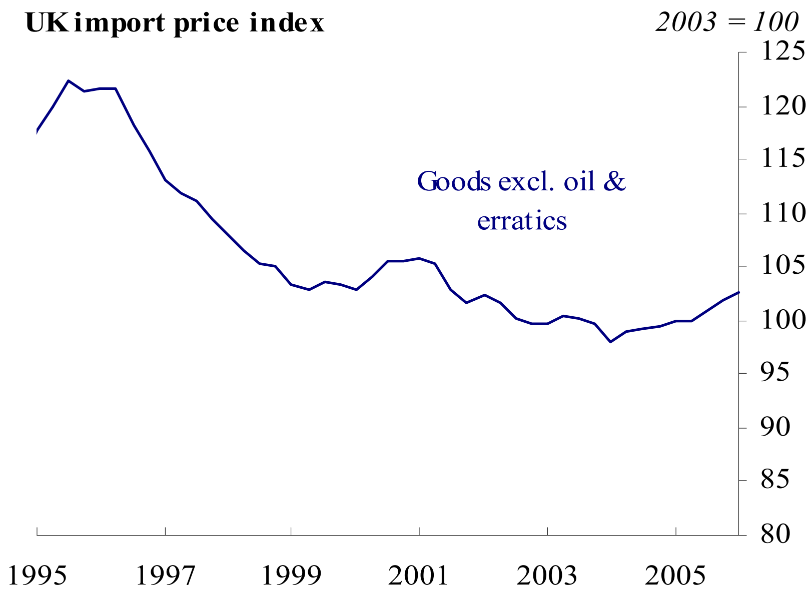
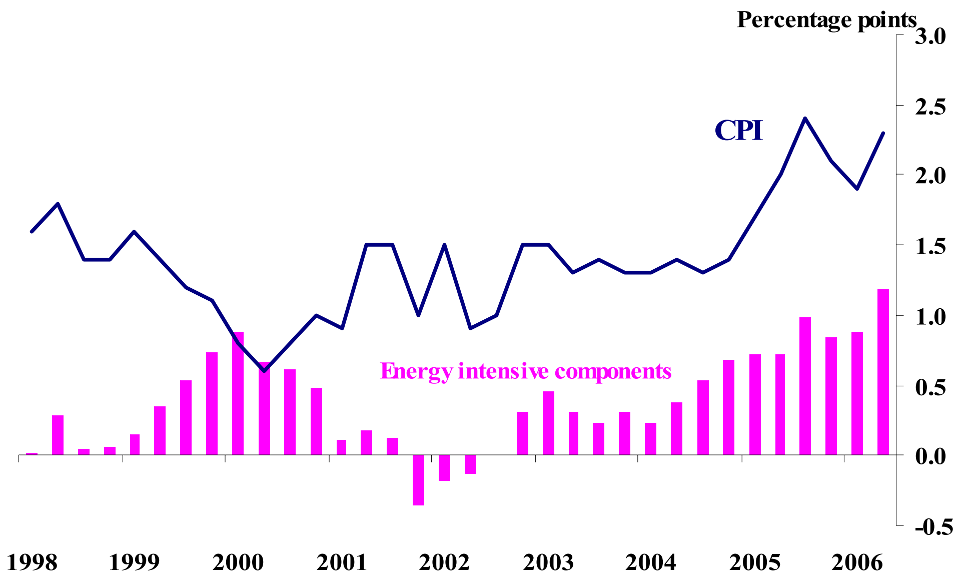


Chart 5: CPI inflation and the contribution from energy intensive components



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