

Speech by

**ANDREW SENTANCE**  
**MEMBER OF THE MONETARY POLICY COMMITTEE**  
**BANK OF ENGLAND**

**UK Monetary Policy – How long should  
“The song remain the same”?**

Thames Valley Chamber of Commerce Group, Reading  
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I would like to thank Michael Hume, Tomasz Wieladek and Abi Hughes for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

It is a great pleasure to be speaking to a business audience here in Reading, in the heart of the Thames Valley. This is an extremely successful economic region – with the highest GDP per head in the United Kingdom outside central London and the 14th most prosperous region in the whole of the European Union.<sup>1</sup> This track record of economic success reflects a concentration of high-tech and knowledge-based industries, particularly in the information and communications technologies sector. The Thames Valley economy also benefits from good transport links to London, other parts of the UK and international connections via Heathrow Airport, which is still Europe’s biggest aviation hub in terms of passenger numbers. It is not surprising, therefore, that a number of recent reports have highlighted the growth potential of this region in the current recovery. According to the Work Foundation, the Reading and Bracknell area is assessed to have the best job growth potential of any UK urban conurbation and Swindon and Oxford also make the top 10 in their league table.<sup>2</sup>

When I accepted the invitation to give today’s speech, I had not appreciated that today – 13th July – was a significant date in terms of my career and my position on the Monetary Policy Committee (MPC). Four years ago today, on 13th July 2006, Gordon Brown – who was then Chancellor of the Exchequer – announced my appointment in Parliament, and I joined the Committee just over two months later.

The course of monetary policy while I have been on the Committee has been dominated by the effects of the global financial crisis, and the recession which ensued. It has also been a period when the Committee has found it more difficult to keep inflation on target than in the more stable global conditions which prevailed until 2007. In 36 out of the 45 months I have served on the Committee, CPI inflation has been above the 2% target. And it has been more than one percentage point above the target – the threshold which triggers an explanatory letter from the Governor of the Bank of England to the Chancellor – in 15 months, a third of the time that I have been on the Committee. That includes June’s inflation rate which was announced earlier today.

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<sup>1</sup> Data refers to Berkshire, Buckinghamshire and Oxfordshire, which is the relevant NUTS (Nomenclature of Units for Territorial Statistics) region for EU comparisons. There are 271 NUTS regions in the EU, and the latest data relates to 2007. See Eurostat (2010) for more details.

<sup>2</sup> See Lee (2010)

The normal monetary policy reaction to a sustained period of above target inflation would be to tighten policy, to create demand conditions which are more conducive to restraining price increases and bringing inflation back to target. But so far, the Committee has not supported that course of action – and is keeping monetary policy extremely loose. Bank Rate remains at the exceptionally low level of 0.5%, the lowest official interest rate recorded since the Bank of England was established over 300 years ago. And the Committee is also currently maintaining the boost to demand from the injection of £200bn of new money into the economy through Quantitative Easing.

Last month, however, I dissented from this approach and voted for a small rise in interest rates. And in today's speech I want to set out the thinking behind my view of current economic prospects and the implications for UK monetary policy that led me to that decision.

### **The monetary policy response to the global financial crisis**

The current stance of monetary policy in place in the UK, and in many other countries, was put in place as the response to the recession triggered by the global financial crisis. Starting in the autumn of 2008 and continuing into the early months of 2009, demand – in the UK and globally – weakened very sharply. Consumers and firms held back spending plans in the wake of the massive negative confidence shocks associated with the events surrounding the collapse of Lehman Brothers and the knock-on effects on the rest of the financial system.

Along with the rest of the MPC, I strongly supported the decision to reduce interest rates from 5% to 0.5% between October 2008 and March 2009, and to inject extra money into the economy through Quantitative Easing. The bulk of this money injection (£175bn of the total £200bn) was agreed by the time of the August 2009 *Inflation Report*, which was published just under a year ago. Though that Report looked forward to a recovery in the economy, very little economic data available at that time pointed in that direction. Rather, the economic data last summer were telling us how sharply the economy had contracted in late 2008 and the first half of 2009 both at home and abroad, and how sharply unemployment had risen as a result.

A strong theme underpinning the analysis of both the May and August *Inflation Reports* last year was that UK inflation was expected to be pushed significantly below target by a large margin of spare capacity. These reports showed fan charts in which inflation was much more likely to be below the target than above it throughout the two to three year horizon over which the Bank produces its forecasts. The central projection in both *Inflation Reports* we produced last summer suggested inflation would fall to around 1% or just above in the first half of 2011 and to struggle to return to the target after that.

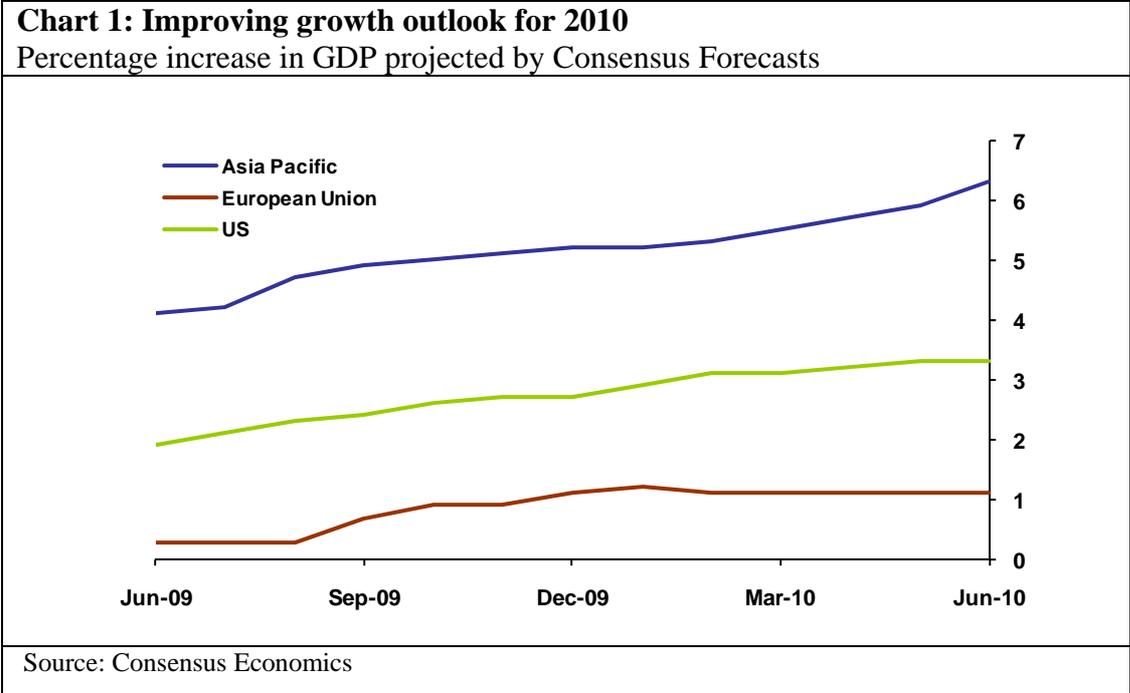
This was the economic backdrop against which I and other members of the MPC took the key decisions to put in place the monetary policy settings which we currently have in place today: sharp falls in demand and rises in unemployment; great uncertainty about recovery prospects; and a general expectation of persistent below target inflation. The Bank was not alone in its prognosis – this was the general view of the forecasting consensus last summer.

A year on, however, the economic situation has changed. There are still many uncertainties about future economic prospects. But there are four features of the current position of the economy which are now very different from the situation we faced last summer – the world economy has bounced back, the UK economy is also recovering, the margin of spare capacity does not appear to be as large as we had expected a year ago, and inflation has run above target rather than falling below it. Before moving on to talk about monetary policy, I will briefly discuss these four factors in turn.

### **Recovery in the world economy**

Over the past year or so, the world economy has bounced back strongly, led by growth in Asia but also supported by recovery in the US and a more gradual turnaround in the European economy. Consensus forecasts for 2010 growth in the three main regions of the world economy have improved significantly over the last twelve months, as Chart 1 shows. The US economy is now projected to grow by over 3% this year, and GDP in Japan is also projected to rise at a similar rate – very strong by comparison with its recent poor growth performance. True, the European economies appear to be lagging behind in this global recovery. But even in this region of the world economy, the growth outlook has improved compared with last

summer when average growth in the European economies in 2010 was projected to be barely above zero.

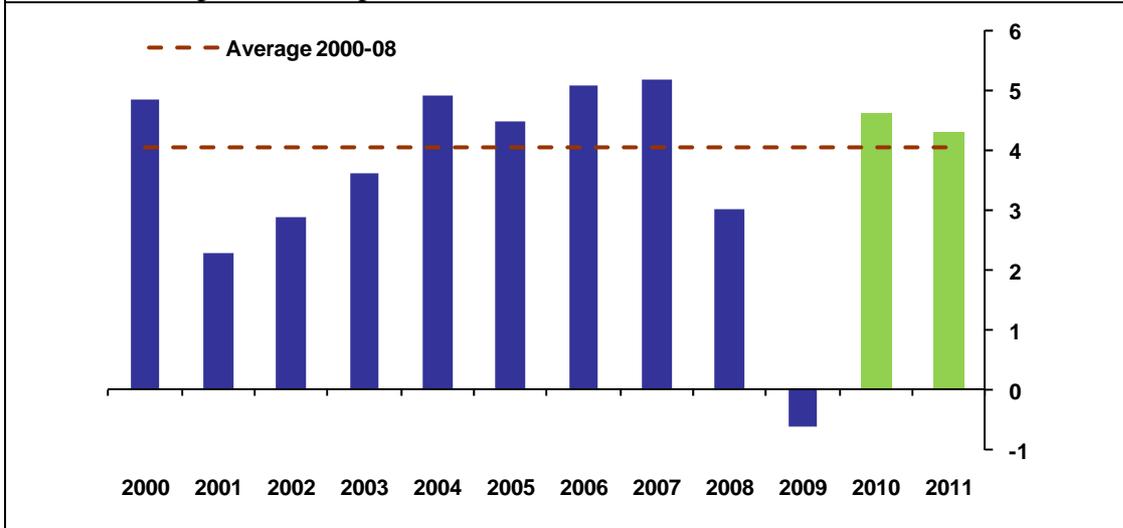


Last week, the IMF updated its growth forecasts and these showed a further uprating of their expectations for growth this year across the world economy, though they also highlighted some of the risks looking ahead. The latest IMF projections are now for world growth of 4.6% in 2010 and 4.3% in 2011. These growth rates are actually slightly above the average growth in the period of expansion before the crisis, with world growth averaging 4% from 2000 to 2008. It is unfortunate for the UK that our main export markets are in Europe, which is lagging behind the global recovery. But UK exporters do have the offsetting benefit of a relatively competitive exchange rate against the euro. And recent data from manufacturing industry and from business surveys shows that this combination of global recovery and a competitive exchange rate is beginning to be reflected in strong export performance.<sup>3</sup>

<sup>3</sup> The latest quarterly GDP figures, released on 12 July, suggest that recent export performance in the services sector may have been relatively weak, but early estimates of exports of services are not particularly reliable.

**Chart 2: World economic growth since 2000**

Annual GDP growth rate, percent



Source: IMF World Economic Outlook, July 2010 update

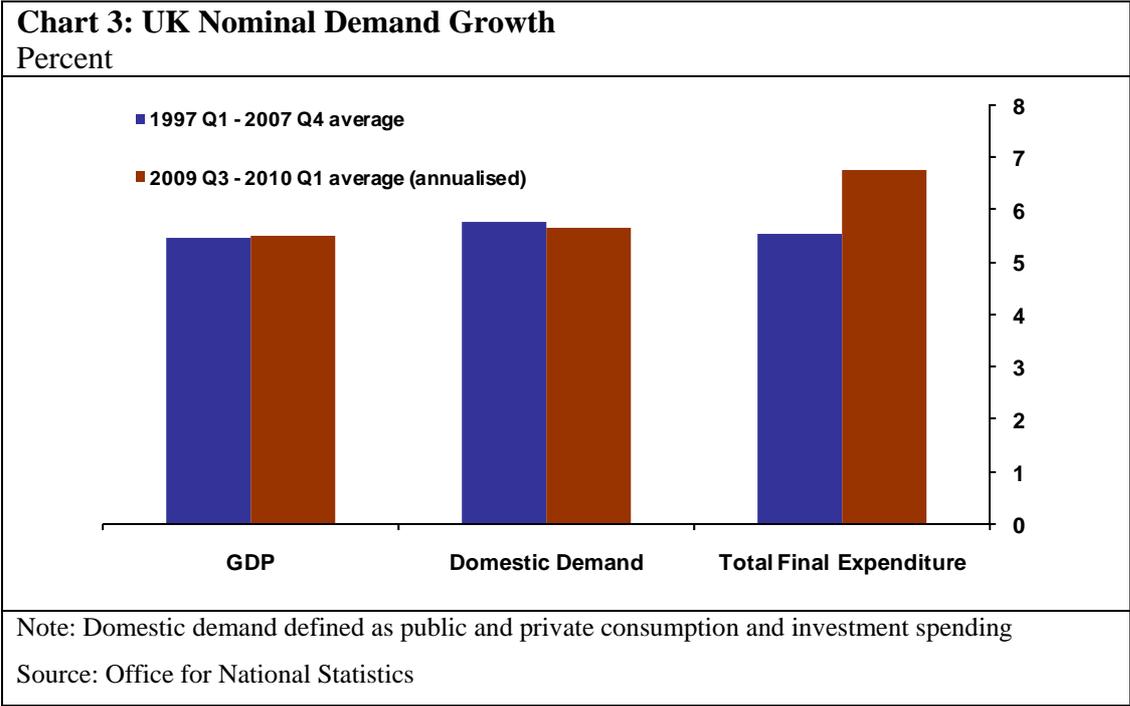
There are still clearly uncertainties about the evolution of the global recovery, and the data over the last month seems to be consistent with some easing back in the rate of global expansion in the second half of this year. But these worries about possible unevenness in the pace of global growth should not be confused with signs of a “double-dip” recession, which in my view is not on the cards. Rather, the world economy has bounced back strongly from recession over the past twelve months, and much more strongly than forecasts a year ago suggested.<sup>4</sup>

### **Turnaround in the UK economy**

Alongside this improvement in the international economy, the UK economy has also turned around since last summer. Business surveys and the labour market data have been suggesting a return to growth since the second half of last year. The official estimates of GDP still show a fairly modest recovery, starting in the final quarter of 2009 – though the estimates of real GDP growth that we currently have over the recovery period are very provisional and may indeed be revised in the future. That is what happened in the early 1990s recovery, where the picture we now have of growth in the early stages of that recovery – in 1992 and 1993 – are very different from the initial estimates.

<sup>4</sup> The current IMF forecast of world GDP growth of 4.6% in 2010 compares with their April 2009 forecast of 1.9%.

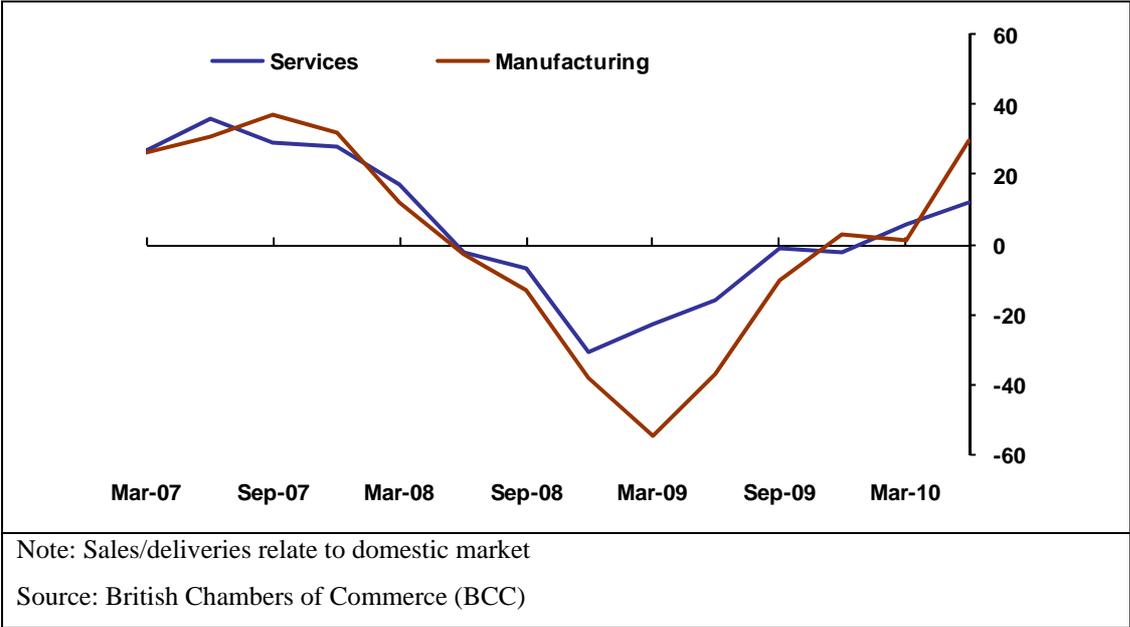
One of the concerns that the MPC had a year ago when policy was being loosened was the sharp fall in measures of nominal demand –the growth of spending in money terms, before adjusting for inflation. As the recession took hold, GDP and other measures of demand not only fell in real terms, but they fell in nominal or money terms too. One of the key reasons for embarking on the policy of Quantitative Easing was to reverse this downward shift in money spending, which would have pulled down inflation sharply if it had continued.



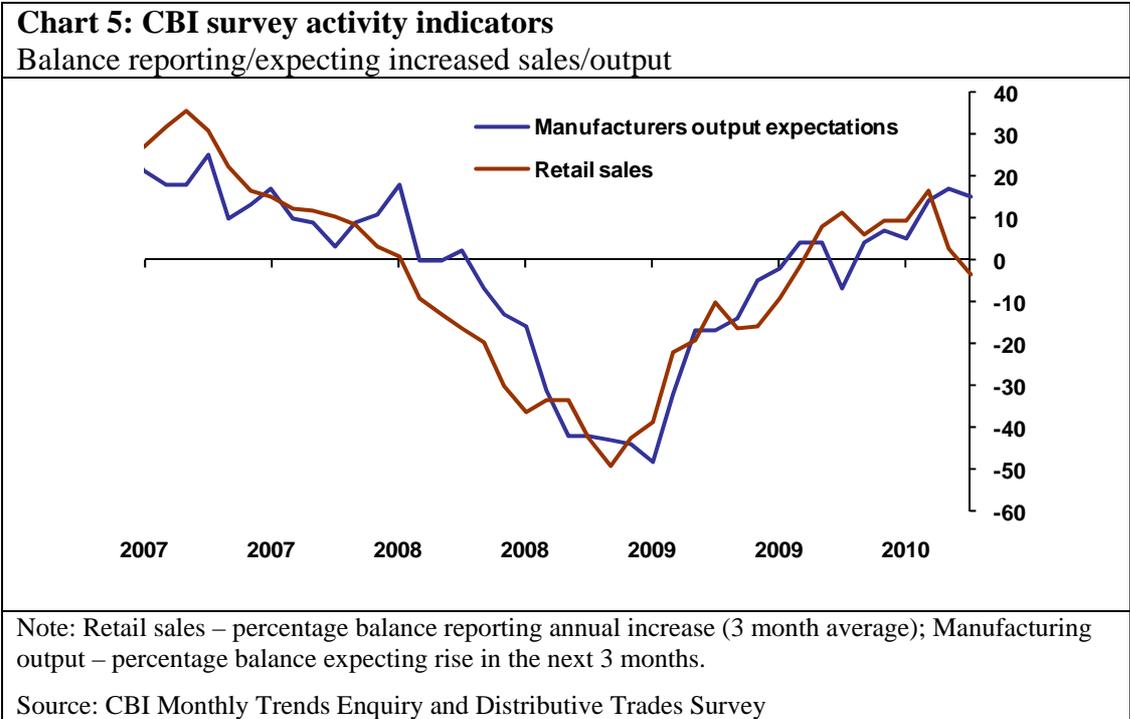
As Chart 3 shows, this trend in nominal demand has indeed reversed. GDP and domestic demand measured in money terms rose at an annualised rate of around 5.5% in the last 3 quarters for which we have data, and total final expenditure – which also includes export demand - grew by nearly 7%. On all the three main measures of nominal demand, growth is now back to or above the pre-recession average rate. This is a rapid turnaround from the sharp falls seen in late 2008 and early 2009.

Business surveys are also showing a generally positive picture. Chart 4 shows the latest responses from the British Chambers of Commerce’s survey – which points to a particularly strong rebound in manufacturing, with a slower recovery in the services sector. But both manufacturing and services are showing a return to growth, alongside positive expectations that the recovery in demand will continue.

**Chart 4: BCC survey activity indicators**  
Balance reporting increased sales/deliveries



The CBI’s most recent surveys show a similar picture, with manufacturing industry bouncing back strongly alongside a muted recovery in the services sector (see Chart 5). According to the CBI, retail sales growth appears to have been weak in the last couple of months – though this may reflect some temporary uncertainties relating to the change of government and the Budget, which could have affected consumer confidence and spending patterns.



I would not want to play down the uncertainties which remain in relation to the growth outlook here in the UK. Access to credit is still being adversely affected by the problems in the banking system. And public spending, which has supported demand in the recession will be significantly restricted, particularly from next financial year onwards. That makes it all the more important that the private sector can act as a strong engine of growth – both in terms of spending and other supply side indicators – such as employment, innovation and enterprise. In this respect, I very much welcome the emphasis in George Osborne’s Emergency Budget on reducing the business tax burden – by keeping down employers’ national insurance and cutting the corporation tax rate. These and other measures should be helpful in sustaining private sector confidence and growth as the public sector undertakes a long process of structural adjustment.

### **Unemployment and spare capacity**

A third area where the evidence has turned out somewhat differently from expectations a year ago is in terms of measures of spare capacity in the economy. Unemployment has been pushed up by the recession, but by less than in earlier downturns. The UK unemployment rate is currently around 8% of the labour force, whereas it peaked at much higher levels following the last two recessions – at nearly 12% in the mid-1980s and between 10 and 11% in the early 1990s. At the equivalent stage of the cycle following the previous two recessions, unemployment was already over 10% of the labour force.<sup>5</sup> The evidence from the Bank of England’s Agents and recent employment surveys is that the labour market in the UK has stabilised and that labour demand in the private sector may have already started to pick up.

Companies also seem to have adjusted quickly to a lower level of demand and activity in the recession, and the most recent surveys do not point to an unusually large margin of spare capacity remaining within firms. For example, the latest CBI survey shows 62% of manufacturers reporting some spare capacity – which is virtually in line with the average for the decade before the financial crisis.<sup>6</sup>

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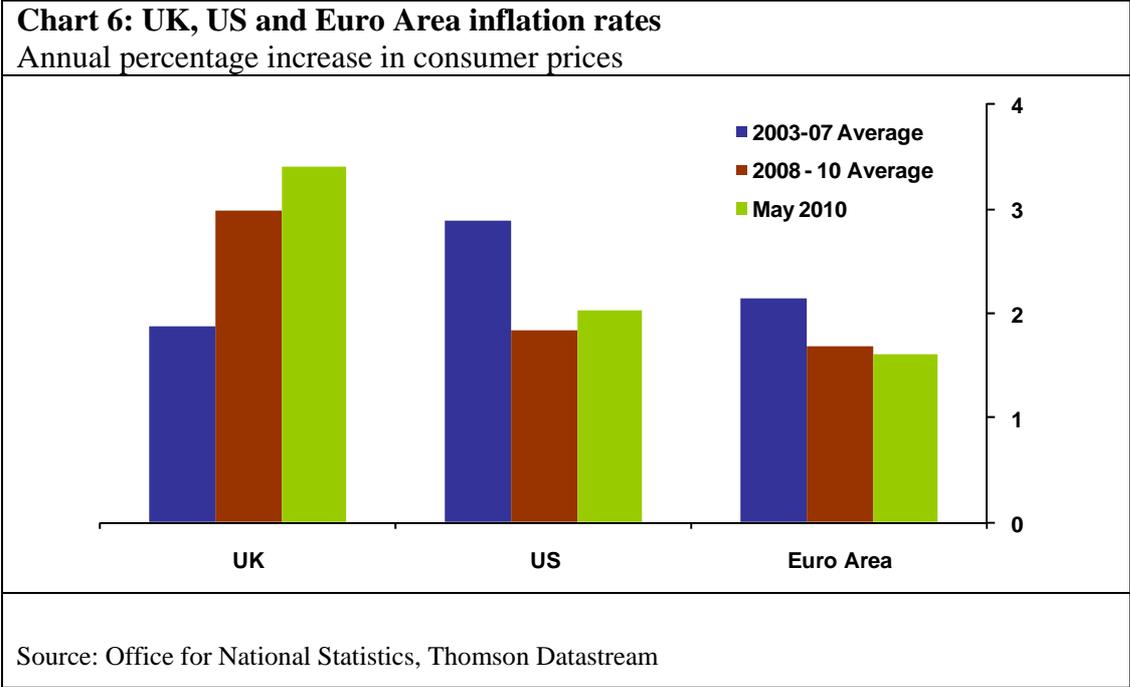
<sup>5</sup> According to the Labour Force Survey measure, unemployment peaked at 11.9% in mid-1984 and 10.6% in early 1993. Approximately two years after the start of the recession in both cases, unemployment was 10.2% at end-1981 and 10.4% at end-1992.

<sup>6</sup> In the April 2010 quarterly Industrial Trends Survey, 62% of manufacturers reported that they were working below capacity. The average figure for the decade 1998-2007 was 61%.

The evidence on wages and prices is also consistent with the view that spare capacity is not exerting as much downward pressure on inflation as the MPC expected last summer. In the manufacturing sector, underlying wage growth is back up to the 4-5% level already, though is more subdued in the services sector. And after quite widespread pay freezes last year, the latest pay settlements data from Income Data Services show that the most popular range for pay settlements is currently 2-3%, which is where four out of ten pay settlements are now being struck. If the recovery continues and headline inflation remains relatively high, there may be a further upward drift in pay growth in the private sector, offsetting some of the downward pressure on wage growth from the public sector.

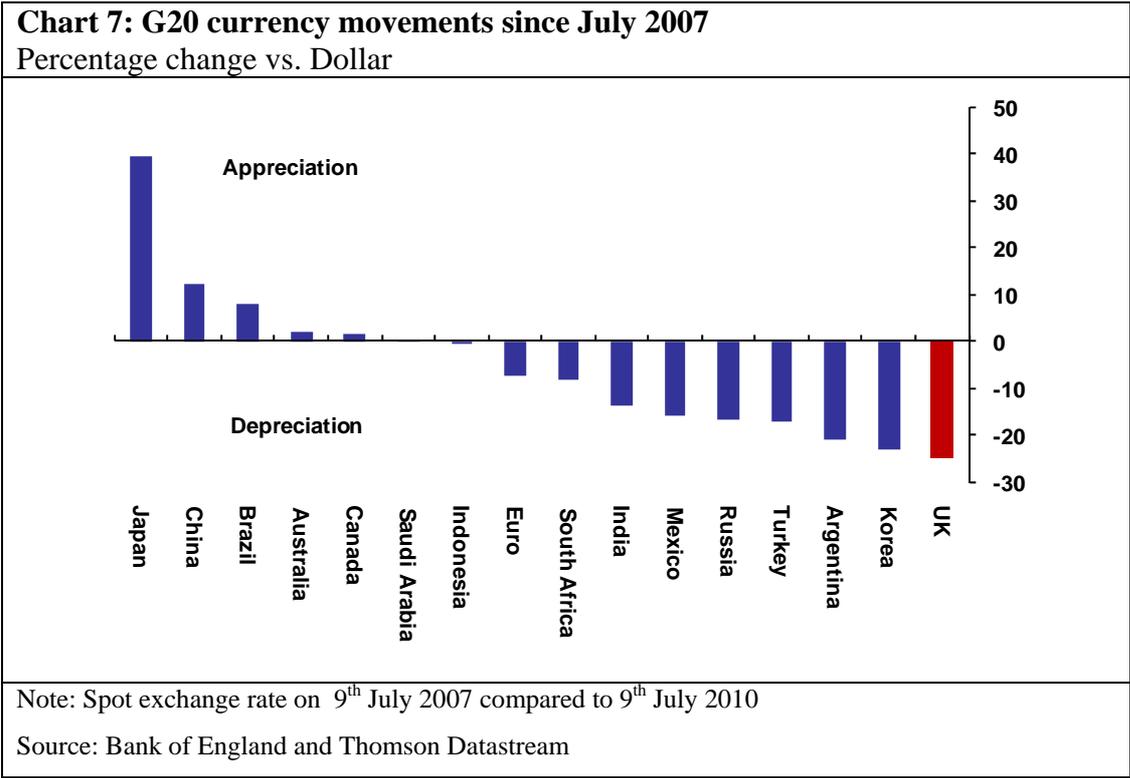
**UK inflation performance**

That brings me to the final area where the UK economy has performed very differently to expectations last summer – headline inflation. The UK has just experienced the second significant upward spike in inflation in the last couple of years. Since the beginning of 2008, when the financial crisis and the ensuing recession might have been expected to push down inflation, consumer price inflation in the UK has averaged 3% - above the 2% target and more than one percentage point higher than average CPI inflation in the pre-recession period of growth.



Our inflation rate is clearly influenced by external factors in the world economy, such as a volatile oil price, and these have clearly made the control of inflation more difficult over the last two or three years. But if these global forces were solely to blame for higher inflation, they would be having a similar effect in other major economies. As Chart 6 shows, the US and the euro area have seen lower and more stable inflation over the last couple of years, with inflation averaging around 1¾% since the beginning of 2008. US inflation has recently been pushed up to over 2% by higher petrol prices, but to a much lesser extent than in the UK.

One obvious reason for this higher level of UK inflation is the weakness of the pound. Since mid-2007, the pound has lost nearly a fifth of its value against the euro and has fallen by around 25% against the dollar. Indeed, as Chart 7 shows, looking back over the last three years, the pound has been the weakest currency in the whole G20 group of currencies, declining more against the US dollar than the Argentine Peso and the Turkish Lira.



There are structural explanations of why the pound has fallen so far, including the potentially high exposure of our economy to the financial crisis and its associated effects. But another contributory factor could be the stance of monetary policy, as changes in the exchange rate

are an important channel for the transmission of monetary policy. So we need to recognise that the weakness of the pound – and its upward impact on inflation – may also have been affected by UK monetary policy and perceptions about its future stance.

### **Implications for UK monetary policy**

In four important respects, therefore, I believe the economic world has changed significantly since we put in place the current set of monetary policy settings last year. The world economy has bounced back, demand is recovering in the UK, there is less spare capacity than we feared and inflation has been higher.

But monetary policy needs to be forward looking, so that does not add up to a compelling case for a change in monetary policy. The question is how has the growth and inflation outlook changed as a result.

In my experience, recoveries have momentum. While growth might not be totally steady and even across sectors, as recovery progresses, various mechanisms begin to operate which can give it added momentum. Pressure on existing capacity grows, causing companies to dust off their investment plans. Supply chains tighten and firms start to re-stock. Memories of the uncertainty created by the shocks that generated the recession fades and confidence recovers. The labour market stabilises and unemployment should eventually start to fall, improving job prospects. These things happen over a period of time, so from month to month not much change may be perceptible. But looking back over a longer period, improvement is clear.

In my view, this is the process that has been underway for the last year, and this process of gradual healing and recovery is likely to continue in the absence of big negative shocks which could derail growth. Given our experience over the last few years, we should certainly worry about future major shocks from the international economy. But the big downside worries resulting from the financial crisis which were present a year ago have receded, in my assessment. And the response of monetary policy has played a part in that process – though it has not been the only factor at work. The positive “animal spirits” – which Keynes believed drove economies forward through their impact on business and consumer confidence – do have a natural tendency to reassert themselves after major shocks.

The big worries about the future stability of the financial system in late 2008 and the first half of 2009 seem to have been replaced by an underlying structural nervousness in financial markets. So, as we have seen over the last few months, we are bound to experience setbacks in financial sentiment from time to time. This is entirely understandable given the shocks we have seen in recent years. We may need to be prepared to live with this nervousness for some time to come – and it should not be the dominant influence on the policy and judgements of the MPC, which should be based on the performance of the real economy and the outlook for inflation.

The MPC has a clear remit, which is to keep inflation on target at 2% over the medium term. Our framework recognises this will not always be possible, but what we need to do is to maintain confidence that inflation will still be anchored around this target in the future. A year ago, the predominant worry was that inflation could be significantly depressed by the impact of the recession. That risk did not materialise. And while I'm not yet worried that we face a major and serious risk in the opposite direction, I do think we need to adjust the policy settings we put in place to head off the downside risks to inflation identified in the immediate aftermath of the big financial shocks in late 2008 and early 2009.

It is possible to describe this challenge in different ways – as a gradual “normalisation” of policy or a gradual withdrawal of policy stimulus. Words which I don't think create the right impression in the current environment – particularly in relation to an upward move of Bank Rate from 0.5% to 0.75% - are “rate hike” or “tightening” of policy. “Rate hike” implies a sharp rise in interest rates, which is not what I favour. I favour a gradual rise in Bank Rate which would be aimed to avoid destabilising confidence through a sudden lurch in policy. “Tightening” may be technically correct as the opposite of “loosening” but it implies that monetary policy might become objectively tight and restrain the growth of the economy significantly. Again, that is not my view about the policy stance we currently need.

So how should we characterise the current challenge in front of the MPC? The Bank Governor, Mervyn King, is fond of sporting analogies. But I have always been pretty useless at sport and my greatest interest outside of my working life is music, and in particular rock music. Indeed, the first time I came to Reading was in 1977 when I was supporting a

pub-rock band called Sounder, who persuaded me to drive the band members to a gig in the town centre.

Also around that time, the great rock band Led Zeppelin released a film and soundtrack album called “The Song Remains the Same” – featuring their live performances around the world in the mid-1970s. The question in my mind now is how long the monetary policy song can remain the same, when it might be out of tune with the rest of the background music from the real economy - of economic recovery and above target inflation.

That Led Zeppelin album “The Song Remains the Same” contained an extremely long live version (lasting nearly half an hour!) of a track which appeared on their first album – entitled “Dazed and Confused”, in which Jimmy Page plays his guitar with a violin bow – something I must say that I have not attempted in my guitar-playing career. There have been many aspects of the current financial crisis and the recent performance of the economy which have left us all “dazed and confused”. The financial crisis has served as a severe jolt to the prevailing view in the mid-2000s that the economy had entered a period of “Great Stability” of steady growth and low inflation. As I have argued in earlier speeches, the globalised economy we now inhabit may have many potential sources of instability, including the potential upside pressure on energy and commodity prices as well as volatility in financial markets.<sup>7</sup>

In addition, we have learned through this recession that inflation has not performed in the way conventional economic models and our earlier forecasts suggested. As spare capacity has not exerted much downward pressure on inflation so far, there must be a high degree of uncertainty about its future impact. In the highly integrated world economy we now inhabit, the margin of spare capacity in the UK economy may have less impact on our inflation prospects than global inflationary pressures – which have been less benign in recent years. And the exchange rate can play a key role in the transmission of these global price pressures to the UK economy, which may help to explain the above-target inflation the UK has experienced in the last three years.

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<sup>7</sup> See Sentance (2009a) and Sentance (2009b) for a more detailed discussion.

For a legendary rock band like Led Zeppelin, the song should indeed remain the same. When the band reformed at the end of 2007 at the O2 Arena, everyone wanted to hear “Stairway to Heaven”, “Dazed and Confused”, “Whole Lotta Love” and their other classics. But in monetary policy, we need to adapt our tune to the changing performance of the economy, and to absorb what we learn about the economy in new and unprecedented circumstances, such as the recent financial crisis. In my view, that now points to a gradual withdrawal of some of the stimulus we provided to the economy in more difficult circumstances last year – not so much as to undermine the recovery, but to keep it on a low inflation path, consistent with the Committee’s remit.

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