



BANK OF ENGLAND

Speech

Monetary Policy: Sticking to the Basics

Speech given by

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Good evening, ladies and gentlemen. I am delighted to have this opportunity to talk to you this evening at this very impressive Gala Dinner hosted by the Leicester Chamber of Commerce. It is always a great pleasure for me to visit this region where I have strong family connections.

Looking back at the history of Leicester and its development as England's tenth largest city, I am struck by the resilience of the local economy in the face of major economic changes. The bulk of the textile and clothing industries which once underpinned this city's wealth have now departed these shores for Asia and other low-cost locations. But despite the decline of these traditional industries, Leicester retains a strong manufacturing base and a diverse range of service industries also help to underpin employment and local economic activity.

The resilience and strength of this city's economy will hopefully serve you in good stead as the UK economy is buffeted by the current round of economic shocks. When I was appointed to the Monetary Policy Committee (MPC), two years ago, a former Treasury civil servant wished me well in my new role. "You should have a relaxing time on the MPC", he said. "They don't do much these days – interest rates hardly ever change."

Well he could not have been more wrong! These are definitely not relaxing times to be involved with monetary policy. And for most of the time I have been on the Committee, changes in interest rates have been under active consideration. The Bank Rate has changed seven times in the last two years and at all but three of the twenty-four MPC meetings I have attended there has been at least one vote for a change.

In all walks of life, we have to be prepared for unforeseen and unusual shocks. When Harold Macmillan was asked about the biggest challenge in politics, he famously quipped "Events, dear boy, events". You will also know from your own business experience that "events" - sudden shifts in market conditions or unforeseen changes in costs - can throw the best-laid plans off course.

Since last summer, the key issue in front of the Committee has been how to deal with the combined impact of two big global economic events – financial market turbulence and rising energy and food prices. Indeed, we have seen further developments on both fronts

over the last two weeks, with renewed concerns about bad debts in the banking system and a further bout of volatility in the oil market.

While it is too early to fully assess the implications of this latest round of market volatility, this evening I want to discuss how the global shocks we have experienced since last summer are affecting the outlook for the UK economy and the MPC's task of keeping the economy on a low inflation course.

The UK economic outlook

Over the course of this year, the economic situation in the UK has deteriorated markedly. After sixteen years of rising economic activity, growth appears to have stalled and some sectors of the economy are seeing declines in demand and output. At the same time, inflation has also risen sharply – to 4.7% on the CPI measure used by the Monetary Policy Committee – more than double the 2% target that the Committee is meant to achieve. Both the economic slowdown and the pick-up in inflation are the most significant we have seen in the UK since the early 1990s.

Rising food and energy prices have contributed significantly to both these developments. As the Governor pointed out in his open letter last week, 80% of the rise in inflation since last December is directly attributable to food, petrol and domestic energy bills. These factors have also contributed indirectly to rising inflation through their impact on business costs more generally. At the same time, as households have faced rising bills, their incomes have been squeezed in real terms. Inflation is now outpacing the growth of wages, which are rising by less than 4%.¹ As a result, households have trimmed their spending, with retail sales and other indicators of consumer activity pointing to a sharp slowdown

Adding to this real income squeeze is the impact of the “credit crunch” and the associated financial market turbulence. The impact of this can be seen most noticeably in the housing market, where the major lenders report price falls of over 10% in the last year.² The drop

¹ Increase in whole economy average earnings (including bonuses) was 3.7% in the year to July 2008.

² According to the Halifax, the decline in the year to August was 12.8%, while the Nationwide measure shows a 10.5% decline.

in housing market activity has been even more dramatic. In August, loan approvals for house purchase were 70% down on a year before. There has been a significant knock-on impact on housing construction with the major builders putting new housing development on hold and laying off workers.

More generally, the turbulence in financial markets is clearly having a negative impact on both business and consumer confidence. In the current climate of uncertainty, businesses are more likely to defer major investment projects and consumers are putting off major items of expenditure. We have seen this reflected in a downturn in car sales and falling retail spending on household durable goods.

Until recently, manufacturing industry appeared to be holding up better than other sectors of the economy, with export demand and a more competitive pound helping to offset the impact of weaker domestic orders. But even here the latest indicators have been quite negative. The September CBI survey published last week showed a sharp decline in order books and the weakest outlook for production since 2001. For producers of consumer goods, output expectations were the weakest seen since 1991.

All this evidence suggests that the economy could start to contract in the second half of this year or early in 2009, giving us one or more quarters of negative growth over this period. Economic forecasters and commentators are increasingly highlighting the risk of recession – at least on the technical definition of two consecutive quarters of declining GDP used by many economists. But the current prospect for the UK economy is very different to the major recessions we have previously seen in the mid-1970s, early-1980s and early-1990s. In these episodes, economic activity fell sharply for one to two years. In my view, the current outlook is for a much milder period of weak economic activity on this occasion.

The Bank's August *Inflation Report* – which still remains a reasonable assessment of the outlook in my view – suggested that the most likely scenario was broadly flat output over the next year with GDP showing small increases or small declines in the second half of this year and the first half of next. In the second half of next year we should see a gradual recovery, as the spike in inflation would be behind us and the growth of real incomes should resume, stimulating consumer spending. The main impact of the “credit crunch” should also be fading by the second half of next year, creating a more positive backdrop for

business and consumer confidence. However, the recent market turbulence highlights the possibility of further shocks from financial markets and commodity price movements. So there is a particularly large range of uncertainty around forecasts for the economy at present.

Given the sharp rise in inflation so far this year, a key risk around the outlook for the economy remains the possibility that the short-term rise in inflation becomes more persistent, either because imported inflation has a more sustained impact or because wage settlements pick up in response to higher headline inflation. On the other hand, there is also the risk that we face further financial market shocks or consumers and firms respond more aggressively in cutting back their spending. In that scenario, there would be a more pronounced downturn and inflation could undershoot the 2% target.

Implications for monetary policy

Over the last year or so, as this pair of global shocks has unfolded, the Monetary Policy Committee has been grappling with the issue of setting interest rates in response to this most unusual and unprecedented situation. Interest rates have already been reduced from 5.75% to 5% since last autumn. As we move into this autumn, the key question is whether further adjustments to monetary policy will be necessary in response to the changing economic situation. It is widely recognised that the MPC faces a difficult balancing act, allowing the economy to slow sufficiently to counter upside inflationary risks, but not allowing the economic slowdown to develop into a deflationary spiral which would not be consistent with our mandate to meet the 2% inflation target.

Though this is a challenging task, there is one important fact that should give the Committee some encouragement. For the preceding eleven years, the monetary policy framework under which we are operating did help to deliver a remarkable period of low and stable inflation accompanied by sustained economic growth and a high level of employment.

The favourable global inflation backdrop of the late 1990s and early 2000s played a part in delivering this period of low inflation and sustained growth. But the MPC also had to deal with its fair share of shocks from the global economy over that period too. The late 1990s

saw the Asian crisis, the Russian financial crisis and the collapse of Long Term Credit Management. In the early 2000s, the bursting of the “dotcom bubble” was followed by the events of 9/11, as well as war in Afghanistan and Iraq. The Committee also successfully contained the inflationary impact of the initial wave of rising oil and commodity prices from 2004 to 2006.

In my view, our best chance of navigating the UK economy through the current period of turbulence is to stick to the basic fundamentals which have underpinned the successful operation of monetary policy over the last eleven years. In doing this, I would highlight four key elements: first, keeping our focus on the objective of price stability and the achievement of a low and stable rate of inflation; second, continuing the tradition of independence, open-ness and accountability which underpins the processes of the MPC; third, basing our decisions on an understanding of how the real economy of business and households is operating; and fourth, ensuring that we have a forward-looking perspective, focussed on the medium term.

Let me say a few words on each of these points.

Price stability and the inflation target

First of all, we need to keep our focus on price stability as the prime objective of monetary policy. The performance of the British economy suffered greatly in the 1970s, and in the late 1980s and early 1990s, from a failure to maintain price stability. The length and depth of the recessions in this period were greatly aggravated by the need to get on top of a deeply embedded inflation problem. We discovered then that allowing inflation to creep up simply makes the economic adjustment which is ultimately necessary even more painful. And in an economy in which prices are continuing to rise rapidly, investment decisions and price signals more generally are distorted – making it very difficult for business to plan for the longer-term.

By contrast, price stability enables the market economy to function efficiently and underpins economic prosperity more generally. Firms and individuals can plan ahead and make sound investment decisions, creating a much better climate for economic growth and job creation.

The current remit for the Monetary Policy Committee mandates us to target price stability, defined as 2% inflation measured by the Consumer Price Index. This might be thought of as inflation that is so low that it is not noticeable. We are clearly not in that world at present – the rises in food and energy prices which have pushed up inflation to 4.7% have been very noticeable. But as the Governor emphasised in last week’s open letter, the MPC remains determined to bring inflation back to the 2% target, as our mandate requires us to do.

There are two concerns that I hear frequently expressed in the media and elsewhere about the focus on price stability which I believe are misplaced. The first is that the MPC might react too aggressively to short-term inflationary pressures and cause more economic volatility by behaving as “inflation nutters”. In fact, that would be contrary to our remit. As Alistair Darling’s letter to Mervyn King in March, confirming our mandate states:

“The framework takes into account that any economy at some point can suffer from external events or temporary difficulties, often beyond its control. The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output.”

The MPC has to be pragmatic about the speed with which we can bring inflation back to target. When inflation is pushed up or down sharply by external pressures – as it has been recently – there may be little that we can do in the short-term to counter this price volatility. The challenge in the current circumstances is to ensure that high inflation does not become embedded in wage and price setting, through its impact on people’s expectations. As long as such a wage-price spiral is avoided, inflation should settle back to target over the medium term.

The second concern that is sometimes expressed about the inflation target framework is the view that it means that the MPC does not give enough weight to the growth of employment and output. In my view, this is totally wrong. We are mandated to achieve price stability precisely because it does provide the best climate for employment and growth in the longer term. And our experience since the mid-1990s has born this out. In its short term monitoring of the economy and through the *Inflation Report*, the MPC pays a great deal of

attention to the growth of demand, output and employment. We do this because the demand side of the economy – and the pressure it puts on capacity and labour markets – is a key driver of inflationary pressures. To control inflation, we need to know if there is too much money chasing too few goods or vice versa!

In my view, the emphasis on price stability allows us to put short-term economic developments in their proper context. The mistake of the 1960s and 1970s was to try to use economic policy to sort out short-term disturbances to the economy – irrespective of what was driving them. That resulted in many policy mistakes. By focussing on price stability, the MPC should allow the economy to adjust to external shocks when necessary while allowing the economy to follow a sustainable growth path over the medium-term.

Independence, open-ness and accountability

The second element of my basics agenda is that we should build on and reinforce the traditions of independence, open-ness and accountability which have been hallmarks of the MPC. There are two reasons why I think this is very important.

The first reason is that in the “bad old days”, when inflation was allowed to get out of control, there were very inadequate processes for setting monetary policy. In the 1960s and for much of the 1970s, there was widespread scepticism about whether monetary policy could do much to control inflation at all. In those days, incomes policy was the main instrument of inflation control – and was clearly found wanting. Even when monetary policy came to the fore as the main instrument of inflation control in the late 1970s and 1980s, it was often difficult to identify why interest rate decisions had been arrived at and there were frequent shifts in the framework and targets used to guide monetary policy. There was sometimes the suspicion that political, rather than purely economic, considerations were influencing policy. Or that monetary policy had been overtaken by other priorities.

Now, the processes for setting monetary policy are much more transparent and subject to public scrutiny. Monetary Policy Committee meetings are fixed in advance – in the early part of every month, even when the rest of the nation is on holiday, in August and January! Our minutes are available to the public less than two weeks after our decision so that the

public can see the arguments underpinning the decision and the votes of individual members. The members of the Committee are free to explain publicly and openly their thinking, as I am doing this evening. And not only is the whole process more open, but it has become more business-like. Coming from a business background, I have been impressed by the way the MPC goes about its important task and the quality of the input from the Bank staff.

The second reason for focussing on the open-ness, transparency and independence of the MPC at present is that these will help underpin confidence that we can and will bring inflation back to target. For the first eleven years of the MPC, that confidence and credibility was heavily reinforced by the fact that inflation only once strayed more than one percentage point from target. In the current climate, we cannot point to the present experience of inflation to maintain that confidence and credibility. To maintain confidence in low inflation, we are therefore now more reliant on the ability of the public and the business community to see that the processes are still working in the way they should.

It's the economy, stupid!

The third way in which monetary policy needs to “stick to the basics” is by making our decisions based on a detailed and fully up-to-date understanding of how the real economy is operating. In the famous words of Bill Clinton from the 1992 US Presidential election – “It’s the economy, stupid!”

The media headlines and the economic commentary inevitably focus on a subset of economic activity. They focus on what is moving most dramatically, rather than what is most important. So, after a week in which it appeared that the financial markets went to hell and back, it is important to keep in mind that total financial services employment in the UK is around 1 million out of a total of nearly 32 million workforce jobs – about 3% of total employment.³ The impact of financial market developments on the other 97% is the main issue that we need to worry about in terms of the performance of the economy.

³ According to the British Bankers Association, employment in financial services is 1.1 million of whom close to half a million work in the banking industry. ONS estimate there were 31.68 million workforce jobs in the UK in June 2008.

While I do not want to underplay the importance of financial market developments, it is important that monetary policy does not over-react to developments on volatile markets. Our judgements on monetary policy must take into account a broader assessment of how financial and commodity market developments will ultimately affect the decisions of real businesses and consumers in all sectors of the UK economy – and hence our rate of inflation.

The MPC has very well-developed processes for analysing and understanding the impact of its decisions on the real economy. The Bank Agents keep in contact with a network of around 8,000 businesses and MPC members undertake regular visits throughout the country which is what has brought me to Leicester today. Alongside the official statistics, the MPC pays attention to a vast array of surveys from business organisations. As someone who has worked with and developed business surveys throughout my career, I put particular emphasis on these sources of information. They can be more immediate barometers of economic conditions than the official data which come out with a delay and are frequently revised.

A medium-term perspective

My final “sticking to the basics” principle is that monetary policy must have a medium-term and forward-looking perspective. That is because we know that the processes through which interest rate changes affect the economy can take up to two years to have their full impact on inflation. In addition, short-term volatility affects all economic indicators – including our CPI measure of inflation itself. We need to focus on the underlying factors and look through the short-term volatility. Monetary policy is a long-term business. Our objective is to sustain price stability over a prolonged period of time and a temporary deviation in inflation – which is what I believe we are seeing at present – should not be used as evidence of policy failure.

A key element of the MPC’s medium-term and forward-looking approach to setting monetary policy is the quarterly *Inflation Report*. This contains our assessment of the future outlook for inflation and the growth of the economy. Those of you who are avid readers of our reports will know the famous fan charts through which we communicate our views. These show the MPC’s collective assessment of the range of uncertainties affecting

the future outlook. The process of developing the forecasts and agreeing the content of the *Inflation Report* plays a key role in the way the MPC discusses economic issues and comes to its policy decision. So even if you might not have been an avid reader of the report in the past, you might find it useful to peruse in the future!

Sticking to the basics

The Monetary Policy Committee has been setting interest rates for over eleven years with the objective of maintaining price stability and keeping inflation close to the target level. Over that period we have become accustomed to a world of low inflation and sustained growth.

But recent events have reminded us we cannot take that for granted. We have seen that shocks to global prices can push inflation significantly away from target. And the same shocks, amplified by financial market turbulence, have halted the growth of the economy and there is a significant risk that output and activity may begin to contract for a while.

The going has clearly got tougher for monetary policy in the UK and around the world, and this has led to some suggestions that we may need to adapt the framework for monetary policy or modify the inflation target in some way. In my view this would be a big mistake. It would not change the fundamental economic dilemma we face and would risk making things worse by undermining the hard-won credibility that has been built up around our current framework.

Rather, this is a time when we need to stick to the basics of monetary policy – targeting price stability, using the well-established processes of the MPC, focussing on the real economy and taking a medium-term, forward-looking perspective. Having established a monetary policy framework which works better than anything I have experienced in my working life, we need to use its key elements to help restore economic stability.

As I have emphasised, an important element of this approach to monetary policy is basing decisions on the impact they have or can be expected to have in the real world. As an economist who has spent the bulk of his working life in and around the business community, that will be a key focus for my actions as a member of the MPC. I can assure

you that in the months ahead I will be aiming to keep in close touch with business conditions on the ground throughout the country, to ensure my judgements on interest rates are informed by the most accurate and up-to-date assessment of the condition of the real economy.