BANK OF ENGLAND

Speech

Speech given by
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Chairman, First Minister, Ladies and Gentlemen,

Two years ago I spent a few days walking along Offa's Dyke. Up on the ridge, between Hay and Pandy, there is a magnificent 360˚ view. The patchwork quilt of green fields in England lies to the east. But the eye is drawn to the rugged and spectacular scenery of the Black Mountains in 'Wild Wales' to the west. The landscape, however, is not everything because as George Borrow wrote in 1862:

"Wales has something beyond wonderful scenery, its eventful history, and its illustrious men of yore to interest the visitor. Wales has a population, and a remarkable one."

It is a population that has had to adapt to great changes in the world economy over the past century and continues to do so today. You need only look outside at the Cardiff Bay development to see the way the Welsh economy has changed.

When you take a flight, the aircraft may well have wings made in Wales. Your car might have a Welsh engine and be insured in Cardiff. And when you holiday in France your morning croissant has probably been baked in an oven made in Swansea.

What happens in Wales matters for the UK economy. That is why the Bank of England has a team who live and work in Wales. Last year our Agents – Adrian and Ian – drove 30,000 miles to talk face-to-face with you. The rugged scenery is, I suspect, less appealing to them as they wind their way – slowly – through the valleys and mountains. When you talk to them, you are speaking to the Monetary Policy Committee at only one remove before it sets interest rates.

On this occasion, I am not in Wales to enjoy the scenery. I am here to listen to your views at first hand. But tonight I want to explain.

Over the past year Bank Rate has risen four times to reach 5½%. A year ago, few expected that to happen – markets thought that by now Bank Rate would be only 4¾%.

Market expectations of where Bank Rate will be at the end of this year have risen from 5% in the middle of last year to 6% now. So what has happened over the past twelve months?

The right place to start is with inflation – that is, after all, the Bank of England's target. A year ago inflation was bang on the 2% target. The latest figure – for April – is 2.8%. In recent months inflation has been volatile, rising to above 3% in March, when I had to write an open letter to the Chancellor, and subsequently falling back. The number for May, to be published tomorrow, is awaited with interest. Many column inches have been devoted to these short-run movements. But, because it takes some time before changes in Bank Rate affect inflation, it is important that the Monetary Policy Committee look through this short-run volatility and try to understand where inflation might be heading in the medium term.

That poses a real challenge. None of us can foresee the future. To assess the likelihood of different possible outcomes for inflation, we examine all the available information – official statistics, business surveys, and reports from around the country, including those from our team in Wales. Then we make a judgement about the outlook for inflation.

That judgement cannot be made on the basis that just because certain developments seem to have forecast inflation in the past they will do so again. Such correlations are not stable over time. We have to try to discover the driving forces behind the mosaic comprising all the different pieces of information that we examine each month. To understand what is likely to happen in the economy, we have to behave like the child who cannot stop asking "why?" Why is output growing so steadily? Why did recorded employment fall last quarter? Why are money and credit rising so rapidly? Why have oil prices picked up? And each answer inevitably provokes another question "why?" So setting interest rates is not straightforward.

Our job, in fact, is rather like taking part in a "spot the ball" competition. Although the Western Mail and the South Wales Echo stopped running such competitions in 1992 – at the same moment that the inflation target was being introduced – I am sure many of you will remember that in those competitions the key piece of information, the location of the ball or, in our case, the outlook for inflation, is missing. You are shown the position of the players from which you have to deduce the position of the ball. That is no easy matter. To pinpoint the ball you need to ask: why is that player jumping? Or why is that player looking there? Only when you have identified the factors to which the players are responding can you try to spot the ball itself. And obviously in our case there is rather more than guesswork involved.

In essence, each month the Monetary Policy Committee is trying to identify the changes in the driving forces to which the economic data are responding. Those changes are described, somewhat obscurely by economists, as “shocks”. That is not to say they are necessarily sudden, violent upheavals. “Shocks” are forces that stop the economy running with clockwork regularity. They are the answer to the question “why?”

The Monetary Policy Committee is constantly engaged in an exercise of “spot the shock”. Without understanding why the economy is moving in the way that it is, we cannot gauge correctly where it might be going and hence set the right course for interest rates. There is no mechanical link between any piece of data and inflation – despite the impression often created by newspaper headlines. Policy cannot be set by a simple scorecard. There is no substitute for asking the question “why?”

One of the achievements of Alan Greenspan during his time as Chairman of the Federal Reserve Board was his recognition that when output growth picked up in the United States in the late 1990s it reflected an increase in supply capacity as productivity growth rose in the wake of the application of IT to business processes generally. This ‘supply shock’ meant that output could expand faster without generating inflation.

“Spotting the shock” is a perpetual challenge for us. The shocks we have identified are the reasons we raised Bank Rate four times over the past year. We spotted them by asking three questions, all beginning with ‘why’. So let me give you those questions and our answers.

The first question is why total output has grown steadily at an annualised rate of around 3% for 18 months – the longest run of stable output growth since 1997 and much stronger than most commentators anticipated, even though interest rates and the sterling exchange rate have risen. And why are business surveys even more upbeat? Notwithstanding a slowdown in the United States, the world economy, especially the euro area, our largest export market, has been surprisingly buoyant. World GDP growth over the past three years has averaged over 5% a year, the strongest such period since the late 1960s. And business investment has expanded at the fastest rate for almost a decade. These upside demand “shocks” have not – at least so far – been offset by a slowing in consumer spending.

Given past relationships, we might expect some upward pressure on inflation. But we should be cautious. Like the US in the late 1990s, we have experienced our own positive “supply shock” in the form of a significant wave of inward migration, especially from the accession states, of people looking for work. That has reduced the risk of a rising demand for labour leading to faster wage inflation.

But despite greater availability of labour, businesses have not over the past year expanded employment sufficiently to prevent stronger demand from increasing capacity pressures. The Bank’s Agents report that capacity utilisation is now at an unusually high level. These pressures encourage businesses to raise prices. And that is exactly what the business surveys suggest has been happening. A position in which growth is above its long-run average and businesses are already operating with pressures on capacity is unlikely to be one without inflationary risks. That is one reason why the Monetary Policy Committee has raised interest rates over the past year.

The second question is about money and credit. The quantities of broad money and bank lending are now around 14% higher than a year ago – rates of growth last seen in 1990 when inflation was more than 8%. But again, we should be cautious. If credit becomes cheaper and more widely available, thereby increasing the stock of money (a "money supply shock"), households and businesses will increase their spending on goods and services and on assets, both financial and real, and this will push up on inflation. But if they wish to hold more money in their portfolios – a "money demand shock" – then the extra money will have few, if any, implications for inflation.

So why have money and credit been growing so rapidly? Given the pace of their expansion, it is likely that there has been both a demand and a supply shock. The supply shock is that banks have become increasingly willing to provide finance. Credit has been readily available and the spread between interest rates paid by households and businesses and interest rates available in the money market has fallen. That is one factor behind the rapid growth of business investment spending over the past year.

In light of the greater availability of credit, any person or family that borrows at a variable rate should recognise that the interest rate they will pay in the future may vary. Obvious though the point may seem, it is unwise to borrow so much that the repayments are affordable only if interest rates remain at their initial levels. Indeed, wider and cheaper availability of credit was a 'shock' that boosted spending, and so was a further reason why the Monetary Policy Committee raised interest rates over the past year.

The third, and most important, question is about inflation. Why has it picked up so sharply over the past year? Are those changes temporary or more persistent? The recent rise in inflation to over 3% does look temporary. The pickup in the months leading up to March this year reflected in part a rise in domestic gas and electricity prices. And the fallback in inflation which has already begun, and which is likely to continue for several months, is in part the result of cuts in domestic gas and electricity prices which have already been announced.

Those shocks are relatively easy to identify. But it is much harder to know where inflation would have been without them. Sharp rises in the prices of energy and food have squeezed spending on other goods and services, putting downward pressure on those prices. That is why measures of ‘core inflation’ that strip out certain prices can be highly misleading. Even accounting for the temporary influences, more persistent inflationary pressures have picked up. Some of that stems from the shocks to demand and credit supply that I described earlier. And against that background, expectations of inflation over the next year, on which price and wage decisions are based, have drifted up. That is the third reason why the MPC has raised Bank Rate.

Those are the shocks we have spotted. A boost to supply from inward migration has not compensated for a positive shock to both domestic and overseas demand. And it would be optimistic in the extreme to suppose that the rapid growth of money and credit could be dismissed solely as a positive shock to the demand for money. So there has been some underlying upward pressure on inflation that is in part hidden by the volatility in domestic energy prices.

That is the past. What about the future? Our central view is that inflation will fall back this year as the rises in domestic gas and electricity prices last year drop out of the annual comparison and the recent cuts in prices feed through to household bills. Looking through those temporary effects, if inflation is then to remain around the 2% target businesses will need to expand employment to relieve pressures on their capacity. And they will need to do so with only a limited impact on pay. Average earnings seem so far to have been subdued, although the two main official measures of pay growth are sending conflicting signals and the Committee awaits an explanation of their divergence.

Faster employment growth and lower domestic energy bills will, by boosting real incomes, add to consumer spending. With continued robust growth of the world economy, the past rises in Bank Rate will need to slow domestic demand. And inflation expectations will need to fall back in line with the 2% target.

The Monetary Policy Committee will be watching closely indicators of capacity pressures, pricing intentions and inflation expectations. If these indicators remain elevated, the MPC may need to take further action. There is no simple or self-evident answer to the question of what path of interest rates will be necessary to bring inflation back to the 2% target and keep it there.

By now you must be asking your own “why?” question – why is he keeping us from such a splendid dinner? So I will not detain you. I have tried to explain this evening why interest rates have gone up. Each month we try to spot the shocks, evaluate their implications for inflation, and set interest rates to meet the 2% target. We do that to provide a backdrop of macroeconomic stability so that you can focus on the really important questions for your businesses. Why is that product selling better than this one? Why is my competitor changing his prices? And, most important, why did the Wallabies run the Welsh defence ragged in Brisbane, where Wales lost by almost as big a margin as England did to South Africa?

I don’t have the answers to those questions. But, of one thing I can assure you, in terms of the economy we will never stop asking “why?”

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