



BANK OF ENGLAND

Speech

A Tale of Two Shocks: Global Challenges for UK Monetary Policy

Speech given by

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I am delighted to have the opportunity to speak at this inaugural meeting of the Warwick City Alumni Group, and I hope this is the first of many such meetings. Warwick alumni have made, and continue to make, a significant contribution to the Bank of England's work. Many of the Bank's economists have either a first degree or postgraduate degree from the University. At least one Warwick alumnus has served on the MPC – my predecessor David Walton, who died so tragically last year. My own association with Warwick is relatively recent, but I am very grateful for the opportunity the University has provided me to pursue my interest in the economic issues surrounding climate change, in parallel with my role on the Monetary Policy Committee.

Recent events have given us plenty to think about on the Monetary Policy Committee. Until this summer, our main preoccupation was how far we needed to tighten monetary policy to counter the strength of demand globally and nationally and to dampen down associated inflationary pressures. But over the last six months, two major global shocks have come along to complicate our task.

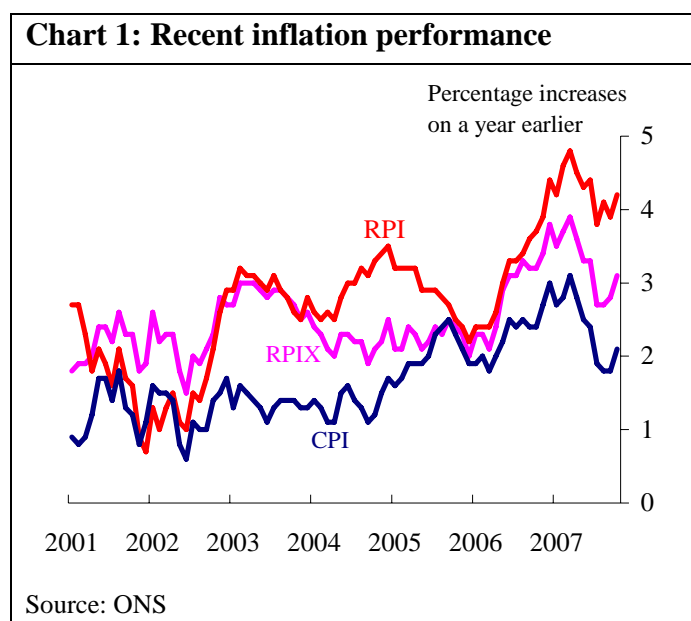
The most noticeable and widely discussed has been the turbulence on financial markets, prompted by emerging losses in the US sub-prime mortgage market.¹ Spreads have widened significantly in inter-bank markets and in credit markets more generally. The liquidity of inter-bank markets was significantly disrupted in August and September. And there are indications of a tightening of the availability of credit, particularly to more risky borrowers, leading to worries that there will be a knock-on effect constraining consumer spending and business investment, not just in the UK but across Europe, North America and other developed countries.

However, while attention has been focussed on these developments in the financial system, we have had another global shock which has not generated so many headlines, but is just as significant. Over the last six months, the oil price has risen by around a further \$30/barrel. This is a much sharper rise than we saw in the period from early 2004 to late 2005, when it took about eighteen months for the oil price to travel roughly the same distance – from \$30 to \$60/barrel. If these high prices are

¹ For discussion of these events, see King (2007) and the October 2007 *Financial Stability Report*.

sustained, there are likely to be upward pressures on inflation, at least in the short term.²

Both these shocks threaten to reinforce trends which may already have been present in the economy. On the growth side, five successive rises in interest rates were already expected to dampen domestic consumer spending and business investment over the second half of this year and into 2008. So one important issue is how far the financial turmoil will reinforce this slowdown, and whether it will create a bigger dampening impact on the economy than is necessary to keep inflation on target.



Similarly, the oil price rise has added to inflationary risks which were already apparent in the UK economy earlier this year. As Chart 1 shows, with the exception of a couple of brief periods, consumer price inflation has been above the 2% target now since the summer of 2005. Other measures of inflation, including the Retail Prices Index, have been at relatively high levels over the same period. Strong growth has created capacity pressures in some sectors of the economy and surveys of both business and the public show elevated expectations of price rises. And price pressures are in the pipeline from other global commodity markets, particularly in terms of food price inflation.

² Though the rise in sterling against the dollar has ameliorated the increase in sterling oil prices recently, this was also true in 2004 and 2005. From the first half of 2004 to the second half of 2005, the sterling oil price rose by £15, from an average of around £18.50 to £33.50. Over the winter of 2006/7, the sterling oil price averaged £29, and has since risen to £46, a similar increase of £17.

The objective of the Monetary Policy Committee is to keep inflation on target. So these upside inflationary risks from oil and other commodity prices need to be weighed in the balance against the downside risks to growth – and hence inflation – from the recent financial turmoil. The fact that these shocks are pushing in different directions adds to the uncertainty surrounding the outlook for inflation. In the face of these uncertainties, the latest evidence on activity, costs and prices will be an important guide to how the various risks are unfolding.

The Bank of England's recent *Inflation Report* sought to highlight some of the key issues on which the MPC will be looking for evidence to inform our judgements in the months ahead.

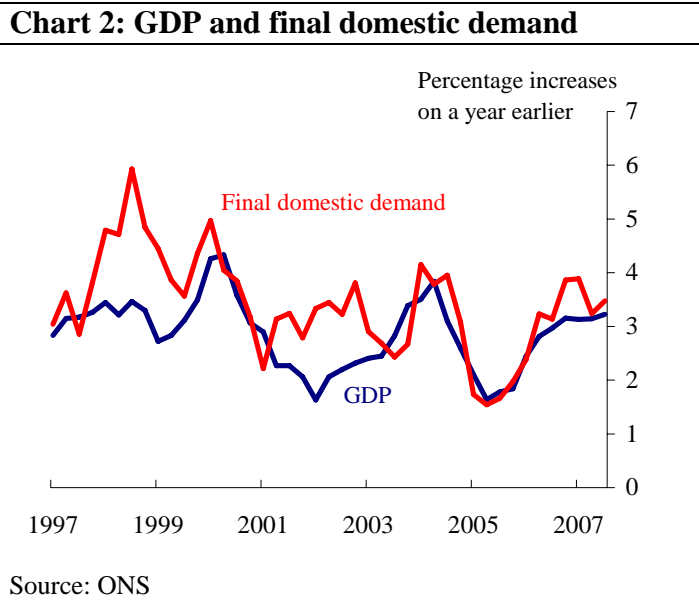
First, to what extent is UK domestic demand slowing, both in response to past rate rises and the knock-on impact of the financial turbulence?

Second, how much momentum will the UK continue to receive from the global economy, which has been growing particularly strongly in recent years?

Third, how much price pressure will be generated in the UK by rising oil and commodity prices?

And finally, what will be the influence of other domestic factors – price expectations, capacity pressures and wage growth – on the medium-term inflation outlook.

I will discuss these issues in turn, before turning to their implications for UK monetary policy.



The background to any discussion of the influence of domestic demand must be a recognition that we are starting from a position where the UK economy has been growing strongly, supported by healthy increases in domestic demand, as Chart 2 shows. The two main components of private sector demand – consumption and investment – drove a strong pick-up in activity over the course of 2006 and the first half of 2007. According to the Office for National Statistics, GDP growth in the year to the third quarter was 3.2% with final domestic demand up 3.5%. Indeed, business surveys and the Bank’s own staff analysis suggest that these figures may understate the momentum of growth.³

Even before the recent financial turmoil, the MPC was expecting a slowdown in the growth of consumption and investment in response to higher interest rates. This weakening in demand growth was expected to help damp down cost pressures coming through from the global economy and head off domestically-generated inflation. The likelihood is that the recent financial market turmoil will tend to reinforce this slowdown in the short term – particularly through its effect on the cost and availability of finance for riskier borrowers in both the household and corporate sectors, and by adding to uncertainty about business conditions. But the timing and scale of these impacts is highly uncertain.

So what does the latest evidence show? There are growing indications – particularly from the Bank of England’s regional Agents’ reports – that we may have passed a

³ The new GDP fan chart in the November *Inflation Report*, explained in the box on page 39 of the *Report*, shows the MPC’s best collective judgement of the most likely path of output over the past, and the uncertainty around it. Further information is available in Bean (2007) and Cunningham and Jeffrey (2007).

turning point in recent months for both consumption and investment. But the extent of the slowdown is still very hard to gauge.

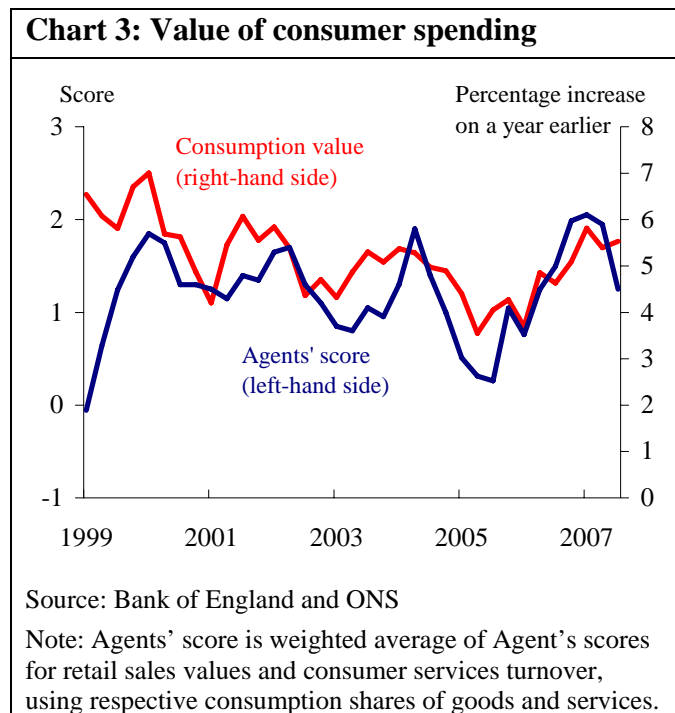
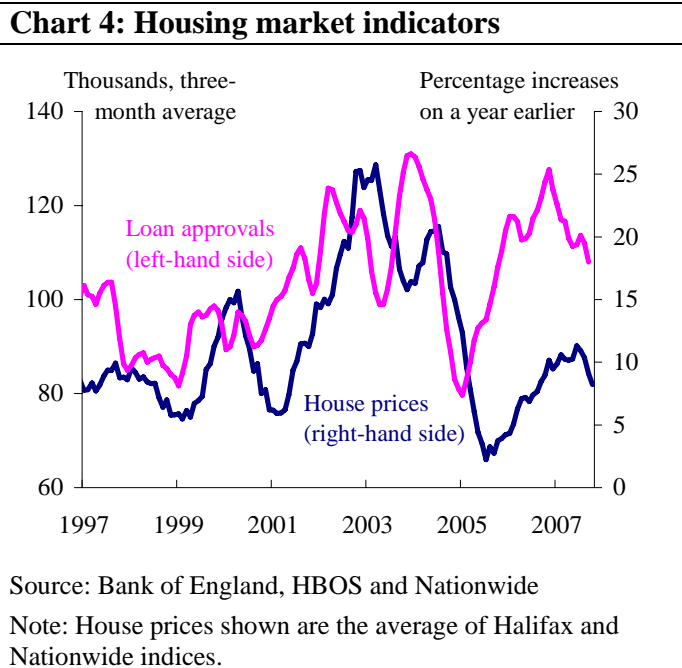


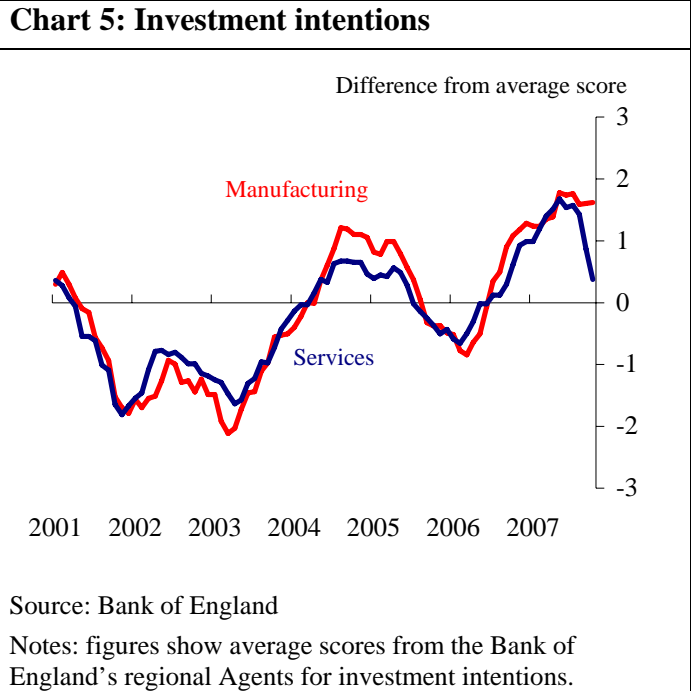
Chart 3 shows the picture in relation to consumer spending. If anything consumption has so far proved more resilient than we might have expected in the face of five rises in Bank Rate. The annual growth in the value of consumer spending hit a peak of nearly 6% earlier this year, the strongest rate of growth for five years, and has only eased back slightly since then. The retail sales data, however, show a more pronounced easing in the growth in sales values, though in volume terms spending has been sustained by price discounting. Reports from the Bank of England's Agents also show a turning point in consumer spending, but we are still a long way off the weak scores for consumption growth which were recorded as recently as 2005.



Housing market developments have often been correlated with consumer spending. They also have an added impact on demand through their effect on house building. Here too we see signs of a turning point, as Chart 4 shows. This has been most noticeable in terms of measures of activity – such as loan approvals, shown on this chart. Some other activity measures – such as the RICS survey of new buyer enquiries – show an even more pronounced downward movement. More recently, measures of house prices have also begun to reflect the weakness of the market. However, as with the broader consumption picture, it is still too early to say how significant the current housing market correction will turn out to be.

Though house price inflation has dropped back in recent months, the annual increase was in double digits until a few months ago. Some further slowing is probably in the pipeline, as the market adjusts to higher interest rates and riskier borrowers find it harder to obtain finance for house purchase. Some commentators are now predicting house price falls, but it is too early to say whether we will actually see this. And even if we do see a fall in house prices, the economic impact will depend greatly on how significant and sustained it is. It goes without saying that the MPC will continue to monitor housing market developments closely, as part of our assessment of how significantly household spending will slow over the year ahead.

The other key component which is expected to contribute to weaker domestic demand is business investment. Though the value of business investment is just one-sixth of consumer spending by households, it tends to be more volatile, and hence can still be an important contributor to swings in total demand.



Robust investment growth in 2006 has been followed more recently by indications of a slowdown, according to the latest official data.⁴ This evidence of slowing investment is also consistent with a weakening in investment intentions in the services sector detected by the Bank's Agents in recent months, as Chart 5 shows. Though manufacturing investment intentions have remained resilient, reflecting the continued strength of demand on world markets, the services sector accounts for a much larger share of business capital spending - over 70% of the total.

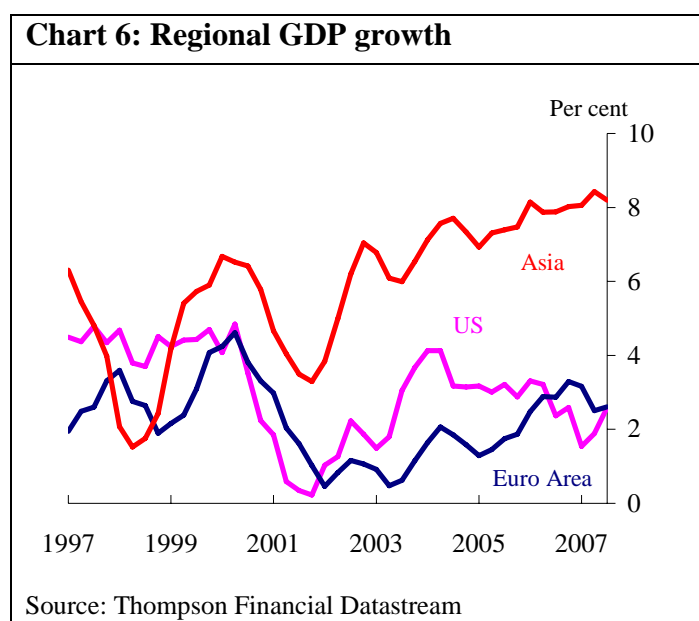
This slowdown in investment growth is not unexpected and has been a feature of the Bank's forecasts for some time. First, the prospect of weaker consumer demand reduces the need for additional capacity to serve these markets. Second, commercial property investment is likely to be dampened by higher interest rates and increased uncertainty about future prospects. Third, there may be financing constraints and higher borrowing costs for some companies resulting from the recent financial turbulence. The Bank's credit conditions surveys have pointed to a tightening of lending criteria, which might be expected to affect small and medium-sized

⁴ Early estimates of business investment are especially prone to revision so this evidence from the official statistics needs to be treated with caution. See Cunningham and Jeffrey (2007) for a more detailed discussion of the reliability of this data source.

companies in particular. However, the latest evidence from the CBI surveys shows little indication of credit constraints affecting investment yet.⁵

Global economic growth

The picture for global economic growth is not dissimilar to the domestic economy. Like domestic demand, the recent momentum of global growth has been strong. Indeed, we have to go back to the early 1970s to find a period of sustained economic growth as strong as we have seen in the last four years.⁶



As Chart 6 shows, strong growth in Asia has been an important contributor to this buoyant global economic picture. Over the past two years, Asian GDP growth (excluding Japan) has averaged over 9% per annum, whilst Chinese growth alone has averaged over 11%. Of more significance to the UK, though has been the healthy state of European markets, which account for the majority of our exports. In the last eighteen months, the Euro-zone has enjoyed its strongest growth phase since the late 1990s.

The situation in the United States is very different. While growth has been picking up elsewhere, the US economy has been slowing. As Chart 6 shows, US GDP growth actually peaked at around 4% year-on-year in early 2004, slowing to rate of around

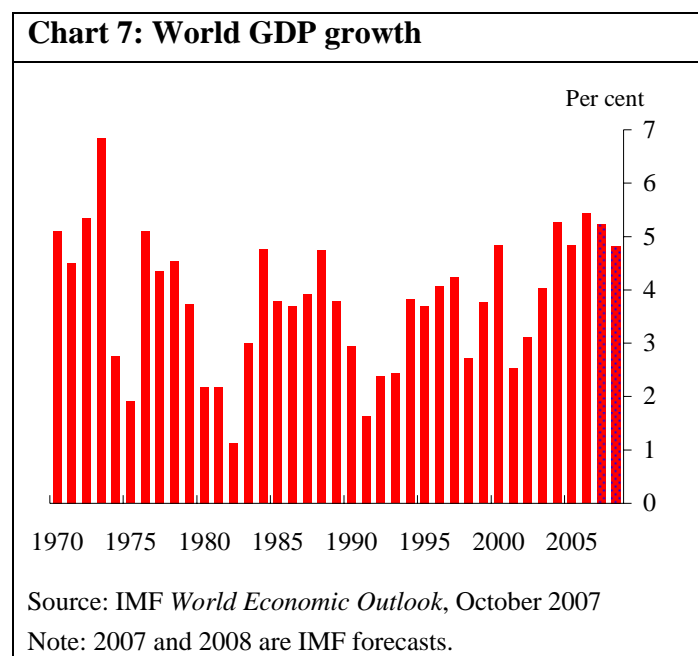
⁵ According to the October CBI Industrial Trends Survey, only 2% of companies reported the availability of finance as a constraint on investment, which is a very low figure by historical comparisons.

⁶ Growth calculations using purchasing power parity (PPP) exchange rates.

2% in the first half of this year. The last two quarters have seen stronger growth. But with renewed uncertainty created by the recent financial turmoil and potential knock-on effects from the downturn in the US housing market, most forecasters – including the Federal Reserve – expect US growth of around 2% next year.

There has been quite a bit of discussion about the impact of slower growth in the US on the wider global economy. Can healthy growth in Asia and Europe be sustained if the US turns down more sharply? Given the importance of the American economy to world demand – the US accounts for around a quarter of world GDP at market exchange rates⁷ – there could be some further negative impact on world growth from a more pronounced weakening across the Atlantic. But we can take some comfort from the fact that the world economy has already survived an effective halving in the US growth rate since early 2004.

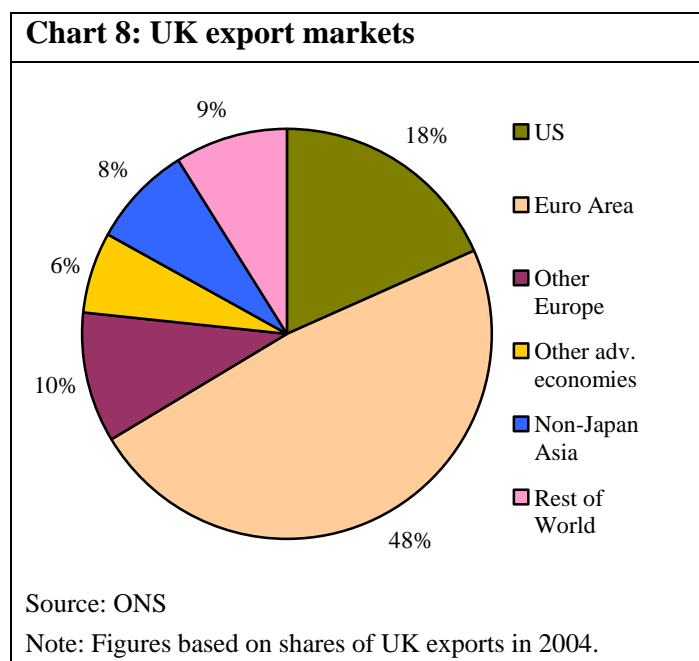
Perhaps the bigger risk to the world economy as a whole is not the US economy *per se*, but the possibility that financial market developments will have an impact on consumer and business spending across a wide range of advanced economies, including Europe as well as the US. This risk would increase if the global financial system was hit by further financial shocks, such as a sharp fall in equity prices and the value of financial assets more generally.



Though further shocks to the global financial system cannot be ruled out, most current forecasts point to a fairly modest slowdown in world economic growth in 2008. For

⁷ Figures for 2007 from October 2007 IMF *World Economic Outlook* database.

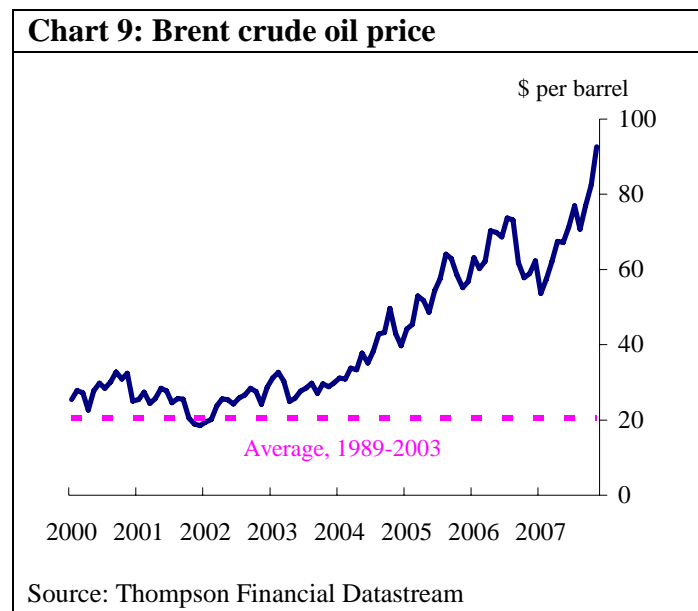
example, the IMF is still forecasting growth above its long-run average in 2008 – as Chart 7 shows. With strong domestic demand sustaining growth in Asia and other emerging markets, the performance of these economies is expected to largely offset the negative impact of weaker US growth.



For the UK, a key issue will be what happens to growth in the Euro-zone, and in Europe more broadly. As Chart 8 shows, these European markets account for nearly 60% of total UK exports, more than three times as important as the United States. A sustained slowdown in European growth therefore poses a bigger risk to the UK economy than potential developments in the US. The most recent data point to reasonably healthy Euro-zone growth so far in the second half of the year, with third quarter data showing a bounceback from a more muted second quarter growth performance. However, some business survey and confidence indicators have weakened. Over the months ahead, data on economic activity from the major European economies and survey evidence on UK export orders will indicate whether these are early indicators of a broader European slowdown or simply short-term confidence effects which will unwind next year.

International price pressures

One of the most significant consequences of the recent strength of the global economy is the upward pressure that this has exerted on energy and other commodity prices.⁸



This is reflected most clearly in the recent moves in the oil price, shown in Chart 9. Of course, a rising oil price is not a new phenomenon. The oil price has been on an upward trend on and off since early 2004. But, as I observed earlier, the rise we have seen over the last six months has been much sharper than the more gradual drift upwards between early 2004 and early 2006.

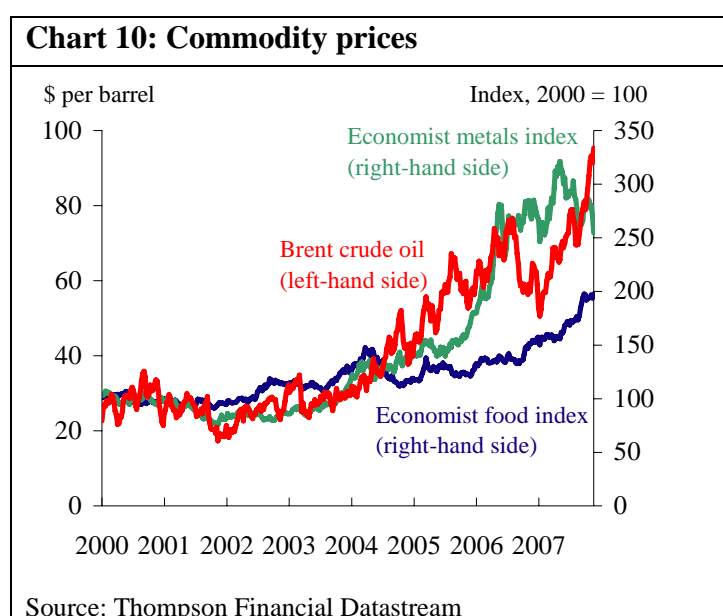
Early last year, talking to another audience of Warwick alumni, David Walton posed the question: “Has oil lost the capacity to shock?”⁹ He concluded then that the chances of a benign economic outcome were higher than in the 1970s and early 1980s for three main reasons. First, the shock to oil prices was more gradual and the economy was less dependent on oil. Second, the UK economy was in a better position to absorb the shock, starting from a position with fewer inflationary pressures, less excess demand and a more flexible labour market. Third, the monetary policy framework has helped to anchor expectations much better than in previous episodes.

⁸ See Sentance (2007) for a more detailed discussion of how changes in the global inflation climate and recent strong global growth have affected UK inflation and monetary policy.

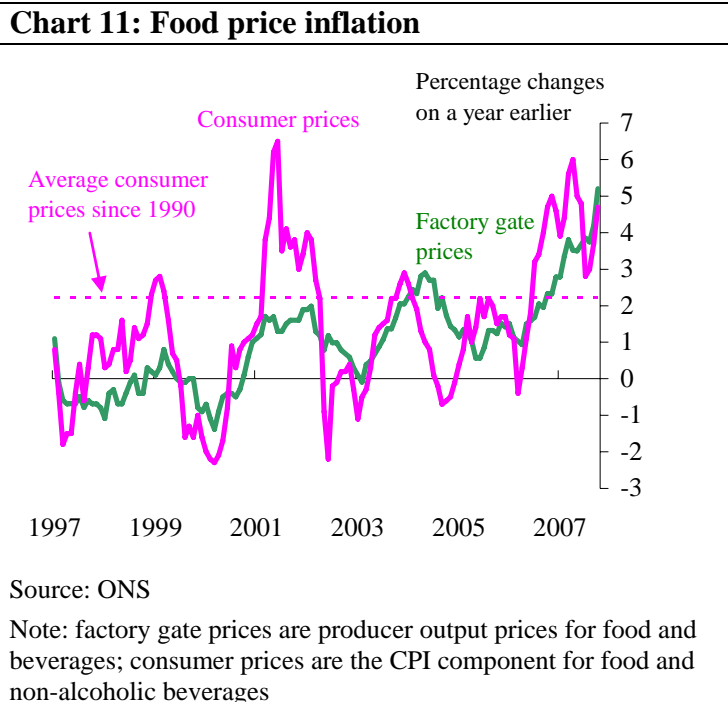
⁹ See Walton (2006).

This prognosis has turned out to be broadly correct, though CPI inflation and other measures were pushed above target by higher energy prices in late 2006 and early 2007, they have since come back down again. As past energy price rises have dropped out of the annual inflation calculation, CPI inflation has returned to around its target level of 2% in recent months.

However, in some respects we might be less sanguine about the impact of this further oil shock than David Walton was in early 2006. First, the shock itself has been more severe. As I have already observed, the oil price movement in this latest shock has been much sharper this time round than in 2004 and 2005.



Second, we have not just seen upward shocks to the oil price, but a more general upward pressure on commodity prices. As Chart 10 shows, metals prices rose sharply in 2005 and early 2006, and remain at elevated levels. More recently, food prices have risen sharply. Strong global demand, particularly from Asia and other emerging markets, has played a major part in driving these price developments. However, supply factors have also contributed in the case of food – including impacts related to climate change, such as changing weather patterns and a switch in the use of agricultural land towards bio-fuels.



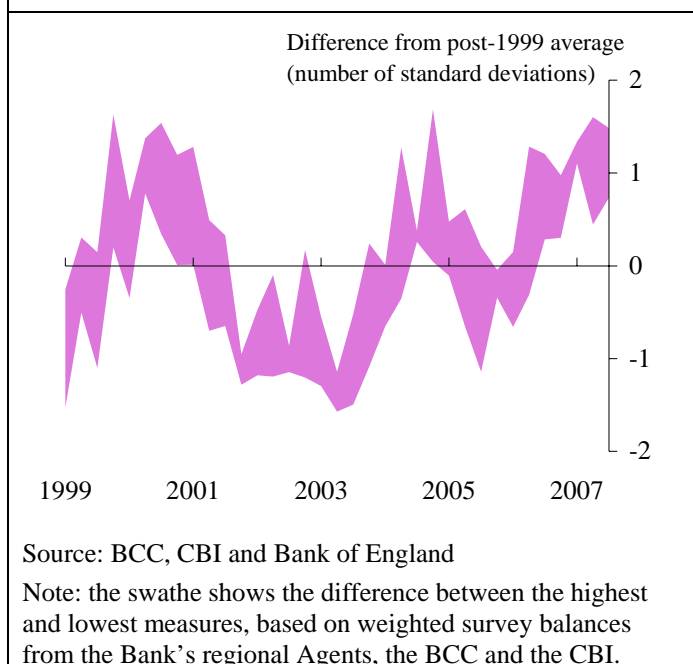
As Chart 11 shows, both consumer food price inflation and the price of food products at the factory gate are at elevated levels relative to the last decade – running at more than twice the average rate of food price inflation since 1990. This is not totally unprecedented – there was a sharp spike in food price inflation in 2001 (associated with the impact of flooding and foot-and-mouth disease).¹⁰ However, rising food prices do run the risk of aggravating an upward short-term move in CPI inflation in response to the latest oil price shock, unless other prices adjust downwards to compensate.

Capacity pressures, pay and inflation expectations

Short-term external shocks such as recent rises in energy and food prices should not affect the path of inflation over the medium term, as long as price expectations are not destabilised and demand and cost pressures do not turn a temporary rise in inflation into a more sustained increase. In his speech last year, David Walton noted that the monetary policy framework – which had by then established a track record of low inflation – would help to anchor inflation expectations. Inflationary pressures in the economy more generally were also muted when oil prices were rising in 2004 and 2005. Both factors helped to limit the inflationary impact of the oil price rise.

¹⁰ See the August 2001 *Inflation Report* for further details.

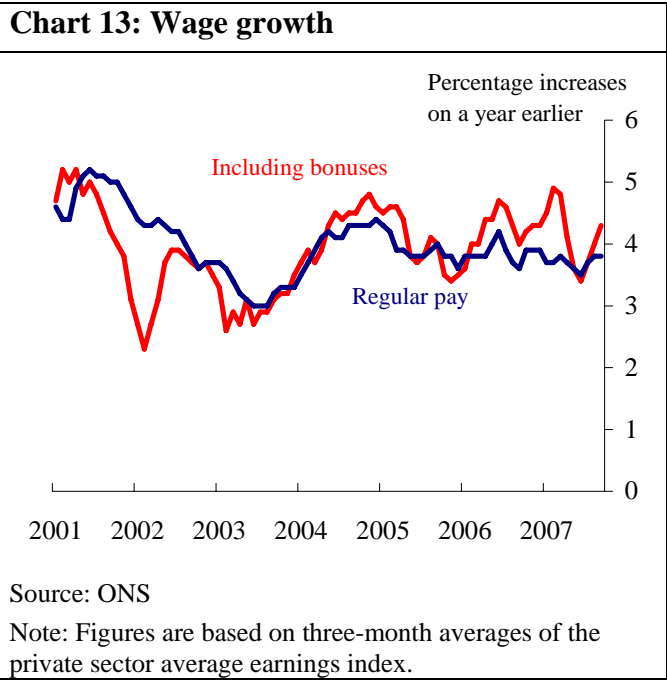
Chart 12: Capacity pressures



The conjunctural situation now is less reassuring. First of all, the strong growth in the economy over the last eighteen months has resulted in increasing reports of capacity pressures. This is shown in Chart 12, where business surveys and the reports from the Bank's Agents are used to compile a "swathe" of measures of capacity pressure. This contrasts with the position in the run-up to the oil price rises in 2004 and 2005, when the economy had been operating below capacity for a number of years.

The fact that the economy is running at a relatively high level of activity relative to capacity increases the risk that cost increases will feed through more rapidly into prices. That makes it all the more important that we do see some slowdown in demand and a reduction in capacity pressures, if we are to mitigate the inflationary impact of the recent rise in energy and food prices.

Another important difference from the situation in 2004 and 2005 is the potential impact that the recent experience of inflation might have on expectations and hence wage and price behaviour. Inflation was running below target in the run-up to the oil price rises in 2004 and 2005, and this reduced the risk that an upward shift in inflation in the short term would dislodge expectations. Recently, CPI inflation has been running above target and other measures of inflation have also been at elevated levels. The risk that further upward shocks to inflation begin to dislodge expectations is therefore probably greater now than when oil prices were rising two or three years ago.



Inflation expectations implied from financial markets, along with surveys of business and the public, do provide some evidence of some slight upward movement in inflation expectations. Another important set of key indicators is the evidence on the rate of wage growth. If employees and employers expect inflation to be higher, pay settlements and other measures of wage increases are likely to drift upward.

On this score, we can take some comfort from the recent trends in average earnings, shown in Chart 13. With the exception of movements driven by bonuses, the main official measure of pay growth – the Average Earnings Index – has been remarkably stable at below 4%, despite recent fluctuations in measures of price inflation. Pay settlements also show a similar pattern of stability. This broad stability in wage growth has been one of the more reassuring indicators for the MPC at a time when global factors have been exerting upward pressure on inflation.

But there are some contrary straws in the wind. The Average Weekly Earnings Index, which is a newer and less well-established measure,¹¹ does show some signs of a rise in pay increases – which could point to upside risks to wages. So, in the months ahead, the Monetary Policy Committee will need to monitor closely the full range of indicators of pay growth to establish whether inflation expectations are shifting. In this context, the evidence from pay settlements struck in the early months of 2008 is likely to be particularly important.

¹¹ See Duff (2007) for an ONS analysis of the difference between the two AEI and AWE estimates of earnings growth.

Implications for monetary policy

The UK economy has probably passed a turning point and a slowdown now appears to be underway, driven mainly by a weakening in domestic demand. That is not an unexpected or indeed an unwelcome development. The starting point for the slowdown is a healthy growth rate of GDP and domestic demand around 3½% per annum, which appears to have been sustained up to the third quarter. Slower growth of demand should help to ensure we will meet the inflation target over the medium term, by reducing the risk of a build-up of inflationary pressures.

At the same time, the economy has been hit by two shocks – financial market turbulence and a sharp rise in oil and some other commodity prices. These shocks are operating in opposing directions in terms of their impact on inflation. So judging the appropriate monetary policy response will not be easy.

One benefit of the MPC process is that we meet monthly and base our decisions on a detailed analysis of the latest data and evidence. This evidence-based approach has been a strong hallmark of the MPC's past response to economic shocks and should serve us well in the current climate. At our forthcoming meetings, we will need to weigh the evidence on the extent and likely duration of the slowdown in UK growth against the impact of inflationary pressures coming through from the global economy, and their potential impact on inflation expectations. The effect of financial market and credit developments on growth in other major global economies, particularly the US and Europe, will be a significant factor on both sides of the equation.

The months ahead look set to be a challenging time for UK monetary policy – and I am sure that the MPC won't be short of external advice over this difficult period! I should emphasise that our primary objective is to maintain price stability. As the experience of the last decade and a half has shown, low and stable inflation provides a solid platform for healthy growth and a more stable economy over the longer term.

However, in the wake of recent shocks from global financial and commodity markets, we cannot guarantee that the economic road ahead in the short term will be easy or smooth. On the MPC, we will be focused on our remit of keeping inflation on course to meet the 2% target. But against a background of global financial turbulence and a sharp rise in the oil price, it may be a bumpy ride.

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