BANK OF ENGLAND

Speech

The Global Economy and UK Inflation

Speech given by

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The global economy and UK inflation

Good evening, Ladies and Gentlemen. I am delighted to have the opportunity to speak this evening at this event organised by the Leeds Financial Services Initiative. The financial services industry is a major contributor to economic activity and growth in the UK, accounting for nearly 10% of total GDP.[1] Leeds is one of the UK's major financial centres outside London, and financial and business services account for around 270,000 jobs in this City region.[2]

Because of the international nature of financial markets, the financial services industry is heavily influenced by global economic developments. Events over the past two months have provided a very clear reminder of that! These financial linkages to global markets are just one of the many ways in which broader international developments affect the UK economy.

Global economic developments – such as the recent turbulence in financial markets – also have an important bearing on the decisions of the Monetary Policy Committee (MPC). Our objective is to keep inflation low and stable, and as close as we can to the target level of 2% (as measured by the Consumer Price Index). In an open economy like the UK, global forces can cause inflation to fluctuate around its target level in the short term, and also inject volatility into the real economy. We have seen rising oil and commodity prices driven by strong global demand push up inflation in the UK and other major economies over the past couple of years. By contrast, the recent changes in global financial market conditions could weaken demand conditions in the UK and internationally – exerting downward pressure on inflation. These are all factors we need to take into account in our interest rate decisions.

Ultimately it is domestic monetary policy – not the state of the global economy – which will determine the UK inflation rate. The challenge for the MPC therefore is to adjust interest rates to ensure that global influences do not create prolonged and significant deviations in inflation from its target. It was the failure to do that in

[1] The financial services share of UK GDP was 9.4% in 2006, up from 5.3% in 2001.
[2] Source: Leeds Financial Services Initiative

response to the oil price shocks of the 1970s which resulted in high inflation in many countries in that decade.

The challenges which the world economy throws at monetary policymakers are many and various. Deciding the “appropriate” response to global developments has been a recurrent theme of discussions within the MPC throughout the past decade. And the past year – while I have been a member – has been no exception.

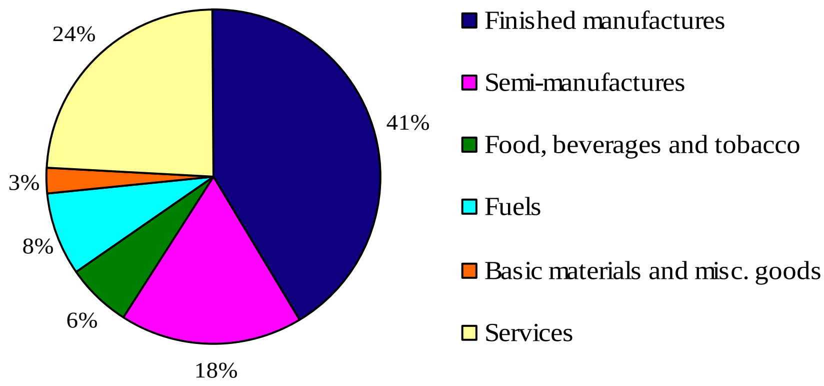
This evening, I want to discuss in more detail the influence of changes in the global economy on UK inflation and how monetary policy should respond to them. I will first talk about this in general terms, and then relate these general principles to the experience of the past decade. I will conclude by talking about some of the current UK monetary policy challenges posed by the changing global demand and inflation picture.

How the global economy affects UK inflation

There are a wide variety of ways in which global economic developments impact the UK economy and hence influence our rate of inflation. The whole process of globalisation has structural effects on the UK economy, including the impact of labour migration, which I do not plan to discuss in detail this evening.[3] Rather, in this speech I will focus on the main channels of influence from the global economy to UK inflation in the shorter term.

[3] See Bean (2006) and Blanchflower (2007) for more detailed analysis of these issues.

Chart 1: Composition of UK imports by value, 2006



Source: ONS

Note: Data adjusted for fraud.

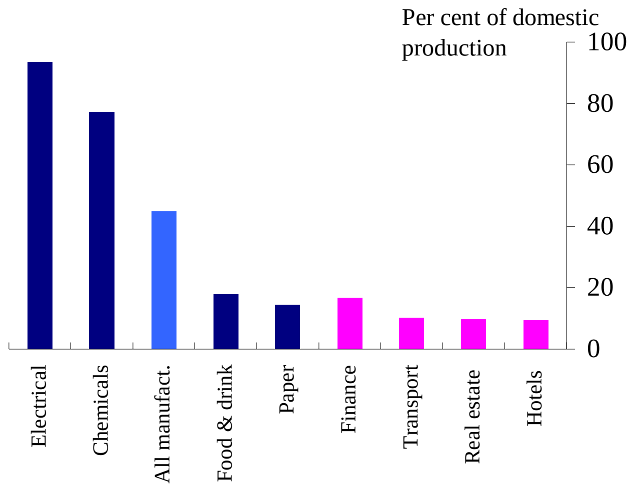
The first of these is the impact of the prices of imported goods and services. Directly and indirectly, imports account for around 30% of the value of goods and services sold by UK business at home and abroad.[4] As Chart 1 shows, finished and semi-manufactured goods account for the bulk of this import bill, and imported fuels and basic materials make up a relatively small proportion of the total – around 10%. However, the prices of imported manufactured goods will also reflect the raw materials and energy used in their manufacture, creating an additional indirect impact from commodity markets.

The second channel of influence from the global economy is via demand. Strong growth of demand – whether it originates at home or abroad – allows profit margins to expand and can put upward pressure on costs, particularly when the economy is operating close to its capacity limits. By the same token, weak demand exerts a dampening influence on cost and price increases. Influencing demand conditions through interest rates is one of the main ways through which the Monetary Policy Committee controls UK inflation.

[4] UK business is defined as the whole economy excluding public administration, defence, education, health and social work. In 2004, UK imports were 28.5% of final expenditure at factor cost on this basis. Given the significant rise in imports as a share of GDP since 2004, 30% is a reasonable estimate.

Global economic developments affect demand conditions in the UK both directly and indirectly. The direct influence comes through changes in the demand for UK exports of goods and services, which make up around a quarter of the output of UK businesses on average.[5]

Chart 2: Exports as a share of production



Source: ONS

Notes: figures calculated as five-year average 2000-2004.

As Chart 2 shows, the importance of overseas demand varies greatly between different sectors of the UK economy. Some manufacturing sectors sell a large proportion of their output overseas, and for manufacturing industry as a whole exports are around half the value of production. For most services sector activities, the figure is closer to 10%, though financial services is one of the most export-intensive services industries. We should therefore expect to see more sensitivity to fluctuations in the global economy in manufacturing and financial services than in other sectors.[6]

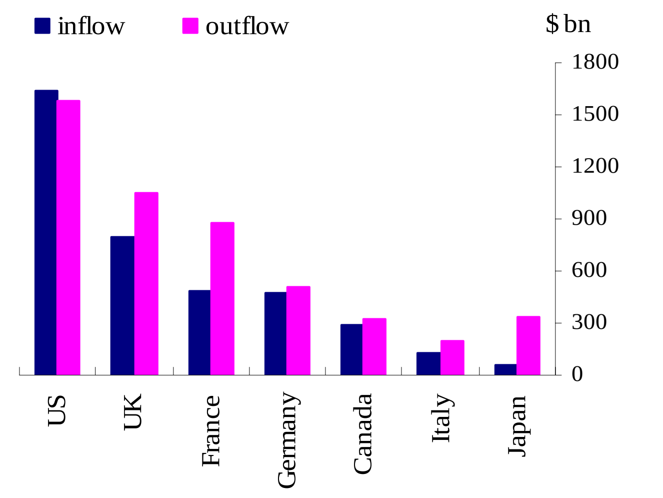
In addition to this export channel, there are also indirect financial linkages through which global economic conditions can influence UK demand. The UK business community is very international, reflecting our tradition as a trading nation and the openness of our financial markets to overseas investment. Chart 3 shows that, apart from the United States, we have been the largest major industrialised economy in

[5] For UK business (as defined above), exports of goods and services accounted for 24.3% of final demand in 2004.

[6] However, the impact of services exports on UK GDP will generally be greater than for manufactures (£ for £) due to their lower import content, which means their contribution to UK value added is higher.

terms of flows of inward and outward direct investment over the past decade.[7] Many UK businesses are part of larger international groupings, which is likely to reinforce the sensitivity of their investment and other business decisions to global demand and profitability.

Chart 3: G7 foreign direct investment, cumulative flows 1997-2006



Source: OECD

The globalisation of business activity we have seen in the 1990s and over the past decade has reinforced this pattern. UK-owned companies have expanded their overseas production facilities, often to take advantage of lower costs, while global corporations and other foreign-owned companies have sought to expand their presence here, often with a view to serving the wider European market from a UK location. I was intrigued to hear recently that four out of the top five fastest growing IT services suppliers in the UK were Indian companies.[8]

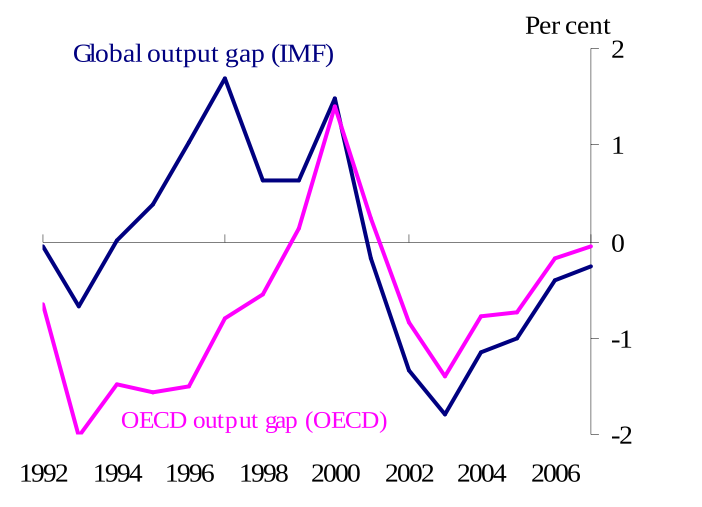
There are also linkages from the global economy to UK demand through financial markets. Because many UK financial institutions operate in global markets, the cost and availability of finance to UK customers is affected by global financial market conditions. UK financial markets can also be directly influenced by market

[7] OECD (2007)
[8] Source: UK software and IT services industry ratings, published by Ovum, September 2007. Information supplied by Intellect (IT trade association).

movements overseas, as we have seen recently. Assessing the impact of these changes in global financial market conditions is clearly a key issue now for the MPC. In addition to these cost and demand impacts, there is a third way in which global economic conditions might also affect UK inflation, which is through their impact on the pricing climate. As businesses become more specialised and international in focus, some economists have argued that global conditions have become increasingly important in affecting pricing behaviour, relative to domestic factors.[9]

According to this view, the global balance of demand and supply and competitive pressures on global markets may come to have a significant impact on prices in economies which are open to international trade, such as the UK. Excess global capacity represents a ready supply of traded goods which can readily enter the UK market, exerting a competitive discipline on price increases by UK businesses and holding down inflation. When global capacity is tight, this disciplining effect on price-setting will be much weaker.

Chart 4: Measures of global spare capacity



Source: OECD and IMF

Chart 4 shows measures of global spare capacity produced by the OECD and IMF. They show different trends in the 1990s, but over this decade there is a consistent picture. The reduction in spare capacity on global markets may account for some of

[9] See Borio and Filardo (2007) for an exposition of this hypothesis and evidence from developed countries, although Ihrig, Kamin, Lindner and Marquez (2007) have cast some doubt on the robustness of the empirical evidence.

the upward pressure on traded goods prices we have recently seen in the more international sectors of the UK economy, such as manufacturing. The impact is likely to be weaker in sectors which are less open to international trade, including many services activities.

The role of monetary policy

In a world in which global developments have an important bearing on UK inflation, how should monetary policy respond? One conclusion you might draw from my discussion so far is that UK inflation will be heavily influenced by global developments. And yet, despite the shifts we have seen in the global economy over the past decade, UK inflation has been low and remarkably stable. So what has been going on? One view is that we have been living in a lucky period, where global influences on inflation have been exceptionally benign. Another view is that the credit lies with the way in which monetary policy has responded to the shocks from the global economy, and the stabilising role it has played.

Chart 5: Monetary policy, the global economy and inflation

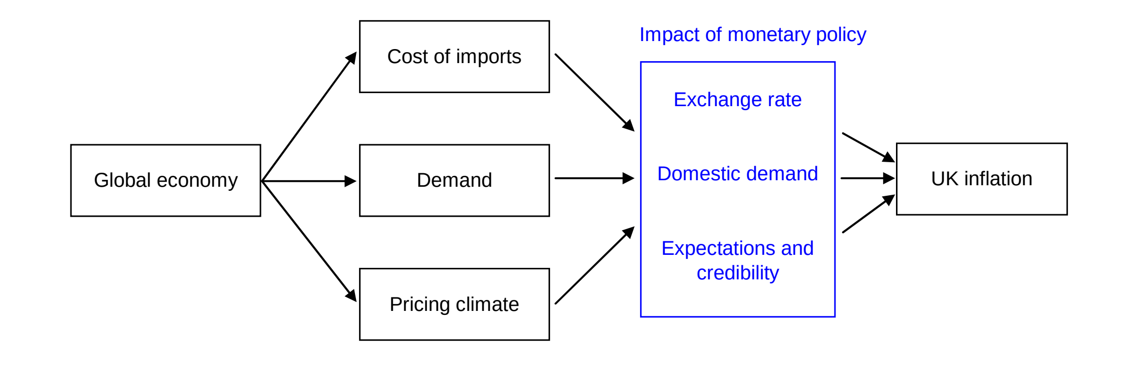


Chart 5 shows three main ways in which monetary policy can act as a stabilising influence on inflation when the UK economy is buffeted by global shocks. The first of these is the impact of interest rates on the exchange rate. The exchange rate is not directly controlled by monetary policy. But monetary policy has an important influence. The interest rate differential between different currencies – and the factors which are expected to influence it – affect currency markets through their impact on the potential returns to investors. If monetary policy is tightened relative to other countries, or is expected to be tightened, this will tend to push up the exchange rate in the near term.[10] Such a rise in the exchange rate should have a dampening impact on import price increases, and can therefore counter a rise in global inflationary pressures. It also influences how attractive overseas markets are to exporters and therefore has an additional impact via the state of demand.

The second way in which monetary policy can counter global economic forces is through its impact on domestic demand – spending by consumers and investment by the private sector, both of which are affected by interest rate changes. Consumer spending is the largest single component of demand in the UK, and accounts for about 60% of domestic spending. A tightening in policy – such as we have seen over the past year – should have a significant impact on the growth of consumption, and hence domestic demand.

However, it has been difficult to predict how consumers will respond to higher borrowing costs. The increased gearing of the household sector in the UK may well have heightened the sensitivity of consumer spending to changes in domestic interest rates in the longer term – though it may take longer for interest rate changes to feed through to households because of the increased prevalence of fixed rate mortgages. Judging how these factors are affecting the response of consumer spending to changes in interest rates and financial conditions is a key issue at present for the MPC.[11]

A third stabilising factor is the credibility of monetary policy and its impact on price expectations. If inflation expectations remain anchored at or close to the inflation target, disturbances to the inflation path should prove temporary, and it will be easier for monetary policy to ride out a temporary shift in inflation. But when inflation expectations are not well-anchored, it is much easier for an external shock to set off an inflationary wage-price spiral, as we experienced in the 1970s and early 1980s. The task of the MPC is now made easier by the experience of a decade and a half of low and stable inflation which has helped to anchor UK inflation expectations.

[10] According to economic theory, this appreciation occurs because a future depreciation is then expected to compensate for the interest rate differential.
[11] See Besley (2007) for a fuller discussion.

The practice of monetary policy continually involves judgements about how to react to shocks to UK demand and inflation arising from the global economy. It is clearly not practical for policy-makers to try and offset every shock. We do not have the information to do it perfectly, and the lags and uncertainties in the operation of monetary policy mean that we could inject unwanted volatility into the economy in the attempt to do so.

However, if the MPC is to be true to our mandate, we should be trying to avoid large and persistent deviations in inflation from our target arising from shifts in the global economy. On the upside, there is the risk that a temporary rise in inflation becomes embedded in expectations, and begins to affect companies' pricing behaviour and the level of wage settlements. We have learnt from past experience that unwinding such a rise in expectations can be very costly - in the early 1980s and early 1990s it led to two damaging recessions.

On the downside, there is an outside risk that very sharp falls in global prices could tip the economy into deflation, which was a concern for some MPC members earlier this decade.[12] More likely, however, is the situation where downward global price pressures are associated with weak demand in international markets. In these circumstances, the MPC's mandate allows us to offset this by allowing domestic demand to grow more rapidly, which helps to stabilise the real economy, as long as this does not compromise our ability to meet the inflation target.

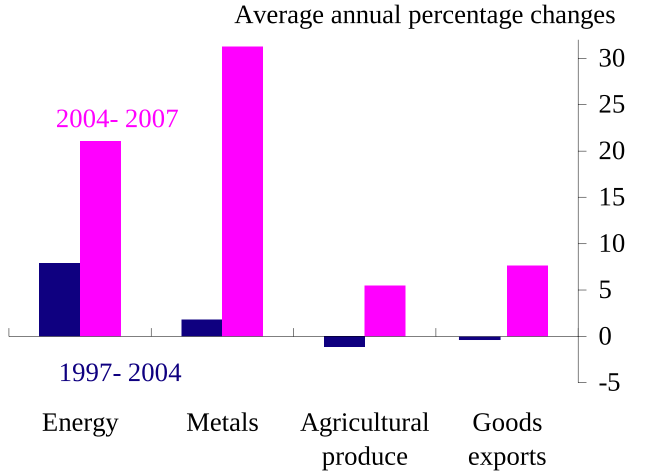
The most difficult situation for policy-makers is where an upward shift to prices and costs is associated with weak demand. This could occur if rising prices reflect a change in supply conditions, rather than strong demand. Then, trying to stabilise the real economy by increasing demand could add to inflationary pressures and compromise the inflation target. This appeared to be the policy dilemma in the wake of the two oil price shocks of the 1970s, though the difficulties then were compounded by high inflation expectations and labour market inflexibility.[13] This experience highlights the importance of ensuring that inflation expectations do remain well anchored when there are upward price shocks from the global economy.

[12] Julius (2000) and Wadhwani (2001)
[13] See Walton (2006) for an analysis.

The global economy since 1997

Earlier in this speech, I highlighted import costs, demand and the pricing climate as the three main ways in which global factors are likely to impact UK inflation and influence monetary policy in the short term. Looking back over the past decade, while the MPC has been in charge of monetary policy, there have been two distinct periods in terms of the way these pressures have impacted the UK economy.

Chart 6: Global price trends, 1997 – 2007



Source: Datastream, Goldman Sachs, IMF

Notes: figures calculated in US dollars; goods exports inflation shown for the periods 1997-2003 and 2003-2006, based on annual data.

In terms of both price and demand pressures, the period 1997 to 2003 was a very different environment to the period since 2004. Chart 6 shows this in terms of measures of global prices. Until the beginning of 2004, energy and commodity prices were either falling or rising very slowly and goods export prices were on average flat. For some manufactured goods, prices fell very sharply, as production shifted to lower cost locations, particularly China. These trends contributed to the disinflationary global pricing environment which provided the backdrop to MPC discussions in the late 1990s and early 2000s.

Since 2004, the global environment has been much more inflationary. Goods export prices have risen on average by over 7% per annum in dollar terms (though by less in sterling), and energy and commodity price inflation has been around 20-30% a year. This has created a very different import cost environment for economies like the UK in recent years, compared to the period in the late 1990s and early 2000s, as Chart 7 shows. The prices of imported goods have risen significantly over the past two years, compared with the earlier experience of falling imported goods prices (with the exception of the year 2000). The strong deflation in manufactured import prices in the late 1990s has been replaced by rising prices.

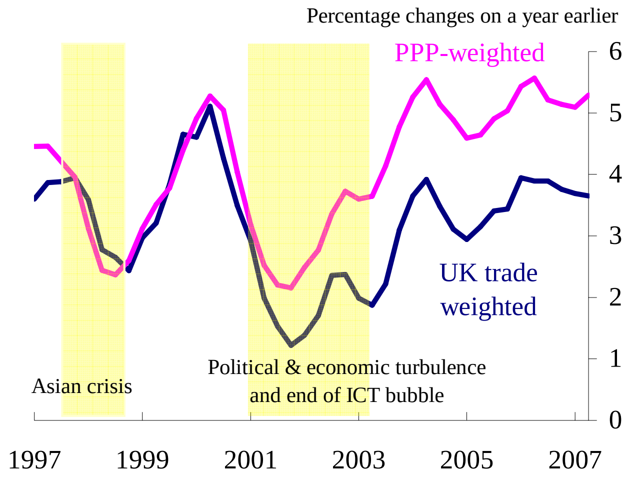
Chart 7: UK goods import price inflation

Source: ONS

Notes: Excludes estimated impact of fraud

This change in global inflationary pressures has been accompanied by – and is closely linked to – changes in the strength of demand across the global economy. The early years of the MPC were dominated by the Asian crisis and its aftermath. Then after a couple of strong years of global growth in 1999 and 2000 came the bursting of the "dot-com" bubble, and associated sharp falls in equity markets. Global growth and business confidence was also affected by the political events between mid-2001 and mid-2003: the 9/11 attacks; war in Afghanistan and Iraq; and the general background of concern about global terrorism.

Chart 8: World GDP growth

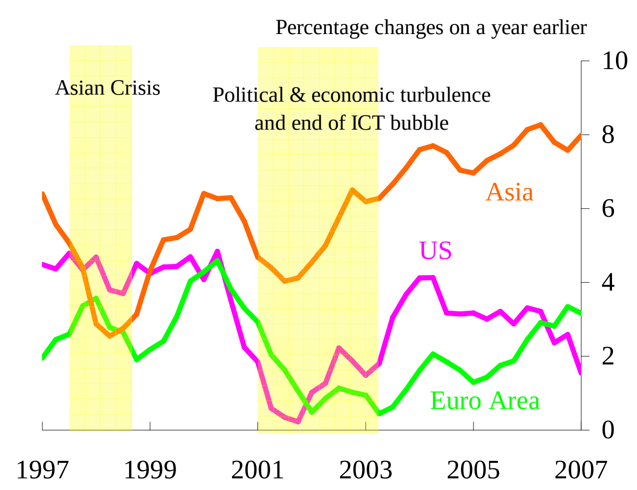


Source: Datastream, Bank calculations

However, as Chart 8 shows, since the second half of 2003, the global economy has been in a very strong growth phase. Based on the current forecast from the IMF, 2004 to 2007 will be the strongest four-year period of world growth since the late 1960s and early 1970s. On a UK trade-weighted basis, global growth is not quite as strong, reflecting the UK's greater exposure to slower-growing European markets and the lower weighting of dynamic Asian markets. However, the dynamism of the global economy may have boosted UK demand conditions in other ways – for example through its impact on business investment, which has recently recovered strongly.

What is providing the momentum for this period of strong global growth? Three factors have, I believe, played a part. The first is the relaxation of monetary policy in the world's major economies in response to the weakness of demand in the early years of this decade. This loosening of policy was most striking in the United States, where interest rates fell to 1% and did not start to rise again until the summer of 2004. It is not surprising therefore that strong growth in the US was a feature of the early years of this period of global expansion, as Chart 9 shows. More recently, however, the US economy has slowed as the monetary stimulus was withdrawn through interest rate rises from mid 2004 to mid 2006. However, so far, strong growth in other regions of the international economy has offset the impact of this US slowdown, and global demand conditions more generally have remained buoyant.

Chart 9: Regional world GDP growth



Source: Datastream, Bank calculations

One reason for this is that global growth is also being supported by structural changes in the world economy. In particular, growth in Asia is being powered ahead by the shift of production to lower cost economies, including China and India, with abundant labour supply. The strength of demand in Asia has played an important part in generating recent price pressures in energy and commodity markets. This provides a reminder that globalisation is not a one-way street when it comes to inflation, and there is a flip side to the "China tailwind" of downward pressure on manufactured goods prices.[14] As well as putting upward pressure on energy and commodity prices, strong growth in Asia has also created capacity pressures in some sectors of manufacturing where previously there was excess capacity, changing the global pricing climate.

The third element supporting global growth in recent years has been a liberalised financial system, which has provided access to relatively easy credit and channelled finance from surplus countries such as China and energy producers in the Middle East into investments in the US and Europe.[15] This has prevented the negative demand impacts we saw in the 1970s, when barriers to capital movements created difficulty in "recycling" oil revenues. However, it may be that this time round credit and finance have been too readily available for some risky investments as lending and borrowing

[14] See King (2006) for a more detailed discussion.
[15] See Sentance (2007) for a discussion of the implications of global financial imbalances more generally.

have been sustained by relatively easy credit and the expectation of rising asset values.

In this respect, the financial market background to the global economy may now be changing. Over the summer, markets have begun to re-assess the risks in the wake of the fall-out from US sub-prime mortgages, and this has created difficulties in interbank markets and financial turbulence. It remains to be seen how significant the resulting changes in the financial climate will be. The MPC is monitoring the situation in credit markets closely and will be assessing carefully the consequences for the real economy, in the UK and overseas markets.

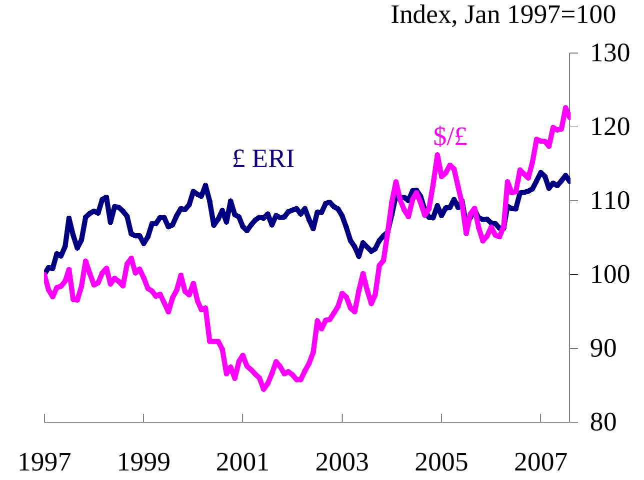
Monetary policy implications

As I mentioned earlier, we should not be surprised to see short-term fluctuations in inflation driven by changes in the global economy. Indeed, in the face of the global volatility we have seen over the past decade, it is perhaps surprising that it took nearly ten years of operation of the MPC before the Governor had to write his now famous letter to the Chancellor to explain why inflation had moved more than one percentage point away from the target. Interestingly, in that letter, the Governor highlighted the Bank’s forecast that inflation would come back to target later this year, which is exactly what has happened.

The key to ensuring that inflation stays on target lies not with the state of the world economy, but in ensuring that the monetary policy response to external events is appropriate. In the era of global disinflation and weak global demand in the early years of this decade, the MPC was able to loosen policy to support domestic demand and counter the negative impact on inflation from the global economy. Interest rates fell to 3.5% in the UK as a result and were reduced even further in the US and in the Eurozone. This relaxation in UK monetary policy should not have put the inflation target at risk as long as policy was tightened appropriately when economic conditions improved and if inflationary pressures picked up.

Over the past few years, there has been a need to reverse this relaxation of policy to offset a recovery in demand at home and abroad, associated with increasing price pressures from energy, commodities and other traded goods. In the UK, this policy tightening has taken place in two phases – in 2003/4 and over the past year. As I noted earlier, tighter policy should help stabilise inflation through its impact on the exchange rate, on domestic demand and by anchoring price expectations.

Chart 10: Movements in UK exchange rates since January 1997



Source: Bank of England

The exchange rate has certainly helped to moderate the inflationary impact of robust global demand and rising commodity prices. As Chart 10 shows, the sterling effective exchange rate has been strong relative to its trading range in the MPC era, and there has been a marked appreciation of the pound against the dollar. The sustained appreciation of the pound against the dollar since the early 2000s has helped to moderate the rise in sterling import prices we have faced in the UK.[16]

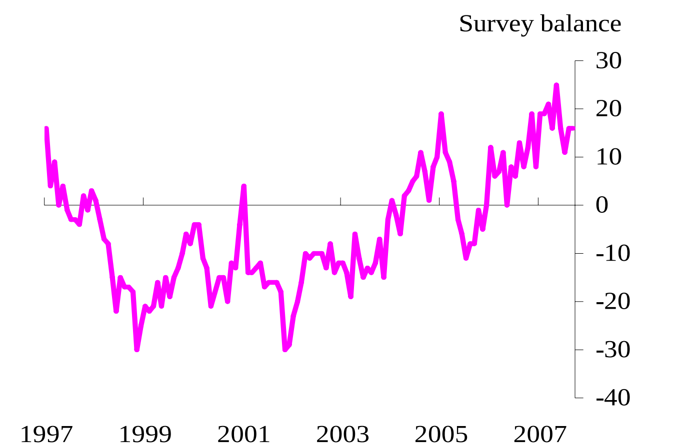
Over the summer, there have also been some signs that the recent tightening in policy is beginning to slow the rate of growth of domestic demand – particularly consumer spending – though these indications are still tentative. In the Bank's latest Inflation Report, we projected that the annual rate of UK GDP growth would slow by about one percentage point as a result of weaker consumption and a moderation in investment. That moderation in demand underpinned our view that CPI inflation would stabilise at around 2% in the medium term. We will be updating that

[16] Commodity and other traded goods price indices in sterling have increased by around 3% per annum less than the dollar equivalents since the start of 2004.

assessment in November, when we will be better able to take account of the recent financial turbulence, which will clearly have some impact on the balance of risks for growth and inflation.

The fall-back in CPI inflation in the past few months is also a welcome development – though the recent surge in the oil price is a reminder that global inflationary pressures are still a potential threat. Earlier this year, I was concerned that a prolonged period of above target inflation would result in a broader upward shift in inflation expectations. So far, the evidence on the wage front has been reassuring on this point. And some of the business survey evidence which was causing concern about pricing expectations, such as the CBI manufacturing survey shown in Chart 11, have moderated somewhat. The MPC's actions in raising interest rates over the past year should have reinforced the view that demand conditions would not support a sustained rise in inflation above the 2% target – helping to moderate price expectations in the business community.

Chart 11: Manufacturers' price expectations



Source: CBI Monthly Trends Enquiry

Note: Expectations refer to average prices for domestic orders over the next 3 months.

As a Committee, we now face a new challenge – of assessing the impact of financial market developments over the summer and deciding how they should affect our monetary policy judgements over the remainder of this year and into 2008. I am not going to pre-judge that issue this evening. As the public statement from the MPC earlier this month made clear, we need to assess the impact on the real economy and inflation before coming to any judgements on monetary policy. So far the full implications are far from clear. To inform our judgements we will be monitoring closely any changes in the cost and availability of credit to businesses and households alongside all the other data relevant to the outlook for inflation.

Over the past decade, the strength of demand from the world economy and the impact of global inflationary pressures have both had an important bearing on UK monetary policy. They have certainly been important factors over my first year on the MPC and I would expect this to continue to be the case in the future. Looking ahead, a key issue will be how far recent financial market developments affect the current momentum of global demand. Evidence on that issue will be an important influence on my policy judgements as a member of the MPC in the months ahead.

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