BANK OF ENGLAND

Speech

Speech on the Economic Outlook given by

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Good evening! It is a great pleasure to be here tonight at this magnificent stadium, winner of the RIBA Building of the Year Award in 1995, and home to the Giants Rugby League team and Huddersfield Town Football Club. Huddersfield boasts sporting heroes too numerous to list. But given the presence of Lord Coe tonight, I cannot pass without singling out Derek Ibbotson, who smashed the world record for the mile exactly fifty years ago. I am sure he is as thrilled as the rest of us that the Olympics are returning to this country.

I have been asked to say a few words tonight about the outlook for the British economy. Last year, the economy notched up growth of 2.7%, close to its average rate over the past decade. That growth was underpinned by a recovery in consumer spending from its weakness the previous year, a revival in business investment and an expansion in exports buoyed by continuing robust growth overseas. Although the services sector remains the primary source of growth, we have also seen a welcome, if modest, recovery in the fortunes of manufacturing.

The Bank's Monetary Policy Committee believes that there are good reasons to expect this healthy performance to be maintained over the next year or two. First, while the recent data for retail spending have provided mixed signals, consumer spending seems likely to continue to grow at a moderate pace. Certainly, the ¾ percentage point increase in the Bank's official interest rate since last August will be a drag on spending, particularly that of highly-indebted households. But last year, higher domestic gas and electricity prices ate into consumers' purchasing power. This year, the price of energy is set to fall rather than rise. That should boost family budgets, enabling them to spend more. And the continued buoyancy of house and equity prices should also provide a fillip to spending. But the pace of growth of household spending will probably be rather less rapid than for much of the past decade. So the temperature on the High Street may nevertheless seem a little cool.

As far as investment goes, forecasting is always perilous because so much depends on the expectations and 'animal spirits' of those who run businesses. But surveys of investment intentions suggest that capital expenditure will remain buoyant in the near term. Moreover, though profit margins have been squeezed by higher energy costs, subdued investment spending since the turn of the millennium and lower prices for capital goods mean that the rate of return on investment is nevertheless fairly high. And corporate finances also look to be in reasonable shape. To be sure, the migration of labour-intensive production to Eastern Europe and Asia where labour is cheap means that some investments will no longer be taking place in this country. But other parts of the economy have been expanding to fill the gap, particularly in services and high value-added manufacturing. So the need for other sorts of investments, particularly exploiting the possibilities of information technology, has simultaneously been increasing.

As far as export prospects are concerned, the world economy looks set for another year of healthy growth. The US economy slowed through last year on the back of a cooling housing market and a sharp decline in the building of new homes. But that slowdown does not appear to have spread to the wider economy, and growth there has recovered. More importantly, as far as this country's trade is concerned, the euro area has picked up steam after a prolonged period of sluggish growth, and the signs are that this revival will be maintained. And, of course, the rapid development of China and India continues apace. It is true that sterling has risen noticeably since last spring and that will make it a bit harder for British exporters to benefit from continuing global expansion. But business surveys suggest that export orders have so far held up reasonably well.

All this might sound rather heartening. However, developments on the inflation front were somewhat less benign last year. And it is inflation that the MPC is charged with targeting, not the growth rate, unemployment, the exchange rate, house prices or anything else. For much of the MPC's life, inflation has in fact been pretty close to the target given to us by the Chancellor – much closer than was expected when the framework was set up in 1997. Indeed, inflation has so far not deviated by more than one percentage point from the target, the point at which the Governor has to send an Open Letter of explanation to the Chancellor. But as I expect many of you will be aware, the Governor did come close to getting his pen out just a month ago, when consumer price inflation for December hit 3%. Yet a year earlier it stood at just 1.9%, a smidgen below the 2% target.

So what has happened to push inflation up? The obvious answer is that there was a significant increase in the prices of oil and gas. But given the scale of the increase in energy prices, the striking thing is the mildness of the rise in inflation. If you had told me in early 2004 that oil prices would double and gas prices triple over the next couple of years, I would have been seriously worried about the inflationary impact. In the seventies, increases in oil prices of that order were associated with a spiral in wages and prices that took inflation to above 20%. Nothing like that has occurred this time round.

Why is that? In part, the more muted response reflects increased efficiency in our use of energy. But more importantly it reflects changes in the way the economy functions. Part of it is down to the monetary framework that has been in force since 1992, which has helped to embed low inflation in the economy. Part of it is down to increased competitive pressures in product markets, associated with the integration of China and India into the global economy, which makes it harder for businesses to pass on cost increases in the form of higher prices. And part of it is associated with the moderating pressures on pay exerted by substantial inward flows of migrant labour from Eastern Europe and the threat of moving jobs offshore to cheaper localities.

As a consequence, far from seeing the triggering of a spiral in wages and prices, this time round we have seen energy-consuming businesses in the first instance taking the hit on their profit margins, and then looking for ways to bear down on other costs, for example by boosting productivity or pushing down on pay growth. Moreover, with more of the household budget going on petrol and utility bills, there has been less available to spend on other things, which has also helped to keep price rises in check. So the response has been to cushion the effect of higher energy prices on inflation, rather than amplify it, as was the case thirty years ago.

So does that mean everything is set fair, now that oil prices have eased back from their late-summer high and the energy companies have started to announce future cuts in retail gas and electricity prices? Certainly inflation is likely to fall back sharply through this year. Just how quickly it will fall back is difficult to predict, because so much depends on the pricing decisions of a few energy suppliers. Indeed, it is quite possible that inflation could be temporarily well below the 2% target in the latter part of this year.

But that does not mean that the MPC can afford to relax about inflationary pressures. Just as the sharp upward movement in inflation over the past year may have exaggerated the pick-up in underlying inflation, so the prospective fall-back is likely to overstate the extent to which inflationary pressures have abated. The MPC needs to look through all this near-term volatility in order to judge whether inflation is on track to meet our target in the medium term.

The increase in inflation over the past year has been associated with a rise in households' inflation expectations and an upsurge in media coverage suggesting that inflation is higher than the official measure suggests. Much of the media criticism has been a bit misconceived. But there is a good reason why inflation may seem higher to many households, as the prices of necessities – like energy – and of things that we buy frequently – like food – have risen more rapidly over the past year, whereas the prices of things that we buy only once in a while – like cars and furniture – have picked up less. And quite naturally, households will tend to be more aware of changes in the prices of necessities and things that they buy regularly than in the prices of things that they purchase only occasionally.

Against this background of raised inflation perceptions, there is a risk of heightened pressures on pay. These days, businesses' ability to pay is probably more important in determining wage settlements than last year's RPI increase. But with adequately skilled labour still in relatively short supply despite the rise in unemployment, some increase in pay growth is on the cards. The limited information so far available regarding this year's pay settlements suggests just a modest pick-up, a picture that is confirmed by reports from our regional Agents, who are in touch with around 8,000 business contacts across the country. But it is early days yet, so the MPC will be continuing to watch pay developments closely.

Against a background of firm demand growth and only a limited margin of spare capacity, there are also signs from business surveys that firms have become somewhat more confident in their ability to push through price increases. That may not matter too much if it is just a one-off adjustment, as margins recover from last year's energy-price-induced squeeze. But we would be concerned if it foreshadowed a more persistent uptick in output price inflation.

Moreover, for much of the past decade, access to cheap goods from Asia has depressed the price of imports, providing a beneficial 'tailwind' to our efforts to keep inflation low. But the biggest gains from switching production to the Far East may have already taken place. If so, we can expect less assistance from this tailwind in the future.

At the present juncture, we believe that CPI inflation is broadly on track to meet our 2% target in the medium term. However, there are considerable uncertainties surrounding that prospect, on both the upside and the downside. Those uncertainties are reflected in some differences of opinion within our Committee and inevitably make it hard to know where interest rates will go next. Journalists and market pundits are forever trying to deconstruct the MPC's communications for hidden hints as to the timing and direction of the next move in the Bank's official interest rate. But as we have repeatedly stressed, this makes little sense as our decisions are not pre-cooked in advance. Rather we take them one month at a time in the light of the latest information, focussing always on our objective of keeping inflation on track to meet the target in the medium term.

One of Huddersfield's most famous sons, Harold Wilson, once declared that he was an optimist, but an optimist who always carried a raincoat. The prospect that I have painted tonight is a generally optimistic one. But central bankers, like business people, need to be prepared to deal with the unexpected.   So even if it looks like a cloudless day, I can assure you that we will be carrying our raincoats, and that we will be ready to act as necessary in order to maintain the low and stable inflation to which we have now become accustomed. And doing that is the best contribution that we can make to providing you with an environment in which your businesses can flourish. Thank you!

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