



BANK OF ENGLAND

Speech

Speech given by

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Ladies and Gentlemen,

“When it comes to measuring success, don’t count money, count happiness”. The advice, not of a Government monitor of our wellbeing, but Ken Dodd in 1964. Unfortunately, happy is not the word to describe the global economic scene. As Tolstoy might have said: all happy economies are alike; each unhappy economy is unhappy in its own way.

Happy economies combine growth, stability of prices and of the financial system, fiscal sustainability, supply-side flexibility and low unemployment. In contrast, unhappy economies are very different from each other, as we have seen in Europe recently. In Ireland, the problem was the size and indebtedness of excessively large banking and real estate sectors. In Greece the problem was different – years of weak control of spending led to an unsustainable level of public debt concealed by misleading statistics. And in Portugal, delays in announcing measures to tackle the budget deficit led to a loss of confidence among some investors and a sharp rise in the cost of financing the national debt.

Elsewhere too problems vary. In the United States the main concern is the high level of unemployment. In some emerging markets the principal worry is asset price appreciation threatening financial instability; in others it is high levels of capital inflows.

So should we in the United Kingdom be happy or unhappy? There is no shortage of voices reciting reasons for unhappiness. And today’s GDP figures remind us that, as I said last year, the recovery will be choppy. Of more immediate concern to the Monetary Policy Committee is that we are experiencing a period of uncomfortably high inflation. CPI inflation was 3.7% at the end of last year, and has averaged 3% since the start of 2008, above our 2% target. With the standard rate of VAT rising to 20% this month, and recent further increases in world commodity and energy prices, inflation is likely to rise to somewhere between 4% and 5% over the next few months, before falling back next year.

So why has inflation risen? Three factors account for almost all the increase in prices over the past four years.

First, import prices (excluding energy) have risen by over 20%. Much of that reflects the fall in sterling in late 2007 and 2008. In order to rebalance our economy towards net trade and away from consumption a fall in sterling was necessary. At the time, it was far from clear – to either companies or the MPC – for how long the fall in sterling would persist, and pass-through to consumer prices was delayed for a while. But sterling has been broadly stable since the beginning of 2009, and the adjustment of the exchange rate now appears to have passed through to domestic prices. More recently, large and unexpected increases in the prices of a range of commodities, including food, have pushed up import prices. For example, over the past six months the prices of base metals have risen by 25%, foodstuffs by 40% (with wheat prices up by 60%), and cotton prices by no less than 70%. Since imports account for somewhere between a quarter and a third of overall

expenditure, higher import prices have driven up the overall price level by around 6%. That can be seen in higher inflation for goods than services early last year, something not seen at all during the period from 1997 to 2008 when the normal higher growth rate of productivity in manufacturing led to goods prices falling relative to services.

Second, there has also been a rise in world energy prices. Sterling oil prices have risen by 110% since the start of 2007 and gas prices by 130%. Those prices are determined in world markets in which demand, especially from some of the emerging economies, has outpaced supply. That too has pushed up on overall prices. Its impact can be seen in the contributions that petrol and utility prices have made to CPI inflation over the past four years. Through that direct effect alone, energy prices have pushed up on the level of CPI by almost 3% since 2007. But this understates the overall effect of energy price rises on CPI as fuel price increases are likely to feed through indirectly, and with a lag, to the prices of other goods and services. To take an obvious example, fuel is a significant part of an airline's costs and affects airfares. The total effect of energy price rises on the level of the CPI is probably between 4% and 5%.

Third, the combined effect of the recent changes to the standard rate of VAT, including the rise to 20% this month, is likely to push up the level of prices by around 1½%.

Taken together, those three factors by themselves would account for a remarkable 12% addition to the price level over four years, or an average increase in the inflation rate of 3 percentage points a year. Since the consumer price index as a whole rose by not much more, the contribution of domestically generated inflation over that period was close to zero, and obviously well below the target. It has always been understood that supply shocks – shocks such as these that move output and inflation in opposite directions – pose a dilemma for monetary policy. Should inflation be brought back to target quickly, reducing the risk of a rise in inflation expectations, or more slowly, reducing the impact of the shock on output? Let me quote what I said in 1997 about how the MPC would resolve that dilemma:

"Many supply shocks are price level effects. For example, changes in indirect taxes or commodity prices often affect the domestic price level but do not in themselves change the underlying rate of inflation. An appropriate monetary response is to accommodate the first round price level effects, while ensuring that changes in the published twelve-month inflation rate do not alter inflation expectations and lead to second round inflationary changes in wages and prices. ... Since shocks may take several months to have their full effect, a horizon of about two years is a reasonable one over which to try to bring inflation back to its target. But if shocks are sufficiently large – in either direction – then it may be sensible to extend the horizon over which inflation returns to its target level."

The numbers I have given you make clear that, on this occasion, the MPC has not accommodated any second round effects. In fact, after the event, it is clear that it has accommodated only about one-half of the first-round effects. The depth of the downturn in output has exerted strong downward pressure on

domestically generated inflation. Wage settlements and average earnings are increasing much more slowly than would normally be necessary to meet the inflation target, reflecting the fact that output is still below its pre-recession peak and unemployment remains high.

So why is there so much unhappiness about inflation at present? The answer is clear. The three factors I described – higher import and energy prices and taxes – have squeezed real take-home pay by around 12%. Average real take-home pay normally rises as productivity increases – money wages normally rise faster than prices. But the opposite was true last year, so real wages **fell** sharply. And given the rise in VAT and other price rises this year, real wages are likely to fall again. As a result, in 2011 real wages are likely to be no higher than they were in 2005. One has to go back to the 1920s to find a time when real wages fell over a period of six years.

So it is hardly surprising that unhappiness describes the reaction of many, and that the unhappiness is focussed on the high rate of inflation. But there is a misapprehension in some quarters that the MPC could have prevented the squeeze in living standards by raising interest rates over the past year to bring inflation below its present level. That view is a misunderstanding of how monetary policy works. Monetary policy cannot change the amount that we in the UK have to pay to buy food and other commodities, such as energy, from the rest of the world. Nor can it alter the need for a fall in the prices of the products that we sell to the rest of the world relative to world prices in order to reduce our trade deficit and rebalance the UK economy. Nor can it alter the burden of reducing our large budget deficit. Monetary policy can affect the inflation rate at which these adjustments take place, but it cannot alter the fact that, one way or another, the squeeze in living standards is the inevitable price to pay for the financial crisis and subsequent rebalancing of the world and UK economies.

If the MPC had raised Bank Rate significantly, inflation might well have started to fall back this year, but only because the recovery would have been slower, unemployment higher and average earnings rising even more slowly than now. The erosion of living standards would have been even greater. The idea that the MPC could have preserved living standards, by preventing the rise in inflation without also pushing down earnings growth further, is wishful thinking.

Of course, it is possible to argue that the current recession should have been even deeper in order to keep inflation closer to the target. But that proposition is one few commentators seem willing to embrace, nor is it consistent with the remit given to the MPC which states 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 stuck to its remit.

In many ways, the counter-factual policy choice is similar to the one that countries like Greece, Ireland, and Portugal are currently being forced to make. They too have to improve their competitiveness, but because they are part of a monetary union and so do not have their own currency, they can do so only through

outright falls in nominal wages. And to force that adjustment, unemployment has had to rise very sharply compounding the impact on living standards. Indeed in all of those countries, unemployment now stands well above 10%.

Monetary policy cannot be based on wishful thinking. So, unpleasant though it is, the Monetary Policy Committee neither can, nor should try to, prevent the squeeze in living standards, half of which is coming in the form of higher prices and half in earnings rising at a rate lower than normal. That is why the MPC, despite vigorous debate and perfectly reasonable small differences in view on policy, was unanimous in recognising the need for an exceptional policy response to the banking crisis and the subsequent downturn in the UK and world economy. Even if we had known a year ago that 2010 would bring further increases in food, energy and other import prices, as well as a rise in VAT, it would not have been sensible to pretend that a tightening of monetary policy to offset those upwards pressures on CPI inflation was consistent with aiming to keep inflation at the target in the medium term.

Looking ahead, the strength of monetary policy is that it can be re-evaluated each month in the light of new information. Within the MPC there is always an active discussion of the path of monetary policy. At some point Bank Rate will have to return to a more normal level.

When that time comes, it will I know be a relief to many people dependent on income from savings. I sympathise completely with savers and those who behaved prudently who now find themselves among the biggest losers from this crisis. But a return to economic stability from our fragile condition will require careful and well-judged steps looking beyond the next few months.

Should Bank Rate rise now? The answer depends on the outlook for inflation in the medium term, and the MPC will set out its judgement in full in our February *Inflation Report*. The outlook is shaped by the two conditions that are necessary for a successful rebalancing of our economy: the significant fiscal consolidation over the next five years and the large fall of 20% in the real exchange rate that will enable our export and import-competing sectors to expand and take advantage of the recovery in the world economy. Over the past year, output growth has recovered and, according to the latest estimate published this morning, GDP rose by 1.7% during 2010 – and would have grown by more than 2% had it not been for the estimated disruptive effects of snow in December. Similar recoveries have been taking place in the euro area and the United States. And growth in emerging markets has been impressively buoyant.

Nevertheless, even abstracting from the effects of snow, growth at home slowed in the second half of last year. Looking ahead, domestic spending still faces strong headwinds. Private consumption, having fallen by nearly 5% during the crisis, is likely to recover only slowly, restrained by the squeeze in real take-home pay and the rise in unemployment. And fiscal consolidation implies slow growth of public consumption. The economy as a whole must deal with the legacy of extraordinarily high debt levels built up prior to the crisis. In particular, shrinking the size of the balance sheet of the financial sector will constrain lending for some

time, as many of you will have experienced firsthand. The indebtedness of the financial system doubled, from 3½ times GDP in 1998 – already high by international standards – to over 7 times GDP in 2008. To appreciate the scale of that increase, even if the financial sector were to cap its debt at today's level, it would take more than a decade for growth in the economy to return indebtedness relative to GDP to its 1998 ratio.

With a weak outlook for domestic spending, the prospects for UK exports are crucial. Encouragingly, exports of tradable goods are growing quickly. Goods export volumes have risen by over 20% since their trough in mid 2009, facilitated by the depreciation of sterling. And, consistent with the picture painted by business surveys, the Bank's Agents report that exports are growing at the fastest pace since they began collecting evidence for the MPC in the summer of 1997, although exports of services have been weaker. That explains why manufacturing output is expanding rapidly – by over 5% compared to a year ago. Production for export at Nissan's Sunderland plant rose by almost 30% last year. So the rebalancing of the economy towards net exports and away from consumption is well underway.

What does this mean for inflation? The volatility of world commodity and energy prices means that no-one should pretend that short-run movements in inflation are predictable. But the determinants of inflation further ahead remain consistent with inflation falling back quite sharply next year. Output is still around 4% below the level it reached prior to the financial crisis almost three years ago and is close to 10% below a continuation of its pre-crisis trend. As many are so painfully aware, unemployment remains high and wages are rising slowly. Broad money growth is subdued – an annual rate of around 2%. In these respects, the behaviour of the UK economy has been much closer to that of our American and European counterparts where underlying inflation is below their target.

Nevertheless, there are upside risks to inflation. Further rises in world commodity and energy prices cannot be ruled out, and attempts to resist their implications for real take-home pay by pushing up wages would require a response by the MPC. There is some evidence – for example from household surveys – to suggest that inflation expectations have moved higher. But by itself, such evidence is not sufficient to suggest that inflation will persist above the target. Other measures of inflation expectations from financial markets do not suggest a similar pick up. And the experience in 2008 and early 2009 shows that the household measures of inflation expectations respond to movements in CPI inflation itself. Moreover, inflation expectations will not generate persistently higher inflation of their own accord unless they are supported by the underlying determinants of inflation – broad money and nominal spending growth.

When the MPC meets next month it will need to consider carefully those upside risks to inflation. Every member of the Committee is committed to bringing inflation back to the 2% target in the medium term. But in reaching its decision, the Committee will take note of the fact that the stance of monetary policy is not, especially in current circumstances, well measured by the level of Bank Rate for two reasons. First, the way in which policy affects behaviour is partly through its impact on short-term real interest rates. For most borrowers these are much higher than the unprecedentedly low level of Bank Rate. Indeed, since the onset

of the crisis the interest rates faced by many households and companies have changed rather little, and in some cases have increased. Other households and small businesses, with little housing equity, may be unable to borrow at all or are able to borrow only in the unsecured market – where rates are much higher than before the crisis. And the prices of many assets and products financed by borrowing are not expected to rise, leading real rates of interest to be higher than usual relative to nominal rates. Second, the longer-run monetary determinants of inflation, principally broad money growth, far from exhibiting signs of monetary laxity, are reflecting the monetary squeeze imposed by the continuing deleveraging of the UK banking sector. So our asset purchase programme has not pushed inflation above target; it has done no more than stabilise (broad) monetary growth.

We must not lose sight of the big picture. Large – very large – shocks to relative prices are an inevitable part of the real adjustment vital to the rebalancing of the UK economy. That has led to inflation well above target, and further increases are likely for a few months. None of this means that we cannot return inflation to the target in the medium term, nor that the MPC has abandoned its commitment to meeting the inflation target. Quite the contrary. Attempts to have kept inflation at the target in these circumstances would almost certainly have resulted in even bigger falls in output and higher unemployment, with inflation then falling below target further ahead.

Communicating this big picture is not easy. But it is important for the MPC to do so if we are to prevent an unnecessary rise in medium-term inflation expectations. The headlines will inevitably focus on the immediate effect of shocks on CPI inflation rather than the outlook further ahead. Central banks, though, do not set policy or react according to headlines. They simply do their work. We shall try even harder to explain the basis for policy decisions. Credibility was not earned in a year, and it will not be lost in a year. It is the result of experience over a number of years.

I do not believe we are about to return to the days before independent central banks ushered in a period of price stability. The Bank of England cannot prevent the squeeze on real take-home pay that so many families are now beginning to realise is the legacy of the banking crisis and the need to rebalance our economy. But we can determine our own inflation rate in the long run, whatever happens in the rest of the world.

The first sentence of Tolstoy's novel *Anna Karenina* is the famous characterisation of happy and unhappy families which I paraphrased earlier. But the final sentence is more important. In it Tolstoy acknowledges that, despite life's ups and downs, happiness is less important than trying to live in the right way. Central banks have learnt the lesson of both sentences. We are less concerned with the inevitable short-run fluctuations of either inflation or GDP than with a sustained and determined application of our policy framework to achieve long-run stability.

The UK economy is well-placed to return to sustained, balanced growth over the next few years as a result of a fall in the real exchange rate combined with a credible medium-term path of fiscal consolidation. Of course, there will be ups and downs as the squalls from the world economy blow us around. But the right course has been set, and it is important we maintain it.