BANK OF ENGLAND

Speech

Speech given by
Mervyn King, Governor of the Bank of England

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Lord Mayor, Lady Mayoress, President, Distinguished Guests, Ladies and Gentlemen,

Two weeks ago your Chamber of Commerce called on the Bank of England to take manufacturing more seriously when it sets interest rates. In arguing against an interest rate rise, the Birmingham Chamber said, “we would urge the Bank of England to once again consider the effects this will have on the beleaguered manufacturing sector”. It will not have escaped your attention that Bank Rate did rise in January and has now increased by 75 basis points since the beginning of August. So tonight I want to explain why the Monetary Policy Committee took that action, and why the Bank believes that the control of inflation is essential for the success of Birmingham – and all British – manufacturing.

Last week we learnt that inflation, as measured by the Consumer Prices Index, was 3% in December, the highest level since the Monetary Policy Committee was set up almost ten years ago. If it rises by one further decimal point to 3.1%, I shall have to write an open letter to the Chancellor explaining why inflation has risen to more than one percentage point above the target of 2%, and what measures the Committee are taking to bring inflation back to target.

RPI inflation has risen to 4.4%, the highest rate since December 1991. And RPIX inflation – the target which governed our decisions until December 2003 – has risen to 3.8%, which would have triggered a letter under the old target.

In 1997, I suggested that “Given past experience of inflation volatility, it is likely, even allowing for the change in policy regime, that the MPC will have many opportunities to restore the lost art of letter writing to British life”. It is really very surprising that no opportunity has yet arisen. As I stressed back then, it is important to understand – and many commentators seem to misunderstand – that the inflation target is not a range of 1-3%, but a target of 2% at which the Monetary Policy Committee continually aims.

So an inflation rate of 3.1% is simply a trigger for a public explanation of why inflation has risen above target and what the Committee proposes to do about it. Letter writing is a key part of the accountability provisions of the monetary policy framework created in 1997, and I would welcome the chance to demonstrate how the process is meant to work. The opportunity to write to the Chancellor did not arise last week. But since we are so close to the level that would trigger a letter, let me instead write a letter to you.

Over the past year CPI inflation has risen by a percentage point, from around 2% to 3%. That was not the Committee's expectation a year ago when it believed the most likely outcome was for inflation to stay around 2%. And at that point many commentators were predicting cuts in interest rates in 2006. So what happened? Part of the story has been a further sharp rise in energy prices during 2006. But it is only a part. It is impossible to be sure what explains the rest of this unexpected drift up in inflation. But three factors seem to be relevant.

First, the historically low level of interest rates and rapid growth of money and credit have contributed to rising asset prices and buoyant nominal spending, not just in the UK but around the industrialised world. Spending and capacity pressures in the UK economy recovered from the slowdown in 2005 faster than many had expected.

Second, and a direct consequence of the first, is that inflation expectations have risen. Firms have been able to raise prices a little faster than before with the expectation that now those increases would stick. As the Birmingham Chamber's own recent quarterly survey showed – "over half of the City's manufacturers were intending to increase prices in the next three months". One of the reasons for the success of inflation targeting is the anchor which it gives to inflation expectations. But, when inflation moves away from target, we must prevent the anchor from dragging. Expectations need to be firmly fixed on the 2% target.

Third, increasing cost pressures have made it more difficult to sustain profit margins without raising prices. Energy and import prices are one source of higher costs. Another is the cost of employing labour which has been rising faster than the growth of real take-home pay. Higher pension costs for companies, on the one hand, and higher taxes, petrol and utility prices for employees, on the other, have opened up a gap between increases in the pay bill and real take-home pay. If investment and employment growth are to be maintained, the burden of these higher costs must either be passed back in the form of reduced input costs or forward as higher prices. So far, pay pressures have been subdued, but not sufficiently so to mitigate the rise in costs to employers. As a result, companies have scaled back their demand for labour and looked to raise prices.

The risks to money spending, inflation expectations and cost pressures were not overlooked by the MPC and were explicitly identified as upside risks to inflation both in speeches and in our monthly minutes back in 2005. In the event, the upside risks to inflation did materialise to some extent. And a year ago, the MPC thought the risks to GDP growth were on the downside. Yet, the total output of the UK, leaving to one side the energy sector, has been rising at an annual rate of over 3%. And over the past month some of the key spending and activity indicators have been strong.

The balance of risks to output growth and inflation has shifted towards the upside. As those risks began to materialise, the MPC acted.

The Committee started to raise interest rates to deal with the changing balance of risks last August, and has now raised rates by 75bp in total to keep inflation on track to hit the target. But, by responding early to changes in the inflation outlook, the MPC ultimately needs to raise interest rates by less than would be the case if we delayed.

Looking forward, some of the factors responsible for the pick up in inflation through 2006 are likely to unwind during 2007. Oil prices have fallen by around a third since August, and will feed through to petrol and utility prices. The rise in the exchange rate will dampen the impact of higher import prices.

It is also important not to exaggerate the effect of stronger demand on inflation. As we pointed out in our November *Inflation Report*, the ability to recruit migrant labour continues to offer a safety-valve for demand pressures in the economy, and is, no doubt, in some part responsible for the continued muted level of wage pressures. That is a particular help in present circumstances, and has reduced the extent to which interest rates have needed to rise.

But how quickly and by how much inflation will fall over the next year or so is difficult to judge. Falls in some important prices, such as petrol and utility charges, mean that people will have more disposable incomes to spend on other goods and services. That may encourage producers of those goods and services to raise prices. Equally, companies will be under less pressure to reduce other costs, affecting their response to upward pressures on earnings growth. The Committee will be monitoring carefully the outcomes month by month. All I can say is that the Committee's central view remains that inflation is likely to fall back in the second half of the year, possibly quite sharply.

As ever, there are risks around that central view – in both directions. Some of the biggest risks surround energy prices, supply factors such as migration, the level of asset prices, and the extent to which inflation expectations will prove to be a fixed or dragging anchor. Pay growth is also important. As I said earlier, if investment and employment growth are to be maintained, the burden of higher costs on employers must either be passed back in the form of lower input costs or forward as higher prices. All of us – whether on the shop floor, in the board room, or in the public sector – are coming to terms with the fact that those higher costs imply a temporary, but only a temporary, slowing in the growth of our real take-home pay. That adjustment – difficult but inevitable – will be helped by the fall in energy prices since last autumn. But the belief that we could avoid the adjustment by pushing up our pay would lead to a self-defeating process of higher wages offset by higher prices. It is the task of the MPC to ensure that the process of adjustment does not lead to a persistent rise in inflation.

Bank Rate was raised in order that inflation will come back to its 2% target, and future action will depend upon how those risks to the inflation outlook materialise.

The month by month path of interest rates required to bring inflation back to target is a matter of judgment. There is certainly room for reasonable people to disagree about the level or timing of changes in interest rates. There is no absolute truth here, and it is vital that the MPC keeps an open mind at all times.

That in essence is my letter to you and all the members of the Birmingham Chamber of Commerce.

Achieving the inflation target is, I believe, in the long-run interest of manufacturing no less than the rest of the economy. I recognise that the burden of changes in interest rates often falls disproportionately on manufacturers and other exporters as increases in interest rates push up the sterling exchange rate. And that comes on top of a secular decline – fifty years ago almost 40% of GDP was produced by the manufacturing sector. Today that share is around 14%. But the continued relative decline of manufacturing – and indeed the strength of sterling – over the past decade or so reflects, not the stance of monetary policy, but the remarkable wind of change that has blown across the world economy with the advent of China, India and much of the former Soviet Union into the world trading system. To their great credit, business people and politicians have not resisted changes to the structure of the British economy, unlike many of their counterparts abroad. As a result, total output and employment here have grown rapidly, and our living standards are higher than could have been sustained with policies aimed to defend the old industrial structure.

Those changes, however, have led to the closure of many manufacturing companies. There are over a million fewer people employed in manufacturing now than a decade ago, and 200,000 fewer in the West Midlands. It is just over a hundred years since car production started at Longbridge, just over thirty years since it was nationalised, and no vehicle has been built there for over a year. But there are also many success stories. Since I became Governor, I have made regular monthly visits to the regions and countries of the United Kingdom, and visited around one hundred companies, large and small, new and old. I have been impressed by how they have focussed on products in which they can add value and exploit their comparative advantage – whether a company in Northern Ireland exporting wall heaters to the newly rich of Shanghai and Beijing, a manufacturer in the North-West exploiting a patent for paint which is resistant to very high temperatures, or a company in the Potteries passionate about the plates they make for the hotel and restaurant trade. And if you want a digger, why look further than a JCB? Proof that vehicle assembly in the West Midlands can be successful.

All of them – as all of you – are working in a highly competitive environment. It is indeed much harder to run a business than to run a central bank. But seeing those companies at first hand has made me even more convinced that our duty is to ensure that you do not experience the macroeconomic instabilities of the past and that we keep inflation on track to meet our 2% target. Stability is in your interest just as much as mine.

Speeches on monetary policy rarely whet the appetite for a good meal, and I apologise for that before the splendid dinner your Chamber is about to serve. But tonight has been an opportunity to share our analysis of the economic situation with you. I hope you will understand the reasons behind our decisions to raise interest rates over recent months, even if it goes against the grain to support them.

Long before I became Governor I said that my ambition was for monetary policy to be boring. You may feel that the latest decision was far from boring. But while it is true that the precise timing was unexpected by analysts, the direction in which interest rates were heading was predictable in terms of the underlying economic data, and indeed was quite clearly predicted – financial markets were anticipating a 25 basis point rise at the February meeting. Looking behind the stunned surprise in the headlines, much of the reaction to our latest decision was that it was only too clear why rates needed to be raised. As one paper wrote last week, “while the timing of last week’s rate rise caught many commentators on the hop, the reasoning behind the move is not at all a surprise”.

So I have certainly not abandoned my ambition to be boring. The basis for our prosperity is business. And the excitement in the economy will, I hope, continue to come from your businesses, your new products and ventures. After all, the MPC is there to make inflation, and hence the economy as a whole, more stable. It’s up to you to steal the limelight and the headlines from us.