BANK OF ENGLAND

Speech

Current Monetary Policy Issues

Speech given by

Rachel Lomax, Deputy Governor, Bank of England

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Tonight I want to talk about the current issues confronting the Monetary Policy Committee.

It's hard to tell the story of an economy as open as the UK without starting with global developments. That's not a point I need to labour here in Hull, the Gateway to Europe, and home to a brand new World Trade centre. And it's never been more true than today.

The past 4 years have seen the fastest growth in the world economy since the early 1970s[1]. But even more striking than its pace has been the change in the balance of global growth, with emerging economies contributing nearly three quarters of the increase in world output[2]. This has become even more pronounced over the past year, as Chinese growth has picked up even as the US economy has slowed.

The world's economic see-saw has tilted. That's the new reality behind two dramas that have held the world's attention since last August: the turmoil in financial markets; and the renewed surge in energy prices.

Both these developments are highly unusual and very recent. No-one knows how they will play out. So you would be right to take all forecasts – including our own – with a large pinch of salt. But the MPC has to take a view, when it sets interest rates. My aim tonight will be to share some of that thinking with you.

Financial market developments

Let me start with the problems in global financial markets.

Over the course of the summer, growing arrears in the US sub prime mortgage market triggered a global loss of confidence in the valuation of securities backed by bundles of mortgages and other loans. How could a relatively limited problem – confined to the bottom end of the US housing market - spark a global financial crisis? It's a good question.

The short answer goes as follows. Investors had come to rely too heavily on the ability of rating agencies to value what had become exceedingly complex financial instruments. The

[1] Calculated using purchasing power parity (PPP) exchange rates.
[2] Again, calculated at PPP exchange rates.

realisation that their faith had been misplaced cast doubt on the value of a wider class of asset backed securities. Many of these were embedded in ever more complex, highly leveraged, investment vehicles.

This set the stage for a period of turmoil in international money and credit markets which has now been through several phases, and may go through several more.

At its heart, the problem is one of uncertainty.

First, there is great uncertainty about the eventual size of losses from defaults on US sub prime mortgages that the global financial system will have to absorb. There are different estimates and they change all the time as the news from the the US housing market deteriorates.

Second, there is great uncertainty about where these exposures will end up. So banks have become more worried about the creditworthiness of their counterparties.

And third, this lack of information, in a complex and globally interconnected financial system, breeds fear: of ratings downgrades, of fire sales and just of unknown consequences. And fear breeds more uncertainty.

So banks have been hoarding liquidity, to protect themselves against further upsets; and they have become more reluctant to lend to other banks. So the rates at which they lend to each other have risen, relative to the levels which are expected to be set by central banks.

The squeeze in core liquidity markets has already been unusually prolonged. And it is very hard to say when conditions will return to something more like normal. When the dust has settled, the financial landscape may look a bit different. Investors may be more aware of risk and warier of complexity. Some recent financial innovations will disappear. Others may survive but in modified form, and probably at an increased cost to final borrowers.

What does all this mean for UK monetary policy? The MPC's remit is to keep inflation at its 2% target, so the key issue for us is how far the financial crisis will affect the wider economy. That will depend on the answer to three broad questions.

First, in the short term, how far will the severe liquidity squeeze that has already happened turn in to a full scale credit crunch – by which I mean a sharp tightening in the price and availability of credit to households and firms;

Second, how well placed are households and firms to weather any such change in credit conditions?

And third, in the longer term, will there be a significant lasting impact on credit conditions, for any given level of Bank Rate?

It is too early to answer these questions with any great confidence, especially the last. But we do have some early evidence.

There are signs that credit conditions facing firms have already tightened. The terms on corporate bank borrowing are often directly linked to the rates that banks charge each other. These rates have risen and remained high. Our latest intelligence suggests that the main lenders have tightened the terms on which they are willing to lend to businesses, and they plan to tighten them further. UK firms' financial position is currently pretty healthy, on average, and large corporate borrowers in particular may have good alternatives to bank borrowing. But smaller and more highly geared firms may be more adversely affected.

In time tighter credit conditions could mean weaker business investment, though so far forward indicators of investment intentions still point to fairly strong growth. And any marked increased in uncertainty about demand conditions could lead to investment plans being shelved. But it is still early days - too early to draw strong conclusions about the size of these effects.

Even more uncertainty surrounds the possible impact of tighter credit conditions on household spending, which alone accounts for three fifths of total domestic demand. There is already some evidence that banks are tightening the price and non-price terms on which they lend, especially to borrowers with relatively poor credit histories. And quoted fixed rate mortgage rates have already risen relative to market expectations of Bank Rate –

though since markets now expect Bank Rate to fall instead of rising, the pick up in actual mortgage rates remains quite small.

Overall, households seem to be in a relatively strong position: debt has risen a lot relative to incomes, but so too have holdings of financial and real assets. Mortgage arrears and repossessions remain well below their peak levels in the early 1990s. But the share of income which needs to be devoted to interest rate payments was already set to rise sharply, largely as a result of rising debt levels. And there is a growing minority of households who are reporting difficulties with their debts.

In short, it looks as if events in financial markets are beginning to affect the terms offered to retail borrowers. This should act as a brake on consumer spending and investment. But the size of this effect is highly uncertain, partly because so far it seems to be focussed on certain groups. Much may depend on whether recent developments shake consumers' confidence in future income growth and employment – and so far that does not seem to have happened.

What about possible longer term effects on the price and availability of credit?

Over the past three years, competition and financial innovation have put steady downward pressure on the rates at which banks have been prepared to lend, at any given level of Bank Rate. Between 2003 and the beginning of this year, 2-year-fixed mortgage rates fell by around 50bps relative to the wholesale interest rates they are usually priced off. This is one reason why credit has gone on rising so strongly, despite increases in official interest rates.

At this stage, we can only speculate about what will happen next. My guess is that over the next 3-5 years, we will see a sustained – though not necessarily complete - reversal in these trends, as banks re-appraise the risks around certain business models and complex financial instruments. This would increase the cost of credit to final borrowers, for any given policy rate.

If that happens, this summer's crisis will influence the economy – and potentially the interest rates set by the MPC – for some time to come.

Energy prices

Let me now turn to the second of the global developments I mentioned earlier: higher energy prices.

During the past month , the oil price has threatened to breach the $100 a barrel. Just last January a barrel of oil cost $55; four years ago, it cost less than $30. Some of this is due to the weakness of the dollar. But the rise in sterling terms has been pretty spectacular too – from £17 a barrel four years ago, to £27 last January, to around £45 now. At these levels, oil is almost back to its 1979 high, after correcting for inflation[3].

What's going on? It's always hard to disentangle underlying demand and supply factors from the speculative froth. It's possible to point to some short run factors behind the recent surge. Stocks of oil across the OECD economies have been falling, at a time of year when they should be rising. This reflects temporary supply disruptions such as weather-related problems in Mexico and in the North Sea. As production comes back on stream, the market should ease.

But short-run influences can only have this kind of leverage over the price because underlying market conditions are so tight. World demand for oil has been boosted by a strong world economy, led by booming emerging markets. China alone has been responsible for a third of the growth in global oil demand over the past four years. Meanwhile supply has struggled to keep pace – partly because of policy decisions by oil producing economies, but partly because it takes quite a long time for investment in extra production capacity to come on stream.

What are the risks that oil prices will stay around their current level for a time – and maybe go even higher? It's hard to say – but the market is not discounting the possibility of even higher oil prices. Options prices point to an increase in near-term uncertainty - and an increasing concern about further large price rises.

[3] Using US consumer expenditure deflator to adjust for inflation.

There are risks on the downside too: the last time the world economy slowed significantly, oil prices slumped. Could a slowdown in the world economy cause oil prices to collapse again? Projections for the growth in oil demand over 2007 and 2008 have been revised downwards a little recently. But much may depend on the pattern of any slowdown – and in particular whether China continues to expand strongly even as the US economy slows.

What's the likely impact of higher oil prices on the UK economy? Twenty or thirty years ago, sharp increases in energy prices coincided with much higher inflation and much lower growth. Over the last four years, our experience has been very different: inflation has been better behaved, and growth much steadier. There are several reasons for that, including major changes to the energy intensity and flexibility of the UK economy. But one important difference has been monetary policy. Unlike in the 1970s, the MPC's focus has very clearly been on controlling inflation.

Today, higher energy prices are an important influence on interest rate decisions. That is because they have an immediate impact on inflation, which has the potential to fuel inflationary expectations. And they may also affect the balance between overall demand and supply, though it is hard to judge the timing and size of this effect. Soaring oil prices were an important reason why some members of the MPC, including myself, were reluctant to cut interest rates when the economy slowed in 2005.

The Policy Dilemma

Today, in 2007, global developments – in financial and oil markets - are posing downside risks to output as well as upside risks to inflation. That's a very difficult combination. So how well placed is the UK economy to weather these headwinds?

As far as output goes, we start from a strong position. The latest official figures show annual growth still above its average rate, as it has been for more than a year, reflecting robust domestic spending by households and businesses as well as a buoyant world economy. But in the last month, the businesses surveys have started to weaken - a few quite sharply. And retail spending may be slackening, though heavy discounting has

clouded the underlying picture. There are clearer signs that the slowdown in the housing market is gathering pace. But the impact of this on consumer spending and ultimately on inflation is highly uncertain. And that is what matters for monetary policy.

So growth does now seem to be slowing. But what is less clear is whether the scale of this easing is likely to be broadly what we need to keep inflation on target in the medium term – neither too much nor too little. That's not just because we don't know how much slowing is in the pipeline. There are a couple of other important uncertainties too.

First, it's hard to judge the underlying strength of inflationary pressures.

When inflation picked up quite sharply last winter, there was a lively debate about how far this reflected strong monetary growth, and how far it was due to the temporary effect of a very big jump in gas and electricity prices. Although inflation has now come down sharply, there is still room for debate about the margin of spare capacity in the economy. Various indicators seem to be telling slightly different stories. On the one hand, overall wage growth seems to have been moderate, by past standards. On the other hand, business surveys of capacity pressures and price expectations remain above average.

Second, there is a lot of uncertainty about the risks to inflation, if oil prices do continue at their present levels. Should we take heart from the relatively muted impact of previous increases in oil prices? Or does the fact that workers had already absorbed the impact of a doubling in oil prices since 2004, even before the latest surge, make it more not less likely that they will hold out for higher pay?

A key point for the MPC is that its own actions will help to determine how far oil prices have a lasting impact on inflation. There are always risks in signalling that policy will be eased, at a time of rising energy prices. This is all the more so after a year when inflation has been above target and on some measures remains uncomfortably high.

On the other hand, we need to be very alert to the risk that the economy may be slowing too abruptly. At current interest rate levels, monetary policy may be on the restrictive side. And the duration and impact of financial turbulence is very hard to call. There must be a

risk that at some stage it will spill over into asset and property markets more generally, and trigger a damaging loss of confidence.

Conclusions

The MPC faces a tricky period as we try to weigh the risk of an unduly sharp downturn, against the threat to inflation posed by a sharp surge in global energy prices. Much will depend on developments in the rest of the world; on whether the slump in the US housing market causes a sharp slowing in the wider US economy: and on how far this acts as a brake on demand – and inflationary pressures - in the rest of the world, especially Asia and the euro area.

The projections we published in last week's Inflation Report were centred around a relatively mild slowdown, by historical standards – on the same scale as we experienced in 2005 – based on the assumption of a gradual and modest easing in interest rates over the next two years. But those projections are subject to a very wide margin of error – in both directions. The MPCs monthly decisions are always grounded in a careful analysis of all the evidence. Given the uncertainties we face, now is a time to pay extra attention to the emerging data.

We can, and should, respond quickly and flexibly to early signs of the changing economic weather. According to most recent official economic statistics, the weather is still set fair. But we know fouler weather is brewing off shore. What is still far from clear is whether we are in for a force 6 strong breeze, or a full force 8 gale.

We will need to deploy all our meteorological skills. In the Inflation Report we highlighted a number of early warning indicators on both output and inflation, which will help us judge the strength of the wind. These include the reports from our own Agents around the country, drawing on businesses such as your own. If you are one of our regular contacts, let me take this opportunity to thank you warmly on behalf of the MPC for your help. We may be making additional demands on you over the coming months. I hope my remarks tonight have helped to explain why your co operation is so necessary – and so valuable.